Taper Capers

John Mauldin | October 1, 2013

Michael Lewitt has long been one of my favorite thinkers and writers on matters economic. He's incisive, thorough, and, well, pithy. No holds barred. Today's *Outside the Box* features an extended excerpt from the October issue of Michael's *The Credit Strategist,* which he has kindly allowed me to pass on to you.

Michael leads off this month with some useful thoughts on "the art of learning to live with intellectual and emotional discomfort," which he says is a key requirement for successful investing. Then he extends these thoughts in order to give us a critique of recent Federal Reserve behavior that is different from any I've seen. The FOMC (Federal Reserve Open Market Committee), he says, has been seized by intellectual rigidity:

> The fact that central bankers are agonizing over whether to begin reducing bond monthly purchases by $10-15 billion within the context of a $3.5 trillion balance sheet suggests that they have lost the forest for the trees….
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> The FOMC now seems to consider quantitative easing as virtually a status quo policy tool. No doubt employment growth and inflation are not where the central bank would like them to be, but monetary policy is not going to solve those problems – and economists of sufficient stature to serve as governors of the Federal Reserve are supposed to know that.

Michael goes on to examine the FOMC's continued focus on employment and housing:

> Some now think that the FOMC won't be satisfied until U6 (the unemployment measure that includes discouraged and underemployed workers) drops below 13%. Recent comments from Mr. Bernanke started to back off from the 6.5% target and it is clear that the FOMC is trying to slip out of its own noose.) That is why the FOMC stressed what it termed a tightening in financial conditions in its statement. The one area of the economy that has undeniably seen deterioration is housing and there is little doubt that the 100 basis point increase in mortgage rates since June is the primary reason. The committee appears to have placed enormous weight on this factor in deciding not to taper in September.

Aside from housing, though, Michael doesn't see any meaningful tightening in financial conditions, and so "it is difficult to reconcile the Federal Reserve's dire view with what is actually happening in the financial markets."

You will only see about half of *The Credit Strategist* here today. There were also sections on the Middle East, JC Penney, bond-market liquidity, currencies, and stock and credit investment recommendations. You can subscribe to *The Credit Strategist* by going to www.thecreditstrategist.com.

In a note he sent me over the weekend, Ben Hunt lends weight to the notion that the Fed is intellectually (and, I would say, politically) frozen. I include that here as a follow-up to Michael's analysis:

> [I]f the Fed believes "a fairly typical cyclical recovery" requires all-out, pedal-to-the-metal QE, under what economic conditions would QE ever be wound down? What level of QE would be required the next time we experience a fairly typical cyclical recession? I mean … it's not like political risks and growth uncertainty are ever going to just magically disappear. It's not like the business cycle has been eradicated.

As regular readers of our ***Over My Shoulder*** service know, I have become a big fan of Ben Hunt's *Epsilon Theory,* and I featured Ben's "Uttin' On the Itz**"** piece last week in *Outside the Box.*

I write this note from Chicago, where I am in town for a series of presentations for my partners at Altegris. This morning I decided to trade my usual treadmill time for a longish walk on the lake front. The temperature was a pleasant and the view scenic, removed from the turmoil that is Illinois and Chicago, but the sky was overcast and the atmosphere somewhat gloomy. Which seemed appropriate after I what I had written about their pension and budget woes. I note, too, that city buses are adorned with ads for Indiana, trying to get businesses to relocate there to lower their taxes and overhead costs. I stayed at an historic old hotel, the Millennium Knickerbocker, which, like a metaphor for Chicago, has some great parts but is coming apart at the edges. Service is spotty, although I could get a cup of coffee at 6:30 in the morning as long as I was willing to walk around the corner to the Hilton.

At the desk as I checked in was a sign that said valet parking was $83 a night (not a typo!). When queried, they defended their pricing as cheap because other hotels in the area charged over $100. I was picked up for my early morning meeting with a full room of Merrill brokers. We parked the car for 90 minutes, and it set me back $33. Good thing inflation is so low in Chicago. On a bright note, I found a marvelous new pan-Asian restaurant called Jellyfish on Rush Street. If it was in Dallas it would be my new favorite place. Fresh-faced staff, management with a drive to please, and really good – no make that great – food. Chicago will not go away, of course, but doing business here is going to be a challenge.

