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

The Wayback Machine Birthday Tour

JOHN MAULDIN | October 4, 2014

> "That men do not learn very much from the lessons of history is the most important of all the lessons that history has to teach."
>
> – Aldous Huxley, *Collected Essays*

> "Would you tell me, please, which way I ought to go from here?"
>
> "That depends a good deal on where you want to get to," said the Cat.
>
> "I don't much care where –" said Alice.
>
> "Then it doesn't matter which way you go," said the Cat.
>
> "– so long as I get *somewhere*," Alice added as an explanation.
>
> "Oh, you're sure to do that," said the Cat, "if you only walk long enough."
>
> – Lewis Carroll, *Alice in Wonderland*, 1865

Today, in the spirit of the wisdom the Cheshire Cat offers Alice, I would ask how you can know where you are now and where you're going if you don't know where you came from. You and I have lived through the first nearly 14 years of this topsy-turvy new century together, and many of its details as well as its overarching themes deserve to be recalled. But rather than offering you a dry, plodding recap of recent history, I've come up with a different and hopefully more fun way to revisit the past decade and a half.

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I've been writing this letter for some 15 birthdays now, well over 10,000 pages of collected work. Every word is still at my website – a history, if you will, of what I was thinking at the time. I asked my longtime (and long-suffering) editor, Charley Sweet, to go back over this past decade and a half and give us a review of what I was saying my birthday week. When I perused what he came up with, a few things leapt out at me.

First, it turns out to be quite lucky that I was born in October, because when we assembled all the letters for the first week of that month, it turned out we hit on most of the big issues that came along in the first 15 years of the century: the tech-bubble collapse and ensuing recession; the actions of the Fed in the early '00s, especially with regard to the housing bubble; the fundamental challenge – and promise – of accelerating change; the subprime collapse and Great Recession (including "the bailout"); the problems with Keynesian excesses at the Fed and other major central banks; the crisis in the Eurozone; and the healthcare crisis (and Obamacare).

Second, I could see my own thought process evolving and realized again how truly important it is to continually test your ideas in the marketplace.

The plan was to take a short stroll through the history of my letters to get a feel for how our world and my thinking about it have changed over time. As it developed, Charley presented me with a rather voluminous package of excerpts, one far too long to send out as a *Thoughts from the Frontline* letter. So I will have to viciously edit myself to make the retrospective more consumer-friendly for TFTF readers. But for those who are interested, we are posting the entire summary here (and it will remain available here).

As you read the entry for each year, think back on your own thought process and actions at the time. Surprisingly, as I did the same, it appeared to me that, more often than not, I "got it right" (even if I got it early). So let's climb into the Wayback Machine and take a spin through the last 15 tumultuous years. We will begin with my call in October 2000 for a recession in 2001.

[Note: comments in brackets were written as we edited this. Everything else is verbatim from the original letters.]

The Probability of a Recession Grows

October 20, 2000

I get lots of mail from readers asking me to tell them if I think we will have a recession next year. I think I can say with some authority that making predictions can get you out on a limb. There are scores of variables that affect our economy. At any given time you can find trends that will seem to be pointing us to one conclusion, and other trends that might yield the opposite conclusion. It is only in hindsight that the pundits will tell us that we should have seen the most important trend all along. So instead of predicting a flat yes or no, I am going to assign some probability to the potential for a recession, and then as we go along I will either increase the probability or decrease it….

[If the yield curve is functioning as an accurate predictor of recession] we should be looking to see a recession next summer at the earliest and probably next fall. As I think back over the last few recessions, there were very few signs one year ahead that a recession was coming. For most economists and analysts, the recession was a surprise even one quarter out!...

Since the yield curve is an EARLY predictor, it would be more worrisome if we were seeing confirming signs in the economy now. That would mean the recession was probably going to be a very deep one. Thus we shouldn't be surprised that we see no recession clouds on the horizon….

This year, the yield curve went negative for a few days in early April but has been decidedly negative since July 7. The worst the yield curve has been this cycle is a -.66, where it is today. The 90-day average is now -.40.

The Fed study says at this level there is approximately a 35% chance of a recession within four quarters. I would remind you that the study also says the probability should be raised somewhat due to the more fluid bond markets of today, so the number is probably around 40-50%....

That also means there is a 50% chance we won't have a recession. But every time we have been at these yield curve levels for the last 40 years we have had a recession.

[A recession ensued in March 2001 and persisted through November.]

Rules of Engagement

October 4, 2001

[A month after 9/11 and a month before recession officially ended]

As far as the economy this week, not much has changed. Japan just gets worse and Europe is getting weaker, which means the US will have to lead the world out of a global recession. But our consumers are saving dramatically more and spending less, manufacturing is down, as is capacity utilization etc. etc. Long bonds are back to new highs. Same old, same old.

But the cavalry is on the way. The Fed cuts again and again and pumps $100,000,000,000 into the economy in a few weeks; Congress is likely to provide significant fiscal stimulus; and travel and business are starting to pick up again. I can hear the bugles, but I don't see the troops yet. It is still not safe to get out of the fort, but it is time to make plans for the future….

We are now in a new type of war. The enemy is a few thousand individuals in 60 countries hidden in communities of millions, unknown to 99% of their neighbors, sympathized with and supported by nations and peoples who hate us for reasons most of America does not comprehend. They intend to first destabilize us, then demoralize us, and finally provoke attacks upon various countries and groups within the Islamic world. They will try to tell the poor of these countries that an attack upon Muslim terrorists is an attack upon all Muslims, turning their terror into a religious war. They hope to stir the Islamic masses to overthrow any moderate governments and install governments based upon the terrorists' radical religious beliefs.

Faced with an enemy which is both deadly and disperse, with goals that don't value the lives of either their enemies or themselves, and with a methodology of war that is unlike anything we have experienced in this country, we are now having to develop new strategies for conducting this war.

The Rules of Engagement for warfare have changed. I think it is fair to say that our nation, if not much of the world, has realized that. What would have been unthinkable only a few weeks ago is now promoted as necessary and wise by (almost) all parts of the political equation. It is clear that our military leaders are hoping to avoid the most costly and typical of all military mistakes: using the tactics of the last war to fight the current one.

