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San Francisco. Bermuda, and Real Clear Politics

By John Mauldin

A battle plan, we are told, seldom survives contact with the enemy. Nonetheless, military leaders throughout the world wisely persist in making plans they know will be changed time and time again once the battle starts. Contingency plans are made for all sorts of events, whether likely or unlikely, on the off chance that when something goes wrong (and Murphy assures us it will) that there will be a plan to deal with the next crisis, even if it is to declare victory and go home. Armies train to fight in every form of terrain, in all types of severe climes, as who knows from whence the next source of conflict may arise?

What would we think of a military force that failed to plan or train? We might question the political wisdom of a particular course of military action, but we expect our various militaries to be professional – to have planned for many different scenarios in which they might be called to act.

This week we watch as again the plans of governments and companies, of individuals and families for dealing with catastrophic events are put to the test. Can you imagine the disaster and loss of life from the three hurricanes (with more apparently on the way!) that would have happened had everyone waited until the winds and waves were at the door?

Should we expect that our economic generals will not also plan for various throws of the economic dice from Dame Fortune? Should not they in advance map out their calculus of response to all sorts of attacks upon the common economic good? So it is, gentle reader, that this week we take notice of the battle plans of the Federal Reserve to combat that most serious of monetary enemies, the Zero Bound.

The Zero Bound Dilemma

What would happen if interest rates went to zero? It was just last year when we were asking ourselves that question I know, the Fed is raising rates now. Zero interest rate issues are so yesterday's worry. As Dennis Gartman points out, whenever the Fed starts the process of raising or lowering rates, they generally go much further than anyone anticipates at the beginning of the process. No one in January of 2002 as rates started to come down thought that rates would go to 1%. But deflation became the concern. Was the Fed powerless to stop it? What would happen if interest rates indeed went to zero and the Fed had no more cuts in its arsenal?

It was around that time that Ben Bernanke, as many will recall, gave the answer in his famous "Fed printing press speech" in November 2002. (Prior to his 2002 appointment as a Federal Reserve governor, Bernanke was the chairman of the department of economics at Princeton University. He was the director of the monetary economics program of the National Bureau of Economic Research (NBER) and the editor of the *American Economic Review*. He co-authored a widely used textbook on macroeconomics and is one of the more influential governors.)

Most pundits focused on the printing press part of the speech. In my opinion, that was a cute anecdote but nowhere near the important part. What intrigued me was the part where he talked about "moving out the yield curve" to bring long rates down and thereby provide economic stimulus. Here we were in new intellectual and theoretical territory. Clearly, the Fed could do so (fix long term rates just like they do short term rates) if they wanted to, but to what effect? What would be the unintended consequences?

I draw your attention to a new 113 page paper by Bernanke. The paper is called "Monetary Policy Alternatives at the Zero Bound: An Empirical Assessment." Here Bernanke and fellow Fed governor Vincent Reinhart along with colleague Brian Sack author a paper discussing what actions the Fed could really take if interest rates dropped to zero and whether or not they could ascertain from historical evidence if they would work. As a service to my readers, I will summarize the issues presented later, thus saving you from pages and pages of rather mind-numbing equations and obscure referential economic language. (Masochists and insomniacs can see this paper and many others at: http://www.federalreserve.gov/pubs/feds/2004/#2004-48.)

They set the table with these thoughts at the beginning:

"Central banks usually implement monetary policy by setting the short-term nominal interest rate, such as the federal funds rate in the United States. However, the success over the years in reducing inflation and, consequently, the average level of nominal interest rates has increased the likelihood that the nominal policy interest rate may become constrained by the zero lower bound on interest rates. When that happens, a central bank can no longer stimulate aggregate demand by further interest-rate reductions and must rely instead on "non-standard" policy alternatives.

