Forecast 2014: The Killer D's

By John Mauldin | January 12, 2014

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It seems I'm in a constant dialogue about the markets and the economy everywhere I go. Comes with the territory. Everyone wants to have some idea of what the future holds and how they can shape their own personal version of the future within the Big Picture. This weekly letter is a large part of that dialogue, and it's one that I get to share directly with you. Last week we started a conversation looking at what I think is the most positive and dynamic aspect of our collective future: The Human Transformation Revolution. By that term I mean the age of accelerating change in all manner of technologies and services that is unfolding before us. It is truly exhilarating to contemplate. Combine that revolution with the growing demand for a middle-class lifestyle in the emerging world, and you get a powerful engine for growth. In a simpler world we could just focus on those positives and ignore the fumbling of governments and central banks. Alas, the world is too complex for that.

We'll continue our three-part 2014 forecast series this week by looking at the significant economic macrotrends that have to be understood, as always, as the context for any short-term forecast. These are the forces that are going to inexorably shift and shape our portfolios and businesses. Each of the nine macrotrends I'll mention deserves its own book (and I've written books about two of them and numerous letters on most of them), but we'll pause to gaze briefly at each as we scan the horizon.

The Killer D's

The first five of our nine macro-forces can be called ***the Killer D's***: Demographics, Deficit, Debt, Deleveraging, and Deflation. And while I will talk about them separately, I am really talking threads that are part of a tapestry. At times it will be difficult to say where one thread ends and the others begin.

Demographics – An Upside Down World

One of the most basic human drives is the desire to live longer. And there is a school of economics that points out that increased human lifespans is one of the most basic and positive outcomes of economic growth. I occasionally get into an intense conversation in which someone decries the costs of the older generation refusing to shuffle off this mortal coil. Typically, this discussion ensues after I have commented that we are all going to live much longer lives than we once expected due to the biotechnological revolution. Their protests sometimes make me smile and suggest that if they are really worried about the situation, they can volunteer to die early. So far I haven't had any takers.

Most people would agree that growth of the economy is good. It is the driver of our financial returns. But older people spend less money and produce far less than younger, more active generations do. Until recently this dynamic has not been a problem, because there were far more young people in the world than there were old. But the balance has been shifting for the last few decades, especially in Japan and Europe.

An aging population is almost by definition deflationary. We can see the results in Japan. An aging, conservative population spends less. An interesting story in the European *Wall Street Journal* this week discusses the significant amount of cash that aging Japanese horde. In Japan there is almost three times as much cash in circulation, per person, as there is in the US. Though Japan is a country where you can buy a soft drink by swiping your cell phone over a vending machine data pad, the amount of cash in circulation is rising every year, and there are actually proposals to tax cash so as to force it back into circulation.

A skeptic might note that 38% of Japanese transactions are in cash and as such might be difficult to tax. But I'm sure that Japanese businesses report all of their cash income and pay their full share of taxes, unlike their American and European counterparts.

> Sidebar: It is sometimes difficult for those of us in the West to understand Japanese culture. This was made glaringly obvious to me recently when I watched the movie *47 Ronin.* In the West we may think of Sparta or the Alamo when we think of legends involving heroic sacrifice. The Japanese think of the 47 Ronin. From Wikipedia:
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>> The revenge of the Forty-seven Ronin (四十七士 *Shi-jū-shichi-shi*, forty-seven samurai) took place in Japan at the start of the 18th century. One noted Japanese scholar described the tale, the most famous example of the samurai code of honor, bushidō*,* as the country's "national legend."
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>> The story tells of a group of samurai who were left leaderless (becoming *ronin*) after their *daimyo* (feudal lord) Asano Naganori was compelled to commit seppuku (ritual suicide) for assaulting a court official named Kira Yoshinaka, whose title was Kōzuke no suke. The *ronin* avenged their master's honor by killing Kira, after waiting and planning for almost two years. In turn, the *ronin* were themselves obliged to commit *seppuku* for committing the crime of murder. With much embellishment, this true story was popularized in Japanese culture as emblematic of the loyalty, sacrifice, persistence, and honor that people should preserve in their daily lives. The popularity of the tale grew during the *Meiji* era of Japanese history, in which Japan underwent rapid modernization, and the legend became subsumed within discourses of national heritage

and identity.

