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By John Mauldin

Given the wide disparity of views about the economy, it is little wonder that the reaction to Greenspan's latest speech has been all over the board. That is compounded by the fact that bond price expectations are totally disconnected from Fed expectations. Are the bond market critics just a bunch of whiners (give me back my risk free trade!) or is there substance to their major beef? Who's really in charge here? Can the Fed trump the market? Predictably, I answer the latter question with both yes and no. It all depends upon your time perspective, but timing is everything. There's a lot to cover, of course, so we begin.

But first, while we are speaking of timing, I have to comment on the latest mutual fund scandal uncovered by Elliot Spitzer based on a tip from some (presumably) knowledgeable source. Basically, a hedge fund (Canary Capital Partners) was allowed to buy and sell mutual funds after the market close. Canary was allowed to do so because it was controlled by a mega-wealthy family (the Sterns of Hartz-Mountain) who gave Bank of America a lot of other business.

When Spitzer and/or the SEC went after the investment banks for analyst fraud, IPO scandals, self-dealing, etc., I was not surprised. In fact, I predicted that analysts would be targeted. Everyone knew the whole system did not pass the smell test. WorldCom, Enron and their kin were specific surprises, but certainly these types of scandals were to be expected somewhere at the end of a major bull run which so blatantly rewarded such hubris. In that respect, it was analogous to the end of other bull economies of different eras. Much of our current investment laws came about because of the scandals of the 20's. Human nature changes very slowly, if at all.

But I must confess to being shocked at this latest scandal. And for reasons which go deeper than this one incident.

First off, there is no gray to this violation. It is three feet the other side of the clear black line. There were no attorneys who would tell their clients that this was aggressive but within the guidelines. No counting of the angels on the head of a pin logic by the legal types who tell the client what they want to hear. This was clearly breaking the law.

I can see one guy doing so and getting kick-backs and bribes. But this was evidently sanctioned by management. They had to know that it was career ending, if not jail time, if they got caught. How can a few extra dollars be worth such a catastrophic risk if you get caught? If two people know a secret, it is no longer a secret. Someone was bound to find out.

It is a relatively easy crime to commit. You fax two mutual fund orders (both buy and sell) to the trading firm, they get stamped as coming in before 4 pm or the close of the trading day. At 5 pm, you decide which one you want to keep and throw the other in the paper shredder. (This is in all likelihood what broker Red Bones did for Hillary Clinton with her cattle futures trading. In 15 years of industry watching, I have never met a professional commodities trader with such brilliant trading; at least, not one who could stop after making only $100,000.)

Since most orders for mutual funds are consolidated later in the evening, it is not difficult to get a one or two hour edge. If you know the portfolios of the mutual funds (which the managers might show such large investors), you look to see who is making an earnings announcement after the close, wait for the reaction, and buy or sell based upon the reaction. You might make only a few pennies each trade in “alpha,” but you get to do it a lot. It is an advantage of huge dimensions, like betting on a horse race with only a hundred yards to go. Not a slam dunk, but certainly more likely to succeed than betting before the race began.

Were the other investors in the fund robbed? The answer is yes, a percentage point here and there. A small enough difference to allow the human penchant for rationalization to perhaps begin its dark work. Let’s set some background.

Market Timers or Market Cheaters?

First, while Spitzer was entirely right nailing these guys, he is wrong when he chose to lump a number of illegal or questionable trading activities in the mutual fund industry under the name of “market timing,” citing this as a “banned” investment technique.

There is a clear difference between market cheating and market timing. “Mutual Fund Market Timing is a legal method of trade. In fact, Rule 3a4 of the Investment Company Act contemplates the timing of portfolios of mutual funds. This rule allows for baskets of mutual funds to be traded similarly - without this rule Registered Investment Advisors could not market time those baskets. The Securities and Exchange Commission’s Form ADV requires Investment Advisors to check the boxes describing their investment approach. “Market Timing” is one of those boxes. There are thousands of managers who practice “Market Timing”. Over the years the SEC has audited thousands of managers who practice one or more forms of “Market Timing.” (CMG and Steve Blumenthal).

