THE MIKE ALKIN SHOW
TALKING STOCKS OVER A BEER

Ep. 5: The Mike Alkin Show – Why the Fed Is Bad for America

Speaker 1: Free and clear of the chatter from Wall Street, you're listening to Talking Stocks Over A Beer, hosted by hedge fund veteran and newsletter writer Mike Alkin, who helps ordinary investors level the playing field against the pros by bringing you market insights and interviews with corporate executives and institutional investors. Mike sifts through all the noise of mainstream financial media and Wall Street to help you focus on what really matters in the markets.

And now, here is your host, Mike Alkin.

Mike: Welcome to the podcast. It's Monday, March 12th 2018. Quite a week last week. We saw the bulls took the grip back on the market. Investors struck a very decidedly bullish tone last week, and they had a lot of news to digest, and data. And we saw a big rally in the equity markets, which more than recouped the week prior's loses. Some of the things the market was thinking about is it had to contemplate a battle over the steel and the aluminum tariffs. I don't know if you saw that. President Trump came out and said he was going to put a 25% on steel, a 25% tariff on steel, and 10% on aluminum, which scared some people initially at the thought of a trade war. But, that kind of worked its way through into this past week, as he talked about giving some exemptions to some important trading partners. But, we'll see where that all takes us.

The European Central Bank had a policy meeting and they indicated that they were not going to increase the rate of their purchases, which the market took well. And there was a very strong employment situation report Friday, which took the market up over 1 1/2%.

But for the week, the tech heavy NASDAQ led the charge, with stocks up 4.2%, and they closed Friday I think at an all time high. And the S&P and the DOW Average, they advanced 3 1/2% and 3.3% respectively.

Now the tariff debate, though, is interesting, because it infuriated some of Trump's own party with both Republicans and White House officials urging him to reconsider the duties on steel and aluminum imports that he proposed, fearing that could cause

a trade war. And trade wars typically are not good for anyone. But, he didn't back down. And that led to the resignation of his top economic advisor, Gary Cohn on Tuesday. And a lot of people saw Gary Cohn, myself included, as someone who brought real perspective to the economic equation. And I think it's a big black mark that he left, but the market has so far shrugged that off.

Overseas, I mentioned the ECB left its key policy rate unchanged on Thursday, and what they did is they removed from its policy statement a promise to increase its bond purchases if needed. And the ECB, if you don't know, has been extremely accommodative with massive bond purchases. And the exclusion from its policy statement about increasing the purchases was interpreted by the market as a step in the right direction towards normalization.

And we're going to talk about, with my guest coming up, Danielle DiMartino Booth, the author of 'Fed Up,' we're going to talk about quantitative easing, quantitative tightening, and what all these years of this ultra-accommodative policy have meant.

And so, in Asia last week, we saw some interesting news out of North Korea with leader Kim Jong Un extending an invitation, and one that was accepted by President Trump, and I think they're going to try and meet in May. And so, I think that marks the first face to face meeting between a sitting U.S. President and a sitting North Korean leader.

And I mentioned the jobs report Friday. Non-farm payrolls, they increased by 313,000. And the market was expecting just 210,000. Interestingly though, in that report and what the market liked was that average hourly earnings increased just 0.2%, as expected. So there wasn't that wage pressure. We're going to talk about that with Danielle, as well. But the unemployment rate stayed at a remarkably low 4.1%.

So, all of this news in last week ignited the market on Friday and it was a big day. For the week, 11 of the 11 sectors finished the week in the green. So, a good week for the bulls. I think weeks like this, and days like that, and weeks like that are a good reason to be lightening any risky assets for many reasons that you've heard me talk about.

So, I get asked by friends a lot, who are not professional investors, "Mike, how do you come up with your investing ideas?" And they

want to know what my formula is. "What's your secret sauce? What's the one thing that you look at that gives you ideas?" God, if it were only that easy. I look at data points and financial statements, I read a ton of earning calls. And I have a personal checklist. Some call it a system, if you will, that helps me form my conclusions after I've identified something. But, finding the idea is as much art as science.

And for me, one of the best ways to generate investment ideas is to get out from behind my desk and go into the real world. And I've been doing that for, God, as long as I've been investing. And I do it here domestically, and I do it abroad. I don't think there's any substitute for seeing, listening, observing what's going on.

But, to begin with, before I go somewhere, I have to have an inkling of what I'm looking for. And for me, the seed of many of my investment ideas just comes from being a voracious reader. And people say, "Well, what do you read?" Everything. I read a vast array of topics from geopolitics to political and economic issues in developed and emerging markets. I read a lot about inflation around the world, what's driving it, who's doing well, who's not. I stay very educated on the agricultural/commodity complex, because the input cost affects so many businesses on the metals markets and what's going on there. I read a lot of about energy issues, global housing markets intrigue me, what the global central banks are doing.

And I'm also a big reader of financial market's history. So, I consume a lot of information. And then once I digest all that, personal investment antenna starts to go up and I hone in on those things that match my own personal investment style. I'm a contrarian. I'm skeptical, and I'm usually distrusting of mass emotion. So, when I'm reading something, I tend to gravitate towards where I see extremes. And these are usually areas where there are cycles, where those cycles are at extended peaks or valleys. For me, I find that at extremes, that the narrative of the prevailing wisdom is often wrong, and it's dated, because complacency sets in. And it's in that realm where I think you can find tremendous investment opportunities.