The point of my sidebar (aside from talking about cool guys with swords) is that, while Japan may be tottering, the strong social fabric of the country, woven from qualities like loyalty, sacrifice, and diligence, should keep us from being too quick to write Japan off.

"Old Europe" is not far behind Japan when it comes to demographic challenges, and the United States sees its population growing only because of immigration. Russia's population figures do not bode well for a country that wants to view itself as a superpower. Even Iran is no longer producing children at replacement rates. At 1.2 children per woman, Korea's birth rates are even lower than Japan's. Indeed, they are the lowest in the World Bank database.

A basic equation says that growth of GDP is equal to the rate of productivity growth times the rate of population growth. When you break it down, it is really the working-age population that matters. If one part of the equation, the size of the working-age population, is flat or falling, productivity must rise even faster to offset it. Frankly, developed nations are simply not seeing the rise in productivity that is needed.

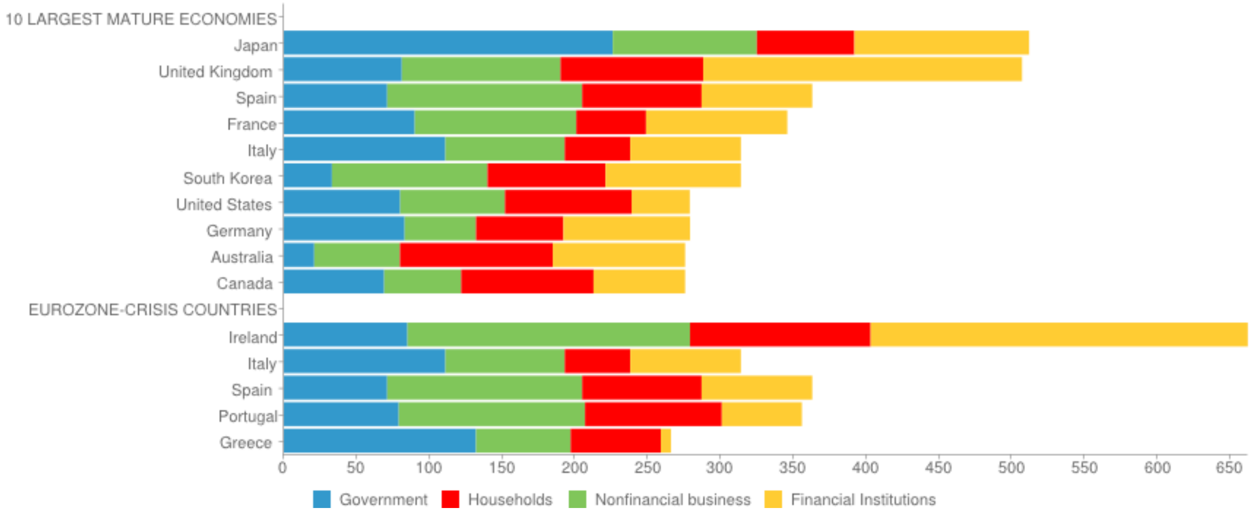
As a practical matter, when you are evaluating a business as a potential investment, you need to understand whether its success is tied to the growth rate of the economy and the population it serves.

The Twin Dangers of Debt and Deficits

In our book Endgame Jonathan Tepper and I went to great lengths to describe the coming crisis in sovereign debt, especially in Europe – which shortly began to play itself out. In the most simple terms, there can come a point when a sovereign government runs up against its ability to borrow money at reasonable rates. That point is different for every country. When a country reaches the ***Bang!*** moment, the market simply starts demanding higher rates, which sooner or later become unsustainable. Right up until the fateful moment, everyone says there is no problem and that the government in question will be able to control the situation.

