When Readers Speak

By John Mauldin | March 2, 2024

“The Fed Is Trapped and Everyone Knows It”
Fundamentally Unknowable
An Upstairs/Downstairs Reality
Home Again, DC, and Opportunities

Today, we have a different kind of letter. I’ve been in California for some rather innovative and hopefully life/health span-extending medical treatment. I’m fine, but it has been a bit tiring. So this week, I’m handing the keyboard to you, my intrepid and smart readers.

This is easier than it used to be, thanks to our new online community platform, where you can follow all our Mauldin Economics publications, leave comments, and interact directly with our team as well as other readers. It’s been quite a hit, and I think that’s because it’s so simple. You can access it through your computer or as a mobile device app. Learn more here.

I’ve always said our readers are the smartest group of investors I know. Your talent is just amazing, and I’m thrilled we have this new way to unleash it. Below, I’m sharing just a few of the many dozens of replies to these letters and adding some comments. You can read the rest and even reply to the authors on our app. Check it out.

“The Fed Is Trapped and Everyone Knows It”

We’ll start with comments on my February 10 letter, Desperately Seeking Neutral. I talked about the Federal Reserve’s endless pursuit of the undefinable “neutral” interest rate, often using models with questionable assumptions.

John's explanation about a neutral interest rate as a sensible abstract concept, and the fact that there is no way to produce a scientifically based value for it is enlightening. In addition to the Fed's consideration of attempting to move interest rates above or below the fictional neutral rate for business activity, there needs to be explicit consideration of any administration's level of inflation of the money supply by legislating "expensive" programs, such as those supporting adoption of green energy.

Inflation is now declining in part as a result of a Republican House majority that is hostile to the Administration's policies that have been diluting the purchasing power of the middle class by inflating the money supply with funding of its programs by borrowed money, borrowing largely supported by the Fed. With the huge debt now existing, if the Fed decides to suppress inflation by raising rates to suppress business, it thereby also increases the cost of the existing debt and thus shrinks the amount of government spending from its available tax income. So, given the huge federal debt, rate changes not only directly affect business vitality, but also government spending levels. It's no wonder that economics is voodoo science based on complex math models that lack any firm, objectively set parameter values for its modeled variables.

Then, too, does anyone really believe the Fed would raise rates as the '24 election approaches? Instead, the Fed will be inclined to support the Administration that selected the Fed's members by lowering rates.

So, valid, accurate economic modeling must reflect politics as well as purely economic variables, but inserting any variables to attempt to reflect political considerations is verboten. Bottom line is that the Fed's economic modeling is a hopeless exercise. **—Jack H.**

***

The Fed is setting prices with models that do not really work. Great. How about we change the Fed mandate to inflation/price level only and stop the price manipulation, including the massive balance sheet of Treasuries and MBS and games in repo markets? Scarce resources are best allocated by price signals from market participants, and interest rates are prices. Politicians and the public need to see the price signal from all the state/Fed borrowing and the unfunded entitlements to change behavior. **—Jeremy H.**

***

I agree that the Fed would like to keep rates higher for longer, but that aim runs directly into the need of the US Treasury to finance our debt and deficit. The cost of interest is turning into a material portion of the deficit problem. In short, rates must come down because the Treasury needs them to come down to finance the government. And when they come down, the marginal buyer of the US debt will be—you guessed it—the Fed, which means more expansion of the ***money supply (by definition). The Fed is trapped and everyone knows it.*** **—Tad S.**

JM here: As you all point out, Fed officials face multiple quandaries. How do they lower rates when PCE is still close to 3%, the economy is doing better than most expected, the markets literally seem to be making highs almost every other week, and unemployment is under 4%?

Cutting rates in March is clearly off the table. I would seriously take the under on a rate cut in June. Does anyone think the wheels will come off in May? In 60 days? From where we are? It could happen, of course, and no one wants that. Those clamoring for a rate cut just want to go back to "easier" (pardon the pun) times, which distorted the economy in myriad ways.

