Thoughts from the FRONTLINE
John Mauldin's free weekly investment and economic newsletter

The Lions in the Grass, Revisited

JOHN MAULDIN | April 5, 2014

IN THIS ISSUE

> "In the economic sphere an act, a habit, an institution, a law produces not only one effect, but a series of effects. Of these effects, the first alone is immediate; it appears simultaneously with its cause; ***it is seen***. The other effects emerge only subsequently; ***they are not seen***; we are fortunate if we ***foresee*** them.
>
> "There is only one difference between a bad economist and a good one: the bad economist confines himself to the ***visible*** effect; the good economist takes into account both the effect that can be seen and those effects that must be foreseen.
>
> "Yet this difference is tremendous; for it almost always happens that when the immediate consequence is favorable, the later consequences are disastrous, and vice versa. Whence it follows that the bad economist pursues a small present good that will be followed by a great evil to come, while the good economist pursues a great good to come, at the risk of a small present evil."
>
> – From an 1850 essay by Frédéric Bastiat, "That Which Is Seen and That Which Is Unseen"

I've come to South Africa a little bit ahead of my speaking tour next week to spend a few days "on safari." Which is another way to say that I am comfortably ensconced in a game lodge next to Kruger Park, relaxing and trying to get some time to think. We've been reasonably lucky on the game runs: besides the usual lions, rhinoceri, water buffalo, etc., we've seen both cheetah and leopard, two animals that avoided my vicinity on every other trip to Africa. I'm here at the end of the rainy season, so everything is lush and green, and you have to get a little lucky to find the animals in the dense bush.

In several moments here, I was reminded of an essay I wrote two years ago called "The Lion in the Grass." So I went back and read it and decided to update it fairly extensively in order to talk about the hidden lions we don't see today that could catch us unawares tomorrow. Just like the African bush I am surveying at this moment, the economic landscape out there could harbor some serious but still unseen problems.

I have been captivated by the concept of the seen and the unseen in economics since I was first introduced to the idea. It is a seminal part of my understanding of economics, at least the small part I do grasp. It was introduced by Frédéric Bastiat, a French classical liberal theorist, political economist, and member of the French assembly. He was notable for developing the important economic concept of opportunity cost. He was a strong influence on von Mises, Murray Rothbard, Henry Hazlitt, and even my friend Ron Paul. (I will have to ask Rand about his familiarity with the Frenchman the next time I see him.) Bastiat was a strong proponent of limited government and free trade, but he also advocated that subsidies (read stimulus?) should be available for those in need. "[F]or urgent cases, the State should set aside some resources to assist certain unfortunate people, to help them adjust to changing conditions."

Today we explore a few things we can see and then try to foresee a few things that are not quite so obvious. The simple premise is that it is not the lions we can see lounging in plain view that are the most insidious threat, but rather that in trying to avoid those we may stumble upon lions hidden in the grass.

But first, I really want to urge you to consider joining me in San Diego May 13-16 for my **Strategic Investment Conference**. We are continuing to fill out the strongest list of speakers we've ever had in our 11 years at this. My good friends George Gilder, Stephen Moore of the *Wall Street Journal*, and Neil Howe (who wrote *The Fourth Turning*) have all agreed to come and join Niall Ferguson, Newt Gingrich, Kyle Bass, David Rosenberg, and a dozen other A-list speakers from around the world. You can see who else will be there by clicking on the link above or **here**.

And I'm especially honored and pleased to announce that Vice Admiral Robert S. Harward, Jr., has agreed to join us on Wednesday night as a special keynote speaker. The three-star admiral (just recently retired) is a Navy SEAL and former Deputy Commander of the United States Central Command. In addition to his numerous other positions and awards, he also held the title of "Bull Frog" from 2011 until 2013 (longest-serving SEAL on active duty).

This is simply the finest economic and investment conference anywhere in the country. Don't procrastinate; make your plans to come and register now.

The Lion in the Grass

When I was discussing this concept with Rob Arnott (of Research Affiliates and the creator of Fundamental Indexes) in Tuscany a few years ago, he mentioned the following photo, which he took on the savannah in Tanzania. I think it's a perfect way to start out our discussion of the lions in the grass.

The Lion in the Grass

Going back to Bastiat, let's look at that first sentence:

> In the economic sphere an act, a habit, an institution, a law produces not only one effect, but a series of effects. Of these effects, the first alone is immediate; it appears simultaneously with its cause; ***it is seen***. The other effects emerge only subsequently; ***they are not seen***; we are fortunate if we ***foresee*** them.

It is natural to focus on the apparent dangers in front of us. That is part of our evolutionary heritage from the time when humans were first dodging lions and chasing antelopes on the very African savannah in Rob's picture. But we soon learned that, if we were to survive, it wasn't enough to dodge the lions we could see. ***It is the hidden lions that may spring upon us suddenly and take an arm or a leg.***

Below I have once again reproduced Rob's picture. Even when I knew there was a hidden lion, I couldn't find it. But after it was pointed out to me, it is now the first thing I see. And there is a direct analogy there, to both economics and investing.

So, before you go to the next page, I suggest you go back and look one more time to see if you can spot the hidden lion. Just for fun, you know.

I showed this to a friend of mine who is a hunter, and he found it almost immediately. But then he has taught himself over the years to look for hidden game. And as Bastiat noted, it is the skilled economist who looks for the effects that are hidden, the surprises that are unseen. ***It should be a habit to look at the potential second- and third-order consequences of what we can see happening before our eyes.*** That way, we not only avoid the hidden lions, we also turn what would hunt us and do us harm into the hunted. Sometimes, the dangers themselves can be turned into a very nice trophy indeed – if you can act in time.

As I noted, that previously invisible lion is now the first thing I see. And that is the way with economic lions in the grass. Once someone points one out, it's obvious, so obvious that we soon convince ourselves that we would have seen the lion without help. How many people told you they "knew" all along that subprime debt was going to end in tears? Or that the housing market was a bubble? Or that we would be plunged into the Great Recession?

I remember that in the fall of 2006 I was beginning to talk about the probability of a recession, in this letter, in speeches, and in numerous media interviews. (There is one such episode still up on YouTube.) I was told I was ignoring what the market was telling us, and indeed the market proceeded to go up for another six months or so. Being early is lonely. Me and Nouriel.

Today there are a lot of people who tell us they knew there was a recession coming all along. In fact, the farther we get from 2006, the greater the number of people who remember making that call. It now seems I had no reason to feel so lonely out there on that limb, scanning the tall grass of the savannah. In retrospect, it seems that limb was rather crowded.

So, with that in mind, let me show you where the other lion is. Then go back and look at the first picture. After a few times you will see the hidden lion almost before you see the obvious ones.

Black Swan or Hidden Lion?

