THOUGHTS FROM THE FRONTLINE

Pivot to the Fourth Turning

By John Mauldin | April 29, 2023

Control Process
Booms and Busts
Feedback Loops
Travel Plans, Webinars, and Grandkids

The week we've been waiting for is here. The Strategic Investment Conference starts Monday, and we have a jam-packed schedule.

This year is clearly the best SIC we've ever had in 19 years—a wide-ranging set of topics dealing with the issues that are most important to each of us. You really should join us. You can watch the videos at your own convenience or read the transcripts or treat it as a podcast. Attendees say it is clearly the best information they get all year. You should be one of them! Sign up to see it all online.

Next week also brings what could be a **pivotal Federal Reserve policy meeting**. We use this word "pivotal" to say an event is important. Taken literally, it means to *turn in a different direction* than you were previously going.

For the last year the Fed's direction has been quite consistent: Every FOMC meeting ended with an interest rate increase. Jerome Powell's crew observed, correctly though very belatedly, that inflation was a serious economic threat and acted to stop it. One can take issue with their specific tactics or timing (as I do), but most every Fed-watcher I know agrees the FOMC has been *directionally* correct since the "pivot" against inflation.

That consensus is starting to break down. As tighter policy has more noticeable effects, some think the Fed has gone too far and should loosen up. A smaller number think the Fed should tighten even more. The largest group is somewhere in between. I'm in that category, which thinks inflation has stabilized at least enough to pause (at least after this rate hike) and reassess.

The choice isn't simply "pause vs. pivot" as the media likes to frame it. **If a pivot is a change of direction, then a pause *is* a pivot.** It means interest rate policy's direction changes from upward to sideways. That's not the same as reducing rates but it's definitely an important change.

My Still Rethinking the Fed letter drew a lot of interesting feedback, some of which I'll share with you today. I say "interesting" because it was quite different from the feedback the same letter (more or less) received in February 2022. I think that illustrates how attitudes change with circumstances. Back then, almost everyone agreed that we needed to deal with inflation.

Of course, higher interest rates have brought changes with them. When the situation changes, adept investors change, too. Sometimes we have to think the unthinkable.

Control Process

My readers have a wide range of expertise that helps me think from different perspectives. That's why I read every word you send, though I can't possibly answer everyone.

This letter is a good example. It's from Tom Fruth, who describes himself as a "John Kasich Republican" with a background in chemical engineering. This turns out to have some relevance to the Fed's economic engineering. Here's Tom:

> "It has been a long time but one thing I remember is we were given a process perspective because many of us would be hired to work in chemical plants and petroleum refineries. Process control is a crucial aspect not only of these facilities but of many other areas you may not think of. Undergraduate chemical engineers can also become very good cardiologists, for instance, as the human heart is a process. They would also make great Federal Reserve chairmen.
>
> "Let me give you the most succinct illustration I can imagine. All processes are prone to upsets that will cause the process to deviate from a set point. You don't know how severe the upset is, so the control system is modeled to have an anticipatory feedback response to offset the upset. The upset may be 'transitory' or it may not. If the upset is not transitory and you have done nothing, your process may have gotten out of control.
>
> "So last year when inflation first emerged, the Fed should have raised rates by one quarter of a percent with the statement that this is a precautionary increase because we don't know if it is 'transitory.' If the market knew the control process dynamics, it would have already made the adjustment when the first inflation numbers hit; each month's inflation increase would have automatically generated an interest rate increase. Failure to do this has resulted in the steepest rate increases in our economic history.

> "But this is only the latest of 30 years' worth of mismanagement. No other profession could survive this level of performance. However, the resulting instability of this level of performance has been wildly beneficial to those who know how and are nimble enough to 'game' the Fed; and they finance the political process that could change things."

What Tom describes here is a kind of "rules-based" monetary policy with interest rates mechanically adjusting to inflation. The Fed's response would be clear to everyone even before it happened. Indeed, we might not even need a committee if the rules were sufficiently detailed.

That has some appeal but also risk. I have seen enough mechanical, rules-based trading systems to know they all eventually reach a point where the rules stop working—what Tom calls an "upset." They need some way to adapt. And for the Fed, the consequences of failure aren't just a chemical spill you can clean up, but economic havoc.

Arguably, it's the Fed's "control process" that put us in the current mess. It failed to recognize how faulty data was producing faulty policy. Let's open up that concept a little more.

Booms and Busts

Last week I sent *Over My Shoulder* members one of David Bahnsen's letters about inflation. It recounted some of a dialogue he and I had over dinner about housing prices distorting the CPI. David calculates that if not for the lagging effect of rental (OER or Owner's Equivalent Rent) rates, annual CPI change would be somewhere between 2.2% and 2.8% right now instead of the 5.0% headline rate as of March.

