THOUGHTS FROM THE FRONTLINE

Caught in a Debt Trap

By John Mauldin | October 16, 2020

We're caught in a trap
I can't walk out
Because I love you too much baby

Elvis Presley's rendition of *Suspicious Minds* topped the record charts in 1969. The lyrics portray a romance that couldn't work, but was also impossible to escape. That's also a good way to describe our relationship with government debt. We know it can't last, but we can't walk out. We love government spending and its benefits (like Medicare, Social Security, and unemployment insurance) too much.

In other words, we are in a ***debt trap***. Our political process can't reduce spending and/or raise taxes enough to balance the budget, so the debt grows and grows. As it does, paying the interest plus the accumulated debt load pulls more capital away from more productive uses. This depresses economic growth, thereby generating even more spending and debt.

This has to end, and I think it will do so in the event I've called The Great Reset. When I first started talking about The Great Reset, we weren't in the debt trap. We were "merely" in a situation with only bad choices. I didn't think we would make them. Thus the underlying presumption was that we would end up in a debt trap.

The Great Reset will be our escape from the debt trap. While there will be some winners and (probably more often) losers, it won't be fun for anyone. And it all springs from the debt trap.

Today I'll talk about how we got into this trap, why we can't escape without completely resetting the taxation/spending structure, and what it is doing to the economy. Let me warn you: Some of this will get political—but not in the way you might expect.

Whatever your persuasion, you aren't going to like this. Nor should you.

Diverted Capital

I have the great privilege of being able to talk to some of the finest economic minds in the country. Rarely a week goes by that I do not spend significant time on the phone with Dr. Lacy Hunt. He and Van Hoisington write in their most recent quarterly review, (a must-read) which I think is one of their most important about the economic environment we are in, including the debt trap. (Mauldin Economics VIP members and *Over My Shoulder* subscribers can read a highlighted version with key points summarized here.)

I'll quote directly a few short points from the beginning of his letter (emphasis mine) and then we'll do a deep dive into two of those points.

The conclusions of this analytical review are five-fold:

> 1) A very powerful secular downdraft has occurred in major measures of economic performance.
>
> **2) The US is caught in a debt trap, a term originated by the Bank for International Settlements: a condition where too much debt weakens growth, which elicits a policy response that creates more debt that results in even more disappointing business conditions.**
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> 3) The secular decline in economic conditions and the debt trap preclude the textbook conditions for powerful monetary policy measures to stimulate economic activity. Furthermore, debt-financed fiscal programs only boost the economy in the very short run, and ultimately reduce growth.
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> 4) The secular deterioration in economic growth has created a condition of excess resources and disinflation.
>
> **5) The workings of the Fisher equation, which have brought Treasury bond yields lower, have been reinforced by a sharp decline in the marginal revenue product of debt.**

They go on to amplify point 2:

> **The concept of the debt trap is consistent with scholarly research, from the 19th century to present, which indicates that high debt levels undermine economic growth. This causality is supported by the law of diminishing returns, derived from the universally applicable production function.** Historical declines in economic growth rates have coincided with record levels of public and private debt. Total public and private debt jumped from 167.2% of GDP in 1980 to 364.0% in 2019, with an estimated record 405% at the end of this year. Gross government debt as a percent of GDP accelerated from 32.6% in 1980 to 106.9% in 2019 to ***an estimated 127% by the end of this calendar year***.
>
> As proof of this connection, each additional dollar of debt in 1980 generated a rise in GDP of 60 cents, up from 54 cents in 1940. The 1980s was the last decade for the productivity of debt to rise. Since then this ratio has dropped sharply, from 42 cents in 1989 to 27 cents in 2019.

[Sidebar: The usdebtclock.org with debt to GDP has 137.7%. I asked Lacy about this. Essentially, he uses the same convention Ken Rogoff uses, which doesn't count some intergovernmental debt. He does this so that he can compare debt across nations without the distortion of different conventions of counting debt. Perfectly legitimate, as Lacy frequently compares international debt in his writing. By any measure, we are long past the point where debt negatively affects growth. We have entered the territory of Japan and Europe.]