I should note that a lion in the grass is different from a black swan. A black swan is a random event, something which takes us all by surprise. Economic black swans are actually quite rare – 9/11 was a true black swan. Other than Nostradamus some 500 years ago, who saw it coming?

The last recession and the credit crisis were not true black swans. There were those who saw it all coming, but few paid attention. They were dancing right along with Chuck Prince to the rousing music of a bull market and swelling profits.

As we know now, a few people saw the subprime crisis coming and made huge fortunes. Sadly, pulling that off generally required one to risk a small fortune to play in that game. So while I talk about the lions hidden in the grass, remember that if you can figure out how to play it, there can be large profits betting on that which is unseen by the markets.

Now, let's look at a few obvious lions and then see if we can spot a few hidden lions lurking nearby.

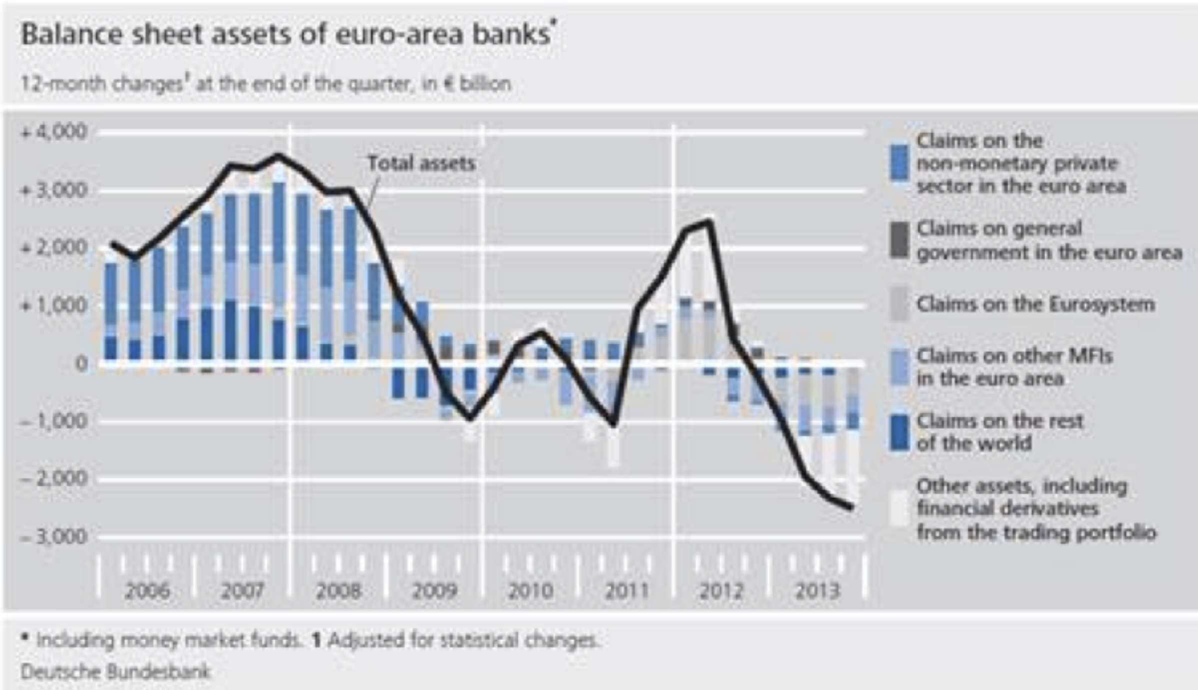
The Lions in Europe

By some miracle, Mario Draghi and his team at the European Central Bank (ECB) continue to get from their communication tools what most central banks have to take by force. Widespread complacency has washed over the region in the months and quarters since July 2012, when Mr. Draghi introduced the Outright Monetary Transactions (OMT) facility and adamantly promised to do "whatever it takes" to preserve the euro system.

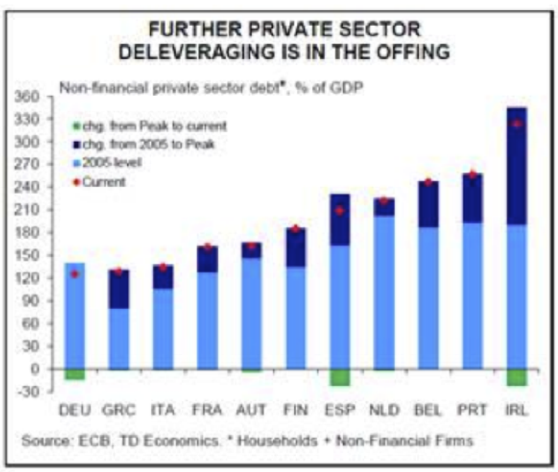
As a result, government borrowing costs are converging back to pre-crisis levels even as falling inflation brings the next debt crisis forward … and markets are clearly still responding to the ECB's increasingly hollow commitments.

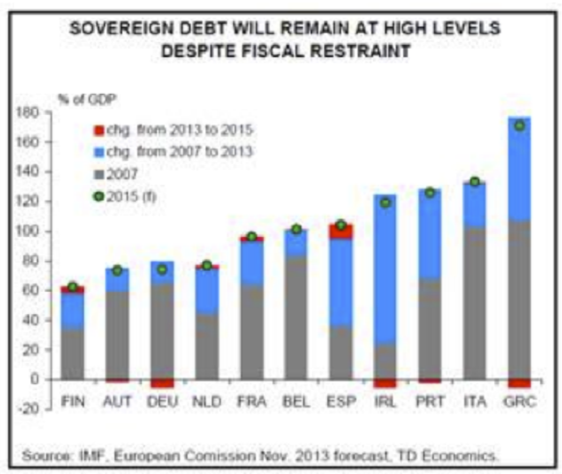
Without changing the ECB's main policy rate at this week's monetary policy meeting, Mr. Draghi once again attempted to talk his way to a policy outcome by suggesting that he has the broad-based support to authorize quantitative easing, if and when it is needed. It will be needed – and maybe soon.

