

## **A Considerable Predicament**

**A Considerable Predicament**  
**Where is that Crystal Ball When You Need It?**  
**Is Greenspan Secretly Tightening?**  
**My Personal Business Guru**  
**New Orleans, Chicago, New York**

**By John Mauldin**

This week we re-visit Federal Reserve policy, and how their current policy may be setting up a very real problem with interest rates. Is the dollar getting ready to make its next move down? We do live in interesting times.

Yesterday I had long telephone conversations with both Jim Bianco and Greg Weldon, talking about Federal Reserve policy, interest rates and the dollar. There was an apparent disagreement on some concepts between them. Last night I did some meditating on those discussions, and decided a summary of them would give us an excellent starting point for this week's letter. Because they may both be right, and that may not be a good thing

Jim Bianco is one of the smarter independent researchers in the business. I always enjoy readings his thoughts. He recently took me to task on my analysis of Greenspan's recent speech. I took the opportunity to call him and discuss that and a few other topics. He did make one point in the conversation, which I have missed, that I think is very important, and is one of the main points of today's letter. Let's go back and review what I wrote, his critique and then some comments.

Summarizing both Paul McCulley of Pimco and myself, Bianco wrote

***"Pimco.com - Paul McCulley: Sunshine Is A Great Disinfectant***

'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. In contrast, constrained discretion, with full scope for the Fed to react to shocks, offers the scope for the financial markets to transmit most efficiently the impulse of the Fed policy actions to where it matters – the real economy, where 130 million Americans get up and go to work each morning. And where another 2 million who've lost their jobs over the last three years wish they could go. Constrained discretion works, Mr. Greenspan. We practice it everyday here at PIMCO. We cherish our flexibility, as do all successful active portfolio managers. We also believe that transparent discussion of our philosophy and process – our reaction function, if you will – enhances our ability to add value to clients' portfolios, disciplined by an equally-transparent risk management process. Give it a try, Mr. Greenspan. I submit that you would be amazingly liberated by the increased degrees of freedom that would come with

## A Considerable Predicament

increased transparency about your degrees of freedom. In the matter of trust, Sir, sunshine is a great disinfectant.'

### **"Frontlinethoughts.com - John Mauldin: Market Timers or Market Cheaters?"**

'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?

**Bianco Comment** - Mr. Mauldin goes on to answer the question he posed immediately above:

*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 or 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.*

And then Bianco writes in reply "Respectfully, we completely disagree with this passage. It suggests that Adam Smith's 'invisible hand' is dead. If twelve Fed governors know better than the market regarding the proper price of credit (interest rates), then why have markets at all? Maybe we should close the NYSE and the Government bond markets and replace them with a 'Federal Securities Pricing Board' (FSPB)? We can all submit our purchase and sale requests to the FSPB and they will decide the appropriate price we should pay. Sounds like the old Soviet Union.

## **A Considerable Predicament**

“Furthermore, Government price supports and caps are universally recognized failures every time they have been tried. Isn't the FOMC holding the funds rate too low (per the market's viewpoint) nothing more than a Government sponsored price support? Why will this one work when all others failed? Do markets make mistakes? Sure they do, all the time. However, who is ‘smart enough’ to know when a market is making a mistake? That's why we invented the job of speculator - it is their job to make these judgments, with their own money. They get the rewards (profits) when they're right and suffer the punishment (loses) when they're wrong. And as Mr. Mauldin states, it's a hard job fighting the markets as 95% of futures speculators lose money over time. Given how difficult it is assessing when a market is wrong, why turn this function to twelve Government employees that sit on the FOMC - especially when they refuse to offer any transparency to their decision-making process (see the McCulley story above). They will not suffer the speculator's fate (losses/bankruptcy) if they're wrong. What incentive do they have if their academic theories about inflation/deflation are wrong? This sounds like a prescription for disaster.”

### **Where is that Crystal Ball When You Need It?**

First, I was not denying Adam Smith's Invisible Hand. I just don't think it holds a crystal ball. The invisible hand moves markets. It is the market's collective judgment about the future. It does not mean that any such predictions will be accurate. That does not mean I do not think the judgment of the market is better than that of 12 men. Markets should rule.

