Open Letter to the Next President, Part 3

By John Mauldin | March 27, 2016

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> "The liberating army we need in the Americas today is one of leaders who come together in peace, in the spirit of cooperation."
> – Oscar Arias

> "There are two Americas – separate, unequal, and no longer even acknowledging each other except on the barest cultural terms."
> – David Simon

Today we continue my series of open letters to the presidential candidates. In the meantime, we've drawn a little closer to knowing whom the two major parties will nominate. A few people are vowing to consider minor parties, too.

In any case, whoever replaces Barack Obama will face a world of challenges. The good news is that most (not all) of the challenges are manageable – given the willingness to make very difficult choices. Remember, in this letter we are focusing on the economic realities that the new president will face, and those realities will force stark choices in other arenas such as healthcare, defense, and geopolitics. The economic picture is unequivocal – more so than in any era since Roosevelt – and will compel the president to either choose among merely very difficult options at the beginning of his or her term, or to put off choosing and be left with only seriously bad choices toward the end of a first term. There will be no easy choices, and the process will be messy, but I think we'll will muddle through.

In Part 1 we looked at China and Japan. Part 2 covered Australia, India, the Middle East and Europe. That leaves Africa, South America, and North America. Let's dive back in.

Buying African Futures

Dear Presidential Candidates:

Many Westerners still think of Africa as the Dark Continent – a mysterious, unknown place brimming with danger. Many Africans think the same of the West. Faraway lands are always mysterious and a little forbidding until you visit them, or at least try to learn about them.

Having been, at last count, to 15 African nations, I have learned how little I know about Africa. It is a land of astonishing economic and cultural diversity. As president, you shouldn't have an African policy – you should have a whole series of policies for different parts of Africa. One size will most definitely not fit all.

You should also remember that your actions as president will have consequences for future presidents. Demographic projections suggest that by the year 2100 Nigeria will have a larger population than China will. Africa is going to make up for lost time. From an economic standpoint, Africa as a whole is unlikely to directly impact the United States for years to come, but there is an opportunity in Africa that we have neglected for 100 years.

Owing to the original colonial presence of the European powers, the various nations of Africa are still economically connected to Europe. I remember being in Zaire (now Congo), and meeting a young man who, oddly enough, is now one of the country's leading politicians. Kinshasa was a town of multiple millions of people, and the local TV station did a story on "the" American who was visiting and looking to do business. Talking with the European expatriates there, I was left with the impression that in the early 1990s there may have been fewer than 100 adventurous souls from the United States on the whole continent. Given the ease with which Europeans bribed their way into business in the countries I dealt with – and the fact that if a US businessman acted similarly, he would go to jail – US entrepreneurs started with one hand tied behind their backs.

Thankfully, attitudes and practices are changing, and there is an anticorruption movement in a host of African countries today. Africa is going to be one of the growth stories of the coming 30 years, and it is a place where US businesses should definitely be involved. The US can facilitate that involvement by appointing ambassadors who are not just career diplomats looking to check another box on their résumés but are instead actually US businessman with connections who can introduce US businesses that would like to get involved. Not only would this approach help our trade balance, it's just good basic policy. In general, Africa doesn't need aid, but it does need our business acumen.

Oddly enough, Africa's relative lack of development may help it leapfrog the rest of the world. Instead of slowly replacing outmoded telecom and energy infrastructure, Africa is right now expanding mobile internet and solar energy capacity faster than some developed nations are. Kenya's M-Pesa payments platform is helping millions of the "unbanked" enter a thriving economy, even as the US struggles to adopt microchipped credit cards.

South Africa, where I have many good friends, is struggling a bit from the commodities downturn and some unwise decisions by the Zuma government. (I have met with Zuma three times, and each time he affirmed that he wanted to create economic growth and change. Instead, he has done nothing and made the situation far worse.) Thankfully he will be leaving soon, and South African businesspeople may once again have an opportunity to prosper.

As president, you can set up the US to have good relations with Africa, or you can create damage that will take decades to fix. Choose wisely.

Latin American Limbo

Our next flight takes us westward to South America. Here we find a blend of good, bad, and very bad news. We'll start with the country in the worst fix, which is definitely Venezuela. The word *meltdown* is no exaggeration here. Years of socialism are having the predictable result.

Unlike the Socialism Lite that Senator Sanders represents, Venezuela has the real thing. Government controls the means of production and so produces the wrong things. The result is massive inflation and a crazy mix of excesses and shortages – but no shortage of misery.