As I wrote late last year, European banks are in terrible shape compared to US banks. We think of German banks as the epitome of sobriety, but they have been on a lending binge to creditors who now appear to be in financial trouble; and with 30- or 40-1 leverage, they could easily see their capital fall below zero. Despite modest bank deleveraging across the Eurozone since early 2012…

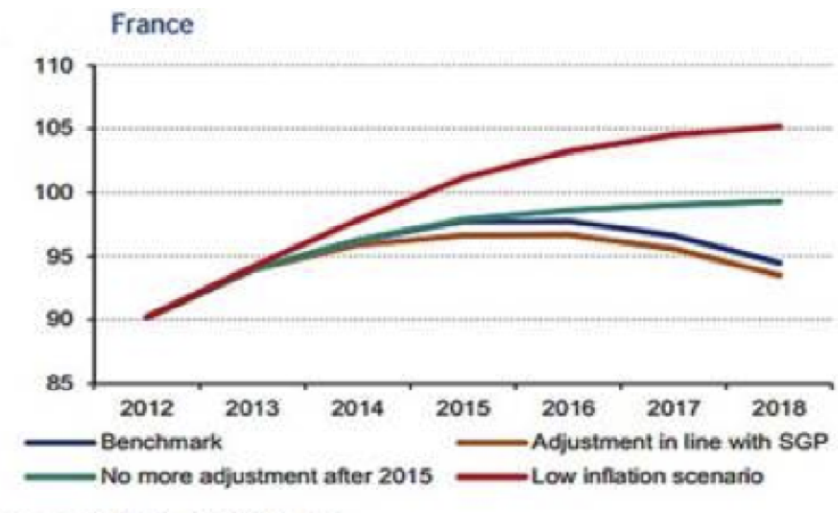


… public and non-bank private debt burdens have not improved:

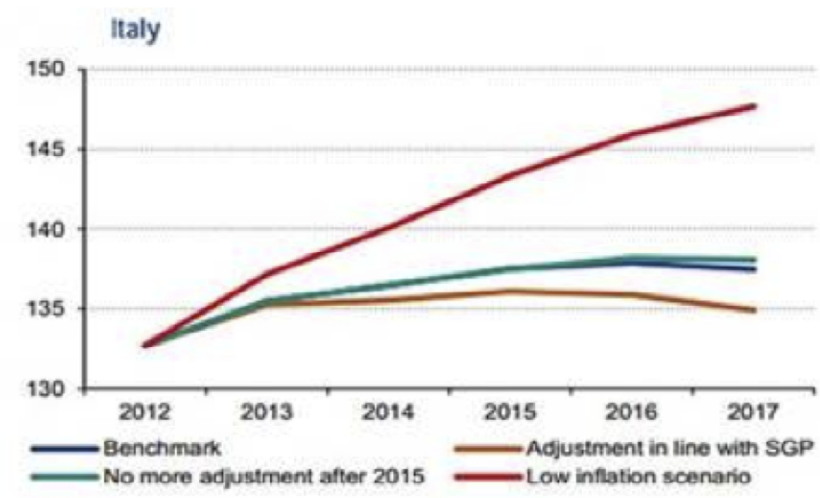




Low inflation is also seriously disrupting government debt trajectories. The analysis below from Bank of America Merrill Lynch shows how low inflation, near 0.5%, raises debt trajectories in France and Italy that would be a lot lower under a normal, 2%, inflation scenario. As the charts show, persistent "lowflation" for several years could add another 10% to 15% to the public debt-to-GDP ratio in each country … even if rates stay where they are today.

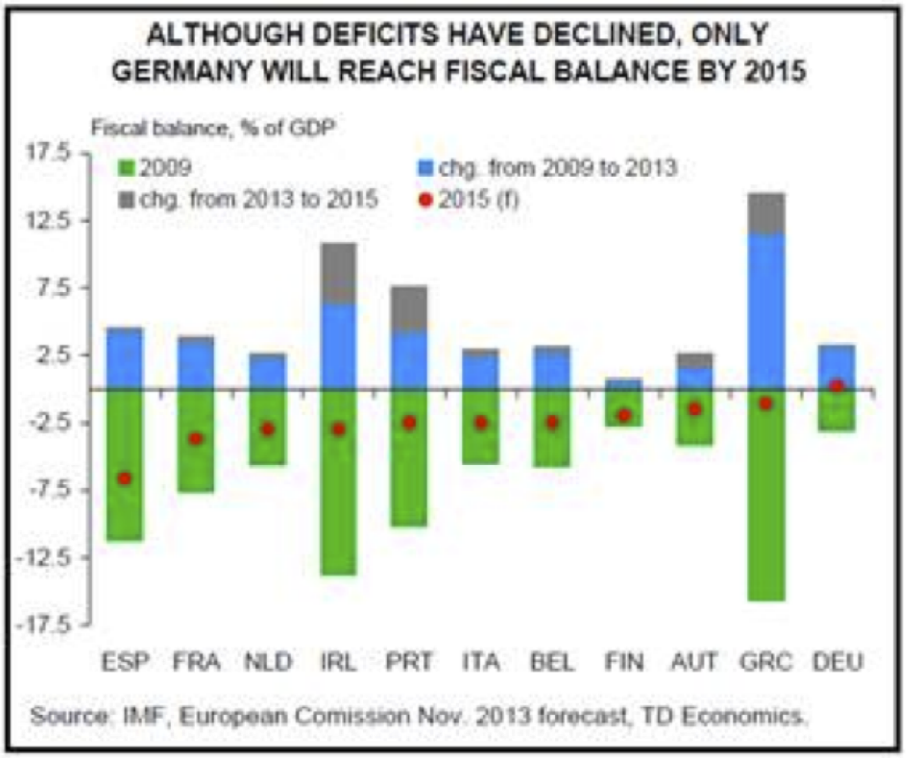


Source: BofA Merrill Lynch Global Research



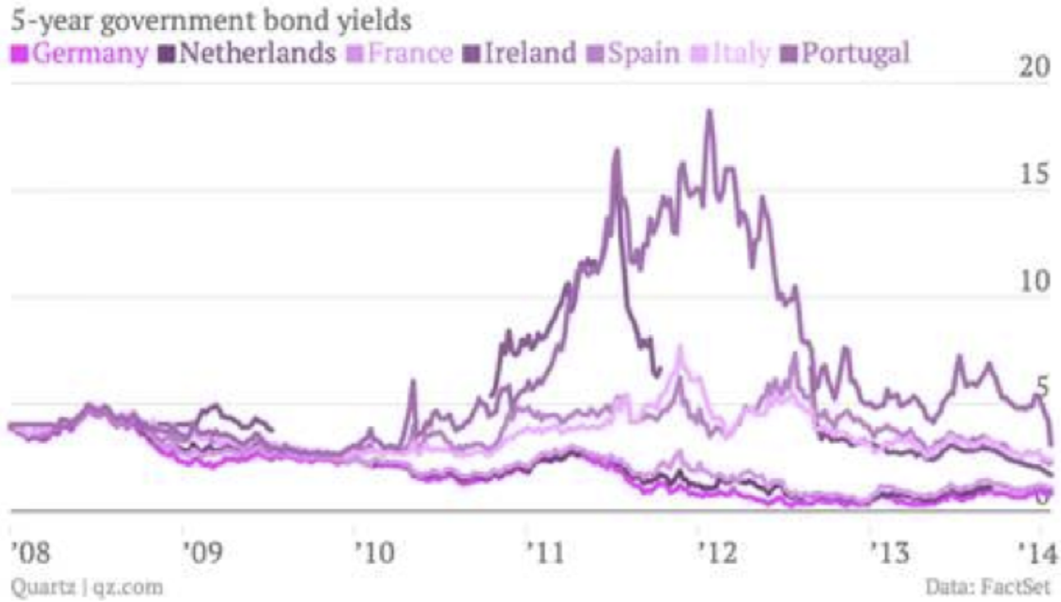
Source: BofA Merrill Lynch Global Research

