THOUGHTS FROM THE FRONTLINE

Capitalism Without Competition

By John Mauldin | February 8, 2019

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Puerto Rico, Dallas, Houston, Cleveland, New York, and Austin

The Soviet Union's collapse and spread of semi-free markets through Eastern Europe seemingly ended the socialism vs. capitalism argument. Capitalism had won. Collectivist economies everywhere began turning free. Even communist China adopted a form of free market capitalism although, as they say, with "Chinese characteristics."

The fruits of capitalism: millions of people freed from abject poverty and a few who got rich indeed. Nor is this a recent phenomenon. Capitalism in the last three centuries, with all its faults and problems, with all its contradictions, generated the greatest accumulation of wealth in human history. From a few hundred years ago when the vast majority of the people of the world lived below the poverty line, barely above subsistence levels, today we have less than 10% doing so and that number is shrinking every year.

Yet now, perhaps because this prosperity is so easily taken for granted, some on the left are again embracing socialist ideas and irrationally high tax rates. What drives this thinking? One problem is "capitalism," in practice, does indeed provide many points for justifiable criticism. It is, to paraphrase Winston Churchill, the worst of all systems, except for everything else.

Today's capitalism has a contradiction that is increasingly hard to ignore: lack of competition in key markets. That's a problem because competition incentivizes producers to get more efficient and reduce prices for consumers. Without competition, you end up with bloated monopolies that may be highly profitable for the owners, but don't serve the greater cause of economic growth.

My good friend Jonathan Tepper, with whom I wrote *Code Red* and *Endgame*, has an excellent new book on this: *The Myth of Capitalism: Monopolies and the Death of Competition*. He and co-author Denise Hearn explain why this is a serious problem with world-shaking consequences. I highly recommend the book and today I want to give you a brief taste of it, plus a few more thoughts afterward.

First, let me once again remind you that registration is open for my Strategic Investment Conference in Dallas, May 13–16. As always, we have an amazing lineup of speakers but that's not even the best part. The *best* part is the time you'll spend and friendships you'll make with other like-minded people. You might consider it, "Thoughts from the Frontline LIVE." If you like my letters you'll love the SIC. Click here for more info, the agenda, and registration.

Monopoly Rents

Before we get to the book, let's deal with one contradiction. People think capitalism and government are opposing forces. Certainly, there's tension between them, but in fact they *need* each other. The government needs a thriving economy to generate tax revenue, and business needs the civil order that government protects.

Capitalism in its current form would not exist unless governments had sanctioned corporate business structures distinct from their human owners. The Romans had something like this, but it really took off with 17th-century mercantilism. That's when the Dutch East India Company emerged along with similar groups in England like the South Sea Company (now often used to describe asset bubbles).

Corporate structures shield business owners from personal liability, which lets them take greater risks and ultimately produced the economy we have today. But that protection *depends* on a government guarantee. And because governments are prone to corruption, capitalists almost immediately began using their influence to reduce or eliminate competition. This is nothing new. It dates back centuries.

If you would like to understand the 19th-century creation of the modern corporation and subsequent monopolies, read *The First Tycoon*, the amazing biography of Cornelius Vanderbilt. Vanderbilt was possibly the only trillionaire in history (in current inflation adjusted dollars). He and his friends and government contacts literally created the modern corporation seemingly from scratch. As noted, there were precedents, but Vanderbilt brought it to the level we would recognize today. He and the other 19th-century robber barons created wonderful monopolies and vast wealth for themselves. Later the same government that enabled these monopolies broke them up.

These monopolies had dire economic consequences, as we can see in the "Monopoly" board game. Gain ownership of all the properties on a street through which everyone must pass, and you can charge higher rents without delivering any additional benefits. But then what happens? Eventually the renters run out of money, go bankrupt, and the game ends with your monopoly rendered worthless.

Something along those lines is happening right now in numerous industries. Usually it's not a single-company monopoly (though these do exist, like state-protected utility companies), but duopolies are growing common.

The vast majority of personal computers run on either Microsoft Windows or some version of the Apple OS. Those two companies are often your only choices. Google is trying to break in, but has hope only because it is so huge and ubiquitous. Smaller players are effectively locked out, no matter how superior their products may be (cf. Firefox). Creating a new operating system and effectively marketing it would be prohibitively expensive. As a result, we pay more and receive less. That may not be the best way to grow an economy.

With that as prologue, let's look at *The Myth of Capitalism*.

Not Free to Choose

Like me, Jonathan respects capitalism and capitalists. He's not a leftist shill. It's *because* he respects capitalism that he wants to see the best version of it, just as we all want our children to reach their full potential. Sometimes, that means pushing them to change.

The book refers to Milton Friedman's old TV series "Free to Choose," then says this.