Notice, I think you can find tremendous investment opportunities, because one of the things I've learned over the years being

contrarian is that if you are a contrarian for contrarian's sake, that is a recipe for disaster, not a successful investment strategy.

I learned a long time ago that markets can stay in one direction a lot of longer than you might think. So, it's just not enough to find a market at extremes, you need to find a market where the narrative is stale, and there's fundamental change occurring beneath the surface, but it's being ignored to the complacency that sets in.

And what I'm looking for is the marginal buyer or seller. Who are the buyers that are going to come in, after all the news that's known out there, what's going to get that marginal buyer to get off their bottom and buy? And the same thing, who's going to be that marginal seller? So, what motivates them to buy or sell?

And that brings me to a piece I recently read from a CitiBank credit strategist named Matt King. He did a presentation that I thought was very interesting, and he makes a critical point, and he says in his presentation, "It's the flow, not the stock, that matters." And for any listeners who subscribe to my newsletter, you'll know why I bring this up. And for those of you who don't, you should know that the name of my newsletter is 'Money Flow Trader.' So, for me, it's so important to know which way the money is flowing into an asset class, into a sector, or into a stock. And in his presentation, Matt asks what I think is a critical question, he asks, "We all know how this ends. So, why are we slow to price it in?" And he's talking about the bull market just celebrated its ninth anniversary. And he mentions that global central bank balance sheets account very over 20 trillion dollars.

So, what's next? We're transitioning from a time of global central bank easing, in the case of the Fed buying bonds and the ECB buying bonds and equities in the Bank of Japan. So, we're entering a period though now, where we're starting to see the opposite of quantitative easing and we're starting to see quantitative tightening, which means less buying. So, it's a period where natural gravity will begin to take hold, when [inaudible] of a backstop. The rate of change, while the ECB will still be buying, it will be buying less. The U.S. Federal Reserve will be buying assets, but buying less. So, who, at this point, is the marginal buyer to come in and buy these assets?

So, it's a very interesting time in the markets, and to discuss it further and to really try and understand what's going on, I

wanted to bring a guest in who I met last year through a friend of mine, and someone I have a great deal of respect for, and she has a tremendous wealth of experience, both on Wall Street but also at the Federal Reserve. Her name is Danielle DiMartino Booth. And she wrote a book last year that is a fabulous seller and it's a tremendous read, and one I recommend for everyone, just to understand the importance in our everyday lives at the Federal Reserve. But, don't worry, it's not a dry read, because she goes after them, so it's a great read. And the book is called 'Fed Up, An Insider's Take On Why The Federal Reserve Is Bad For America.'

And, like I said, I have Danielle coming on and we're going to talk about myriad issues around where we are right now, and what this global financial experiment could lead to. So let me bring her in right now. Danielle DiMartino Booth, thanks for joining the podcast.

Danielle: So happy to be here.

Mike: I understand you had a pretty early wake-up call today.

Danielle: Indeed. A good friend of mine, Brian Sullivan, took over a new post at CNBC's 5 AM show, so I was up at 2 AM here in Texas so that he could get off to a great start.

Mike: Well, that's being a good friend.

Danielle: There are people who are wide awake, bright eyed and bushy tailed in London, and that's their favorite show of the day. So, it's always good to reach different cohorts of people from time to time.

Mike: Absolutely. And so, you talk about a good friend of yours, a good friend of mine is the one who introduced you and me, Reed Walker. I used to work for Reed, as you know, back in the mid 2000's down in Dallas at his hedge fund, Walker-Smith, which he ran with Stacy Smith, and I learned a lot from Reed and have stayed in close contact with him. And he and I are very good friends. And last year when he knew I was contemplating launching the newsletter, he said, "You know, you should come on down to Dallas. You should meet a few friends of mine." And John Maulden was one, and he said, "You have to meet Danielle DiMartino Booth." He said, "She's just awesome." He said, "She just wrote a book and it's a great read. And come down, because she's also doing a newsletter and

you should come down and meet each other."

And you were very gracious with your time. I think we spent a couple hours in Reed's office, and you had just written the book, 'Fed Up, An Insider's Take On Why The Federal Reserve Is Bad For America.' And you were doing a lot of talk shows and you were going from interview to interview, and you were great. You took a couple of hours, and I really appreciated that. And then, on the ride home, on the plane, I read your book. And it blew me away. It was fantastic.

So, that's a long winded way of just an introduction of how you and I know each other, but why don't you tell the listeners, give us a little bit of your background, where you came from and what led you up to writing the book, and we'll get into what you're doing now.

Danielle: Sure. So, I was a young girl from Texas who landed in Austin at their business school ready to get my MBA in I had no idea what. And a book influenced me way back then called 'Liar's Poker.' And I ended up interviewing at Solomon Brothers, really not even understanding how Wall Street worked, but again, then I read a very influential book, I read 'Liar's Poker' and I was determined to try and make it on Wall Street, which not many young girls from Texas decided at a young age.

Mike: Right. Yeah, that's right.