I would rather have a 5% fed funds rate than 5% unemployment or a recession, which would mean a rate cut. And part of the reason the consumer economy is doing well is that those who have saved are finally getting some real interest earnings. Clearly, some are spending it.

Fundamentally Unknowable

Here are some reactions to Choose Your Own Economy, my February 17 letter on the difficulty (some would say "futility") of accurate economic forecasting.

Best reality check article on forecasting, ever! So many articles I've read through over time seem to be written with the intent of eventually, or more like hopefully, being able to say, "See, I told you so!" There are no guarantees—period. Indicators? Maybe, if they can be trusted. Do your homework, take your best shot, and be ready to pivot if need be. Best to all, and let the good times roll. —**Gregory W.**

***

Because we have individual agency, human society (and the things we create, like our economy and financial markets) is a complex adaptive system.

CAS have several important properties: they are highly non-linear, tending to obey power laws, and are deeply interconnected, rendering invalid classic techniques such as breaking a system down into individual components, having experts solve each component separately, and then reconstituting the whole.

This method will work for systems which are complicated, but not for systems which are mathematically complex.

As in the world of quantum mechanics, there is no independence between the system under observation and the people doing the observing, resulting in these systems exhibiting the property of adaptivity (a property which the financier George Soros refers to as "reflexivity" in the context of financial markets); they change over time in ways which are unpredictable, rendering invalid forecasting techniques based of the analysis of historical data.

Collectively, these properties are the reason why, in respect of human affairs, the future is fundamentally unknowable, and why the expectations of even the best economic and financial market forecasters are routinely confounded.

Trying to create better forecasting models is doomed to fail because the markets will continue to adapt. I'm afraid the phenomena you observe, John, are fundamental, and we just have to live with them. —**Paul S.**

***

The Fed rate didn't actually exceed inflation until about March of last year. And the rate is barely equal to the deficit spending forecast for last year far into the future.

So, for all the wailing, sack cloth, and gnashing of teeth, the economy has only been paying a real interest rate for 10 months since the Great Recession of '08, and the "real rate" is likely close to 2% for short-term notes, and close to 0.0% for the 7-year Treasuries.

We're not "higher for longer" at this point, more like "slightly positive for the time being." —**Don B.**

JM here: All good points and thanks for the kind words, Greg. Don, I like the "slightly positive for now" line. Jim Bianco and others would agree.

An Upstairs/Downstairs Reality

To wrap up, let's look at the responses to last week's The Good News/Bad News Economy. I described how easy it is to construct whatever forecast you like just by cherry-picking data to support it.

Is the confusion arising from measuring the wrong things? Most historical indicators were developed for an industrial/goods economy, but we have transitioned to a primarily services-based world. Employment is fluid, layoffs in the tens of thousands don't even blip employment because severance packages bridge gaps, and the newly unemployed so quickly find other employment. Services are notoriously difficult to evaluate, many being location dependent. All the meetings that moved online in the past few years still produce the benefits of meeting without the diseconomies of physical displacement, travel, etc. How many airline tickets, business lunches, or hotel nights are eliminated by online meetings, increasing productivity of participants while reducing costs of doing business? How might we measure such intangibles, and if we could, how would that change our understanding of apparent anomalies? —**Michael U.**

***

My feeling is that our economy today can be compared to that of Pompeii around 75 AD. The Romans there could note that Vesuvius was emitting more smoke than in previous years, and probably the tremors were more frequent, but in general, life was proceeding pretty much according to what they considered normal. Then Vesuvius erupted and destroyed them all.

I am reminded of a quote attributed to Lenin: There are decades when nothing happens, and there are weeks when decades happen.

