

## **The Road to Default**

By John Mauldin | November 15, 2019



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Nothing is forever, not even debt. Every borrower eventually either repays what they owe, or defaults. Lenders may or may not have remedies. But one way or another, the debt goes away.

One of Western civilization's largest problems is we've convinced ourselves debt can be permanent. We don't use that specific word, of course, but it's what we do and is why government debt keeps rising. We borrow faster than we repay previous borrowing—and I mean governments everywhere, China as well as the US.

Our leaders have no real plan to reduce the debt, much less eliminate it. They just want to spend, spend, spend forevermore. And most citizens are okay with that. As I will note below, the Republican Party I grew up with, which back then seemed to constantly talk about deficits and debt, is now comfortable with 5% (and growing) of GDP deficits.

As a result, I think we will spend the latter part of the 2020s going through a kind of worldwide bankruptcy. We won't call it that, and it will take a lot of argument because we won't have a court to take charge. But we will collectively realize the situation can't go on and find a way to end it. I've taken to calling this "the Great Reset."

Once the Great Reset is over, we'll find a much better world waiting for us. Getting there will be the hard part.

## Debt Monster

In last week's "[Slowing but Not Stopping \(Yet\)](#)" letter, we talked about the mounting signs of economic slowdown and possible recession. Falling freight volumes are particularly troubling.

My friend and economist Peter Boockvar wrote about the latest shipping data, which came out this week:

*The October Cass Freight index fell 5.9% y/o/y which is the 11th straight month of y/o/y declines. Cass Freight repeated what they've said for the past 5 months that "the shipments index has gone from 'warning of a potential slowdown' to 'signaling an economic contraction.'" Moreover, "Several key modes, and key segments of modes, are suffering material increases in the rates of decline, signaling the contraction is getting worse." The underline is theirs, not mine. To continue, "The weakness in spot market pricing for many transportation services, especially trucking, along with recent airfreight and railroad volume trends, heightens our concerns about the economy."*

*Here are the 3 main areas of concerns:*

*1) "We are concerned about the increasingly severe declines in international airfreight volumes (especially in Asia) and the ongoing swoon in railroad volumes, especially in auto and building materials;*

*2) We see the weakness in spot market pricing for transportation services, especially in trucking, as consistent with and a confirmation of the negative trend in the Cass Shipments Index;*

*3) As volumes of chemical shipments have lost momentum, our concerns of the global slowdown spreading to the US increase... The trade war looks as if it has reached a 'point of no return' from an economic perspective, as the rates of decline are accelerating." Again, the underline is theirs.*

But not all the news is bad, and we could muddle along in this slow-growth mode for a few more quarters or even years. The problem is that even this mild growth is happening only due to monster amounts of debt. A decade of bailouts, QE, ZIRP, and so on encouraged everyone to lever up, and they have. Ray Dalio described this in [his latest LinkedIn post](#).

*Because investors have so much money to invest and because of past success stories of stocks of revolutionary technology companies doing so well, more companies than at any time since the dot-com bubble don't have to make profits or even have clear paths to making profits to sell their stock because they can instead sell their dreams to those investors who are flush with money and borrowing power.*

*There is now so much money wanting to buy these dreams that in some cases venture capital investors are pushing money onto startups that don't want more money because they already have more than enough; but the investors are threatening to harm these companies by providing enormous support to their startup competitors if they don't take the money.*

*This pushing of money onto investors is understandable because these investment managers, especially venture capital and private equity investment managers, now have large piles of committed and uninvested cash that they need to invest in order to meet their promises to their clients and collect their fees.*

In other words, much of what we see right now isn't real economic activity. It is artificial, incentivized by the monetary policies that ended the last crisis, but should have stopped much sooner.

Now people are beginning to see this emperor has no clothes. The first evidence is in the failure-to-launch of "unicorn" companies like WeWork, whose early investors assumed they could palm off their shares to unwitting IPO buyers. Nope, didn't happen, not going to. But that's minor compared to the other threat they face: rising interest rates.

In case you haven't noticed, our negative-rate-loving overseas friends are having a change of heart. The Bank of Japan and European Central Bank are plainly looking for an exit from NIRP as their commercial banking sectors find it increasingly impossible to turn a profit. And whatever many on the progressive left think about banks, they are a critical part of the economy.

Over here, the Federal Reserve's rate-cutting at the short end is raising rates at the long end and, not coincidentally, un-inverting the yield curve. (By the way, the yield curve almost always normalizes as recession begins. So that is not an "all clear" signal.)

This is happening, in part, because the Fed is having to "help" the Treasury sell enough T-bills to cover the government's growing deficit. This is helping reduce interest costs a bit because shortening the average maturity lets the Treasury pay lower rates. But it also leaves less capital at the long end, pushing those rates higher. And loan demand isn't shrinking because so many people figured they would keep refinancing forever.