In addition to unsustainable debt loads and steeper debt trajectories, debtor countries continue to run relatively large fiscal deficits. Just look at Spain, France, the Netherlands, and Italy:

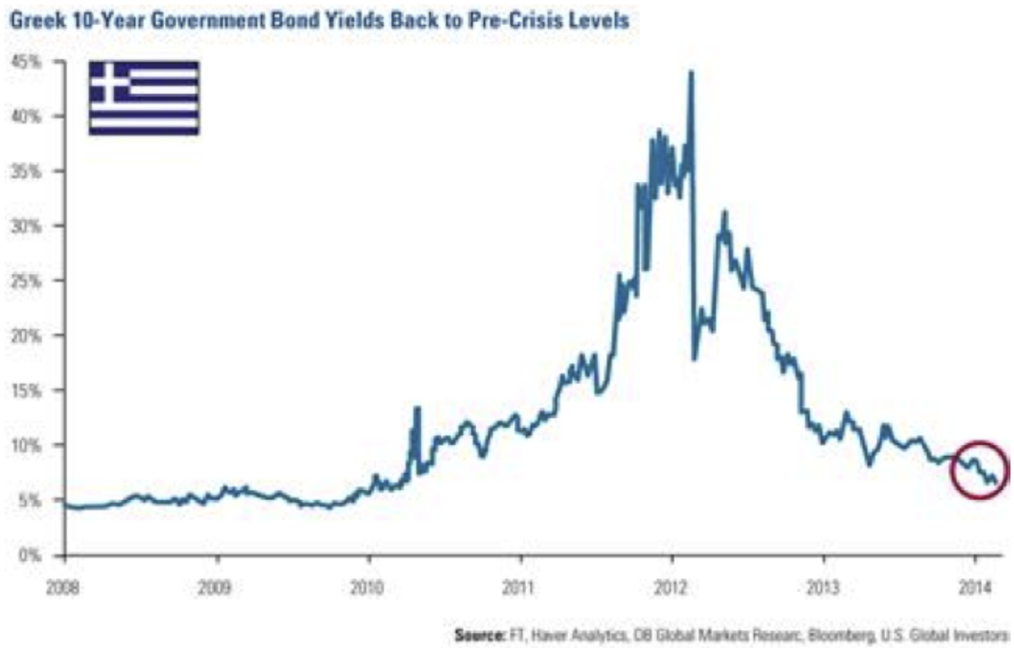


While this toxic combination bluntly confirms higher default risk in countries like France, Italy, and Greece relative to Germany, risk premiums over German bunds have collapsed in the quarters since Draghi's July 2012 statement. The bond market clearly does not see any risk in sovereign debt.

As you can see in the chart below, government borrowing costs across the Eurozone have converged to pre-crisis levels without the ECB's buying a single bond. (In fact, the ECB has let its balance sheet shrink dramatically over that time.)



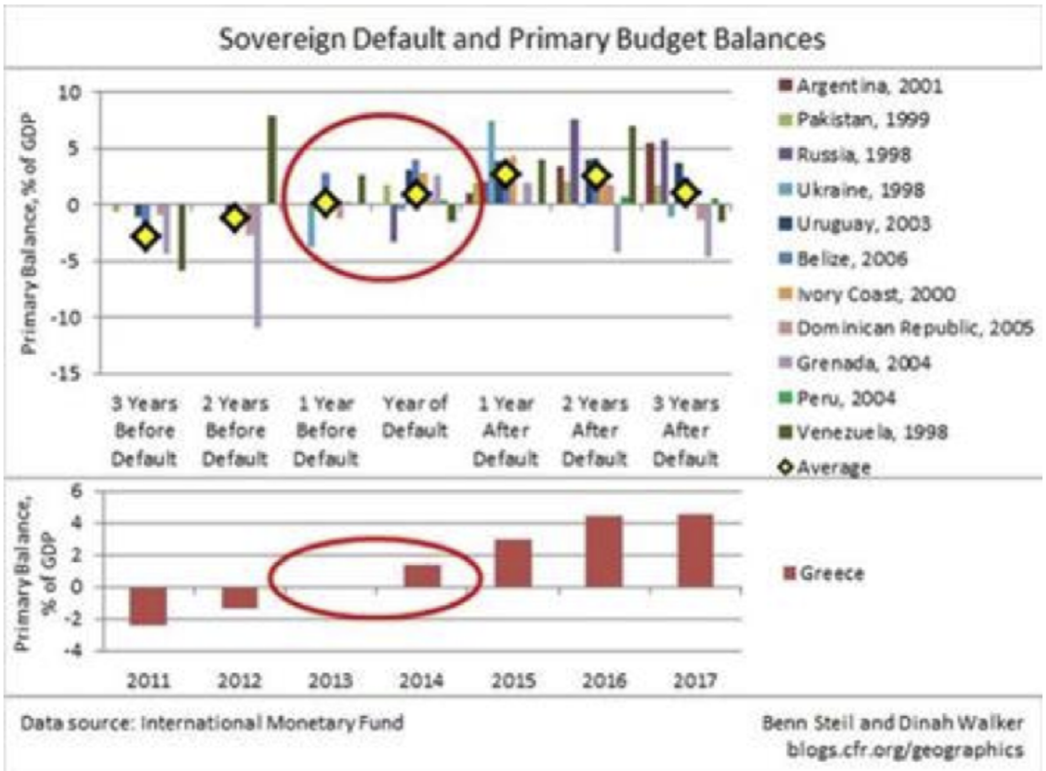
Even Greek rates are back to pre-2010 levels:



Both France and Italy are getting close to the point at which the markets will begin to question their ability and willingness to deal with their deficits. Without serious action by the ECB, this situation has the potential to become quite unstable very quickly. But the lack of effort by France, at least by the Hollande government so far in its first term, is clearly taxing the patience of the Germans. They recently signaled willingness to allow the ECB to begin to come up with its own form of quantitative easing; but without French cooperation on its deficit, it is difficult to imagine the Germans staying as patient as they have been.

The bond market is clearly not paying attention to the nuances of how defaults happen. Greece's hard-won primary budget surplus may actually raise the odds of a formal default. According to Benn Steil and Dinah Walker at the Council on Foreign Relations,

> The Greek government has far less incentive to pay, and far more negotiating leverage with, its creditors once it no longer needs to borrow from them to keep the country running…. This makes it more likely, rather than less, that Greece will default sometime next year. As [the graph below illustrates], countries that have been in similar positions have done precisely this – defaulted just as their primary balance turned positive.