Danielle: New York proved to be my kind of a city, it became my home and I loved it. I had a great career. But, at some point I started to grow up and a long distance relationship between Dallas and New York, circuitous route that life is, and ended up leaving Wall Street, of all things. It was shortly after 9-11 and all of our perspectives had changed to a certain extent, especially those of us who lived in New York. And I had gotten a second Master's in journalism at night, that was at Columbia. When I worked in New York that was always going to be my retirement plan, so I was able to start writing about the markets, which had become a passion of mine when I was on the Street in New York. I was writing a weekly newsletter then, which was not easy to do with compliance and being on the wrong side of what they call the Chinese Wall.

But, I ended up writing when I moved to Dallas, and that is how

one Warren Buffett found me, and that ended up being how one Richard Fisher found me. So, several years later, I landed at the Fed, a bureaucrat, which was in a million years I never thought I'd be a bureaucrat. In a million years I never want to go back to being a bureaucrat, but I learned the lessons of a lifetime when I worked inside the Federal Reserve. And at some point midway through, in the heat of the crisis, I got really fed up enough to write about it. Which is exactly what I did the minute I left.

Mike: So let's go back. So, you're working at the Dallas Morning News, you're a columnist. And you're telling it like it is, and you received a call one day from Richard Fisher, who was the president of the Dallas Fed. And I think you had called the house in crisis, so a lot of the stuff you wrote about, you didn't have a lot of friends when you wrote it, because you called BS on people and you called BS on industries. So, what did Fisher, why did he call you? What did he see and what did he want to bring you in to do at the Fed?

Danielle: Well, I had a lot of friends in security, trying to make sure there wasn't a target on me. But, he called one day and I sat there saying to myself, "Isn't that that new guy at the Fed?" And he invited me for a lunch. I was like, "Look, I'm barefoot, I'm pregnant, I'm retired." And I literally was all of those things, writing from home. That was the good news about leaving Wall Street is you could pretty much dictate your terms, in terms of where you were going to work.

But, he and I met for lunch, and I would say within 18 months of that first initial lunch at the Petroleum Club, that I ended up being called to serve my country. And I couldn't believe I was answering the call, but the reason had a lot more to do with the fact that ... one of my favorite mantras was "ladies don't dance on graves" ... and once the housing crisis that I was predicting started to come true and families were being booted out of their homes and losing them to foreclosures, and lives completely disrupted, it wasn't near as much fun anymore to write about it. And I said to myself, "Well, maybe the Fed's someplace where I could do something about it."

The minute I landed there, though, I quickly realized that part of the reason that they had hired me in the first place was to shut me up. Because, the people there at the Fed completely disagreed with what I had to say.

Mike: We'll talk about that, too.

Danielle: It was an interesting culture clash. It was an immediate culture clash. On the other hand, Richard Fisher did not think inside the box. He has never been a conventional thinker, and eventually I fit in, for his purposes, but for his purposes alone.

Mike: Interesting. So, educate our listeners, who may not know. They know the Fed influences the economy. I don't know if they know they do it with unrivaled power as they do. But, talk to the listeners about what the true nature of the Fed is and what you think it should be.

Danielle: Well, in theory, in 1907, J.P. Morgan, the man, not the bank, he brought people together in his parlor and he was able to mitigate the damage of the financial panic of 1907. And at that time, he decided that he was not going to live forever, and because mortality was part of the game plan, that some entity besides him needed to be created such that when there were times of financial panic, they needed a lender of last resort when nobody else would do the lending, that there would be a backstop for the financial system.

And that was kind of the philosophical genesis of the findings of the Fed. And in times of peace in financial markets then the Fed's primary responsibility was making sure that the dollar that we carry around in our wallet maintained its buying power. In other words, that inflation as we call it, was minimized. And that was the underpinnings of the original Federal Reserve. In 1977, the economy had gone through a terrible time. It was set to continue, going through a very bumpy period. And Congress saw fit to double the Fed's peace time mandate to include maximizing employment. I would say that that was a grave error in judgment. But, nevertheless, that is what the Fed is legally mandated to do today.

They are supposed to maximize the buying power of our currency, and they are supposed to maximize the number of people in our workforce. And that is not what I discovered that they did fairly quickly.

Mike: Why do you say you disagree with the mandate in unemployment?

Danielle: Well, that gets us into a lot of what is wrong at the Federal Reserve. Janet Yellen herself is probably delighted to have seen

the one and a half million individuals come in off the sidelines recently. In other words, the size of the pool of laborers in this country is increasing. And so, there are 95 some odd, theoretically, warm capable bodies able of working, and it is every Keynesian central banker's dream to bring those people off of the sidelines. And that is how they fulfill their employment mandate. And that sounds like a great thing, so why would I stand in the way of that?

Well, I would argue that had their mandate been left to the simplified one mandate version of minimizing inflation, that the Fed would have never been tempted to keep interest rates for as low as they have now for a third cycle in a row because of the vestiges, what we know to be the vestiges, of too low for too long. Nobody believes it, again. Right now, we are back in denial. We are back in pretty much majority consensus blanket denial, in terms of the financial stability that has been facilitated by keeping rates too low for too long.

But, you cannot convince a central banker that because they're trying so hard to bring workers in off the sideline, that the byproduct of keeping interest rates too low for much, much too long, is that you end up with something much worse on your hands, and that would be financial instability that eventually hurts Main Street a lot more than it hurts Wall Street. You cannot convince central bankers of that. And that is one of the reasons I became as fed up as I did.