"An extensive literature has discussed monetary policy alternatives at the zero bound, but for the most part from a theoretical or historical perspective. Few studies have presented empirical evidence on the potential effectiveness of non-standard monetary policies in modern economies. Such evidence obviously would help central banks plan for the contingency of the policy rate at zero and also bear directly on the choice of the appropriate inflation objective in normal times: **The greater the confidence of central bankers that tools exist to help the economy escape the zero bound, the less need there is to maintain an inflation "buffer," bolstering the argument for a lower inflation objective**." (emphasis mine)

Before we get too far into today's letter, let me start with what is a small heresy to many of my readers. This week's letter is not going to deal with whether or not a Fed policy of lowering rates or providing stimulus is appropriate. For purposes of this discussion, it is irrelevant. The Fed is not going to listen. We are going to explore what I think they will actually do.

When armies are gathering, smart people move away from the battlefield. If the Fed decides to use its arsenal to fight deflation on some future economic battlefield, you do not want your investments to be at ground zero. Arguing about dialectic materialism or whatever the current political nonsense is does little good when there are bullets in the air. Likewise, debating theoretical economics might make us feel good, but it will not protect your retirement portfolio.

An Unwelcome Fall in Inflation

Let's start with a summary of recent Fed policy and where we are today. Inflation as of late 2003, early 2004 had fallen about as low as it could go without being too close to deflation. Recessions are by definition deflationary, and having one in the current low-inflation environment would probably lead to outright deflation and bring up thoughts of Japan. The Fed repeatedly referred to "an unwelcome fall in inflation" in the meeting summaries as a possible risk to the economy. Remember, those words were used only last year.

Low interest rates were clearly a major stimulus to the economic recovery. The recession of 2001 would have been much deeper without aggressive Fed action combined with Bush's repeated tax cuts. The lowest mortgage rates in 40 years led to a booming housing market as more people could afford to buy first-time homes, and more people could afford to move up to larger and newer homes. In addition, mortgage refinancing allowed consumers to lower their mortgage payments as well as take money out of their home equity for other purchases. If interest rates (and especially mortgage rates) were to rise significantly in a fragile recovery that is largely stimulus driven, the recovery could be aborted before it has time to develop a firm foundation in business spending. Thus Fed policy was to keep rates lower for a longer period than in any previous recovery.

But what would happen next? What happens when it is time to raise rates (and/or the market does it for you) or if business spending (the third leg of the economy) is not prepared to pick up the slack from slowing housing and consumer sectors? What does the Fed do then and what are the likely results of its actions?

As I wrote early this year in Bull's Eye Investing:

"The members of the Federal Reserve are genetically programmed, deep within their economic DNA, to fight recessions with all the tools available, and especially a deflationary recession that might develop. They do not believe that it will make things worse….They will risk a little inflation in order to drive a stake through the heart of the deflationary vampire. The belief (or hope) at the Fed is that with enough stimulus we can work through the hangover of the 1990s (debt, deflation, excess capacity, dollar bubbles, trade deficits, etc.). Rather than one very big recession that hits the reset button on the economic imbalances created during the 1990s, the Fed hopes to slowly deal with them one by one by growing our way out of the problems, stimulating demand every time we slip nearer to deflation and/or recession."

Now, fast forward to today. The Fed is slowly raising rates. They will raise rates once again in a few days. The market seems to think they will raise rates at least once more this year, leaving us at 2% Fed rates by the end of the year. Some think they will then stop and wait to see if the coast is clear before they raise rates again. By coast is clear, they mean that the economy is still doing fine and job creation is proceeding apace. Full employment is a congressional mandate the Fed is supposed to work on. Paul McCulley of Pimco seems to be in this camp.

Others, like Gartman, think they will keep right on going as they work to keep inflation from coming back, another sometimes conflicting congressional mandate of the Fed. A 2% Fed funds rate is not even keeping up with inflation. Such rates represent a negative real interest rate, and will ultimately result in inflation. The thinking is that they will raise rates until they are at least at the level of inflation, and tack on a few points for good measure.

I think there may be a third way to look at the current situation. I think we can see hints of it in the Zero Bound paper. Let's go back to one sentence I quoted earlier:

"Such evidence obviously would help central banks plan for the contingency of the policy rate at zero and also bear directly on the choice of the appropriate inflation objective in normal times: The greater the confidence of central bankers that tools exist to help the economy escape the zero bound, the less need there is to maintain an inflation "buffer," bolstering the argument for a lower inflation objective."

