

## February 10, 2012

*"I never give them hell. I just tell them the truth and they think it's hell."*

- HARRY S. TRUMAN, 33RD PRESIDENT OF THE UNITED STATES

**A Midwinter Night's Dream.** It's easy to be a dreamer in Hawaii. Between the leisurely pace and the paradise-found scenery, life's cares simply drift away. The often ironic goodnight wish "pleasant dreams" (an especially elusive goal for those of us who manage our own and other people's money) becomes a reality when the soothing sound of the ocean can be heard through doors open to the gentle island night. Life is good for those of us vacationing in the Aloha State—at least until you read the latest newsletter from John Mauldin.

Of course, blaming John Mauldin for shattering vacation escapism is like blaming the airline for flying you back to the mainland; both are just returning you to reality. Most EVA readers have become familiar with John's work due to the fact that I have quoted him numerous times over the years and even relayed some past editions of his highly popular newsletter in their entirety. Roughly two million souls receive his weekly email, "Thoughts from the Frontline," including many EVA readers (you can sign up to receive his free service by clicking on [this link](#)).

To all of you who do regularly peruse his always insightful missives, I apologize for the redundancy as I am once again running one of his recent essays as this month's "guest" EVA. But for the many more of you who don't, I believe you will find his January 28th issue, The Transparency Trap, to be well worth your time. I say this despite the fact that its message runs counter to the prevailing "don't worry, be happy" mood of the stock market these days, an attitude of insouciance that would make the ultimate Hawaiian surfer dude envious.

Although it would be nice to stay in paradise permanently, if not longer, that's simply not realistic; it's time to say our farewells to the beautiful Aloha State. Similarly, it would be wonderful if we could ignore the challenges that face all investors, such as the Fed's ongoing war on savers, the squishy underpinnings of the US economy, and Europe's latest incomplete attempt at Armageddon avoidance. Yet, as John accurately points out, these issues are very much still with us even though the stock market seems to feel they are now yesterday's news.

One of his most interesting points (and I promise this will be the only one I leak) is that if the US economy is truly as sprightly as recent data would seem to indicate, the Fed's extension of return-free interest rates for years to come is most puzzling. This is consistent with a point I made in the January 27th EVA in which I observed, as have numerous others, that a 10-year Treasury yield under 2% doesn't square with a healthy economy. Either the Fed and the bond market have things very wrong or the stock market does.

Now let's see what John has to say on why it might be better to listen to the message from the former rather than the latter.

### The Transparency Trap

By John Mauldin | January 28, 2012

The Fed announced this week that it will keep rates low until 2014. Interest rates responded by getting even flatter. This policy change has caused a lot of negative press, for some good reasons, but I want to offer a somewhat different take on their motives.

Telling us that rates will stay low for another three years has a lot of negative implications. First, it says that the Fed does not expect a recovery of any significance during that time (more on this week's GDP numbers further on). Second, it tells any individual or business that there is no reason to hurry and borrow money to get lower rates. You can wait and see how things turn out before you decide to act.

Comstock Partners minced no words in their scathing criticism:

"In our view the Fed's new policy is an act of desperation rather than something to celebrate. The FOMC has used all of its conventional weapons and a lot of unconventional ones and is essentially out of ammunition. The banking system is swimming in excess reserves that it is not using---adding more won't make much of a difference. This is a classic liquidity trap where further easing will not be much help. The stock market strength assumes that the economy is getting stronger and that company earnings will remain at elevated levels. We think that this will not be the case, and that the market is subject to substantial downside risk."

I agree with their sentiments and conclusions, but I think the Fed is in more than a liquidity trap. For lack of a better term, let's coin one and call it a "transparency trap." The Fed and the FOMC do not create their policies in a vacuum. The individual members talk to business leaders at length every week, and their staffs are also seeking out opinions and reactions. While they may not talk to you and me, they are aware of the reactions to their positions. Let's take that as a given. These are not men and women who are easily pushed into a position. They get where they are by being able to forcefully take a position and push for their policies. We may not like their positions, but they put some thought and a lot of work into making them. Frankly, it is a damn hard job. No matter what they do, they will make a lot of people upset. And this week is a case in point.