Mike: Well, it's interesting. So these are unintended consequences we're talking about. And in the book, you detail the institution that is the Fed. It's made up of wonky and stodgy economists who sit in their ivory and remote towers, and few of them have any type of real world work experience. And one of the things I took away from reading your book is that every day anecdotes and things that you experience in the real world, they are secondary to just the hard data. And many of the people there haven't failed in the real world and they haven't come from the school of hard knocks.

So, explain what that was like, and explain the ramifications. And I want to transition then with that into that fateful evening in December of 2008 when the Federal Open Market Committee approved the unprecedented financial experiment of lowering the rates to zero. So, explain if you can, just start with the ivory tower mentality, and what happened in December of 2008 when they

took the interest rates to zero, and why that matters. Because I had mentioned unintended consequences, but what's happened over the last nine years and the unintended consequences of that.

Danielle: I'm going to back up for two seconds and say consequences are unintended the first time around. At some point they become very much intentional if you don't learn from your mistakes.

Mike: Yeah, great point.

Danielle: And that's an important distinction that I need to make. So, on to what ended up happening on that fateful day, December the 14th, 2008. The Fed was guilty, the gravest sin was that the academics at the Fed, and this was something that I learned in the aftermath of the crisis, but the academics of the Fed recognized that the way they were measuring prices, the way that they were gauging inflation was broken. It was the wrong inflation metric. It's the inflation metric, by the way they use to this day, called the core PCE. And it overstates health care, it understates housing. It doesn't include asset prices at all.

And these were things that were recognized internally by the academics. They said, "Gee, our model failed to capture runaway residential house prices. Had it done so, we might have known that we should have been tightening policy. That the worst of the bubble years could have been prevented." So they recognized this.

Mike: And didn't the Boston Fed come out in '07 and say that there wasn't any problem in housing, if I'm not mistaken?

Danielle: Oh, gosh, my hair was on fire, and they're like, "But the chairman says that it's going to be contained and that we haven't had nationwide home price decline since the Great Depression, and therefore we will not." And again, my hair was on fire saying, "How can any of what's going on right now, when you have liar loans and 125% loan to value toxic garbage trading hands on trading desks, how can anybody say that this is a normal state?"

But, I digress. So, there was a recognition that they had the wrong metric and they chose to do nothing about it. Because, if that underlying model was broken, all of the other models that came from it would also be broken. They might have had to have gone back to the drawing board and started from scratch. Which would have been a great way to start in the aftermath of the greatest financial crisis since the Great Depression. Would have been-

Mike: Clear the decks.

Danielle: A deep look within. Hey, it's time to figure out a whole new way that we need to make monetary policy, because our methods failed us. But a lot of the words that I just used are not used. Failure is not a word that is used inside the Fed, because brilliant doctors don't fail. I mean, A, they can't write prescriptions, so I wish they quit it with the doctor business. But, they do. And we're all fallible, and we are only as good as the guidelines that we accept to send us in direction A, B, or C, and their guideline was broken and they chose to do absolutely nothing about it.

In fact, they chose to double down, knowing that they did not know how to measure prices, a small group of people on the Federal Open Market Committee at the St. Louis Fed's huge economic gathering at Jackson Hole late every summer, got together in a room ... by the way, against Fed policy ... and devised what was called the Bernanke Doctrine. Very important piece of research. It was born, again, in a very small group of people who did not know how to measure prices. But, they still nevertheless decided, determined, pre-determined, that they would have to take the price of money, that they would have to take interest rates down to zero before they could begin to embark upon quantitative easing, before they could buy the first bond and begin to grow the Fed's balance sheet. One must precede the other. Why? Because that's what our models say.

It made absolutely no sense. The price of money was irrelevant to what was plaguing the markets when the time finally came. But, this was done in the summer of 2007. This is before Lehman Brothers failed. This is before AIG was right behind it. This was before systemic risk took hold. All of it was pre-determined.

Mike: Why is it the Fed's job to put a floor under risky assets? I think the last time-

Danielle: It's not.

Mike: The Fed allowed true price discovery to occur was back in the '20's. 1920-21. And why does not natural price discovery occur? What's the rational behind that?

Danielle: To Paul Volcker's defense, the last time we had a single digit price

to earnings multiple on the Standard and Poor's 500, the world's benchmark, was in '81. But, it actually occurred long before 1981, several years before that. And that is what we consider to be a clearing price for the stock market. That is when things get as bad as they possibly can be, is when you break through to the downside, pass the double digit 10 line, and you hit a single digit PE on the S&P. Because Paul Volcker really didn't give a darn about Wall Street traders.

But, I do see your point. And there have been very few points in history that markets have been allowed to function in an unfettered fashion, for true price discovery to occur as Mother Nature intended it. William McChesney Martin, he was one of the best Fed leaders ever, and he was truly agnostic to political pressures through different administrations, different political parties. He also is a great hero of mine, and he stood the line as the longest standing Federal Reserve Chairman in the history of the institution.

But, something funny happened with a man who had not been popular in high school. And I in no way, shape or form, mean to be condescending. These are things that came out in Greenspan's memoir. Somebody was able to trail him for two entire years of his life, and ended up determining that it was against Alan Greenspan's better judgment to allow the tail to wag the dog, to allow price discovery to begin to be harmed. And that happened, beginning on October the 20th, 1987, when Alan Greenspan said that the Federal Reserve stood ready to backstop the banking and financial systems. He did something then that was, I believe, illegal. I'm trying to look for the correct term.

