Plexus Mauldin
Alternative Investments (Pty) Ltd

Volume 4 No 41
9 November 2009

JOHN MAULDIN'S THOUGHTS FROM THE FRONTLINE

THE GLIDE PATH OPTION

In this week's *Thoughts from the Frontline* John Mauldin looks at the recently released unemployment numbers and comments on the implications of the data. He then looks at different scenarios of deficit alleviation as attempted in different countries. Examples examined are positive and negative and highlights the difficulties involved in addressing this predicament.

Enjoy the read.

The present contains all possible futures. But not all futures are good ones. Some can be quite cruel. The one we actually get is dictated by the choices we make. For the last few months I have been addressing the choices in front of us, economically speaking. Today I am going to summarize them, and maybe we can look for some signposts that will tell us which path we're headed down. For those who are new readers and who would like a more in-depth analysis, you can go to the archives at www.2000wave.com and search for terms I am writing about. And I will start out by briefly touching on today's ugly unemployment numbers, with data you did not get in the mainstream media.

But first, let me welcome the readers of EQUITIES Magazine to this letter. The publisher is sending the letter to you directly. This letter is free, and all you have to do to continue receiving it is type in your email address at www.2000wave.com. Likewise, I have arranged for my regular readers to get a free subscription to EQUITIES Magazine, if you would like. You can go to www.equitiesmagazine.com. For those who don't know, I write a brief monthly column for them.

The Ugly Unemployment Numbers

The headlines said unemployment, as measured by the "establishment survey," was down by 190,000; and even though that was slightly worse than forecast, market bulls were cheered by the fact that the number was not as bad as last month's. It is an improvement that we are not falling as fast.

Well, maybe. What I did not see in many of the stories I read was that the number of unemployed actually soared by 558,000, to 15.7 million, as measured by the household survey. The establishment survey polls larger businesses; the household survey actually calls individual households.

Let's look at the real number in the establishment survey. If you don't seasonally adjust the number, the actual change in unemployment for October was 641,000, or about 450,000 more than the seasonally adjusted number. And the Bureau of Labor Statistics added 86,000 jobs that they simply guess were created through the so-called birth-death ratio. Interestingly, the birth-death ratio number is not seasonally adjusted, so it is just added to the unemployment number. http://www.bls.gov/web/cesbd.htm

The total (U-6) employment rate is at a record high of 17.5% (this includes those who are part-time for economic reasons). There are now over 10.5 million people who have lost their jobs since the beginning of the downturn.

My favorite slicer and dicer of data, Greg Weldon (www.weldononline.com), offers up an even more horrific number. As I have noted before, if you have not looked for work in the last four weeks, the BLS does not count you as unemployed. Quoting Greg:

"Moreover, when we combine the monthly change in the number of Unemployed, with the number Not in the Labor Force, we might consider the result to be a proxy for the actual 'change' in the underlying labor market situation ... in which case, October's figure of 817,000 represents the fourth LARGEST yet, behind last month's (September's) second largest figure of 1,021,000 ... for a two-month combined figure of 1.838 million, in newly Unemployed, or no longer 'in' the Labor Force ...

"... the second LARGEST two-month total EVER posted, barely trailing the December-08/January-09 total 1.955 million.

"Bottom line ... basis this measure AND the 'Total Unemployment Rate,' we could conclude that not only is there NO 'improvement' in the labor market, but moreover, that it continues to DETERIORATE, intently."

There are plenty more implications in the data, but let's turn to the topic of the day.

The Present Contains All Possible Futures

Like teenagers, we as a US polity have made a number of bad choices over the past decade. We allowed banks to overleverage and, in the case of AIG (and others), sell what were essentially naked call options of credit default swaps, based on their firm balance sheets, far in excess of their net worth; and that put our entire financial system at risk. We gave mortgages to people who could not pay them, and did so in such large amounts that we again brought down the entire world financial system to the point that only with staggering amounts of taxpayer money was it brought back from the brink of Armageddon. We assumed that home prices were not in a bubble but were a permanent fixture of ever-rising value, and we borrowed against our homes to finance what seemed like the perfect lifestyle. We did not regulate the mortgage markets. We ran large and growing government deficits. We did not save enough. We allowed rating agencies to degrade their ratings to a point where they no longer meant anything. The list is much longer, but you get the idea.

