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By John Mauldin

Today's letter may be one of the more controversial, or at least debatable, letters I have written in some time. I take a very out of consensus position on interest rates. As promised last week, we deal with the question, "What ever happened to the Muddle Through Economy with the GDP is growing at 7.2%?" Is it time to abandon the concept? I think this week I will leave you a few things to think about, so let's get started.

First, let us recall Keynes' bon mot when asked about why he changed a previously stated position, he replied "Sir, the facts have changed, and when the facts change, I change. What do you do sir?"

I first used the term Muddle Through Economy to describe my view of what the economy would be in 2002. It was in hindsight a rather good call. By Muddle Through I mean that the economy will grow, but by less than trend or less than the 3% historical average. There will be quarters where growth is well above trend, but over the long-term I thought that the average would be below trend.

At the beginning of this year, I was less convinced, but still saw a continuation of such for the first half of the year. My very clear position was that without a tax cut and other stimulus we would face the probability of a recession sooner rather than later. We got the tax cut, which kicked in for the third quarter as well as rebate checks mailed into consumer hands. In the second quarter we had a massive mortgage refinancing binge which was the result of record low interest rates engineered by the constant referral to deflation by the Fed, along with the implications the Fed would move to lower long term rates. The resulting spending showed up the third quarter and is still being felt.

It was clear early in the third quarter that things were improving. I readily admit to being caught by surprise as to the size of third quarter growth. In that regard I have a lot of company.

Let us remind ourselves one quarter reversing itself does not necessarily mean a new trend. The key is to determine how sustainable any above trend growth is likely to be or how pervasive any recession is likely to be. It is at times of powerhouse growth or in the midst of a recession, that the notion of a Muddle Through Economy will be most called into question. It is a simple human tendency to project recent events into the future. We tend to see "facts" as support for our basic bias.

We "talk our book." By that I mean if you are a long only manager, then every fact is seen as bullish or irrelevant. The opposite if your portfolio is short. If you own

gold, then there are a hundreds reasons why gold will go up, and if it doesn't it is clearly a conspiracy. If all you have is a hammer, the world looks like a nail. It is at these times we must return to basic premises.

Have the facts changed? My answer is that the long-term imbalances and trends which will result in a decade long Muddle Through Economy or below trend growth are still in existence. They have not changed nor have the challenges been addressed in a manner to suggest they have been dealt with. But the short term facts have changed, and they have changed materially. In fact, they have changed so much that we could see above trend growth in all of 2004, or at least until the 4th quarter.

First, we will briefly look at the long term challenges and then look at how sustainable the short term material changes might be.

1. I am going to quote a rather remarkable speech by Fed governor Ben Bernanke made yesterday (Nov. 6) at the Global Economic and Investment Outlook Conference at Carnegie Mellon University. I like Bernanke in that he writes in a very clear style. Whether or not you agree with him, it is refreshing to find someone associated with the Fed who can clearly state a position without forcing the reader to try and read the nuances to gather the import of the words. (There are some others but Bernanke stands out in this regard.) This stands in stark contrast to Greenspan's speech of yesterday which, I might add, has everyone trying to figure out what he meant. It is all too often too easy to read what you want to read into a Greenspan speech. Quoting from the Bernanke speech:

"As is widely recognized, the U.S. current account deficit cannot be sustained indefinitely at its current high level and will eventually have to be brought down to a more manageable size. However, eliminating the U.S. current account deficit too quickly is neither desirable nor feasible. Any attempt to do so would probably involve sharp reductions in domestic spending, which would have far worse effects on U.S. employment than the current account deficit does. [to attempt to do so]… is simply not a feasible alternative right now. For now, our best strategy is to encourage pro-growth policies among our trading partners, in the expectation that more-rapid growth abroad will raise the demand for U.S. exports."
http://www.federalreserve.gov/BoardDocs/Speeches/2003/200311062/default.htm#f11#f11

The trade deficit is $500 billion a year and growing. This is an unsustainable trend. When does it stop? Federal Reserves studies suggest it should have stopped $100 billion dollars ago. Practical analysis, which I have documented at length, suggests it could go on for some time. But the longer it goes, the more difficult the adjustment. It will continue as long as foreigners continue to take our electronic dollars for their goods and services. Japan and China alone financed 45% of our trade deficit in the first half of this year (almost $120 billion) by buying US treasuries, helping hold down rates.