The oil price collapse hasn't helped. Venezuela's high production costs made it one of the first victims of the downturn and will also make the country's recovery that much harder. I do not know a painless way to pull Venezuela out of its hole. I feel terrible for the people who must live in this manmade economic disaster zone.

A collapse in Venezuela could lead to a possible interruption in a significant part of our oil supply. It's not that there's not plenty of oil in the world, but many of our refineries are set up to handle the rather thick, low-grade oil that comes from Venezuela. Retooling the refineries would be time-consuming and very expensive. There is little that you as president can do to keep Venezuela's oil flowing, but the situation is one to watch.

You will not be able to ignore Brazil, the world's eighth-largest economy and fifth-most populous country. The outlook there is better than in Venezuela, but not by much. You are no doubt aware of the enormous scandal that is going on at the highest levels of government over bribery and corruption charges involving major government figures and Brazil's national oil company, Petrobras. President Dilma Rousseff is deeply implicated and will likely face impeachment. A recent conversation between her and former President Lula has been made public and furthers the impression of corruption.

The Brazilian economy shrank 3.8% last year and is still heading south. It is not likely to turn around until the political situation has been settled. Ordinary Brazilians are making their displeasure known through massive street protests, but it is hard to know from afar exactly who is unhappy with whom. Brazil's poorest have been in dire straits for a long time. The wealthy Brazilians caught up in the scandals also control the country's media outlets.

Making a bad situation worse, the mosquito-borne Zika virus has brought to Brazil a heartbreaking wave of deformed infants, with more on the wayexpected. And the country will host this year's summer Olympics, diverting resources from the other problems and showing the whole world a nation in distress. (The Zika virus is a real concern, as it is likely to come to the United States sooner or later, and the Southeastern part of the US is home to the type of mosquito that carries the virus. There are companies developing both a cure and a preventive vaccine, but their efforts are bogged down in bureaucracy, which you as president could cut through.

As with Venezuela, you may not be able to help Brazil much, but you also can't ignore it. US businesses and investors poured capital into Brazil when it looked like a promising emerging market. Those investments don't look so hot now.

Argentina is another economic basket case, but one that actually appears to be improving. Argentina cycles through huge ups and downs. The government defaulted on about $100 billion in international debt back in 2001. It is now in final negotiations with some creditors who declined to accept previous restructuring offers. If the parties can reach a deal, Argentina will again have access to global capital markets.

That deal can't happen too soon. New President Mauricio Macri says he will reduce deficit spending and keep inflation down to "only" 20–25%. He has already lifted currency controls and done away with agricultural export tariffs. These are important steps but only a beginning.

Finally, let's head up to Mexico, our North American neighbor and trading partner. I find it stunning how ignorant most US citizens are about Mexico. On a purchasing-power-parity basis, Mexico is the 11th-largest economy in the world – larger than Italy, South Korea, Canada, Australia, or Spain. It is generally growing faster than the countries ahead of it on the list. It is not located in a faraway continent like Africa – many of us could easily drive from our homes to the border in less than a day. Yet we still have a caricatured view of Mexico. The caricatures do fit in some instances, but Mexico is so much more.

My colleague George Friedman recently shattered some misconceptions in an excellent article, "Mexico as a Major Power." A quick excerpt:

> Mexico is commonly perceived, far too simplistically, as a Third World country with a

> general breakdown of law and a population seeking to flee north. That perception is also common among many Mexicans, who seem to have internalized the contempt in which they are held.
>
> Mexicans know that their country's economy grew 2.5 percent last year and is forecast to grow between 2 percent and 3 percent in 2016 – roughly equal to the growth projection for the US economy. But, oddly, they tend to discount the significance of Mexico's competitive growth numbers in a sluggish global economy.
>
> Here, therefore, we have an interesting phenomenon. Mexico is, in fact, one of the leading economies of the world, yet most people don't recognize it as such and tend to dismiss its importance.

Some of you candidates are having great success spinning Mexico as some kind of conspiracy of nefarious people wanting to sneak into our country and do us harm. Yes, people do cross the border illegally and ought to be stopped. But the irony is that today more Mexicans here illegally are going back to Mexico than are coming in. This has been the case since the Great Recession hit. Over one million Mexicans, including US-born children, have left the US for Mexico since 2009, far more than have entered illegally. They cross the border headed south because they see *better opportunities in Mexico* than they do in the US. *That* is the real problem you should talk about – and try to change, if you reach the White House.

