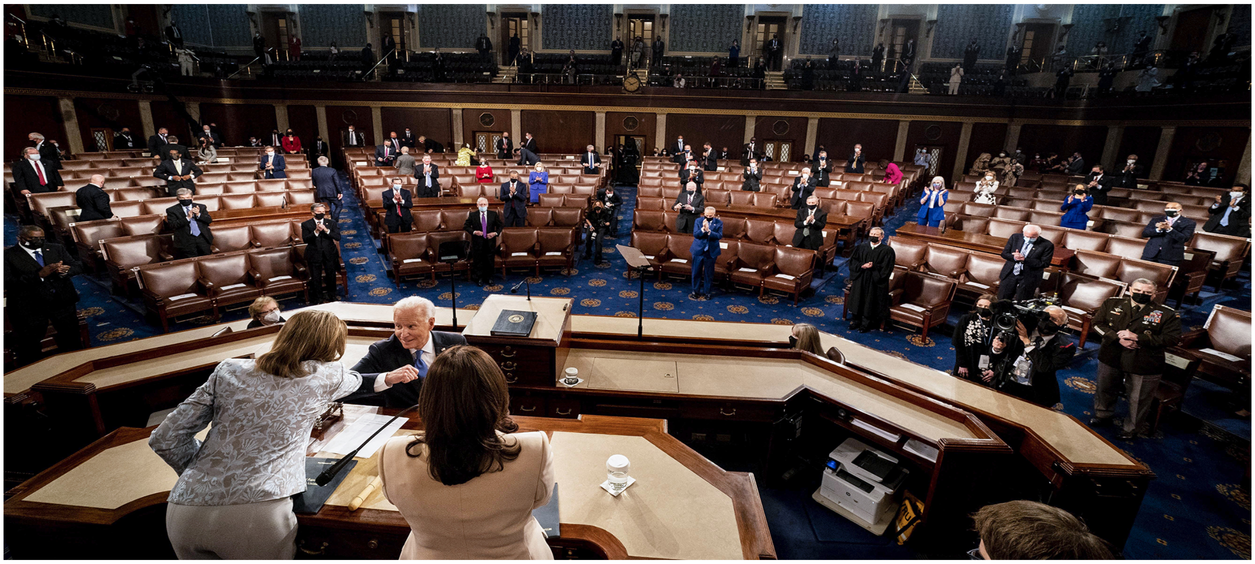
Anomaly of a Recovery

By John Mauldin | May 1, 2021



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Capital Record: From Muddling to Stumbling

David Bahnsen is one of the most original thinkers I know, which is why he is all over TV and podcasts, and is rated one of the best money managers in America. His father was an esteemed theologian back in the 1970s and 1980s whom I had the privilege to personally know and publish. He tragically died way too early, and David had to pick himself up at a very early age to get where he is today. There is a long story there, and I can't tell you how deep my respect goes.

As far as original thinking goes, the apple did not fall far from the tree. David does a podcast for *National Review* called *Capital Record*. We did a two-part series. The following is an edited partial transcript of the first part. Next week I will share some of Part 2.

Please note that some of the best ideas here will be David's. I always learn a lot when I am with him. If there is something in brackets […] it means I inserted it today. Let's jump in:

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David Bahnsen: Hello and welcome to another episode of *Capital Record*, very excited today to have what I believe is one of the most influential economists and writers in my adult life, who I've been reading religiously for my entire career, is a very well-known financial pundit, macroeconomic thinker, and hopefully so much of his wisdom is going to come out in our conversation. The gentleman I refer to is John Mauldin. John also penned a book in 2003 called *Bull's Eye Investing*. I read John's entire book and was really quite moved by his rare ability.

As some of you know, financial writers often can fall into a trap where they go for a brand. I'm going to be a permanently optimistic guy or often in the newsletter publishing world, the brand of being that doom and gloom pessimistic person all the time. John carved out a niche as an actual free thinker, which is all too rare, a lot of objectivity. He can be wrong. He can be right like any other economist, any other thinker, any other writer. But he is right or wrong out of an earnest pursuit of truth and earnest pursuit of objective understanding of economic challenges and situations. He intellectually wrestles with topics. And I've learned a great deal from John. We've become very close friends and have dined together for hours upon hours, many times, discussing many of the things we're going to discuss in the podcast today and have a friendship that enables us to run different things past each other as we seek to better understand the economic challenges of the day. So he's involved extensively in capital markets and in a number of aspects of the investment field.