Bernanke very clearly shows us the consensus among the international central banking community. Slow and steady progress to a "manageable" size (whatever that is) so as not to damage the main engine of the world economy, the US consumer. If foreign nations wanted to pull the plug on the US economy, they could do so in a Shanghai

minute. Simply selling our bonds and forcing rates up would tank the economy, as we will note later. That foreign nations do not do so, and are willing to take paper they clearly know will be worth less (NOT worthless, I might add) in the future, is clear testimony to that current consensus.

A dramatic adjustment, as Bernanke alludes to, would cause a dramatic recession. A slow adjustment which is the hoped for outcome will also be a slow drag on the US economy.

2. Interest rates are going to rise over time. It is a matter of when, not if. The carrying cost (interest rate expense) for consumers is going to rise along with them. Much (but certainly not all) of the growth of the US economy stems from consumer borrowing. While I do not currently think consumer debt levels are in a crisis status, they are approaching a ceiling. There are limits to the ability of US consumers to increase their exposure to debt. Debt and the cost of interest cannot long rise faster than income, as it has been doing for several decades. Rising rates will mean increased costs for that debt, much of which is not fixed. Increased costs means less debt growth which means less consumer spending. That means a slower growing economy.

Buttressing the above fact, look at the positive employment report of today. Buried in that data I note that average hourly earnings rose by a mere penny during the last month, to $15.46. Indeed, since earnings did not rise at all in September, that means one thin penny for the last TWO MONTHS! That is a 0.4% annual pace, which is less than inflation. There was only a 2.4% rise in earnings over the last year, or only slightly more than inflation. If one cent was all that earnings could rise in the hottest two months in 19 years (since 1984, if one looks at GDP), then what are we to think of future individual earnings growth? Without consistent earnings growth you cannot have continued and consistent consumer credit growth. There is only so much a family can borrow and adequately service.

In 1980, with interest rates at 15-18%, household debt payments were 11% of disposable income. With the lowest rates in 40 years, debt service is now close to an all-time high of 13.3%, down slightly in the last year. Total financial obligations are over 18% of disposable income. Again, this is close to an all-time high. We are approaching the limits of significant credit financed growth.

The Unsustainable Trend

Wait, can't we borrow against the values of our ever rising home prices? (Note I did not say home values.) Since 2000, mortgage debt has risen $2.65 trillion (with a T) to almost $9 trillion. That is a growth of 42%. Nominal GDP (we must include the affects of inflation to be accurate on the assessment) has only grown 14.4% over the same period. Can someone say unsustainable trend? Is anyone remotely suggesting that the rate of mortgage debt growth will rise by $2.65 trillion in the next 3.5 years, which would "only" be a 30% growth rate against a probable nominal GDP of 15%? How much stimulus did

mortgage refinancing and increased home loans contribute to the growth of the US economy in the past few years?

I am not suggesting that consumer credit actually contracts, although it might if rates rise too fast. I am not suggesting the housing market contracts over the decade, although higher rates will certainly be a drag on housing prices. For a below trend Muddle Through Economy to once again manifest, growth in credit and the rate of mortgage growth simply has to slow down.

There are limits to such abnormally high credit growth, and we are near them. Again, please, do not take that to mean the world ends. Credit and mortgage growth will simply fall back in line with GDP, earnings and inflation. But "in-line" growth is not the substance of roaring above trend economies.

3. The Baby-Boom Generation will start to spend less and save more as they get increasingly close to retirement and find their 401k's have not rebounded to the levels they once thought. 10% compound growth of the stock market will not happen. As I have written many times, we are in a secular bear market and the historical precedents suggest zero (or very little) growth in the stock market over the next ten years as valuations drop close to single digits. 80% of the real growth of the stock market since 1982 has been in increased valuations. By that I mean investors are willing to pay more for a dollar of earnings. To think such growth in valuations over the next 10-20 could repeat is simply ludicrous.

