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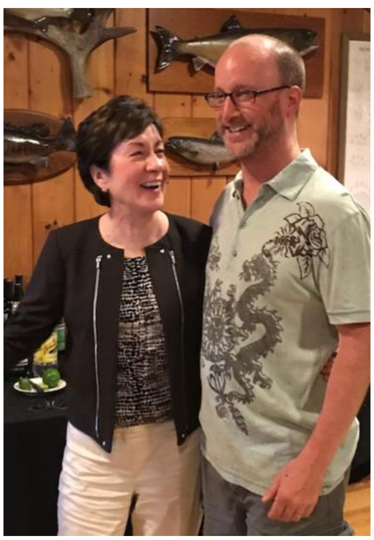

The senior United States Senator from Maine joshes around with the balding kid from Ottawa

Current View

Flat

Monday, August 21, 2017

Camp Kotok 2017

I have returned from mandatory block leave and from my annual pilgrimage to Camp Kotok. The trip is a gathering of economists, current and ex-Fed staff, traders and journalists in the bucolic backwoods of Maine. This year's gathering also included a visit from Susan Collins, one of three Republican senators voting "No" to the hastily-crafted skinny repeal health care bill. Most time was spent talking about the economy, markets and the financial industry. Here are the topics and themes I found interesting:

1. Fed relevance and credibility are making new lows. Maybe this is partly because a fair bit of discussion revolved around Danielle DiMartino-Booth's new book "Fed Up". She was at Camp Kotok and so naturally some of the topics in the book came up for discussion. I listened to the audiobook on the 9-hour drive north and have to say I found it incredibly enlightening and entertaining. The last thing I want to read (ever) is another rehash of the financial crisis so I went in with some hesitation but came away impressed. I plan on writing a review of the book for a future AM/FX but Danielle's insider status and extreme lack of filter make for some spicy reading (she worked at the Dallas Fed for 9 years, advising Richard Fisher).

   In recent years, the most intense discussion at Camp Kotok has revolved around the Fed as everyone eagerly anticipated and attempted to forecast first Fed tapering and then the timing and pace of rate hikes. This year, nobody really seemed all that interested in the Fed, and many said they thought marginal ECB and BOJ policy adjustments were more important than FOMC moves going forward. This highlights the importance of Mario Draghi's Jackson Hole message. On one hand, the ECB has tried to temper expectations into the event by saying nothing new will come of it but on the other hand the ECB Minutes' reference to EUR overshoot supports the idea of a dovish Draghi as financial conditions tighten in Europe.

   With regard to the Fed as an institution, there was a fair bit of criticism about their extremely academic and PhD / ivory tower viewpoint (again, echoing themes from "Fed Up"). The Fed is home to roughly 769 economists[1], making it (probably) the largest employer of economics PhDs in the world. It employs a total of 22,801 people at a cost of $3.3 billion per year or $142,011 per employee[2]. The Fed employs about the same number of people in the USA as American Express[3]! This compares to 4,600 employees at the BoJ, 3,600 at the BoE, 1,800 at the ECB and 1,600 at the Bank of Canada.

   Interesting side note that I ran into while researching the last paragraph: The BoJ sets a ceiling of 4,900 employees[4], perhaps in recognition of bloat risk. Jim Bianco and a few others thought that a Gary Cohn Fed Presidency might introduce a little sanity and downsizing to the organization but the room generally expected the Fed to remain risk-averse and PhD/academia-driven for many years to come.

[1] Estimated. Source: Bob Eisenbeis, Cumberland Advisors (estimate)
[2] Source: Federal Reserve 2016 Annual Report (pages 412 and 420). If you are ever super bored, there is all sorts of fascinating stuff in the Fed's Annual Report.
[3] Source: American Express 10-K
[4] https://www.boj.or.jp/en/about/activities/strategy/yosan/teiin2017.htm/

If you want to see a cool infographic showing the changes in the Federal Reserve Board of Governors over the years and how it has evolved from a multi-faceted and diverse organization to one that is very monolithic, monotheistic and dominated by academics, check this out: http://goo.gl/eCKVrS. And one final tidbit on the PhD monoculture at the Fed: The last Fed President without a PhD was Paul Volcker[5] so clearly you don't need a PhD to succeed as Fed President.