This will change in due course. And as we see debt-laden businesses run into difficulty—often because they were bad ideas in the first place—bankers will tighten lending standards, and the dominoes will start to fall.

## Recipe for Conflict

I realize some readers are of the progressive persuasion that debt doesn't matter, we owe it to ourselves, etc. This is not correct. Debt *does* matter, and there are limits to how much an economy can bear. I'll admit, the limit is proving higher than I thought, but there is one and every day brings us closer to it.

You really need to [watch this video](#) of a recent conversation between Ray Dalio and Paul Tudor Jones. Their part is about the first 40 minutes. Jones begins by positing that Donald Trump is the best salesman in American history because he (a) got the Republican Party to accept annual deficits at 5% of GDP and (b) convinced the Fed to *cut* interest rates even with unemployment at 50-year lows.

Of those two, the budget deficit is the least surprising. I (sadly) realized long ago that even Republicans are fiscal conservatives only rhetorically, and like all politicians will respond to constituent demands. Everybody wants lower taxes (for themselves) and higher spending (on their own priorities). That's what our system delivers. Not good, but it's reality. And so the debt grows ever larger.

No candidate can run on anything close to fiscal balance, because to do so would mean either advocating higher taxes or cutting entitlement programs. Both are guaranteed vote killers.

We learned this week that the federal deficit for the last 12 months rose above \$1 trillion for the first time since 2013. The official on-budget debt is only part of it, too. Off budget will be at least another \$200 billion. With GDP weakening (today the New York and Atlanta Fed models both cut their fourth-quarter GDP growth projections to 0.4% or below) and without a significant trade deal (something more than just around the margins for optical reasons), we can expect lower government revenues and higher government spending to further increase the deficit.

Add in unfunded pension debt, both at the federal level and lower. Does anyone really think that in a serious crisis, Washington won't bail out bankrupt state and local pension plans? And of course it will step in to save the laughably unfunded Pension Benefit Guaranty Corporation, which insures private defined benefit pensions. All these unaccounted-for liabilities will amplify future deficits at some point.

We are not going to get out of this debt trap by cutting benefits or raising taxes. I agree with Ray Dalio that we are almost certainly going to monetize it. I highly suggest that you read his latest piece titled "[The World Has Gone Mad and the System Is Broken.](#)" It is the shortest and best summary of his views that he has put out in a long time.

*Since there isn't enough money to fund these pension and healthcare obligations, there will likely be an ugly battle to determine how much of the gap will be bridged by 1) cutting benefits, 2) raising taxes, and 3) printing money (which would have to be done at the federal level and pass to those at the state level who need it). This will exacerbate the wealth gap battle.*

*While none of these three paths are good, printing money is the easiest path because it is the most hidden way of creating a wealth transfer and it tends to make asset prices rise. After all, debt and other financial obligations that are denominated in the amount of money owed only require the debtors to deliver money; because there are no limitations made on the amounts of money that can be printed or the value of that money, it is the easiest path.*

Note, Ray isn't saying he *prefers* this path, or that it is a good choice. He thinks it is what we will do. I agree. This is what will happen, and it's going to have consequences.

*The big risk of this path is that it threatens the viability of the three major world reserve currencies as viable store holds of wealth. At the same time, if policy makers can't monetize these obligations, then the rich/poor battle over how much expenses should be cut and how much taxes should be raised will be much worse. As a result, rich capitalists will increasingly move to places in which the wealth gaps and conflicts are less severe and government officials in those losing these big tax payers will increasingly try to find ways to trap them.*

If that sounds like a recipe for conflict, you're right. It will probably get ugly. We can't yet say exactly how, because there are lots of ways this could unfold. The Fed has plenty of power already, and Congress can give it more. The only real limit is what the markets will bear in terms of currency depreciation.

One way or another, this will get to a Great Reset in which debt simply... disappears. That will inevitably create winners and losers. Some people who did everything right will get punished. Some irresponsible fools will get rewarded. Neither is good, but that's not the point. We are talking about what will happen, not what we want.

## Currency Wars?

In the video conversation mentioned above between Paul Tudor Jones and Ray Dalio, Ray again highlights some problematic similarities between our times and the 1930s. Both feature:

1. a large wealth gap
2. the absence of effective monetary policy
3. a change in the world order, in this case the rise of China and the potential for trade wars/technology wars/capital wars.

He threw in a few quick comments as their time was running out, alluding to the potential for the end of the world reserve system and the collapse of fiat monetary regimes. Maybe it was in his rush to finish as their time is drawing to a close, but it certainly sounded a more challenging tone than I have seen in his writings.