All's Turbulent on the Investment Front

I am going to suggest that the Rules of Engagement, as it were, for investing are changing as well. The advent of this war is going to accelerate that change. **What has worked for the last 20 years is now going to frustrate those who want to use the old investing rules to fight the next investment war. If you do not see and adjust to these changes, in my opinion you will not be happy with your investment returns over the next decade.**

[And you weren't!]

History Versus the Fed

October 4, 2002

Longtime readers know I am a big fan of History. Central bankers, businessmen, and investors continually try to beat History to a pulp, and often win a few early rounds. Like Mohammed Ali and his rope-a-dope strategy, History lets his opponents wear themselves out throwing ineffective jab after futile blow. In the end, my man History always wins in the final rounds. Betting against History can look good for the first few rounds, as History looks drugged, but the outcome is always the same.

History told us there would be a recession in the fall of 2001 because of the inverted yield curve in the fall of 2000, which I wrote about in August and October of 2000. An inverted yield curve is always followed a year later by recession. Greenspan and the Fed fought back by aggressively lowering rates. They lost. Hopefully they can do better fighting deflation….

A little deflation is not the end of the world, if the Fed can "reflate" the economy. Prolonged, systemic deflation will not be good, however. It will lead to lower home values, which will hurt the housing market, which will hurt jobs, which will hurt consumption and trigger a serious recession.

The Fed increasingly understands this. Dallas Fed Research Director Harvey Rosenblum notes that "There is a distinct possibility inflation could morph into deflation." Greg Weldon notes a recent strange comment by the Richmond Fed president: "The Fed knows what to do, if the Feds fund rate has been pushed to zero, and prices are falling." As Weldon points out, that must mean that at least a few people in the Fed system think this is a distinct possibility.

There is a huge discussion on this issue going on inside the walls of the Fed. At least some of the leadership understands the problem. They need to act NOW. If Greenspan lets deflation get away from him, the next sword at his neck will not be the Queen knighting him.

The Nature of Change

October 3, 2003

My career path echoes that of a million other entrepreneurs and businessmen and women. We all deal with change. In fact, the amount of change that I have had to deal with is rather unremarkable. There are millions of people who go through far more abrupt changes.

Some of the changes were forced upon me. Some of them I willingly embraced. I have told my friends that I hope this is the last time I have to "reinvent" myself. [It was not.] I succumb to the fantasy that most investors have: that the trends of today will continue. And yet I know that this is not likely. The field in which I plow and reap is changing rapidly, and it is unlikely that in 10 years it will look the same at all…. [It most decidedly does not. The goal posts keep getting moved!]

When I began 30 years ago, there were no faxes, no overnight delivery, and phone service was expensive. Computers? Not until 20 years ago, and they were toys compared to today's machines. It cost a lot of money to deliver a newsletter until just a few years ago; now the marginal cost is almost nothing. One or one million is pretty much the same to me.

Research was a visit to the library to pour through books, plus a few magazines and newsletters. Now I get scores of letters and articles every day delivered to my "mailbox," plus an almost infinite amount of data at my fingertips using something called Google. I have almost five gigabytes of research and other articles from just the past few years stored on my computer, which I can search with a few strokes [how quaint]. To write a letter like this even ten years ago would take a week, after a month of research. Now I can access huge amounts of data each week, and I write the letter on a computer in about five hours on Friday afternoon….

International readers? Very few ever graced my musings in the last decade. Now I have thousands of international readers, often from some amazingly remote locations. Soon, I am told, my words may be translated into Mandarin.

In short, the changes have been dramatic. At times, I complain that it has been hard to adjust. A lot of times those changes were just plain not fun. Some of them were very expensive lessons….

Since I plan to write for another 30 years, I will probably witness another 2-3 cycles. I will see yet another secular bull market, in which long-only funds will be precisely where you should put your money. Some new technology will drive a fundamental change in the world. Things will change. We'll end up in 2030 (or whenever) with a new cast of characters telling us that "this time is different." Nanotechnology and/or artificial intelligence and/or cold fusion and/or whatever alchemy we invent in the coming decades will be predicted to somehow repeal the business and investment cycle that has prevailed since the Medes were trading with the Persians. It will be interesting to see if I can recognize when the "times are a'changing."…

I am not certain about much, but I am certain about this: the future will be different than we think it will be today. We can plan and dream, but more than ever we need to think about Plan B and C and D. The odds are, your personal world is going to change dramatically in the next ten years. How you cope with the change, and even use it to make your life better, will be the measure of how well you thrive.

It is the unique ability of Americans to deal with change that makes me an optimist. We are going to have to face some very difficult changes, which, given the acceleration of change, will be even more challenging than what we have already faced. But coping with change is in our DNA. It is what we do.

I hope I can be part of your "let's think about the future" planning for a long, long time. And I bet you we find the future far more fascinating and fun than we can even begin to imagine.

Horse Racing and the CIA

October 1, 2004

This week we explore in depth an essay on how we think from that bastion of investment analysis, the US Central Intelligence Agency. We look at the rookie mistakes made even by pros. I describe one of my own more embarrassing rookie moments and how it highlights an investment principle that the best-performing professionals always keep in mind. I finish with a note on what you can give me (and your friends) for my birthday. It should make for a lively letter….

Jim Williams, founder of the Williams Inference Center, recently sent me a pile of fascinating research which I am wading through. One of the first articles I read was an essay by Richards J. Heuer, Jr., entitled "Do You Really Need More Information?" It was published in a book called *Inside CIA's Private World: Declassified Articles from the Agency's Internal Journal 1955-1992*.

Buried among articles on how (and how not to!) to spy is this rather straightforward piece on what to do with the information you get and the problems with objective and accurate analysis that are caused by our human thought process. The essay is quite timely, even though it was written in the spring of 1979. While reading the critique, one could not help but wish that it would be required reading at the CIA today. Perhaps we could have avoided a few problems. But that is a topic for someone else. Our beat today is thinking about money.