I get asked what I think about the current shutdown of government, and privately, I admit I hate to think about it, which I suspect is how most of you feel. The real issue will be the debt ceiling. We will get through this, of course, but it is sad and difficult to watch – not just the budget issues, but the whole foreign policy show, the scandals, the NSA issues, not to mention the Fed feeling like they have to micro-manage an economy that can't be taken off the training wheels. It makes me wonder whether Chicago is not an even larger metaphor. I truly hope not. The federal government has so got to change. Actually, it will change; the question is how.

Your wondering what the catalyst will be analyst,

John Mauldin, Editor
Outside the Box

Taper Capers

Excerpted from the October, 2013 edition of *The Credit Strategist,* by Michael Lewitt

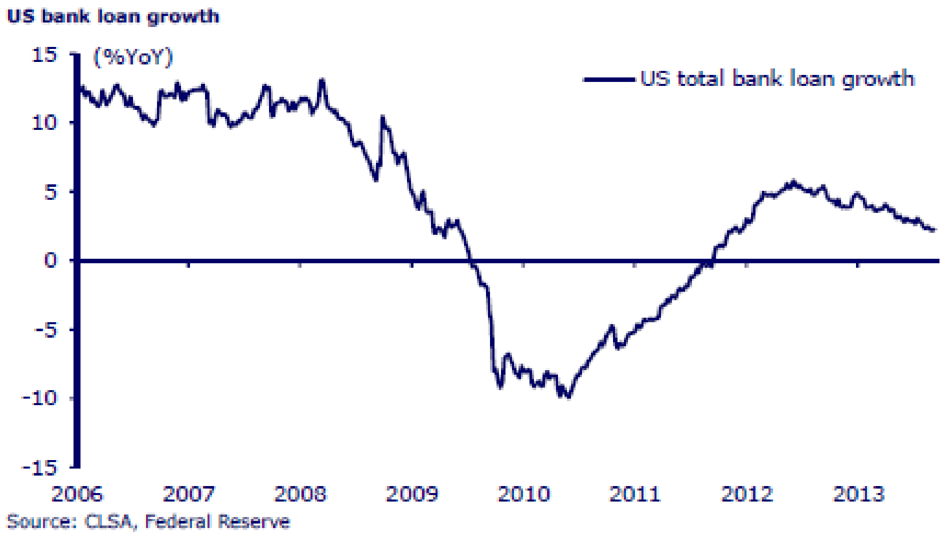
> A foolish inconsistency is the hobgoblin of little minds, adored by little statesmen and philosophers and divines. With consistency a great soul has simply nothing to do. He may as well concern himself with his shadow on the wall. Speak what you think now in hard words and to-morrow speak what to-morrow thinks in hard words again, though it contradict every thing you said to-day. – 'Ah, so you shall be sure to be misunderstood.' – Is it so bad then to be misunderstood? Pythagoras was misunderstood, and Socrates, and Jesus, and Luther, and Copernicus, and Galileo, and Newton, and every pure and wise spirit that ever took flesh. To be great is to be misunderstood.
>
> – Ralph Waldo Emerson

It is unrealistic to expect consistency in a world painted in shades of gray. As much as we may long for stability and coherence, we live in a world begotten in instability and chaos. We try to construct coherent narratives in order to bring sense to this disorganized and discordant reality, but if our stories are too neat they will mislead us into error. The ability to analyze the investment landscape requires the intellectual and emotional ability to reconcile conflicting ideas without forcing them into a false coherence. Investing is ultimately the art of learning to live with intellectual and emotional discomfort. A comfortable investor is a complacent investor, and a complacent investor is someone who is about to get his head handed to him.