It brought to mind an [essay](#) I read last week from my favorite central banker, former BIS Chief Economist William White. He was warning about potential currency wars, aiming particularly at the US Treasury's seeming desire for a weaker dollar. Ditto for other governments around the world. He believes this a prescription for disaster.

*One possibility is that it might lead to a disorderly end to the current dollar based regime, which is already under strain for a variety of both economic and geopolitical reasons. To destroy an old, admittedly suboptimal, regime without having prepared a replacement could prove very costly to trade and economic growth.*

*Perhaps even worse, conducting a currency war implies directing monetary policy to something other than domestic price stability. There ceases to be a domestic anchor to constrain the expansion of central bank balance sheets.*

*Should this lead to growing suspicion of all fiat currencies, especially those issued by governments with large sovereign debts, a sharp increase in inflationary expectations and interest rates might follow. How this might interact with the record high debt ratios, both public and private, that we see in the world today, is not hard to imagine.*

I called Bill to ask if he thought this was going to happen. Basically, he said no, but it shouldn't even be considered. It was his gentlemanly way of issuing a warning. Currency devaluations against gold were part of the root cause of the Great Depression. Coupled with protectionism and tariffs, they devastated global economic growth and trade.

Do I think it will happen in any significant way in the next few years? It is not my highest probability scenario. But imagine a recession that brings the US deficit to \$2 trillion, possibly followed by a governmental change that raises taxes and spending. This could bring about a second "echo" recession with even higher deficits. This would force the Federal Reserve to monetize debt in order to keep interest rates from skyrocketing, thereby weakening the dollar.

Couple this with a concurrent crisis in Europe, potentially even a eurozone breakup, resulting in countries all over the world trying to weaken their currencies with the potential for higher inflation in many places.

In such a scenario, is it hard to imagine a desperate president and Congress, toward the latter part of the next decade, regardless of which party in control, instructing the US Treasury to use its tools to weaken the dollar? Can you say beggar thy neighbor? Can you see other countries following that path? All as debt is increasing with no realistic exit strategy except to monetize it?

## Timing Is Everything

As Bill and I talked scenarios, he reminded me of Herbert Stein's dictum: "If something can't go on forever, it won't." But then he quoted another famous economist (whose name escapes me) who replied, "But it can go on a lot longer than you think." Kind of like Keynes reminding us that the markets can remain irrational longer than you can remain solvent.

The world has grown accustomed to having the dollar as reserve currency. It is comfortable letting central banks monetize debt and governments run ever-larger deficits. Somehow, we've even become used to negative rates. Things can indeed go on longer than one might think.

I can seriously imagine the market rising significantly over the next few quarters as easily as I can imagine a bear market. But it will be a few years before the gut-wrenching Great Reset happens. We have time, if we properly use it, to position our lives and help those around us prepare for the coming storm.

We will have the chance to invest in new companies that will absolutely, astoundingly change the world for the better. They're going to be extraordinarily valuable franchises. There will be fixed income opportunities even as interest rates drop.

I almost find it ironic that on the one hand I talk about the Great Reset while I am writing a book called the Age of Transformation, marveling at all of the wonderful new opportunities we will have.

Learn to deal with change and take advantage of it. Oh yeah, and consider slowly increasing your allocation to physical gold. I don't think of gold as an investment. I think of it as central bank insurance. And after meditating on today's letter, I think I may need a little more insurance. Just a thought...

## Philadelphia and Dallas

I will be flying into Philadelphia for a "hit-and-run" set of meetings Thursday before flying back on Friday morning to Puerto Rico. Then the next week, Shane and I will be in Dallas for Thanksgiving with the family (I will have a big hand in the food preparation) and a wedding.

I have been trying to arrange a meeting with Ray Dalio, as I seriously want to talk with him about some of the scenarios he would pursue. Schedules are tricky things. I really appreciate his willingness to expose his ideas to the world, when at this stage of the game, he really doesn't need to. But he clearly cares about the future of the Republic. And Leon Cooperman. If you haven't read his latest letter to Elizabeth Warren, you should. I have always been a big fan of Paul Tudor Jones and after seeing him in that interview, it just reminded me how funny and thoughtful he is.

Thousands of others, less well-known but all up and down the income and political spectrum, are just as committed to the future of the country and humanity. Am I naïve to hope we can overcome the partisan divide? It wouldn't be the first time that a divided country has come together to work for the common good. In fact (spoiler alert), that is precisely the scenario I see happening around the time of the Great Reset.

Do we have to get there? No, there are paths we can take to avoid all that. Just not one that I see as politically possible today. But by 2024, who knows? One can always hope.

And with that, I will hit the send button. You have a great week.

Your already thinking about Thanksgiving dinner analyst,



John Mauldin

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