I am not arguing that we don't need to control our borders. Of course we do. Every nation should. But we need to remember that we have right next door to us a country that is quickly becoming an industrial powerhouse. In 20 years Mexico is likely to be one of the five largest economies in the world. We need to figure out how to do more business with Mexico, not less. The country is going to become a huge potential market for us.

Canadian Capitalism

Our other neighbor, Canada, managed to avoid much of our last financial crisis, but its turn finally came. Instead of housing, it was energy prices that pushed Canada toward the edge. The country is now in a technical recession, one from which the new Justin Trudeau government promises it will escape by resorting to old-fashioned fiscal stimulus. Keynes himself would be proud.

Will Trudeau fail? Maybe, but it won't be for lack of trying. The forthcoming deficit spending will add to an already significant debt burden. I would be very concerned if I were a Canadian. Thegovernment is well on its way to amassing the kind of permanent debt burden we enjoy (?) here in the US.

The whole point of fiscal stimulus is to boost consumer demand. Give people cash and they will buy more stuff. Yet lack of demand is not Canada's problem, especially in the energy-driven provinces. Depressed oil prices are the problem. Trudeau's stimulus plans will do nothing to raise oil prices. That problem is far outside his control.

I fear Canada will fall into the same trap we are in. We ran deficits thinking they would restore growth, boost tax revenue, and let us pay down our debt. In fact, we got growth that is mild at best, not enough tax revenue, and yet more debt.

As I wrote recently, growth is the answer to everything. Enable economic growth and your other presidential mistakes won't matter so much. Suppress growth and even your best efforts will not be enough to move us forward.

On that note, we finally arrive back home.

Pivot Back to the United States

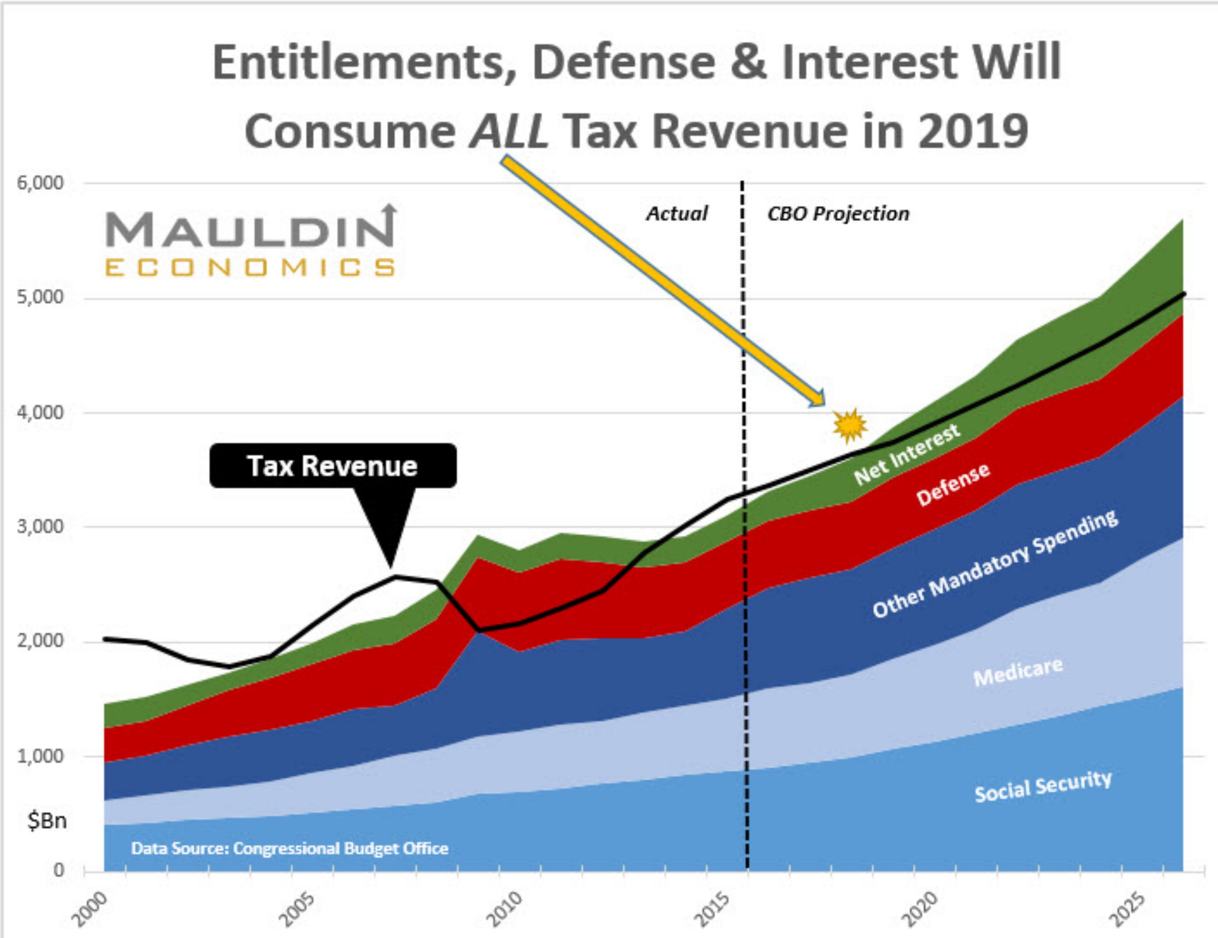
Obama announced a pivot to Asia at the beginning of his last term. Given the importance of Asia to the world's future, that is an understandable decision. But in the next four-year term, economic reality is going to force the president to pivot his or her focus back to the United States. There are a number of factors coming together that are going to require serious crisis management.