That does not mean I am predicting a current crash of the stock market. I am not. There are reasons to think this bear market rally might have some more legs. But that does not take away from the fact it is a bear market rally. We are at nosebleed valuation levels, especially in the NASDAQ. As the formidable Jeremy Grantham put it in this week's Barrons, "This is a sucker rally."

However, whatever happens in the next 6 months or year, the long term historical trend is clear. It is bearish for Boomers who are counting on wealth reflation for their retirement. Pretty soon (in the next few years) you will see savings levels increase and their outstanding debt will be reduced. This will slowly let the air out of the growth in consumer spending, which is a huge part of the US and world economy. Again, this is not some fall off the cliff moment in time, but it will mean gradual slower growth and a Muddle Through Economy.

The International Labor Arbitrage

4. What Stephen Roach calls the International Labor Arbitrage will hold down job growth in the US for much of this decade. Simply put, there is a lot of job growth due to American demand and business. It is just that the job growth is in China and India. Until job growth in the US can maintain itself consistently above trend, it is my position that slower economic growth is in the cards. The adjustment to the increasing portability of jobs is going to be a drag on job growth. It will not be the end of growth, but certainly

slow things down. Slow job growth means slow economic growth. Increased foreign competition for service jobs means lower pay levels in the US, which is a drag on growth.

(By the way, as boomers start to retire, that will actually help the employment picture, so employment begins to rise above recent trends later in this decade and increasingly as the next decade progresses. The Muddle Through Economy will eventually give way to a period of above trend growth, for a variety of reasons I outline in my I-promise-I-am-almost-finished book.)

But sustainable long term above trend growth needs to see the creation of jobs, which is precisely what we have not seen. But aren't things getting better? Didn't the jobs data of today show a clear growth in jobs? Aren't continuing claims falling?

The answer is a clear yes, but with an asterisk. Non-farm payroll employment rose by 126,000 jobs. The number of unemployed persons, 8.8 million, was essentially flat. Unemployment remained essentially unchanged at 6.0%. As Bernanke noted in his speech, because of the growth in the population economists believe that the US economy must generate job growth by 150,000 per month to materially decrease unemployment.

Further, the report tells us, "…in October, 1.6 million persons were only marginally attached to the labor force, which is 170,000 more than last year. These individuals wanted and were available to work and had looked for a job sometime in the prior 12 months. They were not counted as unemployed, however, because they did not actively search for work in the 4 weeks preceding the survey. 462,000 of those were "discouraged workers," or people who were not looking for jobs because they believed there were no jobs available to them. This number is up 103,000 in the last 12 months." (from the BLS report)

Average job growth in the third quarter was about 85,000 per month in the hottest quarter in 19 years. Manufacturing lost another 24,000 jobs. Employment in the food sector rose by 13,000, or about 10% of the total employment rise, in response to strikes in the grocery stores in California.

If employment was truly getting ready to sky-rocket, we should see the number of hours worked rising. It is up only 0.4% over the last two months and down year over year. Overtime barely bulged. Hourly pay did not increase. Again, this is the hottest quarter in years and no growth in these important statistics?

Bernanke gave us a litany of factors which point to a weak labor market. After a very interesting (to me, at least) analysis of the relative strength and weaknesses of the two competing surveys of employment, which are clearly not in sync, he goes on to say:

"Whatever the verdict regarding the relative reliability of the two surveys, their differences should not obscure the fact that the U.S. labor market has been weak. Indicators of labor market underperformance include:

(1) the unemployment rate, which remains 1.9 percentage points above its level at the March 2001 peak of the business cycle;

(2) a significant decline in labor force participation, particularly among younger workers;

(3) the rising share of the unemployed who have been out of work six months or more;

(4) the relatively slow decline in initial claims for unemployment insurance, as well as in continuing claims (though both of these have improved a bit lately);

(5) the fact that the Conference Board's index of help-wanted advertising remains below the level of the recession trough; and

(6) the relatively pessimistic views about prospects for the labor market revealed in surveys of both employers and workers. (For example, the Conference Board's index of household perceptions of job availability has continued to fall this year and currently is close to the lowest levels since 1993.)"