But, this is when the Fed used to release no information, no statements, no minutes, no nothing. [crosstalk 00:32:25]

Mike: The 200 word minutes that said nothing, right?

Danielle: No. Back in '87, there weren't even any [inaudible 00:32:35]. There wasn't any communication with the market. In fact, the Fed would only release information after the fact, after it had made moves to inject liquidity into the system. But, Alan Greenspan did something after the crash of 1987 spooked him, scared him, intimidated him. He started releasing to bond trading desks ahead of ... you don't remember this part of the book ... ahead of bond moves to

inject liquidity, he started giving fixed income traders a head's up, allowing them to front run the Fed.

And that is truly when, over 30 years ago, price discovery in the modern age began to become ravaged. And things got worse under Bernanke, who was much more of a nervous soul, much more intimidated by the markets. And they got worse yet under Janet Yellen, who will go down, right now her legacy is one of perfection. I don't think legacies are written in the past, legacies are written in the future, so we will see. But, it will go down in her own memoirs, that she launched the slowest Fed rate hiking campaign in the history of the institution. That's what Janet Yellen can hang her hat on.

Mike: So, we talk about quantitative easing. We talk about interest rates at zero. Explain to listeners what that means. And you say expand the balance sheet. Educate them as to what the mechanisms are and why they did it.

Danielle: So, on December the 14th, 2008, and my boss was the only one who initially voted against the professors, as we say, saying it is not the price of money. Right now, Company A will not lend to Company B, regardless of what the price is. If you lower the price from 2% down to 0%, you might actually introduce distortion into the market. Which is, indeed, exactly what ended up happening. But, they insisted. "No, no, we must get the price of money to 0%." Despite the fact that it's ... and it did not. That did not incentivize banks to make mortgages. Banks were frozen in time. It took years. It took the better part of a decade for mortgage lending to begin to open up again.

Again, it was not the price of money. Look at it simply, through that simple prism of price. Because nothing was happening regardless of the price, and yet they lowered it to zero. The price was zero, mind you, for companies in the capital markets. It is why we've had seven years of consecutive record issuance in the corporate bond market, because if you were one of the corporate 'haves' so to speak, then you do have access to the lowest interest rate regime in 5,000 years of record keeping. But, if you were Joe Shmoe who wanted to buy a Ford 150 pickup truck, it might be closer to 10-15%, if you were not a good credit-worthy buyer. [crosstalk 00:36:02]

Mike: That's a great point. And the dichotomy is stunning, because if you think about those low interest rates, companies who couldn't get revenue growth, who had already squeezed out a lot of their margins, went and borrowed and have levered up their balance sheets. But they did that to buy back stock to help their earnings. So, another term is financial engineering.

Danielle: Of course.

Mike: Right. And at some point, that too comes to an end. So now the Fed's around the world, you had this global coordinated easing, and they're out buying bonds and they're buying stocks. Explain to people why that matters, what they were trying to do.

Danielle: I saw an interesting statistic, and that is that global central banks have acquired securities that now are worth nearly 50% of global GDP. They have done this in concert with the aim of making the price of credit so low, that if you're a company or an individual, you simply cannot resist the allure of cheap money. And there has been some traction by creating more debt than has ever existed. They have been able to generate some economic growth, and it has become a global phenomenon. But, in the process, we now have instability the likes of which, as a world, we have never seen.

I will try and give, in plain English, a simple example. When the Federal Reserve was buying back securities at its maximum run rate, that was 85 billion dollars per month. Which equates, by the way, to the bailout of AIG. If you can think back on those dark days of 2008, it was a scandalous number at the time, but in the end Fed policy had ramped up to the extent that we were executing an AIG bailout every single month.

But, when the Fed was at its maximum run rate for quantitative easing back in 2014, it was buying the equivalent of 70% of Treasury issuance, of more than 70% of mortgage backed issuance, and if there's one buyer in the market buying that much of a product, sometimes you run into mechanistic [inaudible 00:38:49], you run into ceilings where you can't source enough product. And that is the real reason that the Federal Reserve had to taper its purchases. There's a reason behind what I'm saying.

At the maximum run rate, the European Central Bank led by Mario Draghi, who makes Janet Yellen look like Paul Volcker himself he's

so dovish, at the maximum run rate the European Central Bank, the ECB, late last year was buying seven times the amount of issuance. Which is why it ended up delving into the corporate bond market, where it ended up owning a junk bond inadvertently. And this is the mission creep that I speak of and present to you as one of the biggest risks of this gigantic 20 plus trillion dollar global experiment into trying to force debt to create economic growth.

That's what it has been all about.

Mike: So, one of the things in your book I thought that was interesting, is you called yourself a rebel. And in the book you said, "I've always been a rebel since I was a little girl, because I always asked the 'why' question." And people sometimes don't like the 'why' question. Now we're at the when point, because at some point we're talking about quantitative tightening and we have a new Fed Chairman, but the banks are not going to buy. And the ECB said they're not going to increase the rate at which they purchase. When this happens, what happens?