Ben Bernanke has been quite open in that he wanted a more transparent Fed. He wanted explicit inflation targets long before he joined the Fed. He wanted more communication and openness from the FOMC. Many in the media and elsewhere lauded those sentiments, including me, as the more we know about their thought process, the better we can all plan.

However, there were others who said that the Fed needed to keep their cards closer to their chests. Showing too much of their inner reasoning could mislead as well, as policies could change and the Fed should not feel locked into any one position if the underlying circumstances shifted. There should be an element of mystery, they maintained. Some former members of the Fed were very outspoken in their desire to not increase the transparency of the Fed. As with sausages and laws, we simply do not want to know too much about what goes into making Fed policy, they asserted

But slowly, Bernanke has put his stamp on the Fed, including his views on transparency. His speeches and presentations are far more comprehensible than the foggy pronouncements of Greenspan. He has started doing press conferences. And with this meeting, he has persuaded the 17 members of the FOMC to offer projections about the economy - in this case, where they think rates will be for five years into the future.

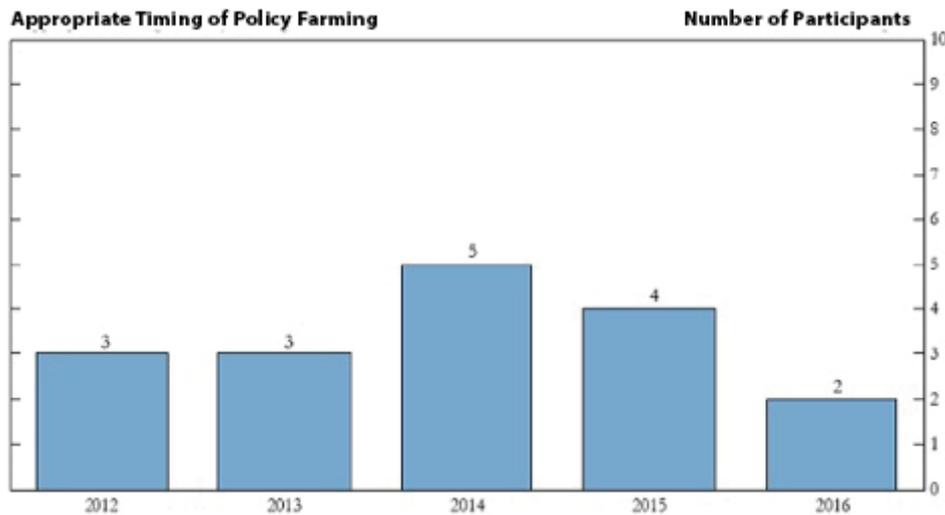
The headlines talked about the Fed keeping rates flat into 2014, but if you look at their median forecast, they expect rates to rise by all of 0.5% at some point in 2014. And for the record, here are the rest of their more significant forecasts:

"The Fed knocked down its forecast of economic growth a few notches for the entire forecast period (see table below). The Fed sees the economy growing around 2.2%-2.7% in 2012. The Blue Chip consensus forecast of growth in the US is 2.2% on an annual average basis as of January 2012, while the IMF projects growth of 1.5% for the United States in 2012 on a fourth quarter to fourth quarter basis.

"The central tendency of the unemployment rate for 2012-2014 was lowered but the longer run projection was left intact. The unemployment rate is expected to be around 8.2% to 8.5% by the end of the year, which is different from the Blue Chip consensus of 8.5% (determined by a survey taken prior to the publication of the December employment report, most likely to be revised down). Inflation is projected to below the Fed's target of 2.0% until 2014. With regard to inflation, Bernanke formally indicated that 2.0% inflation is the Fed's target rate and this rate as being consistent with the Fed's dual mandate." (Asha Bangalore, Northern Trust)

All in all, not a very upbeat group. Given their views, it is no wonder they expect rates to stay low. And thus we have the transparency trap. They are now telling us what they really think, something that most people in most places wanted only a short while ago. And we see the 17 individual forecasts, so we can get a sense of the range of opinion, which is quite wide, actually. Look at the following graph, which shows us when the members of the FOMC expect rates to finally begin to inch up.

Note that six members expect rates to rise within the next two years and four expect rates to be flat into 2015, with two members thinking rates will not rise until 2016. And over whatever they define as the "longer term," they expect the Fed Funds rate to be 4.25%. (Which causes me to mangle that song from the children's movie classic, Snow White: "Some Day My Price Will Come.")