The Federal Reserve is charged with promoting financial stability in an unstable world. This task is complicated by its inherent intellectual challenges and its intense politicization. In recent months, the narrative emerging from this body has been particularly discordant. This is no doubt due to several factors, including the pressures surrounding an imminent change in leadership and mixed data on the economy. There are clearly serious disagreements on the Federal Reserve Open Market Committee (FOMC) regarding policy; yet, as profound as those disagreements appear to be, they have not yet led to a change in direction. I think is important to ask why. I attribute the failure to change course to an intellectual rigidity that has come to dominate monetary policy. The fact that central bankers are agonizing over whether to begin reducing bond monthly purchases by $10-15 billion within the context of a $3.5 trillion balance sheet suggests that they have lost the forest for the trees. The much larger question is why they are continuing to treat the U.S. economy as though it is stuck in a severe recession. Coupled with clear signals that interest rates aren't going to be raised for another two years (at least), the terms of debate appear to be circumscribed by parameters that limit policy choices to one version or another of easing. Five years after a traumatic financial crisis, the men and women charged with managing the world's largest economy remain stuck in a trap of their own design.

The recent taper capers were particularly interesting in that the market, with an able assist from the media, had talked itself into believing that bond purchases would be cut back starting in September. That conclusion was as much a matter of the markets negotiating with themselves as the Federal Reserve sending mixed signals. I had expected the taper to begin in September as well, so shame on me. I chalk up my error partly to my consistent view that Federal Reserve policy has been ineffective and, in the long run, extremely dangerous, as much as to my misreading of Ben Bernanke's public comments. I cannot reconcile current policy with the economic data. Quantitative easing is not supposed to be business-as-usual; it is a non-conventional policy measure that was invoked to stimulate first a crisis and then a post-crisis economy. The FOMC now seems to consider quantitative easing as virtually a status quo policy tool. No doubt employment growth and inflation are not where the central bank would like them to be, but monetary policy is not going to solve those problems – and economists of sufficient stature to serve as governors of the Federal Reserve are supposed to know that. We have a crisis policy for an economy no longer in crisis. It is as simple as that. And it needs to change as soon as possible so the artificial suppression of market forces and distortion of asset prices can end.

Figure 1
Fading Fuel?



Based on an analysis of the data as well as the FOMC's statement, Ben Bernanke's post-meeting press conference, and subsequent public statements by individual governors, it is apparent that the FOMC is highly focused on two specific areas: employment and housing. Furthermore, these two areas are tightly linked in the minds of the most influential members of the committee, Ben Bernanke, Janet Yellen and Bill Dudley. Not only do these dominant members want to see continued improvement in the employment numbers, but they want to see that improvement carry through to sustain the housing recovery. (FOMC members appear to be justifiably concerned about the large drop in the work force, which has allowed the unemployment rate to decline to 7.3% in a manner that is fooling nobody. The committee was always going to have to adjust the 6.5% target it (carelessly?) set as a trigger for changing policy since that figure grossly understates the true employment situation. Some now think that the FOMC won't be satisfied until U6 (the unemployment measure that includes discouraged and underemployed workers) drops below 13%. Recent comments from Mr. Bernanke started to back off from the 6.5% target and it is clear that the FOMC is trying to slip out of its own noose.) That is why the FOMC stressed what it termed a tightening in financial conditions in its statement. The one area of the economy that has undeniably seen deterioration is housing and there is little doubt that the 100 basis point increase in mortgage rates since June is the primary reason. The committee appears to have placed enormous weight on this factor in deciding not to taper in September.