Kevin Warsh has been beating the drum on Fed groupthink for a while. His most recent comments appear here: https://www.bis.org/publ/bppdf/bispap92.pdf.

And there is another great Warsh piece from 2016 called "Challenging the Groupthink of the Guild" here. A couple of highlight paragraphs from his most recent speech:

> *What is the groupthink of which I speak? It's a groupthink on monetary policy tactics, tools, governance and strategy, all. Its stated mantra of data dependence causes erratic lurches owed to noisy economic measures. Its statutory medium-term policy objectives are at odds with its myopic compulsion to keep asset prices elevated.*
>
> *Its inflation objectives are far more precise than the residual measurement error. Its preferred output gap models are deeply flawed and troublingly unreliable, obfuscating uncertainty and masking policy bias. Moreover, the groupthink seeks to fix interest rates and control foreign exchange rates simultaneously. Its forward guidance begets ambiguity in the name of clarity. It licenses a cacophony of communications in the name of transparency. It recasts poor economic results with a high-sounding slogan of secular stagnation. And it expresses grave concern about income inequality while refusing to acknowledge the effect of its policies on more consequential asset inequality*
>
> *All the while, the groupthink gathers adherents as its successes become harder to find. Too many in the guild tighten their grip when they should open their minds to new data sources, new data analytics, new economic models, and a new paradigm for policy.*

2. Eight years of zero rates have not generated a strong US recovery simply because of demographics and we need to stop foolishly expecting 3% growth all the time when working age population growth is at all-time lows[6]. The only way to grow GDP is to grow output per person, or grow the number of people. In other words, a big chunk of GDP growth in most countries comes simply from population growth. US demographics are getting worse and worse as you can see in the chart on the next page…

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[5] Though the details around Alan Greenspan's PhD are sketchy.

[6] For more on the topic of economic growth as a flawed and illogical religion (and much, much more) check out the book Homo Deus: A Brief History of Tomorrow by Yuval Harari. Like Sapiens (his previous book) it's an incredibly well-written and enlightening book that makes hamburger out of many sacred cows.