But John is a thinker and writer and has been a great influence, hopefully, on many of you and certainly on myself. And so I'm going to invite John into a conversation today around the economy, the last 20 years of economic challenges, the next 20 years of economic reality. And we're going to dive into these things and see where the conversation goes. So we're looking forward to another episode here with you of *Capital Record*.

John, I've been reading you since the very, very beginning that you've been putting out macroeconomic commentary. Since then we've had Y2K and a tech crash. We had a financial crisis. We've had all kinds of Federal Reserve machinations the last 10 years. We've had ups and downs in China. And now we've had COVID and here we are. You coined the phrase "Muddle Through," I believe about 20 years ago now.

John Mauldin: I'm getting old.

David Bahnsen: Yeah, I'm just playing catch-up with you. But the Muddle Through Economy, would you say that description has been pretty accurate for what we're going through?

John Mauldin: Well, let's go back 20 years ago and look at the context. In 2001 we'd come off a recession and then we had 9/11, which gave us even more of a recession. Now I am like you, I'm a big technological optimist. I am really long humanity and maybe we'll get into that. What I mean by long humanity, I think human progress is on an accelerating pace. But that being said, I'm [currently philosophically] short government. I didn't see how we would get through the rest of the decade without another one. I certainly wasn't expecting the level of the traumatic Great Recession in 2007–8. But I said then we're going to muddle through the decade, likely to have 2% GDP growth for the entire decade. People called me too bearish. And as it turned out, I was an optimist. We did 1.9%.

Economics 101 says that GDP is productivity times the number of workers. I mean, it's just a simple number. The number of workers was falling as Boomers retired and we had milked a lot of the tech-driven productivity gains. Consumption and services became such big parts of the economy, and they aren't as responsive to productivity growth as manufacturing had been.

Looking forward to the 2020s, I think 2% growth will be hard. I think 1% to 1½% growth will probably be more characteristic because technology will be eating the service jobs and other low-income jobs.

David Bahnsen: Let's separate the economic growth challenges coming out of COVID from the really macro. When we take a step back and look at the 20 years we've just lived through, my own view is that we had a certain degree of real GDP growth that was becoming a new trend line post financial crisis, and it was less that the postwar trend. And then, of course, the COVID moment pulled us off that number. And now, as you point out, we're going to have an anomaly of a recovery because of everything coming back online in this post-vaccine society. But then we're going to pick up where we stopped.

But let's fast-forward to the other side of the recovery, and this is where I'm going back to your muddle through point of 20 years ago. We had a kind of asterisk recession due to COVID, and we're going to have a footnoted recovery because of everything rebounding. But when we get back to some degree of normal, we're going to have a national debt at least $6 trillion bigger than it was, plus bigger deficits of well over a trillion a year, even after this initial cost absorption. Has all this changed the way you see the next 20 years?

John Mauldin: I actually changed my "muddle through" metaphor here about a year ago. I think this decade we'll be stumbling through instead of muddling because, as Milton Friedman said, the most permanent thing in the world is a temporary government program. We're going to run, this year, well over a trillion in off-budget deficit spending and trillions more in regular budget deficit. We're going to be $40 trillion in debt by 2025. **That's 180% debt to GDP.** That looks like Japan and Europe.

David Bahnsen: Well, John, if you get debt to 180% of GDP, and I'm not sure we'll get that high, but I accept your numbers, then it doesn't look like Europe. Then Europe has to play catch-up to us.

John Mauldin: They have worse problems than we do. They're way behind the vaccination curve. And that's not good for us because we need the world to get vaccinated. All that death does slow down the economy. That's why I said if we could get 2% growth this decade, I'd just book it right now and say thank you.

Apolitical Answers

David Bahnsen: Let's offer our listeners a little history. Japan experienced a self-induced asset bubble, the predominant characteristics of which were insanity and euphoria around real estate and asset prices in the late 1980s. After that bubble, which burst violently, Japan found itself in a deflationary spiral which it chose to treat with excessive, you could argue necessary, but nevertheless incredible amounts of government debt. Which then exacerbated the deflationary debt spiral they've been trying to fight out of for a long time, currency weakening, and so forth and so on.

And now we are sitting here fighting debt to GDP growth. Europe has been fighting it since the financial crisis. Japan had the 1980s bubble that burst. What was the predicate to our situation? The housing crisis? Was it 30, 40 years of budget deficits? How did we find ourselves in this position? And you're like me. I think you're very capable of giving an apolitical answer. This is just an objective economic question. How did we wake up in this position?