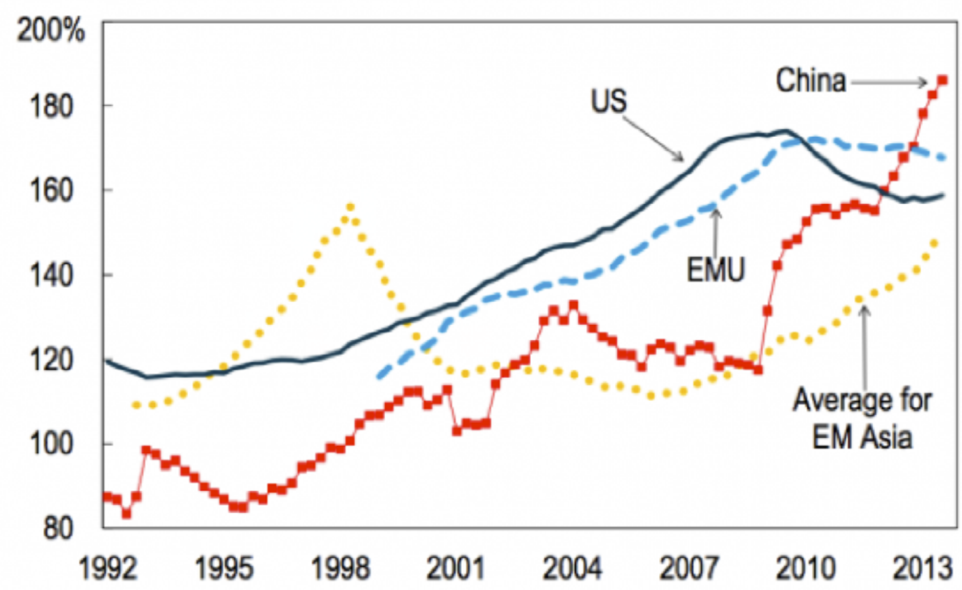
Here we may catch sight of a lion's face peering out from the tall grass – not just the long anticipated possibility of a Greek default but the roaring return of default risk in Eurozone sovereign spreads. That lion could pounce this year if startled by Greece, or it could lie in wait for a distinctively French BANG! moment … but it is only a matter of time, as long as highly indebted governments continue on their current trajectories.

Hidden Tigers in China

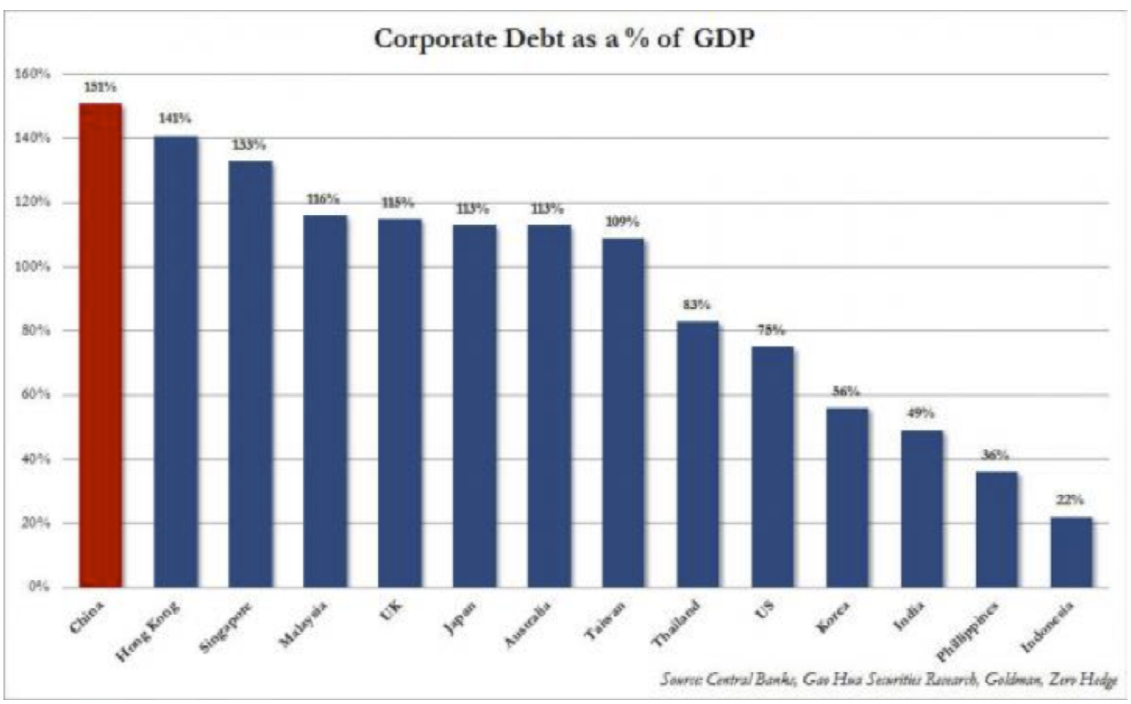
My young partner and protégé, Worth Wray, wrote about the nasty prospects for a Chinese slowdown in Thoughts from the Frontline just a couple weeks ago; and he pointed to a series of signs that may eventually reveal the most dangerous of big cats hiding in our global economic grasslands. I'll let you [go back]() and read his research for yourself, but the main ideas are powerful:

China's private-sector debt is going parabolic…

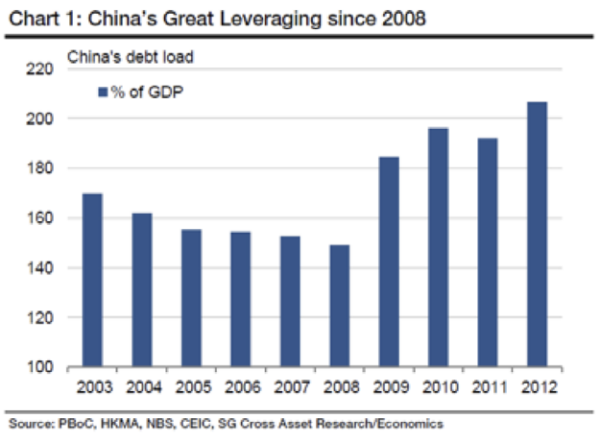
Figure 8. Selected Countries — Private Sector Debt as Pct GDP, 1992-2013

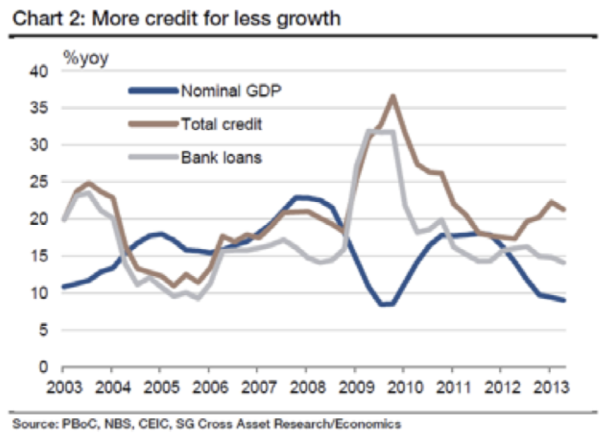


… and the Middle Kingdom's corporate debt is now the highest in the world.