When you take office in January 2017, the weakest recovery in modern history will have stretched on for 81 months. It will already be the third-longest recovery without a recession since the Great Depression. By 2018 it will be the second longest. Only during the halcyon economic daze of the 1960s have we seen a longer recovery; but that record, too, will be eclipsed sometime in 2019 – if we don't see a recession first. And note that we were growing at well over 3% in the '60s, not the anemic 2% we have averaged during this recovery and certainly not the positively puny 1.5% we have endured lately. As we have surveyed the economic scene around the world for this series of letters, it has been clear (and IMF and BIS data confirms) that global growth is slowing down. Given the fact that the US economy is barely growing at stall speed, it won't take much to nudge us into recession.

The odds that you will see a recession during your first four years are therefore quite high. Maybe not in your first year in office, but a recession is something you need to plan for. Given the fiscal reality that you will be facing and the limited number of arrows left in the Federal Reserve's monetary policy quiver, your administration is going to have a difficult time dealing with the fallout from a recession.

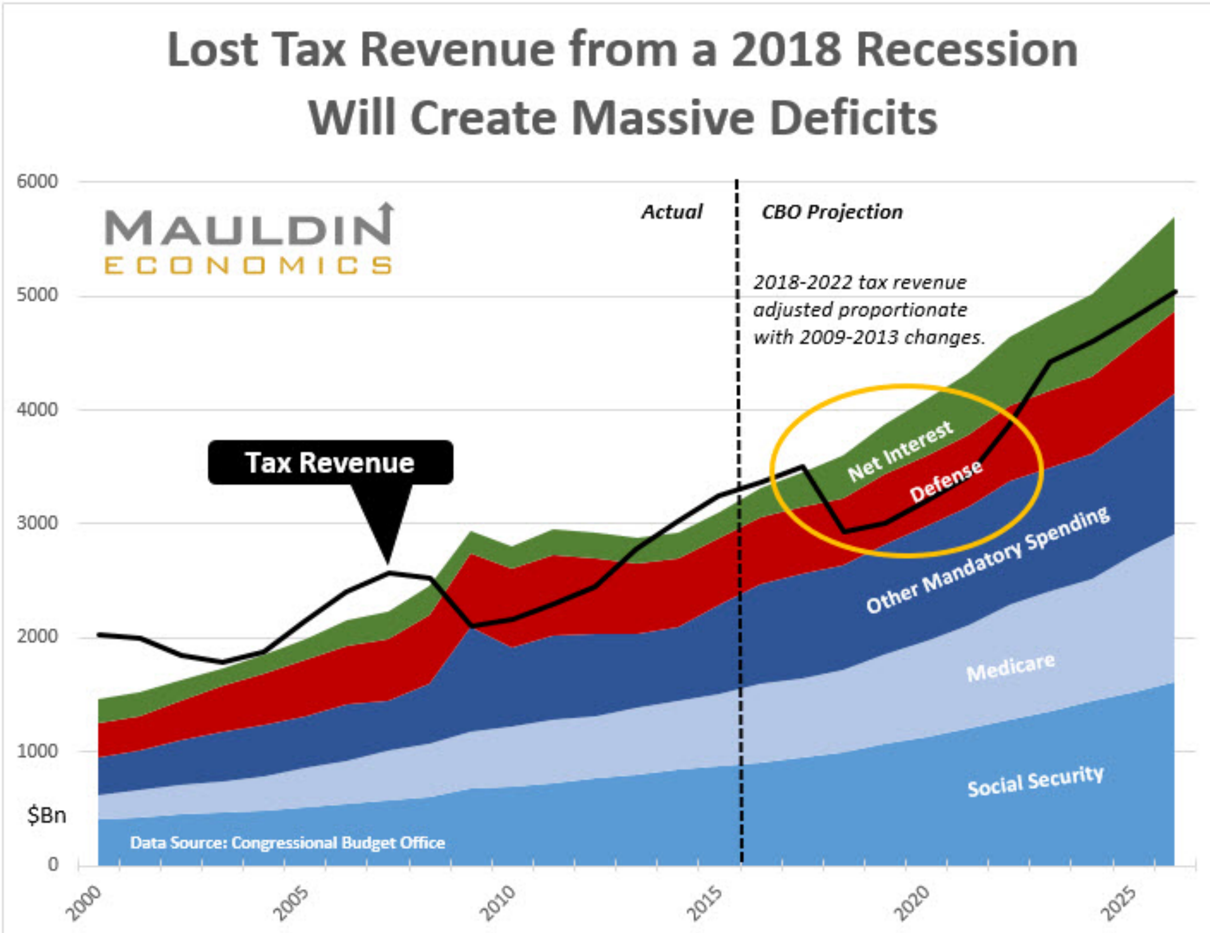
Let's look at fiscal reality. Sometime in your first year the US national debt will top $20 trillion. The deficit is running close to $500 billion, and the Congressional Budget Office projects that figure to rise. Add another $3 trillion or so in state and local debt. As you may imagine, the interest on that debt is beginning to add up, even at the extraordinarily low rates we have today.

Sometime in 2019, entitlement spending, defense, and interest will consume all the tax revenues collected by the US government. That means all spending for everything else will have to be borrowed. The CBO projects the deficit will rise to over $1 trillion by 2023. By that point entitlement spending and net interest will be consuming almost all tax revenues, and we will be borrowing to pay for our defense. Let's look at the following chart, which comes from CBO data:



By 2019 the deficit is projected to be $738 billion. Almost every president wants to run for a second term. To forge any hope of being successful with that second run, a president needs to able to say that he or she made a difference on the budget. There are only three ways to reduce that deficit: cut spending, raise taxes, or authorize the Federal Reserve to monetize the debt. At the numbers we are now talking about, getting rid of fraud and wasted government expenditures is a rounding error. Let's say you could find $100 billion here or there. You are still a long, long way from a balanced budget.

But implicit in the CBO projections is the assumption that we will not have a recession in the next 10 years. Plus, the CBO assumes growth above what we've seen in the last year or so. Let's contemplate what a budget might look like if we have a recession. I asked my associate Patrick Watson to go back and look at past recessions and determine what level of revenue losses occurred because of the recessions, and then to assume the same average percentage revenue loss for the next recession. We randomly decided that we would hypothesize our next recession to occur in 2018. Whether it happens in 2017 or 2019, the relative numbers are the same, and so is the outcome: it would blow out the budget. Here's a chart of what a recession in 2018 would do. Entitlement spending and interest would greatly exceed revenue.



The deficit would balloon to $1.3 trillion, and if the recovery occurs along the lines of our last (ongoing) recovery, then unless we reduce spending or raise revenues, we will not see deficits below $1 trillion over the following 10 years. The deficit will climb to $1.5 trillion just as you dive into the thick of your second campaign in 2020. Not exactly a great campaign platform.

But before I get all gloom and doom on you, let me say that I think there is a path by which you can actually prevent a recession. There is a path to stimulating growth, creating new jobs, and spurring a real economic recovery – but not by doing the same things we have done for the past 16 years. If we continue in the same general direction that we have been going, the economic realities I talked about above are going to clobber you and what will be a very scared Congress in the next four years.