Let's unpack this. Debt, even government debt, isn't *necessarily* bad. It can actually be positive depending on how it is used. Borrowing to build a productive asset can make sense, if its output is sufficient to repay the debt and then produce even more.

Like many other temptations, debt can be good in moderation but destructive if abused. Some infrastructure spending doesn't have a direct payoff, but clearly helps the overall economy, like the US interstate highway system.

Let me offer a few illustrations. It seems that every congressional representative gives lip service to the concept of "infrastructure spending." And they never really get around to doing it in any sufficient quantity. Airports are necessary infrastructure and are typically paid for by landing fees. That's productive debt.

I have read that much of the US loses as much as 20% of the water our water systems produce due to leaky pipes. To rebuild the national water system would take hundreds of billions if not over $1 trillion. Congress can easily allow the formation of a public-private partnership and guarantee the bonds so the Federal Reserve could buy them. Cities could access those bonds and raise the cost of water by 1% or so to pay for the bonds. Consumer water bills should still drop since we would be saving 20% of the lost water.

Everyone knows this. Congress does nothing. The same could be done with electric power. A smart grid could pay for itself even with debt costs. And consumer power prices would likely go down. I could go on and on.

But the debt we are accumulating now is not productive in that way. We use it to finance current expenditures like Medicare and Social Security. Necessary? Absolutely. But not the economic definition of productive debt.

Problems arise when debt grows excessive, relative to the output it will produce. The costs of repaying it diverts capital from other uses, leaving less capital available for productive investment. You start needing more debt to generate the same amount of production. Or, said another way, each additional dollar of debt produces less GDP. Lacy calls this “debt productivity” and it dropped from 60 cents in 1980 to 27 cents in 2019.

Debt service comes from taxation and even more borrowing (which is the definition of a Ponzi scheme), which leaves businesses and families less money to spend on other things. This results in lower economic growth, inflation, and interest rates.

Why is it a trap? Here’s where I have to get political.

Fiscal Futility

To those on the conservative side, the problem is simple. We have excessively high taxes and debt because the government spends too much.

That’s easy to say but gets a lot more difficult when you talk specifics—particularly if you are a member of Congress who must answer to voters. Exactly which government spending would you like to cut? What programs, departments, and agencies would you eliminate? Every dollar the government spends has a constituency—people who benefit from it, and will fight to preserve it.

Large amounts of spending are essentially on autopilot: Social Security, Medicare, assorted social programs, interest on the debt. These “mandatory” expenditures happen automatically, no matter the amounts, without Congress acting at all. The simple fact is that this mandatory spending plus defense spending is now consuming all tax revenue before any other government services are paid for on the federal level.

The so-called “discretionary” budget that Congress votes on (defense and all the assorted departments and agencies) is relatively minor. You could cut it all in half and we would still have a serious problem.

When Trump entered office the US deficit as percentage of GDP was less than 5%. The deficit for fiscal 2020 will be about 16% of GDP, or $3.1 trillion. The CBO estimates $1.8 trillion for fiscal 2021 (plus the off-budget debt they never mention) but that doesn’t include a stimulus package of close to $2 trillion that will be passed at some point. That will raise the deficit to much more than 2020’s, no matter who wins the election in a few weeks.

Sad to say, government spending just keeps growing no matter which party is in power. We have crossed some form of a political Rubicon where past performance is not indicative of future results. The few serious fiscal conservatives are now gone after finding the Republican Party under Trump spends differently than Democrats would, but has no desire to spend less.

In 2018, 39 Republican House members didn't run for reelection. Another 22 literally "left the House" in 2020. I know a few of them personally. They were deficit hawks. They were also in the senior Republican leadership. They know the constituency for controlling government spending is simply not there.

And that's the real problem: Voters *like* all this spending. They differ on priorities but no one really wants to balance the budget. There is no desire to make the sacrifices and endure the pain it would take to change the course we are on. So, it won't change, and debt will keep piling up.