That's obviously quite a difference (and, if correct, is good reason for the Fed to stop raising rates). My contribution was to ask David (who is on the SIC faculty, by the way) if this distortion went both ways. Here's David:

> "John agrees with me on the basic construction above—that shelter inflation is overstated by the present methodology, and therefore overall inflation is lower than is presently reflected. I won't speak for him on anything else I have said, but the conversation was not about the present lag (i.e., a reality of lower prices in shelter showing a higher figure), but rather, the same exact dynamic doing the exact opposite in 2020 and 2021.
>
> "His challenge to me: *'Wouldn't that mean the 'shelter' number was UNDER-stating the price impact in 2020 and 2021, as the same lag effect was creating a LOWER price growth than was actually happening on the street?'*
>
> "My answer:
>
> *"'Yes, yes, yes, yes, yes, yes !!!!!!!!!!!!'*
>
> "The reason for the question?
>
> *"'David, wouldn't that mean the Fed was staying too loose then, not factoring in the data of what was happening to housing and rents then, just as you allege they are going too tight now, not factoring in the clear softening in prices now?'*

“My answer:

“‘Yes, yes, yes, yes, yes, yes !!!!!!!!!!!!’

“The zero-bound policies of the Fed were not okay in 2021 (all the way to spring 2022, by the way), and I said that over and over and over again. [John: so did I on these pages.] The reasons include but are not limited to that *they were under-counting higher prices in things like real estate and rents then*. John’s point is EXACTLY correct—that their excessively easy policies then were not justified by the real price data, just as their over-tight policies (in my mind) are not justified by the real price data now.

“I will say that this is the most intellectually honest argument against Fed interventionism—not that it creates booms, and not that it creates busts, *but that it creates BOOMS AND BUSTS*.

“The Fed’s tightening in 2022 and 2023 came about because of their looseness out of COVID, which was way too loose for way too long. The housing data is only one proof of this, but it is a legitimate one and one in which I am in total agreement with my friend, John Mauldin.”

To expand on that, the problem isn’t simply the Fed thinking inflation is higher or lower than it actually is, and then setting interest rates too high or too low. **Fed policy tries to respond to a boom-bust cycle that Fed policy largely *creates*** or at least aggravates. That this circular firing squad doesn’t produce ideal results should surprise no one.

Would a rules-based policy regime be better? In some ways, yes. It would need oversight, but the oversight would have to focus on managing the rules, not dictating results.

The rules as I would like to see them would reduce the involvement of the 12-member FOMC committee. To think that 12 people can sit around a table and determine the most important price in the world—the overnight interest rate for the global reserve currency—without creating booms and busts goes against what I understand about human nature *and* against the Fed’s own 110-year history. Especially the last 60+ years.

Feedback Loops

The Fed distorts the economy in other ways, too. Even keeping rates steady for years can be a problem if they’re steady at an artificially low level. Reader Dr. Richard Marshall pointed out why.

“Hi John, I liked this week’s letter.

“Your thought that some issues are due to the Fed lending too cheaply resonated strongly. I think that the economic corollary is that the economy needs more ‘friction’ for the actors to be prudent enough so that the businesses they run are more stable and robust.”

This is a really important point. Walking would be impossible without friction. Wheels wouldn’t roll, either. Friction is necessary and interest rates are a kind of economic friction.

The Fed acts on the assumption that looser credit stimulates growth. That may work in the short run, but it has other effects when rates are lower than the market would set them. Cheap money enables businesses and consumers to do economically unproductive and even counter-productive things. As Charles Gave often notes, when rates are too low people use the borrowed money to buy existing assets instead of financing new innovation. That leads to distortions like the asset bubbles and industry concentration we saw after 2008.

Starting with Greenspan in the 1990s and moving forward, ever-lower rates made it easier for businesses to buy their competition than to actually compete. An industry with six major competitors gives consumers choices. When one of those competitors buys another one because rates are so low instead of investing in their own businesses to improve prices and costs, consumers lose a choice. This can lead to higher prices and/or worse service.

Let me hasten to note that I am not talking about businesses buying other businesses for competitive reasons. I'm a firm believer in Schumpeter's Creative Destruction. The loose monetary policy of the Federal Reserve has short-circuited creative destruction. The Fed policy is actually short-circuiting the buildup of new businesses.

In fact, the consequences are far greater. Another (nameless) reader picked up on this.

