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JOHN MAULDIN'S THOUGHTS FROM THE FRONTLINE

WHY I AM AN OPTIMIST

In this week's *Thoughts from the Frontline* John Mauldin provides a more optimistic view of the future by commenting on the potential advancement in technology and the continued wider spread of information. However, the letter does start on a more sombre note with a look at Dubai and the influence the debacle has had on the market, as well as the latest US unemployment numbers.

Enjoy the read.

I admit that of late my writings have had a rather dark tone. There are certainly a number of severe long-term problems that we must deal with, and they're going to serve up a lot of economic pain. But the Thanksgiving weekend with the kids has me in a reflective mood, and one that has only served to underscore my long-term optimism. This week we look at why 2007 will not be the good old days we will yearn for in 20 years, after we briefly visit Dubai and the latest unemployment numbers.

Subprime Dubai

While we in the US spent our Thursday eating turkey and watching football, the rest of the world's markets went into a downward spiral as Dubai announced it wanted its lenders to give the country a six-month moratorium on some \$80-90 billion in debt. This has the potential to be the largest sovereign debt default since Argentina. Somehow this was a shocking development. (How can too much debt and real estate be a problem?) And by markets I mean gold, commodities, oil, stocks, and risk assets everywhere. They all went down. Today the US markets experienced their own sell-off, though not as deeply as the rest of the world.

As I wrote last Friday, the world is now negatively correlated with the dollar, and as money went into the dollar and US treasuries, everything else went down. Vietnam devalues, Greece is looking increasingly risky, Russia wants to devalue some more, the world is still deleveraging, etc. Is this another repeat of 1998, when Russia and the Asian debt crisis tanked the markets?

To get an answer, let's look at some facts about Dubai. It is one of the Arab Emirates; but unlike its neighbour Abu Dhabi, oil is only about 6% of the economy. While the foundations of the country were built with oil, the country has diversified into finance, real estate, tourism, trading, and manufacturing. It is a small country, with a little under 1.5 million residents, but with less than 20% being natural citizens - the rest are expatriates. The gross domestic product is around US \$50 billion.

(Note: <http://www.ameinfo.com/67802.html> and then converting the currency. I found the numbers on various websites and services strangely at wide discrepancies. This seems close to a median number. I think the discrepancy is mostly people confusing the GDP for the United Arab Emirates as a whole, which includes Abu Dhabi, rather than just Dubai.)

Dubai has become a byword for thinking large. The world's tallest building, underwater hotels, the largest manmade islands (plural), indoor snow skiing in the desert... For links to more information try this from Wikipedia: "The large-scale real estate development projects have led to the construction of some of the tallest skyscrapers and largest projects in the world, such as the Emirates Towers, the Burj Dubai, the Palm Islands and the world's second tallest and most expensive hotel, the Burj Al Arab." The list goes on and on.

UBS suggests that the \$80-90 billion in debt may not include rather large off-balance-sheet debt (where have we seen that one?). So, a country with a GDP of \$50 billion borrows \$100 billion. They build massive projects, which are now among the most expensive real estate in the world. The latest manmade island plans for one million people to buy property there. Seriously. Talk about Field of Dreams.

Then came the credit crunch. Property values dropped by as much as 50%. Sales, say the developers in understatements, have slowed. Seems there was a lot of debt used to speculate on real estate, not to mention buying Barney's, Las Vegas casinos, banks, etc. And while US banks have little exposure, it seems England has about 50% or so of the debt, with the rest of Europe having the lion's share of the remainder. Admittedly, the estimates seem to confuse the debt of Dubai with that of Abu Dhabi, so it is hard to know a reliable number, other than that European banks are the most exposed.

Now, here's the deal. Abu Dhabi has the world's largest sovereign wealth fund, at over \$650 billion. Dubai has a "mere" \$15 billion. If they cared to, Abu Dhabi could write a small check and make all the problems disappear. It just seems that they are not ready to do that, at least not yet. Abu Dhabi already got the world's tallest building on past debt problems.

Construction and real estate were as much as 25% of the economy. Let's see. Large leverage with maybe \$5 billion in interest in a \$50 billion economy that is 25% construction? A construction and real estate-driven economy. A real estate bubble. Sound like California, Florida, Spain? How can this be a surprise, except that everyone expected big brother Abu Dhabi to pick up the check?

While Abu Dhabi did advance \$5 billion earlier, Dubai is not letting that money out of the country. There are projects to be finished, you understand. From where I sit, this is just rather hard-headed negotiations, a restructuring of who owns what and who will get what assets. It will all settle out. Given the massive losses that world banks have already taken, this is rather small potatoes.