Moreover, the Chinese economy is employing that credit very inefficiently, taking on more and more debt for less and less growth.





History suggests that China's Minsky Moment is approaching quickly, since corporate debt has topped 150% and total debt is over 210%. Investors around the world should prepare for the inevitable demand shocks and falloff in global growth … regardless of the specific outcome. The Chinese government may have the assets to backstop a truly horrific crisis and maintain slow growth in the 2-3% range, but history suggests that China could land very hard.

Over the last fifty years, every investment boom coupled with excessive credit growth has ended in a hard landing, from the Latin American debt crisis of the 1980s, to Japan in 1989, East Asia in 1997, and the United States during both the late 1990s internet bubble and the mid-2000s housing bubble.

The lesson is always the same, and it is hard to avoid. Economic miracles are almost always too good to be true. Broad-based, debt-fueled overinvestment (misallocation of capital) may appear to kick economic growth into overdrive for a while; but eventually disappointing returns and the consequent selling lead to investment losses, defaults, and banking panics. And in cases where foreign capital seeking strong growth in already highly valued assets drives the investment boom, the miracle often ends with capital flight and currency collapse.

Worth and I talk about China constantly and always reach the same conclusion. There is no way to really know what *is happening* there today, much less what *will happen* tomorrow. The primary data is flawed at best, manipulated at worst, and riddled with inconsistencies when we compare official data to more concrete measures of economic activity.

Since we published "China's Minsky Moment?" two weeks ago, the official data flow – which shows admittedly soft but fundamentally sound production – continues to conflict with real-world indicators, which reveal some alarming declines in production, prices, and demand. For example, the *official* manufacturing Purchasing Manager's Index (PMI) for March 2014 indicates that manufacturing expanded, while the more objective HSBC MarkIt PMI suggests an alarming contraction in manufacturing activity that is consistent with a rough landing.

With such an ambiguous picture, we cannot know for sure whether Chinese production is moving ahead or falling behind… but a Kookaburra in the regional economic coal mine is calling at the top of its lungs. The recent collapse in Australian new export orders and moderate contraction in Australian production could point toward a real man-eater lurking in the Chinese bamboo (now that's what I call some real tall grass!).

Table 1: Headline PMIs and New Export Orders (source: Markit, HSBC)

	PMI			New export orders		
	Mar 14	Feb 14	Jan 14	Mar 14	Feb 14	Jan 14
Australia	47.9	48.6	46.7	31.1	25.8	34.1
New Zealand		56.2	56.3			
China HSBC	48.0	48.5	49.5	51.3	48.5	48.4
China NBS	50.3	50.2	50.5	50.1	48.2	49.3
India	51.3	52.5	51.4	56.8	54.1	52.6
Indonesia	50.1	50.5	51.0	50.4	50.8	50.4
Japan	53.9	55.5	56.6	52.3	51.5	52.8
Korea	50.4	49.8	50.9	50.7	50.5	51.8
Singapore		50.9	50.5		51.5	52.4
Taiwan	52.7	54.7	55.5	53.8	56.7	56.3
Vietnam	51.3	51.0	52.1	52.7	49.4	52.2
Global	52.4	53.2	53.0	51.7	51.5	51.2
US (ISM)	53.7	53.2	51.3	55.5	53.5	54.5
US (Markit)	55.5	57.1	53.7	51.0	51.6	48.4
UK	55.3	56.2	56.3	52.8	54.6	56.8
Germany	53.7	54.8	56.5	52.2	55.2	57.2
France	52.1	49.7	49.3	51.8	50.2	50.3
Eurozone	53.0	53.2	54.0	53.4	54.5	55.3

expanding + stronger	expanding but weaker	contracting + weaker	contracting but improving

Lions in the US Stock Market?

Before the credit crisis, market makers like Bear Stearns, Goldman Sachs, Merrill Lynch, Morgan Stanley, and Bank of America created a huge amount of the overall liquidity in major markets by consistently taking "the other side" of trades. If the markets were selling, market makers bought, and vice versa.

In the wake of 2008, the big market makers either went out of business, merged, and/or were forced to operate at much lower levels of leverage. The net effect is far less trading volume from market makers and other forms of "real money," to the point that high-frequency trading and ETFs accounted for about 66% of all trading volume in 2010. While that number has fallen to about 50% today, equity mutual fund flows suggest that higher trading volume from smaller investors, not the resurrection of market makers, is responsible for the shift.

In fact, the following chart from Credit Suisse suggests that the average daily trading volume from "real money" fell by more than half from 2008 to 2012, as high-frequency trading advanced. I do suspect that "real money" volume is rising today with the rotation that is underway into an overvalued, overbought, and overbullish market (but let's save that for our conclusion).

Understanding how the structure of market participants has changed, let's think about the effect of there being less market-making volume to balance against high-frequency trading and the retail/institutional herd.

