Interview with Steve Forbes

By John Mauldin | December 7, 2013

How Central Bankers Will Ruin The Global Economy
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I'm not certain how many interviews I've done over the last decade. Hundreds? I know it is a lot. There are some interviewers who can somehow tease out what you really have in you. Tom Keene at Bloomberg, for instance, forces you to bring your A game, at whatever level you play. He brings it out of you. You know that he is smarter than you will ever be and that you should really be asking him the questions. Except that you're not smart enough to ask the questions. I have to confess that every time I walk into the room with Tom I'm a little intimidated. I try never to show it, somewhat like the new kid on the block trying to put on a brave face, but inside I keep looking for the exit doors just in case I throw up all over myself. At the end of the day I'm still a small-town country boy from Bridgeport, Texas, trying to figure out how the big city works.

And then there's Steve Forbes. If I've done hundreds of interviews, then Steve has done many thousands, on the presidential campaign trail with the best of the best, and gods did he learn the craft. I've done multiple interviews with Steve, and every time I sit down with him I feel that I'm with my best friend. Maybe it's because we have a ton of shared values and I have read and admired him for years. I truly think he would've made a great president in the mold of Ronald Reagan, but for whatever reason New Hampshire did not agree. As I think even Steve will admit, while he may have a philosophical mind meld with Reagan, the Gipper had some small genetic extra, call it what you will.

But for whatever reason, Steve seems to bring out the passion in me. When I think about what central bank policies are doing to savers and investors, how we are screwing around with the pension system, circumventing rational market expectations because of an untested economic theory held by a relatively small number of academics, I get a little exercised. And Steve gives me the freedom to do it.

And so a few weeks ago, philosophically like-minded old friends sat down at his offices in New York to talk about the world in general. Monetary policy, Janet Yellen, gold, stocks, commodities, the time value of money, grandchildren, and a lot of other stuff, all folded together into what I think may be the best interview I've ever done in my career. Steve gives me the room to be me and allows that passion that has always been inside me to come to the fore. And with his smile and gentle demeanor, he eggs it on.

So this week, for the first time in 14 years of *Thoughts from the Frontline,* I offer you a wide-ranging interview with John Mauldin, as conducted by the inimitable Steve Forbes. You can watch the video on our home page (lower right, under "Latest Video") or read the transcript below.
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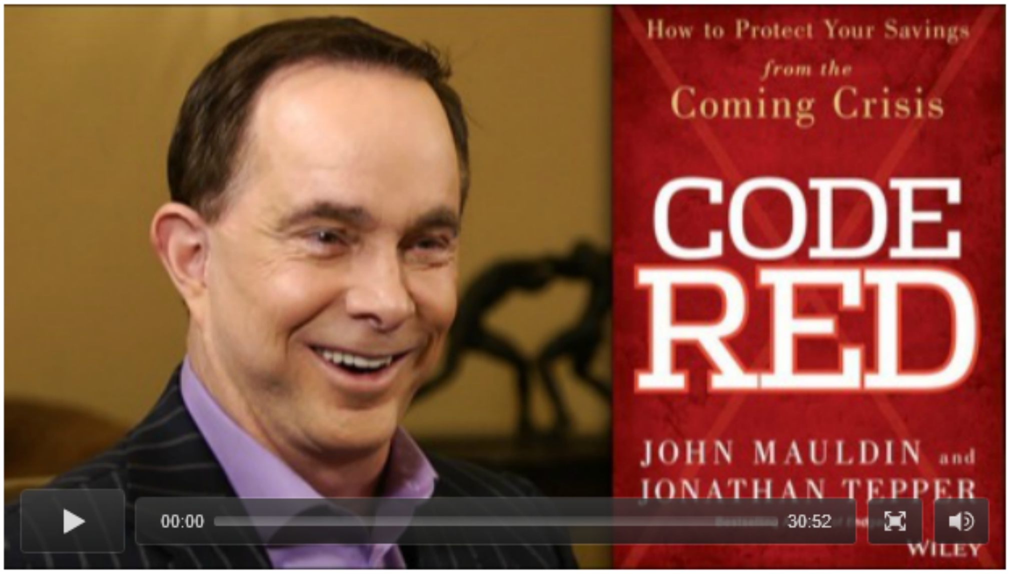

John Mauldin: How Central Bankers Will Ruin The Global Economy

John Mauldin, investor and co-author of the new book Code Red, *recently sat down with me to discuss monetary policy, a still-lagging economy, and how he might operate the Federal Reserve if he were in Ben Bernanke's or Janet Yellen's shoes.*

Steve Forbes: John, good to have you back again.

