

Decoding the Fed

By John Mauldin | October 18, 2019



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“In the economic sphere an act, a habit, an institution, a law produces not only one effect, but a series of effects. Of these effects, the first alone is immediate; it appears simultaneously with its cause; **it is seen**. The other effects emerge only subsequently; **they are not seen**; we are fortunate if we **foresee** them.

There is only one difference between a bad economist and a good one: the bad economist confines himself to the **visible** effect; the good economist takes into account both the effect that can be seen and those effects that must be **foreseen**.

Yet this difference is tremendous; for it almost always happens that when the immediate consequence is favorable, the later consequences are disastrous, and vice versa. Whence it follows that the bad economist pursues a small present good that will be followed by a great evil to come, while the good economist pursues a great good to come, at the risk of a small present evil.”

—Frédéric Bastiat, “*That Which Is Seen and That Which Is Unseen*,” 1850 (JM’s emphasis)

You may have noticed strange events in Washington, DC—strange even by today’s standards—and I don’t mean the White House or Capitol Hill. I’m talking about Federal Reserve policy.

In less than 12 months we have seen the Fed raise rates, cut rates, shrink its balance sheet, expand its balance sheet, inject liquidity, withdraw liquidity, and do who knows what else behind the scenes. Either Fed officials are confused or we are at some kind of economic turning point. Or possibly both—there is no playbook. At a minimum, I think we are at a turning point and the Fed is having to improvise policy as events dictate.

Observing all this, it’s easy to fixate on the present and forget what led to it, those “seen and unseen” effects Bastiat described. At times like this, it helps to take a step back and review the process that got us here. Today we’ll do that, considering the latest Fed activity in longer context.

That’s what the Fed does, after all, and understanding them may be easier if we try to think like them.

First, a small request. I am trying to learn more about the Japanese pharmaceutical sector and regulations and in particular looking for a potential biotechnology partner. I will be eternally grateful to any readers with contacts at senior level management who would be willing to make an introduction. If that’s you, [drop me a note here](#). Many thanks.

Six Bears

We’ll start by noting six events/trends, in no particular order because they’re all important.

First, worldwide economic growth is weakening, with some key markets approaching recession. This week the International Monetary Fund reduced its 2019 [global growth forecast](#) to 3.0%, the lowest since 2009 when recession was still underway. They think it will improve to 3.4% in 2020. That’s better than the alternative but not much of a recovery.

Note, that’s the global average, which would be lower without considerably above-average growth in China and India. IMF pegs US growth at closer to 2%, with Japan and most of Europe even lower. Problems in China could worsen the IMF’s outlook quickly.

Second, if you don’t want to believe the IMF (and there’s reason to be skeptical), look at global shipping trends. The economy is increasingly digitized but the movement of physical goods is still its circulatory system. The latest Cass Freight Index data shows global blood pressure is dropping, when looking at the trends on both the total shipment and expenditures basis. Shipping volume has been down for 10 straight months on a year-over-year basis (hat tip Peter Boockvar).

Third, monetary and fiscal stimulus is proving less effective. Not that it was so great last time, but it helped. It also had side effects that may have reduced its usefulness. You can’t force credit on those who don’t want or need it, even at zero or negative rates. The European Central Bank and Bank of Japan are learning this the hard way.

On the fiscal side, the 2017 US corporate tax cut helped but the trade war offset some of it. Other countries, because they don't have the dollar's "exorbitant privilege," have less fiscal flexibility than the US. Hence we see, for instance, Mario Draghi practically pleading with European governments for more stimulus spending and those governments shrugging their collective shoulders. They can't do it.

Fourth, the US budget deficit is huge and growing. As I've shown, a recession in the next few years will likely push it far higher as revenue drops and spending rises. The Treasury's increased borrowing is also having an effect on credit markets.

The investors who aren't plunging into stocks seem to be holding more cash. Money market balances have been creeping up. A little caution might seem to be in order, but it matters *where* investors store their cash. If it's not available for the banking system to grease its wheels, bad things can start happening. (More on that in a minute.)

Fifth, we are starting to see confidence break in important corners of the capital markets. The WeWork IPO turned into a fiasco. In fact, the entire company looks just like the [train wreck](#) Grant Williams said it would be. I don't see how anybody could look at the business model of WeWork and not see an obvious hustle. What does that say about the supposedly brilliant venture capitalists who threw cash at the company? Nothing good. Though maybe they knew what it was and just figured they could flip their shares to the public before it fell apart. If so, they appear to have been wrong.

But the broader point is that once-invincible Silicon Valley unicorn companies are losing their allure. It turns out business success is hard when you have to actually, you know, generate more revenue than expenses. Other WeWork-like stories are probably coming. Nor is it just unicorns; look at Boeing's struggle to fix the 737 Max planes, and the shortcuts we are learning it took. These are bad signs for a market that needs earnings growth if it is to maintain current prices, much less see them rise further. (Note: I would not be afraid at all of flying a 737 Max on a US carrier. Just saying...)