> "Hello John -
>
> "Turning the pages back even further, I believe we can credit the Fed and central banks with most of today's dismal state of affairs regarding families and relationships.
>
> "Just think of all the problems we've encountered because most families require dual income just to survive."

This is rarely noted but incredibly important. Economic and monetary policy affects *everything*—politics, technology, business, culture, health, family life, everything. And these things affect policy. **Looking at "the economy" like it exists in some separate sphere will lead you wrong every time.**

That's one reason I've asked Neil Howe to take a prominent role at this year's SIC. He ties it all together better than anyone I know. Here's a short excerpt from his forthcoming (and very important) book, *The Fourth Turning is Here*.

> "Economists typically examine GDP growth or standard of living growth as 'conditioned' on a social and policy environment they regard as exogenously determined. Heads of global institutions, filled with economists, are therefore always exhorting government leaders to 'pull together' and 'do the right thing' in order to make prosperity return. It's as though these leaders are always free to behave rationally—once they receive rational advice.
>
> "But is that assumption realistic? I don't believe so, and I don't think many others believe so either—maybe not even David Malpass, who earnestly goes through the motions of exhorting policymakers to somehow forget about untethered demagogues, impatient voters, vengeful social media, and rumors of war. Just ask Emmanuel Macron how 'doing the right thing' on pension policy is working out for him right now.

"So let me propose a broader perspective. Let's imagine that the economic performance of a nation or region together with its social and political mood are all part of one large system. If so, then every part of this system is connected by multiple feedback loops. Poorer economic performance may then feedback into a less optimistic social and political mood—which in turn changes the menu of policies that the public will find acceptable.

[John: There's our chemical engineer process control feedback showing up again!)

"Back in 2006, Harvard political economist Ben Friedman wrote an eloquent and prescient book (*The Moral Consequences of Economic Growth*) saying exactly this. All the liberal and democratic features of our political system, he pointed out, grew and developed during decades of buoyant economic growth. Almost any economist will agree on this much: Take away the democracy and liberalism, and you can watch our robust economic growth screech to a halt. But Friedman's point was that the opposite is also true: Take away our robust economic growth, and watch democracy and liberalism disappear. Or, at the very least, watch everybody fear that they will disappear—which may amount to the same thing.

"I have no doubt that we have entered such an era of mutually reinforcing negatives."

(*Over My Shoulder* members can read more from Neil here.)

Neil calls this era "The Fourth Turning" and we are in the middle of it right now. It's the culmination of a roughly 80-year cycle, the last of which encompassed the Great Depression and World War II. Before that it was the Civil War, the Revolutionary War, England's Glorious Revolution, and so on. These cycles have been going on for centuries in the Anglo-Saxon world. Other parts of the world have similar patterns. It is evidently part of human nature. (In an attempt to be humorous, I once told Neil it appears each generation screws up their kids the same way their forebears did 80 to 90 years earlier. Why should we expect different results?)

The final cycle in Neil's generational cycle—The Fourth Turning—brings huge, fundamental change—not just economic but social and political change. Some of society's core institutions collapse and new ones rise. That's the kind of period we are about to enter. And it's why I've made "Thinking the Unthinkable" our SIC theme this year.

The days of expecting Institution X to take care of our problems are gone. And whether the X you're thinking of is a company, a government agency, or some private organization, we should not assume it will be there to fulfill its normal role. In a Fourth Turning, everything is on the table.

In that light, in the grand scheme of things, whatever the Fed does next week may not matter so much. But it is important in the near term because many investors still expect the Fed will start cutting rates this year. They are positioning themselves accordingly. If it doesn't happen that way (I think it won't), they will need to change course, which could mean an uncomfortable adjustment for everyone. That discomfort could, in turn, accelerate the Fourth Turning's next steps.

That's why I'm putting Neil on the final panel with Felix Zulauf, one of the greatest investors in the world; William White, former chief economist of the Bank of International Settlements and my favorite central banker. We'll tie all this together, talking about how these cycles will play out over time. Frankly, the preparation session for this final panel was electric with ideas and thoughts about how these cycles play out.

Please join me at SIC as we think the unthinkable.

Travel Plans, Webinars and Grandkids

This last week has been a whirlwind of travel, SIC preparation Zoom calls, and planning. I met with my partners at King Operating while I was in Dallas. While there was mostly good news, I think my personal takeaway is that it is good to do business with people you actually like to be around. I'm getting too old to deal with ^&%$. You will get to meet some of them as we start doing webinars on energy in the near future.