Danielle: Well, I think we're finding out. A, nobody knows what's happening. I take real issue when I am on my Twitter feed, or if I'm having a discussion or if I'm being interviewed, I take real issue with individuals who begin to even guess at what's to come. Because, nobody can say. Nobody can say what's to come, because it's an unprecedented experiment going in. Therefore, it's an unprecedented experiment, by definition, coming out.

But, what we do know is that the markets should not like the prospect of quantitative tightening, because that's what it is. In 2017, quantitative easing globally was two trillion dollars. And that was a record run rate. It was as if Lehman Brothers was going under every single month. Because, otherwise, why would you have a record level of quantitative easing being pumped into the financial markets when it was the most quiet year, global synchronized growth, dogs and cats were living together, and happily so. Everything that could have gone right in 2017 did, and yet, we had quantitative easing running at a two trillion dollar rate. In 2018-

Mike: Well, think about that just, and it's still not knock your socks off growth, it's okay growth. And they're throwing the kitchen sink at it.

Danielle: But it's as good as it's been for a very, very long time.

Mike: Yep. But they had to throw two trillion dollars at it, right?

Danielle: They had to throw two trillion dollars to get okay growth. You are correct. So, the question is now, what happens when you divide that by two? If you add up the inadvertent quantitative tightening that's taking place at the Bank of Japan, and we won't get into those weeds, but let's just say it's because of how they execute quantitative easing. So, they have pulled back on their monthly purchases. If you consider the tapering that the European Central Bank has committed to undertake, that they've committed to stop buying new bonds by September. They've already cut in half, compared to last years rate, what they're buying on a monthly basis.

And if you take into account the 420 billion dollars that the Federal Reserve in our country has committed to shrink its balance sheet by, by the end of 2018. You add all that up and you get to a trillion dollars being pumped into global markets in 2018. Half the stimulus one year later. And people wonder why it's been so volatile this year.

Well, guess what? There's no mystery. There's no mystery to it. If you take the patient off of the methadone, if you begin to cut what you give the patient, the patient's not going to feel as good. They might throw a tantrum or two. It might start to be a little bumpy and volatile out there, and that's exactly what we've seen.

Mike: I was reading a piece, I think it was yesterday, from the CitiBank credit strategist, guy named Matt King.

Danielle: Matt's a great guy.

Mike: Yep, yep, and he was talking about it's the flow, not the stock that matters. Really talking about the marginal buyer. Who's the marginal buyer of this stuff, of the market. So, what we've seen from all of this is we've seen asset prices increase across the board. Every level. I look at every different asset class and I have a very hard time finding an asset class where I think its cheap.

So, here we are at these near record high valuations across the board, and we have this unwinding of the balance sheets. What

do you do? So, there's a new Fed Chairman, Jerome Powell. And first I'm going to ask you your opinion about him, because he's different than a lot of the other guys. But, what do you do if you are in charge of the largest central bank in the world, with the most power in the world, what's the remedy here?

Danielle: Oh, that's a big word, remedy. I don't think [crosstalk 00:45:09]

Mike: I had to look that up. I don't normally have a big vocabulary.

Danielle: A, if you have really bad insomnia, go back and read the, starting with June 2012 going forward, read the FOMC transcripts. Talk about watching paint dry. But, if you read his words, this is an individual who was keenly aware, who was very, very focused on making sure that the Fed had an exit strategy before he would even sign on to doing QE3, which then he in turn had many arguments against doing it. Remember my methadone example from a few minutes ago. He's my inspiration, because on the month before, at the meeting before they voted for the third round of quantitative easing, QE3, Powell made the statement, "Are we not concerned that this is going to become habit forming?" Habit forming. His word. So, he's not sold on the efficacy, to use a big terrible word that central bankers love to throw around. Along with exogenaity and endogenaity, a bunch of other mumbo jumbo words.

But, he was not convinced that QE would work, and he was convinced that it would cause more harm than good. And he was focused on making sure that the markets had a clear understanding, communicated by the Fed what the exit strategy would look like going in. So, this is not a Janet Yellen, Ben Bernanke, Alan Greenspan clone. This is Jerome Powell. J. Powell is his own man. He took a year out of his life and was paid a $1 salary, this is in his past life, in order to educate the Congress on the perils of the United States defaulting on its debt. I call somebody like that a true patriot, because he's effectively serving his country for free.

Mike: So one of the things-

Danielle: He doesn't need to be there. He doesn't have anything to prove. [crosstalk 00:47:30]

Mike: He's a wealthy man, he doesn't need this. He doesn't have to worry about keeping a job. He could ride off into the sunset.

Danielle: He founded the Industrials Group at the Carlyle. He understands private equity. He understands the shadow banking industry. He understands the banking industry. He gets the perspective of the CFO who is rightly, you can talk about the ethics all you want, but if I'm Joe Q. CEO and money's free and stocks are fairly valued, I'm going to borrow money and buy back my stock and maximize shareholder return.

Now that's no longer the case today. Clearly if you're Joe Q. CFO you're buying a very expensive stock, but I'm talking about years ago. He understood their perspective back then, but they were doing what they should do in such an environment and that is maximizing shareholder value. Because, in a world where interest rates are held at artificially low levels, it's very difficult to find a true rate of return. If the rate at which you are discounting values, if the rate at which you are valuing investments is zero.