Second, let me state that I agree with Bianco that the current situation is a prescription for disaster. I was not trying to defend Federal Reserve policy. I was simply acknowledging what I feel to be reality.

You can call for the abolishing of the Fed as do many libertarians and as Gene Epstein of Barron's does. You can want guidelines for Fed policy as do McCulley or Bianco. I would philosophically probably lean toward the former more than the latter.

But my philosophy doesn't make any difference. As long as Congress is allowed to run a deficit, especially of the magnitude of today's deficit, there will be no move by Congress to abolish or reign in the Fed. Congress will not willingly submit itself to the gentle hands of market discipline.

You can count on exactly one vote in congress to abolish the Fed. It would be a 434-1 vote, with my friend Congressman Ron Paul being the Lone Texas Ranger willing to stand in a very small crowd of one.

### **Greenspan wins the debate because he has the votes.**

I applauded Greenspan's speech not because I agreed with or even liked what he said, but because I thought he was being very clear about his views, which has not always

## **A Considerable Predicament**

been the case with his mutterings. I also thought his critique of the use of econometric models was excellent.

Am I comfortable with the “Trust Me” apologetics in his speech? Of course not. But we are stuck with trusting Alan Greenspan whether or not we like it, and thus need to figure out what his likely policies are and invest accordingly. Call me pragmatic.

Now, let’s look at what I think is Bianco’s real insight and very valid concern: the Fed use of the word “considerable.” The Fed has told us they are going to hold the Fed funds rate low for a “considerable” period of time.

Exactly how long, Mr. Greenspan, is a “considerable” period of time? Six months? A year? Two years?

Interest rates are beginning to once again slowly drop. The reason that the Fed has decided they need to hold rates low for a “considerable” period of time is their concern about deflation and its risks. Indeed, core inflation rates are the lowest since 1966. Measured by the Fed's preferred gauge of inflation, the core price index for personal consumption expenditures (PCEPI), core consumer inflation likely fell to 1.2% in August. What happens to inflation when oil drops into the low \$20s, which I think it will within a year, if not much sooner?

On the other hand, what happens if the Fed promises to reflate the economy actually begin to work and inflation starts to creep back up?

Bianco asks, “What happens when the Fed issues a meeting statement which no longer contains the word ‘considerable’?” The answer is that the bond market will take about 10 seconds to violently begin to move interest rates. We will have a replay of this summer’s volatile bond market in spades. By promising low rates for a considerable period of time, with no guidelines to allow an orderly anticipation of rate increases, there is an almost built-in volatility kicker coming to a bond market near you.

As Bianco pointed out (and my experience completely confirms this), the world thinks of the players in the bond markets as a bunch of older gentleman sitting about in tweed suits, smoking pipes and ruminating about the ebb and flow of inflation, world economies and the likely direction of interest rates. In reality it is probably more volatile than the stock market, with trigger happy traders moving large sums on very short notice.

It is a world with massive amounts of derivative exposure, leverage and hedging. First off, no matter when the Fed signals a rise in rates, there is going to be volatility in the market. Traders and investors will begin to move interest rates. What happens if the volatility is in a few days rather than a few months?

The answer is no one knows. Having such an event is problematic in the extreme, and the Fed has to know this. All of which means that the Fed will begin to signal such a move long before the actual disappearance of the word “considerable.” To do so in a

## A Considerable Predicament

surprise manner simply begs for a crisis. We will see Fed types begin to hint that the threat of deflation is lessening. The market will react a little bit. More hints. More reaction. A consensus will develop that the Fed will soon be raising rates, and then the Fed will remove the word considerable.

“Trust Me” is no substitute for the ability to make reasonable assumptions about the future. Such a process is far more messy than the simple guidelines for which McCulley and Bianco call. Having such guidelines would not remove the volatility from the bond market, but it would dampen the potential extremes.

However, it is what we are stuck with, at least until Ron Paul can round up 217 more votes, or Greenspan decides to retire and somehow debate about Fed policy can develop outside of the long shadow of Greenspan. Don't hold your breath.

### Is Greenspan Secretly Tightening?

But speaking of Greenspan, what is happening to Easy Al's money machine?