If you or I have a debt issue, the solution is very simple: balance our family budget. But it is manifestly more difficult, politically and otherwise, for a major developed country to balance its budget than it is for your average household to do so. There are no easy answers. Cutting spending is a short-term drag on the economy and is unpopular with those who lose their government funding. Raising taxes is both a short-term and a long-term drag on the economy.

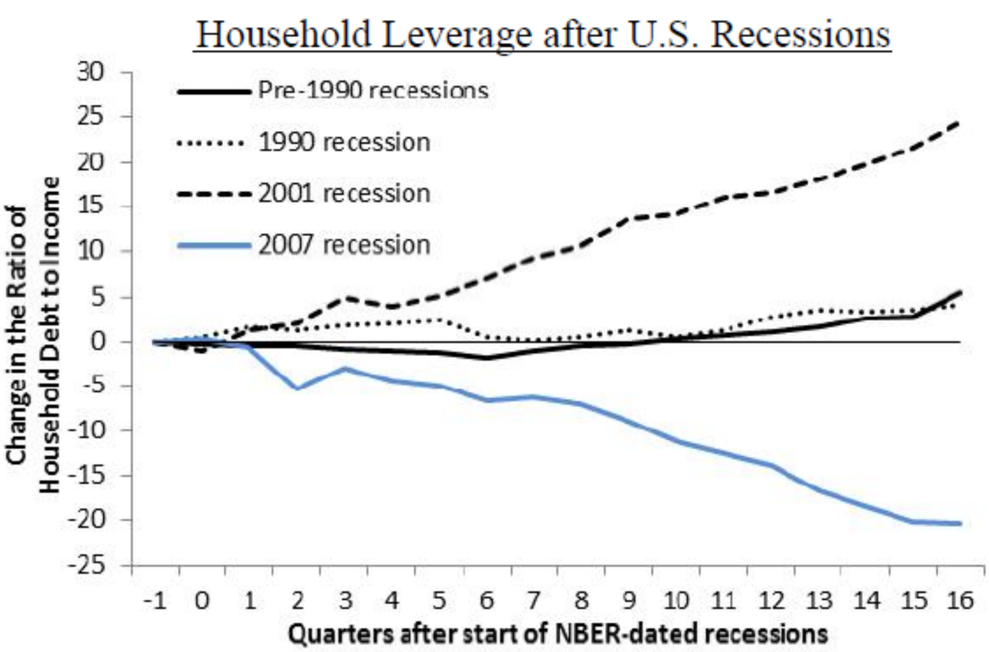
The best way to get out of debt is to simply hold spending nominally flat and eventually grow your way out of the deficit, as the United States did in the 1990s. Who knew that 15 years later we would be nostalgic for Clinton and Gingrich? But governments almost never take that course, and eventually there is a crisis. As we will see in a moment, Japan elected to deal with its deficit and debt issues by monetizing the debt. Meanwhile, in Europe, the ECB had to step in to save Italy and Spain; Greece, Ireland, and Portugal were forced into serious austerities; and Cyprus was just plain kicked over the side of the boat.



There is currently a lull in the level of concern about government debt, but given that most developed countries have not yet gotten their houses in order, this is a temporary condition. Debt will rear its ugly head again in the not-too-distant future. This year? Next year? 2016? Always we pray the prayer of St. Augustine: "Lord, make me chaste, but not today."

Deleveraging and Deflation – They Are Just No Fun

At some point, when you have accumulated too much debt, you just have to deal with it. My associate Worth Wray forwarded the following chart to me today. There is no better explanation as to why the current recovery is the weakest in recent history. Deleveraging is a b*tch. It is absolutely no fun. Looking at this chart, I find it rather remarkable and somewhat encouraging that the US has done as well as it has the past few years.