“Agree or disagree as to its benefits vs. a buy and hold strategy, market timing has never been banned. To the contrary, for many years, hundreds of investment firms have successfully served the investing public utilizing market timing strategies. There is absolutely no relationship between the strategies employed by these investment firms (who are registered with, supervised by and conduct their investment management business in accordance with the rules promulgated by the SEC and state regulatory authorities) and the example cited by Mr. Spitzer. To draw such an inference is both irresponsible and a disservice to the investing public." (Thomas Giachetti, attorney)

There are lots of hedge funds which do mutual fund timing. Many of them use the so-called “International trade.” In essence, you see where the US market is closing and then buy or sell international funds, knowing that there is a statistical correlation between the US market today and foreign markets tomorrow. Given the recent so-so track records of most of these funds, it is a lot harder to do than it sounds.

As an aside, the mutual fund families know who these hedge funds are and allow such trades, for a variety of reasons. However, if as Spitzer alleges, they state in their prospectus they do not allow such practices and then let some violate their written policy, then throw the book at them.

I called around to some of my hedge fund friends to get their take on this. All but one had never heard of anyone getting after hour trades. One attorney tells me he was approached by a fund who was offered such an after hours trading deal in return for moving business to the service provider. After the attorney convinced both the fund and the provider that this was as illegal as hell, the offer was withdrawn.

But the concern I have is that this offer was made in the first place (most likely by what is known as a prime broker), presumably (only my guess) under competitive pressures to match other such offers. If this was a one time deal, I might shrug it off. But I fear it is not. As Dennis Gartman frequently points out, when you see one cockroach on the kitchen floor, there are another hundred in the baseboards.

Spitzer and/or the SEC are unlikely to catch this illegal trade by looking at mutual fund records. Vanguard or another mutual fund family just get a list of consolidated trades sent to them at the end of the day. The crime was committed at the service provider or broker level that consolidates the trades. It will take some good (some @#$@% very good) forensic accounting teams to catch this. I hope they nail them to their trading desks. Banning them from the industry should only be a start.

Trust, But Verify

Interesting reaction to the Greenspan speech and my analysis. Bob Prechter (of Elliot Wave Theory fame) wrote to say, “I concur with you on every point.” David Tice of the Prudent Bear Fund also said he liked the analysis, as did many others. However, Paul McCulley of Pimco sent me his analysis, politely noting that he disagreed a bit with me.

Then Jim Bianco writes, “Last **Friday** Greenspan spoke in Jackson Hole in what **we termed** his worst speech since becoming Fed chairman in 1987. What made it so bad, in our opinion, was its unbridled arrogance. Essentially Greenspan said there are two outcomes to monetary policy (1) the Fed is right or, (2) the market doesn't understand and further transparency/ communication is necessary. Where is the option ‘the Fed is wrong?’ (or, the market *does* understand monetary policy but thinks it is wrong?) This is often the case.

“While this arrogance is bad enough, Greenspan then went on to defend the Fed's ‘make it up as we go along’ approach to monetary policy by rejecting any kind of guidelines or rules. So the Fed's never wrong and doesn't need any guidelines. Scary.”

Bianco points out the Fed policy is in direct contradiction of what the market is saying. The bond futures market tells us short term rates are going to rise in our not too distant future. The TIPS market says inflation is going to rise, even as the Fed says further disinflation is a risk. Today and yesterday Fed governors were out in force, telling us they intend to keep rates low for a considerable period of time. Who wins this debate and why?

First, let me state outright that the collective wisdom of a million investors is not any more prescient, nor is it any more accurate, than is that of 12 men sitting around a Fed board room 8 times a year. Both make guesses, educated as they may be, about the future. To think either group possesses some true grip on the future is patently silly. Greenspan admitted as much last week, and we only have to look at the results of the investment markets to see how accurate the average investor is. 95% of futures investors, as an example, lose money over time. I can go on with many examples. This is not to say that 12 men should supercede, manipulate or over-ride the market. It is that the market is neither right or wrong when it forecasts (guesses) the future. It simply is what it is. To make it into more than that deifies collective wisdom, which does not even come up to the level of psychic, let alone demi-god status.