### Tell Us What You Think We Want to Hear

If we want to know what they think, and they tell us, are we then going to shoot the messenger? We asked, they delivered. If they gave us those projections and did not change their interest-rate projections from the last meetings, they would be subject to ridicule, because they did not say in the statement what they really believed.

In a very real way, they were forced to say they expected rates to be flat for 2-3 years. To say anything else would have been rather pointless, at best, and subject to even more intense criticism at worst. Once they opted for transparency, they were forced to take the position they did. Put this in the category of "be careful what you ask for, because you may get it."

Now, take note. And I do not mean this as a specific indictment of Fed economists and forecasters. This goes for all of us who dare venture a thought about the future.

There is a natural tendency to take current conditions and project them forward. Which is why stock analysts who forecast earnings are so predictably bad. And the all-star team of blue chip economists (in the US) have yet to predict a recession, even when one has started, let alone in advance! Once you rely on models, you are doomed to error. I have read studies that show analysts are not even as accurate as one would expect from simple random selection.

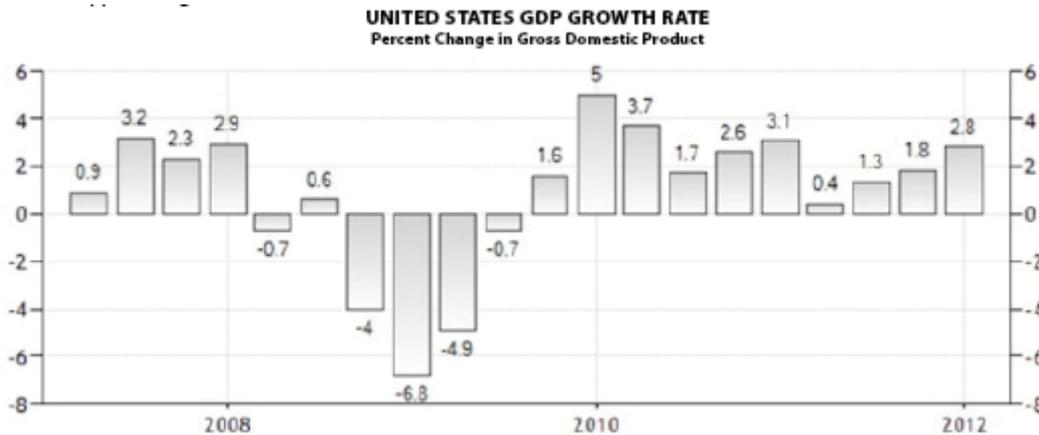
I think we should take these Fed projections as more of a curiosity, for at least the next two years. In two years we will have 16 data points (8 meetings a year) which will show us some of the evolution of their thinking, and that will be very interesting.

For what it's worth, if someone had asked me, I would have said that rates will be flat for a very long time. We inhabit a deflationary, deleveraging reality. That suggests lower inflation. I have written at length why unemployment will be higher than we are comfortable with; it is just a product of the current environment and simple math. To see unemployment come down we need to see growth in the

3.5% range, and our next topic will show us why we are not even close to that number.

## A Very Soft GDP Number

GDP came in at 2.8% for the 4<sup>th</sup> quarter of 2011. That is a respectable headline number, given that the US economy only did 1.6% for the whole of last year. For those who look at this number as half full, I offer the following observations. First, examine GDP growth for the last few years. The 4<sup>th</sup> quarter has been much better than previous quarters, and then GDP dropped off again.



The 2.8% number is softer than it looks. Two-thirds of that growth (1.9%) was from inventory build-up (standard accounting practice says that growth in inventory increases GDP, while sales of inventory reduces it). "Real final sales (GDP less inventory changes) expanded at an anemic 0.8% annual pace in the fourth quarter, a sharp slowdown from the third quarter's healthy 3.2% rate. That paints a different picture from the apparent pick-up in headline GDP growth from the third-quarter's 1.8% yearly rate. The difference reflects the shift to inventory building in the fourth quarter from a drawdown in the third quarter." (Barron's)

I suppose one could spin inventory growth as businesses being optimistic about future sales and building inventory, but given the weaker retail sales of late (in comparison to previous years) that is rather doubtful. And so all that really happened was a total reversal of inventory sales in the previous quarters. There will be a drawdown of inventories over the next few quarters, which will be a drag on future GDP numbers, much like the pattern we have seen the past few years.