So why the reaction by the markets? Because I think many participants know that the potential for there to be a serious correction is quite real. When anything as relatively small as Dubai spooks the market, it should serve as a warning sign. The world has priced in 5% GDP growth for the US and much of the developed world in the equity and commodity markets. Either we have to get that or the markets are going to have to come back to the reality of what I think is going to be a much lower growth figure.

But in any event, one of the lessons to be learned is that investors should pay attention to where the leverage is. Unsustainable debt trends end in tears. They always do. Spain, Greece, Italy, the UK, and Japan will all have to face major restructuring in the next decade due to leverage. And we in the US will also find that we cannot grow debt at our current levels. Will we pare our debt willingly or be forced to by the market? Either way, it will make for a less than optimal economy over the coming years. Muddle Through, indeed.

More Government Data Fun: Unemployment Claims Were Not Down

The headlines said that initial claims dropped to 466,000 here in the US, finally falling below 500,000. This was greeted with proclamations of recovery. First, let me say that 466,000 people filing for unemployment is still way too high. That is a lot of people losing their jobs, and when we first crossed over 450,000 a few years ago that level was seen as a sign of recession.

Second, the headline number was a seasonally adjusted number. The actual number was 543,926. What is happening is that we are coming off of wickedly high numbers in 2008 and a seasonal number that was much lower in the preceding years. It is another part of the Statistical Recovery. And this trend is likely to keep on for the rest of the quarter. My friend John Vogel, who analyzes the unemployment numbers for me each week, shows pretty convincingly that the average for this current quarter will be over 500,000 per week on a non-seasonally adjusted basis. This is less than a 10% drop from last year for the same quarter. Job losses are continuing to mount, and we are on our way to an 11%-plus unemployment number by next

summer. Statistical Recovery, indeed.

Why I Am Optimistic About the Future

I am optimistic by nature. An entrepreneur friend of mine gave me a term that I have grown to love. She calls it "psychic income." It's that bit of hoped-for future income that is in our minds, that drives some of us, inflicted with the entrepreneurial gene, to do the next deal, make the next big plan, scheme yet another scheme to finally hit whatever counts as the big one for each of us. How much better would our life be, how our problems would go away, if only this one thing would come about! It has not yet become real income, yet we live and act as if it is almost real. We can feel it getting ready to happen. It is still in our heads, this psychic income. Yet it is in some ways real for us.

I get my propensity for psychic income naturally. My Less-Than-Sainted Dad lived on psychic income. He was always trying to invent something or launch a new business. He had large ups and downs, and at times we would be now classified as below the poverty line. Not that I knew that as a kid. Mostly, Dad lived in his dreams, though often alcoholic ones, of a better future, but he never gave up. In his mid-70s he was re-inventing the small printing press in his garage, with plans for national production. It was only after we had to take his car from him in his mid-80s that he quit. It was a very sad day. I now know we had not just taken his car, but far more than that: his dreams, his psychic income.

For some, I should note, psychic income is not just about money. It may be about the next promotion or the next big discovery. For some of us, it is just having our ideas accepted and validated in the court of human opinion. It is simply what drives us.

I graduated from seminary in the winter of 1974, entering the workforce in the hard year of 1975. We were coming off a recession, about which I technically knew little. I did know jobs were tight. I was unknowingly facing another eight years of high unemployment, a tumultuous stock market, rising commodity prices, high inflation, and rising interest rates. Japan was just beginning to be a real force in the world. People were still buying bomb shelters, as Russia was a feared and powerful enemy. As the price of gold rose, there were those who told us the dollar would soon be worthless (the Fed was a problem and the deficit was out of control), and so we needed to buy yet more gold and also a year's worth of dried food.

Not the best time to start a business; yet within a year or so, I ended up starting my own print brokering business, as jobs were scarce and that is what I knew. I often get letters from readers giving me grief about my rich hedge-fund friends and our fabulous wealth, and how little we relate to the real world. And for some of my rich hedge-fund friends, that may be true (although for most of my friends that is not true). And I am sadly far from rich, although I have dreams.

I remember waking up in the late 70s at 2 AM with a knot in my stomach, because a small bank was in trouble and had called my loan (an amount which now seems so small, but at the time it was all the money in the world). How would I make payroll? Gas and food? I know what it is like to work long hours and live on a very tight budget, with some months being behind on everything, while all the while your family is growing.

But I got lucky, and through a series of events got into the investment publishing field in the early '80s, then partnered in an investment firm, and then went on my own in 1999. I stuck this letter on the internet in August of 2000, and things just took off.

But how many setbacks, bumpy rides, and false starts have I gone through over the decades? Frankly, I try to forget. But the point is that each of those episodes was another learning opportunity. And I woke up the next morning and started trying to figure it all out.

But it's not just me, it's tens of millions of entrepreneurs and businessmen and women in the US, and hundreds of millions worldwide, that have the same ambitions and drive. Every night we go to sleep on our psychic income, and every day we get up and try to figure out how to turn it into real income. And some of

us are talented or lucky (that would be me) enough to make it happen.

