

The End of the World, Part 1

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Some Thoughts on Getting Older

By John Mauldin

August 26, 2011

Fine, then. Uh oh, overflow, population, common food, but it'll do to
Save yourself, serve yourself. World serves its own needs,
listen to your heart bleed – dummy with the rapture and
the revered and the right, right. You vitriolic, patriotic, slam,
fight, bright light, feeling pretty psyched.

It's the end of the world as we know it.
It's the end of the world as we know it.
It's the end of the world as we know it and I feel fine.

R.E.M. song from 1987

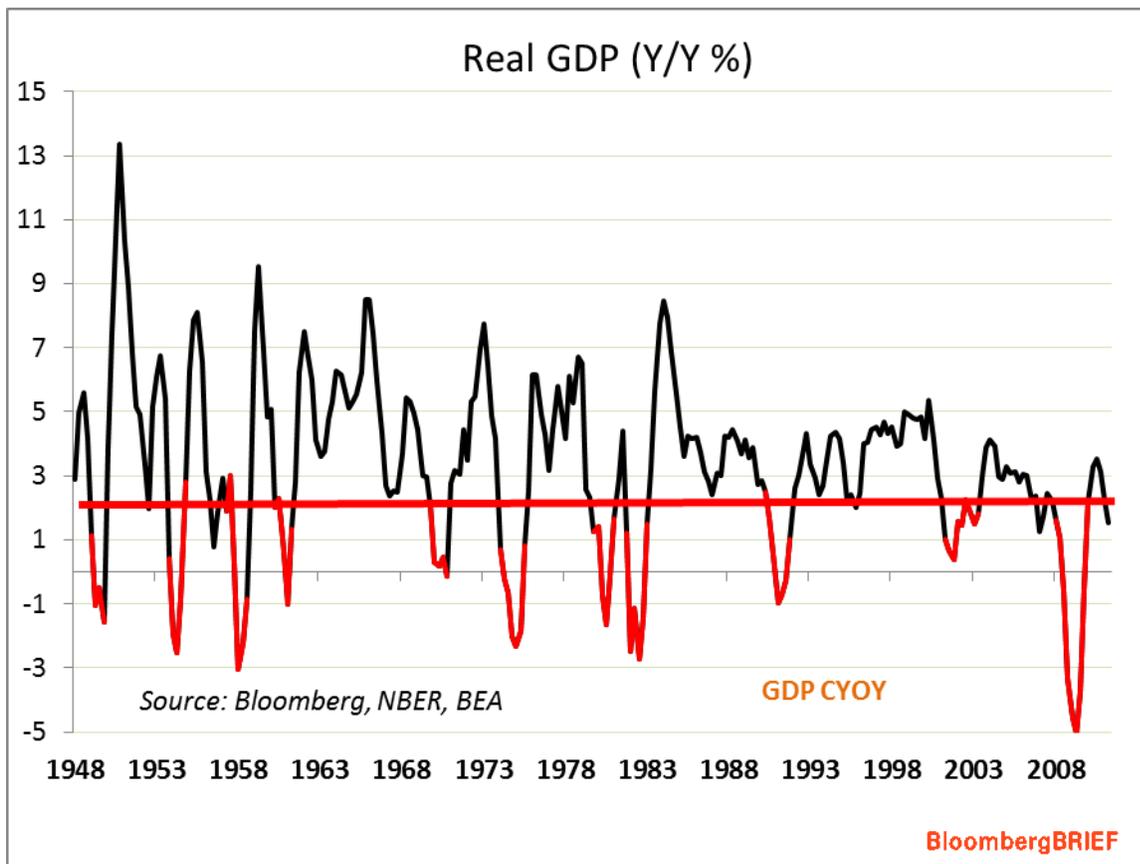
It's not really the end of the world, but to read some of the analysis and data over the past week, it's hard not to wonder if it's not the beginning of the Endgame at the very least. There is more to cover than I can really do justice to, but we will just start. We HAVE to look at the US data first (briefly) and then on to Europe, where it will may be the end of the euro experiment, depending on two voting populations. Can you spell "Banking Crisis," gentle reader? A nod to Bernanke's finger-pointing speech, some links on the scourge of high-frequency trading, and we end on a positive note about the Boomer generation growing older. And, I answer the question that is burning in your brain: "How many years of US corn production will China's dollar reserves buy?" Write your answer down now. This letter may print out longer than usual, as there are plenty of charts. Let's skip the "but firsts" and jump right in.

What Is the CBO Seeing (or Smoking?)

Last week I finally stopped being wishy-washy (with my 50-50% chance of a recession call) and said the US would be in recession within 12 months. And suggested that you consider moving to the sidelines your longer-term equity investments, except your conviction stocks. (I have some of those in the biotech space and simply intend to buy more if the prices go down. But remember, I am looking out ten years and expect an eventual bubble, so I don't care if I am early for some of my high-risk money.) Stocks typically go down about 40% or more in a recession. David Rosenberg estimates that we have seen 27% of a typical bear-market move, so that would suggest the possibility of another 30% downdraft (give or take).

None of the data this week makes me want to change my opinion on recession. Rich Yamarone (Bloomberg Chief Economist) and I traded emails as we got new data this morning, comparing notes. He does better charts than I do, so we will use his. (I hear, by the way, that he is being addressed as Lord Vader in the halls of Bloomberg. Come to think of it, his voice is rather raspy.)

