Thoughts from the FRONTLINE
John Mauldin's free weekly investment and economic newsletter

Hot Summer Mailbag

By John Mauldin | August 4, 2017

Three Black Swans
Prepare for Turbulence
Trade War Games
The Wedge Goes Deeper
What It's Like

Perhaps the best part of being a writer is the chance to interact with readers. I can't tell you how much I've learned from you over the years. Whether it's through our online comment threads or emails or conversations in the hallway at a conference, nothing pleases me more than to share thoughts with you. The exchanges are always stimulating, even when we disagree. Believe it or not, I make a special point to read those who disagree with me if they come armed with cogent thoughts. And I will admit to changing my mind at times. Or at least softening my position. I know many of you think I have too much going on to take time to read your comments, but I make it a priority.

Today I am at Camp Kotok in a remote area of Maine where connectivity (the electronic kind) is limited. Rather than try to write a regular letter, I decided to hand the keyboard over to you – or at least to a few readers like you. I went through the feedback to my last few letters and picked some comments to share and respond to. These are a small fraction of the feedback we received, so forgive me if I omitted your brilliant submission! And because I want to get to the Camp Kotok opening reception in a bit, this letter will be shorter than usual.

Photo: Kevin Baird via Flickr

But first, a quick request. I had a visit with an ear specialist (ENT) about three years ago, a doctor whose office is near Baylor Hospital. I have lost track of his name, but I really need to see him again. I know he was a long-time reader. If you recognize yourself here, would you please get in touch with me? Thanks. Now to the comments.

First, a follow-up to last week's note about Google email delivery. Reader **Thomas Hurley** sent this advice for other Gmail users:

> *Dealing with Gmail is not extremely hard. First, decide that you are smarter than Google and only have one category: PRIMARY. I never, ever let Google decide where to put my email except for Spam, which I do review because they make mistakes. But if I tell them that something is NOT SPAM, then that mail goes into the Inbox in the future.*
>
> *Under SETTINGS set INBOX TYPE to DEFAULT. Under CATEGORIES check PRIMARY and uncheck all the rest so that there is only one Inbox except for SPAM. Final optional step is to open a Mauldin Economics email and then click on the Labels icon at the top of the page and create an icon. All future emails will still go into the Inbox but will also show up under that label for quicker identification. Additionally, one might sort for Mauldin Economics, and in that case I can add the Label MAULDIN ECONOMICS to 100 past emails at a time.*

I hope that advice helps. Our Mauldin Economics tech team tells me that email delivery is a never-ending battle. Email providers constantly tweak their algorithms to screen out junk, and we occasionally get caught in their dragnets. You can always point your browser to mauldineconomics.com, where you will see links to our last few articles on the home page to see if you are missing the letters we send. If you find that you are, just resubmit your name, and the team will get you back on the list. And check your filters and firewalls – you may be missing a lot of things you would prefer to have.

Now, on with the mail.

Three Black Swans

This comment came in response to my July 22 "Three Black Swans" letter:

> *Gas prices – what role has this played in the economy? Seems to me that inflation for the masses is good and bad for the government. Deflation is good for those who save and bad for those who spend. What person wants to pay more for goods? What I see in my household budget is inflation, yet they tell me we have deflation. It's all so confusing – or is it?* **– Glenn De Vries**

John: Thanks for writing, Glenn. The problem with understanding price inflation is that not every price rises the same amount at the same time. That means your perceived (or, if you could calculate it, even your actual) inflation rate can be quite different from someone else's, simply because we all spend our money differently. Healthy young people don't notice that prescription drug prices are rising. Retirees may not be aware that video game prices are dropping.

Benchmarks like the Consumer Price Index try to reflect the experience of an "average" family, but few families are actually average. We all have our own preferences and priorities.

And I want to clear up a common misconception. Deflation is actually good for your household budget in that it means that you have to spend less to get the same goods and services. Inflation, in contrast, means that you have to pay more. Governments like to have inflation because they want to inflate away their large debts.