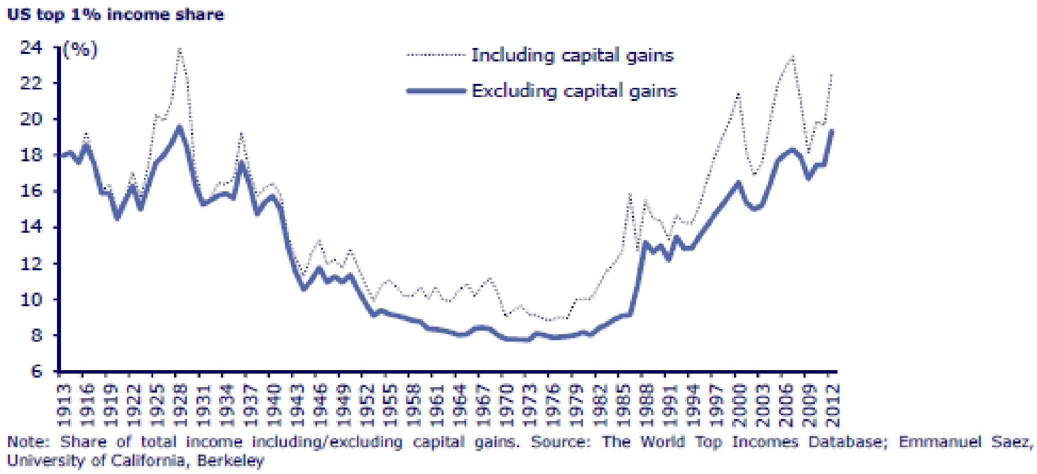
Other than housing, however, it is difficult to discern any meaningful tightening in financial conditions. Corporate credit markets are partying like they are back in the mid-2000s, a disturbing sign as far as future credit quality goes. In August, 66% of the leveraged loans sold were of the covenant-lite variety. Unlike earlier in this cycle, no longer are only the strongest borrowers able to demand such terms; today, covenant-lite loans are the status quo for even weak borrowers. The high yield bond market also saw a marked deterioration of covenant protections in August, continuing a trend that began in July 2012. Last week, the global head of The Blackstone Group L.P.'s private equity business, Joseph Baratta, told the Dow Jones Private Equity Analyst Conference in New York City that "[w]e are in the middle of an epic credit bubble… The cost of a high yield bond on an absolute coupon basis is as low as it's ever been." Actually, it was about 130 basis points lower at the beginning of May on an average basis, but Mr. Baratta's point is well-taken. The IPO market also appears to be quite healthy as well. From a capital markets standpoint, financial conditions are extremely robust. (One important difference between today's corporate credit markets and that of the mid-ought's is that there is far less new LBO activity today than in the previous period. Further, the types of M&A activity we are seeing are largely strategic in nature such as Verizon Inc.'s (VZ) deal with Vodafone Group plc. The dearth of new leveraged buyouts in an environment where financing is so cheap points to the challenges facing private equity firms and their investors.) With stocks continuing to hit all-time highs and record issuance of high yield debt, it is difficult to reconcile the Federal Reserve's dire view with what is actually happening in the financial markets.

Employment data continues to improve, with the four week moving average of unemployment claims for the period ending the week of September 21 dropping to 308,000 from 350,000 in June. (I find the declining unemployment claims number more meaningful than the decline in the unemployment rate to 7.3% since the latter is distorted by large numbers of working exiting the work force and therefore being excluded from the calculation. The actual unemployment rate is much higher though gradually declining.) Furthermore, as David Rosenberg points out (David Rosenberg, Gluskin Sheff, *Breakfast with Dave*, September 19, 2013), there is a slew of data that is improving on an 3-month annualized rate-of-change basis: aggregate hours worked are up 1.6%; retail sales are up 5.4%; manufacturing production is up 2.5%; single family housing starts are up a strong 21.5%; capital goods orders are up 13.7%; capital goods shipments are up 9%; personal disposable income is up 2.7%; and finally, exports of goods and services are up by 5.5%. The Federal Reserve appears to be peering into a different crystal ball than the rest of us.

The Federal Reserve also continues to wring its hands over insufficiently high inflation, a stance that seems unusually wrongheaded. There is absolutely no indication that the economy is at risk of experiencing the dangerous type of disinflation or deflation about which a central bank should be concerned. Further, while official measures of consumer inflation are muted, few Americans feel that the prices of the items they require for everyday living are actually declining (with the possible exception of a recent sharp decline in gasoline prices, which remain extremely volatile). This concern on the part of the FOMC strikes me as a stunning example of a bunch of economists allowing theory to trump reality. It is also a sign that the Federal Reserve is perpetuating the error of trying to micro-manage and fine-tune the economy in order to minimize natural economic and market functions. The result is that volatility and price discovery are being artificially suppressed. The suppression of these natural forces is rendering the system more vulnerable to large dislocations in the future. While the Federal Reserve is attempting to create the veneer of stability as measured by GDP growth, inflation and employment, it is allowing pressures to build under the surface. Exhibit number one in this effort is the $3.7 trillion balance sheet it has built up as it has absorbed enormous amounts of mispriced capital. Exhibit number two is the enormous amount of debt sitting on the balance sheets of the other major global central banks. And exhibit numbers three and four are the unprecedented amounts of debt sitting on the books of the world's governments and corporations. This Everest of debt dwarfs the ability of the global economy to generate sufficient income to service and repay it, leaving monetary and fiscal authorities with little choice but to try to engineer a massive devaluation of that debt through currency devaluation and inflation that is certain to be disruptive and destabilizing. The further this necessary adjustment is deferred into the future by micromanagement of the economy by central bankers, the more traumatic it is likely to be.