As I've outlined at length in other letters and in Code Red, central banks can print far more money than any of us can imagine during periods of deleveraging and deflation. For the record, I said the same thing back in 2010 when certain hysterical types were predicting hyperinflation and the end of the dollar due to the quantitative easing of the Federal Reserve. I remain actively opposed to the current level of quantitative easing, not because I'm worried about hyperinflation but for other reasons I have discussed in past letters. As long as the velocity of money keeps falling, central banks will be able to print more money than we would have thought possible in the '70s or '80s. And seemingly they can get away with it – in the short term. Of course, payback is a b*tch. When the velocity of money begins to rise again for whatever unknown reason, central banks had better have their ducks in a row!

Deflationary conditions make debt worse. If you borrow money at a fixed rate, a little inflation – or even a lot of inflation – helps a great deal. To think that even conservative Republican leaders don't get that is naïve. Certainly it is understood in Japan, which is why the success of Abenomics is dependent upon producing inflation. More on that below.

For governments, there is more than one way to deleverage. You can default on your payments, like Greece. We're going to see a lot more of that in the next five years – count on it. Or you can get your central bank to monetize the debt, as Japan is doing. Or get the central bank to convert your debt into 40-year bonds, as Ireland did. (Brilliant move, by the way, for tiny Ireland – you have to stand back and applaud the audacity. I wonder how much good Irish whiskey it took to get the ECB to agree to that deal?)

Inflation is falling almost everywhere today, even as central banks are as accommodative as they have ever been. Deflation is the default condition in a deleveraging world. It can even create an *economic singularity.*

Singularity was originally just a mathematical term for a point at which an equation has no solution. Then, in astrophysics, it was proven that a large-enough collapsing star would become a black hole so dense that its own gravity would cause a singularity in the fabric of space-time, a point where many standard physics equations suddenly have no solution.

Beyond the "event horizon" of the black hole, the physics models no longer work. In terms of general relativity, an event horizon is a boundary in space-time beyond which events cannot affect an outside observer. In a black hole it is "the point of no return," i.e., the point at which the gravitational force becomes so large that nothing can escape.

Deflation and collapsing debt can create their own sort of black hole, an economic singularity. At that point, the economic models that we have grown comfortable with no longer work. As we approach a potential event horizon in a deflationary/deleveraging world, it can be a meaningless (and extremely frustrating) exercise to try to picture a future that is a simple extension of past economic reality. Any short-term forecast (less than one or two years) has to bear that fact in mind.

We Are in a Code Red World

We need to understand that there has been a complete bureaucratic and academic capture of central banks. They are all run by neo-Keynesians. (Yes, I know there are some central bankers who disavow the prevailing paradigm, but they don't have the votes.) The default response of any present-day central banker faced with a crisis will be massive liquidity injections. We can argue with the tide, but we need to recognize that it is coming in.

When there is a recession and interest rates are at or close to the zero bound, there will be massive quantitative easing and other, even more creative injections of liquidity into the system. That is a reality we have learned to count on and to factor into our projections of future economic possibilities. But as to what set of econometric equations we should employ in coming up with *accurate, dependable* projections, no one, least of all central bankers, has a clue. We are in unknown territory, on an economic Star Trek, with Captain Bernanke about to turn the helm over to Captain Yellen, going where no reserve-currency-printing central bank has gone before. This is not Argentina or Zimbabwe we are talking about. The Federal Reserve is setting its course based on economic theories created by people whose models are demonstrably terrible.

Will we have an outright recession in the US this year? I currently think that is unlikely unless there is some kind of external shock. But short-term interest rates will stay artificially low due to financial repression by the Fed, and there will be an increased risk of further monetary creativity from a Yellen-led Fed going forward. Stay tuned.

China, Europe, and Japan – Crises in Waiting

We have been waiting for over a decade for a hard landing in China. When you go to Asia it is the number one topic you are questioned about. How long can the Chinese continue to forestall the sort of correction that has needed to take place in every other developed economy in the world?

China is undergoing its most serious policy changes of the last 30 years. The new leadership appears to be taking an aggressive stance toward correcting the problems of excess leverage and bank debt that are obvious to anyone who pays attention. The correction will not be easy, and it will be quite costly, but they may in fact have the ability to skate through without the major depression that typically accompanies a massive bank restructuring. What the unintended consequences are remains to be seen.