Sixth, as I was wrapping up this letter, the latest Ambrose Evans-Pritchard [column](#) hit my inbox. He read the IMF's latest financial stability report and came away with a distinctly darker view:

The International Monetary Fund has presented us with a Gothic horror show. The world's financial system is more stretched, unstable, and dangerous than it was on the eve of the Lehman crisis.

[Quantitative easing](#), zero interest rates, and financial repression across the board have pushed investors—and in the case of pension funds or life insurers, actually forced them—into taking on ever more risk. We have created a monster.

There are 'amplification' feedback loops and chain-reactions all over the place. Banks may be safer—though not in Europe or China—but excesses have migrated to a new nexus of shadow-lenders. Woe betide us if this tangle of hidden leverage is soon put to the test.

According to the IMF, globally there is about \$19 billion of “debt-at-risk,” in which a global slowdown and/or recession would render borrowers unable to make their payments. I have written a great deal about the high-yield and leveraged loan market in the US, but globally it is much worse.

“In France and Spain, debt-at-risk is approaching the levels seen during previous crises; while in China, the United Kingdom, and the United States, it exceeds these levels. This is worrisome given that the shock is calibrated to be only about half what it was during the global financial crisis,” it said.

...In Europe, almost all leveraged loans are now being issued without covenant protection. The debt to earnings (EBITDA) ratio has vaulted to a record 5.8. Is the ECB asleep or actively promoting this?

The IMF’s directors call for “urgent” action to stop these excesses but in the same breath suggest/admit that the cause of leverage fever is the easy money regime of the authorities themselves—that is to say the central banks and their political masters who refuse, understandably, to permit debt liquidation and to allow Schumpeter’s creative destruction to run its course in downturns.

This is all going to cause precisely the crisis that I mentioned last week with pension funds. There is no way they can make the returns they need to meet their obligations. The next serious global recession/bear market will create a death spiral for many pension funds, requiring extraordinarily painful bailouts, to the point where they may simply default on the obligations. Don’t think that it can’t happen.

So that’s a quick survey of where we are. Now let’s add something else to the mix.

Repo Weirdness

Banks are a place where you store your cash, right? Not exactly.

When you deposit money in a checking or savings account, you aren’t just letting the bank hold it on your behalf. You are *lending* the bank that money and the bank is borrowing it. That’s why deposits show as a liability on the bank’s balance sheet.

We think of banks as lenders, and they are, but they’re also borrowers. They make money by lending at higher rates than they pay borrowers, and by leveraging their deposits via fractional reserves.

This is obvious if you think about it. How can your bank simultaneously a) promise you can withdraw your cash on demand and b) lend that same cash to someone else? That’s possible only because they know only a few people will want their cash back on any given day. And if cash requirements are more than expected, they can borrow from other banks or the Federal Reserve, as needed.

Modern central banking and regulatory practices have practically eliminated the old-fashioned bank run. It still happens occasionally, but the system can absorb it. That's because, while depositors can withdraw cash from a given bank, it is hard to withdraw from the banking *system*. Even if you buy gold, the gold dealer will probably deposit your cash in *their* bank, leaving the system exactly where it was before.

Now, the system is vulnerable if too many people decide to hold physical paper money, or they transfer deposit money into other instruments banks can't leverage as easily. Central bank reserve requirements also play a role. The banking system is far more elaborate than the most complicated Swiss watch but it just keeps on ticking... until it stops.

Something weird happened in September, for reasons that remain a little murky. The repurchase agreement or "repo" market seized up. I'll spare you a plumbing lesson; all you need to know is that repos are really, really important for overnight funding. Without them, it's very hard for banks, brokers, funds, and other market participants to square their books. Modern banking simply wouldn't function and the system would shut down.

Now, this wasn't a catastrophe. The Fed injected some liquidity and everything seems okay for now. The important part is that it shouldn't have happened and worse, apparently no one saw it coming.

We had a string of similar hiccups in 2007–2008. All were manageable but eventually they added up to something much worse. So, this wasn't a good sign for market stability.

That's the problem with unconventional monetary policy. It may solve your immediate problem but create bigger ones later, just as Bastiat said. We now know the Fed's 2017–2018 rate hikes, concurrent with the balance sheet reductions or "QT" (quantitative tightening) was probably too aggressive, as even the Fed now tacitly admits. I said at the time they were running a two-factor experiment with unpredictable results. Could we now be seeing them? And if so, are they over?

No one knows, but the Fed looks rattled. And a rattled Fed isn't what we need.

"Ample Supply"

The Federal Open Market Committee had an unscheduled meeting on October 4. That happens occasionally and they often don't reveal it occurred until the next regular meeting. That would mean Oct. 30, in this case.

But for some reason (and you can bet they had a reason) they decided to [announce](#) this one on Oct. 11. In between, Fed Chair Jerome Powell said in an Oct. 8 speech that the Fed would soon start growing its balance sheet again. He characterized the move not as QE, but as a more permanent operation to make sure the Fed has enough reserves to deal with market volatility.