But how confident can a central banker be? Not all that much, judging by a few sentences further down the page, "Despite our relatively encouraging findings concerning the potential efficacy of non-standard policies at the zero bound, caution remains appropriate in making policy prescriptions. Although it appears that non-standard policy measures may affect asset prices and yields and, consequently, aggregate demand, considerable uncertainty remains about the size and reliability of these effects under the circumstances prevailing near the zero bound.

"**The conservative approach—maintaining a sufficient inflation buffer and applying preemptive easing as necessary to minimize the risk of hitting the zero bound — still seems to us to be sensible.** However, such policies cannot ensure that the zero bound will never be met, so that additional refining of our understanding of the potential usefulness of nonstandard policies for escaping the zero bound should remain a high priority for macroeconomists." (emphasis mine)

The key words to me are "maintaining a sufficient inflation buffer."

Let's look at what happened as the last recession started. Inflation was still above 3.3% in 2000 prior to the start of the recession. In 2001, the Fed had 6.75% fed fund rates, so they had plenty room to lower rates to try and provide stimulus to the economy. In 2001, the government budget was in surplus and we were actually lowering government debt (although we were still incurring Social Security obligations).

There was budgetary room for significant tax cuts to work in tandem with lower rates to maintain consumer spending. Additionally, Bush and congress sent billions in direct payments not once but twice to consumers. To top it off, the Fed was able to talk long term mortgage rates down to their lowest level in 40 years. This kept the housing market alive but also lowered consumer costs as million refinanced. Home-owners also pulled out billions as they refinanced their homes.

It was a perfect storm of stimulus. It produced what I called the Steroid Economy. GDP went to a rate of over 8%. Slowly employment began to creep back up. Unemployment is now down to 5.4%.

Let's make no mistake. Without all this stimulus, and coming off the bursting of the largest investment bubble in history, not to mention the severe shock of September 11, we would have entered into what Bill Bonner calls a "soft depression" in his book, Financial Reckoning Day. Without such aggressive policies we would have slipped into deflation. Unemployment would have gone to 8% or higher. A difficult world-wide recession would have resulted as the engine of the American consumer would have lost its fuel. But the point is that we did have the stimulus and it did work. You can argue that we merely postponed the pain, but others would argue that it was simply minimized. In any event, that is an argument for another day. All that is history and at this moment we need to think about the future.

The Problem of the What Ifs

Now let's look at the question "What would happen if the US economy were to go into recession early (or even the middle of) next year?" There would be trouble in River City, that's what.

First, inflation is still less than 3%. Using the measure that the Fed prefers, the GDP deflator, it may be less than 2%. (Because it isn't based on a fixed basket of goods and services, the GDP deflator has an advantage over the consumer price index (CPI). Changes in consumption patterns or the introduction of new goods and services are automatically reflected in the deflator.)

Interest rates are obviously already low. There is no room for future tax cuts of any significance. Even if mortgage rates were to drop back to close to 5%, much of the boom from refinancing has already happened.

In short, there are few "standard policy" means to try and jump-start an economy.

If we were to soften into a recession in early 2005 (an event which is not all that likely, but we are talking hypothetical here), we would soon be talking of deflation.

2% inflation is not a sufficient buffer from a deflationary recession when interest rates are only 2%, at least from a central banker's view point. The Fed is on a course to increase rates as fast as possible while also allowing inflation to rise more than one would normally think. They need to re-load their guns. But they cannot risk the economy getting soft at this point, as the only "weapons" they would have would be lowering rates to zero. The "real" stimulus that one would get at the Zero-Bound is not all that much more than 1%.

So perhaps (and this is what I think) both the McCulley's and the Gartman's of the world are right. The Fed will go slow but they will keep going longer than we now think, perhaps pausing here and there, letting a little inflation pressure build, because they do not in fact want to experiment – and experiment is the word, make no doubt - with "non-standard policy alternatives."