John Mauldin: Steve, it is always fun to be with you.

Forbes: You've got a new book out, called *Code Red*.

Mauldin: Yes.

Forbes: Hot off the press.

Mauldin: Yeah, show it up twice now. There we go.

Forbes: *Code Red*, Jack Nicholson, *A Few Good Men*. Explain first the title.

Mauldin: Well, in that movie Jack Nicholson famously felt that he had to protect America. He was in charge. And so he issued his famous "code red," and his line was, "You need me on that wall." So at the beginning of the book I paraphrased his speech as if it were Ben Bernanke talking or now Janet Yellen:

> "You need me on that committee. You want me on that central bank. Yes, you work for savers and creditors, but I'm responsible for whole economies. I have greater things to worry about."

So in 2008 the central banks of the world had to issue a code red.

It's like, a patient is brought by ambulance to the hospital, and instead of operating you put him on morphine. Or it's like asking the arsonist to put out the fire. Part of the reason we had this very crisis was because of central bank policies and government regulations and the interweaving of large investment banks and politicians and central bankers. I don't want to get into conspiracy theories; I think it's just people's self-interest.

Forbes: How about a stupidity theory?

Mauldin: Some of it was stupid, but some of it was just greed. Nonetheless, we had a crisis. The banking system froze up. We went to the edge of the abyss. We looked over and it was a long way down. And I believe central banks appropriately provided liquidity. That was their function, and I would argue that almost the sole true function of a central bank is to be there when the stuff hits the fan.

Forbes: To be what Bagehot called the lender of last resort.

Mauldin: Yes, the lender of last resort. That being said, they never took the patient off morphine. At your and my age, we've had the unpleasant experience of caring for friends who are in the hospital. And in today's world, my mother has a hip operation, and they have her up and walking the next day.

They just opened up her hip, put a new hip in. One of my good friends, the same thing – the next day he's up and walking. Forget this morphine stuff. Forget lying around in a hospital bed like we used to have to do. Well, the central banks are still operating with 1900s medicine, so they just kept the patient on morphine.

And now the patient is addicted. The problem is, when you want to end that addiction, whether it's alcohol or drugs or quantitative easing, withdrawal is not going to be pretty. But the Fed's hope is that somehow or other, "We can get the economy going. We can create animal spirits," and that people won't notice when they start withdrawing a trillion dollars a year of monetary easing out of the global system.

And when they even hinted that they might reduce the amount of the *increase,* the market just went crazy. And the next week, all the Federal Reserve governor types went, "Oh, no, no, no. That's not what we meant! We mean something different. And it's going to be all about the data."

Everything's data-dependent. It's like, weren't we data-dependent already? Central bankers and economists serve the function of shamans and evangelists. They're there not to gaze at sheep entrails; they look at data and try to tell us what the future is going to be.

Now, as we discuss in several chapters of the new book, Fed economists are particularly bad at predicting the future. It's worse than if you and I just flipped a coin. Okay? It's almost statistically impossible to be as bad as central bankers are at predicting the future. And yet we're supposed to trust them when their data tells them and they tell us, "Well, we need to apply this amount of quantitative easing and create this amount of money at this interest rate level. And somehow or other it's gonna magically transform into these economic numbers out here in the future, even though for decades we've been predicting this stuff, and we haven't been right yet."

So it doesn't end well. We have 12 men and women sitting in a room thinking they can manipulate an economy with data they don't truly understand and that they can't actually measure with tools they're making up as they go along. Is that passionate enough, Steve? I get wound up, but their actions have consequences.

Forbes: So you talk about central bankers going wild.

Mauldin: Yes.

Forbes: How do they avoid blame? Powerful agency, unchecked, make their own money.

Mauldin: I think at the end of the day they're going to, what I call, lose the narrative. They're gonna lose their ability to be the guy behind the curtain making the magic happen.

Forbes: Now, that leads into a quick, interesting subject. Why are so many people intimidated by monetary policy? Capitol Hill, for all the stupidity there, people do master, many of them, complex subjects. What's the inhibition about monetary policy?

Mauldin: Steve, it's magic. Okay? Economists would like to think that…

Forbes: So maybe David Copperfield should be Fed?

Mauldin: David Copperfield might do as good a job. Economists like to think that we can create models full of equations; we have physics envy. But economics is art as much as it is science. It is not something that is to the level yet – maybe in the future, with new systems and new theories – but we are not yet able to truly model an economy and to understand what the inputs are.