To be fair, let's read [Powell's own words](#), with my emphasis in bold.

In mid-September, an important channel in the transmission process—wholesale funding markets—exhibited unexpectedly intense volatility. Payments to meet corporate tax obligations and to purchase Treasury securities triggered notable liquidity pressures in money markets. Overnight interest rates spiked, and the effective federal funds rate briefly moved above the FOMC's target range. To counter these pressures, we began conducting temporary open market operations. These operations have kept the federal funds rate in the target range and alleviated money market strains more generally.

While a range of factors may have contributed to these developments, it is clear that without a sufficient quantity of reserves in the banking system, even **routine increases in funding pressures can lead to outsized movements in money market interest rates**. This volatility can impede the effective implementation of monetary policy, and we are addressing it. Indeed, **my colleagues and I will soon announce measures to add to the supply of reserves over time**. Consistent with a decision we made in January, our goal is to provide **an ample supply of reserves** to ensure that control of the federal funds rate and other short-term interest rates is exercised primarily by setting our administered rates and not through frequent market interventions. Of course, we will not hesitate to conduct temporary operations if needed to foster trading in the federal funds market at rates within the target range.

So the Fed needs ample reserves to do its job. Fair enough. But until the last decade, a fraction of the current level sufficed. Now we are told the Fed needs far more reserves *and* it needs them permanently.

We have reached a point at which the Fed believes it must have nuclear weapons just to swat flies. I am sorry but that doesn't inspire confidence it will handle the next crisis well.

At the risk of saying I told you so, I said many times that reducing the Fed's balance sheet at the same time they were raising interest rates was a major mistake. Some market analysts believe one of the causes of the repo crisis was the adjustment to that Fed balance sheet.

Note also, the Fed can only buy Treasury bills to the extent the Treasury issues them. That means a shorter maturity on our large and growing federal debt, further implying government borrowing costs could spike quickly at some inconvenient future point.

There will be other effects, too. The Fed's new buying at the short end will probably steepen the presently-inverted yield curve to a more normal shape. That might reduce recession worries, but it probably shouldn't. The inverted yield curve is a *symptom* of the pressures that lead to recession. Manipulating the inversion away won't solve the underlying problems. The horse is out of the barn, already in the north 40 and still running.

This could go many different directions, and that is the problem. Remember the sandpile analogy. It is inherently unstable and anything could set off a collapse. Our highly leveraged banking system is also inherently unstable, not accidentally but *by design*. It needs huge leverage to function in the way bankers want it to. And as noted, the central banks are pretty good at keeping the sandpile intact. But they aren't perfect, and when they fail it tends to be ugly.

Add in the other stress factors I mentioned above, and it's hard to see how we avoid some kind of crisis in the relatively near future. I don't know where it will begin but I'm pretty sure it will be somewhere in the debt markets.

Seven Deadly Sins

I also wanted to report that our “**7 Deadly Economic Sins**” Week is a great success. Today's video clip is Lacy Hunt, former senior economist at the Dallas Fed, discussing the unsustainable national debt. Make sure to watch for my email in your inbox. And then we'll end the week with a bang by having Bill White and Grant Williams talk about the insanity of negative interest rates.

We got many reader comments and questions about the “7 Deadly Economic Sins,” the likely root causes of the coming global economic crisis. Let me just say that even though some of these prospects are scary, it won't be the end of the world.

It never is; it just sometimes feels like it.

Knowledge is power when it comes to preventing excessive damage to your personal life and assets. Knowing what to expect can give you the head start that you need to escape unscathed. Like those few with enough foresight to get out of Zimbabwe or Yugoslavia before the roof came down.

So my team and I are putting together a special package for you that, if you take us up on the offer, will greatly increase your knowledge of what's to come. I'll have more on that next week.

New York, Houston?, Philadelphia?, And...?

I will be in New York Monday and Tuesday for a series of meetings before flying back home to write next week's letter. In November I will visit Philadelphia to explore new biotechnology potential, along with several meetings in Houston with my SMH partners. We'll be looking at potential new investments for my readers and clients. There really is power in my network.

Today I do something unusual and play golf on a Friday. My friend and business associate Brian Lockhart of Peak Capital is in Puerto Rico looking at its investment potential. He's an avid golfer and I live on a TPC course. Even better, he'll spend the night. Brian is the seemingly endless source of great stories.

Shane comes home from Dallas late tonight. She went to close down our apartment there as we just don't get back enough to justify renting one. Airbnb or hotels make a great deal more dollar sense. She's also putting her rental homes in Denison on the market, as it is hard to be a landlord from a few thousand miles away.

And with that I will hit the send button. You have a great week. Let's hope that somehow a reasonable Brexit process emerges, along with a truce in the tariff wars. A little success that tones down the rhetoric would certainly help stave off a recession next year, all things considered.

Your needing to get to the gym more analyst,



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