Markets greeted the no-taper announcement with the usual knee-jerk rally in both stocks and bonds on the afternoon of Wednesday, September 18; by Friday the 20th, stocks were selling off and bonds were rallying after having digested the Fed's dim economic outlook. Sooner or later, the markets will realize that too much of a good thing is a bad thing, and when that day comes a lot of investors are going to be damaged. Gold also rallied in reaction to the clear signal that fiat currencies will continue to be debauched by central bank policies. I have written in previous issues of this publication that the taper would begin sometime between September and December and end by next summer. I had expected the taper to begin sooner rather than later; I was clearly incorrect. Since there is no press conference after the October FOMC meeting and the Federal Reserve's books are closed by the time of the December meeting, the taper may now be delayed until early 2014. Mr. Bernanke and his colleagues are publicly keeping their options open but are clearly conflicted about pulling the needle out of their arm. If the taper does not begin in 2013, it likely means that second half 2013 growth will come in under 2% and corporate earnings growth could start to taper instead.

Figure 2
Summers Subtext?



The Next Federal Reserve Chairman

President Obama appears to be extremely reluctant to name Janet Yellen as Ben Bernanke's replacement. The longer he delays, the greater is the chance that he could surprise markets with a different choice for the most powerful non-military job in the world. Even after the withdrawal of Larry Summers from consideration for the position, Mr. Obama seems in no hurry to announce his choice. I believe there is an explanation for this that has not been discussed in the media. One of Mr. Obama's major economic policy goals is to address the growing gap between rich and poor in America. While some would like to leave this issue to the free market to solve, the reality is that growing wealth disparities are evidence of the fact that the market is anything but "free" and that both monetary and fiscal (primarily tax) policy are heavily weighted in favor of those who own and control capital. Under Ben Bernanke's Federal Reserve, the wealth disparity has grown at a record pace largely as a result of policies that were adopted during the depths of the financial crisis to rescue the financial system from collapse. These policies necessarily involved bailing out the banks and other large financial interests. But they have been kept in place far too long and have disproportionately benefitted owners of financial assets and those able to borrow money at record low interest rates. The latest evidence of the effect of these policies is found in a study by University of California, Berkeley Professor Emmanuel Saez. Professor Saez analyzed recent IRS data and discovered that the incomes of the top 1% of Americans rose by 19.6% in 2012 while the income of the bottom 99% grew by only 1%. The result is that the top 1% accounted for 19.3% of total household income in 2012, their highest share since 1928. If capital gains are included, the top one percent's income share has risen from 18.1% in 2009 to 22.5% in 2012 (as show in Figure 2 above). The 1%/99% is not just a political caricature; it is a social and economic reality. (I am indebted to my friend Christopher Wood for drawing this study to my attention in the most recent issue of his indispensable *GREED & fear*, September 26, 2013. The study is titled "Striking it Rich: The Evolution of Top Incomes in the United States," September 3, 2013.)

By all accounts, Janet Yellen is highly likely to perpetuate these policies. Perhaps Mr. Obama believes that another candidate for the Federal Reserve chairmanship would be more inclined to engage in policymaking aimed at reducing the wealth gap. I believe that Mr. Obama is reluctant to name Mrs. Yellen because he still wants to see if he can identify a politically palatable candidate who would be willing to steer policy in a direction more amenable to dealing with this issue. Whether he can find such a candidate remains to be seen – it is a tall order – but I wouldn't dismiss the possibility completely. Janet Yellen remains the odds-on favorite for the job, but Mr. Obama's lack of urgency suggests that he may not be entirely happy with the choice or with the direction of policy.