Retail sales growth was not strong. And for the last year, 90%-plus of total retail sales has come from decreased savings, as the savings rate dropped from 4% to 2%. It will be hard to go much lower, so the "boost" we got last year from retail sales accounts for most of the year-over-year growth in GDP. If most of retail sales growth came from reduced savings, that suggests that retail sales will not offer much in the way of growth for the coming year. Just saying.

Further, when calculating real GDP, one subtracts inflation. The Fed prefers an inflation measure called PCE (Personal Consumption Expenditures). It is essentially a measure of goods and services

targeted toward individuals and consumed by individuals. The number you read in the various media is the CPI or Consumer Price Index. The CPI is inflexible, in that it's always the same basket of goods. PCE on the other hand, is supposed to take into consideration the notion that if steak is too costly, we'll eat hamburger. The CPI is typically 0.3-0.5% higher than the PCE, which is convenient if you want the GDP number to look better.

The Fed changed to PCE in February of 2000. The change was buried in the footnotes of the annual Humphrey-Hawkins testimony by then-Fed Chairman Greenspan. So the anemic growth of 1.9% for the last decade would have been even worse if we had used the previous measurement of inflation (CPI). Understand, there is an argument in favor of using PCE, as many academics argue that CPI actually overstates inflation. But there is also an argument to use CPI. It somewhat depends on what you want the final numbers to be.

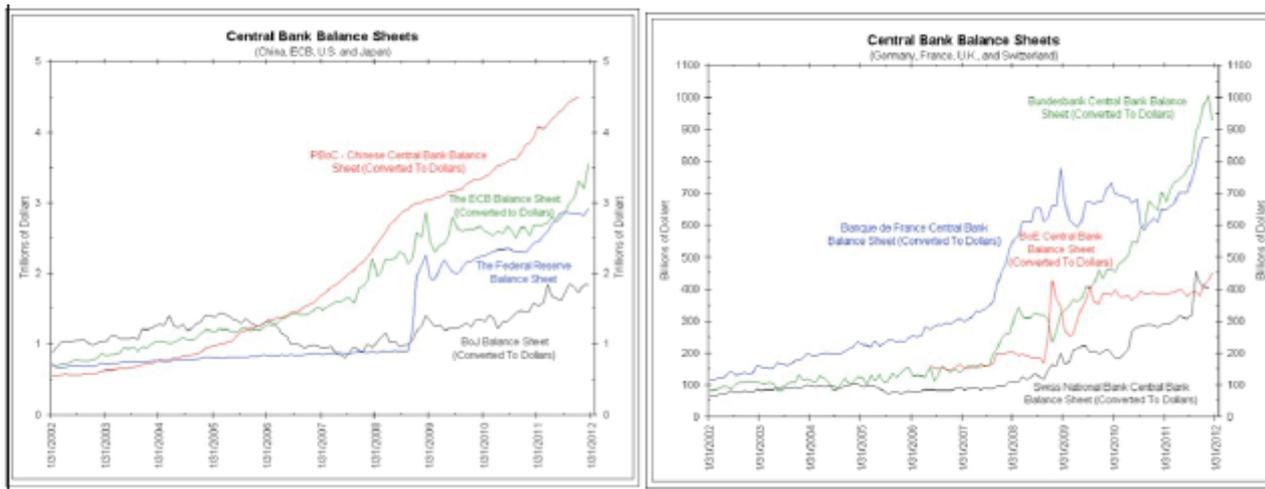
Fast forward to today, and the year-over-year change of CPI was 2.5%, with the PCE only rising 1.7%. And last quarter was down sharply, to +0.04% on an annual basis. An anomaly of lower energy and commodity costs? Partially, for sure. So if their target rate of inflation is 2%, using PCE gives the Fed grounds for a looser monetary policy.

All in all, GDP was helped by numbers that are not likely to repeat. For a long time I have maintained that the US economy is in a Muddle Through range of around 2%. I remember when last year at this time we had estimates of 4-5% growth for 2011. I looked so bearish. Now, not so much, as 2% would have been better than what we got.