Forbes: Can't model one person, for cryin' out loud.

Mauldin: Well, I have trouble modeling my seven kids. Just like you – we were talking about your daughters. Life is amazingly complex. And when we try to manage the ups and downs by not allowing the system to correct in minor ways, then we build up the potential for a very large correction.

Forbes: Sort of like suppressing forest fires?

Mauldin: Like suppressing forest fires. It's a great analogy. In fact, we use it in our book. The consequence is that we're now at a trillion dollars' of quantitative easing a year. The Fed balance sheet is at $4 trillion. One of my questions to Janet Yellen – we were talking about this earlier – if I was on the Senate committee, I'd ask, "What's the theoretical limit? Is there a theoretical limit to the Federal Reserve balance sheet?"

Now, you and I and most right-thinking human beings and economists would say, "Well, yes, there has to be a theoretical limit." Well, what is that theoretical limit? And if the answer is, "It's data dependent," then let's look at the data. We both knew that's exactly what the Fed's answer was gonna be.

"It's data dependent" is a non-answer. That's saying, "We won't know what the theoretical limit is until we've passed it." Well, are we going to have to get into a situation that looks like the '70s again? And today we get away with printing of money that we couldn't have gotten away with in the '70s, because the velocity of money is slowing down.

Forbes: Well, that leads to an amazing question. How could the Fed have created the balance sheet that it has? If anyone had looked at that five years ago, they'd have said it would be Weimar German Republic hyperinflation.

Mauldin: Which many people did.

Forbes: Why didn't it happen?

Mauldin: It is all about the velocity of money. That money hasn't moved out; it's still in reserves.

Forbes: Why has that happened?

Mauldin: Well, that's a good question, and I would like you to find a paper anywhere that explains Fisher's concept of the velocity of money that he gave us back in the '30s. Here's what we know about it. It rises and it falls over long periods of time. And the velocity of money started turning down well before this last crisis, from a very high level. And now it's falling. And it will continue to fall until some moment in time at which it begins to rise again.

And when it begins to rise, if we've got a $5 trillion, $6 trillion balance sheet and things get bad, we get a recession. 'Cause God knows we have not figured out how to tame the business cycle. I don't care what they think they can do with targeting nominal GDP. Then what does the Fed do? Do they give us $2 trillion in an era of a rising velocity of money? Do they have to find Volcker and bring him back?

This just doesn't end well at some point. And now, people wanna go, "Well, *when?* Can I ride it out? When do I need to get out?" I don't know. And they don't know, either. This is not Tom Landry sitting on the sidelines of a Dallas Cowboys game – for those of us of a certain era, remember the man with the fedora? He had a plan. If it was third and 27 and they were down a touchdown, he had a play for that. He had everything planned out. The Federal Reserve doesn't have that. They're making it up as they go along. And it's frustrating for investors because we don't know the outcome, nor do we know what they're going to do. We're guessing.

Forbes: Now, if you were Janet Yellen, going into the Fed knowing what *you* know, what would you do?

Mauldin: If I were Janet Yellen, I'd be talking about data dependency. I would do exactly what she's going to do, which is to give non-answers so that she can go back and do whatever the heck it is she wants to do.

Forbes: What would you do? How would you try to get us out of this mess?

Mauldin: I would become kind of like Volcker was back in the '80s, when he was burned in effigy. If you remember…

Forbes: Oh, I remember.

Mauldin: You remember. He was not popular. There was a reason Reagan didn't reappoint him. We look back now and we go, "Oh, Volcker was a great man." He did what had to be done. He allowed the economy to function on its own. He said, "We're not going to allow inflation to be the controlling agent. We're going to be opportunistically disinflationary over time."

But to start that process, he had to take the patient off the morphine. And I would not immediately end quantitative easing because God knows that could be terrible. But I would begin to taper. I would probably, contrary to some of my more aggressive fellow analysts, I would just say, "Ah, the Fed's got a $4 trillion balance sheet. Leave it alone."

That's what they did in the '30s. And eventually nobody notices it. But if you have to start letting it taper off, then you allow it to taper off by simply rolling over sales. And so much of it is mortgages, it'll reduce anyway. And you allow rates to rise to a somewhat more natural rate. We don't have enough time here now, but there is this concept of the natural rate of interest. And when you artificially hold interest rates below that natural rate of interest, which we've done for four years now, you get in trouble. And now, in the new Fed research and policy papers coming out, they're talking about giving us forward guidance to 2017.