I would also note that productivity rose by over 8% in the third quarter. While this is wonderful for profits, and for the economy as a whole, as it means we produce more "stuff" or services for less per unit cost, it does not contribute to a demand for new employees to meet rising demand.

Let me finish this section by acknowledging that the recent job reports was real and it was a considerable improvement over prior months and years. I hope it continues, and for reasons I mention below, I think we will see some improvement over the next year. But

(1) given the long term pressures of the international labor arbitrage and the fact that 7.2% growth produced just 265,000 jobs when

(2)combined with the probability that such growth will come down dramatically for reasons I outline below, the long term above trend growth of employment is in doubt, at least in my mind.

Let's stop here. Suffice it to say, I still think the long term growth trend for this decade is going to be Muddle Through.

But John, Are you Blind?

But what about last quarter? Why can't we see more of the same and a continuing economic boom, lasting for another 8 years, as I just heard one Yale professor and unrepentant cheerleader suggest on TV?

First, let me be very clear that I am not suggesting the third quarter 7.2% GDP growth was smoke and mirrors. Whether or not it was due to stimulus, it was very real. The growth this quarter is also going to be well above trend, probably close to 4%. That is very good, and no one could be happier about that than me. I much prefer to see

powerhouse growth to Muddle Through. I am not some congenital bear. But this growth does not have the earmarks of sustainability.

The Steroid Economy

Let's start this section with an analogy. In the early 70's, a young blond demi-god became Mr. America on his way to becoming Mr. World. Before steroids, Dave Draper built his massive frame the hard way. He pumped iron. Today he is 62. He is still one of the most muscular, powerful body builders you will have the pleasure to meet. He does it the old-fashioned way. He pumps iron. No drugs, no stimulant. Just good nutrition and hard work. (You can get his wonderful and well written weekly letter by going to www.davedraper.com, not to mention all sorts of health tips and wonderful pictures of him training with all the greats of my youth, including Arnold. It is my best source for motivation to get into the gym.)

I take a small steroid shot every 12 months, to control my fall allergies. For me, they are a life-saver. That extra "stimulus" is something I need to keep me productive in September and October.

But many athletes take large amounts of daily steroids to make them bigger, faster, and more powerful. Daily steroid use can work wonders. It can make some athletes into superstars. I remember watching Jose Canseco when he was a Texas Ranger. He put up Hall of Fame numbers and was absolutely a physical presence. After he retired, he admitted to using steroids, and was eventually jailed for violating the terms of his probation by using steroids. Did steroids make him a better player? Sure, but there is a price.

We all know what happens over time. The effects are well documented. The hair falls out. Even with the little blue pill, the equipment does not work. Joints begin to fail. Liver damage, high blood pressure, acne, irrational behavior, anger and a host of other side effects.

If you stop the steroids, the immediate muscular effect soon goes away, and pretty quickly. Even pumping more iron will not get you back to where the steroids had. It is a sad cycle. How many athletes do we look at and wonder, "Is it natural or is it steroids?"

I look at the economy and wonder the same thing. Is it sustainable or is it stimulus? Let's look at some numbers.

Over 3%, and as much as half, of the growth has been attributed to the $13.7 billion in child credit tax rebate checks which went out in July and August. This was a one time event.

The third quarter clearly benefited from the massive mortgage refinancing boom that occurred in the second quarter. Such refinancing has not stopped, but it has dropped significantly from second quarter levels.

Consumer credit grew by almost $10 billion over expectations in October. Estimates were $5.9 billion and actual was $15.1. Does anyone think debt did not play a big role in the third quarter GDP? (Of course, I suppose you could also say that means consumers are more confident.)

Thus, consumer spending grew at a 6.6% pace, while income barely budged.

Car sales grew at a 38.9% sales pace. This contributed significantly to the GDP numbers, and borrowed from future growth. Car sales clearly cannot grow at that rate next year.

Now let's look at some of the positive reasons for this growth. The tax cut simply put more money in the hands of consumers, and they obliged by spending it. This cut is not going away. While the child tax credit checks were a one time event, the tax cuts are with us until the Democrats control Congress.

