Central Banks and the Rise of Extremism

JOHN MAULDIN | May 11, 2016

Do you feel as if you're the rope in a tug of war? That's the closest analogy I can come up with to describe what's going on inside my own head – and in the world. And at the last few conferences where I've spoken, talking with the participants afterwards, I've found that my feeling is widely shared. Our sense of direction, the sense of knowing where we're going, is gone. To analogize some more, I told a friend last night that I feel as if we have slipped our anchor and are adrift on the ocean on an overcast night. There's no wind and we have only limited rations, so we need to start rowing, but we know that landfall in one direction would be impossible to reach, two other directions would be extremely problematic, and we might, just might, get lucky with the fourth. But how do we choose, with no North Star? Especially when our compass seems to be spinning!

And that's what the constant onslaught of contrary data and the continual head-snap of political events, not to mention geopolitical events, is doing to our investment compasses. We keep tapping the glass, hoping the needle will settle down. How's that working out for you?

I found some comfort in this week's letter from my good friend Danielle DiMartino Booth. She will be at my conference to both participate on a panel and to moderate the Q&A for former Dallas Fed President Richard Fisher, whose right-hand advisor she was for 10 years. Hardly anyone knows him better. With President Fisher's departure, Danielle likewise went out on her own. She's been doing a lot of writing and speaking and is a justifiably a rising star. Her site is Money Strong.

Danielle's letter that just hit my inbox, "Central Banks and the Rise of Extremism," echoes some thoughts that I've been expressing in speeches around the country and will again next week in Abu Dhabi. I am rethinking the whole Adam Smith invisible hand paradigm and am coming to believe that Smith was far more evolutionary – indeed revolutionary – in his thinking than we give him credit for – and we give him credit for a great deal.

I won't steal any of Danielle's incendiary thunder but simply let you appreciate her powerful prose yourself.

I am back in Dallas until Sunday, when I fly out to Abu Dhabi. My friend Dr. Peter Traber, the CEO of Galectin Therapeutics, along with fellow board member Kevin Freeman, are coming over later this afternoon to watch me cook for about a dozen dinner guests and make a presentation on the latest research results from the company. I see prime rib and mushrooms in our near future, but I'm going to have to get up from the computer now and start cooking. You have a great week!

Your thinking central banks have gone too far analyst,

John Mauldin, Editor
Outside the Box

Central Banks and the Rise of Extremism

Danielle DiMartino Booth
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"Those who honor me I will honor." So read the scripture on a piece of paper slipped into the hand of 1924 gold medal runner Eric Liddell. Liddell's refusal to run on the Sabbath catapulted him into a jeering hall of athletic infamy. That gut wrenching scene is memorably and painfully recreated in Chariots of Fire, winner of 1981's Oscar for Best Picture. But ultimately, it was the ideal of so gifted an athlete standing unflinchingly before his stunned country to defend his principles and the appeal of his unwavering faith that earned Liddel the Champion of Conviction Crown.

On a recent trip to England, that classic film and its not so distant period setting of a Britain deeply divided across class and religions lines were both brought to mind. Portrayed against this backdrop, Liddell's Chariot co-protagonist, Harold Abrahams, found himself continually confronting the scourge of anti-Semitism so readily apparent in his fellow countrymen's thinly-veiled bigotry and snobbery. Time and ability saw these two real-to-life athletes prevail. The country under whose flag they ran was not to enjoy such a storied fate.

Britain and its superpower counterparts are chronicled in Liaquat Ahamed's "Lords of Finance." It is this more than any other written work that so clearly captures the era depicted in Chariots, one in which the increasingly speculative financial markets were fonts of brewing instability. Booms were followed by busts in a seemingly perpetual cycle. Geopolitical tensions were at a generational peak. And the world's all powerful central bankers were driven blindly to cleave, come what may, to an orthodoxy that was to prove fatally flawed. Now, if only the past could be placed squarely in the past.

Ahamed's book also recalls a time when the world suffered from a leadership vacuum. It is this parallel in particular that, combined with today's equally myopic monetary philosophy, makes one shudder to contemplate what the future holds. If there was one takeaway from traveling abroad, it was that the anger emanating from the U.S. populace is matched and then some overseas.

It is no longer as simple as squabbling about Greek debt or fretting over the possibility of a Brexit. The very fate of the euro hangs in the balance as the migrant crisis bleeds into economies and feeds nationalistic leanings. Look no further than Germany itself and its announcement that it would begin to rebuild its armed forces for the first time since the Cold War. The acknowledgement that conflicts will rise, not fall, is in and of itself a validation of the growing menace of extremism.

It is increasingly a simpler task to tally the countries within the Eurozone that are not expressing their outrage at the deteriorating landscape. The ouster of Turkey's prime minister greatly decreases the probability that a controversial deal the EU struck with the Turks will reduce terrorism in that country. Hungary's parliament has voted to hold a referendum challenging the EU's migrant redistribution quotas. Meanwhile, voters in Austria, Denmark, the Netherlands, Poland, Slovakia, Sweden and even France are backing anti-immigration efforts in one shape or another.

Of course, the migrant crisis is a relatively new phenomenon to these countries, but one country, Italy, has struggled and been entrenched in this crisis for the better part of a generation. And, while all eyes may now be on Great Britain and its upcoming vote, some suggest that Italy's September constitutional referendum poses the greater near term threat. The hypothetical dominoes could line up as such: Prime Minister Matteo Renzi quits in protest to the referendum failing and Mario Draghi comes to the rescue of his embattled country, leaving his post at the ECB before his term ends in 2019. Germany easily gathers the necessary consensus to replace Draghi with a hawk from its own country who then reestablishes monetary order.