We're talking eight years of artificially low, financially repressed interest rates? That is theft. And what it is is a theft of *time.* Because we have a generation of people who have played the game by the rules. They've saved their money. They've done what they were supposed to do. And now we're saying, "You're not going to get enough return unless you move out the risk curve." But they are precisely at the point in time in their lives when they shouldn't be taking risks.

Then Bernanke comes on the stage and says, "We made the stock market look good. How wonderful is that?" What have we done? We have given bankers and people with assets the opportunity to make enormous amounts of money. 2009 came along, and bankers were on their backs. The world was coming to an end, but who has made out the most since then? Bankers, because we flipped the world to make the world good for them.

I want a banker to take my deposit and to lend it out. And to pay me money on it. I want him lending it into the community for productive purposes. I don't want him lending money unnecessarily to hedge funds. I make money, and I invest in a lot of hedge funds, but I don't want that community bank lending to hedge funds; I want it going into productive purposes.

The hedge funds can find money somewhere else, thank you. They're very good at that. What we need is to understand that we have stolen time from people when that was the only thing they had. And when you take it from them, you're taking away their lifestyle. You're taking away their ability to enjoy what should have been a golden time.

Forbes: Now, well, we'll get to what you recommend in the book. But why are economists so obsessed with growth? The only way they think they can do it is by credit bubbles. They wouldn't call it that, but that's in essence what they're reduced to: create a credit bubble.

Mauldin: The reigning theoretical economic paradigm is one of, let's call it neo-Keynesianism. I don't really think Keynes would be completely on board with it today. And it has a fetish for consumption. They want to drive consumer spending. And the way you drive consumer spending is to make money cheap so that people can buy cars and other stuff at lower prices.

And in essence, debt is basically future consumption brought forward. Another way to say that is that current spending, current borrowing, is future consumption denied when it's borrowed for consumption today. Now, debt for productive purposes, debt for me to buy a robot or steel – things I can put labor into to produce a product – that's productive debt.

But consumption debt is what *leverages* what the Keynesian economic guys seem to be wanting to produce. And it does spur income and investment today, just like the housing bubble did. There was no question the housing bubble employed a lot of people. A lot of people made a lot of money, and then a lot of people lost money because then they were on the wrong side of the leverage. It would be more appropriate, I think, to target income. That's the important part of what an economy should be doing. How can we produce more income? How can we produce more profit? And it doesn't have to be widgets; it can be services. Facebook is a perfectly fine economic activity. It's an entrepreneurial service. It allows us to do things that we will all enjoy doing. There are many, many ways. Like restaurants. There's tons of ways to produce a service or a good that people want. But that's production, not consumption.

Stocks

Forbes: In terms of what to do, I love your thing about dimes in front of a steamroller.

Mauldin: Right.

Forbes: About people taking on risks. You talked about stocks. You say you shouldn't avoid stocks, you just gotta know when to buy 'em cheap. How do you pick stocks in an environment like this?

Mauldin: Well, you don't pick stocks by indexes. You don't do the risk-on, risk-off thing. What does an investor have? An investor, now, not a trader. An investor has time. And what you should look at is, how do I get the most value during the time before I sell? If I came to you today, Steve, and said, "I'd like to hire you. And minimum wage is $7.75 an hour, and I'd like you to go work for me $7.75 an hour," you'd just laugh at me 'cause you think your time is more valuable than that.

But so many investors today sell their time at minimum wage. That's what they do, in essence. They sell their investments at minimum wage because they want the certainty of it. They don't realize that their time is valuable. And they don't appreciate the time value of money. So when you're looking at an investment, at a stock, you say, "How much income is this business likely to produce over time? And what percentage of that income can I get? How much of that will accrue to me? What is that income going to do to the value of this business?" There are lots of businesses that I believe are valued inappropriately. Or, they may have values that I find attractive over time. It's classic value investing.

Forbes: Ben Graham

Mauldin: Ben Graham. It's not like this is some new revelation. But there are businesses that have franchises that are special. They're growing. They produce a dividend. They give you a return on your money. But we also need to recognize there are times when businesses are not attractively valued.

If you look at the general stock market today and, as we show in the book, you project ten years forward based on just normal, average earnings, your potential return on stocks is anywhere from 2% to 4%. And there have been periods with those models when returns were negative. Investors are always told to invest for the long run, but that is really terrible, bad advice. You should invest for value.