I am guilty. Mea culpa. I am constantly researching, looking at (sometimes obscure) data, trying to discern patterns and trends. But what to do with all of it? How do we filter it into useful and investable ideas?

> This article challenges the often implicit assumption that lack of information is the principal obstacle to accurate intelligence estimates.... Once an experienced analyst has the minimum information necessary to make an informed judgment, obtaining additional information generally does not improve the accuracy of his estimates. Additional information does, however, lead the analyst to become more confident in his judgment, to the point of overconfidence.

Horse Racing and the CIA

Heuer describes a study done about betting on horse races. They took eight professional handicappers (someone who sets the betting odds based on calculations of the outcome of a contest, especially a horse race) and asked them to rank 80 different pieces of data about a horse race as to what they thought was most important. Do you factor in the jockey's record as well as the recent record of the horse? The weather? The competition? How much weight is the horse carrying? What is the length of the race? There are scores of variables.

Then the handicappers were given what they felt were the five most important pieces of data and asked to project the winner of a race (actual names and races were not given, so as to not bias the projections). They were also asked to rank their confidence about their predictions.

Now it gets interesting. They were then given 10, 20, or 40 pieces of what they had individually considered to be the most important information. Three of the handicappers actually showed less accuracy as the amount of information increased, two improved their accuracy, and three were unchanged. But as a group, their accuracy did not improve and in fact was slightly down.

But with each increase in information, their confidence went up. In fact, by the end, their confidence had in fact doubled. If they had actually been at the track and were betting, would they have doubled their bets as they became more confident? Human nature says yes, they would. But that confidence would not have made them any better predictors. They just doubled their bets, which magnified their gains or losses. Think of it like adding leverage to your stock portfolio.

"A series of experiments to examine the mental processes of medical doctors diagnosing illness found little relationship between thoroughness of data collection and accuracy of diagnosis." Another study was done with psychologists and patient information and diagnosis. Again, increasing knowledge yielded no better results but significantly increased confidence.

The inference is clear and quite important: "Experienced analysts have an imperfect understanding of what information they actually use in making judgments. They are unaware of the extent to which their judgments are determined by a few dominant factors, rather than by the systematic integration of all available information. Analysts use much less available information than they think they do."

Ah, Brave New World

October 7, 2005

Last week we looked at how technology has the potential to slow and possibly reverse aging within the next two decades. Marvelous cures for the main causes of death, including cancer, heart disease, dementia, and Alzheimer's, not to mention the potential to manage weight, are in our future. Amazing innovations in communications are rapidly coming at us, too, as is an increased ability to process information. Hunger and malnutrition are in our sights, as we increase the ability to bring in harvests that yield more, as well as develop biotech and nanotech processes to manufacture food.

Further down the road, the ability to manipulate molecules at the quantum level will mean we can produce the materials we need at much lower costs. As we map and reverse engineer the software that runs our brains, powerful new software can be developed on machines, which can aid in the development of whole new technologies as well as allow us to directly access information and communicate with each other. It will mean I can get rid of this annoying keyboard, which is bouncing around as the plane I am on hits a little turbulence.

(At the end of the letter, I will speculate about how we invest in these trends. Next week, we get back to our usual beat of finance; but judging from the letters I am getting, a lot of you are enjoying the speculation about the future.)

Ray Kurzweil, in his latest book, *The Singularity is Near*, writes of an almost utopian future. For him, as well as others, such a future of marvels cannot come too soon. They see a transition to a world where we merge with our machines, allowing us to think and work at far faster speeds than our unaided biological "wetware" is capable of. And we'll do it from bodies that do not succumb to disease or aging.

There are many objections to his work from a variety of quarters. To his credit, he does not dodge or ignore them. He spends almost a hundred pages in *Singularity* outlining the various criticisms of his views of the future and then rebutting them.

Ray sees us approaching a "singularity" or point in the future where humanity and machines evolve into something we would call distinctly post-human. At that point, things change in ways we cannot predict or presently even comprehend…. Ray sees this event as happening around 2045, with life extension from biotech and nanotech happening in the 2020s and 2030s.

The Inflation of Expectations

October 6, 2006

This week we had two more Federal Reserve members repeat what has become the theme for their chorus, but not one the market seems to be paying much attention to. It should be. The market believes the Fed will soon start to cut rates, perhaps as early as first quarter of next year. It is not altogether clear that this will be the case.

I must admit to being somewhat baffled as to the apparent disregard by the stock market for what I view as a tough environment in the medium term, **with either a slowdown or a mild recession being suggested by numerous factors.** [I was forecasting a recession the next month due to the yield curve, along with other factors.] While there are a lot of positive features to the economy, to me the risk to the economy still seems to be to the downside. I take small comfort in the fact that this perspective is shared by Fed Vice Chairman Donald Kohn, a very solid economist and financial market observer….

A Slowing Labor Market

Central to [the Fed's] problem is the employment rate and consumer spending. Housing is definitely slowing down. At the height of the housing market, consumers (on a national basis) were borrowing almost 10% of their income as mortgage equity withdrawals. This cash-out refinancing added over 1% and maybe as much as 1.5% to GDP. Such re-financing has dropped to under 6% and looks like it is in freefall on the charts. Bernanke said in his speech that a slowing housing market could shave 1% off of GDP. GDP last quarter was 2.6%. Between housing and lower consumer spending due to less borrowing, it doesn't take a lot to get that down to the 1% range.

There is a close correlation between housing prices and consumer confidence, and thus consumer spending. Consumer spending does not have to contract, it just has to slow down for it to have economic repercussions when home building is going to slow down over at least the next two quarters.

[Housing prices peaked in mid-2006, and by Dec. 2007 we were officially in a recession.]

The Slow Motion Recession

October 5, 2007

Let's recall what John Hussman said earlier about recessions being caused by a mismatch between the goods and services supplied to the economy and the demand for them. In past recessions, this has generally come to a culmination where employment turns down relatively quickly and profits take a dive.

Let me offer a scenario where it might be different this time. In past recessions there were generally some portions of the economy that grew beyond the respective demand for their products or services and/or a bubble in some sector burst. Such an event happened relatively quickly, and it took some time for there to be a shift of employment to other sectors and for the economy to start growing again.