Now, we are faced with a continuing crisis and the aftermath of multiple bubbles bursting. We are left with a massive government deficit and growing public debt, record unemployment, and consumers who are desperately trying to repair their balance sheets.

If present trends are left unchecked, we will need to find $15 trillion in the next ten years, just to pay for US government debt, let alone state, county, and city debt. And perhaps some loans for business will be needed? Where can all this money come from? The answer is that it can't be found. Long before we get to 2019 there will be an upheaval in the market, forcing what could be unpleasant changes.

We are left with no good choices, only bad ones. We have created a situation that is going to cause a lot of pain. It is not a question of pain or no pain, it is just when and how we decide (or are forced) to take it. There are no easy paths, but some bad choices are less bad than others. So, let's review some of the choices we can make. (Again, I am being very general here. You can go to the archives for more specifics. This is a summary letter.)

Argentinian Disease

One way to deal with the deficit is to do what Argentina and other countries have done: simply print the money needed to cover the deficits. Of course, that eventually means hyperinflation and the collapse of the currency and all debt. There are writers who think this is an inevitable outcome. How else, they ask, can we deal with the debt? Where is the political willpower?

One large hedge-fund manager in Brazil humorously remarked that Argentina is a binomial country. When faced with two choices (hence binomial) they always made the bad choice. Could it happen here?

Hyperinflation is not an economic event; it is a political choice. I think last Tuesday's election is a sign that the voter population is beginning to pay attention to the need for something more than talk of change. There is growing discomfort with the size of the deficits. Further, the Fed would have to cooperate in order for there to be hyperinflation, and I think there is only a very slight (as in almost zero) chance of that happening. Could Congress change the rules and take over the Fed? Anything's possible, but I seriously doubt there is any appetite in saner Democratic circles for such a thing to happen.

I think the chances of hyperinflation in the US are quite low. It would be the worst of all possible bad choices.

The Austrian Solution

Here I refer to the Austrian school of economic theory, based on the work of Ludwig von Mises and Friedrich Hayek, et al. There are those in the Austrian camp who argue the need to do away with the Fed, return to the gold standard, allow the banks that are now deemed too big to fail to go ahead and fail, along with any businesses that are also mismanaged (such as GM and Chrysler), and leave the high ground to new and more properly run.

In their model, government spending is slashed to the bone, as are (in most cases) taxes. The advantage is that, in theory, you get all your pain at once and then can begin to recover from what would be a very bad and deep recession. The bad news is that you risk getting 30% unemployment and another depression that could take a very long time to climb out of.

Now, let me say that I have GREATLY simplified their argument. If you want to learn more you can go to www.mises.org. It is an excellent web site for all things Austrian. While I am not Austrian, I have spent a lot of time reading the literature and have certain sympathies for this view.

That being said, this also has almost no chance of being implemented. In Congress, only my friend Ron Paul is its advocate. Most Austrian followers are Libertarian by nature, and that is just not a political reality for the coming decade.

The Eastern European Solution

As it turned out, Niall Ferguson (last week I wrote about his brilliant book, *The Ascent of Money)* was in Dallas last night, and I was graciously invited to hear him. He gave a great speech and signed books, and then we went to a local bar and proceeded to solve the world's problems over Scotch (Niall) and tequila (me), and went farther into the night than we originally intended. He's a very fun and knowledgeable guy.

As we were talking about possible paths, he brought one to mind that I hadn't thought of. He reminded me of the period after the fall of the Berlin Wall, as the nations of Eastern Europe broke from the former Soviet Union. They started with very weak economies and simply overhauled their entire governments and economies in a rather short period of time, though not in lockstep with one another. Privatization, lowered taxes, etc. were the order of the day.

We here in the US are always talking about the need for reform. We need to reform health care or education or energy. In Eastern Europe they did not reform in the sense that we use the word. In many cases they simply started from scratch and built new systems. They had the advantage that there was general agreement that things did not work the way they had been, so there was more room for change.

Today in the US there are large constituencies that resist change. We only get to tinker around the edges, when real structural change is needed. Sadly, we agreed that here there is not much chance of major change. We can't even get the obvious changes needed in the financial regulatory world.

