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JOHN MAULDIN'S THOUGHTS FROM THE FRONTLINE
THE NEW, NEW NORMAL

In this week's *Thoughts from the Frontline*, John Mauldin compares healthcare costs across Western countries in response to questions from readers. He then uses a recent Bill Gross article to highlight the changes in wealth accumulation as economic conditions change. The concerns regarding the increasing US deficits are discussed as well.

Enjoy the read.

We are coming to a critical inflection point, perhaps the most critical point that we have had in 70 years for the US and to a great extent the global economy. The choices we make (or that Congress and the Fed make for us) will affect not just our investment portfolios but business and our jobs for a very long time. Last week I talked about the three paths we face as a nation. I want to go back to that theme and expand upon it. You need to clearly understand what the risks are so that you can interpret the actions and data that will be coming at us in the next few quarters. I am feeling a little tired today, so I am going to take the liberty to reproduce Bill Gross's latest comments as well, which are somewhat in line with my own.

A Different Perspective on Health Care

But before we jump into the letter, I want to acknowledge the very large response I got from readers about the cut and paste I did about the differences between the national health care systems of Canada and Great Britain the health care system of the US. To say that I touched a raw nerve is an understatement. I should also admit that I learned a great deal from some very cogent and thoughtful letters. I often write about the problems with using selective statistics in gauging the economy. I have learned that you can do the same with health care statistics.

There are many letters I could quote, but let me give you a counter for the statistics from last week from Raoul Pal of Spain. And of course, there are other statistics that can be brought in to make almost any case you want. But I found these to be very thought-provoking.

"Using the Economists World in Figures I think there is a very interesting and maybe appalling story to tell. In its simplest terms a healthcare system is there to extend the longevity of live of the population. It is the single best and simplest way to judge it because we can all find examples of where one country is better than another but the longevity stats don't lie. When we use that framework the picture is incredibly different. The US has many of the best doctors and medical care in the world but it doesn't work for the population as a whole and therein lies the problem.

"According to the Economist the total US spend on healthcare is 15.4% of GDP including both state and private . With that it gets 2.6 doctors per 1,000 people, 3.3 hospital beds and its people live to an average age of 78.2

"UK - spends 8.1% of GDP, gets 2.3 doctors, 4.2 hospital beds and live to an average age of 79.4. So for roughly half the cost their citizens overall get about the same benefit in terms of longevity of life.

"Canada - spends 9.8% of GDP on healthcare, gets 2.1 doctors, 3.6 hospital beds and live until they are 80.6 yrs

"Now if we look at the more social model in Europe the results become even more surprising:

"France - spends 10.5%, 3.4 docs, 7.5 beds and live until they are 80.6

"Spain - spends 8.1% , 3.3 docs , 3.8 beds and live until they are 81

"As a whole Europe spends 9.6% of GDP on healthcare, has 3.9 doctors per 1,000 people, 6.6 hospital beds and live until they are 81.15 years old.

"The list goes on. The truth is that in many cases as is pointed out the healthcare system is better in the US than in some other countries BUT US citizens must therefore get ill more often than any other country in the West in order to achieve the truly appalling statistic that they are the 41 longest living nation on earth with France, Spain, Norway, Switzerland, Italy, Austria, Andorra, Holland, Greece and Sweden all featuring in the top 20 longest living nations and the UK and Germany at 22.

"This is the big failure of the US system. It is unforgivable. You may get a better chance of recovering from certain diseases but as a whole you will die younger in the US than most developed countries. ... Something is severely broken."

I had many letters from all over the world on this issue both pro and con. And some very lively discussions with health professionals. One pointed out to me that the uninsured in the US when they need a doctor often go to an emergency room for what should be a \$50 office visit and end up with a \$5,000 bill, which does not get paid and runs up insurance costs for those who do have it. As Dr. Mike Roizen points out in his many books, simply eating right, exercising and other common sense things would cut out much of our health care costs. When one-third of children in elementary schools are overweight, we need to get a grip on what we are doing to the next generation.

In the US, many of us are worried about government rationed health care. Others are worried that they have no access to health care at all. It is a very complicated issue. Let's hope that whatever Congress does really does help. And that the coming revolution in new medicines and procedures gets here as soon as it can for all of us. And now to this week's main story.

The New, New Normal

Last week I outlined three possible paths for the economy based upon the political choices we make about the budget deficits.