[Read that paragraph again. I had an epiphany to be shared in a future letter.]

John Mauldin: I blame both parties. It's equal opportunity finger-pointing. In my opinion, the mistake was Greenspan keeping rates too low for too long, then letting the banks get carried away on subprime mortgages. That was how we created our own financial crisis. They created the subprime crisis because they created the conditions for it. Then along came Yellen and Powell and they're doing the same thing today.

David Bahnsen: Let me pause real quick on the Greenspan Fed's culpability in the financial crisis. Are you comfortable with saying the Fed was a necessary but not sufficient condition for the crisis? Or do you really think they were in a singular position?

John Mauldin: Not sufficient. The rating agencies were in there, Countrywide and the mortgage companies, the investment banks. It was it was a group effort. If Greenspan had leaned into the housing bubble, and I don't know politically how he could have done that, other than change how we measure inflation to include home prices. Politically, that wasn't going to happen.

David Bahnsen: When you ask how could Greenspan have done it politically, part of it is by admitting there is such a thing as bubbles. The central bank still seems to deny that a bubble is recognizable until after bursts, which is something that empirically I find very hard to believe. There is a technical point about housing prices and owner equivalent rent in the inflation measurements. But there's also the moral hazard that, outside of the dual mandate, our central bank works under congressional authority that, I believe, started in 1998, not at Y2K, not at the housing crisis, and certainly not at all the things that Bernanke and Powell have done since the crisis—but in 1998 when real GDP growth was over 5% and the market was humming. We'd had a Russian ruble crisis. We were fresh off of a Thai currency crisis the year prior. We had Long-Term Capital Management. Greenspan cut the Fed funds rate in a smoking-hot economy under the pretense it was a preventative move. But what he really did was keep the stock market going.

John Mauldin: And create a bubble.

David Bahnsen: And I think the Greenspan put became codified. And it's no longer fair to call it a Greenspan put because Bernanke used it, too.

John Mauldin: Here's where dinosaurs like me have a problem. I can look at metrics that show the market is as overvalued today as it was back in 2000. Powell can't be any clearer. He's not going to worry about inflation getting to 3% or so. He's going to look right through it because he says, and I think he's right, that it's going to be transitory [over 1–2 years] because we're coming off a low measure. Then he says, and this is where he's wrong, they won't raise rates until we get back down to an unemployment level we've only seen twice since the end of World War II. One was during the Vietnam era when we were shipping a half a million troops off to Vietnam. So, yeah, we employed them in the army and those people don't count. And the other was in the Trump-era boom. Jerome Powell today is saying that's normal, it's where we should be, and until we get back to that number, we're going to keep rates low. **I just think that's the height of foolishness.** At some point, you have to start taking your foot off the pedal.

Chicken or Egg

David Bahnsen: John, I want you to tell me where I'm wrong on this because I might be wrong. Maybe I'm not. We may fully agree, but this is a really good point you're bringing up, as usual. I get very critical when Republicans get deep into conversations about tax policy when we haven't yet addressed spending policy. In other words, until you figure out the size of government you want to pay for, talking about how you're going to pay for it seems to me to be a chicken-or-egg fallacy. And I wonder if, in our criticism of the Fed and where they set rates and all the monetary tools they use in certain crisis moments, we know they go to full-blown "whatever it takes" to keep financial markets functioning. I… think they mean it. Last March in the COVID collapse, certainly in the depths of the financial crisis, I don't think those efforts to reflate commercial paper and money markets were disingenuous.

John Mauldin: There are times when you actually need a central bank. And those were times when you needed a central banker. We needed them to help keep things going. Now they've dug themselves into a big hole and they're continuing to dig. They painted themselves in the corner, whatever analogy you want. If they allow, the US government is going to be at $40 trillion worth of debt within five years. A mere 1% interest rate is another $400 billion of interest. Or something equally ridiculous.

David Bahnsen: I think, by the way, your point is still valid, even at $35 trillion. And I'm saying, isn't the Fed doing the only thing it can do given the insanity they're being dealt by Congress? [We are already at $28 trillion today.]

John Mauldin: You're absolutely right. And this is the corner they painted themselves into by starting with keeping rates too low, by 12 people [and often just one] sitting around the table and setting the price for the most important commodity in the entire world, which is the price of money. They have enabled the government to spend and we spent in the Trump years, the Obama years, the Bush years, and before.