Sometimes investing for the long run – if you're just talking about buying indexes – will give you negative returns for 20 years. There are periods of time when investing in the S&P gives you negative returns after 20 years. And I would suggest that for most people 20 years is the long run.

We have sold investors on the convenience of working with stock salesmen rather than focusing on the returns from their own investments. It's a whole lot more difficult to pick stocks, to allocate properly, to find value than it is to say, "We wanna be in the stock market for the long run because look at this model that Schiller produced and yada-yada-yada." No. I mean I was writing about this in '98 and '99. A secular bear market had started, yet people were saying, "Oh, John, you're so bearish." Well, a cycle's a cycle. This cycle, by the way, is now 14 years old. It's starting to get long in the tooth.

This cycle will be over, and we'll be able to go back to relative-value investing. But in the meantime, you have to go to absolute-return investing. And recognize that it's just a different style. I will lose half my readers or some number the day I turn bullish. And I will turn bullish, because we will get to a place where the market will turn. It always does. These are long cycles, average about 17 years. This one could end anytime now. It won't end at the levels where it is today. We've probably got one more good correction. A good valuation correction is in our future. But the market will turn.

Now, in the meantime, there are other places to go. Not every stock is equally valuable. There are places in the world today where you can find stocks that are global in nature with price-to-earnings valuations of 4. Now, maybe the company is headquartered in Greece. Oops. But that's where investors have to go – "Let's think. Is this company going to go away?"

Forbes: Put emotions aside.

Mauldin: Put emotions aside and begin to think. There are ways, and I was writing about them five years ago, and it's really starting to happen. We're starting to see the rise of private credit. And so rather than investing in a company and selling your time cheaply, look for companies that will come to you and say, "If you will lock your money up for a while, we're going to be able to give you a return in excess of what you would get from a single bond, by spreading your… " It's old-fashioned banking, but done on the private side. There are opportunities out there. They're not traditional opportunities, and they're not easy for brokers and advisors to sell. But they're there. And now, at the close of 2013, looking out another year, we have to figure out how to restructure our thought process about how we want to manage the time value of our money.

Forbes: Where do people find what they should invest in?

Mauldin: Well, you go to Forbes.com.

Forbes: I'm waiting for your dot-com.

Mauldin: Well, you go to MauldinEconomics.com.

Commodities and Gold

Forbes: By the way, in your book you talk about commodities.

Mauldin: Right.

Forbes: Had a great run. You think that's tapering.

Mauldin: I think commodities are probably getting close to a cycle end. That cycle will change, and we'll have to wait for a while. Now, that doesn't mean there aren't still good ways to play commodities. Rather than just being long a commodity index, you might want to find managed commodities, traders who can be either long or short. And take advantage of the other side of the cycle. So there's ways to do it. And I personally think it's a very good idea to allocate a portion of your portfolio to people who have demonstrated an ability to manage the cycles.

Forbes: Now, you say one exception is gold. And you talk about the pricing of gold, real interest versus the price, the Gibson paradox. Can you explain that?

Mauldin: Not in less than ten minutes. But I believe gold is insurance. It's central bank insurance.

Forbes: Right. Fire insurance.

Mauldin: I buy fire insurance. I have health insurance. I hope I never use them. I'm particularly, aggressively working at never having to use my life insurance, although I do have it. And I hope I never use my gold insurance. But I do have some. I buy some every month.

I'm getting ready to establish an account. I now have five grandchildren. You're working on catching up, I understand. But I have found a place where I can buy a small amount of gold for them every month. It'll be stored outside the United States. And my grandchildren are from six months to four years old. So I can buy that small amount of gold, put it into an account for them, and when they get to a place where they can use it, it will be there. I'm not certain what education will cost in 20 years; I think it will be significantly different than it is today. But when they get to that launching pad, I believe that gold will prove to have been more of a store of value than putting a hundred dollars a month into a savings account that is going to be stuck in a low-interest-rate regime for a long time.

Now, I might honestly change my mind in ten years and say, "Ah, the world's changed. I'd rather put that money in something else now." But today, when I think 20 years out, I want to make sure that my children have something stored outside of the United States in a neutral facility, that I can move in a heartbeat to another neutral facility if I begin to notice things changing. Yeah, I think gold has its usefulness.

Forbes: The point in your book is that when real interest rates are severely suppressed, that's when gold moves up.