> *"Free to Choose" sounds great. Yet Americans are not free to choose.*
>
> *In industry after industry, they can only purchase from local monopolies or oligopolies that can tacitly collude. The US now has many industries with only three or four competitors controlling entire markets. Since the early 1980s, market concentration has increased severely. We've already described the airline industry. Here are other examples:*
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> - *Two corporations control 90 percent of the beer Americans drink.*
> - *Five banks control about half of the nation's banking assets.*
> - *Many states have health insurance markets where the top two insurers have an 80 percent to 90 percent market share. For example, in Alabama one company, Blue Cross Blue Shield, has an 84 percent market share and in Hawaii it has 65 percent market share.*
> - *When it comes to high-speed internet access, almost all markets are local monopolies; over 75 percent of households have no choice with only one provider.*

- *Four players control the entire US beef market and have carved up the country.*

- *After two mergers this year, three companies will control 70 percent of the world's pesticide market and 80 percent of the US corn-seed market.*

> *The list of industries with dominant players is endless. It gets even worse when you look at the world of technology. Laws are outdated to deal with the extreme winner-takes-all dynamics online. Google completely dominates internet searches with an almost 90 percent market share. Facebook has an almost 80 percent share of social networks. Both have a duopoly in advertising with no credible competition or regulation.*
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> *Amazon is crushing retailers and faces conflicts of interest as both the dominant e-commerce seller and the leading online platform for third-party sellers. It can determine what products can and cannot sell on its platform, and it competes with any customer that encounters success.*
>
> *Apple's iPhone and Google's Android completely control the mobile app market in a duopoly, and they determine whether businesses can reach their customers and on what terms. Existing laws were not even written with digital platforms in mind.*
>
> *So far, these platforms appear to be benign dictators, but they are dictators nonetheless.*
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> *It was not always like this. Without almost any public debate, industries have now become much more concentrated than they were 30 and even 40 years ago. As economist Gustavo Grullon has noted, the "nature of US product markets has undergone a structural shift that has weakened competition."*
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> *The federal government has done little to prevent this concentration, and in fact has done much to encourage it. Broken markets create broken politics. Economic and political power is becoming concentrated in the hands of distant monopolists.*
>
> *The stronger companies become, the greater their stranglehold on regulators and legislators becomes via the political process. This is not the essence of capitalism.*

Now, to be clear, some industries require such massive scale that they can only support a small number of producers. Passenger aircraft, for instance: You have Boeing, Airbus, and a handful of smaller players (like Canadair and Embraer, who make smaller planes).

Most industries aren't like that. Banking certainly isn't. Lots of studies show the economies of scale stop improving once a bank passes $50 billion or so in assets. Yet the megabanks have grown larger without growing more efficient, in the process killing many of the local banks that once financed local businesses on favorable terms.

That's a problem because we *need* those small, local businesses. Here's Jonathan again.

> *Ever since the time of Thomas Jefferson, Americans have idealized the yeoman farmer and the small business. While family neighborhood stores are a critical part of the economy, it is important to distinguish between small businesses and the high-growth startups that Haltiwanger describes.*
>
> *Small businesses like restaurants and dry cleaners create most jobs, but they also destroy most jobs. They create most new businesses, but they have the highest rate of failures. They are important, but they don't drive productivity.*
>
> *It is the small companies that become big, like the next Costco, Southwest Airlines or Celgene. All of these started small.*
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> *Geoffrey West, in his masterful book "Scale," showed that companies are like living organisms. Just like in the animal world, many startups die when they are very young, but those that survive and grow quickly tend to grow exponentially, which leads to higher profitability and productivity.*

Note, this is not an argument against large companies. They have an important role. But the real innovation and growth starts much lower on the food chain. So, it is a problem when small business loses the chance to thrive and prove itself.

As you know, I go fishing in Maine every summer with a group of economists. Maine has complex rules for its lakes, governing which fish you can keep or must release. We rely on professional guides to know the differences, but the general idea is to give the younger fish from underpopulated species a chance to grow. This preserves the lakes as a resource for everyone.

We might look at small businesses the same way. Most won't grow into big businesses, but it serves everyone to protect their opportunity. As Jonathan points out, that isn't happening. We're already paying a price and it is getting worse.

Data Oligopoly

Faulty government aggravates the monopoly problem but isn't its only cause. Another factor is that modern technology requires connectivity, which requires some degree of uniformity and naturally reduces choice.

You've heard of the "network effect," when additional users make a product more valuable. A social network with 100 million users is generally better than 10 social networks with 10 million users each, because it helps to have all your friends in one place. Even for very narrow markets, your social network needs significant penetration to be useful.

Again, this isn't new. It existed in telephones over a century ago, and is one reason hundreds of small phone companies eventually combined into the Bell System, which eventually grew so powerful it, too, was broken up. But this time something else is happening. The Bell companies weren't selling ads based on the content of your phone conversations. In various ways, today's social networks, internet providers, internet search engines, retailers, and others make money from the data we give them.