First, there is the benign path, where we more or less roll back the Bush tax cuts, and do not increase spending for new programs. The fiscal deficit falls into a manageable range. We repeat the Clinton years where spending is held below increase in revenue so that over time the budget gets balanced. While a large tax increase would have negative consequences for the overall economy, it is far better than the other two paths strictly from the perspective of growing the economy as much as possible. This path also has a very small probability.

The second path is that the Obama budget is passed, the Bush tax cuts go away and we have a decade of projected trillion dollar deficits. By the way, those deficits assume 3% growth rates, low unemployment, low interest rates and very large health care savings, and a withdrawal from Iraq and Afghanistan. The deficits are likely to be MUCH larger than the CBO forecasts. This on top of exploding entitlement expenditures in the middle of the next decade, which are underscored in the opinion of more conservative analysts (including me).

The third path is the same as above except that large new taxes are passed in order to bring the deficit to a manageable size relative to the growth of GDP. This means that a tax increase over and above those projected by the Obama administration of around \$700 billion a year (about 5% of GDP!). Deficits would still be in the \$3-400 billion range, but from a funding perspective, it could be done.

The second path is one that will end in heart ache. I do not think that the world or even US investors can buy multiple trillions of dollars of debt for more than a few years without rates rising significantly. That, as Gross points out, will affect both businesses and mortgage borrowers. It is a disastrous train wreck.

The third path is the more likely. I think (hope?) there are enough economically conservative Democrats that will realize the problems of trillion dollar deficits. But they do want a fully nationalized health care, and thus they will pass enough in taxes to pay for it. If they are going to do it, this is their one chance, as Republicans are likely to do better in the 2010 elections and get enough votes to push back any real tax increases other than letting the Bush tax cuts expire.

As outlined last week, it will be a combination of a VAT and taxes on health benefits. There is no other real source for the massive amounts of money needed. It will be a disguised tax on the middle class.

I do not believe they will want to wait until 2010 and an election year. Passing such a huge tax increase is very problematical from the standpoint of a growing economy. It will almost surely put us back into a recession. But it will not be a train wreck. As investors and businesses, we can survive and figure out how to deal with the realities of the new, new normal economy. It will be one in which growth is lower than what we are used to and unemployment is higher. Think Europe.

It will be difficult to ever go back. Perhaps new technologies and industries can develop and help get us back on a path to higher growth later in the next decade. We did survive the 70s, after all.

Now, let's turn to this latest column from Bill Gross, Managing Director of PIMCO. Next week I hope to be back to full speed.

Staying Rich in the New Normal

By Bill Gross

"Behind every great fortune lies a great crime."

Balzac

Balzac was on to something 200 years ago, but to be fair to modern day multi-millionaires, the only real way to accumulate wealth prior to the 18th century was to steal it, or tax it, I suppose, as was the case with kings and their royal courts. It was only with the advent of capitalism and annual productivity gains that entrepreneurs, investors, and risk-takers with luck or pinpoint-timing could jump to the head of the pack and accumulate what came to be recognized as a fortune. Still, the negative connotations persist. I remember a cocktail party in the early 80s where a somewhat inebriated guest engaged me in a debate about the merits of capitalism. "You're filthy rich," he said, which struck me as most unfair from a number of angles. First of all, he hadn't seen anything yet, I thought, and second, I wasn't quite sure where the "filthy" came from. Resentment that he'd missed out on my presumed good deal, I suppose, and in the process using a hackneyed phrase that was bitter and biting, yet had some context of historical sociological relativity. Still, he might have been on to something there - not about me, hopefully, because I've always felt that while PIMCO has prospered, it's only because its clients have benefitted even more so - but about the developing sense of one-sided, perhaps off-sided wealth generation that was to dominate the next several decades. Granted, we had Bill Gates and Steve Jobs and other true capitalistic dynamos who benefitted society immeasurably. But growing percentages of fortunes were being made by those who could borrow or aggregate other people's money. Because our economy was still in a relatively early stage of leveraging, those who borrowed money and used it to invest in higher-risk yet higher-return financial or real assets didn't require a lot of skill, they just needed to be able to convince a bank or an insurance company to lend them some money. After that, the secular wave of leverage would be enough to multiply their meager equity many times over and carry them to a beach where a fortune awaited them much like a pirate's buried treasure.