So, again, but he understands the perspective of the people running the company, because that's what he did for a living. So, this is very much ... he's a non-PhD in economics. He's a lawyer by training, but he didn't practice law but for a short period of his career, but he understands it. He's not intimidated by anybody in Congress, which is plain. I've spoken to more people who are like, "You know what? I tuned in, I watched. I said I was just going to watch it for a few minutes because it's the most boring thing in the world to watch a Fed Chair testify to Congress. And I sat there and watched the whole thing, because he sounded like he was speaking English. How refreshing."

Mike: How refreshing. One of the things-

Danielle: I like J. Powell.

Mike: From analyzing companies for a quarter of a century, one of the things I've come to realize over the years is, no matter how good the CEO is, if he's dealt a bad industry or a bad hand, it's hard to overcome. So, if we put Jerome Powell as the CEO of the U.S. economy, he's been dealt a tough hand, based upon having to tighten now. What are some of the things that, if you're sitting in his chair, if you were at the Fed now, if you were advising him, what would you be advising him to do?

Danielle: Pray. You are right, he's been dealt a very bad hand. And when you have blowout labor reports, the likes of which we saw for the February non-farm payrolls north of 300,000, that's the third time that's happened since 2014. It was a very rare set of numbers. You

had the largest natural disasters in the history of the country occur in 2017. The rebuilding effort is causing inflation to run hotter than it would otherwise. The rebuilding effort has caused many jobs to be [inaudible 00:50:49]. The implementation of minimum wages across a good number of states at the start of 2018 will also push up wages. We're seeing wages build. The duration of unemployment 22.9 weeks in the latest unemployment report. That was the lowest, which means that people can find jobs more quickly than they've been able to in years and years.

All of the evidence points to rising inflation, which is why I say Powell needs to pray. Because, these things are going to be backwards looking, and yet he is going to be compelled, especially by his committee, to hike into these data points and it has never failed that the Fed has overtightened the economy into recession. And I would remind you of what I spoke about a little bit earlier, the 420 billion dollars of balance sheet shrinkage that is set to be deployed this year in 2018. For every two hundred billion or so, give or take, in quantitative tightening, you can equate that to one more rate hike.

So, let's just take the extreme example that the Fed was to raise interest rates four times in 2018. Well, they would be raising interest rates an equivalent of six times, by the time you take into account the balance sheet shrinkage. And that is much more tightening than an economy that has been highly dependent on debt, that's much more tightening than this economy can withstand.

Mike: So for listeners-

Danielle: I worry.

Mike: I agree with you. So listeners say, what we were just talking about is record low unemployment, wage hikes, so the average consumer is doing well. Right? On the surface. So, why is that bad, right? And I often talk to people who are not in the financial markets, and I always like to say, "Don't confuse a good economy with a rising stock market, because it's going to lead to rising interest rates, and that's not good for stocks." But, when I look at the U.S. consumer, I see a different story, and I think I struggle, and I love your view on this.

So, I look at the auto sector and I see subprime auto loans, which

are 20% of all auto loans, and they're back to global financial crisis delinquency rates. VHA mortgage defaults are near highs. Banks are taking big reserves on credit card losses. Student loan debt is 1.-

Danielle: You sound like you've been reading me, Mike.

Mike: Danielle, I'm telling you. I told you, I need to get smart somewhere. I spoke at a conference I think six weeks ago in Vancouver, and I talked about the auto sector, the consumer staple sector, there was no pricing power. Where is the disconnect? What is going on? Why is Main Street with record low unemployment? Why does it appear that things are struggling? And the other thing is, the bulls will say, "Well, look at the absolute level of overall credit card loses, of overall auto losses." But, to me it's more about the rate of change that people care about than the actually absolute level. But, if I look at absolute level on subprime auto, it's really high. And we're seeing things climb. Why the dichotomy?

Danielle: You know, it's interesting. It's interesting that you bring up FHA mortgages, and that's just one example of the many that you just brought up. I was so intrigued to read the Mortgage Banker's Association press release for the most recent quarter of mortgage delinquencies, because it only stated the amount by which FHA mortgages had increased over the quarter.

Now, you should always run, don't walk, run away from any data point that they won't quantify because that means it's bad. So, I finally got on the horn and I said, "Why aren't you naming it? Why did you just give us the delta?" "Oh, no, no. That's just the way we stated it. We weren't trying to hide anything." I said, "Well, then, what was it?" He said, "Well, it's over 10%." And I went, "Oh, it crossed the double digit line. Got it. Okay, thanks for your time. Have a good one."

Again, be wary of information that people do not want to report, because it is critical to watch what is occurring at the margin. We will see stress in the household sector manifest first among those who struggle the most. But, at the core, underlying the main reason that we're seeing this stress, starts to unfold is because of Fed policy. When I was on the inside, there were the equivalent of knock down, drag out fights. That's saying a lot in a very civil

culture. But, I was arguing vehemently that if you allow private equity to crowd into single family rentals, if interest rates are to stay at the zero bound, you really are going to have some very unintended and bad investment in the housing arena.

And you don't want to mess with the housing market. It is household's number one line item. It is the most, it is the largest slice of a household budget's pie. And if you let private equity in, which private equity came stomping in, and if interest rates are at the zero bound, then apartment developers are going to do exactly what they should have done. All they did was construct luxury units, because that's the only way that they could make the math work in a zero interest environment.