I saw a story last week noting that on a revenue-per-user basis, the FAANG companies keep growing even when they don't add any new benefits for users. How is that? One reason is because as time passes, they gather more and more data and can target users more precisely, which makes advertising more effective and advertisers willing to pay more. That's not to say there is no benefit. There is, but it goes to advertisers instead of users. Like the distressingly accurate joke goes, you aren't the customer. You are the product.

The data oligopoly isn't just costing us money. It is rapidly rendering "privacy" obsolete, at least in the sense we once knew it. We have traded it away without considering the cost, and I'm not sure we can ever go back.

This is an area where China is unfortunately leading the way. Data merchants there, many state-owned, gather data far more aggressively than the US companies and often hand it over to the government. Beijing is creating a social scoring/credit system that uses online activities to assign each citizen a certain value. Your score can mean higher access and lower costs, can improve your chances of getting a date, and even allows the state to say whether you should own a dog or not. If you jaywalk in certain areas of China, the system, armed with facial recognition software, recognizes who you are and sends a fine to your phone within seconds. Welcome to the future. The link above is actually scary reading for Western eyes but apparently, most Chinese approve and think it helps make everything better.

Very little prevents the same from happening in Western democracies because we are so happy to give up our data. Most people (especially younger generations) simply don't care. Much of the Millennial cohort *wants* everything it does to be on video. And where does the video go? On Google-owned YouTube, where it sells targeted ads.

Now we have in-home devices and even cameras that we think (hope?) only capture us when we ask them to. Orwell's *1984* "telescreen" is no longer fantasy. The technology exists now, businesses are making money from it, and governments would love to have the data.

I personally saw a demonstration around five years ago where a gentleman was able to start audio recording and taking pictures on another person's phone, without their knowledge or approval. I told the developer that I knew he was brilliant, but if he was doing it…? He readily agreed that there were others who likely could. And that that technology is now five years more advanced.

In a less concentrated economy, this might be a smaller problem. We would have more choices about how our data is gathered and used, and those that gather would have less influence on governments. That is not the case. Monopolies aren't just costing us money; they are taking our privacy and, ultimately, maybe our freedom as well.

Who owns your data? Could the government step in and require companies using your data to get your permission via your private block chain identity? And pay you for the privilege? As an incentive to let them use your data? Watch this become a political topic in the near future.

Jonathan and Denise performed a great service by highlighting the loss of competition and bringing more attention to it. I don't necessarily agree with all their proposed solutions, which I think could have serious side effects. But we certainly have a problem. And it calls for vigorous debate and discussion. Read the book to learn more.

We will talk more in the coming weeks about the ways that government and business interact, but one negative impact is that government banking regulations increasingly mean that it is more difficult for banks to lend money to small and medium-sized businesses. But that doesn't mean the businesses still don't need money. And that becomes an opportunity for regional brokers, hedge funds and other groups to step in meet the various and sundry needs that local bankers used to.

There are many ways to diversify your portfolio. I have long been a fan of private investments and strategies. Getting access to these investments can be difficult. Unfortunately, there is generally a net worth minimum that must be met in order to access them. But if you meet the qualifications of an accredited investor (generally speaking $1 million net worth), I would invite you take the time to talk to some of the investment professionals at Sanders Morris Harris (SMH) and see what is behind their curtain number three. I've had long relationships with the principals of this firm. I have had my personal brokerage and private investment account with one of them for a very long time. I sometimes refer to him in this letter as "the plumber" as he can reduce your trading costs if you are a large institution of fund. He is the best I know at figuring out how to reduce all the little costs that can add up and eat up profits. (Drop me a note if you want an introduction.) I am glad to now be able to periodically "partner" with them by referring them to my readers and friends and thus make available a variety of private opportunities that can potentially help you diversify your investment portfolios.

Through SMH you can access a wide variety of private equity, private credit, venture capital and private partnerships. Their professionals have the experience to help you find the right investments that may be a fit your particular portfolio needs.

I spend a lot of time carefully selecting who to work with as I seek to support my readership with timely ideas for their consideration, and SMH continues to impress me. Click here, fill out very brief questionnaire and then you can learn for yourself why I am so enthusiastic. I believe you will be glad you did and you can trust they will be introducing additional opportunities in the weeks and months to come as we endeavor to assist you as we journey together will into an uncertain future.

(Full disclosure: In this regard, I am the president and a registered representative of Mauldin Securities, LLC, member FINRA and SIPC, and receive referral fees for the introduction. Please read the risk and disclosures of all investments offerings before you actually invest.)

Puerto Rico, Dallas, Houston, Cleveland, New York, and Austin

That string of cities sounds like a lot of traveling, except that it is one city after another rather than separate trips. Right now, I am happily ensconced in our home in Puerto Rico, enjoying the weather. And because the letter is already running a little long, I will hit the send button without further comments. You have a great week!

Your thinking about governments and business analyst,

John Mauldin
subscribers@mauldineconomics.com

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