The best outcome, and what is the current "plan," is one where business starts to invest and spend their cash horde (cash to debt ratios of US businesses are at cycle highs), employment drops below 5%, and consumer spending continues to modestly grow. Hopefully long term rates don't rise that much and therefore housing keeps rocking along. The Fed can continue to raise rates, we get a little "buffer" inflation and things are back to normal. The longer we go without a recession, the higher that rates go, the sooner the Fed can return to its comfortable role of inflation fighter. The next recession comes along and the Fed is ready to make it a short, brief affair. Hey, it could happen.

We Have Met the Enemy – Where's My Battle Plan?

However, no battle plan survives contact with the enemy. In next Monday's Outside the Box, I offer an essay from Donald Coxe, who gives us his insights about the current oil situation. For the first time in decades, he notes, the free market is setting the price for oil. Tongue in cheek, he notes that we may one day in the future long for the good ole days when OPEC could set the price.

Dennis Gartman (that name again) sent me this note: "With the FOMC to meet, another Governor was very public with some comments that we found worthy of note. Edward Gramlich, speaking in Kansas City, said that

'It is virtually inevitable that (oil) shocks will result in some combination of higher inflation and higher unemployment for a time....The worst possible outcome is for monetary policy to let inflation come loose from its moorings...All things considered, though the present oil shock may not be as significant as the shocks we remember from the 1970s and 1980s, it will definitely register... [Complications] ...begin with inordinately low interest rates.... With the shocks, nominal rates would still likely follow an upward path, though the economic reactions would be bumpier, with temporary rises in both inflation and unemployment.

"We take from this at least one strong vote in favor of tighter monetary policies going forward."

As noted above, the best outcome would be for a long period of economic stability as the world resets. But such periods are the exception and not the rule, so let's look at what contingency plans the Bernanke, et al, are thinking if we enter an earlier recession and interest rates fall to zero without the economy starting to recover.

In such a situation, the immediate goal would be to lower long term rates and thus mortgage rates, and to keep lowering them until the economy finds "traction." How to do that?

Let's remember that last year the Fed "jaw-boned" rates down. Simply hinting that they would use non-standard policies, coupled with the words "a considerable period of time," drove mortgage rates to their lowest level in four decades. Bernanke and team think that might prove effective again.

"Our results [research] provide some grounds for optimism about the likely efficacy of nonstandard policies. In particular, we confirm a potentially important role for central bank communications to try to shape public expectations of future policy actions…If central bank 'talk' affects policy expectations, then policymakers retain some leverage over long-term yields, even if the current policy rate is at or near zero."

They note on pages 40-50 that there are statistical reasons to suggest that the market well and truly did respond to the indications from the Fed about future policy. Well, duh. Statistics? We don't need no stinking statistics to agree that the markets are particularly sensitive to Fed pronouncements. But they do make a point, in that merely talking about policies will move the market.

But what about if talk is not enough? Then, they note, the Fed could actually set the rate for the ten year treasury, offering to buy from all comers at a lower fixed rate for a period of time.

On page 64 we find these remarkable sentences when discussing whether or not the Fed could lower interest rates up the yield curve:

"The events that conveyed information about the possibility of Federal Reserve purchases of Treasuries most likely also conveyed information to the public about the risk of deflation. Changes in the perceived risk of deflation would affect long-term yields independent of supply effects. Nonetheless, it is interesting to note that the downward spike in figure 9 stands out the most for the ten-year Treasury yield—the security that was perceived to be the most likely candidate for Federal Reserve purchases.

"If the Federal Reserve were willing to purchase an unlimited amount of a particular asset, say a Treasury security, at a fixed price, there is little doubt that it could establish that asset's price. Presumably, this would be true even if the Federal Reserve's commitment to purchase the long-lived asset was promised for a future date.

"Conceptually, it is useful to think of the Federal Reserve as providing investors in that security with a put option allowing them to sell back their holdings to the central bank at an established price. We can use our term-structure model to price that option. As a purely illustrative example, suppose the Federal Reserve announces its willingness to purchase the current ten-year (zero-coupon) Treasury security in one year at a yield of 5-1/2 percent."

