THOUGHTS FROM THE FRONTLINE

Inflation Virus Strikes Fed

By John Mauldin | September 4, 2020

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One little-noted aspect of central bank policy is how rarely "policy" happens. Officials at the Federal Reserve and elsewhere long ago learned how to achieve their goals without actually doing anything. Creating perceptions is often enough to modify people's behavior.

For instance, if traders simply *believe* the Fed will intervene should interest rates go above or below a certain level, rates probably won't breach that level, or even get close to it. No one wants to make the Fed pull its trigger. This is why central banks are so obsessed with "credibility." They don't want to actually use their monetary firepower, and they don't need to use it as long as financial markets respect it. Their most-used weapons are just words.

We saw another example in late August when the Fed unveiled changes to its long-term monetary policy strategy. Among other things, they now say they will let inflation "run hot" for extended periods in order to achieve a 2% long-term average. Reasonable minds can differ on whether that's a good idea, or whether the Fed can actually do it. But the Fed certainly wants us to *believe* its new plan. We know this from the enormous effort placed on communicating it.

The problem is that one person's "policy" is another person's unintended consequences. Today I want to argue that the unintended consequences from recent Fed "policy" changes, not to mention those initiated in prior decades, have been at the very epicenter of some of the national problems we have. The Fed would vigorously deny this course, but the results are plain for all to see.

We'll begin with how some of my trusted sources view this Fed move. But first, I'll let the Fed speak for itself.

Words Are Policy

You may have noticed a pattern recently. Jerome Powell's speeches and media interviews usually coincide with some kind of significant policy move. I'm sure Powell gets all kinds of invitations. Not by accident, he accepts those he finds useful.

And sure enough, shortly after the Fed revealed its latest change, Powell was online to explain/defend it via his pre-arranged Jackson Hole virtual address.

Here is what the Fed itself characterized in a press release as "the more significant changes."

- On maximum employment, the FOMC emphasized that maximum employment is a broad-based and inclusive goal and reports that its policy decision will be informed by its "assessments of the *shortfalls* of employment from its maximum level." The original document referred to "*deviations* from its maximum level." [One small word, so much meaning.]

- On price stability, the FOMC adjusted its strategy for achieving its longer-run inflation goal of 2 percent by noting that it "seeks to achieve inflation that averages 2 percent over time." To this end, the revised statement states that "following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time." [We're going to have to unpack these words carefully. It's hard to even begin with the variety of potential for negative unintended consequences in these innocuous words.]

- The updates to the strategy statement explicitly acknowledge the challenges for monetary policy posed by a persistently low interest rate environment. Here in the United States and around the world, monetary policy interest rates are more likely to be constrained by their effective lower-bound than in the past. [Am I the only one who is confused? They feel challenges from monetary policy caused by low rates that they have in fact engineered. It's kind of like saying that adding water to gasoline poses challenges for the proper operation of your automobile.]

We'll get into what all that means below. For now, savor the irony of a central bank explicitly admitting it "seeks to achieve inflation" at all, never mind the level. Central banks once sought to *stop* inflation, not achieve it. Now generating it is the goal. Congress, which created the Fed, mandates that it create "stable prices." In a kind of Orwellian twisting of language, the Fed now interprets the mandate to mean 2% inflation. That means the value of your dollar loses about half its purchasing power every 36 years. ***At a minimum.*** As we will see, it can get worse.

No doubt aware of this, the Fed went to great lengths to explain itself. Linked here you will find an overview, the statement itself, a marked guide highlighting changes since the last review (very handy), Powell's Jackson Hole presentation, speeches by Vice Chair Richard Clarida and Governor Lael Brainard, and a bunch of background documents.

Why such elaborate explanation? Because the words don't just explain the policy. The words *are* the policy. They do the work. The Fed wants us to believe 2% inflation is a worthy goal and that the Fed will make it happen. If we do, the Fed will have accomplished what it wants.