Long-time readers know that I think we are in the midst of a secular bear cycle, much like 1966-82. The next decade is likely to produce less than average growth, due to structural problems and the bad choices we have made with personal and government debt. I am perfectly cognizant that unemployment will be over 10% for a protracted time. That is tragic for those unemployed and underemployed. I realize the entire developed world has huge and seemingly insurmountable pension and medical obligations over the next few decades, which we cannot possibly hope to meet. The level of angst that we will live through as we adjust will not be fun.

But the point is, that is just what we do - we live through it. In spite of the problems, we get up every day and figure out how to make it. Would it be better if we could get our act together in (pick a country) and not be forced to adjust because we have come to the end of the line? Yes, I know we will likely have some very tumultuous times ahead of us, making business and investment decisions more than a little difficult.

So what? The future is never easy for all but a few of us, at least not for long. But we figure it out. And that is why in 20 years we will be better off than we are today. Each of us, all over the world, by working out our own visions of psychic income, will make the real world a better place.

The Millennium Wave

Let's look at some changes we are likely to see over the next few decades. My view is that we have a number of waves of change getting ready to erupt on the world stage. The combination of them is what I call the Millennium Wave, the most significant period of change in human history. And one for which most of us are not yet ready.

Sometime next year, we are going to see the three-billionth person get access to the telecoms (phones and internet, etc.). By 2015 it will be five billion people. Within ten years, most of the world will be able to access cheap (I mean really cheap) high-speed wireless broadband at connection rates that dwarf what we now have.

That is going to unleash a wave of creativity and new business that will be staggering. That heretofore hidden genius in Mumbai or Vladivostok or Kisangani will now have the ability to bring his ideas, talent, and energy to change the world in ways we can hardly imagine. When Isaac Watts was inventing the steam engine, there were a handful of engineers who could work with him. Now we throw a staggering number of scientists and engineers at trivial problems, let alone the really big ones.

And because of the internet, the advances of one person soon become known and built upon in a giant dance of collaboration. It is because of this giant dance, this unplanned group effort, that we will all figure out how to make advances in so many ways. (Of course, that is hugely disruptive to businesses that don't adapt.)

Ever-faster change is what is happening in medicine. None of us in 2030 will want to go back to 2010, which will then seem as barbaric and antiquated as, say, 1975. Within a few years, it will be hard to keep up with the number of human trials of gene therapy and stem cell research. Sadly for the US, most of the tests will be done outside of our borders, but we will still benefit from the results.

I spend some spare study time on stem cell research. It fascinates me. We are now very close to being able to start with your skin cells and grow you a new liver (or whatever). Muscular dystrophy? There are reasons to be very encouraged.

Alzheimer's disease requires somewhere between 5-7% of total US health-care costs. Defeat that and a large part of our health-care budget is fixed. And it will be first stopped and then cured. Same thing with cancers and all sorts of inflammatory diseases. There is reason to think a company may have found a generic cure for the common flu virus.

A whole new industry is getting ready to be born. And with it new jobs and investment opportunities.

Energy problems? Are we running out of oil? My bet is that in less than 20 years we won't care. We will be driving electric cars that are far superior to what we have today in every way, from power sources that are not oil-based.

For whatever reason, I seem to run into people who are working on new forms of energy. They are literally working in their garages on novel new ways to produce electric power; and my venture-capital MIT PhD friend says they are for real when I introduce them. And if I know of a handful, there are undoubtedly thousands of such people. Not to mention well-funded corporations and start-ups looking to be the next new thing. Will one or more make it? My bet is that more than one will. We will find ourselves with whole new industries as we rebuild our power grids, not to mention what this will mean for the emerging markets.

What about nanotech? Robotics? Artificial intelligence? Virtual reality? There are whole new industries that are waiting to be born. In 1980 there were few who saw the rise of personal computers, and even fewer who envisioned the internet. Mapping the human genome? Which we can now do for an individual for a few thousand dollars? There are hundreds of new businesses that couldn't even exist just 20 years ago.

I am not sure where the new jobs will come from, but they will. Just as they did in 1975.

There is, however, one more reason I am optimistic. Sitting around the dinner table, I looked at my kids. I have seven kids, five of whom are adopted. I have two Korean twins, two black kids, a blond, a (sometimes) brunette, and a redhead. They range in age from 15 to 32. It is a rather unique family. My oldest black son is married to a white girl and my middle white son is with a black girl. They both have given me grandsons this year (shades of Obama!). One of my Korean daughters is married to a white young man, and the other is dating a Hispanic. And the oldest (Tiffani) is due with my first granddaughter in less than a month.

