

Code Red

How to Protect Your Savings from the Coming Crisis

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Chapter 1 – The Great Experiment

Before the Great Recession, central bankers used conventional monetary policy. Now they experiment with non-conventional “Code Red” policies like:

- ZIRPs – zero interest rate policies. Many central banks have cut interest rates to zero and can't cut them anymore.
- LSAP – large-scale asset purchase program. This is when a central bank prints money to buy bonds, mortgage securities or stocks.
- QE – quantitative easing. This is when central banks expand the size of their balance sheet to influence the economy rather than through raising or lowering interest rates.
- Currency wars – is a policy to deliberately weaken your own currency. This happens when central banks use QE and ZIRP to reduce the attractiveness of holding cash.

ZIRP - In a ZIRP world, debtors are overjoyed and savers are screwed. Low borrowing costs make it easier for struggling businesses to roll over their debt and reduce the real value of debt payments.

Near zero interest rates are terrible for savers, investors, and lenders. In a ZIRP world you receive very little from interest and coupon payments forcing you to work far longer in order to save more.

Higher inflation allows the Federal Reserve and other central banks to take real interest rates below zero. Nominal interest rates are the actual interest rate you get. Real interest rates are nominal rates minus the inflation rate. So if you are receiving a nominal interest rate of 2% from your bank but inflation is 2.5% then your real interest rate is -0.5%. When real rates are negative, cash is trash. Negative real rates are like a tax on savings. Inflation eats away at your money.

QE – Central banks can increase the money supply through quantitative easing creating winners and losers. The biggest winners of printing money are governments which help to finance very large government deficits.

The second big winners are stockholders. Large-scale asset purchases artificially inflates the value of the stock market.

Debasing Your Currency – Devaluing a country's currency makes their exports more appealing to foreigners. Conversely when a currency appreciates, exports can be hit very hard.

Chapter 2 – Twentieth-Century Currency Wars

- The world is in the early stages of a currency war. Other countries will follow Japan and try to weaken their currencies. Every country will look after its own interest.
- There were two twentieth-century currency wars:
 - In the 1930s when countries devalued competitively after leaving the gold standard. The countries that left first grew fastest and were able to generate inflation.
 - In the 1970s when Bretton Woods broke down and currencies were allowed to float freely. All countries tried to devalue their currencies which led to high inflation worldwide.

Chapter 3 – The Japanese Tsunami

- Japan has been in a deflationary slump for over two decades.
 - Nominal GDP has not grown.
 - Interest rates have been stuck at zero.
 - Government debt-to-GDP is now over 240 percent!
 - There has been no control of the fiscal deficit.
 - The trade balance has deteriorated.
 - The population is both shrinking and aging.
- Japan is about to unleash the most significant currency war the world has ever seen. The rest of the world, especially Japan's direct competitors (Korea, China, Germany) will not sit idly by as Japan takes export market share from them.

Chapter 4 – A World of Financial Repression

- Financial repression results when governments and central banks artificially reduce the cost of borrowing for government debt while they generate inflation at the same time. Negative real yields or interest rates benefit governments and punish bondholders and savers.
- Financial repression makes stocks and bonds more expensive, reduces the yield on financial assets, and ultimately lowers the future potential returns for investors.
- The past several centuries, the expected return investors can make has been related to the level of real interest rates. When real interest rates were high,

investors got high returns. When real rates were negative, investors could expect poor returns. We're living in a negative real rate environment.

- Pensioners are the most affected by financial repression. Pension plans across the U.S. are underfunded and will not be able to pay out what people expect because future returns are so low due to financial repression.
- Keeping interest rates and government bond yields unnaturally low distorts markets. If government bond yields are mispriced, all other asset classes will be mispriced as well.

Financial Repression: Back to the Future

- Most governments don't get rid of their debt by default. History reveals that they slowly reduce it via financial repression.
- Financial repression is most successful in liquidating debts when accompanied by a steady dose of inflation.
- Financial repression is a form of default and debt restructuring. It simply happens to be a more subtle way to screw creditors.
- The key elements of financial repression are:
 - Capping interest rates, particularly those on government debts.
 - Forcing insurance companies, banks, and pension funds to buy government bonds; and
 - Exerting government control over banks and Social Security funds.
- Basel II includes a liquidity requirement that creates an incentive to hold more government bonds which will boost demand for government bonds by the trillions.

Chapter 5 – Arsonists Running the Fire Brigade

- The world is placing an enormous amount of trust in central bankers to get monetary policy right and do the right thing at the right time.
- Central bankers almost everywhere failed to see the Great Recession coming and many contributed to the crisis.
- Central bankers have a dismal record at managing monetary policy even in good times. It is hard to imagine they will do better in the difficult times just ahead.