If this scenario seems far-fetched, consider the tie that binds the yesteryear of the 1920s to today; that is, debt. According to figures compiled by the International Monetary Fund (IMF), public debt as a percentage of global gross domestic product (GDP) reached its nadir in 1914, at 23 percent. The onset of World War I would alter that landscape for generations to come. Global debt peaked at nearly 150 percent in 1946 following the Great Depression and World War II.

By all appearances, the global economy has come full circle, without the World War part, that is. In a March 2011 report, the IMF made the following observation as the world crawled its way out of the darkest moments of the financial crisis:

> While the impact on growth of the recent crisis is less dramatic than that of the Great Depression, the implications for public debt appear to be graver. That's because the advanced economies were weaker at the outset of the current episode – with debt ratios 20 percentage points of GDP higher in G-20 economies in 2007 than in 1928. In addition, the sharp drop in revenues (due to the collapse in economic activity, asset prices and financial sector profits) and the cost of providing stimulus and financial sector support hit debt ratios harder during the recent crisis than during the Depression.

How sweet it would be to report that since 2007 the tide of debt has turned. But, instead, an early 2015 McKinsey report documented that global debt had ballooned with none of the world's major economies taking positive steps towards reducing their debt levels. Such is the disastrous bent of modern day central banking thinking, and its belief that the only way to alleviate the problem of over-indebtedness is with ever increasing debt.

In all, according to McKinsey's math, global debt increased by $57 trillion in the seven years ending 2014. The gold medal winners among creditors were the sovereigns: at 9.3-percent growth, government debt swelled to $58 trillion from a starting point of $33 trillion. Corporations came in second place with their debt levels rising by 5.9 percent to $56 trillion from $38 trillion. The onus was clearly on these two competitors to offset the relatively weaker growth of financial and household debt which was no doubt dragged down by the collapse in U.S. mortgage availability and the recapitalization of (some) lenders.

Where does that leave us? Apparently angry. Very, very angry.

Refer back to the IMF's warning about the critical importance of the starting point for indebted countries' economies. Then flash forward to the reality that the world economy today is that much more indebted. As for its economies, they are on ever weaker footing.

Maybe the anger stems from the injustice of it all, and the knowledge that future growth has been sacrificed for little more than yet another run for a place in the history books of rampant speculative fervors. Though the average man on the street might not be able to put their finger on it, they do know it's impossible to put food on the table with the ethereal proceeds from a share buyback that does nothing more than prop up a stock price.

As *The Credit Strategist's* Michael Lewitt recently noted, "Debt drains away vital resources from economic growth. Fighting a debt crisis with more debt is doomed to failure, yet that is not only what global central banks did during the crisis but long after markets stabilized (though the crisis never truly ended, just slowed). This was an epic policy failure that continues today."

Failure or not, odds are that today's central bankers will double down on their failed philosophy. If you don't believe me, ask any German life insurer buckling under the strain of running their business. It's no wonder regulators estimate that insurers will begin to fail after 2018 due to the impossibility of operating in a negative interest environment with over 80 percent of said insurers' investments in fixed income. These dire circumstances almost make U.S. pensions' plight pale in comparison as managers come to grips with the fact that there can be no Prexit, as in a Puerto Rican exit. The haircuts on the damaged bon holdings will be withstood.

The real tragedy is that the smoke and mirrors perpetuating the veneer of calm in world markets can continue for a while longer. The U.S. consumer remains the world economy's mightiest source of growth. Cheerleading economists were no doubt levitated by news that U.S. household borrowing exploded in March at a breakneck speed that hasn't been clocked since 2001. The $29.7 billion one-month gain works out to a 10-percent annualized pace.

The usual suspects of the current recovery remained hard at work – student debt and auto loans continued their journey into the stratosphere. But the most record smashing category was credit card debt, which spiked by $11.1 billion, or at a blistering 14-percent pace.

In all, household debt rose at a 6.4-percent pace in the first quarter, just shy of three times the pace at which average hourly earnings grew. Looked at through a slightly different prism, personal income grew by $57.4 billion in March, the same month in which American households tacked on about half that in fresh debt. This is good news how?

The very absence of a full scale global conflict is without a doubt a huge blessing. At this juncture, it's difficult to fathom how the world's super-creditors could finance a war. History, however, suggests that times exactly such as the ones in which we find ourselves are fraught with risks. Unprecedented levels of income inequality combined with profoundly threatened developed world pensions make for a frightening recipe for social unrest that can and has been known to boil over into something grave on the world stage.

It is therefore of little surprise that voters worldwide are protesting at their ballot boxes. Debt spirals upwards even as the masses struggle to get by on less and less knowing there will be a dearer price yet to pay.

On June 28, 1914 Archduke Franz Ferdinand was infamously assassinated marking the beginning of a time in world history rife with bloody conflict. Though extremism in Austria today is clearly on the rise, history never repeats itself to a tee. Though impossible to know, history may mark May 9, 2016 a turning point of a different sort, the day a Slovak border guard fired the first shot at a car of migrants crossing into his country.

The migrant crisis promises to exact its own costs, at first political and inevitably economic. It is then that the past 30 years' bad habit of borrowing from Peter to pay Paul will be tested. What happens, one must ask, when Peter himself runs out of money?

Perhaps the world will have to wait it out to finally be graced with leaders who are willing to stand by their convictions and make hard, maybe even unpopular, choices. Such leaders might have to risk sacrificing everything political to be crowned the next true champions of conviction, giving us all a shot at a once again storied fate.

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