No Senator or Representative is going to want to run for election in the middle of a recession, with deficits topping $1 trillion. If you think people are vehement in demanding change today, they will really be out with the pitchforks in 2018 in 2020 if we don't get a grip on our budget and our economy. If we can't figure out how to engender growth and create new jobs – and *real* jobs – the general rejection of "establishment candidates" will continue to intensify. You have an opportunity to really change things, and the public clamor should give you a great negotiating base for forcing Congress to deal with the realities in the above charts.

But you are going to have to have a plan, and that is where the rubber meets the road. Every president chooses a chairperson for his or her Council of Economic Advisers. Whom you should choose is going to be in large part a function of the type of policies you will try to pursue. In the past, presidents have tended to choose an economic advisor who was more or less mainstream (great academic background, general acceptance in the economic community, etc.) –in short, an establishment economist.

And I don't want to demean economists, but presidents and politicians of all stripes tend to choose economists who will tell them what they want to hear. If you feel that a certain policy is needed, you can probably find an economist who will give you a well-thought-out academic justification for what you want to do.

You are going to be faced with problems that are the culmination of hundreds if not thousands of previous decisions by US presidents and governments.

If you choose to listen to economists who tell you that you can continue to run large deficits – and you can find Nobel Prize-level economists who will oblige you – the country will generally continue in the same direction it has been going until the only real choice will be the one faced by Japan a few years ago: they essentially realized they had to monetize their debt, and over time that decision is going to significantly reduce the value of their currency and thus the buying power their citizens depend on.

For some economists, deficits are not a problem. They look at economists who argue for a balanced budget and reduced leverage as antediluvian throwbacks. They seem to feel that a small group of well-educated economists know how to run the world economy better than the market of billions of people working in their own self-interests can run it. They see a market-run economy as messy and inefficient, prone to all sorts of problems.

Sadly, there is no nirvana. Economic policy comes down to philosophical choices. And they are ones you are going to have to make.

Radical monetary policy such as is being applied by developed-world central banks is one of those things that work well in theory but not in practice. In theory, ultra-low rates and quantitative easing are supposed to generate a boom in investment and spending, which in turn will lead to growth and jobs. However, we can look around the world where these solutions are being applied and see that growth is lacking. And as nearly all economists agree, growth is the one thing that can get us through the problems that are coming. There are just some minor quibbles about how that growth should be achieved!

And this is all before we even start talking about the accelerating pace of change in the business and technological worlds, a global network of trade and other interactions among countries that is vastly more complex than it was even a decade ago, and the increasing dissatisfaction of a large group of citizens who feel left out of the new era. As science fiction writer William Gibson said back in 1993, “The future is already here. It’s just not evenly distributed.”

Of course, I’m just focusing on the economic decisions you will have to make. People will be pressing you to somehow solve a myriad of other problems as well.

You are going to get a great deal of advice as to what economic path and solutions you should choose. The choices you make will determine the future of this country and to a great extent the future of the world. That pressure and impact comes with the Oval Office. You have chosen to step into that office at a particularly stressful time in US and world history.

However, the situation is merely hopeless but not critical. There are choices you can make that I believe will reinvigorate the American economy and enable us once again to grow at 3%-plus, deal with the deficits and debt, and as a side benefit solve the problem of how to deliver healthcare. Choosing the right economic team can make that transition doable. And you will actually have the advantage of a potential crisis unfolding in your first term that will force both sides of the political divide to seriously consider and agree on outside-the-box solutions. You just have to come up with those solutions, as very few embroiled in the partisan debate will see past their own time-worn answers to conceive truly unique, workable, and productive policies.

Next week I’m going to outline some of the policies that I think have the potential to do all that. I can guarantee you that there are elements in my proposals that will annoy almost everyone, but that is the nature of a compromise – nobody gets everything they want.

If on the other hand you’re content to go along in the same direction we are today, with only minor course adjustments, I can just about guarantee that we’ll will end up on the shoals, where all of your choices will be bad ones.

Newport Beach, New York, and Abu Dhabi

I fly out on Monday for Rob Arnott’s fabulous annual client conference, where he brings in some of the leading economic thinkers of the world to hash out portfolio construction. The fact that he is one of those leading thinkers helps him attract others. It is one of the few conferences I attend where I sit in the back of the room and take notes and only rarely have the temerity to ask a question. I have learned that you do not go head-to-head with Harry Markowitz unless you are on really solid ground. The last time I was at the gathering, a few years ago, I looked around and saw about $1 trillion of managed capital in the room. And there were only about 50 people. Who take this stuff rather seriously.