Chapter 6 – Economists are Clueless

- Central banks are counting on being able to do all the right things at the right times to exit their Code Red policies. Their track record for forecasting is dismal.
- Economists are useless at forecasting recessions. They've missed almost every single recession around the world over the past 30 years.

- The main reason that economists systematically miss recessions is that they focus on lagging economic indicators.
- Leading economic indicators tell you about the future; coincident indicators tell you about the present; and lagging indicators tell you about the past. Sadly most economists focus on lagging economic indicators. That is like driving by looking at the rearview mirror.
- The Fed is still depending on models that completely failed to foresee the previous recession.
- Central banks are distorting the yield curve, stock prices, credit spreads and other prices that might give useful signals about the future.

Using Leading Indicators

Building permits are the longest, most reliable leading indicator of economic activity. Knowing whether building permits are rising or falling gives you a pretty good advance read on where the economy is going. Changes in building permits have led every economic cycle over the past 70 years.

Other leading economic indicators are:

- Growth in the money supply
- Average hours worked
- Yield curve

Yield curve – by far the best real-time predictor of economic activity is the yield curve. The yield curve is the spread between bond yields for shorter-dated and longer-dated government bonds. In normal times, the yields for longer-dated bonds are always higher than for shorter-dated bonds. However before recessions, the yield curve inverts, and shorter-dated bonds have higher yields than longer dated ones. A yield curve inversion has preceded each recession since the mid-1960s. An inverted yield curve gives you 6 to 18 months lead on a recession. Unfortunately financial repression by the central banks distorts the shape of the yield curve making it a less reliable indicator of economic activity.

Chapter 7 – Escape Velocity

- Central banks are creating potential money, not money that any of us can immediately spend. They are creating a monetary base but it has no effect until commercial banks lend it out and it sloshes around in the economy.
- The velocity of money is the measure of how quickly money moves around the economy. Since central banks have created lots of money, velocity has plunged and offset almost all of the increase in the monetary base.

- In a liquidity trap, businesses and households don't want to borrow, and banks don't want to lend. The monetary base can grow, but velocity will fall. So it becomes very hard for central banks to influence the broader money supply.
- Monetary velocity is highly correlated to the level of central bank interest rates. Low interest rates depress velocity. In a Code Red world, central banks have kept interest rates at zero, and velocity has plunged. Paradoxically, central banks should raise rates if they want velocity to rise and money to flow through the economy.

Two Opposing Economic Views

Inflationistas believe that as a result of quantitative easing extremely high inflation lies just around the corner. They recommend investors buy gold as a hedge against currency debasement.

Deflationistas believe the world is trapped in a rerun of the 1930s depression and that the best solution is for governments to spend money freely, for central banks to print money to finance the spending, and for countries to weaken their currencies to make their export markets more competitive.

Who is right? The truth lies somewhere in the middle.

Stuck in a Liquidity Trap

A liquidity trap occurs when central banks cut the nominal interest rates to zero and they are still unable to adequately stimulate the economy. The Great Recession plunged us into a liquidity trap, a situation in which many people figure they might just as well sit on cash.

The usual rules of economics don't apply when the economy is stuck in a liquidity trap. Large budget deficits don't drive up interest rates; printing money isn't inflationary; and cutting government spending has an exaggerated adverse impact on the economy. Things that worked in the past don't work in the present.

But there is a limit to how much money a government can borrow. That limit varies significantly from country to country but to suggest there is no limit puts you clearly in the camp of the delusional.

Where's the High Inflation?

At the risk of boring you there is an equation that explains why we are not experiencing high runaway inflation despite all the "money printing."

$Money \times Velocity = Price \times Real \text{ GDP}$

This equation tells you that if you increase money or velocity, you can increase nominal GDP. Inflationistas assume that doubling the monetary base will simply double the price level, but that requires velocity to stay constant.

What is velocity? It is the speed at which banks lend out the money and the speed at which it then turns over in the general economy. The Fed can dramatically increase the money supply, which they've done with quantitative easing, but they can't force banks to lend it out and consumers and businesses to borrow more than they are willing to borrow.

Despite the massive increase in the Federal Reserve's balance sheet, lending has not remotely kept pace with underlying growth in the monetary base. All the money that the Fed has created sits on the balance sheets as reserves.

So the Fed created money, and very little happened with it. It did not circulate as an infusion of liquidity, the fuel that enables an economy to accelerate. Instead it sat frozen in excess reserves.

The velocity at which money circulates – the speed at which banks, business and consumers drive the economy – has slowed. Consumers and businesses are borrowing less, and banks are lending less.

When velocity falls and banks don't lend, it is difficult to get money into consumers' hands in order to stimulate the economy.