Price Instability

My friend Peter Boockvar may be one of the fastest thinkers I know. Every day, he digests the latest economic data and central bank statements and then issues a quick-take analysis, usually within an hour (and sometimes within minutes). I really don't understand how he does this, but it's quite useful.

So the very same morning the Fed announced this policy, Peter was out with a short but incisive essay on "The 10 Flaws of Inflation Symmetry." Some excerpts:

- Where inflation was in the past should have no bearing on where it should be allowed to go in the future. Is zero inflation one year and 4% the next the new definition of 'price stability'?

- Letting inflation run above 2% for a period of time hurts the least able to afford it the most. In other words, LOWER real wages is a growth depressant.

- There is nothing to equate low inflation with low growth and higher inflation with higher growth.

- Longer term interest rates are not just going to sit there and let inflation run hot, they will tighten for the Fed. This would then hurt the housing sector and any overindebted company.

Peter starts where I would, with the glaring inconsistency between the Fed's "price stability" statutory mandate and its official policy promoting the opposite. And that reducing real wages by raising living costs hurts most of the people the Fed supposedly serves.

But more important, Peter notes how this policy is self-defeating. If the Fed by keeping short-term rates low somehow gets inflation moving toward its goal, long-term rates will still rise to reflect the greater inflation risk. This will raise mortgage rates, make it harder for companies to issue equity, and otherwise stifle economic growth.

Why anyone should want that outcome is unclear, but it's where the Fed wants to take us.

Ideas Have Consequences

The concept of a 2% inflation goal simply did not spring full-blown out of the blue, like the goddess of wisdom Athena from Zeus's head. It has been discussed in academic circles for quite some time.

I was able to attend a small invitation-only symposium in Boston some seven or eight years ago. It was under strict Chatham House rules but I can tell you had a "Who's Who" of economic and financial talent. One panel in particular was seared into my mind—a Nobel laureate economists and another economist whose name you probably know. There was general agreement that a 2% inflation target should be the *minimum* inflation target. One Nobel laureate espoused letting inflation run 4% for a period of time. There was discussion and pushback from some of the audience. An overall very enlightening session.

But the point is that the concept of a 2% (or more!) average inflation level, running even hotter at times, has been discussed in economic circles for many years. It has now reached into the Fed proper. I am sometimes asked why I pay attention to discussions among academic economists. These discussions can become a preview to "policy." Ideas have consequences, and ideas pushed by those with prestigious academic authority have more consequences.

"One Hell of a Dilemma"

Another oddity is that the Fed has already generated ample inflation, but it's not visible in the indexes policymakers watch, like the Fed's preferred "Core PCE" measure.

Back in January, before the pandemic hijacked the news, I explained in Nose Blind to Inflation how none of the benchmarks truly capture the full inflation picture. Everyone experiences inflation differently based on their lifestyle and spending patterns. Yet the Fed indiscriminately forces the same strategy on everyone.

My friend Danielle DiMartino Booth and her Quill Intelligence colleagues recently explained how the Fed ignores the rising healthcare and housing costs that plague most American households.

> Core PCE [Personal Consumption Expenditures] understates to the greatest degree of any inflation metric the cost of healthcare and housing. "Systematic" is the word that comes to mind when you look at the hard data. According to the Organization for Economic Cooperation and Development, in the United States, the average married worker with two children paid an 18.8% tax rate in 2019. In a January 2020 report, Harvard's Joint Center for U.S. Housing reported that the median asking rent for an unfurnished unit completed between July 2018 and June 2019 was $1,620, 37% higher, in real terms, than the median for units completed in 2000. Median income in 2019 was $63,688.
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> Back of the envelope math based on take home pay of $51,714 gets you to 37.6% that renters were spending out of their paychecks on rent last year. The PCE gives housing a 21.4% weight.