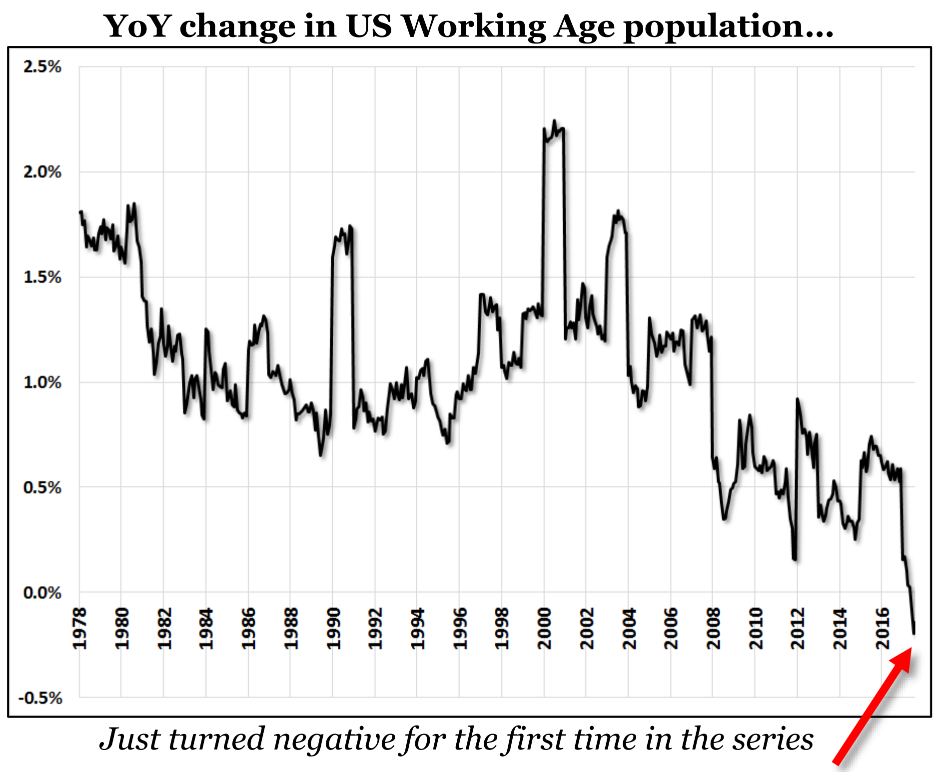


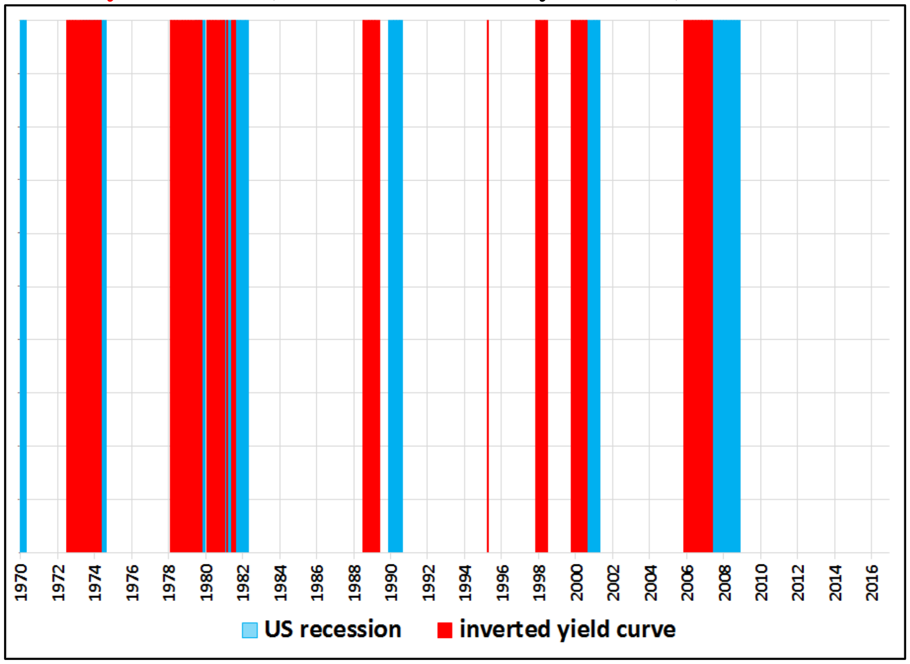
Chart by AM/FX, data from: https://fred.stlouisfed.org/series/LFWA64TTUSM647S

So while the Fed attempts to exert its power over the massive and infinitely-complex US economy via interest rates, the natural headwinds of structurally slowing population growth are probably a much stronger driver than the level of Fed Funds.

3. One economist suggested she was worried about a US recession given Fed tightening, political turmoil, low investment, weakness in auto sales, government debt and so on. I asked the question: Has there ever been a US recession without an inverted yield curve first? Surprisingly, the economists in the conversation didn't immediately know the answer. The answer is no. Every recession since 1970 was signaled in advance by an inverted yield curve. And with US 10-year yields still trading 90 basis points above Fed Funds (FF), we are not that close to the danger point. Also note that when the yield curve inverts, the recession is usually still about two more years away.

   I built a chart (see next page) showing months with an inverted yield curve in red and months of US recession in blue. I use FF vs. 10-year yields because FF is the rate controlled by the Fed and I think the main premise behind the negative yield curve argument is it's a simple way of measuring when the market believes the Fed is too tight. You can see there was a brief false positive in 1995 but otherwise the indicator has a very, very good track record. Even if you extrapolate the slope of the flattening from June 2016 to now, the yield curve doesn't go negative until mid-2018 which puts a US recession far outside most people's relevant forecast / trading horizon.

