THOUGHTS FROM THE FRONTLINE

A Path-Dependent Year—WWJD?

By John Mauldin | January 8, 2022

An Especially Difficult Challenge
WWBD?
Success Is a Problem—WWXD?
Special Opportunity
Washington, DC, and a Path-Dependent Schedule

Twenty-two years of tradition dictate I begin the new year by forecasting what lies ahead. Unfortunately, the future is never really knowable. “Forecast” is a polite synonym for “guess.” The better ones are *informed* guesses, but still inherently uncertain.

The coming year is particularly uncertain. The economy could be wildly different based on how certain events unfold. To use a favorite central banker term, it is “path dependent.” The path we take will depend largely on the decisions of people (and a virus which again depends on the decisions of people) in key positions.

Some evangelical Christian groups wear cryptic little “WWJD?” pins. It stands for “What Would Jesus Do?” That’s a good question to ask when you face a moral dilemma. The economic dilemma, while different, becomes clearer when we ask what certain mortals will do. That will be our framework as we consider what 2022 will bring.

In this Part One of our 2022 forecast, we consider three decision-makers you know… but it’s not entirely clear whose decisions will matter most.

An Especially Difficult Challenge

"WWJD" is our first question for 2022. In this context, it means "What Will Jerome/Jay Do?"

Jerome Powell and the Federal Open Market Committee he leads have no good alternatives. Choices their predecessors made years (and decades) ago limit what they can do now. Choices they made last year certainly have an impact. Powell and the FOMC must choose, and their constrained choices will constrain the economy in 2022.

The main challenge is inflation. Going into 2021, the Fed expected higher inflation but thought it would be "transitory." To be fair, I and many others initially thought the same, but by early summer I was asking for a refund on my "Team Transitory" T-shirt. Inflation rose more and lasted longer than we expected for two primary reasons.

First, rising wages and poorly targeted pandemic relief programs gave Americans enormous new spending power while the continuing virus threat discouraged services consumption. So consumers spent on goods, many of which had to be imported. This snarled overly optimized supply chains that couldn't adapt to the rapidly shifting conditions.

Second, energy prices popped higher in the summer months due to a combination of weather, OPEC policies, US policies, and an unfriendly ESG environment which reduced production as demand for goods grew. This was exacerbated by a serious lack of investment to produce more oil and natural gas (let alone the ultimate clean energy solution, nuclear), which is now socially and politically out of favor, but more necessary than ever, whatever your political beliefs are. Energy is an input to pretty much everything else, so other prices rose, too.

(Note: I look forward to transitioning to a clean energy world but the key word is *transitioning*. It's going to take time and it seems some clean energy proponents want it done today instead of over time. This creates shortages and raises prices.)

The FOMC finally, belatedly, is acting to reduce its bond purchases. Their latest minutes indicate the QE purchases will end in March and a rate hike could come that same month. They also dropped a hint about actually reducing the balance sheet. I applaud their desire to move faster but color me skeptical on the last part. The only reason to reduce the balance sheet, which unless done in real size is meaningless, would be to give them cover for not raising rates, which would be a serious mistake. If the US economy can't handle 0.75% interest rates, we are in deep kimchee.

As of now, the Fed is simply becoming a little less loose. They are still expanding the balance sheet. Real interest rates are still negative, and will remain so unless the Fed hikes far more than anyone expects, or inflation drops faster than anyone expects.

Note that negative real interest rates in policy circles of elite economists is seen as a feature, not a bug. They were part of the solution after World War II to bring the debt-to-GDP ratio from 150% down to under 50%. The other part was massive GDP growth. It would not surprise me at all, though it would disappoint me greatly, if inflation drops to the 3 to 4% range and the Fed essentially accommodates it.

But let's come back to the main thrust. First, we must realize **quantitative easing was intentionally designed to push up stock prices**. It was not a surprise to policymakers. From my friend Peter Boockvar:

> "I want to quote here what former Fed Chair Ben 'arsonist turned firefighter' Bernanke said in a November 4th, 2010 editorial he wrote in *The Washington Post* defending QE1 and the onset of QE2 in terms of its impact on stocks. With respect to QE1 and at the time the newly implemented QE2, 'This approach eased financial conditions in the past and, so far, looks to be effective again. Stock prices rose and long-term interest rates fell when investors began to anticipate this additional action. Easier financial conditions will promote economic growth…And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion.'
>
> "Thus, rather than relying on savings, investment, and quicker income to drive economic growth, QE was specifically meant to lift stock prices in order to do so instead. It is not a symptom of QE, it was a direct intended effect. In reverse, the response in stocks should not be a surprise."

All this is a problem because financial markets are hooked on the Fed's drug infusions. Free liquidity (or *better* than free, in real terms) is Wall Street's fentanyl. The US Treasury is similarly addicted. Withdrawing the extra stimulus, while necessary, could have significant side effects if done too quickly. But continuing it will have side effects, too, namely an overheated economy and even higher inflation.