In other words, core PCE captures only 56% of the median family's rent, but families don't have a choice to pay only 56% of their rent. Healthcare costs are similarly undercounted because PCE imputes them from Medicare and Medicaid reimbursement rates that are far lower than those paid by most individuals and their private insurers. And that's without even considering today's higher premiums and deductibles.

This isn't a small problem. It is enormously consequential, as the *Daily Feather* analysis explained.

> The core PCE they hide behind is, at best, duplicitous. Fed officials would, however, face one hell of a dilemma if they owned up to a metric that captured true pricing, including that of assets. Inflation would long ago have run so hot we wouldn't be in the mess we are while interest rates would be normalized sending the zombies where they belong – not just dead but buried.

Inflation is *already* "running hot" for most Americans, but the Fed doesn't see it. Core PCE serves the same function as those blinders you used to see on carriage horses. The difference is that horses don't voluntarily blind themselves. The Fed does, and as a result has kept interest rates artificially low and let zombie companies take over the economy.

Why would the Fed do this? Because using a more accurate benchmark would force them to get serious about price stability, and that would limit their ability to "stoke" the engine of the economy. PCE lets them pretend inflation is low and achieve their unwritten policy objective of keeping the stock market bubbling along.

The Unintended Consequences of Federal Reserve Policy

A few thoughts on the Fed's twisting the concept of stable prices into a 2% inflation goal.

1. As noted above, 2% inflation cuts the buying power of your savings in half in just 36 years. Combined with a 0% interest rate policy, it means retirees following safe and prudent standards are guaranteed to lose buying power.

   Whether you are just beginning to save for retirement, or you are already retired, such a policy makes you run faster just to stay in the same place. Yes, I understand that in a heavily indebted nation there is a perceived "need" for some level of inflation to lower the burden of debt. But lowering one man's debt burden simultaneously reduces another man's buying power.

   All the words that the Federal Reserve used to describe this new policy never reveal exactly what time period they will use to achieve "average" 2% inflation. That makes a huge difference. It could mean letting inflation run at, say, 4% for several years while keeping short-term interest rates near zero. Does anyone seriously believe that will have no consequences!?!?

2. It follows from the above that at 4% inflation, longer-term interest rates would rise. This, of course, is not what the Fed wants. There is another "policy" being discussed in academic circles today: yield curve control. Will they have to control government rates all along the curve? That will have consequences, too.

   Further, the Fed now owns about a third of all US securitized mortgages. One. @#$%5ing. Third. Great for homebuyers. Will they continue this policy? How long? Will the US securitized mortgage market become like the Japanese bond market? That is to say, controlled by the central bank? The Federal Reserve is not buying jumbo loans. Does that mean jumbo loans will rise with inflation, shutting out wealthier people from buying homes, or at least larger homes, and driving down those home prices? Unintended consequences…

   This massive manipulation of the bond market and the most important price in the world, the interest rate of the global reserve currency, is nothing but plain and simple price control. Can someone show me an instance where significant price controls actually worked over the long-term? Especially in a market this big? In the world's reserve currency?

3. Which brings us to another unintended consequence, or at least I assume it is unintended. This is going to have a result of putting significant downward pressure on the dollar, causing commodity prices and US consumer prices to rise and exporting deflation to the rest of the world. The Aussie dollar is already up by 27%. The Europeans are complaining.

4. It is clear that the extraordinary quantitative easing has boosted equity prices. Not to mention home prices. That means that those with homes and equities have seen their net worth increase. For most of us reading this letter, that's a good thing. But it also increases wealth and income disparity, which is tearing at the nation's psychological roots. I don't believe anyone at the Federal Reserve wants to increase wealth disparity, but that is the clear and obvious unintended consequence/result of their "policy.