Inverted yield curve (Fed Funds > US 10-year rates) and US recession



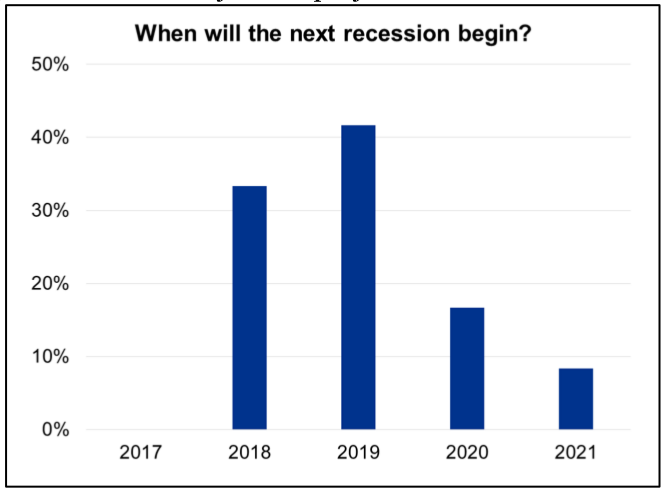
I looked to see if this information would translate into a useful equity model. The answer is "Yes, if you (and your investors) are incredibly patient." If you simply exit stocks when the yield curve is negative for three months in a row and get back in three years later, your Sharpe is much better than buy and hold. You still lose in terms of absolute returns, though. The table below shows the results. Inverted yield curve risk is defined as the 36 months after the yield curve turns negative for 3 straight months.

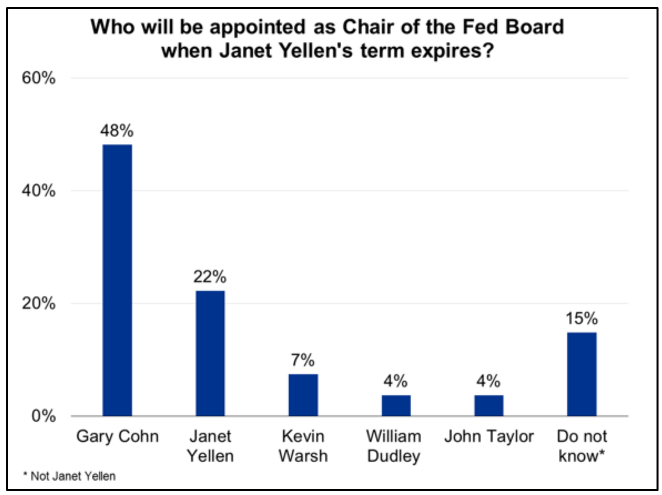
US stocks underperform in the three years after the yield curve goes negative

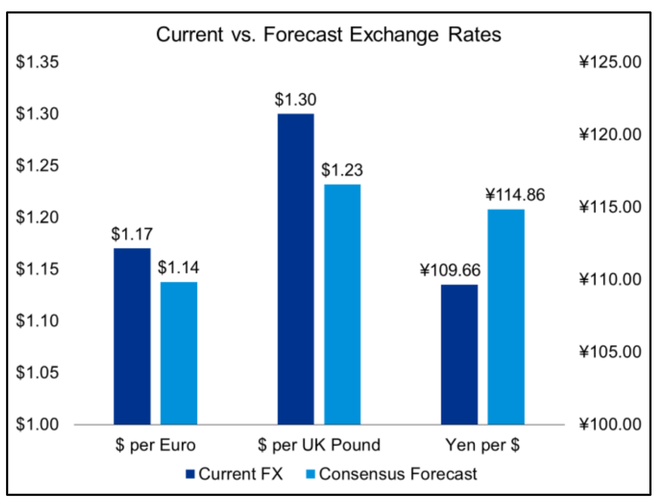
S&P 500 Index	All months	Months without inverted yield curve risk	Months with inverted yield curve risk
Average monthly returns	0.7%	0.9%	0.2%
Monthly Standard Deviation	4.4%	3.8%	5.2%

4. Camp Kotok attendees complete a survey on various topics and here are a few interesting results, courtesy of the press release after the event (see next page):

Survey of 50 economists and finance professionals conducted in early August







Since this is going to be a crazy long PDF anyway, I also put the full survey results at the end of the piece.