Next week I go to New York and Chip Roame’s Tiburon gathering, which is essentially for idea sharing and networking among financial services executives, focused on what’s happening in the industry. I’m really looking forward to it. It looks like a little media time is being slipped in here and there as well, and I will let you know. Then I’m back to Dallas, where I go back to work on my book (like I can ever forget about it – the weight of deadlines hangs heavy) before I head out in the middle of May for Abu Dhabi; work in a quick trip to Raleigh, North Carolina; and then fly home in time for my conference in Dallas.

Now, I'm going to close with a story that I was reminded of as I was writing about Africa earlier. As I said, I've been to about 15 African countries, mostly during the '90s, for a business venture I was pursuing. It was an expensive but interesting pursuit. Back then pretty much every major capital had a few hotels where all the foreign travelers and expatriates gathered. More often than not the hotel was an Intercontinental. I learned that if I went to the bar toward the end of the evening, I could meet old Africa hands who had been banging around the continent for decades, and for the mere price of a drink they would begin to tell me stories. And such marvelous stories. There were a few times when I simply marched up to the bar and loudly announced, "I will buy the drinks for the best Africa story in the room." Somehow it seemed that the last liar of the evening always won. Those were great times, and if you ever get a chance to do something like that you should, though I am sure that Angola and Mozambique and Congo and Côte d'Ivoire have all changed. Given the hellholes that some of them were, that is a good thing.

So let me relate my favorite African story. It was told to me by Pat Mitchell, who had lived all over Africa for 30 years by that time, working as a lawyer after he graduated from Stanford. The story was about his friend Alejandro Beradone, an Argentinian running (I believe it was) a Rayovac battery-manufacturing plant in Kinshasa, Zaire. I later met Alejandro, and we became friends and met on a few occasions in Buenos Aires, where he introduced me to the concept of going out to a steak dinner at 10:30 PM, which is considered normal behavior in Buenos Aires. But then a lot of interesting things are considered normal in Buenos Aires.

It seems that the French Foreign Legion had a small outpost in Kinshasa. They came to Alejandro and asked him if he would sponsor a four-man team to go to Liberia to compete in a parachuting contest. He agreed, with the stipulation that he and his 12-year-old daughter could go along. So a few weeks later they chartered an eight-seat, twin-engine plane and flew to Liberia. It turned out the French team won the contest, so they all went out and partied very hard, along with the pilot (as is the wont in Africa), and then stumbled back onto the plane the next morning. The pilot got them up into the air, set the controls on autopilot, and told everyone to wake him in three hours. At which point everyone promptly went to sleep.

Somewhat more than three hours later, someone woke up and roused the pilot. He looked at his instruments and got quite upset that nobody had awakened him. The plane was running out of fuel. The pilot pulled out his maps and looked for an airfield where he could set the plane down. The only real option was a grass field in the People's Republic of the Congo, a former French colony that was essentially socialist/communist and really didn't enjoy warm relations with the French, to say the least. So when the plane landed, it was immediately surrounded by guards who pretty quickly figured out that the French Foreign Legion was aboard. They detained the group, took them to the capital city (Brazzaville), and put them all in jail. The government decided that this was an international incident because the French were clearly invading the country. It was a big deal in the local papers. They put the entire group, including Alejandro's daughter, into the cell with him. Understand, this was an African jail. Not exactly luxurious.

There was basically no food, so the guards would come in and say, "Give us some money, and we'll go get you some food." It didn't take more than a few days before they ran out of cash. They were still hungry, though; and the guard asked, "Don't you have any other way to pay?"

Alejandro reached into his pocket and pulled out his American Express card. The guards took one look at it and exclaimed, "Why didn't you tell us about this in the first place?" Then they gathered them all up and installed them in suites at the Meridian Hotel (the finest hotel in the city), where they stayed for the remainder of their "detention," basking in luxury. (Remember, *il est l'Afrique.* Different rules.)

That, to me, is the ultimate "The American Express card – don't leave home without it" story.

You have a great week. Walk into a bar or bang on your glass at a dinner gathering and announce, "Everybody has to tell a story," and then sit back and enjoy the evening. I have never really found anybody who didn't have a story. You'll be glad you asked, and you'll walk away with a smile.

Your always ready for a great story analyst,

John Mauldin

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