5. My friend David Bahnsen highlighted another point in a recent market commentary. Quoting (emphasis mine):

> **But the impact of present Fed policy on the stock market extends well past the zero interest rate policy.** In fact, rate policy has not even been the monetary tool that has most impacted markets. The explosive interventions into debt markets, either through direct bond purchases (quantitative easing) or liquidity provisions (commercial paper, corporate debt, asset-backed securities) has had an incalculable impact on equity markets.
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> Besides the basic reality of $3 trillion (and counting) of new reserves in the banking system and liquidity that finds its way into financial assets far easier than it does the real economy, how significant is it to corporate profitability to have borrowing costs reduced to their lowest level in history? Fed interventions in the corporate bond market (shockingly, both investment grade and high yield) have created extraordinary access to capital for companies that know how to use that capital quite productively.
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> **This pendulum shift cannot be overstated—many companies went from challenging business conditions with high cost of debt and limited access to new debt that they needed for this difficult time, to instead, less challenging conditions with brutally low cost of debt and unlimited access to capital needed for this time and useable for growth measures after this time. That shift from "what could have been" to "what is" in credit markets is the most underappreciated factor driving equity markets today.**

6. The combined impact of all this means that the Federal Reserve is putting its thumb on the scale between Wall Street and Main Street, between the haves and have-nots, between the wealthy and the middle class, let alone the poor. Not the intent, I get that. Powell and company are doing what they think will keep the economy moving forward. But unintended or not, the consequences are still there. Is the average man on the street unjustified in thinking that "the elites," whatever the hell that means, are not looking out for his best interest? When a struggling corporation accesses the debt markets because the Federal Reserve made it easy to do so, they are acting in the best interest of their shareholders. They are simply trying to stay afloat in a crisis. But restaurants, hair salons, and small businesses in general don't have that same access because they don't have the same experience or connections.

> We have come to this situation because a progression of "policy" decisions by the Federal Reserve and the US government backed us into a corner. No matter who wins the election in November, they will have no good choices. A $2 trillion deficit is not a good choice. And $2 trillion may not be enough to keep the wheels from falling off the economy.
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> Small business America is getting slammed. It is clear that at least 100,000 small businesses will permanently close. That number could double over the next year. Every one of those businesses represents jobs, including many jobs for lower income Americans. Which is where the brunt of this crisis is being directed.
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> That is why I wrote a few weeks ago that the economy should be viewed as having three parts. One is doing quite well, we could maybe even characterize it as in a boom. One is in a recession of indeterminate length, but is managing. A smaller but significant chunk is clearly in a depression. And you wonder why emotions are running high?

I hope you can see the Federal Reserve's words, and the changes in its "policy," have consequences. And particularly troubling is the consequences that they did not intend.

By the way, *Over My Shoulder* subscribers already saw some of the reports I just quoted, including the Boockvar and Daily Feather analyses. I very rarely promote my own publications in this letter, but I am particularly proud of what co-editor Patrick Watson and I do with *Over My Shoulder*. We both spend a great deal of time digesting economic information. Between us, we probably read well over 100 items a week. And we narrow them down to three to five to send to our readers. Some are well-known sources, some more obscure, but all are powerful. You are literally looking Over My Shoulder, but only the best of the best.

Understand, after 30+ years of this, Patrick and I have a well-developed radar for interesting and thought-provoking ideas. Much of what is written in the mainstream media never makes our inboxes. Boring. So in a way, what we are reading is already "curated" before we narrow it down to what we send you. Many readers say it is the most valuable service they subscribe to. Better yet, we have a limited-time offer that gives you this valuable information at a shockingly low price. Click here for details.

Puerto Rico and Lockdowns

The number one response to the letter last week was, curiously enough, people wanting my mother's banana bread recipe. I was going to include it here, but we are running long. I will have the recipe next week for sure.

Have a great week and/or holiday weekend if you are in the US. We have new, more severe lockdown policies here in Puerto Rico, one of which was absolutely no one could leave their home on Sunday unless necessary, and walking for exercise is not officially necessary. Sigh. But at least I got more reading done.

Your fed up with Fed policy analyst,

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