5. Bitcoin bitcoin blah blah blah. I still think it's going to approximately zero in the next three years but 22-to-32 year-olds want to party like it's 1999. You can't make money

short a bubble so I am doing my best to ignore the current FOMO-driven mania. At least tulips are pretty to look at.

6. Active vs. passive and falling fees was a huge discussion topic. Clearly a worrisome trend for alpha generators and fee collectors and a boon for the ETF sellers at the retreat. Whether the trend to passive is good or bad was in the eye of the beholder (subject to strong bias based on who worked where!) To me, the trend to passive is not good or bad—it just is. Similar to the automation of FX market making through the 2000s, the automation of the investment process will have winners and losers but there will always be room for adaptable and versatile humans to prosper. When I started in spot trading in 1995, there were 30 traders on the spot desk (large USD/DEM, medium USD/DEM, small USD/DEM, DEM/ITL, small USD/JPY, large USD/JPY, etc.!). Now a normal NY spot desk has 4 or 5 traders. But the job is 10 times more interesting. Fewer, but much more satisfying and interesting jobs are the net result of automation. No point complaining. Adapt or die.

7. A remarkable part of the retreat was when Susan Collins (the senior United States Senator from Maine) arrived as a guest Friday evening. She spoke about her historic vote against Trump's skinny health care repeal, about the sleep deprivation from travelling abroad to exotic locales with John McCain (who is apparently always the last one to shut things down late at night) and how she still cannot understand why Trump didn't start with infrastructure, which would have a been a bipartisan layup. Nothing actionable from a markets point of view but it was interesting to see this tiny woman speak with such enormous confidence and brainpower.

8. Finally, there was optimism that 2018 should be a volatile and interesting year. In oil markets, the Aramco IPO + difficult to forecast changes in crude oil supply and demand will matter while the Chinese Congress should increase volatility around all things China as global central bank balance sheets start to contract.

Thanks for reading. Back to the usual one-pager tomorrow.

Good Luck ↕ Be Nimble

Read more about Camp Kotok here:
http://www.cumber.com/category/camp-kotok/

Excerpt from the post-event Camp Kotok press release:

Camp Kotok Economic Survey

Conducted August 1st – August 9th, 2017

An annual retreat of business leaders, economists and journalists, known as "Camp Kotok" brings together some of the brightest minds in the industry to discuss the current economic landscape and trends for the future. Organized by David Kotok of Cumberland Advisors, this annual corporate retreat to Leen's Lodge in Maine provides a unique opportunity to gauge the expectations for the coming year on hot button issues. This year, attendees discussed everything from the Fed to politics to the productivity puzzle. Attendees were surveyed for their views and the attached responses sheds light on their expectations for key economic, fiscal and monetary policy developments 12 months from now.

Table 1 – Forecasts for July 31st, 2018:

Indicator	Average	Median	Std. Dev.	Low	High
3-month LIBOR (%)	1.64	1.58	0.51	0.75	3.00
10 yr. T. Note (%)	2.57	2.63	0.39	1.75	3.16
WTI Crude Oil Price ($/bbl, Current: $49.50)	$50.2	$51.6	$9.7	$30.0	$76.5
S&P 500	2416	2501	275	1800	2718
Gold Price ($/oz)	$1,340	$1,313	$161	$1,100	$1,900
$ per Euro	$1.14	$1.14	$0.12	$0.80	$1.35
$ per UK Pound	$1.23	$1.25	$0.13	$1.00	$1.54
Yen per $	¥115	¥115	¥10	¥99	¥138
Unemployment Rate in June 2018 (%)	4.4	4.2	0.5	3.3	5.5
Core (ex food and energy) CPI % change from June 2017 to June 2018	1.9	2.0	0.5	1.0	3.2
Case-Shiller U.S. HPI % change from May 2017 to May 2018	3.6	4.2	1.8	0.0	6.8
U.S. Real GDP % change from 2Q'17 to 2Q'18	2.12	2.30	0.68	0.35	3.10