If we see a recession now, it is going to be because of the bursting of the housing bubble. But housing is different. There is no "mark-to-market" pricing. You can't look up the value of your house on a computer screen like you can your stocks or bonds. People tend to think their houses are special. They know how much time and effort they put into maintaining the house, and experience has taught them that over time, if they are patient, they will get a good price for their home. They become reluctant to sell at a reduced price.

Enter reality. Home values are starting to fall, and in some areas by a lot, for several reasons. First, because homebuilders are cutting prices in order to move inventory off the market. They have to raise cash in order to pay back loans, even if it means losing money on the sale of houses. They are in survival mode.

A story on Bloomberg notes that some smaller home builders are selling homes at a 40% discount in order to raise cash. D.R. Horton put 58 condominiums up for auction in San Diego. Local real estate agent Steven Moran said, "I ran the numbers, and the condos sold for between 68 cents and 74 cents on the dollar, based on the original asking prices."

The fact that some homebuilders may lose money is not a problem for the general economy. The problem is that anyone trying to sell or refinance a home in one of those neighborhoods is now going to see the value of their home come down – perhaps substantially – in the appraisal they will need for the mortgage. Appraisers look at recent sales of comparable homes to come up with a value for the home. If your neighbor's home sells for 20% less, then your appraisal is going to come down 20% as well. And the amount of money you can borrow on your home depends upon that appraisal.

OK, then you can just stay in the home and make that mortgage payment. And if you made a conventional loan, that's what you would do. You might not like the fact that your home is worth less, but you won't go through bankruptcy and risk your other assets by not making the payments.

Except for about 2,900,000 home buyers who did not get conventional mortgages. [Says] good friend Gary Shilling:

> Subprimes leaped to $1.3 trillion, or 73% of all Adjustable Rate Mortgages (ARMs), in the first quarter, a 17 times jump from 2001. And 57% of mortgage broker customers with ARMs were unable to refinance into new loans in August, given their low initial down payments and falling prices that have put their equity in negative territory. Estimates are that the cumulative loss on subprime mortgages will be $164 billion in home equity and cost financial institutions $300 billion.

The Curve in the Road

October 3, 2008

The "bailout plan" was passed. Will it work? The answer depends on what your definition of "work" is. If by work you mean no more government intervention and no further costly programs and a functioning market, then the answer is no. But there are things it will do. This week I try to help you see what might lie ahead around the Curve in the Road. We look at how the rescue plan will function, see what is happening in the economy, and finally muse as to whether Muddle Through is really in our future….

First, let's look at the "rescue plan" as passed by Congress. As I pointed out last week, this is a bad bill. But it was necessary to pass something, and soon. Earlier this week I sent out a report that reviewed a study of 42 major banking crises. The conclusion: navigating them successfully depended upon quick action.

As everyone should know, the credit markets are almost completely frozen. LIBOR is bid-only, no offers. Commercial paper markets are imploding. And what is trading is often at rates that are much higher than they were a few months ago. Corporations are being strangled on high rates. Corporations have little or no access to normal credit markets, and they will face massive problems when it comes time for them to roll over short-term debt….

As I have said repeatedly for months, the problem is that financial institutions are having to deleverage. They have massive losses and simply have to raise capital in order to survive. If you can't raise equity capital (and most can't), one of the ways you get by is by making fewer loans and taking less risk. You also charge more for the loans you do make.

Larger institutions cannot raise capital on competitive terms. GE is an AAA-rated company. Yet they had to pay Warren Buffett 10% to get $5 billion, plus in-the-money warrants worth at least another 10%. Buffett is likely to double his money on this deal over 4-5 years. A short while ago, GE could get short-term commercial paper for a few percentage points. That difference is going to significantly impact GE's bottom line. But they had no real choice. They took the money.

As did Goldman Sachs. Yet another Buffett $5 billion preferred-share purchase (with more warrants) at a rate that even Goldman will find it hard to make money on. But they had to raise capital quickly, and they had little choice….

If GE and Goldman are paying 10%, what do you think it costs a firm with "only" a B rating? 15%? More? Junk bond yields have simply gone ballistic. Firms that used the credit market to access capital are simply shut out now. If they are a small public company, they can go to what are known as PIPE hedge funds (Private Investment in Public Equity) that sell equity at usurious rates (which is what Buffett does but on a larger scale). But a small or medium-sized private company? It is a hard time to go looking for money.

Left alone for the markets to work out, the economy of the US and the world would be in a depression within two quarters and would need years to recover. Think Japan….

Necessary but Not Sufficient

Now for the bad news. The "rescue plan" was necessary but not sufficient to fix the crisis. There is going to have to be more heavy lifting, I'm afraid. Let me offer a few ideas about what possible actions might be taken in the future. I am not advocating these actions, I am simply telling you what might happen. These are possible, because authorities will do whatever they deem necessary to avoid a systemic economic meltdown and a potential depression….

I had a lot of readers write me very nice letters this week, starting out with how much they like my letter, my insights, etc. Then they (mostly – but not all – and politely) launched on me for backing the rescue plan. Many of you had much better ideas than what was passed by Congress, which is not surprising.

I really do hate the idea of having to support a rescue plan. It goes against my every instinct. But I also know that doing nothing would result in an economy that would blow right through 10% unemployment within a few quarters and take years to recover. The stock markets and the savings of millions of retirees would be wiped out. Home values would really go into a tailspin. Being right in theory is not worth seeing that kind of devastation…. [Oops, we did see 10% unemployment, and it took years to recover.]

In the next few weeks and months, I think you can count on more extraordinary actions by the Fed and Treasury to try and jump-start the credit markets. Actions that were highly improbable a few months ago will be on the table. Will the Fed open its balance sheet to non-banks? Possibly. If they can guarantee money markets, will there be a scheme to insure commercial paper at some price? Not out of the question. Will European governments take more equity in large European banks? Very likely. Will the Fed and/or the Treasury invest even more capital in larger financial institutions? Given that We the People now own 80% of AIG and 100% of Fannie and Freddie, it is certainly within the realm of possibility that we will be the proud owners of even more formerly private institutions.

