

An Uncomfortable Choice

by John Mauldin
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What Were We Thinking?

As a culture, the current mix of generations, especially in the US, has made some choices. Choices which, in hindsight, leave the adult in us asking, "What were we thinking?"

In a way, we were like teenagers. We made the easy choice, not thinking of the consequences. We never absorbed the lessons of the Depression from our grandparents. We quickly forgot the sobering malaise of the '70s as the bull market of the '80s and '90s gave us the illusion of wealth and an easy future. Even the crash of Black Friday seemed a mere bump on the path to success, passing so quickly. And as interest rates came down and money became easier, our propensity to acquire things took over.

And then something really bad happened. Our homes started to rise in value and we learned through new methods of financial engineering that we could borrow against what seemed like their ever-rising value, to finance consumption today.

We became Blimpie from the Popeye cartoons of our youth: "I will gladly repay you Tuesday for a hamburger today."

Not for us the lay-away programs of our parents, patiently paying something each week or month until the desired object could be taken home. Come to think of it, I am not sure if my kids (15 through 32) have ever even heard of a lay-away program, not with credit cards so easy to obtain. Next family brunch, I will explain this quaint concept. (Interestingly, I heard about a revival of the concept on CNBC radio, coming back from dropping Trey off at school this morning. Everything old is new again.)

As a banking system, we made choices. We created all sorts of readily available credit, and packaged it in convenient, irresistible AAA-rated securities and sold them to a gullible world. We created liar loans, no-money-down loans, and no-documentation loans and expected them to act the same way that mortgages had in the past. What were the rating agencies thinking? Where were the adults supervising the sand box?

(Oh, wait a minute. DThat's the same group of regulators who now want more power and money.)

It is not as if all this was done in some back alley by seedy-looking characters. This was done on TV and in books and advertisements. I remember the first time

I saw an ad telling me to call this number to borrow up to 125% of the value of my home, and wondering how this could be a good idea.

Turns out it can be a great idea for the salesmen, if they can package those loans into securities and sell them to foreigners, with everyone making large commissions on the way. The choice was to make a lot of money with no downside consequences to yourself. What teenager could say no?

Greenspan keeping rates low aided and abetted that process. Starting two wars and pushing through a massive health-care package, along with no spending control from the Republican Party, ran up the fiscal deficits.

Allowing credit default swaps to trade without an exchange or regulations. A culture that viscerally believed that the McMansions they were buying were an investment and not really debt. Yes, we were adolescents at the party to end all parties.

Not to mention an investment industry that tells their clients that stocks earn 8% a year real returns (the report I mentioned at the beginning goes into detail about this). Even as stocks have gone nowhere for ten years, we largely believe (or at least hope) that the latest trend is just the beginning of the next bull market.

It was not that there were no warnings. There were many, including from your humble analyst, who wrote about the coming train wreck that we are now trying to clean up. But those warnings were ignored.

Actually, ignored is a nice way to put it. Derision. Scorn. Laughter. And worse, dismissal as a non-serious perpetual perma-bear. My corner of the investment-writing world takes a very thick skin.

The good times had lasted so long, how could the trend not be correct? It is human nature to believe the current trend, especially a favorable one that helps us, will continue forever.

And just like a teenager who doesn't think about the consequences of the current fun, we paid no attention. We hadn't experienced the hard lessons of our elders, who learned them in the depths of the Depression. This time it was different. We were smarter and wouldn't make those mistakes. Didn't we have the research of Bernanke and others, telling us what to avoid?

In millions of different ways, we all partied on. It wasn't exclusively a liberal or a conservative, a rich or a poor, a male or a female addiction. We all borrowed and spent. We did it as individuals, and we did it as cities and states and countries.

We ran up unfunded pension deficits at many local and state funds, to the tune of several trillion dollars and rising. We have a massive, tens of trillions of dollars,

bill coming due for Social Security and Medicare, starting in the next 5-7 years, that makes the current crisis pale in comparison. We now seemingly want to add to this by passing even more spending programs that will only make the hole deeper.

Frugality is the New Normal

I could go on and on, but I think you get the point. The time for good choices was a decade ago. It would have been more difficult at the time, so that is not what we did. And now we wake up and are faced with a set of choices, none of them good.

Reality is staring back in the mirror at the American consumer, and especially the Boomer generation. The psyche of the American consumer has been permanently seared. We are watching savings beginning to rise and consumer spending patterns change for the first time in generations. Even as the authorities try to prod consumers back into old habits, they are not responding. Borrowing and credit are actually falling. Banks, for whatever reason, now want borrowers to actually be able to pay them back. Go figure.

Frugality is the new normal. We are resetting the underpinnings of a consumer-driven society to a new level. It will require a major overhaul of our economy. The normal drivers of growth - consumer spending, business investment, and exports - are all weak, and it is only because of massive government spending that the second quarter was not as bad as the two previous quarters and that the coming quarter will be positive.

But what then? How long can we continue with 10%-plus GDP deficits? We have an economy that is in a Statistical Recovery, fueled by government largesse. In the real world, we are watching unemployment rise, and it is likely to do so through the middle of next year. Deflation is in the air. Capacity utilization is near all-time lows. Housing numbers are only bouncing because of the government program of large tax credits for first-time home buyers and lower home prices. It will be years before construction is significant.

We will be faced with a choice this fall and early next year. If you take away the government spending, the potential for falling back into a recession is quite high, given the underlying weakness in the economy. A few hundred billion for increased and extended unemployment benefits will not be enough to stem the tide. There will be a groundswell for yet another stimulus package. Another 10% of GDP deficit is quite likely for next year.