I remember as a child my parents telling me, perhaps resentfully, that only a doctor, airline pilot, or a car dealer could afford to join a country club. My how things have changed. Now, as I write this overlooking the 16th hole on the Vintage Club near Palm Springs, the only golfers who shank seven irons into the lake are real estate developers, investment bankers, or heads of investment management companies. The rich are different, not only in the manner intoned by F. Scott Fitzgerald, but also in who they are and what they do for a living. Whether some or all of them are filthy is a judgment for society and history to make. Of one thing you can be sure however: over the next several decades, the ability to make a fortune by using other people's money will be a lot harder. Deleveraging, reregulation, increased taxation, and compensation limits will allow only the most skillful - or the shadiest - into the Balzac or Forbes 400.

Readers who are interested in such things as the Forbes annual list of hoity-toities will have noticed that more and more of them are global, not U.S. citizens. The U.S., in other words, is not producing as much wealth in proportion to the rest of the world. Its fortune-producing capabilities seem to be declining, which might suggest that its relative standard of living is doing so as well. If so, the implications are serious, not just for Donald Trump but for wage earners and ordinary citizens, as reflected in their income levels and unemployment rates. Stockholders, 401(k) investors, and yes, bond managers will be affected too. Last week's furor over the possibility of an

eventual downgrade of America's AAA rating demonstrates that only too clearly. On the night of May 20, Standard & Poor's announced a downgrade watch for the United Kingdom and since the U.S. and U.K. are Siamese-connected, financially-levered twins, the implications were obvious: the U.S. might be next. In the space of 48 hours, the dollar declined 2%, and U.S. stocks and long-term bonds were down by similar amounts. Such a trifecta rarely occurs but in retrospect it all made sense: a downgrade would cast a negative light on the world's reserve currency, and since stocks and bonds are only present values of a forward stream of dollar-denominated receipts, they went down as well.

The potential downgrade, while still far off in the future in PIMCO's opinion, seemed dubious at first blush. While country ratings factor in numerous subjective qualifications such as contract rights, military might, and advanced secondary education, the primary focus has always been on the objective measurement of debt levels, in this case sovereign debt, as a percentage of GDP. Yet, as shown in Table 1, both the U.S. and the U.K. entered the Great Recession with attractive ratios compared to such grievous offenders (and AA rated) as Japan.

Sixteen Tons?

Table 1

| Country | Federal Gov't Debt to GDP Ratio |
|---------|---------------------------------|
| U.S. | 45% |
| U.K. | 50% |
| Japan | 171% |
| Germany | 39% |
| Canada | 42% |
| China | 20% |
| Brazil | 36% |

Source: PIMCO. All data as of Q4 2008, sourced from individual country national accounts.

Yet as the markets recognized rather abruptly last week, both countries seem to be closing the gap in record time. To zero in on the U.S. of A., its annual deficit of nearly \$1.5 trillion is 10% of GDP alone, a number never approached since the 1930s Depression. **While policymakers, including the President and Treasury Secretary Geithner, assure voters and financial markets alike that such a path is unsustainable and that a return to fiscal conservatism is just around the recovery's corner, it is hard to comprehend exactly how that more balanced rabbit can be pulled out of Washington's hat.** Private sector deleveraging, reregulation and reduced consumption all argue for a real growth rate in the U.S. that requires a government checkbook for years to come just to keep its head above the 1% required to stabilize unemployment. Five more years of those 10% of GDP deficits will quickly raise America's debt to GDP level to over 100%, a level that the rating services - and more importantly the markets - recognize as a point of no return. At 100% debt to GDP, the interest on the debt might amount to 5% or 6% of annual output alone, and it quickly compounds as the interest upon interest becomes as heavy as those "sixteen tons" in Tennessee Ernie Ford's famous song of a West Virginia coal miner. "You load sixteen tons and whattaya get? Another day older and deeper in debt." Pretty soon you need 17, 18, 19 tons just to stay even and that describes the potential fate of the United States as the deficits string out into the Obama and other future Administrations. The fact is that supply-side economics was a partial con job from the get-go. Granted, from the 80% marginal tax rate that existed in the U.S. and the U.K. into the late 60s and 70s, lower taxes

do incentivize productive investment and entrepreneurial risk-taking. But below 40% or so, it just pads the pockets of the rich and destabilizes the country's financial balance sheet. Bill Clinton's magical surpluses were really due to ephemeral taxes on leverage-based capital gains that in turn were due to the secular decline of inflation and interest rates that at some point had to bottom. We are reaping the consequences of that long period of overconsumption and undersavings encouraged by the belief that lower and lower taxes would cure all.