Second, mortgage refinancing also lowered monthly payments at a lot of homes around the country. Yes, debt went up dramatically, but on a cash flow basis, which is how most people in the real world view their lives, things improved. There was more money left over to spend on "stuff." This is also real, and will last for many years (except for adjustable rate mortgages, but that is a problem for 2005).

Lower taxes and lower mortgages are ongoing stimulus, and will benefit the economy for some time to come.

Let's be clear about this. Without the combination of the two Bush tax cuts and a dramatic lowering of interest rates by the Fed, we would still be in a recession, and one that would be quite severe. Without the recent tax cut and massive second quarter refinancings, we would be in a very slow growth economy at best. The stock market would be in the tank. The charges the Democratic presidential aspirants are making about the worst economy since Hoover would be very true. (That does not mean I approve of the runaway growth in spending, however, and the huge rise in deficits. Bush should have put on the brakes. A few well-placed vetoes might help.)

The very clear hope of both the administration and the Fed is that the economy can begin to grow on its own, without continual injections of stimulus. By keeping the consumer alive, they are giving the business sector time to recover and hopefully take the lead for the next round of growth. Their hope is that the use of tax and monetary policy is like my annual use of steroids. It is remarkably beneficial and with no lingering negative side effects.

To the extent that the recovery is based upon tax cuts and lower mortgage payments, I think the recovery is sustainable. But how much was one time benefits (steroids) and how much from long term "pumping iron"? Is this the Dave Draper economy or the Jose Canseco economy?

That question being asked, let me give you a few reasons why I think the economy will continue to do well for 2004, barring some new shock. Primarily, it is because there is more stimulus on the way.

First, I think we are going to see oil prices drop in the next year, as Iraq oil comes online. Further, Dennis Gartman writes today that Nigeria is going to OPEC to discuss quotas, as they feel theirs does not take into account new production. Algeria is complaining about its low quota. Iran is subtly hinting it may leave OPEC so it can control its production levels. Russia is bringing more oil online every month. Drilling is up substantially in the US. Even Chad is now producing 500,000 barrels a month through newly opened pipeline.

The propensity for OPEC members to cheat is a given. There is the real potential for a sharp roll-back in oil prices, and that works just as well as a tax cut in terms of stimulus, except that it will not be permanent.

Second, there will be another round of "tax cut stimulus" in the spring, as tax refunds will be up due to many people not adjusting their withholding to reflect the new tax rates. As consumers adjust their with-holding levels downward at the beginning of next year, even more money will be available for consumer spending. In that regard, the effects of the tax cut have not been fully realized.

Going Out on a Limb

Third, and here is where I go out on a limb, I do not think the Fed raises interest rates prior to next year's election. This is clearly not the consensus view. Bond maven Jim Bianco argues forcefully that the Fed should be raising rates now (although he privately told me he doubts they will, now or before the election, for which he eloquently castigates them). Larry Kudlow, among others, states that Greenspan's speech this week is setting the groundwork for the removal of the "considerable time" language from the Fed comments, and that a few meetings following that removal rates will being to rise. He seemed to suggest late spring or next summer. The Fed will be following the market, just as it always does. Martin Barnes, the influential head of the Bank Credit Analyst, thinks the Fed will start raising rates next summer. It is never a wise thing to disagree with Martin's prediction, as his track record is solid, and has been so for decades.

I could go on and on with very astute and thoughtful analysts who believe the Fed will raise rates, starting by at least the summer of 2004.

I believe they are making their predictions based upon what they think the Fed should do, and not what they will do. I understand the rationale for raising rates. The market is clearly in agreement with the view the Fed will raise them, sooner rather than later.

I have my doubts, for multiple reasons. Let's go back to Bernanke's speech. I give you 5 paragraphs, but they are important paragraphs. I cut to the end of the speech (emphasis mine):

"**Because new workers are always entering the labor force, the U.S. economy needs to create something on the order of 150,000 net new jobs each month just to keep the unemployment rate stable.** When can we expect to see this (or a higher) level of job creation?

"A few encouraging signs have appeared in the labor market data of recent months…, However, so far these signals of recovery remain tentative; on the basis of the labor-market data alone, asserting that an employment recovery has begun would be premature.