Again, this is not just a US issue. We will likely see similar actions in Europe and some of the developing world. This is a worldwide crisis, and the response will be from central banks all over the world….

Next week we will explore the economic landscape in detail, but let me provide a few thoughts. As I have said for a long time, we will be talking about deflation this time next year. Recessions are by definition deflationary events. Given that we have had two bubbles burst (housing and credit), there is even more potential for deflationary pressures. Add into the mix the deleveraging process, which will take years to finally abate, and the recent bout of price inflation caused by energy and food will pass, as demand destruction for oil will hold oil prices in check.

As I have said for a long time, the next move of the Fed is likely to be a cut. We are now close to such an action. A 1% Fed funds rate is again a real possibility. I am not sure it will help as much as some market participants think, but I think it likely the Fed will move before the end of the year, if not much sooner.

Europe and Japan are also probably in recession, and it is likely we are going to see a worldwide global slowdown. It would be nice if the European Central Bank, the Bank of England, and the Fed could coordinate a joint rate cut to signal that they are working together on the problems. I would not want to be short the markets that day.

At the beginning of the year, I was predicting a small recession with a lengthy and slow recovery period. I now think that the recession could be deeper than a 1% contraction. I think we could see a rather lengthy recession. Quite simply, the credit crisis has been allowed to spin out of control. That Congress almost failed to act is beyond belief. Given the above circumstances, it is not out of the realm of possibility that a recession lasts through the middle of 2009. As recessions go, that is a long time. But trust me on this, it will pass. The recovery will be a slow Muddle Through affair, though. It will be a few years before we are growing at a sustained 3%.

Another Finger of Instability

October 2, 2009

The most-read and commented-upon letter I have written in 15 years was on the theme of Ubiquity, Complexity Theory … and Sandpiles. I reprint it from time to time and so will not include it here, but it is worth your time, and you can follow the link above if you like. It deals with how bubbles build and collapse – seemingly all of a sudden. From a scientific perspective, bubbles make perfect sense.

The Ride of the Keynesian Cowboys

October 9, 2010

To ease or not to ease? That is the question we will take up this week. And if we do get another round of quantitative easing (QE2), will it make any difference? As I asked last week, what if they threw an inflation party and no one came?...

The Fed is basically down to one bullet in its policy gun. It cannot lower rates beyond zero, although it can pull down longer-term rates if it so chooses. But lower rates have not so far been the answer to creating jobs and inflation. All less-subtle instruments of monetary policy have been tried. The final option is massive quantitative easing, the monetization of US government debt. As the saying goes, if all you have is a hammer, all the world looks like a nail. And after the last FOMC meeting, the markets have openly embraced quantitative easing….

The Keynesian Cowboys are saddling their QE horses, and they intend to ride. They have no idea what the end of the trail looks like. This is all a guess based on pure theory and models (like the broken money multiplier). And I really question whether the result they hope for is worth the risk of the unintended consequences. As I wrote a few weeks ago:

> If it is because they don't have enough capital, then adding liquidity to the system will not help that. If it is because they don't feel they have creditworthy customers, do we really want banks to lower their standards? Isn't that what got us into trouble last time? If it is because businesses don't want to borrow all that much because of the uncertain times, will easy money make that any better? As someone said, "I don't need more credit, I just need more customers."

How much of an impact would $2 trillion in QE give us? Not much, according to former Fed governor Larry Meyer, who, according to Morgan Stanley:

> … maintains a large-scale macro-econometric model of the US economy that is widely used in the private sector and in public policy-making circles. These types of models are good for running "what if?" simulations. Meyer estimates that a $2 trillion asset purchase program would: 1) lower Treasury yields by 50bp; 2) increase GDP growth by 0.3pp in 2011 and 0.4pp in 2012; and 3) lower the unemployment rate by 0.3pp by the end of 2011 and 0.5pp by the end of 2012. However, Meyer admits that these may be "high-end estimates."…

It is clear, at least from the speeches I read, that if the economy continues to sputter and looks like it may fall into recession, that the need to DO SOMETHING will overwhelm all caution. Not trying the last tool in the box if the economy is rolling over is just not something that will be considered by those of the Keynesian persuasion. Never mind that Congress is getting ready to raise taxes (and has already done so in the case of Obamacare, to the tune of almost 1% of GDP!); in the face of a slowing economy, the Fed is going to step in and try to do something.

Let me be clear. We do NOT have a monetary problem. And whatever solutions we need are not monetary. This is on Congress and the Administration. The Fed needs to step aside.

An Irish Haircut

October 8, 2011

Just as only four short years ago it was All Subprime, All the Time, and then it was the Credit Crisis, now it is Europe. (When) will Greece default and which banks will implode as a result? Is there another banking crisis in our future? I just came back from a whirlwind four-country visit to Europe, and I will try to offer a few insights….

[H]ere is the issue for Europe. The amount of money needed for Ireland is going to be a lot more than they now think, or at least are willing to admit. When Eurozone politicians worry about "contagion," or one country wanting the debt relief that another country gets, it is a very real worry. And rightfully so, as voters in Portugal or Spain or (gasp) Italy who are burdened by debt that is seemingly intractable will also want relief. It is not just an Irish condition, it is a human trait.

And the money that Europe needs will overwhelm the €440 billion ESFS fund. Stratfor and others think it will take at least €2 trillion. The Boston Consulting Group put out a report that suggests the total number, at the end of the day, will need to be (drum roll, wait for it) over €6 trillion. I don't like their proffered solutions, but their analysis of the debt and the need for relief is sobering.

Whatever the figure, it is staggering. And one the Eurozone is not willing to pay, at this moment. When the next crisis hits, who knows? But now, that much is not on the table. There is talk of leveraging the ESFS up to €2 trillion, but that seems odd, as normally you have to have equity to leverage more debt. The ESFS is debt created by promises to pay by the member governments. Are we now at the point where we need to leverage our leverage? It seems to me that is what got us into the problems to begin with.