Sidebar: I am outraged at the paltry proposed financial "reforms." Rahm Emanuel said that no crisis should be allowed to go to waste. The Obama administration is wasting this one. How can we allow banks to be too big to fail? Where is the reinstatement of Glass-Steagall? If we are going to allow large banks to exist, then their leverage must be reduced to the point where their failure would not risk the system and require taxpayer dollars. I don't care if that makes them less profitable. They are making those large profits because they have taxpayers implicitly behind them, and I get no dividend payments from them, the last time I checked. Where is Fannie and Freddie reform (and their breakup)? No mention of an exchange for credit default swaps? (And yes, I know that such an exchange would reduce the number of swaps and the profitability of them. That is the point. They are dangerous if allowed to become too big a market.) This bill reads as if bank lobbyists wrote it. Where is the populist outrage? We have let the fox set up the rules for running the hen house. Shame on us all if we allow this to happen.

Japanese Disease

I have written a lot over the past year about the problems facing Japan. Their population is shrinking, as is their work force. They are running massive fiscal deficits and have done so for almost 20 years. Government debt-to-GDP is now up to 178% and projected to rise to over 200% within a few years. They started their "lost decades" with a savings rate of almost 16%, and are now down to 2% as their aging population spends its savings in retirement. They have had no new job creation for 20 years, and nominal GDP is where it was 17 years ago.

As bad as our problems are here in the US, their bubble was far more massive. Values of commercial property fell 87%! Their stock market is still down 70%. They had **twice as much bank leverage** to GDP as the US. (Think about how bad off we would be if bank lending was twice as large and had even worse defaults and capital shortfalls!)

And yet, they Muddle Through. Productivity has kept their standard of living reasonable. Up until recently their exports were strong. The trading floors of the world are littered with the bodies of traders who have shorted Japanese government debt in the belief that it simply must implode. While I believe that it eventually will, if they stay on the path they are on, Japan is a very clear demonstration that things that don't make sense can go on longer than we think.

Richard Koo (chief economist of Nomura Securities, in Tokyo) argues passionately that Japan had a balance-sheet recession, and that the only way for Japan to fight it was to run massive deficits. Banks were not lending and businesses were not borrowing, as both groups were trying to repair their balance sheets, which were savaged by the bursting of the bubble. It is said that at one time the value of the land on which the Emperor's Palace sits in Tokyo was worth more than all of California. Clearly this was a bubble that puts our housing bubble to shame.

So, I understand the point that there are differences between Japan and the US . But there are also similarities. We too have had a balance sheet recession, although here it was mostly individuals and financial institutions that have had to retrench and repair their balance sheets.

Japan elected to run large deficits and raise taxes. As I wrote in the October 16th letter (http://www.2000wave.com/article.asp?id=mwo101609), "Savings equal Investments:

GDP (Gross Domestic Product) is defined as Consumption (C) plus Investment (I) plus Government Spending (G) plus [Exports (E) minus Imports (I)] or:

GDP = C + I + G + (E-I)

I don't want to go on at length again, but basically, the literature I quoted suggests that government stimulus and deficits have no long-run positive effect on GDP. In fact, the work done by Christina Romer, Obama's chairman of the Council of Economic Advisors, shows that tax cuts have a three-times-greater positive effect on GDP, and tax increases have the same level of negative effect.

In the equation above, if you increase government spending it will have a positive effect in the short run on

GDP, but not in the long run. In essence, the increase in "G" must be made up by savings from consumers and businesses and foreigners.

But "G" does not enhance overall productivity. Government spending may be necessary but it is not especially productive. You increase productivity when private businesses invest and create jobs and products. But if government soaks up the investment capital, there is less for private business.

And that is Japanese disease. You run large deficits, sucking the air out of the room, and you raise taxes, taking the money from productive businesses and reducing the ability of consumers to save. Then you go for 20 years with little or no economic or job growth.

This is the path we currently seem to be on. The Japanese experience says that it could last a lot longer than people think before we hit the wall; because if savings rise in the US, and if banks, instead of lending, put that money on deposit with the Fed, as they are now doing (in order to repair their balance sheets), the US could run large deficits for longer than most observers currently believe.