I was invited to Shabbat dinner at Joe Lonsdale's home, mostly family but some (very young to me) rather successful VCs. His SIC sessions will be mind-blowing. Dinner with Lacy Hunt and George Friedman. Lunch with Brad Rotter and James Kallimani. Long-time reader and friend Norbert Wagnick picked me up and took me to Terry's for BBQ beef ribs. They were good but I was shocked at the price. Everywhere prices were way up for everything.

While there was some market talk, of course, mostly people were talking about society's problems and how to fix them. I heard a lot of good answers at The Cicero Institute. If Neil Howe and others are right, we are going to need a generation focused on problem-solving and not just scoring political points. I heard about a lot of new tech.

I went to Colorado Springs to see new grandson Odin (Chad and Danielle), then Tulsa to see Abbi, Amanda, and Henry and four more grandkids (out of 9 total). I pondered what kind of world they will live in as I returned home. Pictures of grandkids below.

Source: John Mauldin

And with that, I will hit the send button. The next 10 days of SIC will be busy but one of my favorite times of the year. I learn so much. And don't forget to follow me on Twitter!

Your thinking the unthinkable analyst,

John Mauldin
subscribers@mauldineconomics.com

http://www.mauldineconomics.com/members

Thoughts from the Frontline is a free weekly economic e-letter by best-selling author and renowned financial expert, John Mauldin. You can learn more and get your free subscription by visiting www.MauldinEconomics.com.

To subscribe to John Mauldin's Mauldin Economics e-letter, please click here: http://www.mauldineconomics.com/subscribe

To change your email address, please click here: http://www.mauldineconomics.com/change-address

Thoughts From the Frontline and MauldinEconomics.com is not an offering for any investment. It represents only the opinions of John Mauldin and those that he interviews. Any views expressed are provided for information purposes only and should not be construed in any way as an offer, an endorsement, or inducement to invest and is not in any way a testimony of, or associated with, Mauldin's other firms. John Mauldin is the co-founder of Mauldin Economics, LLC. He also is the President and investment advisory representative of Mauldin Solutions, LLC, which is an investment advisory firm registered with multiple states, President and registered Principle of Mauldin Securities, LLC, a FINRA and SIPC, registered broker-dealer. Mauldin Securities LLC is registered with the NFA/CFTC, as an Introducing Broker (IB) and Commodity Trading Advisor (CTA).

This message may contain information that is confidential or privileged and is intended only for the individual or entity named above and does not constitute an offer for or advice about any alternative investment product. Such advice can only be made when accompanied by a prospectus or similar offering document. Past performance is not indicative of future performance. Please make sure to review important disclosures at the end of each article. Mauldin companies may have a marketing relationship with products and services mentioned in this letter for a fee.

PAST RESULTS ARE NOT INDICATIVE OF FUTURE RESULTS. THERE IS RISK OF LOSS AS WELL AS THE OPPORTUNITY FOR GAIN WHEN INVESTING IN MANAGED FUNDS. WHEN CONSIDERING ALTERNATIVE INVESTMENTS, INCLUDING HEDGE FUNDS, YOU SHOULD CONSIDER VARIOUS RISKS INCLUDING THE FACT THAT SOME PRODUCTS: OFTEN ENGAGE IN LEVERAGING AND OTHER SPECULATIVE INVESTMENT PRACTICES THAT MAY INCREASE THE RISK OF INVESTMENT LOSS, CAN BE ILLIQUID, ARE NOT REQUIRED TO PROVIDE PERIODIC PRICING OR VALUATION INFORMATION TO INVESTORS, MAY INVOLVE COMPLEX TAX STRUCTURES AND DELAYS IN DISTRIBUTING IMPORTANT TAX INFORMATION, ARE NOT SUBJECT TO THE SAME REGULATORY REQUIREMENTS AS MUTUAL FUNDS, OFTEN CHARGE HIGH FEES, AND IN MANY CASES THE UNDERLYING INVESTMENTS ARE NOT TRANSPARENT AND ARE KNOWN ONLY TO THE INVESTMENT MANAGER. Alternative investment performance can be volatile. An investor could lose all or a substantial amount of his or her investment. Often, alternative investment fund and account managers have total trading authority over their funds or accounts; the use of a single advisor applying generally similar trading programs could mean lack of diversification and, consequently, higher risk. There is often no secondary market for an investor's interest in alternative investments, and none is expected to develop. You are advised to discuss with your financial advisers your investment options and whether any investment is suitable for your specific needs prior to making any investments.

All material presented herein is believed to be reliable but we cannot attest to its accuracy. Opinions expressed in these reports may change without prior notice. John Mauldin and/or the staffs may or may not have investments in any funds cited above as well as economic interest. John Mauldin can be reached at 800-829-7273.