For those interested, they also compare the situation in Japan and other issues, but let's cut to the important (and very clear) summary:

"Despite our evidence that alternative policy measures have some effect, we remain cautious about relying on such approaches. We believe that our findings go some way to refuting the strong hypothesis that nonstandard policy actions, including quantitative easing and targeted asset purchases, cannot be successful in a modern industrial economy. However, the effects of such policies remain quantitatively quite uncertain. Thus we believe that policymakers should continue to maintain an inflation buffer and to act preemptively against emerging deflationary risks (Reifschneider and Williams, 2000). There are tradeoffs, of course, in that erring toward the side of ease when rates are low tends to create an inflation bias; but the goal of zero inflation seems unwise in any case, and a systematic tendency to err toward an easier policy when adverse shocks bulk large and nominal interest rates are low can be offset by a willingness to unwind that accommodation quickly once the situation clears.

"Shaping investor expectations through communication does appear to be a viable strategy, as suggested by Eggertsson and Woodford (2003a,b). By persuading the public that the policy rate will remain low for a longer period than expected, central bankers can reduce long-term rates and provide some impetus to the economy, even if the short-term rate is close to zero. However, for credibility to be maintained, the central bank's commitments must be consistent with the public's understanding of the policymakers' objectives and outlook for the economy."

I take that last sentence to mean the public has to feel they really will set long term rates and not just talk about it as they did last time. The Fed will have to be prepared to ante up, to make good on their bluff.

In such an environment, the unintended consequences will be huge. The dollar could (and probably would) come under great pressure. The result might (and I think would) be that we end up with our old friend stagflation. But that is a story for later.

Stock Trader's Almanac Top Investment Book

In closing, I should note that if you would like more thinking along these lines, I invite you to go to chapters 12-15 of Bull's Eye Investing.

I noticed a few weeks ago that Stock Trader's Almanac named Bull's Eye Investing as one of "The Year's Top Investment Books" in the upcoming 2005 edition. James Altucher kindly writes:

"John Mauldin writes a popular email newsletter which I have been fortunate enough to receive for the past year, so when his book came out I wondered whether there would be anything new. Unfortunately, there's so much new in it that I have to read it for the third time, every now and then stopping to check the extensive third-party sources and research he references in backing his claims. I don't always agree with him on everything but this is a must-read for the investment professional and individual investors....

"In several chapters he details (and I can't stress this enough - he DETAILS) his concerns on pension funds being underfunded, the demographics of age in the United States, the effect of a widening trade deficit on our economy and on all the economies we trade with once we start to falter (if we start to falter), and why the psychology of the average investor prevents him from taking appropriate action (i.e. right now)....

"If I were to summarize the main message of each chapter it would be: don't believe the hype. The hype in earnings, the hype in the economy, the hype from Greenspan, the hype from those selling advice (and avoid systems-sellers if the systems return more than 10% a year, avoid the mutual funds and academics who tell you the market always goes up 6-7% a year in the long run, avoid gold bugs (but not completely) and growth stock fanatics and ...) and most of all don't believe your own hype."

You can find **Bull's Eye Investing** at your local bookstore or at www.amazon.com/bullseye .

Real Clear Politics

Let me suggest you go to www.realclearpolitics.com and bookmark it. Every day, they offer political commentary from newspapers and magazines from all over the country, both conservative and liberal. But what is really fun is they are the single best source for keeping up with all the plethora of polls. I know for a fact that the major news organizations use my friend John McIntyre's web site as their one-stop main source for information on the polls.

Now, I have to run as my plane to Bermuda leaves in a few hours and I still need to pack. I had less time to edit this week's letter so I shudder to think what typo's are left. Oh, well. I will catch a few extra typo's next week to make up for it.

If you would like to meet in San Francisco, I still have a few times left for meetings. Write my daughter Tiffani at Mauldin@2000wave.com and she will make it happen.

Your already flying before he gets to the plane analyst,

John Mauldin