I find it passing strange that economists think 2% inflation is the right number to target. First, 2% inflation means that in 36 years you will have lost 50% of the buying power of the dollars you save today. It also means you need to earn at least 2% on your savings just to stay even on buying power; and if you want to grow your future buying power, you have to make more than 2% – not easily done when interest rates are 1% – unless you want to take on some extra risk.

I have been in the room with Nobel laureates conversing under the Chatham House Rule (which means that I cannot name names), when they have argued that the Fed should actually, surreptitiously, target 4% inflation, or let the economy run "hot," because that is the only way that we can "grow" our way out of the massive debt we have accumulated. There is a certain twisted logic to that. If you could have 4% inflation and 2% actual growth, that combination would increase the nominal size of the economy by 6%. If you were increasing total debt by only 3%, then your debt-to-GDP ratio would decline by 3% a year. No one in the room argued that we should actually balance the budget.

And no one spoke up for the little guys (that would be you and me, Glenn) who at 4% inflation would see a 50% loss of their buying power in 18 years. Inflation is a destroyer of capital and purchasing power.

Prepare for Turbulence

The following two comments were posted in response to "Prepare for Turbulence."

> *John wrote: "It doesn't make sense to cover over a problem for years, let it get bigger and bigger, and postpone acknowledging it until the worst possible time."*
>
> *I believe mankind, and especially the Western democracies, are guilty of this for at least 150 years. Think of the financial crises in the late 1800s. Then there are all those in the 1900s. Then 2000 and 2008. The core problem is that we do not learn. Politics blinds us to the correct way forward. Wealth buys Congress and the bureaucrats.*
>
> *On a larger front, the West dithered until we had WW I. Then it dithered again, and we got WW II. Now we are dithering on three fronts at once – the Middle East, N. Korea, and the South China Sea. The West seems incapable of taking the needed action in a timely*

manner. If not us, who? If not now, when? We fail to ask those questions. WW II cost tens of millions dead and trillions in wealth destroyed. Watch and learn, folks. Even bigger things are coming that are not financial. There will be no place to hide.
– **Paul Everett**

John: This is indeed frustrating, Paul. Societies make the same mistakes over and over – the cycle goes back much further than the 150 years you mention. The limitations of our human nature have been with us from the beginning.

Part of the problem is communication. Societies have evolved with leaders who make decisions for everyone and observers like me who comment from the sidelines. I notice things are happening but have little power to change them. Those who do have that power don't notice what is actually happening. We don't have very good feedback loops.

Further, what you and I might believe to be the necessary actions will not be what others think we should do. The lack of consensus – until action is actually required and it's too late – ultimately means a bigger crisis when things finally come to a head.

Here's another comment from "Prepare for Turbulence":

John wrote, "For instance, with a glut of more than 7 million previously leased cars clogging the auto market, new-car production is projected to continue to fall."

That is only half the auto industry problem. The mix of cars has changed quite dramatically over the last decade. Sedans are out and SUV's are in. So, if you have a used SUV you're going to do quite well at trade-in time. However, if you have a sedan to trade in, you are going to be very disappointed. The used car volumes swamp new car sales. There were about 40 million used cars sold last year. A lot of sedan owners are going to be underwater on their car loans because of the low resale value of their car.
– **Michael Yaffe**

John: I was aware of the rather large number of cars coming off lease and affecting future sales volume, but you have given me a new fact that I absolutely love. All of the promotions based on low rates and six- and seven-year loans have pulled consumption forward. Although these promotions make this quarter's and this year's sales look good, they exert a drag on future sales as people are lured into greater debt.