In other words, the Fed has no choice but to aggravate *someone* this year. In 2018, faced with such a choice, Powell "crawdadded" and gave markets what they wanted. Now the stakes are far higher. So are the risks.

Minneapolis Fed President Neel Kashkari, who is typically uber-dovish and is an FOMC voting member this year, described the dilemma in a recent blog post. Summarizing, he acknowledged the Fed must lean into inflation to re-anchor inflation expectations at 2%. But he also worried about inflation dropping back to the disinflationary era of the last 10 years. Quoting:

> "If the macroeconomic forces that kept advanced economies in a low-inflation regime are ultimately going to reassert themselves, the challenge for the FOMC will be to recognize this as soon as possible so we can avoid needlessly slowing the recovery, while at the same time protecting against the risk of entering a new, high-inflation regime. This strikes me as an especially difficult challenge for policymakers."

This strikes *me* as the understatement of the decade. I see no reason to think the FOMC can walk the tightrope. What Kashkari is saying in a roundabout way is that he hopes the Fed can engineer a "soft landing" with inflation brought back under control without inducing a recession. The skeptical among us might note that the Fed's track record for engineering soft landings is essentially 0 for (number of attempts).

The current bunch and their predecessors spent the last 10+ years avoiding hard decisions that might upset someone (someone being Wall Street and the stock market), and now they're trapped. The real question isn't whether they will fail, but in which direction.

And that brings us to the question WWJD? What happens when they try to end QE and the stock market drops 20 or 30%? I'm not forecasting that but it's a real possibility. Valuations are stretched. Remember the taper tantrum? That was a very slow and measured withdrawal of quantitative easing compared to the current plan.

Some of my favorite internationally known analysts believe that Jay will blink and accommodate Wall Street under the rubric of promoting financial stability. This will of course make inflation worse, creating a bigger problem.

I hope Powell sees that stopping inflation is his number-one job because that affects Main Street. If he chooses Wall Street over Main Street, he will destroy the Fed's inflation fighting credibility and provoke a major outcry against the "elite" protecting Wall Street insiders. Forget that many of them own stocks. All they will see is that a government (and most people see the Federal Reserve as the government) chose the wealthy over the middle class and Main Street. I cannot even begin to say how big a mistake this will be. Like Titanic-level disaster.

WWJD? I have no idea. Further, I don't think he does either. At most he will say that his choice will depend on the data at that time. He will have a very dovish and politicized board pushing him, not wanting a weak stock market in an election year.

As I keep saying, Powell will have only bad and difficult choices. Let us hope he makes the difficult one.

The Fed has the gift of a relatively strong economy going into the first half of the year. Supply chain problems will continue to improve. Unemployment, at 3.9%, is historically low. Wages are up, especially for the bottom tier. Going from minimum wage to $13–$15 an hour is a huge increase for low-wage workers. They won't get a better opportunity than now to tighten monetary policy.

WWBD?

The COVID era gave us fiscal as well as monetary headaches. As I've said, these are bipartisan. Neither party has handled it well. For now, Democrats (tenuously) control the levers of power, which makes "WWBD?" another key question. What Will Biden Do?

We know one thing Biden *won't* do: Get congressional Democrats to pass another giant social spending/climate bill. Without Senator Joe Manchin he simply doesn't have the votes, and Manchin isn't budging. They may yet find some compromise but it will be a shadow of the original proposal. Manchin wants tax increases to pay for any incremental new spending. Sen. Kyrsten Sinema from Arizona has staked out her position of no new taxes. She currently seems quite happy with Manchin taking the heat. (Protesters following her into the restroom and yelling at her is not really a good way to create an atmosphere for constructive conversation. Shame on them. Everyone should have privacy in the restroom.)

From an inflation perspective, this is positive. It means we won't see more of the cash injections that drove goods demand so high. This should let the economy move back toward normal spending patterns—though it will be a new normal in some ways. It also means government borrowing will grow at a somewhat slower pace. That may ease the Fed's burden a bit.

Last week the president announced an initiative to increase competition in the meat industry. Currently a handful of processing firms, some foreign-owned, control most of the beef, pork, and poultry markets. That contributes to rising food prices and puts independent ranchers and meat processors at a disadvantage.

Market concentration has been a problem in many industries for a long time, but especially since 2008. The Fed's cheap-money policies (essentially creating an environment which financializes everything) encourage companies to buy competitors instead of innovating and delivering better products at lower prices. That's not how a free economy should work. Antitrust policy is easily abused, but if done properly it helps both consumers and businesses. With Fed policy, assorted other pandemic programs like the CARES Act, and a general market mania, the balance has gone way too far in the wrong direction. We need to restore it.

If the administration succeeds in promoting real competition, it could bring down food and other prices. This would put some downward pressure on inflation and maybe help the Fed engineer a softer landing. But, similar to the Fed's dilemma, anything Biden does here will gore someone's ox. He will get resistance and not just from business groups. We'll see what happens. It could turn into a helpful surprise later this year.