Jobs, Growth and Spirals

“It seems to me that, with inflation already low, disinflation risk will remain a concern for some time," said Fed Governor and intellectual force Ben Bernanke in New York. From the AFP summary: “He agreed with private forecasters that the US economy will grow quickly through next year as business investment improves but that growth probably won't be accompanied by any significant hiring. Because growth without new jobs will not reduce idle capacity in the economy, inflation rates are likely to fall to even lower levels. The Fed and private economists have expressed concern that weak prices could eventually lead to a crippling deflationary spiral.” (AFP)

Depending upon which speech you read, the Fed is committed to keeping rates low for a “considerable” or “significant” period of time. “If we convey a sense we're serious about not raising rates, the market will see an arbitrage opportunity and interest rate will start to fall," said Bernanke.

Fool Me Once, Shame on You

The old line is “Fool me once, shame on you. Fool me twice, shame on me.” The bond market feels betrayed as Greenspan and the Fed meeting announcements did not follow through on the rhetoric that rates would remain low because the Fed was prepared to resort to unconventional methods. Now, the Fed governors are trying once again to talk interest rates down, but without the use of the word “unconventional.”

So far, the bond futures market does not believe Bernanke and his fellow governors. The Eurodollar Deposit swap predicts the Fed will raise rates by at least 175 basis points in the next 18 months, and over 100 basis points in the last half of 2004. Or maybe they think that what the Fed means by “considerable” is 6 months.

The bond market thinks the economy is going to be so strong, or inflation will come back so quickly, that the Fed will be forced to raise rates, even in the months running up to a presidential election.

Or, there is one other possibility, which I find more reasonable and appealing.

Paul McCulley makes the argument today on Pimco’s web site that it is precisely the lack of Fed clarity that is causing the bond market to price in rate hikes. It is “risk premium.” Because the bond vigilantes don’t know what the Fed is going to do, they have to hedge and make a bet that to the casual observer (me) doesn’t make sense. (You should read both his and Bill Gross’s latest excellent columns at www.pimco.com.)

McCulley argues for “constrained discretion” on the part of the Fed. By that he is not arguing that the Fed should not have discretion to make decisions and even to change its mind as the facts change. But these decisions should be constrained (limited) by a set policy which everyone understands. Quote:

“…since the passage of the Full Employment and Balanced Growth Act of 1978 (commonly known as the Humphrey Hawkins Act), the Fed’s operational autonomy has been under an **enabling** umbrella directing the Fed “to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.”

“…If PIMCO’s ***Investment Committee*** were given the (intellectual only!) challenge of carrying out the Fed’s legislated mandate, the first thing we would ask would be: How do you define “***maximum, stable and moderate?”***

“We would want to know what those adjectives mean, so that we could establish a benchmark for performance. We would also want to know the relative weights that we should put on the three objectives, on both a static and dynamic basis. Put differently, we would want to know the accepted deviation from target for all three of the objectives, so that we could use our fancy-dancy quantitative models to develop both an optimization framework and a risk-management framework. And finally, we would want to know the guidelines regarding which tools, with what horsepower, we could use in pursuing the objectives.

"We would treat the assignment as one of 'constrained discretion.' And once the terms of the portfolio management assignment were agreed, we would negotiate a communication strategy with the client, so as to minimize the chance for 'surprises' on either side. Yes, that's how we'd go about it. We would want flexibility in the day-to-day management of the assignment, but we would also want the terms of that flexibility to be well understood, all in the context of well-defined goals, objectives and reporting requirements."

Then McCulley gets down to his critical points:

"Mr. Greenspan would not be comfortable with the PIMCO style. He has long argued for maximum flexibility for the Fed, with minimum quantification of the Fed's goals. In a nutshell, Mr. Greenspan's management style is best described as 'trust me' – sometimes known as 'constructive ambiguity.'… Greenspan disagrees [with specified policies], when it comes to carrying out his job mission. **His definitions of the Fed goals are what his gut says they are, but what he cannot bring his lips to say, subject to change when he has an undisclosed stomach ache.** Broadly speaking, such a paradigm has worked for him, with both inflation and unemployment relatively low. Such a paradigm is not, however, an institutional framework for monetary policy management; rather, it is a **maestro-digm."**

"To be sure, the FOMC has told us that it will remain accommodative for a '*considerable period*. But the FOMC has not told us either its definition of price stability or full employment. Therefore, the markets cannot reliably predict the length of a '*considerable period*.' Accordingly, the fixed income market is "buying insurance" against uncertainty as to the Fed's intentions by pricing in some 200 basis points of Fed tightening next year…If Mr. Greenspan ever wanted evidence of the cost of his infectious hubris, he need not look any further than the money market futures market, as displayed on the cover. **Unconstrained** discretion, as Mr. Greenspan advocates, is not a free good, because it raises risk premiums for uncertainty about monetary policy, acting as a headwind to the FOMC's accommodative will."

