THOUGHTS FROM THE FRONTLINE

The Fed Is Playing a Dangerous Game

By John Mauldin | March 1, 2019

Infested with Crawdads
Not Applauding
Steadily More Dovish
#3 Mandate
Puerto Rico, Cleveland, New York, Cleveland, Austin, and Dallas

In an ideal world, we wouldn't have to read the Federal Reserve's rabbit entrails to discern the economy. But Since the Fed exists in the real world, and its decisions matter, we have to pay attention.

Just so new and perhaps even old readers know my views on the Fed: I believe we need it to handle the practical matters of the banking system plus interact with other international central banks (we live in a complicated world) and, in the midst of crisis, act as a lender of last resort and liquidity provider. I agree with Walter Bagehot's (pronounced badget) very important pronouncement (often called "Bagehot's Dictum") that "in times of financial crisis central banks should lend freely to solvent depository institutions, yet only against sound collateral and at interest rates high enough to dissuade those borrowers that are not genuinely in need." That rule or dictum remains wise.

I would prefer that the market set rates at the lower end as opposed to the Federal Reserve, again, except in times of crisis. I don't believe 12 people sitting around a desk, no matter how brilliant and educated they are, can arrive at a proper market-clearing rate better than the market itself. Seriously, LIBOR was set for decades without government intervention. Yes, in times of crisis it got a little funky, but that is when you want the central bank to step in (and then get out as soon as possible).

Before we get back to the letter, let me remind you we'll be talking about the Fed and a lot more at my Strategic Investment Conference in Dallas from May 13–16. If you want to attend you had better act quickly because it is almost sold out. Seriously. We intentionally limit the number of attendees to keep the conference from becoming so big that it becomes impersonal. We just added a *Very Important Speaker* to help us understand how future central bank policy will impact your investment portfolio and what you can do to insulate yourself.

Not only will this be the largest SIC ever, it is going to be the most informative and impactful. You don't want to miss it. We'll start a waiting list when it sells out but you really, really don't want to take that chance. Click here to register now.

Infested with Crawdads

Following Fed policy has been whiplash-inducing over the last year. It was just two months ago that Jerome Powell set off a market panic by suggesting the FOMC would do what it thinks is right and let asset prices go where they may. They were promising at least two if not three more rate hikes in 2019. The stock market fell out of bed.

Fast-forward to now and it seems the market won and got the "Powell Put" it wanted. The Fed has given up its tightening dreams and might even loosen policy. It is even (gasp!) losing its fear of inflation.

Nassim Taleb in his book Antifragile argues that preventing small "crises" from happening on a regular basis eventually causes a very large crisis. It's analogous to not allowing small forest fires to clear out undergrowth. Eventually you get one very large fire which is far more destructive. The Fed assuming a "third mandate" to protect asset prices is similarly dangerous.

Not Applauding

To understand what's going on, we need to review some ancient history, and by "ancient" I mean December 2018. That's several eons ago in today's news cycle.

Recall what had just happened. The US stock benchmarks had peaked in September before weakening to create a rough fourth quarter. The Fed was continuing to raise rates even as President Trump grumbled they were hurting the economy. In early December he had called a temporary delay on higher Chinese import tariffs. That helped a little but Wall Street was still worried. The Fed seemed tone deaf.

On December 19, following a regular FOMC meeting, Powell held the usual news conference which was, not to put too fine a point on it, a disaster. The more he talked, the more markets plunged as he seemed to dismiss concerns the Fed was affecting asset prices.

I said two days later in Powell, the Third Mandate, the New Fed and Crawdads that I thought this was exactly the right move. Powell's predecessors had given the Fed an unofficial third mandate: defend stock prices as well as maintain low inflation and full employment. His comments that day seemed to reveal Powell had no interest in continuing that practice.

As I said in that letter,

> *I think there is the very real possibility Powell wasn't being tone deaf at all. He could have wanted to remind everyone that the Federal Reserve is independent from Wall Street as well as politics.*
>
> *Yes, Powell worked on Wall Street, is quite wealthy and was an investment banker, and even ran his own hedge funds, as well as numerous posts for the Treasury before he came to the Fed, so he is clearly an "insider." He is also wicked smart, maybe even wicked brilliant. He didn't stumble or mumble at his press conference. He was quite deliberate. He knew exactly what he was saying and I'll bet you a dollar against 27 doughnuts he knew the market would react negatively. You cannot have his resume and not know exactly what the market would do given his quite careful press conference.*
>
> *This makes me think Powell is perfectly willing to walk away from that unofficial third mandate. Is he letting his inner Volcker show just a little bit? If so… damn, Skippy, it's about time!*
>
> *The Federal Reserve should be just as concerned about Main Street as it is about Wall Street. The serial bubbles of the last 30 years all had serious negative consequences. Yes, the ride was often fun, and some of us made good money in both the up and down cycles. But Main Street would be better served with a steady-as-she-goes Fed policy.*

I went on to explain how we would know if Powell were serious, metaphorically using the little creatures we call "crawdads" in Texas.