China must be watched. It is a major world power in the midst of restructuring. It is in the process of growing old before it grows rich, something no other country of its size and importance has ever done. At the same time that it is dealing with its banking issues, it is trying to shift to become a consumer economy rather than a cheap-labor economy. Like Singapore, it wants to move up the intellectual-capital chain. Singapore has made important transitions multiple times and is a model to be admired. But China is some 250 times larger than Singapore. And its government institutions, especially at the lower levels, are corrupt and inefficient. There is an apparent recognition by the current new leadership that this is a situation that must change, too.

Japan May Be a Moose in Search of a Windshield

I have written about Japan on numerous occasions. My classic line is that Japan is a bug in search of a windshield. We devoted chapters to Japan in *Code Red*. Upon reflection, I think that referring to Japan as a bug might give the wrong impression. We all know what happens to a bug upon impact. It might be more appropriate to think of Japan as a moose. Ask a Canadian what happens when you hit a moose late at night at high speed. While the collision is not good for the moose, the car and driver are not unaffected.

Japan has opted to monetize its debt. Given their situation, I would do the same. They have no good choices, only potentially disastrous ones. From their standpoint, monetization makes the most sense. The yen is going to drop inexorably in value over the coming decade, unless they decide to choose disaster B (massive deflation or default), which seems unlikely at the moment.

For all intents and purposes, Japan is firing the first missile in what will be a major currency war over the next five to seven years. We have seen such a situation only twice in the past century, and neither of those contests ended well for any of the participants.

For the record, and for the sake of full disclosure, shorting the government of Japan is my biggest single investment. That position is going to get much bigger in the next few months, as I am finally able to hedge my new mortgage. I fully intend to let Abe-san and Kuroda-san to pay for half of my new apartment.

I will have a very personal vested interest in paying attention to the political situation in Japan. I will keep you updated if I change my mind!

The world has never experienced a major nation like Japan monetizing a significant portion of its debt. Weimar Germany, by contrast, was a defeated nation, did not print a reserve currency, and was not accorded the status that Japan has today. Further, Japanese industry brings its A game to the international competitive markets. Biggest head-to-head competitor with Japan? It's not Korea but Germany. And neither country will be happy when the yen is 150 to the dollar. It will be interesting to see the reactions around the world when it is 200 to the dollar. Stay tuned.

And then there is Europe. Again, I have written extensively about the debacle (another D) that is Europe. It is going to cost multiple trillions of euros for them to deal with their situation. Essentially, they either have to break up or mutualize their debts. They have to decide whether there will be a fiscal union as well as a monetary union. While I think they will make the hard decision and elect to remain as a monetary union, that course is not a given. The pain that will come from the required austerity in France and other countries is not to be sneezed at. The various nations of Europe will have to give up a measure of independence in their budgetary process in order to get Germany to agree to the mutualization of debt and unleash the hounds of the ECB.

The greatest impediment to getting such an agreement may not be in Germany; it may be in France. If Marine Le Pen is the answer, then the French are asking the wrong question. Her policies may have some appeal for the French, but they are ultimately disastrous for the European Union. National Socialism is not an answer that has worked well in Europe.

The following cool note on the Germany and its relations with France and the rest of the Eurozone comes from Quartz.com:

> Germany is justifiably proud of its many world-class products, and bristles when others criticize its export-driven economic model—as US Treasury secretary Jack Lew did yesterday. Critics like Lew contend that the country needs to focus its attention on boosting domestic spending rather than fine-tuning its export machine, in order to benefit its trading partners, particularly less well-off members of the euro zone.
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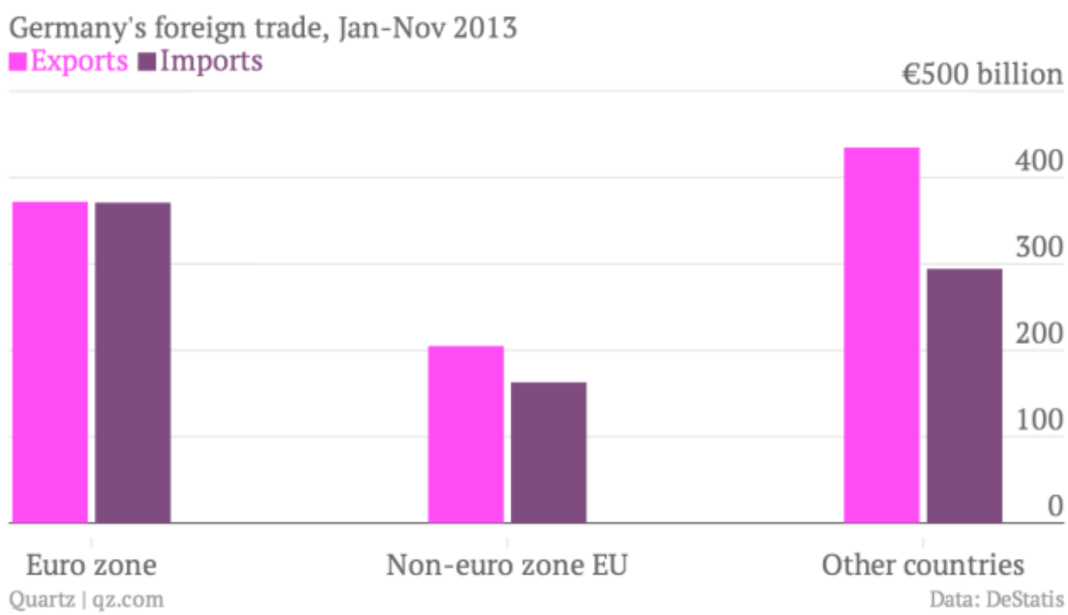
> On the very day of Lew's rebuke, new data on German foreign trade provided grist for his critique: November exports rose for the fourth consecutive month and imports unexpectedly plunged. But dig into the details and the picture is much more complicated. In the first 11 months of 2013, Germany's trade surplus with the rest of the euro zone was only €1 billion ($1.4 billion); its surplus with non-EU counties was more than €140 billion over the same period.



> If German exporters can generate profits by selling goods far from Europe, they may have less incentive to compete with local European suppliers on their home turf. They also gain the financial firepower to spend more at home in Germany, including on imports produced by its hard-up euro zone neighbors.
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> Diving into country-by-country trade details complicates the picture even more. It also becomes clear why you hear little criticism of German exports in Amsterdam, while Paris seems positively obsessed. Germany ran a trade deficit of more than €15 billion with the Netherlands in the first 10 months of 2013 (the latest data available), while Germany's trade surplus with France was worth more than €30 billion.

The key goods that Germany trades with other euro zone members are varied, as the chart below shows. It is easy to say that Germany should export less and invest more, but on the ground the policies dealing with exports of aircraft to France will have little impact on vaccines sold to the Netherlands, just as efforts to promote more imports of olive oil from Italy are quite distinct from the trade in cars made in Spain. These and countless other examples make sweeping calls for Germany to "rebalance" its economy more difficult to achieve in practice than on paper.

There are no easy solutions for Europe. France has to balance its budget or lose access to the markets, just as Italy and Spain did. This will be the moment of truth for the European Union. I think it probably happens in 2015 or possibly in late 2014. (Although, for the record, I'm almost always early with my predictions. At least I usually get the direction right, and in this case I think the direction is clearly that France is going to have to make difficult decisions in the next few quarters. This is not a country that has made difficult decisions easily in the past, nor is it in a mood to do so today.

If you want to see an intriguing and rather blunt article that is provoking furious reaction in France, then I invite you to read the fascinating piece by Janine di Giovanni in *Newsweek,* entitled the "The Fall of France." This was followed almost immediately by an article in the same magazine entitled "Fall of France II: How a Cockerel Nation Became an Ostrich," which elicited even further outrage in the French press. Given that Ms. Giovanni lives in Paris, I wonder whether she will be the recipient of many invitations to lunch in the coming months. Give her a call if you are in Paris; she may need friends.