The Fed and Greenspan have been given a free ride for quite a long time. As long as things were going well, who wanted to rock the boat, other than some bond traders and a few Austrian (economist) curmudgeons?

Why is Greenspan resisting such a reasonable guy like McCulley's request for transparency? Why is he saying "trust me" is a better policy than understandable parameters? And why, if the economy is growing so well, is the Fed telling us that rates will remain low for a "considerable" period of time?

Let's look at some uncomfortable long-term facts facing the Fed.

First, they must clearly mistrust that the current economic growth spurt that is forecasted has "legs." In my opinion, I believe if they thought that for one minute the economy was going to grow on its own at 5% real growth for the next 18 months, I cannot imagine they would not begin to raise rates, if for no other reason than to have some room to lower them the next recession.

Why mistrust this growth? Because much of the growth is from stimulus that is not lasting. This growth is caused by (1) Bush's tax rebates, which are clearly kicking in (Wal-Mart's sales are up 5-6% year over year), (2) a huge government deficit spending (more than half the GDP growth last quarter was government [mostly defense] related) and, (3) massive mortgage refinancing which was done in the second quarter which produced a huge amount of spendable cash, which is now being spent.

But where are the jobs, as I have been writing about for months? With productivity at 6% plus (a number about which I think there is reason to doubt), you would need somewhat more than 5% growth to produce jobs. A jobless recovery is not sustainable, and the Fed knows it.

Greg Weldon slices and dices the numbers from today's ugly jobs report. (www.macro-strategies.com) Employment is down 113,000 since June. Unemployment is down 453,000. That means 340,000 of those formerly classified as unemployed have now dropped out of the labor force. Part-time employment is down 200,000 in the month of August. Thus, the "lower" unemployment rate does not reflect any real growth in jobs, but statistical games.

He does an analysis of the breakdown by sector and sex and comes up with this conclusion: "Bottom line … there is one macro-conclusion of significance to be gleaned from today's labor market input: 'second income jobs,' many of them part-time jobs, held primarily by women, are being eliminated."

The Fed is all too aware that even as GDP was revised upward for the 2nd quarter, that housing investment was cut by half from the first quarter, and this before rates began to rise.

Thus it comes as no surprise the Fed governor's are out and about, trying to talk rates down. It is apparent to me they feel the recovery is fragile and thus are willing to risk a return of inflation.

In talking today with one of the smartest analysts I know, Rob Arnott, he notes a concern that Ben Bernanke seems to be backing away from his former hard line of price stability. Is he saying that we are now targeting 2-4% inflation? From this, Arnott infers that the Fed won't raise rates until real inflation of more than 2-3% develops.

Japan and China say: Go Away

GM, Ford and Chrysler watch their domestic auto sales drop year over year by a respective -8.2%, -27.7% and -28.6%(!) as sales for Nissan and Toyota rise by over 17%. Thus, it must be frustrating in Detroit to see Snow rebuffed in Tokyo, when even as he was talking about letting the market set the exchange rates, the Bank of Japan was massively intervening again and again to force the yen lower, making Japanese automakers more competitive.

China said, "We will allow the yuan to rise when we decide it is in our own best interests and not a moment sooner."

This competitive currency devaluation cannot go on forever, and Bill Gross of Pimco points out quite succinctly what I have been writing for a long time:

"…In turn the hundreds of billions that the Japanese and other Asian countries have been buying in order to keep their currencies competitive with the Chinese Yuan (Renminbi) and the U.S. dollar will be subject to a sanity check as well. The currency/bonds/stocks of a reflating economy engaged in guns and butter, Hummer and Hummvee spending of near historical proportions are bad investments. Sooner, perhaps later, our Asian creditors will wake up and smell the coffee. Perhaps their java will take the form of dollar or Treasury Note sales. Perhaps the aroma will resemble a revaluation of the Yuan and then the Yen. Either way we pay the price: higher import costs, a cutback in spending on cheap foreign goods, rising inflation, perhaps chaotic financial markets, a lower standard of living. Mark these words well for what they're worth (not much some will say): China holds the keys to our kingdom, and our Hummers. Their willingness to buy our bonds, their philosophy of fixing their currency to the U.S. dollar will one day be tested. And should their patience be found wanting, all of their neighboring Asian China wannabes will move in near unison. Reflation's second round will have begun, U.S. interest rates will rise, our goods in the malls and the showrooms will be less affordable, and the process of national belt tightening and increased savings will have begun."