France is at risk of losing its AAA rating. From my far-removed seat, I think it is almost a certainty they will, as the amount they will have to raise for French banks is enormous. Add another few hundred billion euros for bailout funds for Spain and Italy, and the idea of AAA euro debt goes right out of window. To keep the current AAA, a majority of guarantees needs to be from AAA countries. That is a very touchy issue right now….

We are now in the final innings of the Endgame. Greece is likely to default no later than the end of this year, if not by the end of this month. Which for all intents and purposes they have already done. If you can't get the market to finance you, that means you can't pay your bills without the kindness of strangers. If Greece were an individual or a company, it would be in bankruptcy proceedings. It is now just a matter of time.

Can the euro survive? The short answer is yes, but not without a lot of pain on the part of a lot of people. The drive for a united Europe is strong and may indeed overcome the drive that would tear the union apart. I actually hope so. But it will not be done without a lot of sacrifice. I think the valuation of the euro is at serious risk. And while European markets look cheap on a relative and historical-valuation basis, one needs to ask, compared to what? Long European stocks, short the euro? Maybe, especially if the Germans turn the ECB loose as a way to keep (and pay the price for) the European Union.

I heard no consensus. There are dozens of different plans, enough to make any politician's head swim. Stay tuned.

Economic Singularity

October 15, 2012

[This is one of my all-time favorite letters. You can click on the link above to read the entire letter, but I'll excerpt portions.]

There is considerable disagreement throughout the world on what policies to pursue in the face of rising deficits and economies that are barely growing or at stall speed. Both [the austerity and stimulus] sides look at the same set of realities and yet draw drastically different conclusions. Both sides marshal arguments based on rigorous mathematical models "proving" the correctness of their favorite solution, and both sides can point to counterfactuals that show the other side to be insincere or just plain wrong….

Both sides have arguments that are intellectually appealing, yet both cannot be right at the same time. What I think we need to consider is the possibility that there is something that is happening outside of traditional economic theories, which will mean that following either traditional policy solution could lead to disaster.

But is there a third alternative? If we want to find one, the first thing we need to do is to properly diagnose the problem. In today's letter we begin to explore why the models aren't working. Sometimes the best way to understand a complex subject is to draw an analogy. So with an apology to all the true mathematicians among my readers, today we will look at what I will call the Economic Singularity. And maybe we'll have a little fun on the way….

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

Beyond the "event horizon" of the black hole, the models no longer work. In general relativity, an event horizon is the boundary in spacetime 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 pull becomes so great that nothing can escape….

I think we can draw a rough parallel between a black hole and our current global economic situation. (For physicists this will be a very rough parallel indeed, but work with me, please.) An economic bubble of any type, *but especially a debt bubble*, can be thought of as an incipient black hole. When the bubble collapses in upon itself, it creates its own black hole with an event horizon beyond which all traditional economic modeling breaks down. Any economic theory that does not attempt to transcend the event horizon associated with excessive debt will be incapable of offering a viable solution to an economic crisis. Even worse, it is likely that any proposed solution will make the crisis more severe.

The Minsky Moment

Debt (leverage) can be a very good thing when used properly. For instance, if debt is used to purchase an income-producing asset, whether a new machine tool for a factory or a bridge to increase commerce, then debt can be net-productive.

Hyman Minsky, one of the greatest economists of the last century, saw debt in three forms: hedge, speculative, and Ponzi. Roughly speaking, to Minsky, hedge financing occurred when the profits from purchased assets were used to pay back the loan, speculative finance occurred when profits from the asset simply maintained the debt service and the loan had to be rolled over, and Ponzi finance required the selling of the asset at an ever higher price in order to make a profit.

Minsky maintained that if hedge financing dominated, then the economy might well be an equilibrium-seeking, well-contained system. On the other hand, the greater the weight of speculative and Ponzi finance, the greater the likelihood that the economy would be what he called a deviation-amplifying system. Thus, Minsky's Financial Instability Hypothesis suggests that over periods of prolonged prosperity, capitalist economies tend to move from a financial structure dominated by (stable) hedge finance to a structure that increasingly emphasizes (unstable) speculative and Ponzi finance….

"A fundamental characteristic of our economy," Minsky wrote in 1974, "is that the financial system swings between robustness and fragility and these swings are an integral part of the process that generates business cycles." (Wikipedia)

But a business-cycle recession is a fundamentally different thing than the end of a Debt Supercycle, such as much of Europe is tangling with, Japan will soon face, and the US can only avoid with concerted action in the first part of the next year.

A business-cycle recession can respond to monetary and fiscal policy in a more or less normal fashion; but if you are at the event horizon of a collapsing debt black hole, monetary and fiscal policy will no longer work the way they have in the past or in a manner that the models would predict.

There are two contradictory forces battling in a debt black hole: expanding debt and collapsing growth. Without treading again on ground covered in many past letters, let's take it as a given that if you either cut government spending or raise taxes you are going to reduce GDP over the short run (academic studies suggest the short run is 4-5 quarters). To argue that raising taxes or cutting spending has no immediate effect on the economy flies in the face of mathematical reality. Note that I'm not arguing for one approach or the other, just simply stating that there will be consequences, either way. The country might be better off with higher taxes and/or more spending, or the opposite. But those choices are going to have consequences in both the short and long term.

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

The Event Horizon

In our analogy, the event horizon is relatively easy to pinpoint. It is what Rogoff and Reinhart call the "Bang!" moment, when a country loses the confidence of the bond market. For Russia it came at 12% of debt-to-GDP in 1998. Japan is at 230% of debt-to-GDP and rising, even as its population falls – the Bang! moment approaches. Obviously, Greece had its moment several years ago. Spain lost effective access to the bond market last year, minus European Central Bank intervention. Other countries will follow….

The policy problem is, how do you counteract the negative pull of a black hole of debt before it's too late? How do you muster the "escape velocity" to get back to a growing economy and a falling deficit – or, dare we say, even a surplus to pay down the old debt? How do you reconcile the competing forces of insufficient growth and too much debt?...