We will need 15-18 million new jobs in the next five years, just to get back to where we were only a few years ago. Without the creation of whole new industries, that is not going to happen. Nearly 20% of Americans are not paying anywhere close to the amount of taxes they paid a few years ago, and at least ten million are now collecting some kind of unemployment benefits or welfare.

Choosing large deficits does not reduce the amount of pain we will experience, it just seemingly reduces it in the short term and creates the potential for a serious economic upheaval when the bond market finally decides to opt for higher rates. This path is a bad choice, but sadly, in reality it is one we could take.

The Glide Path Option

A glide path is the final path followed by an aircraft as it is landing. We need to establish a glide path to sustainable deficits (could we dream of surpluses?). That is because at some point there will be recognition, either proactively or forced upon us by the bond market, that large deficits are unsustainable in the long term.

If Congress and the president decided to lay out a real (and credible) plan to reduce the deficit over time, say 5-6 years, to where it was less than nominal GDP, the bond market would (I think) behave. Reducing deficits by $150 billion a year through a combination of cuts in growth and spending would get us there in five years.

The problem is that there is real pain associated with this option. Remember that equation above. Absent a growing private sector, if you reduce "G" (government spending) you also reduce GDP in the short run. You have to take some pain today in order to do that. But you avoid worse pain down the road: a bubble of massive federal debt that has to be serviced will be very painful when it blows up, as all bubbles do.

The Glide Path Option means that structural unemployment is going to be higher than we like (which is actually the case with all the options). And the large tax increases that come with this option will by their very nature be a drag on growth (and cause a double-dip recession in 2011). We can debate tax increases all we want, but I sadly think we will soon have a VAT tax. There are no good options. I just hope that we cut corporate taxes enough when we do create a VAT, that it will make our corporations more competitive, which will be a boost for jobs.

That's pretty much it. This is not a problem we can grow ourselves out of in the next few years. We have simply dug ourselves into a huge hole. This is not a normal recession. There is not a "V" ending to this recession. We are going to have deal with the pain. It will be the pain of reduced returns on traditional stock market investments, a lower dollar, low returns on bonds, European-like unemployment, lower corporate profits over the long term, and a very slow-growth environment. But if we choose this path, we will get through it in the fullness of time.

And of course, then we will eventually have to deal with the $70 trillion in our off-balance-sheet liabilities in Medicare and Social Security and pensions. Sigh. But that's for another time.

Philadelphia, Orlando, and Phoenix

I really am more optimistic than this letter makes me seem. But if you ignore reality, then you have no chance to figure out how to make the best of your situation. It is the efforts of hundreds of millions of individuals trying to make their own lot a little better than will get us back to a robust economy.

Monday I fly to Philadelphia and then the next day to Orlando for two speeches, and then the following week a quick trip to Phoenix, then home to start to plan for Thanksgiving. I will be in New York the first weekend of December (the 4th) for Festivus, a great fundraiser for kids sponsored by Todd Harrison and the team at Minyanville (http://www.rpfoundation.org/), Interestingly, they hold it every year at a "Texas" barbecue joint. Look me up if you are there.

Tiffani has been out the last two days of this week. She is due in seven weeks or less, and her hips are expanding. The pain is too much right now for her to walk up the stairs to the office, so she is working from home. The doctor says this is the one time that her pain is not a sign of something bad. She is being a trooper and not taking any pain meds.

It has been 30 years since I was around a pregnant lady for more than a few hours, and it does bring back some memories. Watching her grow and change has brought back the sense of awe over how our bodies are designed.

Ryan and Tiffani have decided on the name Lively for my first granddaughter, to add to the two new grandsons this year. From zero to three grandkids in just six months! Kind of makes me dizzy.

I really enjoyed my time in South America. Rio is quite beautiful and I want to go back and spend some time.

Have a great week. There will be enough good friends and family that I know I will. And tomorrow night I finally get to go to a Dallas Mavericks game. We may have a real team this year.

Your always optimistic at the beginning of the season analyst,

John Mauldin

Plexus. Independent Insight in an Uncertain World.

Tel: +27 (0) 21 970 2400 • Fax: +27 (0) 21 975 2248 • E-mail: info@plexus.co.za • Web: http://www.plexus.co.za

---