Now, here's what's the problem. We can't allow rates to rise without completely blowing the budget. We're not going to see a deficit under $2 trillion [this decade]. Look at the numbers. I mean, the economy is going to come back. OpenTable this last weekend in Miami actually showed higher restaurant numbers than it did before 2020. That wasn't the rest of the country. But Miami was certainly willing to party.

David Bahnsen: And it's coming back everywhere. I agree.

John Mauldin: It's going to come back, but differently. We're changing.

David Bahnsen: If I told you that you can get 5% real GDP growth, which you can't and I know we can't and I know we won't. And even with the supply-side reforms that were done in the Trump administration, corporate tax reform, repatriation, a pretty fair amount of both energy and financial deregulatory efforts, we still got just one year of 3% growth. I'm not belittling it, but I'm just saying we're fighting to get to trend line and I'm asking if we could get 5%. Would you feel any more sanguine about the debt outlook?

John Mauldin: Well, yeah, because the entire premise goes back to Dick Cheney when he said deficits don't matter. He was technically correct, in the sense that if your deficit is below the nominal GDP growth, you're fine because you're shrinking the total debt to GDP. We've gone way past that and the Federal Reserve is going to have to buy more of that debt. It's Japanification and how long can this go on? When does it collapse? And the answer is we don't know. And the second answer is we really don't want to know. Because the only way we're going to know is when it's already happened. That's a very dangerous trek.

Now, the US dynamic is significantly different from Japan's. It's significantly different from Europe's. But nonetheless, that excess debt is going to slow our economic growth. I don't see any impetus from either political party to say we're going to lock in our spending and then try to grow our way to balance. There's just no limit there. You've pointed out that it looks like the next round of spending will be $3 trillion or more over 10 years. It's likely to get passed. I mean, that's just the reality. You're shaking your head…

David Bahnsen: I am. The thing is likely to be passed and yet perhaps not be as deficit-significant because there will be more "pay-fors" than with COVID. Everyone had the luxury of using the COVID moment to not even pretend they were going to pay for their spending plans. I think this may be less debt-impactful because they'll try to have offsets. But then it becomes more growth-impactful because they have to pay for it by raising corporate tax rates, by raising capital gains tax rates and impacting capital formation, economic incentives, and impacting productivity. And this is the supply-sider in me coming out. They're trading one problem of runaway prolific spending for another problem, which is disincentivizing the only antidote we have, which is productive economic growth.

John Mauldin: I have written about this, I'm sure you have too. There's just not enough [income] taxes that we can raise to make a dent. In this problem, the only way we get out of this is to have a crisis and to completely restructure the tax code to where it's a VAT, probably in the 18 to 20% range, get rid of Social Security and include it in the VAT, drop the income tax rate to a flat rate on higher incomes. And you use the VAT to be your safety valve. That's the only way we can get back to a balanced budget. But the only way we're going to be motivated to do that is if we have a crisis, if we become Japan.

David Bahnsen: Well, John, here's the thing on our conversation, I think we have to do a two-parter here because I want to get into the optimism you and I both have. You talked about it in the context of humanity. I'm bullish. The human spirit. We're both, I think, bullish on the American DNA, albeit with a lot of concerns right now about the debt profile and our growth trajectory. But there's more to unpack.

The SIC Begins, Dallas, and New York

The SIC begins Wednesday. You want to watch and/or read. Participate in the question-and-answer. I can't even begin to tell you how much mind-blowing information you'll get. You will thank me when you hear it.

By the way, if you like what you read from David Bahnsen above, he will be on a panel with another multibillion-dollar investment advisor (and Louis Gave partner) David Hay and Ed Yardeni. They will offer very specific, "here's what I'm doing in this market" investment ideas.

This weekend my partners Steve Blumenthal and Dick Pfister meet here with a group of businessmen to talk about investing in Puerto Rico. There is so much opportunity here because there are problems to be solved. I think you will be amazed to see what Puerto Rico becomes in 10 years.

It looks like I will be in Dallas in late May and likely in New York in June. I doubt my travel schedule will ever get back to the level it was, but that's okay. It means I get to spend more time in paradise with Shane.

And with that, I will hit the send button and I know you're going to have a great week because you are going to join me at the SIC.

Your salivating about everything I will learn analyst,

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