As I (and Woody Brock) have made very clear in these e-letters, deficits that are higher than nominal GDP cannot continue without dire consequences. Good friend Richard Russell writes today:

"The US national debt is now over \$11 trillion dollars. The interest on our national debt is now \$340 billion. This is about at 3.04% rate of interest. In ten years the Obama administration admits that they will add \$9 trillion to the national debt. That would take it to \$20 trillion. Let's say that by some miracle the interest on the national debt in 10 years will still be 3.09%. That would mean that the interest on the national debt would be \$618 billion a year or over one billion a day. No nation can hold up in the face of those kinds of expenses. Either the dollar would collapse or interest rates would go through the roof."

That would be at least 30% of the national budget. How would your household do, paying that much as interest? How can you operate when interest payments are 30% or more of the budget? Do you borrow to pay the interest? And the Obama administration openly admits to deficits of over a trillion a year for the next ten years, under very rosy growth assumptions. Anyone outside of Washington and rosy-eyed economists think we will grow 4% next year? I am not seeing many hands go up.

And Then We Face the Real Problem

If we do not maintain high deficits, it is likely we fall back into recession. Yet if we do not control spending, we risk running up a debt that becomes very difficult to finance by conventional means. Monetizing the debt can only work for a few trillion here or there. At some point, the bond market will simply fall apart. And it could happen quickly. Think back to how fast things fell apart in the summer of 2007. When perception of the potential for inflation changes, it changes things fast.

The problem is that we are now in a very deflationary world. Deleveraging, too much capacity, high and rising unemployment, falling real incomes, and more are all the classic pieces of the formula for deflation.

Let's look at what my friend Nouriel Roubini recently wrote. I think he hit the nail on the head:

"A combination of higher official indebtedness and monetization has the potential to yield the worst of all worlds, pushing up long-term rates and generating increased inflation expectations before a convincing return to growth takes hold. An early return to higher long-term rates will crowd out private demand, as lending rates on mortgages and personal and corporate loans rise too. It is unlikely that actual inflation will emerge this year or even next, but inflation expectations as reflected in long-term interest rates could well be rising later in 2010. This would represent a serious threat to economic recovery, which is predicated on the idea that the actual borrowing rates that individuals and businesses pay will remain low for an extended period.

"Yet the alternative - the early withdrawal of the stimulus drug that governments have been dispensing so freely - is even more serious. The present administration believes that deflation is a worse threat than inflation. They are right to think that. Trying to rebuild public finances at a deflationary moment - a time when unemployment is rising, and private demand is still contracting - could be catastrophic, turning recovery into renewed recession."

There are no good choices. Nouriel, optimist that he is (note sarcasm), suggests that there is a possibility that the government can manage expectations by showing a clear path to fiscal responsibility that can be believed. And thus the bond markets do not force rates higher, thereby thwarting recovery.

And technically he is right. If there were adults supervising the party, it might be possible. But there are not. **The teenagers are in control.** Instead of fiscal discipline, we are hearing increased demands for more spending. Please note that the very rosy future-deficit assumptions assume the end of the Bush tax cuts at the close of 2010. But raising taxes back to the level of 2000 does not make the projected future budget deficits go away.

I mean, seriously, does anyone think Pelosi or Reid are going to lead us to fiscal constraint? Obama talks a good game, but he has not offered a serious deficit-reduction proposal, other than further tax increases. And by serious, I mean we need cuts on the order of several hundred billion dollars. The Republicans lost their way and their power (deservedly, in my opinion). Just as at the high school prom, the very few adults are being ignored.

It is the proverbial rock and the hard place. Cut the stimulus too soon and we slide back into a deeper recession. Let the budget spin out of control for a few years and we will see inflation return, with higher rates and a recession. Raise taxes by 1.5-2% of GDP in 2010 and we are shoved back into recession.

There are no good choices. If we do the right thing and cut the deficit, it means very hard choices. Can we keep our commitments to two wars and our massive defense budget? Medicare and Social Security reform are not painless. Education? Research? The "stimulus"? But cutting the deficit by hundreds of billions while raising taxes by even more than is already in the works, is not the formula for sustainable recovery.

Have we grown up? Are there adults in the room? Sadly, I don't think there are enough. We are still a nation of teenagers. We will do whatever we can to avoid the pain today. We will kick the can down the road, hoping for a miracle. Will we grow up? Yes, but the lessons learned will be hard.

There are no statistical signs of an impending recession. We are not going to get an inverted yield curve this time, which made it relatively easy for me to predict

recessions in 2000 and 2006. We are in a deflationary, deleveraging world. A far different world than in the past.

I see little room for us to avoid a double-dip recession. It would take the skill and speed of former Cowboys running back Tony Dorsett hitting a very small hole in the line to break us into the open. I see no running back in our national leadership with such ability. As I have outlined above, recession could be triggered again in any number of very different economic environments. It all depends on the choices we make. But the choices lead to the same consequences, at least in my opinion.

As I wrote in August 2000 and August 2006, I write again in August 2009: there is a recession in our future. I was early both of those times and I am early now, maybe two years early, though I doubt it. And as I pointed out both of those last times, the stock market drops an average of over 40% during a recession. When I was on Kudlow in October of 2006, I was given a hard time about my recession call and prediction of a bear market. I think it was John Rutherford who dismissed my bearish vision. And he was right for the next three quarters, as the market proceeded to rise another 20%. I looked foolish to many, but I maintained my views.

You have choices. You can buy and hold (buy and hope?) or you can develop a strategic alternative. The next bear market, as I wrote in 2003 and in *Bull's Eye Investing*, will likely be the bottom. (It takes at least three of them to really take us to the bottom.) But the next one will change perceptions for a long time. Valuations will drop. Savings will rise even more. And a generation will grow up. The adults will return. Chastened. Scarred. Shaken. But we will Muddle Through. That is what we do. Even my teenagers.

Choose wisely.