Bill King noted this morning: “**M2 has fallen under its 5-week moving for the first time since March and April.** This occurred in March/April '02; stocks then tanked. After M2 spiked for 9/11, it fell under its 5-week MA when that extraordinary monetary injection was removed. You have to go back to April 1995, when the Bank of Japan went to zero interest rates, for any protracted occasion of M2 trading under its 5-week MA.

“Except for three weeks in April 2002, M2 has not traded below its 13-week (quarterly) moving average since April 1995. M2 is about \$16B over its 13-week moving average. Stay tuned; stay alert!

“M2 fell \$4.1B for the week end 9/8, but M3 rose \$11.5B (Fed and central bank debt buying?). The M2 chart shows the biggest decline since just after 9/11. There is no comparable decline in the past 12 years.

“It's only one week, but Fed 'free reserves' for the 2 weeks ended 9/17 fell to a meager \$790m. We cannot recall the last time Easy Al allowed free reserves to fall under \$1B! The previous 5 reports for 'free reserves' are: \$2.051B (9/3), \$5.148B (8/20), \$2.012B (8/6) and \$2.098B (7/9). The monetary base fell \$3.547B (9/17). Is Easy Al quietly tightening? The summer bond collapse is a seminal event, a revolt against Fed largesse. For years, Fed easing produced bond rallies as wise guys poured into bonds because financing costs were reduced. However, now there is little room for cost-of-carry profits and pros are concerned about currency risk and the budget deficit. Easy Al and the Fed realize that the exploding budget deficit and dollar weakness, with foreign central banks holding the bulk of US debt, is a dangerous environment. They also increasingly realize that they are at the limits of easy money and if the dollar tanks, rates will rise. It's time to closely watch Fed behavior because it appears to be diverging from its rhetoric, which will soon be encumbered by the '04 campaign.”

## A Considerable Predicament

And thus we are now set-up for the conversation with one of my favorite macro analysts, Greg Weldon. He answers some of Bill's questions, writing in this afternoon's Metal Monitor ([www.metal-monitor.com](http://www.metal-monitor.com))

“The Fed is buying US Treasuries, and has now for two consecutive weeks, as revealed within last night's Fed money supply data. Japanese investors are buying UST, and ....increased their NET exposure by a whopping \$12 billion, in just the latest week.

“...And, last, but FAR from 'least', Foreign Central Banks are buying US Treasuries, as reflected by a string of weekly increases in Custody Holdings, including the \$3.2 billion increase posted last night.

“And yet ... USD-JPY is still ... lower.”

“We feel that a MAJOR shift is taking place, where the US and Japan might agree, to allow the USD to depreciate....”

This echoes readings from others over the past few weeks, but Weldon crystallizes the trigger point. I sense we are ready for another round of dollar depreciation.

If the dollar were allowed to drop against the yen, might other Asian currencies allow it to drop as well? Slowly re-adjusting the trade balance and the value of the dollar?

If Asian countries buy fewer dollars, thus allowing their currencies to rise, this would normally mean that US interest rates would rise. Not only would their US bonds be worth less in terms of their local currency, they would also lose as their US bonds fall in value. A double whammy! It is the old supply and demand conundrum.

But if the Fed quietly agrees to buy enough bonds to maintain the value as they seem to be doing now, and foreign governments don't actively sell (in effect, they just buy less), the hope would be a slow re-setting of the value of the dollar, a reflation of the US economy and a lower trade deficit.

Weldon believes the Fed does not give a time frame because they don't have a clue as to what the time frame is. They are playing this one by ear. If they announce an inflation target north of where we are today, would that spook the bond market? Would they feel boxed in if they set a target at 2% and then decided we needed more stimulus even if we were already at that same 2%?

Think of the European Central Bank. They set inflation targets and then came under enormous pressure to ease their money supply as some of their main countries went into recession. Greenspan does not want in that box. Trust me on this one. He made that very clear in Jackson Hole.

## **A Considerable Predicament**

Everybody and their dog knows that the dollar is going lower. The debate is only about how far. If the Fed were to allow interest rates to rise as foreign central bank buying slows up, that would trigger higher home mortgage rates, which would put in jeopardy home values. Deflating home values, as Weldon points out, is the last thing the world or the Fed wants to see.