These articles will give you background to understand how fully difficult it is going to be to turn the French ship around. The majority of the French simply do not want to change the direction in which they are sailing, although they might prefer another captain with another banner. The bond markets have subsidized their wishes a for very long time. I think we are fast approaching the Endgame for Europe.

This has been a very brief inventory of the headwinds for economic growth in the next few years. It counterbalances the rather joyous view of the future that I outlined last week. I get the incongruity. How could one be so excited about the future on the one hand and so dismal on the other? That is the main thought conundrum of my life. That and trying to figure out my kids. I've completely given up trying to understand women.

We will turn to the third part of the 2014 forecast next week.

Some Thoughts from Dubai

I finish this letter in my hotel room at the Park Hyatt in Dubai. I visited Abu Dhabi yesterday and drove home in the evening to the towering vision of Dubai. Everyone has always told me you have to see it to understand it, but I really didn't grasp what they meant until I got here. When you try to comprehend the enormity of what they have built in the last 20 – and really in the last 10 – years, it is overwhelming.

I get Singapore. Singapore is just as impressive, but it is at the center of one of the most important shipping lanes in the world. I can understand the economics and grasp what [Lee Kuan Yew](#) did to wrest his nation from the throes of poverty and turn it into the dynamo that it is today. He is one of the most intriguing personalities of the 20th century.

But I am simply staggered by Dubai and Abu Dhabi. This is the ultimate Field of Dreams, built by men who must have a vision that is beyond extraordinary. It is not just about oil, as Dubai has nowhere near the wealth of Abu Dhabi. Oil wealth alone is not enough to ensure the enterprise and generate the vision that I see manifested here. The oil wealth of this region is legendary; and yet across the Straits lies a country with far more oil wealth and cultural heritage, and yet it languishes.

The city landscape of Dubai reminds me of the science fiction book covers that we saw 15 to 20 years ago. Today, as I walk out of my hotel room and look across the bay, the towering spires and surreal architecture of science fiction have come to life. There is development everywhere. While some of the office buildings are obviously "see-through," the local home market seems to be booming, particularly since the Arab Spring.

I had to make a trip to the local shopping mall. The shops and restaurants were all familiar to someone from the West, yet the cultural diversity was amazing. I must have heard every major language spoken. I've been to 60 countries, and nowhere have I seen the amalgamation of people that I've encountered here – not in London or even New York. Cosmopolitan, clean, and seemingly prosperous, this is a city to be admired. I will admit to not getting the economics of building on such a massive scale in the middle of the desert, but then I'm a country boy from Texas.

As if to punctuate my trip, as I was writing this note I began to hear very loud booms outside my ground-floor room. After a second, I recognized the sounds of fireworks. (Hey, I'm in the Middle East, so you know what I thought of first).

I walked out of my room to the sidewalk beside the yacht docks and witnessed what was perhaps the most impressive display of fireworks I've ever seen in my life – and I make a point of going to watch fireworks. I truly enjoy them. I guess it's the little kid in me. In the distance you could see multiple fireworks displays going off everywhere you turned. I was lucky in that from my vantage point the main fireworks were almost overhead. Until the culmination of the show, that is, when they began coming even closer. I am hard-pressed to describe the experience; but for you science fiction fans, it was almost as though the gaping maw of one of the great worms in Frank Herbert's *Dune* was descending ever closer with each burst of flame. I stood in awe, waiting to be engulfed, until it all magically ended.

What could have possibly provoked such artistic excess? What great event did all this signify? I walked down the way to the restaurant and asked some of the staff about it. "Oh," they replied, "This is a celebration of National Shopping Week."

And with that I will close, as I need to get some sleep so that I can explore little bit more of Dubai before I head to Riyadh tomorrow. I will let you know next week what I see and learn there. In the meantime, have a great week.

Your still not all that jaded analyst,

John Mauldin

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