Table 2 – Supplementary Expectations:

Indicator	Mode	Low	High
Next Fed Funds Rate Change	4Q'17	3Q'17	Later
Fed Funds Target EOY 2017	1.25-1.50%	1.00-1.25%	1.75-2.00%
Fed Funds Target EOY 2018	1.75-2.00%	0.50%	3.00-3.25%
Peak Fed Funds Target	2.25-2.50%	1.25%	3.50-3.75%
Peak Fed Funds Period	2Q'19	4Q'17	4Q'19
Beginning of Fed Balance Sheet Shrinking	3Q'17/4Q'17	3Q'17	4Q'17
Will Janet Yellen be reappointed Chair of the Fed Board?	No	-	-
If not, next Fed Board Chair	Gary Cohn	-	-
Will individual income tax reform pass in the next 12 months?	Yes	-	-
Will corporate income tax reform pass in the next 12 months?	Yes	-	-
Potential GDP Growth Estimate	2.1	1.3	3.5
When will the next recession begin?	1Q'19	1Q'18	4Q'21

Source: Sharon Prizant's phone

The senior United States Senator from Maine joshes around with the balding kid from Ottawa

Official Susan Collins pic:

Source: Wikipedia

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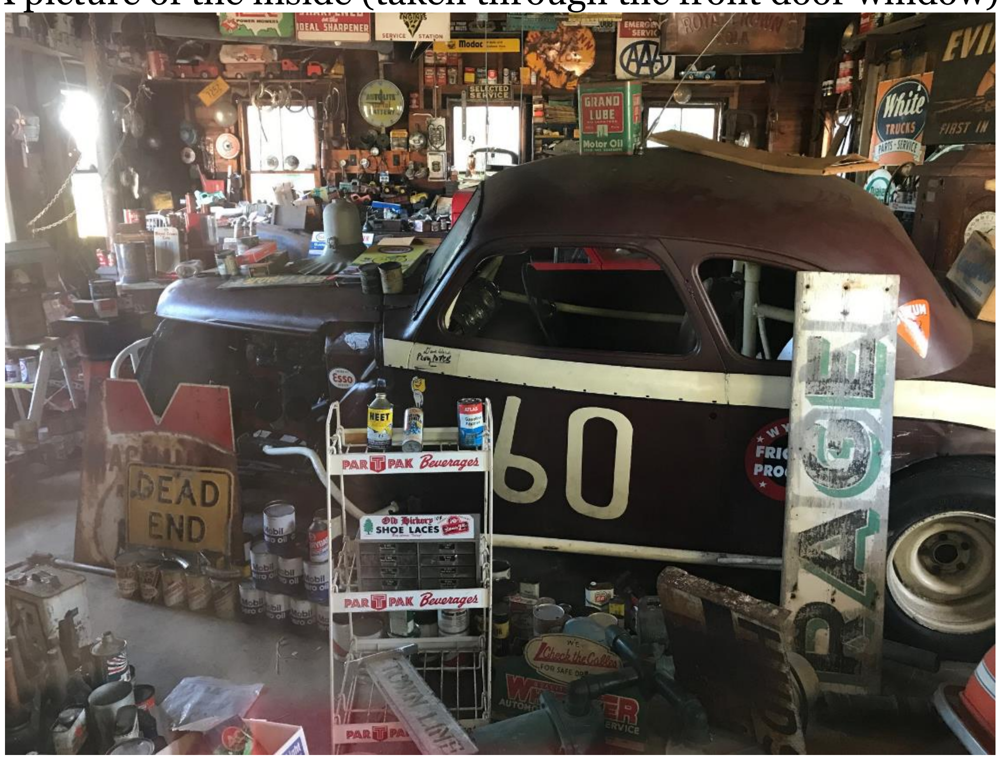
Some cool shots I took of an abandoned gas station
I drove past in rural Maine:

From the outside:

A picture of the inside (taken through the front door window):



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