And the interesting thing? None of them think any of that is unusual. They accept it as normal. And when I am with their friends, they also see the world in a far different manner than my generation. (That is not to say the trash talk cannot get rather rough at the Mauldin household at times.)

I find great cause for optimism in that. I am not saying we are in a post-racial world. We are not. Every white man in America should have a black son. It would open your eyes to a world we do not normally see. But it is better, far better, than the world I grew up in. And it is getting still better.

My boys play online video games with kids from all over the world. And the kids from around the world get on the internet and see a much wider world than just their local neighbourhoods.

Twenty years ago China was seen as a huge military threat. Now we are worried about them not buying our bonds and becoming an economic power. Niall Ferguson writes about "Chimerica" as two countries joined together in an increasingly tight bond. In 20 years, will Iran be our new best friend? I think it might be, and in much less time than that, as an increasingly young and frustrated population demands change, just as they did 30 years ago. Will it be a smooth transition? Highly unlikely. But it will happen, I think.

I look at my kids and their friends. Are they struggling? Sure. They can't get enough hours, enough salaries, the jobs they want. They now have kids and mortgages. And dreams. Lots of dreams. That is cause for great optimism. It is when the dreams die that it is time to turn pessimistic.

I believe the world of my kids is going to be a far better world in 20 years. Will China and the emerging world be relatively better off? Probably, but who cares? Do I really begrudge the fact that someone is making their part of the world better? In absolute terms, none of my kids will want to come back to 2009, and neither will I. Most of the doom and gloom types (and they seem to be legion) project a straight-line linear future. They see no progress beyond that in their own small worlds. If you go back to 1975 and

assume a linear future, the projections were not all that good. Today you can easily come up with a less-than-rosy future if you make the assumption that things in 20 years will roughly look the same as now. But that also assumes there will not be even more billions of people who now have the opportunity to dream up their own psychic income and work to make it happen.

We live in a world of accelerating change. Things are changing at an ever-increasing pace. The world is not linear, it is curved. And we may be at the beginning of the elbow of that curve. If you assume a linear world, you are going to make less-than-optimal choices about your future, whether it is in your job or investments or life in general.

In the end, life is what you make of it. With all our struggles, as we sat around the table, our family was content, just like 100 million families around the country. Are there those who are in dire distress? Homeless? Sick? Of course, and that is tragic for each of them. And those of us who are fortunate need to help those who are not.

We live in the most exciting times in human history. We are on the verge of remarkable changes in so many areas of our world. Yes, some of them are not going to be fun. I see the problems probably more clearly than most.

But am I going to just stop and say, "What's the use? The Fed is going to make a mess of things. The government is going to run us into debts too big to deal with? We are all getting older, and the stock market is going to crash?"

Even the most diehard bear among us is thinking of ways to improve his personal lot, even if it is only to buy more gold and guns. We all think we can figure it out or at least try to do so. Some of us will get it right and others sadly will not. But it is the collective individual struggles for our own versions of psychic income, the dance of massive collaboration on a scale the world has never witnessed, that will make our world a better place in the next 20 years.

All that being said, while I am an optimist, I am a cautious and hopefully realistic optimist. I do not think the stock market compounds at 10% a year from today's valuations. I rather doubt the Fed will figure the exact and perfect path in removing its quantitative easing. I doubt we will pursue a path of rational fiscal discipline in 2010 or sadly even by 2012, although I pray we do. I expect my taxes to be much higher in a few years.

But thankfully, I am not limited to only investing in the broad stock market. I have choices. I can be patient and wait for valuations to come my way. I can look for new opportunities. I can plan to make the tax burden as efficient as possible, and try and insulate myself from the volatility that is almost surely in our future - and maybe even figure out a way to prosper from it.

A pessimist never gets in the game. A wild-eyed optimist will suffer the slings and arrows of boom and inevitable bust. Cautious optimism is the correct and most rewarding path. And that, I hope, is what you see when you read my weekly thoughts.

New York and My Own Psychic Income

This week I go to New York to be with Todd Harrison and so many friends at the annual Festivus, put on by the folks from Minyanville. Then the theatre on Saturday with Barry and Toni Habib to see *Gods of Carnage*. Then back home for the rest of the month, turning to book writing and waiting for my granddaughter to appear.

And speaking of psychic income, I remarked to some of the kids the other day that for the first time in my life I have no psychic income. There is no scheme I am working on that will change the world, no dramatic visions of grandeur. Just working on improving what we do in the best ways we can, which should be enough; but for me it is a different feeling. I worried that I was losing my edge, my drive.

"Dad," said Tiffani, hopefully prophetically, "that just means the best and most exciting thing of all is actually going to happen. Finally."

I love the future. It is going to be the best thing ever. Have a great week.

You're going to have fun on the ride analyst,

John Mauldin

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