Raising taxes, as a Biden administration would probably seek, would in fact help the budget deficit if they didn't also plan to add even more spending than the new taxes would collect. So that's not a solution, either.

To be clear, sometimes debt makes sense. Congress should have passed another economic relief package months ago instead of playing the present pre-election games. We are in a dire national emergency. Adding debt to address it would be less problematic if we hadn't piled up so much non-emergency debt.

Jaws of the Trap

Debt, as I have said many times, is *future consumption pulled forward in time*. It lets us consume more today by consuming less in the future. There is a school of thought which says this doesn't matter because we can always just keep pushing the due date further out. I disagree, and Lacy Hunt's research explains why.

While debt can be a problem, debt is also critical to economic growth. It finances innovation and adds to the economy's productive capacity. *Excessive* debt diverts resources away from investment, without which growth slows to a crawl. Lacy proves this mathematically but really, all you have to do is look at GDP growth around the world since 2008. Europe, Japan, and the US have all struggled to maintain positive growth. It was only a matter of time until something pushed us all underwater. The pandemic did it.

This is why interest rates are so persistently low. Our aggregate debt burden reduces growth, which reduces demand for credit while also increasing the supply of credit. Lower demand + higher supply = lower prices. Interest rates are the price of money.

Lacy explained his fourth point in a short section you should read several times until it sinks in.

> Falling real yields and inflationary expectations, via the Fisher equation, force government (risk-free) bond yields lower. But full application of the law of diminishing returns is also at work. Diminishing returns occur when a factor of production, such as debt capital, is overused. This observation is confirmed by the decline in the marginal revenue product of debt.

> Economic theory demonstrates than when the MRP [Marginal Revenue Product] of a factor declines, the price received for that factor also declines. If, for example, labor is overused to the extent that its MRP declines, so do wages, the price of labor. Thus, the decrease in MRP of debt due to its overuse indicates that interest rates, the price of debt, should fall. This is exactly what is happening in all the major economies of the world that are suffering from a debt overhang.
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> [JM note: from conversation with Lacy. Wages can decline several ways. Either they can directly go down or businesses can hire fewer workers. The combined effect to the economy is the same.]
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> Thus, considering decreasing interest rates as an inducement for governments to spend more borrowed funds will add to the severity of the debt spiral. If policy makers are incentivized to borrow more because interest rates are low, then the MRP of debt will fall, leading to even weaker growth.
>
> Moreover, interest rates are lowered indirectly by poorer growth and inflation, and by a further fall of the MRP of debt. Thus, the whole premise of Modern Monetary Theory is flawed at the core. The low interest rates are not a potential benefit for the economy, they are a result of the overuse of debt.

At some point, you would think interest rates will have to rise. And in a totally free market that would be the case. But you can bet (as the market does) that the Federal Reserve will step in and implement yield curve control, further distorting the market and hurting savers. This financial repression has severe negative consequences on retirees.

We are enduring this recession as well as we are because debt-financed spending programs sustained many (but not all) workers and businesses. That may not be an option next time.

All that being said, this can continue far longer than most people think. Japan is now at 260% of debt to GDP. Eurozone debt is about 86%, but that understates the true situation in most countries. Europe and Japan both have low or nonexistent GDP growth. The explosion of US debt means the US will soon join them. **The answer from almost every economist of any stripe about how to fix the debt problem is to "grow our way out of it." The problem is we have passed the point of no return.**

We can't stop growing debt. That would bring down the system in a true greater-than-the-Great Depression crash. What do you cut? Social Security? Medicare? Military pensions? Education? Interest payments on the debt? The State Department? The only way to maintain that spending is to keep adding debt, which sends us further into the debt trap.

At some point, this will simply stop working. That moment is when the world will face what I call The Great Reset. I am often asked exactly when it will happen. The simple fact is I don't know. My best guess is toward the latter part of this decade. I simply believe/know we will reach a point where everything has to change, and so it will.

In the song I quoted above, Elvis sang,

We can't go on together
With suspicious minds
And we can't build our dreams
On suspicious minds

In a debt trap we've turned this around. We already built our dreams on excessive debt. Now we can't go on together.