"Nevertheless, I find it reasonable to expect that job growth will begin to pick up in the next quarter or two. Real GDP has accelerated considerably since the spring, and most forecasters project that it will continue to grow strongly in 2004. Moreover, it appears inevitable that the recent outsized gains in labor productivity will soon begin to moderate, reflecting both the normal cyclical pattern of productivity growth and the likelihood that employers will soon begin to exhaust opportunities to squeeze out still further gains in productivity. Arithmetically, if output growth remains strong and productivity growth returns to more normal levels, employment must begin to rise. Some solid job growth, in turn, would help to ensure that the recovery is self-sustaining by increasing consumer confidence.

"What role does monetary policy have in this scenario? **As you know, the Federal Reserve has a dual mandate, which requires the central bank to try to achieve both maximum sustainable employment and price stability**. An employment recovery will require continued strong growth in spending and output to induce firms to hire and invest more aggressively. **The employment half of the dual mandate thus suggests a need to continue the Fed's current accommodative monetary policy.**

"Of course, the Fed's policies must also be consistent with ensuring price stability --the other half of the dual mandate. As I noted in earlier talks**, I believe that the current low level of inflation, the expansion of aggregate supply by means of ongoing productivity growth, and the high degree of slack in resource utilization together leave considerable scope for a continuation of the currently accommodative monetary policy without undue risk to price stability.**"

This Fed, if Bernanke is any indicator, is not going to start raising rates until job creation is securely in place. He clearly stresses the job growth mandate. Not one quarter that may be the result of steroids, but the sustainable growth that comes from old-fashioned pumping iron.

Further, to allow interest rates to rise before the job growth pattern, plus a clear rebound in business spending, are clearly established risks hurting the consumer and the

housing markets. An economy that is pumping iron can handle interest rate rises with no problem. An economy that is on steroids can't.

I do not think Alan Greenspan is going to raise rates three or four months before an election. Once rates start to rise, the markets could react violently. Mortgage rates might shoot up, throwing the housing market into a spin before an election. It is just too much of a variable. Only if we are creating 200,000 jobs a month OR MORE will he be able to explain a rate hike in the summer. I do not think that happens, nor do I think the Fed does.

If the Fed was going to raise rates before the election, they should do so now. To do so prior to an election and subject the process to a number of unknown reactions would simply not be prudent or wise. But they are not going to raise rates now, for reasons stated above and because they are committed to an easy monetary policy. To raise rates now would subject them correctly, to charges of lying (or at the very least misleading) the investment community. Raising rates this year would throw the markets into turmoil.

No, Bernanke gave us the key when he talked about the trade deficits. It needs to be handled slow and steady. Ditto with the economy. Slow and steady. Remember Greenspan's speech last August, one of his few very clear speeches? He told us that the essence of central banking is risk management. It is better to buy insurance to protect against the unlikely event that would be a disaster than to manage for the most likely outcomes and ignore the potential disaster.

I believe the Fed is going to buy insurance for a growing economy in the form of lower rates until after the election. They will risk a little inflation, which they can handle with higher rtes later. In the short term, all this stimuli will work. In the long term, the imbalances will be corrected. When rates begin to rise, and they will, the economy will slow.

Let's watch the jobs report over the next few months and quarters. I fervently hope I am wrong. I hope Larry Kudlow ridicules me (in hindsight, not next week) for being such a pansie.

I am just not a believer that this recovery will be the continual boom that I read in the headlines today. I fear it is too much steroids and not enough pumping iron. We will return to the Muddle Through Economy in 2005, if not before.

Show Me the Way To Go Home

This has been one of the later Friday nights I have spent writing, which means there are probably more typos than usual. I hope you find my efforts worth your time. I am really focused on finishing the book, so had to catch up on my reading for this letter from scratch this morning. I have been thinking about the interest rate moves and the economy for some time, though. I recognize that making predictions, especially out-of-

consensus ones like the above, is usually a precursor to egg on your face. That being said, if I start thinking like the herd, what value to you would I be? I hope I made you think, even if I ultimately prove to be wrong.

Have a great week.

Your feeling lonely on the edge analyst,

John Mauldin