Chapter 8 – What Will Happen When It All Goes Wrong

- Central banks have expanded their balance sheets massively. If banks loan out the excess reserves they have parked at the Fed, money growth would surge and create very high levels of inflation.
- Most central banks will tighten too late because they are afraid that they will kill off any recovery.
- Central banks are holding trillions of dollars of bonds and will sustain large losses on paper when interest rates rise. Technically, central banks will likely be insolvent.

The Mechanics of Exit

How do the central banks of the world stop quantitative easing? Based on speeches by Ben Bernanke the key steps the Fed would have to take to shrink its balance sheet are:

- **Stop buying bonds** – stock markets will not like it
- **Sell bonds in the open market** – Central bank bond selling will mean horrific losses for any who owns treasuries and much higher bond rates
- **Passively redeem agency debt and mortgage-backed securities** (MBSs) as they mature
- **Increase the interest rate paid on excess reserves** – to keep excess money parked at the Fed, central banks would be incentivized not to lend out excess reserves
- **Offer term deposits to depository institutions** in hopes of locking up cash for a long time so that it won't be lent out and start circulating.

Let's do a back-of-the-napkin calculation to estimate the costs of normalizing interest rates. An increase of 2 to 3 percent on the national debt could double the deficit over the coming years.

Exiting QE will cause all sorts of problems, but the biggest problem will come if there is no exit at all. The dirty secret of central banks is that they will likely not shrink balance sheets at all.

Chapter 9 – Easy Money Will Lead to Bubbles and How to Profit From Them

Bubbles look the same because they go through five typical phases:

- **Displacement:** A real technological advancement or economic change provides for investment opportunities.
- **Boom:** Other investors wake up to the opportunity and lending and borrowing help finance purchases.
- **Euphoria:** Everyone finally wakes up the opportunity and everyone and their brother tries to get involved in the bubble. Prices shoot up and everyone piles in.
- **Crash:** In the crash phase, insiders sell first and then everyone tries to head for the exits at the same time. Usually, banks that lent the bubble go bust in this phase.
- **Revulsion:** Investors have almost all sold and do not want to see or hear anything relating to the bubble. Prices usually become extraordinary cheap. Journalists and politicians investigate the bubble and uncover fraud and scams.

What Causes Bubbles? It should come as no surprise that bubbles happen when central banks bring rates too low. Like all bubbles, rapid price increases can rapidly reverse when interest rates return to normal levels.

The Secret to Making Money in Bubbles – The true secret to making money in bubbles is patiently waiting until the bubbles burst (they always do) and then invest when there is “blood in the streets.” With this thought in mind, cash is not simply sitting idle. Cash should be seen as a call option on a future “blood event.” If you are patient and do your homework, you can often find the best bargains of your life in the revulsion phase of a bubble. Your profits when you sell are going to be determined by the price when you buy.

Chapter 10 – Protection through Diversification

- Unless you are a superstar investor, it makes sense to let professional managers help you manage your money and diversify your investments.
- Diversification is the best protection against uncertainty and ignorance. It works because it helps you to avoid catastrophic losses.
- Investors are often their own worst enemies. Avoid common investment mistakes:
 - *Avoid being emotional.* Don't attempt to time the market. Invest for the long term.
 - *Avoid home bias.* Investors typically allocate too much money to their own country's stock market.
 - *Avoid overpaying fees.* Find funds with low management costs.
 - *Avoid overinvesting in stocks.* Many investors allocate almost all their money in equities.
 - *Avoid borrowing money to invest.* Leverage is a bad idea.

Chapter 11 – How to Protect Yourself Against Inflation

- Inflation harms savers, but it works very well at getting rid of debt.
- Inflation hurts bonds and cash more than it does stocks.
- Stocks do better than bonds, but not all stocks do well when inflation rises.
- Don't overpay for a good company. Pay a fair price for a good stock, not a high price. Even great companies can be bad investments if you overpay.

Chapter 12 – A Look at Commodities, Gold, and Other Real Assets

- Buying commodities for the long term implies betting against human ingenuity. Humans always find ways to get things out of the ground or to grow more crops more cheaply than previous generations.
- The real, inflation-adjusted prices of commodities rise or fall based on the supply that is mined or grown. In the short run, commodities can go up a lot when there are bottlenecks and supply shortages. In the long run, though, new supplies come on line and bring the value down to equal to or lower than before the shortage.

- The price of gold is most closely tied to the change in real interest rates. When inflation is above the interest rate that you can get on the cash in your bank account, gold goes up. When inflation is below the level of interest you can earn for your cash, gold will go down.
- **Gibson's Paradox** – A rule of thumb that investors expect to a real return on their cash of 2 percent. The rule states that for every percentage point the real interest rate is below 2 percent, gold returns 8 percent year-on-year *times that multiple*. So if real interest rates were 4 percent, then gold would *decline* by 16 percent. If real interest rates were 0 percent, then gold would *rise* by 16 percent. This rule has held true for over 40 years.