We're caught in a trap. We can't walk out.

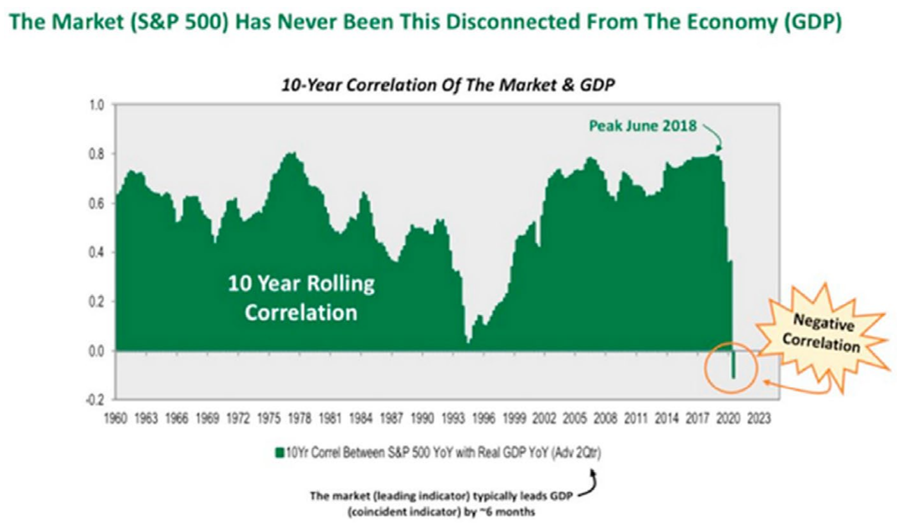
Special Opportunity

I mentioned above we sent *Over My Shoulder* subscribers a special version of Lacy Hunt's debt paper. You can get *Over My Shoulder*, plus a lot more, as one of our Mauldin Economics VIP members. It gives you all our premium services at a much lower price than the *a la carte* menu offers. As we approach The Great Reset, I can't think of a better way to stay informed and in touch with some of the best investment research available. Click here to learn more.

Anomalies in Paradise

I never knew how much exercise I got simply traveling. Just walking around stretching my legs at conferences and airports, trying to get a little gym time, etc. Now that I sit reading and writing entirely too much, which ultimately makes me stiffer, I am having to spend more time in the gym and walking on the trails around here just to avoid becoming a chair potato.

But then, I do come across lots of good material and I get a lot of thinking time out on the trails. For instance, my friend Tony Sagami sent me this:



Source: Investing.com

It makes sense when you think about it. A few tech stocks are basically driving a bull market even as we face the worst recession in 80 years.

I read a lot about how inflation is coming back. And my answer is, well, yes, but not the way you think. We're going to get another stimulus package which, combined with supply chain destruction, will be inflationary. But when that wears off the general deflationary trend caused by massive debt will kick back in.

But in the meantime, we will get lots of hysteria about how 1970s-like inflation is returning. I suppose there is a nontrivial chance of that, but it's not how I would bet. I think we will be stuck with deflation and low rates for a very long time. After the election, I intend to write on what tax-and-spend policy would actually help us out of the crisis we are approaching.

Spoiler alert: We will need to completely revamp our tax code, with a greater percentage of GDP going to taxes than any of us want. But we'll have to collect it differently and not destroy incentives as Europe and Japan have done. Sadly, I don't expect a willingness to do that, at least political willingness, until we are already in the middle of a deep crisis. The good news is we will get one, and maybe change some things.

And with that I will hit the send button, and schedule nine holes of golf with some good friends this afternoon just to get my body moving. You have a great week! And by the way, here are a few links if you're interested in following up the whole debt trap concept.

- Low inflation and rising global debt: just a coincidence?
- The financial cycle, the debt trap and secular stagnation
- The world is caught in a debt-trap built by central bankers

Your trying to figure out why the weights in the gym are heavier than they used to be analyst,

John Mauldin
subscribers@mauldineconomics.com

http://www.mauldineconomics.com/members

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