I think we will be lucky to Muddle Through again this year. Mind you, if it was not for a potential shock coming from a serious European crisis and real recession, the US should not slip into outright recession this year.

### **Central Banks: A High-Wire Balancing Act**

I got this note from bond maven (and Maine fishing buddy) Jim Bianco (courtesy of Barry Ritholtz). It made me sit up and take notice. He compared the balance sheets of the four largest central banks (the US, Europe, Japan, and China) and then four European central banks (Germany, England, France, and Switzerland). There has literally been an explosion in all their balance sheets. Interestingly, China has seen the largest growth. And where is the inflation that one would expect from all the monetary printing? You can see some of it in China, but not anywhere else.



Jim points out that central bank balance sheets, when taken together, have spiked recently in relationship to total world stock market capitalization. He concludes with these thoughts:

What Does It All Mean?

"2011 was so difficult because all stocks seemingly moved together. It was as if every S&P 500 company had the same chairman of the board that knew only one strategy, resulting in a high degree of correlation between seemingly unrelated companies.

"Massive central bank involvement in the *markets* risks returning us to a de facto centrally planned economy. Those S&P 500 companies all have the same chairman; it is Ben Bernanke because his policies are affecting everybody. That is what makes money management so difficult. Correlations will ebb and flow; they always do. But what makes them go away? This will only happen when governments and central banks go away.

"But if they go away, then does that not mean things get ugly? Maybe they do get ugly, but it also means that we sort out the excesses in the market. We reward the people that do the right thing and we punish the people that do the wrong thing. And we have an adjustment process that may be ugly, but then we have a period of long expansion.

"Central banks are ruling markets to a degree this generation has not seen. Collectively they are printing money to a degree never seen in human history.

"So how does this process get reversed? How do central banks pull back trillions of dollars of money printing without throwing markets into a tailspin? Frankly, no one knows, least of all central banks as they continue to make new money printing records.

"Until a worldwide exit strategy can be articulated and understood, risk markets will rise and fall based on the perceptions and realities of central bank balance sheets. As long as this is perceived to be a good thing, like perpetually rising home prices were perceived to be a good thing, risk markets

will rise.

"When/If these central banks go too far, as was eventually the case with home prices, expanding balance sheets will no longer be looked upon in a positive light. Instead they will be viewed in the same light as CDOs backed by sub-prime mortgages were when home prices were falling. The heads of these central banks will no longer be put on a pedestal but looked upon as eight Alan Greenspan's that caused a financial crisis.

"The tipping point between balance sheet expansion being bullish for risk assets versus bearish is impossible to know. Given the growth rate of central bank balance sheets around the world over the past few years, we might not have to wait too long to find out. Enjoy it while it is still bullish."

You can read the whole piece at The Big Picture:

<http://www.ritholtz.com/blog/2012/01/living-in-a-ge-world/>

### **A Few Thoughts on LTRO**

The ECB is taking almost any quality asset a European bank offers up and putting it on its balance sheet, as part of its long-term refinancing operation (LTRO). Basically, this allows a bank to post an asset at the central bank and receive 1% money, which they can turn around and use to either improve their own balance sheet and liquidity or buy European sovereign debt at, say, 6%. If the bank then makes 5% on the loan and leverages it up, it can "get whole" in a short time.

This is the same principle (in theory) that Paul Volcker used in 1980 when he allowed US banks to carry the debt of defaulting Latin American countries at face value. Given enough time and interest-rate spread, a bank can work its way out of a problem. And it worked for Volcker. Eventually, US banks made enough money to be able to write off the bad debts.

While this is a band-aid, an attempt to cover up the real problem of banks that are basically bankrupt and sovereign countries that are either in default or at risk of default, it is so far proving to help. Germany has essentially thrown in the towel on keeping the ECB from printing money. While they still growl and bark, like any well-trained dog they stay in the yard. They are a big dog, and their barking makes you nervous as you walk past, but so far they are allowing the ECB to prop up banks throughout Europe. On that point at least, Sarkozy won.

As long as LTRO continues, it should postpone the problem of a true banking crisis - until Portugal has to default, and then all eyes turn to Italy and Spain. If the ECB is allowed to fund Italy and Spain, even through the back door, it will mean Germany has made its choice to keep the euro intact, no matter the cost.

Your am I having fun or what analyst,

John Mauldin

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