The challenge is being prepared when those catastrophic weeks happen, especially when what we need to do to prepare is not clear, and the cost of preparation is not trivial. You can go broke waiting for a disaster to arrive, and then suffer like everyone else because you ran out of resources the week before the disaster hit. —**Gordon F.**

***

John, I'm a longtime reader and fan of yours. My view from the Midwest is that a fiscal deficit that equals nearly 6% of the overall US economy is helping to drive our prosperity. The question "why is the government spending so much money when unemployment is so low" is the wrong question. The unemployment rate is so low because the government is spending so much money. Who knows when we'll fly off the cliff?

*Japan's been going a long time on this program, as you noted several weeks ago. I'm with your pal Keith Fitz-Gerald on this issue. It doesn't matter what the Fed does when the fiscal deficit is 5–6% of GDP. AND PS, recessions don't typically occur in election years of an incumbent president running again (GHW Bush excepted). —***Ted J.**

***

*The United States is a divided economy that is closer to two differing countries. By conflating the economic data into one national expression, it becomes confusing. The US is in an Upstairs/Downstairs reality. The Upstairs economy is booming because it has control of an abundance of capital employed in productive and rewarding activities. The Downstairs economy has minimal capital and relies heavily on government inputs resulting in minimal productivity gains. Traditionally, the rate of people moving from Downstairs to Upstairs was aided by affordable education and relatively low asset prices. Today (for all the reasons you have chronicled), the ability to move Upstairs has been choked off. The US now has effectively become two countries pretending to be one. You now need to interpret the economic data separately for US Upstairs and US Downstairs, in my opinion. —***Ken G.**

***

*Just from my own observations from our (small) business, it seems that the first cracks in the system start to appear. For example, we are suddenly able to find quality staff much easier, including high-quality software engineers, which was very difficult before. We also are getting a good number of applications from great people in general. Our competitors had rounds of layoffs and reorgs, more of our customers than usual discontinued their business or downsized (we are lucky our company is still expanding, although "only" at a 20% rate now), and so on. Things take time to work through those complex systems. At this time, it does not look alarming in our industry yet (which is heavily investor-funding dependent, but if the trend continues, then this will create more cracks in the system. —***Sylvia E.**

***

*My gut sense is that a key economic indicator, the unemployment rate, is going to behave differently than in the past 50 or so years because of so many retirements and the COVID crisis messing up day-care options keeping parents out of the workforce. I.e. it's going to take quite a slowdown in the economy to push unemployment above 5% nationally. —***James W.**

JM here: Thank you, everyone. Ken, (and the rest of you) hit a point on the disparities in the country. We are literally watching a political realignment of our traditional party associations. It brings to mind Peter Turchin's point about what he calls the elites versus the immiserated.

We are going to really highlight this point at the SIC this year, along with so much else we need to cover. I feel like it is 2008, trying to plan a conference with so many must-cover topics!

Again, I am beyond overjoyed to have this new way for us to communicate. Unlike most of the internet, I can open up this app and know my readers will inform me, educate me, and even challenge me to rethink my ideas. It's incredibly valuable to me personally, and readers seem to enjoy it, too. You can (and should) join us here.

Home Again, DC, and Opportunities

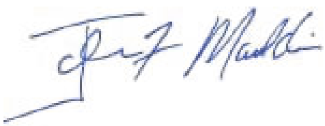
I am literally on a plane from Charlotte to San Juan and home as I write this closing section. This has been the longest time I have been apart from Shane for 10 years. 10 days are just too much!

The otherwise nice hotel I was in had no gym, so I am deflating even as I feel slightly more energetic. I am sorry about being so mysterious about this trip. I promise a full report in a few months after I can assess the results and see if they match the research. I really believe demand for this procedure will greatly outstrip capacity in the near future, even though it isn't cheap. The market will respond, but I am really constrained here for the time being. I dislike not being transparent with you.

I plan to be in DC in mid-April (can I be lucky enough to be there for cherry blossoms?) for yet another dive into new anti-aging technology and therapies. It is an exciting time to be alive and have the possibility to live even longer.

Time to hit the send button. Have a great week, and follow me on X!

Your ready to be home 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.