If the world (read China and Asia) pulled the plug on the US dollar, which they could do in about 15 minutes, the result would be a world wide depression. Nobody wants that. Everyone's interest is aligned in keeping the game going. They want the Us to keep buying and they want to keep selling.

However, it must now becoming apparent even to central bankers that the current trends cannot continue. You cannot keep racking up \$500 billion trade deficits forever. You cannot keep adding up \$500 billion dollar government deficits. We no longer simply "owe it to ourselves." Since foreign governments are buying an ever higher percentage of US government debt (they currently are at an all-time high of 46%), the current trend if left unchecked means eventually the US government owes trillions to foreign nations. When you are increasing the foreign debt by \$500 billion a year, it does not take long.

A rise in rates would mean the US would owe hundreds of billions of tax dollars in annual interest payments to foreign banks, unless the trends are stopped. Such an event would mean an unraveling of the current world economic structure.

Thus, the dance truly begins to allow the dollar to drop. Hopefully slowly, while the Fed keeps rates low, hoping the US economy can begin to produce jobs.

The Fed issued a statement after its meeting this week. It was word for word the same as the one in August, with two minor differences. The one to pay attention to was "a phrase in the next to the last sentence in the second paragraph. In August they said ..... 'labor market indicators were mixed'. In September they rephrased that to..... 'labor market has been weakening.'" (Courtesy of Art Cashin)

I attended a private reception yesterday evening over in Dallas for Jimmie Rogers (former Soros partner and author of *Adventure Capitalist*) given by David Tice, who runs the Prudent Bear Fund. There were a few genetically pre-determined bearish souls in attendance. One complained to me that recent Fed actions are only going to make things worse -- that we need to go through the economic re-balancing, deal with the recession that would occur and move on, or words to that effect. He was from the "take your medicine now" school of thought.

But that will not happen. The members of the Federal Reserve are programmed, deep within their economic DNA, to fight recessions with all the tools available, and especially a deflationary recession which might develop. They do not believe that it will make things worse.

## **A Considerable Predicament**

Weldon makes great sense when he says we may be at a cross-roads in the value of the dollar. I also believe the Fed will do what they feel they have to do to help the world adjust and to try and hold back the forces which would raise rates and shut off a recovery that has been produced by the most massive application of stimulus in the history of the world and that has yet to produce jobs.

If they believed the recovery was powerful enough to properly develop on its own, they would not be using the word “considerable.” They would be raising rates, not talking about a “the probability, though minor, of an unwelcome fall in inflation” as they did in the recent reports.

We live in interesting times. Yes, indeed we do. Think gold.

### **My Personal Business Guru**

Mark Ford is one of the smartest marketing minds, not to mention business coaches, that I know of. This is a friend who from time to time graciously gives me some advice, even though I could not afford his rates, if he even had them. Yet, he consults with me every day, giving me practical ideas for both my personal and business life.

He also does this for a few hundred thousand of his closest friends. He writes a daily letter called “Early To Rise.” It is one of my must reads, as well as that of my staff. If you run a business or want to get ideas to improve your life, I suggest you read him a few weeks to see if he helps you as much as he does me.

The letter is free, and you can subscribe by going to <http://www.earlytorise.com/SuccessStrategies.htm> . By the way, I did not write the copy for the web page you will link to, but I echo the sentiments. I should add Mark is rather a private guy, so you won't see his name on the page. He never uses his name in the letter, either, just his initials (mmf).

### **New Orleans, Chicago, New York**

Here is a link to the web page for the New Orleans conference October 29 through November 1. Join me, Bill O'Reilly, Richard Russell and Jim Rogers, plus a host of excellent investment analysts at one of the more fun events I attend each year. <http://www.neworleansconference.com/event/faculty2003.htm#mauldin> Let me know if you are coming, as I will be doing some private sessions just for my readers.

I will be in Chicago October 8 and New York around November 12. I will have some time for clients and prospective clients.

Once again, it is time to wrap up. Tomorrow night is one for family and friends and baseball. Once again, my Texas Rangers play no meaningful games in September. Disgruntled fans might point out we have played no meaningful games this year. But you wait till next spring!

## **A Considerable Predicament**

Your considerably short of enough book writing time analyst,

John Mauldin