Mauldin: Yes. And we have a real potential for severe repression of interest rates, judging from the latest research papers written by members of the Federal Reserve economics team. I don't think things change under Janet Yellen. I think we get financial repression. And we're going to see savers and retirees screwed. We talk about the problems that pension funds face. Every 60-40 portfolio – 60% stocks, 40% bonds – is required to get something close to 9% or 10%, maybe even 11%, out of their equity portfolios from today's valuations, because the return on their bond fixed-income portfolio, that 40%, is so low.

Can't be done. And yet they're so dependent on those return projections and on growth reverting to trend, because the bulk of the money that's supposed to be in those pension funds in 30 years – that's going to need to be there – is not the money that's being put in now by employees; it's the compound growth of that money.

And if the growth on that money is not there, the pension that the person thought he was paying into is not going to be there. This doesn't end well, and it's a result of the financial repression that central banks are producing. Not just in the US – in England, in Europe.

Forbes: So the bottom line is, when we had the crisis in '08-'09, the cure was worse than, or just as bad as, the disease.

Mauldin: The cure was appropriate at the time. But you don't keep the patient on the morphine. You work through the crisis. And when you're through the crisis, you have to let the patient stand up and walk on their own. "You're gonna have a little pain. Get up and walk, damn it."

Forbes: Well, buy *Code Red*, damn it.

Mauldin: There you go.

Forbes: Thank you, John.

Mauldin: Thank you.

So buy ***Code Red*** damn it! It's available on our site, on Amazon, or from your favorite local bookseller.

Demographics Are Destiny

You've heard the aphorism "Demographics are destiny." My friend Harry Dent has used the science of demographic forecasting for decades to unpack economic trends and keep his readers ahead of the population and societal changes that are reshaping the economy as we speak.

The easiest example in current American life is the Baby Boomer generation. The Boomers worked more, played more, produced more (and, yes, borrowed more) than any other American generation in history. Now, 10,000 Baby Boomers are turning 65 each day, according to Pew Research Center.

The fact that more Americans are receiving Social Security and fewer Americans are paying taxes toward funding Social Security is at the heart of the entitlement crisis we Americans face today. This is just one of several current hot topics where Harry's demographics work and my own writing on debt and monetary policy match up.

But Harry and I don't agree on everything. In fact, our views are sufficiently divergent on enough topics that we recently decided to sit down and compare notes in an interview with Mauldin Economics publisher Ed D'Agostino. The result was one of the most wide-ranging and spirited conversations I've had in quite some time. Watching the interview (completely free and without obligation, of course) could prove useful as 2013 comes to a close and you begin to wonder what 2014 will look like, how you should invest, and what market trends will rule the year(s) ahead.

You can take a look at my conversation with Harry by **clicking here**. You'll quickly see that we had fun during our talk. It's always a pleasure to "do battle" with big brains like Harry. Toward the end of our conversation we also point out a few trade ideas you might find useful – in consultation, of course, with your investment professional. **Here's the link again** to the conversation, if you'd like to take a look.

Seattle, Geneva, Saudi Arabia, Dubai, and Western Canada

Next week features a quick trip to Seattle for my partners at Altegris Investments. Then I'll zip back to Dallas to change suitcases and head to Geneva for a few days before returning home for Christmas. Then in early January I leave for the Middle East to speak at MASIC's CSR Policy Forum and to meet investors and leaders in the area. I also plan to visit Dubai for a few days – I've been told it's a place I must see to believe. If you are in either town, drop me a note.

January 21-23 I'll be speaking at the annual CFA forecast dinners in Vancouver, Regina, and Edmonton. And wearing my thermal underwear.

I am such an optimist. I actually thought we would be in my new apartment at least a month ago, settled in and enjoying the enjoying the new digs, with the only worry being where to hang the family photos. We have moved in, but the construction workers are still here, and my more realistic self is beginning to acknowledge that the goalposts, if we are talking about being actually finished, are a moving target.

It is time to hit the send button. Dallas has had a freak ice storm that has knocked out the power to my children's homes, which means they are ensconced in dad's unfinished apartment. I went to the grocery store to buy dinner, and of course all the stuff that you would want to have for a few nights had already been bought. A small ice storm, and everyone figures they need to clean out everything in the grocery store – before I even get there to buy my share. Dallas just does not do cold weather in anything close to a rational manner. But I love the place anyway.

Let's just call this an adventure and not worry about the details. There are lots of new couches that have never been slept on and enough blankets somewhere down in storage. The grandkids think it's all great fun and are running around screaming. All we need is a fireplace and marshmallows. Have a great week, and next week I will write from Geneva, thinking about German banks.

Your still concerned about the End Game analyst,

John Mauldin

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