The current annual deficit of \$1.5 trillion does not even address the "pig in the python," baby boomer, demographic squeeze on resources that looms straight ahead. Private think tanks such as The Blackstone Group and even studies by government agencies, such as the Congressional Budget Office, promise that Federal spending for Social Security, Medicare, and Medicaid will collectively increase by 6% of GDP over the next 20 years, leading to even larger deficits unless taxes are increased proportionately. Collectively these three programs represent an approximate \$40 trillion liability that will have to be paid. If not, you can add that present value figure to the current \$10 trillion deficit and reach a 300% of GDP figure - a number that resembles Latin American economies such as Argentina and Brazil over the past century.

So the rather conservative U.S. government debt ratio shown in Table 1 will likely be anything but in less than a decade's time. The immediate question is who is going to buy all of this debt? Estimates suggest gross Treasury issuance of up to \$3 trillion this calendar year and net offerings close to \$2 trillion - almost four times last year's supply. Prior to 2009, it was enough to count on the recycling of the U.S. trade/current account deficit to fund Treasury borrowing requirements. Now, however, with that amount approximating only \$500 billion, it is obvious that the Chinese and other surplus nations cannot fund the deficit even if they were fully on board - which they are not. Someone else has got to write checks for up to \$1.5 trillion additional Treasury notes and bonds. Well, you've got the banks and even individual investors to sponge up some of the excess, but a huge, difficult to estimate marginal supply will have to be bought. **The concern is that this can be accomplished in only two ways - both of which have serious consequences for U.S. and global financial markets. The first and most recent development is the steepening of the U.S. Treasury yield curve and the rise of intermediate and long-term bond yields.** While the Treasury can easily afford the higher interest expense in the short term, the pressure it puts on mortgage and corporate rates represents a serious threat to the fragile "greenshoots" recovery now underway. **Secondly, the buyer of last resort in recent months has become the Federal Reserve, with its publically announced and near daily purchases of Treasuries and Agencies at a \$400 billion annual rate.** That in combination with a buy ticket for over \$1 trillion of Agency mortgages has been the primary reason why capital markets - both corporate bonds and stocks - are behaving so well. But the Fed must tread carefully here. These purchases result in an expansion of the Fed's balance sheet, which ultimately could have inflationary implications. In turn, nervous holders of dollar obligations are beginning to look for diversification in other currencies, selling Treasury bonds in the process.

The obvious solution to both dollar weakness and higher yields is to move quickly towards a more balanced budget once a sustained recovery is assured, but don't count on the former or the latter. It is probable that trillion-dollar deficits are here to stay because any recovery is likely to reflect "new normal" GDP growth rates of 1%-2% not 3%+ as we used to have. **Staying rich in this future world will require strategies that reflect this altered vision of global economic growth and delevered financial markets. Bond investors should therefore confine maturities to the front end of yield curves where continuing low yields and downside price protection is more probable. Holders of dollars should diversify their own baskets before central banks and sovereign wealth funds ultimately do the same. All investors should**

expect considerably lower rates of return than what they grew accustomed to only a few years ago. Staying rich in the "new normal" may not require investors to resemble Balzac as much as Will Rogers, who opined in the early 30s that he wasn't as much concerned about the return on his money as the return of his money.

I want to emphasize that we will get through all this, one way or another. Some paths will make it easier than others. But it is very important that you understand what the options are, and build a game plan to deal with them. Over the next few months, I will spend some writing time going into some ideas.

Eastern Europe, Maine and Tulsa

For the next month I will actually be home, then in mid-July off to London and I think Eastern Europe. I am reading through some old International Living issues to help me decide where to actually go. For those with an interest in living in another country, or just like to dream, you should check it out. It is a lot of inexpensive fun. [To learn more click here...](#)

Then Maine in August with my youngest son, and of course Tulsa for Amanda's wedding August 22.

As noted above, I am a little out of sorts, but expect to be back in full swing soon. Have a great week.

Your hoping we can at least Muddle Through analyst,

John Mauldin

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