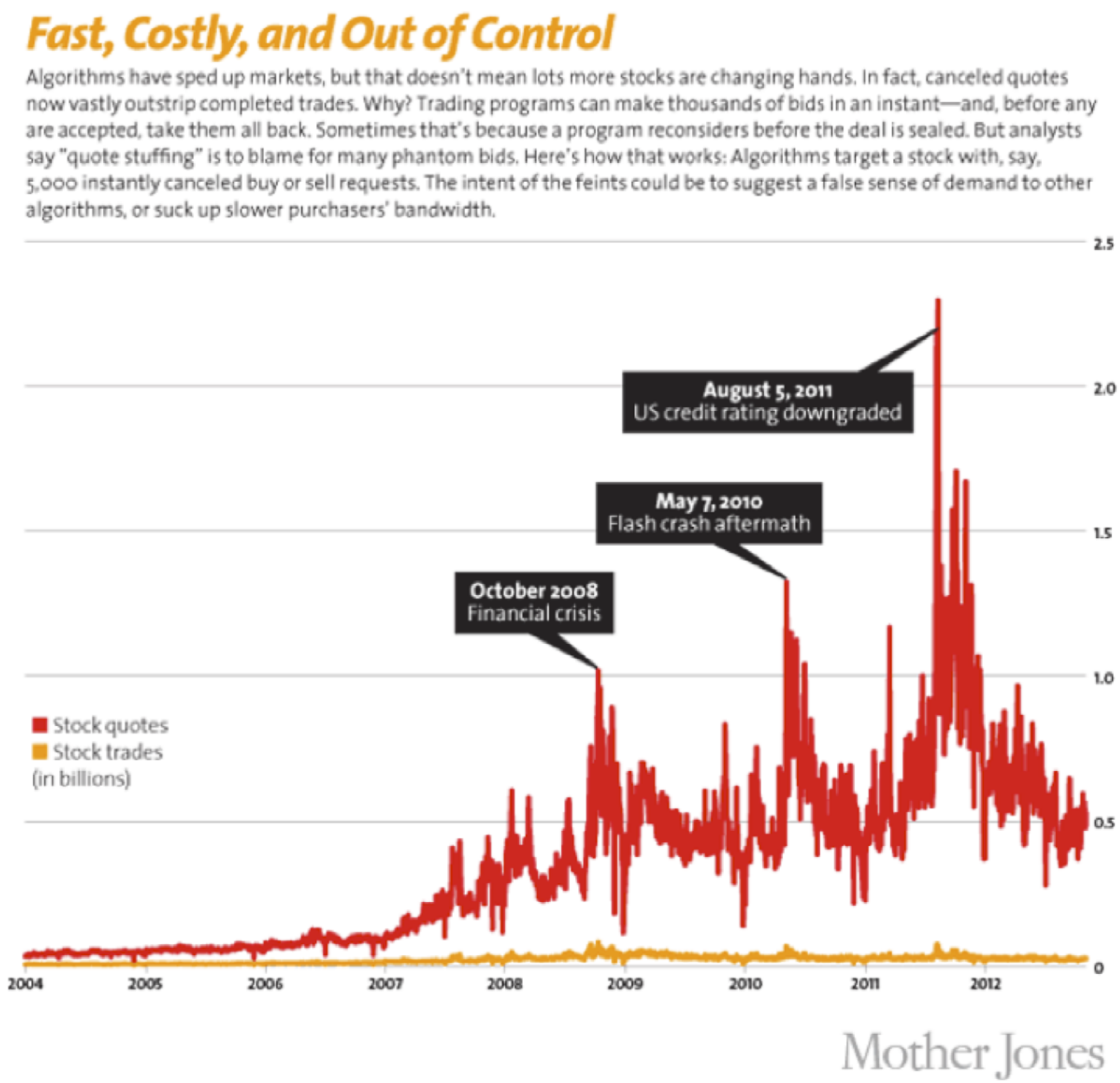
On May 6, 2010, the markets sold off for most of the day, and market makers expanded their volume as the media ran all-day coverage of a small riot in Greece. But (and this is critical), market makers who can no longer buy at 40x leverage will carry only so much inventory overnight. At some point market makers must stop buying ... and they did when a large sell order came into the market toward the end of the day on May 6. The market makers stepped back instead of providing liquidity, precipitating a sharp drop in prices. Then many of the HFTs shut their systems down, seeing an irregular trading pattern and fearing another "Quant Crisis" like the one in October 2007. Liquidity dried up in a matter of minutes, and the market went into free fall … triggering stop losses and emotional selling from the general public. (As they saw the market collapse and the rioting in Greece, people may have thought, "Something big just happened and I am late... sell everything!"). Without market makers to provide volume, an orderly sell-off became a chaotic collapse.

Now, with market-maker volume way down, a similar situation could develop again; and once again the general public will rush to sell if liquidity evaporates. We should really think about this dynamic, because the next correction may look more like the stock market crashes of 1929 or 1987 as opposed to the more gradual "cascading crash" we all experienced in 2008.

With that in mind, investors will do well to pay attention to the ever-changing structural makeup of the markets before blindly jumping in. Just because US stock markets – along with a lot of the major markets around the world – have found new highs since 2008 doesn't mean they have healed structurally. It doesn't mean they are stable. And with long-term valuations at historic levels, both on an absolute basis and relative to the rest of the world, US equity markets are both unstable AND overpriced.

The inevitable correction that is coming to US markets could be a catalyst for a downturn in the broader economy, and without much of a warning. It could be another lion, prowling through fiber-optic cables, data feeds, and stock exchange servers.

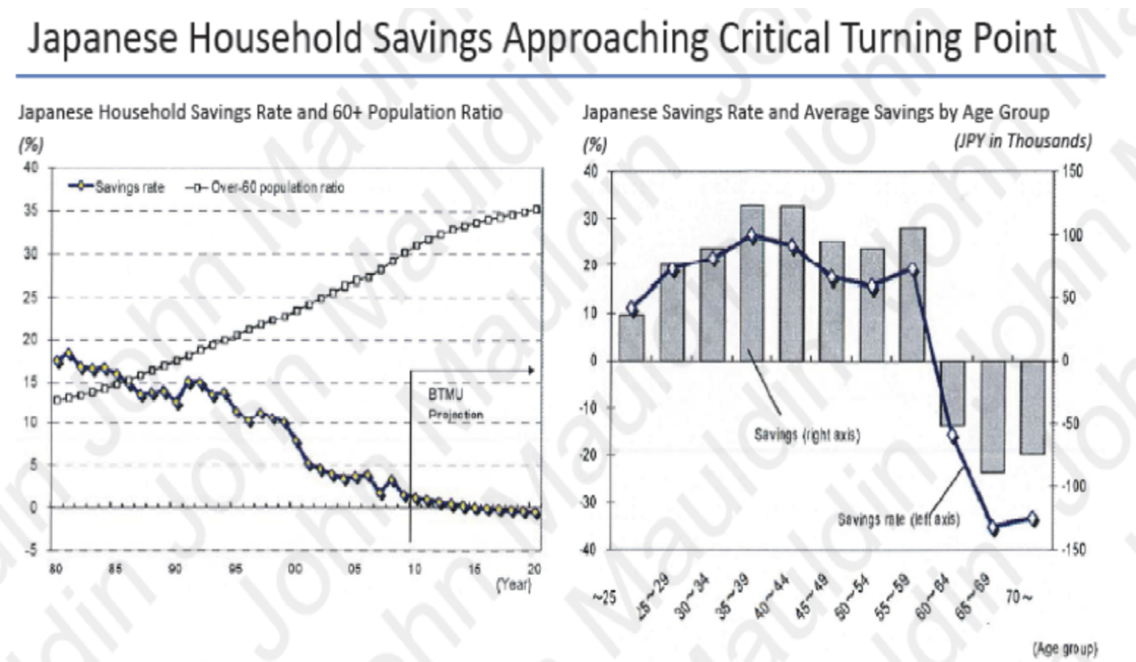
I continue to believe that high-frequency trading should be reined in. It is creating the illusion of liquidity, which can dry up in a heartbeat while at the same time sucking billions of dollars from the trading of individuals and institutions.