> *When crawdads sense danger, they start walking backwards (as in this video) to hide in their hole. Hence the Texas term, "Are you crawdadding on me?" Meaning, "Are you backing away from what you said or want back what you gave me?" It was generally not said in a polite manner. To crawdad on someone meant you broke your word.*
>
> *If Powell lets the markets fall and doesn't crawdad on us without coming back and giving a speech essentially saying "I'm sorry, I really meant to be more dovish," then we will know he really wants to end the third mandate. That would make me stand up and applaud. Loudly and with enthusiasm.*

Unfortunately, I am not applauding in that way. Powell is crawdadding as fast as one can without actually changing species. I now wonder if he was serious in the first place.

Steadily More Dovish

Recall how FOMC meetings go. They have two days of meetings, issuing a policy statement mid-day on the second one, followed by a news conference with the chair.

On December 19, Powell told the media,

> *"Many FOMC participants had expected that economic conditions would likely call for about three more rate increases in 2019. We have brought that down a bit and now think it is more likely that the economy will grow in a way that will call for two interest rate increases over the course of next year."*

But the minutes of the meeting he had just emerged from, which were released on January 9, said,

> *"Participants expressed that recent developments, including the volatility in financial markets and the increased concerns about global growth, made the appropriate extent and timing of future policy firming less clear than earlier. Against this backdrop, many participants expressed the view that, especially in an environment of muted inflation pressures, the Committee could afford to be patient about further policy firming."*

Now, Fed statements are so dense you can probably argue these are consistent. But it sure looks to me like the FOMC observed market volatility and decided they should be "patient about further policy firming."

That is not at all the impression Powell gave in public that day. Markets would not have fallen had he talked about patience. They would have more likely rallied.

So what was going on? I wish I knew. The minutes don't identify who said what, so possibly this reflects some disagreement on the committee. Maybe Powell wasn't among the "many participants" who thought patience was in order. I doubt that, however, because other speeches and statements since then show the FOMC getting steadily more dovish.

In December, I said that raising the benchmark rate while they were also reducing the balance sheet was a mistake, and they should do one or the other. Now they seem intent on stopping both soon, with Powell's full assent. That was nowhere on the radar screen just three months ago.

#3 Mandate

In theory, central bankers are supposed to worry about inflation. The Fed and its peers in other countries exist partly because their governments tired of dealing with out-of-control inflation. Not that they are against inflation completely; they just want it to happen on their terms.

For the Fed, acceptable inflation is 2%, as measured by PCE (not the better-known CPI). It ran below that level for most of this growth cycle and is only now catching up. So they should be happy. They are not.

Last week Richard Clarida, the newly-installed Federal Reserve vice chair, told a monetary policy conference at (where else) the University of Chicago that the Fed might give itself a little do-over. Without changing the 2% target, they would consider allowing a period of above-2% inflation to compensate for the years it was below the target.

We've heard this before. Fed officials talk sometimes about letting the economy "run hot" since it was lukewarm for so long. They haven't done so because the economy hasn't *wanted* to run hot. It has not been an option recently. What would be "hot" in this context is unclear. Maybe 4% real GDP growth? If that's what they now consider unusually strong, we have bigger problems. 2018 appears to have been the best year since 2005 at roughly 3% growth.

In any case, this is a dangerous game, mainly because the Fed has little control over how such inflation would be distributed. If it shows up mostly in asset prices, it will reward the wealthy and punish the lower 80%, who will face higher costs for housing, health care, and other essentials. That is a political problem, as we'll discuss below.

Then this week, Powell went to Capitol Hill for his semiannual congressional testimony. He specifically noted the Fed is watching the markets: *"Financial markets became more volatile toward year end, and financial conditions are now less supportive of growth than they were earlier last year."*

Powell went on to say the Fed remains "data dependent" and that it could adjust the balance sheet based on "financial and economic developments." My friend Peter Boockvar noted in one of his multiple (and highly valuable) daily letters that Powell really meant "S&P 500 dependent."