While deficit spending can help bridge a national economy through a recession, normal business growth must eventually take over if the country is to prosper. Keynesian theory prescribed deficit spending during times of business recessions and the accumulation of surpluses during good times, in order to be able to pay down debts that would inevitably accrue down the road. The problem is that the model developed by Keynesian theory begins to break down as we near the event horizon of a black hole of debt….

Deficit spending can be a useful tool in countries with a central bank, such as the US. But at what point does borrowing from the future (and our children) constitute a failure to deal with our own lack of political will in regards to our spending and taxation policies? There is a difference, as I think Hyman Minsky would point out, between borrowing money for infrastructure spending that will benefit our children and borrowing money to spend on ourselves today, with no future benefit.

In my mind I am playing reruns of old *Star Trek* episodes with Capt. Kirk shouting, "Dammit, Scotty, you've got to give me more power!" as they try to escape a looming black hole. Except, in our national version it's Paul Krugman playing Capt. Kirk (badly), demanding that Ben Bernanke provide even more QE and Congress more stimulus spending. (I should note that Paul Krugman, like myself, is a science fiction aficionado. That may be the one philosophical point, a singularity if you will, that we agree on.) Of course, the Republicans (Romney) are playing the part of Scotty, yelling back at Kirk, "Captain, I cannot give ye any more power! The engines are going to blow!"…

The deficit has to be controlled, of course. To continue on the current path will only feed our Black Hole of Debt even more "mass," making it that much harder to escape from. But to try and power away (cutting the deficit radically) all at once will blow the engines of the economy. Suddenly reducing the deficit by 8% of GDP, either by cutting spending or raising taxes, is a prescription for an almost immediate depression. It's just basic math.

The Glide Path

The US still has the chance to pursue what I call the "glide path" option. We can reduce the deficit slowly, by say 1% a year, while aggressively pursuing organic growth policies such as unleashing the energy and biotechnology sectors, providing certainty to small businesses about government healthcare policies, reducing the regulatory burden on small businesses and encouraging new business startups, creating a competitive corporate tax environment (a much lower corporate tax with no deductions for anything, including oil-depletion allowances), implementing a pro-growth tax policy, etc.

We can balance the budget within five years. If the bond market perceived that the US was clearly committed to a balanced budget, rates would remain low, the dollar would be stronger, and we would steam away from the black hole. I would like to see something like Simpson-Bowles, with an even more radically restructured tax policy. Healthcare is clearly the challenge, but a compromise can be crafted, as has been demonstrated by the several bipartisan proposals that have been sponsored by conservative Republicans and liberal Democrats. The key word is *compromise*.

The crucial outcome in the wake of the upcoming election will not be whether we end up with a Republican or a Democratic budget, but whether we can achieve the compromise that will be needed to get us on a glide path to a balanced budget.

I think the analogy of an Economic Singularity is a good one. The Black Hole of Debt simply overwhelms the ability of current economic theories to craft solutions based on past performance. Each country will have to find its own unique way to achieve escape velocity from its own particular black hole. That can be through a combination of reducing the debt (the size of the black hole) and fostering growth. Even countries that do not have such a problem will have to deal with the black holes in their vicinity. As an example, Finland is part of the eurozone and finds itself gravitationally affected by the black holes of debt created by its fellow Eurozone members.

In science fiction novels, a spaceship's straying too close to a black hole typically results in no spaceship. There are also hundreds of examples of what happens to nations that drift too close to the Black Hole of Debt. None of the instances are pretty; they all end in tears. For countries that have been trapped in the gravity well of debt, there is only the pain that comes with restructuring. It is all too sad.

The Road to a New Medical Order

October 5, 2013

There is no doubt that the single most contentious topic I can bring up in a small group discussion or speech is the Affordable Care Act, otherwise known as Obamacare.

You can feel the tension rise, as everyone has an opinion they want to express – most of them based essentially on preconceived philosophical positions, nearly all of which are seen through their own eyes as reasonable and consistent with civilized behavior. And the facts that can be trotted out to support their positions, pro and con, could fill up a document almost as long as the original 2,300+ page bill. I have avoided writing about the Affordable Care Act (ACA) for a variety of reasons but primarily because it is so difficult for us to get our heads around the economic implications.

Today I will try, though some of my readers may conclude that I have failed, to avoid coming to political conclusions about the ACA. Instead, I will aim to dwell simply on the economic ramifications of the implementation of the bill as it exists today. We are changing the plumbing on 17.9% of the US GDP in profound ways. Many, if not most, of the changes are absolutely necessary.

This letter has grown out of a rather lengthy, ongoing conversation I have had with my very close friend and personal doctor, Mike Roizen, about his perceptions of changes that his institution, the Cleveland Clinic, and others like it have to make concerning the delivery of medicine in the near future, and the Clinic's expectations regarding the income they will receive for providing their services….

I asked Mike if he would be willing to provide me with some notes concerning the future of healthcare in our nation and the Clinic's own future. He kindly obliged, and I have edited and expanded upon what he wrote and shared with me in our conversations….

We want to make something very clear right at the beginning. The US healthcare system as it stands is dysfunctional and can no longer continue as it currently operates. With or without Obamacare, profound change is required to deal with the dysfunctionality, and that change will happen, one way or another. Obamacare is simply one method for "encouraging" that necessary change.

The US currently spends 17.9% of its total GDP on health services (http://data.worldbank.org/indicator/SH.XPD.TOTL.ZS). This figure is projected to rise in the near future by about another 1% due to the population's aging and a further 3% due to the growing incidence of chronic illnesses. Anticipated increases would raise the nation's healthcare costs to an unsustainable 22% of GDP, crowding out spending for other goods and services.

By contrast, the Netherlands spends 12% of its GDP on healthcare; Switzerland, Germany, France, and Canada about 11%; New Zealand 10%; Sweden 9.4%; and the United Kingdom 9.3%. As we travel through these countries, there is frequently a clear, if anecdotal, perception that people are healthier than in the US.

And the data backs up that perception. The US spends more money on healthcare because we are in fact far less healthy on average than the rest of the developed world. This difference is in large part due to poor lifestyle choices, but the good news is there are programs that have clearly and conclusively demonstrated that this difference is reversible. Changing behavior, while it will be difficult, can result in significant cost savings. In fact, changing behavior may allow us to spend more on education, social programs, and even defense….