The Fed is between the devil and the deep blue sea. If the trade imbalance keeps at current levels, then foreign holding of US bonds will rise dramatically. At low interest rates, this is not a huge drag on the economy. But what if rates rise and we start having to send $100 billion or $200 billion to foreign bond holders which would only add to our trade deficit? Can the Fed really allow rates to rise prior to a drop in the trade deficit?

What's a central banker to do? The above problems if allowed to develop before the recovery is clearly established will mean a recession and deflation. Thus, the Fed must feel, as evidenced by their policies, that they have to do everything possible to get an economy to grow its way out of the problem, even if it means a little inflation.

And there is the disconnect. The bond market can see exactly what I have described. Inflation will ultimately mean higher rates. The Fed does not think we can afford higher rates, which might possibly choke off a fragile recovery.

Thus, just as Volker caused a recession to bring down inflation, the Fed is willing to risk inflation to try and avoid the scenario Gross describes.

Do you think the Fed governors do not see the same imbalances that Gross and a hundred other analysts, including yours truly, see? However, rather than acquiescing to the decline of our "hegemonic rule" as Gross terms it, it is ingrained within a central banker's DNA to at least attempt to fight the tides of said decline.

And thus, to establish a "reasonable" set of policies such as McCulley asks for would mean the Fed may to all too soon feel forced to abandon them in order to deal with the potential crisis resulting from today's imbalances. Such a reversal has the potential for creating far more havoc than the current environment of "guess what Greenspan is feeling today." Since the exact nature of the potential crisis is unknown, how can you set a proper course? Better, says Greenspan, to allow them ultimate flexibility than adopting polices. Trust me.

And maybe there won't be a crisis and we do grow ourselves out of the problems, at least for awhile. The current economic growth is very for real, at least for the next 6-9 months. What if oil then comes down in price? Rates drop again? Jobs pick up and the economy gets on sound footing. A new round of technology investment ensues. There are lots of good things that can happen in the short term on the road to balancing the twin deficits. If you are a central banker, you are counting on them.

At the end of the day, it does not matter whether McCulley, Mises or Greenspan is right. Greenspan is going to win this debate, as he holds the cards until someone takes them away. Rates will stay low until the recovery is on a sound footing and producing jobs or inflation is truly back. We will know when that moment is when he tells us. And therefore risk premiums are going to stay high.

Dallas, New Orleans and New York

It is time to quit as there are lots of family events tonight and all this weekend, and I need to go and prepare. The twins are home from college and the boys want a night out. I see meat and games in my future.

I will be the keynote luncheon speaker at the National Investment Banking Association meeting in Dallas September 18. I will be speaking at the New Orleans conference October 29-November 1 (details and sign-up forms next week). I am currently scheduled to speak in New York at a Bank of New York conference November 12, and will be in Chicago October 8. I am trying to stay close to my computer until then and finish my book so I can get on with my life.

I am behind on my writing (what else is new?) and will hopefully soon be back on schedule with my second letter. For those who are interested and who qualify, I write a free letter on hedge funds and private offerings called the Accredited Investor E-letter. You must be an accredited investor (broadly defined as a net worth of $1,000,000 or $200,000 annual income – see details at the website.) You can go to www.accreditedinvestor.ws to subscribe to the letter and see complete details, including the risks in hedge funds. (In this regard, I am registered representative of the Williams Financial Group, an NASD member firm. See the web site for details.)

Final note: I will be turning 54 on October 4. I started in business at 24, after graduating from seminary. Thus, it will be roughly halfway through my "working life," as I do not even want to think about retiring until my mid-80s (I am having way too much fun), so I will be doing a special letter on what the next 30 years could look like, given the acceleration of change that we are seeing, both technological and social. Please feel free to share your thoughts.

Your seeing lots of opportunity analyst,

John Mauldin