> *Jay Powell is implicitly saying to Congress that the Q4 direction of the stock market is the number-one reason why they have become more flexible with rates and its balance sheet. Weakness in China and Europe is number two. Thus, keeping asset prices elevated is officially the #3 mandate of the Federal Reserve.*

That, my friends, is what I meant by crawdadding. Powell has turned the other direction and is now bent on pleasing investors, the exact opposite of the impression he so carefully gave in December.

Why the change? Did the economic data change significantly? I don't think so. My best guess is Powell simply got cold feet. He is worried about recession on his watch and wants to prevent it if he can, or at least make the Fed look less responsible for it.

Michael Lebowitz summed it up:

> *Over the last year, the market has struggled as the Fed steadily reduced the size of their balance sheet. The S&P 500 is unchanged over the past 13 months. The liquidity pumped into the markets during QE 1, 2, and 3 is being removed, and asset prices which rose on that liquidity are now falling as it is removed. The Fed is clearly taking notice. In December Jerome Powell said the QT process was on "autopilot" with no changes in sight. A week later, with the market swooning, he discussed the need to "manage" QT. "Autopilot" became "manage" which has now turned to "end" in only two months.*

> *If the Fed's mandate is to support asset prices, this behavior makes sense.*
>
> *To the contrary, the congressionally chartered mandate is clear; they are supposed to promote stable prices and full employment. Our concern is that capital markets, which are heavily dependent on the Fed and seemingly insensitive to price and valuation, are promoting instability and gross misallocation of capital. One cannot fault markets; they are responding as one should expect on the basis of Fed posture and the prior reaction function. Markets are properly agnostic under such circumstances. It is the Fed that has created an environment that leads markets to react in the ways that it does.*

Remember, the "Bernanke Put" didn't end the Great Recession or the bear markets that accompanied it. The Powell Put is no more powerful. Can it have short-term, market-friendly results? Absolutely. For longer than we might think? Assuredly. Can corporations continue to build up high-yield debt to unsustainable levels? They're trying. As long as the music keeps playing, they will continue to dance.

I think Powell is probably changing course too late, but he might buy another year or so. And given where we are in the electoral cycle, that could make a difference. A recession starting in early 2020 would certainly make Trump's reelection path more difficult. Further, merely postponing recession won't make everyone fat and happy.

Specifically, it is quite possible and even likely that a Fed decision to keep policy soft and let the economy run hot will raise middle-class living expenses faster than it raises middle-class wages. That will make it easier for Democrats to argue the Trump policies aren't delivering the promised results. Then in January 2021 we could see a hard-left Democratic president with solid majorities in both House and Senate. Taxes will rise sharply soon after, as will the deficit when those who argue for more federal spending and even MMT proponents start getting their way.

There is no free lunch. Large deficits will have a cost. Yes, more QE of $3 trillion or $6 trillion or more is possible. As I will demonstrate in a future letter, the cost will be slower economic growth and greater wealth and income disparity. It may not be a crisis, but more of a slow grind that requires a different investing mindset.

I don't want to be pounding the SIC at you, as like I said we are going to sell out, but that is one of the questions that I have brought this specific group of speakers together to answer. I want to dig a lot deeper and broaden my own understanding. This is going to be one of the most important topics that we face in the coming years. Hope is not a strategy.

Right now, investors seem happy to have the Fed back on their side. I think we may regret having that wish granted.

Puerto Rico, Cleveland, New York, Cleveland, Austin, and Dallas

As you read this letter, Shane and I will be flying to Puerto Rico. Week after next we fly to Cleveland where I will speak to the local CFA group on Tuesday, have my left eye cataract surgery on Wednesday, then jump over to New York to catch a show with Barry Habib and on Sunday have lunch with our great friend Suze Orman. We'll then fly back to Cleveland to hopefully do my right eye. Then if all works right in a final checkup, I fly to Austin to do a client presentation and up to Dallas for another client presentation the first week of April. And then hopefully back home to Puerto Rico.

I am writing this letter in Houston at what used to be the old Warwick Hotel when I went to Rice University. Over the years it got a little dated but then was bought and made into a Zaza hotel and is now my new favorite Houston hotel. I go to a Rice University Economics Council meeting in just a few minutes.

Have a great week. I hope yours has been less hectic and stressful than mine. I can see a Sunday with some beach time, some gym time, and maybe even a little driving range time. Puerto Rico does seem to take some of the stress out of life. All the best…

Your not happy with Fed policy 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 Chairman 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.