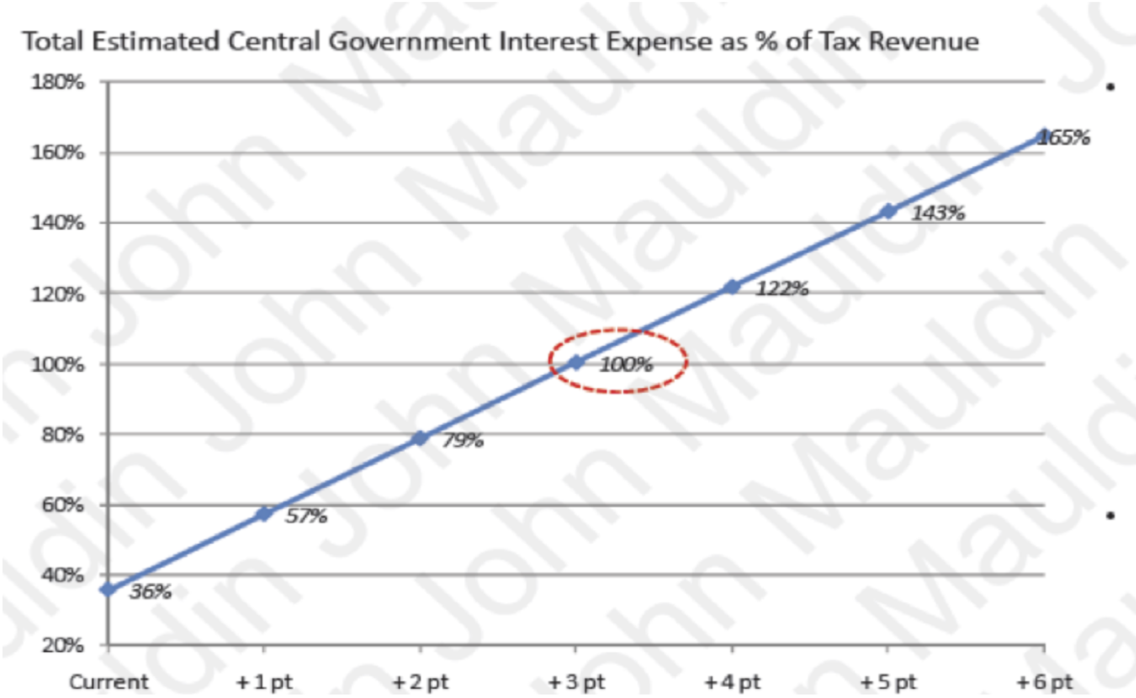


I'm not trying to stop computerized trading, but if the bid or offer were required to last for at least half a second, I think the problem would be mostly fixed.

The Bug That Roared

It has been said that you can't consider yourself a real global macro trader until you have lost money shorting Japanese bonds. Nevertheless, Japan is a bug in search of a windshield, with a debt-to-GDP of almost 230% (and growing by 8-10% a year). The Japanese savings rate (see chart below courtesy of Kyle Bass and team at Hayman Advisors) has steadily declined from its high of nearly 20% in the early '80s and will soon go negative. At that point the thought is that Japan will need to seek out foreign investor to buy its bonds. And who will buy a Japanese bond at 1% for ten years? Yet, if rates only rise by 2%, then Japan would be spending almost 80% of tax revenues on just the interest on its bonds. I would submit that this is not a workable business model.





So traders keep shorting Japanese bonds (JGBs) … and they keep losing money. But what if Japanese rates never rise? How could that be, you ask?

Given that Japan would collapse if interest rates were to rise, it may be that interest rates will not be allowed to rise. The Bank of Japan will crank up the printing press for their own version of Operation Twist, but on a scale that will make the other central bankers of the world jealous.

But if Japanese bonds don't revalue (on an internal basis), the consequence is that the Japanese yen will go seriously south – 125 to the dollar? 150? 200? Do I hear 250?

This week Japan increased its consumption tax rather seriously. That is a deflationary hit to their economy and one they cannot easily withstand. But to me this move is part and parcel of their overall plan to get out of the current crisis. They are raising taxes in an effort to increase government revenue with the hope of being able to balance their budget. They will offset the negative economic effects with continual and increasingly massive injections of quantitative easing. I expect another round to be announced relatively soon.

This will bring howls of protest from Japan's neighbors and will certainly raise eyebrows at the next gathering of the world's major central bankers.

At what point will you be able to buy a Lexus for less than you can buy a Kia? Think that will make Korea happy? Or any of Japan's Asian neighbors? Think the Japanese care? They will continue to churn out quality products made with robots that will compete very favorably with those of any industrial country. Japanese equities will soar in such an environment (in terms of a depreciating yen), which makes buying cutting-edge Japanese stocks and shorting the yen an interesting trade.

But that is the lion we can see. The lion we are missing is the probability that such a development will trigger a massive currency war, which will be far more significant and costly than anything we have seen in our lifetimes, as I described in my latest book, Code Red.

Which brings me to a recent interview my team conducted about the effects of the Fed's actions. It includes segments from my friends and colleagues Grant Williams, Louis Gave, and David Hay. None of us can predict exactly what the Fed is going do next, or the aftermath of their actions (although we certainly try). But regardless of what comes next, we can prepare ourselves … and that's the real point of today's letter and this video.

South Africa, Amsterdam, Brussels, Geneva, and San Diego

I'm finishing this letter on a beautiful morning in South Africa near Kruger Park. Sunday I fly to Cape Town, where I will make several presentations and then fly on to Durban for more presentations and then to Johannesburg, all at the behest of my sponsors, Glacier by Sanlam. It will be a very busy four days. I will spend Friday writing up my notes about what I learned on this trip for your regular weekly letter, and then I'll start the journey back to Dallas. I will be home for a little over two weeks before heading to Europe on another speaking tour. Then I am back home for a few days before hopping over to San Diego for my **Strategic Investment Conference**, where you really should join me!

As my dad would say, "I've been to two hog callings and three county fairs, but I never seen anything like this." I have traveled to a few extremely nice venues over the years, but nothing approaches the level of quality and service – the total experience – that I've enjoyed the last few days at the [Royal Malewane](). The food is simply exquisite, and each night they prepare a feast somewhere under the stars. The attention to detail is amazing in every aspect of this place. It is relatively small, and each villa is set apart for total privacy – except from the monkeys and the occasional elephant that evidently finds the chlorinated water in your personal pool a refreshing treat. I want to thank my Dallas friend Erin Botsford for recommending this place and my South African partner, Prieur du Plessis, for making it happen. It has been a memorable four days and an experience that I am rather inclined to repeat, if I have the opportunity. If you decide to pay the Royal Malewane a visit, tell them John Mauldin sent you.

There has been quite a contrast as I have been plowing through two books dealing with the effects of technological change on our future while living the slow rhythms of Africa in a facility that harkens back to a period of time when life was more genteel. It is probably a good thing I am leaving tomorrow, as I might get too used to this. It's quite the dream for this country boy from Texas.

It is time to hit the send button – they're calling me for my last game run. Have a great week.

Your amazed at what life brings me analyst,

John Mauldin

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