We have an overabundance of luxury units and we have really expensive single family rentals. We have really an overabundance of luxury homes that have been constructed. So, your average household, forget about minimum wages rising, but your average household from the starting point is spending more than they ever had just to put the roof over their head. That's a problem. And it's starting to come out in the inability to take on increasing car payments, which car prices have continued to rise. And an inability to cover rising interest rates, and now they've turned to credit cards for 24 consecutive months that credit card spending growth has outpaced income growth, and to a growing extent every month for 24 solid months. This is not a new trend.

Mike: And there's that word, that variable interest rate that consumers live with every day in their credit card statements, and some in their mortgages. And as these rates go up, that starts the really impact them.

Danielle: It does. And again, it is about what is happening to your average consumer. Your top two deciles, your 80th to 90th and 90th to 100% of income earners, which I dare say that's most of the people listening right now, they are accountable for 40% of consumption in this economy, that is driven by consumption. But, we have to be concerned with the rest of the earners out there, and how very compromised their budgets are, because housing has become so expensive, because healthcare has become so expensive. Because we know that there is inflation in food, because we're not stupid to the fact that the packaging keeps getting smaller.

I'm a mother of four. I buy a gallon of milk every single day. That

price has not gone down at all. So, the cost of necessities, this is discretionary inflation, which I track separately. Discretionary inflation is well past the Fed's 2% "target." It is only inflation for things that we don't need that has been declining, dragging down the aggregate. But for the average American household, they're struggling.

Mike: We won't get to spend too much time, but as the dollar goes down and you see the agricultural, you'll see the cost of commodities go up, because everything's pegged to the dollar and that just exacerbates it more. I was reading a bunch of consumer staples and consumer discretionary earnings reports, and with this so-called headline consumer that's working, these companies, many of them are taking guidance down. Because, yes, they got a tax break, but they had to pay more in wages. So, these companies are seeing wage inflation. Freight costs are going up for them.

So, when I look at the markets, when I look at the equity markets, they move based on growth rates. And so, with all of this good stuff that's happening, their businesses are competing every day. They're dealing now with starting to see inflation in prices in the goods they're selling, and their costs are going up. So, to me from an equities standpoint, it's a very perilous situation right now.

Danielle: The margins are getting squeezed. Absolutely.

Mike: The margins are getting squeezed and the companies have less room on their balance sheets to borrow and buy back stock. And I saw a number, Danielle, I think it's 40% of the Russell 2000 companies have their interest rates tied to LIBOR, a floating rate. So, as rates go up, their earnings go down, because they have to pay a higher interest expense.

Danielle: You bring up something nobody's paying attention to. LIBOR has been on an unrelenting march upward. And too few people, pull it up on your screens if you haven't. Pull up LIBOR.

Mike: Yeah. You're right, I don't see it talked about. When so many U.S. companies are tied to it, it's stunning to me. So, tell us what you're doing now. You're the President and CEO of Money Strong? First off, let me tell people, if you haven't read 'Fed Up,' go buy it. It's a must read. It's a great read. It's educational. Danielle writes in the way that anyone can understand it, but it's a really important subject. But, tell us about Money Strong, what you're

doing, and how readers an subscribe to your newsletter.

Danielle: So, about three days after I followed Richard Fisher into retirement and I left the Fed, I published my first newsletter and I have not skipped a week since. Which is such a delight for my family, through the holidays, et cetera. In any event, I write a newsletter that delves into everything we've been talking about. I write quite a bit about the pension fund system as well, and the lack of a fix, and what that implies for our society going forward.

But, go on DiMartinoBooth.com. You can jump on a free trial and get a 30 day look back into the archive, and get a good feel for my writing style and the fact that, believe it or not after listening to me, I really don't have the ability to hold back. And I certainly don't hold back in my writing, either. But, follow me on Twitter, if you don't already, @DiMartino Booth. It is never boring. And again, read my newsletters, read 'Fed Up.' Read it and then pass it on.

The best things that I have seen are AP Economics classes, high schools, all the students holding up 'Fed Up.' I hear from college professors, "I've put your book in the classroom." It is easy to read and it is a financial literacy primer, and you will actually enjoy yourself in the process. I promise.

Mike: I agree. Danielle, I can't thank you enough for joining us.

Danielle: Thank you for your time.

Mike: You bet. Thank you.

I hope you enjoyed the interview with Danielle. I read her book a couple of times now. I thought it was a fabulous read, and I learned a lot from reading it. And I wanted to bring her insights and thoughts to you, because I do think at times like this that it's very important to really understand what you own, why you own it, and what are some of the things that are important to be focusing on that could have an impact on that. And I hope Danielle was able to bring those insights to you.

The educational segment, I should have said earlier in the podcast, I moved up to the front, where I was talking about the things that I look for in an investment.

So, that's it for now. I'm trying to keep these, as best as I can, under an hour and a half. So, I'll keep working on that, I promise. I know it's a long listen sometimes. But, I will be back next week and I'll have an interesting guest. Somebody that I think is going to bring an interesting perspective on a different segment of the market that you may not hear about every day. But, I think it's very timely.

So, have a great week and we'll talk to you next week. Thanks.

Speaker 1: The information presented on Talking Stocks Over Beer is the opinion of its host and guest. You should not base your investment decisions solely on this broadcast. Remember, it's your money and your responsibility.