Another positive note here is that Biden seems to understand his COVID policy must be economically realistic. Extensive restrictions look unlikely unless this latest wave gets far worse. The CDC actually did something helpful by reducing the recommended isolation period to five days instead of 10. That will let millions of Americans with minor cases get back to work sooner.

But in global perspective, US COVID policy isn't the most important.

Success Is a Problem

Wherever this virus actually originated, it first appeared in China in late 2019. Within weeks the government froze travel, closed businesses, and confined millions to their homes. The response, while ruthless, effectively controlled the virus in China.

Under Xi Jinping, the Chinese government has now maintained this "zero COVID" strategy for almost two years. Widespread, routine testing finds occasional outbreaks that bring swift measures. Locking down entire cities and provinces has had enormous economic costs but, for whatever reason, Xi thinks it is the best course.

It is unclear if this strategy will work with the Omicron variant. This gives us another four-letter question: WWXD? What Will Xi Do?

China's success is actually a problem now. Having seen only small outbreaks, the population has very little immunity except for vaccines. Studies indicate China's vaccines offer precious little protection against Omicron (and even the original Covid variants), and the country is simply too big to import foreign vaccines in sufficient quantity (and might not do so anyway, since it would mean admitting their own vaccine's inferiority—they have refused to license the mRNA vaccines).

That means China is wide open to Omicron which, because it is more transmissible, will require even faster and more rigorous suppression efforts. It's already happening, too. Xian, a city of 13 million, has been in full lockdown for two weeks. The number of cases (at least what they admit) in Xian is trivial by our standards, only about 1,800 as of a few days ago, but obviously more than the regime will tolerate.

As big as China is, there is simply no way Omicron will stay confined to Xian. It's going to pop up elsewhere. That means the country will see more such giant lockdowns as the virus rolls through the population. Xi has no better alternatives. John Browning, a commodity trader living in Shanghai, wrote last week he expects this to persist until at least the next Party Congress in October.

China's COVID problem will have internal and external effects. Within China, it will further slow an economy that was already transitioning to a new "Common Prosperity" paradigm. Rolling, random, weeks-long production shutdowns won't add to anyone's prosperity. They will also further aggravate the global logistical snarls.

Now, maybe Xi will pull a rabbit from his hat. He rose to power because he gets hard things done. I am at a loss imagining what he could do, though, which probably means we will all feel an impact. Lost Chinese imports will further encourage US and European businesses to bring production home, even at higher cost. That will be inflationary in the short run. Companies will continue shifting from "just-in-time" to "just in case" inventory management, where necessary components are produced regionally or in places that are easily accessible.

If all goes well the Western powers may finally emerge from the COVID cloud while China stays in the middle of it. That kind of disparity isn't conducive to cooperation, economic or otherwise. Next week I will write about China's crackdown on various industries, which I think is going to have serious negative effects on their economy. Given China's importance in the world, that is a problem for all of us.

This year's outcome will depend on the paths these various leaders choose. Next week we'll go further into path-dependent choices that complicate the outlook. We have many possible paths forward and we don't know exactly where they lead. Success will depend on your path… which is why I'm calling this a "path dependent" year.

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Washington, DC, and a Path-Dependent Schedule

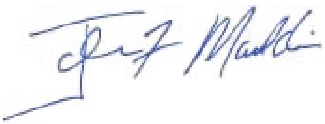
Normally (pre-Covid) I would look at my new year calendar and see at least 8 to 10 trips already planned: conferences, business meetings, speaking engagements, etc. I now have one trip scheduled to Washington, DC, in two weeks, some possible journeys here and there but nothing firm. It seems I can't even forecast my own schedule. I, too, have become path dependent. I know I need to go to Cleveland for Shane and I to get our semi-annual checkup that we have postponed for two years.

Shane and I had a quiet Christmas, lots of phone and zoom calls, dinner with friends, and the first of what I hope will become an annual event: New Year's Day afternoon brunch of black-eyed peas and chili. We only had about 50 people but they went through 5 gallons of chili, even more black-eyed peas, and at least 16 bottles of champagne plus mass quantities of hors d'oeuvres, etc. It was a lot of fun.

I always approach the new year optimistically. It's just in my personality. Then again, I live in a tropical paradise with fabulous neighbors, blessed to be able to work from anywhere. Shane still puts up with me and business has been good so it's hard not to be optimistic. I will soon jump on a call where we will continue planning this year's Strategic Investment Conference in early May. I am convinced it will be our best ever.

And let me close out this personal section by saying one of my reasons to be optimistic is you. Your continued gift of your time and attention is the reason I can stay positive. I can't express enough how grateful I am—22 years and counting. Where has the time gone? But it's been a wonderful trip. Don't forget to follow me on Twitter. All the best to you for the New Year!

Your ready to leave COVID in the history books analyst,



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