This effect is going to be a big problem, and soon. Generous vendor financing by the auto manufacturers has put people in deeper debt than many realize. It will not take much of an economic downturn to throw many of those loans into arrears. And what will the lenders do, repossess vehicles no one wants to buy? I suspect we'll see a miniature version of the extend-and-pretend game that mortgage lenders played in the last recession. If that is not the case, then those lenders are going to take large losses. In many cases the lenders are the very car companies that will be seeing lower sales.

Trade War Games

Here's a comment responding to "Trade War Games" and my concerns about rising protectionism.

> *Much of America's trade deficit stems from our refusal to adopt a Value Added Tax when virtually all of our trading partners have one. To review, VAT is added to the cost of everything purchased inside a country, including imports, but does not apply to export sales. So, if the total tax burden in two countries is equal and the actual manufacturing cost is equal but one uses VAT and the other does not, you can expect that the total cost to produce, ship, and sell goods in BOTH countries will be lower for the company located in the country with the VAT. Those who wish to challenge this notion are welcome to sit down with paper and work it out.*
>
> *Companies in the non-VAT country pay both the full tax in their own country plus the VAT when they try to export to the VAT country against competition from the locals who pay only the full tax. Meanwhile, in the non-VAT country, imports enjoy a tax reduction equal to the VAT percentage while local makers pay full tax.*
>
> *This unfairness has persisted since the 1950s when the VAT was invented. It was, long ago, "justified" in Europe by the need to rebuild their destroyed in World War II economies. I humbly suggest that the need for America to subsidize manufacturing in Europe [and China] via refusing to adopt a VAT is long since past and that using a VAT here, possibly as an exchange for lower or no income taxes, would right our trade situation in multiple industries at once.*
>
> *And, since most of our trade partners already have a VAT, their "bully pulpit" to complain about the US starting a trade war doesn't exist ... they started it, as the saying goes, long ago.* – **Rolf Parta**

John: Regular readers know I would like to see a VAT system in the US. I think it could eliminate or greatly reduce both income and payroll taxes. For some reason, though, the politicians who could make this happen refuse to consider the idea. They fear – perhaps reasonably – that we would end with both a VAT and existing taxes on top of it. There are ways to prevent that from happening, but it would take more vision and dedication than the current congressional leadership seems to possess.

And let me make a further point. Today's deficits will grow even larger because of entitlement programs. The only way to get serious money, and by that I mean the trillions it will take to balance the budget or even come close, is a VAT. Let's face it: We are going to get a VAT sooner or later – probably under a Democratic Congress and administration, but Democrats are not going to look kindly upon lowering income tax rates. A Republican administration, on the other hand, could use a VAT to completely eliminate Social Security taxes and deeply cut corporate and income taxes.

The Republican leaders in Congress currently believe that they're going to be able to make cuts in programs and reform entitlement spending such that they can handle future deficits. Yet they can't pass even a simple tax reform package or healthcare reform. This is the Gang That Can't Shoot Straight.

At the beginning of the year I was really encouraged that Republicans could act and we would get major tax reform and healthcare reform and bureaucratic reform that would push out a potential business-cycle recession or worse at least three or four years. Now, they are likely to pass something they will call tax reform, but it will actually be just tinkering around the edges. Real change requires real change. Real tax reform requires real tax reform. I will openly admit that "my team" talked a good game but just hasn't been able to move the ball down the field. I'm extremely disappointed.

The Wedge Goes Deeper

This comment is in response to "The Wedge Goes Deeper." That letter was written by my associate Patrick Watson, who filled in while I was away on honeymoon. He wrote that Amazon's pending Whole Foods Market takeover, combined with the arrival on the scene of deep-discount grocers like Aldi, would lead to further class separation in the US. Reader **Ron Miller** responded:

> *I'll apologize for what is probably a trivial comment, but the reason for the growing success of the Aldi supermarket chain is not just that it's "spartan" while prices are low. That growing popularity is mainly attributable to the fact that customers are learning that, very contrary to the Dollar-General experience, they need not sacrifice a whit of quality at these low prices.*
>
> *The quality is as good or better than the big chains (not including Whole Foods, which sells Mercedes-priced groceries), and the reduced prices seem to be achieved because they sacrifice a very few amenities (bag boys), they prepackage all produce, and they carry only one brand — i.e., there is seldom any choice other than the Aldi brand which must lead to significant savings in shelf stocking, warehousing, and wholesale prices.*
>
> *Were these Aldi brands not top-notch in quality, the chain would have failed, but the products are just as good or better than the stuff at Kroger for 50% higher prices. I'm not sure what to compare them to – perhaps they are to groceries what Ikea is to furniture… minus all the self-assembly jokes.*

John: Ron, the relationship of price and quality is actually a burning debate among economists. Sometimes the price of a good remains the same but its quality increases. That change ought to be deflationary. Each dollar you spend is buying more utility for you. But making this effect show up in CPI and other stats is difficult. Economists make "hedonic adjustments" for that very reason, but the methodology is still imperfect. And, the aggregate impact could be significant when you consider the rapidly increasing capabilities of electronics products, just to name one category.

Only an economist can say that selling one barrel of oil for $100 is equivalent in terms of GDP to buying two barrels for $50 each. GDP, as measured by dollars spent, may not be the best way to actually measure growth of the economy.

My friend Dr. Woody Brock (one of the smartest economists anywhere) argues that the current CPI numbers significantly overstate inflation because of the way they are calculated. My friend John Williams at Shadow Stats argues, conversely, that inflation is massively *under*stated. Your conclusion basically comes down to the assumptions you make.

What It's Like

Let me offer you a view of what it's like to be at Camp Kotok. This year my son Trey couldn't come, so I invited my friend Steve Blumenthal. Steve has successfully managed money for well over 30 years, has his own significantly successful newsletter called *On My Radar* (of which I'm an avid reader), and is seriously connected within the industry.

But yesterday afternoon and into the night, as he was interacting with the other attendees, ,he came up to me three or four times and said, "Oh my God, he (or she) is brilliant! You can't believe what I learned…" And I had been watching him. He went from conversing with a Fed economist who participated in FOMC meetings for 10 years; to Jim Bianco, who knows all things bonds; to Phillipa Dunne, who is one of the finest data mavens in the world; to Martin Barnes *(Bank Credit Analyst);* to the frontier markets manager you've never heard of but who has been in places you never wanted to go to, making investments you wish you had made.

Camp Kotok is a heady experience. I learn a ton, too. One of the things new attendees quickly grok is that it's okay to disagree and argue a point aggressively, but let the other person make his or her point. For those of us who have been here for a few years, it has become standard operating procedure to let other campers take us to the edges of our thinking. I should probably take an assistant to camp with me to take notes, review them with me at the beginning of the following week, and then share them with you.

The gathering is affectionately called Camp Kotok because David Kotok of Cumberland Advisors organized the original get together for fellow survivors of 9/11. (David was at a conference in the World Trade Center that morning.) I'm sure there were many people who did similar things in the wake of that tragedy, but David brought his remarkable Gift of Association to the effort. While he is thoughtful and insightful on his own, he has the ability to pull people together from all over the world and get them into the room (and onto the lake, fishing rods in hand). And for Camp Kotok he somehow persuades them to assemble in one of the harder-to-get-to places in the world. There are now four or five such "Camp Kotoks," both here in Maine and in other places around the globe. The others are smaller but growing.

In a few minutes I will be sitting down to an amazing breakfast, and then I'll watch as a dozen bloggers, many of whom you are familiar with, get the employment number and try to dig out the meaning in the data. And then we'll go out and do that other thing we came for, which is defined by our "old Maine guides" as drowning worms and other bait. Sometimes the fish oblige us and jump on our hooks.

So I am going to hit the send button and enjoy this fine weekend before I have to go back to the real world and my diet. You have a great week.

Your missing his son Trey at Camp Kotok analyst,

John Mauldin

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