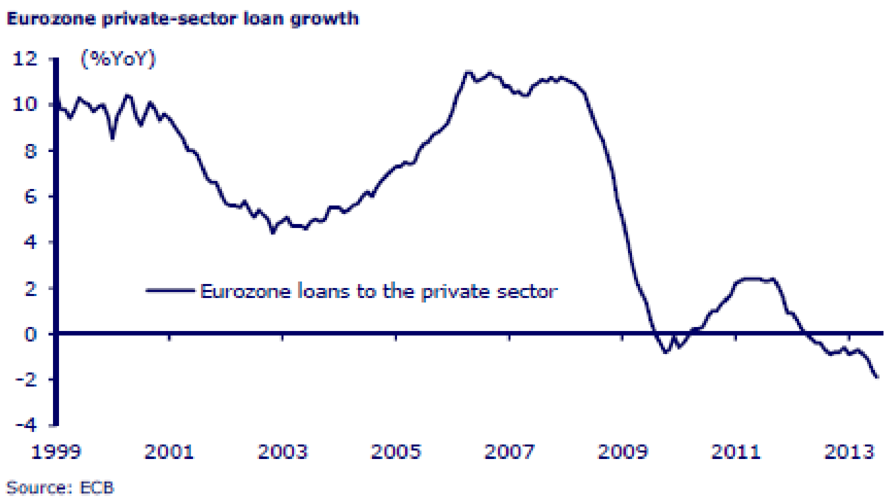
Please Shut Down the Government

Today's Washington, D.C. is bereft of the greatness, Emersonian or otherwise, that built America into the world's greatest economic and military power. Politics is an especially ugly form of sausage-making. When the chefs include characters like Texas Senator Ted Cruz, the feast ends up resembling a Roman orgy where the participants endlessly binge and purge on their own bilious rhetoric. Whether an actual shutdown actual occurs is less significant than the continuing spectacle of political gridlock in the eyes of investors who are seeking hope that the nation's leaders can work together on the tough economic challenges facing the country. The U.S. economy requires serious entitlement and tax reform in order to grow more robustly, but the odds of such reforms gaining traction in today's noxious political climate are zero. Instead, the current spectacle tells investors that nothing constructive is going to come out of the fiscal side of government for years to come. Investors should therefore conclude that monetary policy will have to continue doing double duty for a prolonged period of time. Investors should also understand that the U.S. economy would be at serious risk in the absence of an activist and accommodative monetary policy. This is a very dangerous situation due to the long-term consequences of that policy – growing debt levels, distorted asset prices, growing wealth disparities. That is why what is happening in Washington, D.C. is so disturbing not just on its own terms but because of what it is effectively forcing the Federal Reserve to do in a fiscal policy vacuum. When historians look back on this period from a vantage point that has experienced the consequences of the current policy regime, they will be forced to acknowledge that the failure of fiscal policy forced monetary policy to pursue an extremely dangerous course. Subjects like ObamaCare may be the text of the debate, but the imbalance between fiscal policy and monetary policy is the far more important subtext that is sowing the seeds of the next financial crisis.

Europe

The re-election of German Chancellor Angela Merkel is likely to lead to greater support for non-conventional policies such as the issuance of Eurobonds and formation of a banking union. More immediately, many expect austerity measures to be eased. Frau Merkel is a highly focused politician who has made her support of the European project very clear. In all of her actions and statements throughout the European debt crisis, her one unwavering commitment has been to the survival of the European Union. Given the opportunity to support Greece's withdrawal from the union, which makes eminent economic sense, Frau Merkel would not even consider the idea. She even braved extremely hostile Greek crowds to visit Athens to demonstrate her support for the Greek government's highly unpopular austerity measures. If one thing has been made clear, it is that a Merkel government will pay the price of keeping the union together even when that price seems excessive. But she will continue to insist that the pain be shared; both domestic German politics and her own character and temperament demand that. Any easing of austerity measures will be gradual and conditioned on economic reforms in the countries asking for relief. This means that emergence from crisis will be extremely slow and Europe will not contribute meaningfully to global growth for quite a while yet. Among the signs to look for before we can expect meaningful improvement from the region would be improved loan growth to non-financial corporations; currently, such loans are shrinking as shown in Figure 3 below, particularly in Spain and Italy. Alternatively, European economies should not deteriorate significantly in the foreseeable future and should therefore not drag down global economic growth. From an investment perspective, greater stability coupled with still troubled financial institutions creates an interesting environment for those looking to pick up some merchandise at attractive prices. European banks and insurance companies will be looking to reduce their ownership of troubled assets for years to come.