We Are Changing the Health Care Plumbing

Perhaps the best way to illustrate the problem is by means of a rough analogy. Let's imagine an older, 50-story office building in a big city. New office buildings have grown up all around it, and the business tenants are beginning to vacate. Because of the lower rents available to individuals, people have started renting space and converting it into apartments. But as is typical in office buildings, there are very few bathrooms and no showers to speak of, so residents rework the plumbing to provide bathroom and kitchen supply water and drains for their living spaces. On a small scale it works. One floor after another soon converts, until the building is now an apartment complex.

But at some point the plumbing becomes a huge problem. Not everybody can get enough water at the same time; sewage backs up on some floors at inconvenient moments; and if someone flushes a toilet, someone else gets scalded by hot water in the shower. Depending solely on where you live in the building, you may have access to much better service, while others get none. Because of the plumbing problems resulting from poor infrastructure, many of the apartments no longer receive adequate water or get it only on an emergency basis and at great expense and trouble.

The cost of maintaining the system becomes significant, so the residents get together and decide that the building must have a completely new plumbing system. No one wants to keep the old plumbing, but everyone has a different idea about how to go about creating a new system and what it should accomplish and how much it should cost and who will pay for it. Do you do one floor at a time? All the kitchen sinks at once? And can there be different sinks, or must one type fit all? Do you separate the water for the toilets from the potable water?

In a very contentious vote, the occupants of the building narrowly decide on a plan that requires all of the plumbing in the building to be changed simultaneously. Walls will be knocked out, and new pipes and equipment will be installed. The new system is going to be a marvel of technology and efficiency, but the process has the potential to be very messy, as the all-too-human occupants will be going about their day-to-day business in the midst of the construction. They will need fresh water and sewage disposal even as the plumbing is being reworked.

The United States, by analogy, is changing the plumbing of its healthcare system. In describing the plumbing changes, we will focus primarily in this letter on the financial aspects, and specifically on money flows from patients to providers and from providers to their staffs. How do we go about paying the doctors and nurses and covering other hospital costs? As it turns out, a more efficient system will mean that each apartment (hospital) will actually get less water (money) and will have to organize itself to deal with that.

Again, the fundamental changes that are necessary in the US healthcare system are going to happen with or without Obamacare. The system is simply dysfunctional. ACA is just accelerating the process. With a few noncontroversial (we hope) exceptions, we are not going to be making suggestions about what to do to improve the healthcare system or the new healthcare law. The following is simply an analysis of the economic and business challenges that will occur as a result of the Affordable Care Act as it is currently understood. This is the business reality that hospitals all over America face, not just the Cleveland Clinic.

[You can click here to see what John and Mike came up with.]

Today

Lately I have been focused on what I think is the failure of monetary policy to yield the results its proponents claimed it would. Monetary policy and liquidity are not the primary problems faced by this country. But that's a story for another letter. And my bet is that I will still be writing about it when my next birthday rolls around.

And of course, with the yen and the euro behaving as I predicted in *Code Red*, we are setting the stage for significant currency wars in the latter half of the decade. More to the point, a rising currency actually limits how much the Fed can raise rates without throttling back growth. What happens when the yen is at 120 on its way to 130 and the euro is at 110 on its way to breakeven? We could see low rates (albeit higher than today's) for a very long time. I'll have interesting things to write about for another few birthdays, at least.

Chicago, Athens (Texas), Boston, Geneva, and Atlanta

In the middle of October I will go to Chicago for a speech, fly back to a meeting with Kyle Bass and his friends at the Barefoot Ranch in Athens, Texas, and then fly out to Boston to spend the weekend with Niall Ferguson and some of his friends. I am sure I will be happily surfing mental stimulus overload that week. I fly from Boston to Geneva for a few days and then more or less directly to Atlanta for a day (board meeting), before heading back to Dallas.

But for the next two weeks I am happily ensconced here at home. This weekend I will celebrate my 65th birthday with family and friends. I really have not been allowed to be involved at all, other than to be told when to show up.

All the kids are gathering for the weekend. Now three of them have to come from out of town, so getting them all together is harder to do and more special to me.

My business partners in Mauldin Economics, Olivier Garret and Ed D'Agostino, have come in early for an extended planning session. I'm excited that we are expanding the products and services we are offering you, but it does require coordination and focus. I spent yesterday with Jared Dillian who is taking the reins of *Bull's Eye Investing*. Worth Wray drove up from Houston, and we spent an afternoon and deep into the evening thinking through the pressures on the global economy. It feels good to have a great team around me.

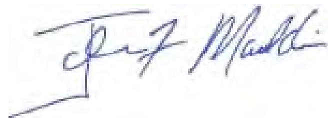
Tomorrow I qualify for Medicare. Many people told me that the process was difficult, but I had no idea. Thankfully I had assistants to help me, but looking at the piles of forms was daunting. I'm not quite certain how I feel about saving $6000 a year (or more) on health insurance. I get that I pay a lot in Medicare taxes, but at some point it seems like we need to have a means test as part of the solution to balance the budget and control entitlement spending.

I remember growing up and being told that retirement was something you did it 65. I also looked around at most of the people I knew then who were 65, and they looked like they were ready to go sit on the porch. I look around now and 65 is the new 45, at least to me. I am in at least as good a shape as I was when I was 45 (I did 75 push-ups a few days ago) and more productive than ever. Thankfully I have no significant health issues, and my chosen profession of writing is not exactly arduous. In fact, I feel like I have to make sure that I add in more gym time and exercise the older I get. Plus, I'm taking a number of cutting-edge supplements that really do seem to be making a difference. Pat Cox and I are working on a special report in which we're going to detail some of the supplements we use and what we're doing to make sure that we have health-spans that are as long as possible.

Let me once again offer my heartfelt thanks to those of you who peruse my weekly thoughts. I do appreciate hearing from you and listening to what's on your mind. It is trying to make sure that I can be of some help to you that gets me going in the morning.

So here's to a great next year together.

Your wondering what the next 15 years will look like analyst,



John Mauldin

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