Figure 3
Fading Fuel II



It's Always Something

By Ben Hunt

> "Well, Jane, it just goes to show you, it's always something – if it ain't one thing, it's another."
> – Roseanne Roseannadanna (Gilda Radner)

There was widespread speculation that the FOMC considered resurgent Fiscal Cliff risks in its decision-making process two weeks ago, speculation that was confirmed on Friday in a speech by New York Fed chief William Dudley. Speaking to an audience at Syracuse Univ., Dudley said that Congressional debate over the federal budget and the debt limit "creates uncertainty about the fiscal outlook and may exert a restraining influence on household and business spending." In fact, he uses some variation of the phrase "fiscal uncertainty" 5 times in his 4 pages of prepared remarks on national economic conditions.

If you needed more evidence that QE is no longer an emergency government policy, but is now a permanent government program … well, there you go. It's not that Dudley thinks the US economy is weak. On the contrary, he sees "persuasive evidence of improving underlying fundamentals", such that "we are experiencing a fairly typical cyclical recovery." Despite this, Dudley and the rest of the FOMC are opposed to ANY reduction in QE right now given the growth risks created by domestic political dynamics and slow growth abroad.

One might well ask that if the Fed believes "a fairly typical cyclical recovery" requires all-out, pedal-to-the-metal QE, under what economic conditions would QE ever be wound down? What level of QE would be required the next time we experience a fairly typical cyclical recession? I mean … it's not like political risks and growth uncertainty are ever going to just magically disappear. It's not like the business cycle has been eradicated. To paraphrase Gilda Radner's tag line, there will always be *something* that poses an economic risk or creates an economic uncertainty. If there weren't, we wouldn't have a market at all! The Fed has expanded the rationale for continued QE to include *political risks*, as well as the maintenance of employment levels from 20 years ago, as well as the elimination of prices that are *too* stable. To repeat the skinny from last week's note: QE is now a creature of Washington, forever and ever, amen.

I also think that the Fed has shouldered an extremely difficult analytic burden by incorporating fiscal policy uncertainty into its decision-making. Political outcomes are not continuous dependent variables with a normal stochastic distribution, and it is impossible to incorporate political outcomes within the cybernetic system that IS Fed policy. Political outcomes are a set of discontinuous events, of leaps from one equilibrium outcome to another, that are determined by behavioral patterns which are entirely independent from anything the Fed does or doesn't do. Political outcomes are an entirely different animal than aggregate employment levels or aggregate price stability. They are exogenous events that the Fed may seek to respond to, but cannot anticipate or control.

Okay, I've used a lot of $10 words here. What does it all mean?

It means that the Fed's use of QE as an insurance program against whatever fiscal policy errors they believe Congress might make in the future is not only a problematic expansion of the Fed's governmental authority, but is also myopic on its own terms. If you want Congress and the White House to establish "good" fiscal policy, then the last thing you want to do is provide an *incredibly* expensive insurance program against "bad" fiscal policy. It's moral hazard in the first degree, which any competent politician (and these are *very* competent politicians) will use to their professional benefit. I'm sure that FOMC members believe in their hearts that they are doing the responsible thing by "protecting" the economy from the "risks" posed by smash-mouth politics in Washington. But I believe that they have (again) misunderstood the *behavioral context* in which their signals are understood. Twice since June the Fed has missed the market context of their communications. Now I think they've done it with Washington.

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