As he points out, when GDP year-over-year drops by more than 2%, we have always had a recession. So with today's second-quarter revision (first revision of many) down to just 1% (technically 0.99%, but we are among friends here), where are we? At 1.5% year-over-year. Here is the chart:



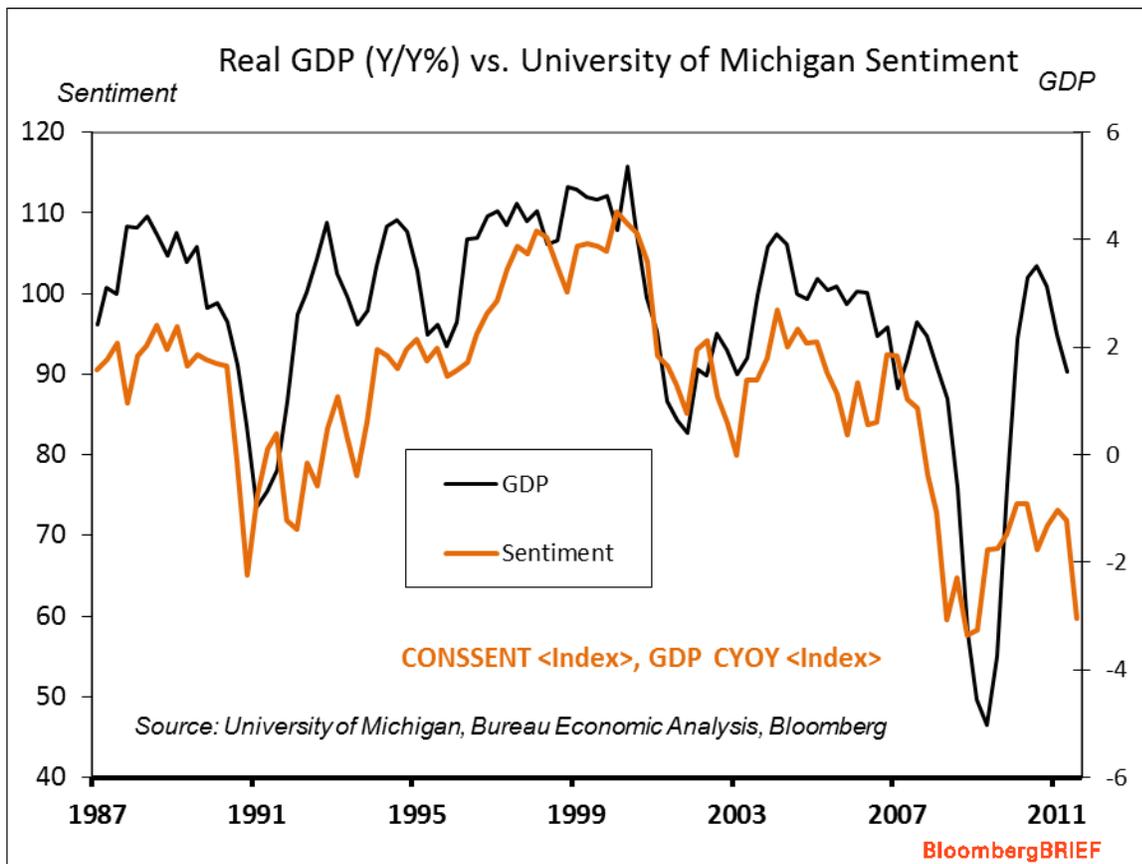
The normally bullish staff at economy.com gave us this rather dismal paragraph tonight as a summary to the week:

“The last week of the summer brings a rare Northeast hurricane and a heavy load of data that will show the economy running close to stall speed. Second quarter GDP was revised down to 1%, and the slight improvement in growth we expect for this quarter assumes no new financial shocks. Upcoming indicators for August will bear the mark of steep declines in stock prices. The employment report will be the headliner; nonfarm payrolls are expected to rise just 30,000, and the unemployment rate likely will tick up 0.1 percentage point to 9.3%. We think the ISM manufacturing survey dipped into contraction territory for the first time in two years, and auto sales and consumer confidence likely also fell during the month. There will also be significant

interest in the minutes of the August Federal Open Market Committee meeting, especially given Chairman Ben Bernanke's omission of details regarding policy easing options in his Jackson Hole speech.”

Ugh. More on the Bernank later.

The Michigan Consumer Sentiment number was just awful. It dropped 8 full points (which is huge for this index) to 55.7. The index has fallen nearly 20 points in three months. In the chart below, note the close previous correlation between sentiment and GDP. Which do you think is more likely to happen: sentiment to rise or GDP to fall?



Unemployment claims are back up over 400,000, to 417,000. If the employment gain is really just 30,000, that bodes poorly for any recovery. So, exactly how does that square with the recent Congressional Budget Office (CBO) projections? Quoting:

“CBO expects that the recovery will continue but that real (inflation-adjusted) GDP will stay well below the economy’s potential—a level that corresponds to a high rate of use of labor and capital—for several years. On the basis of economic data available through early July, when the agency initially completed its economic forecast, CBO projects that real GDP will increase by 2.3 percent this year and by 2.7 percent next year. Under current law, federal tax and spending policies will impose substantial restraint on the economy in 2013, so CBO projects that

economic growth will slow that year before picking up again, averaging 3.6 percent per year from 2013 through 2016.”

Let me work you through the numbers. We grew at less than a total of 1.4% for the first six months of 2011. To get to 2.3% as an average for the year, we would need to grow by (back of the napkin) 3.2% for the last half of the year. We could reduce the deficit by a lot if we could sell what these guys are smoking to engender such optimism. I think demand would be strong, especially on Wall Street. (Note: these are the same people that told us in 2000 that all government debt would be gone by 2010. Just saying.)

Their projections are likely based on assumptions about recoveries from past recessions. But since 1945, all recessions have been business-cycle recessions. We are now in a deleveraging/balance-sheet/post-credit-crisis recession for which we have no modern analogs, except maybe Japan. And that hasn't turned out too well, as in, two decades of going nowhere. Yet we are applying the same methodology (massive debt and deficits along with zero interest rates) that did not work there, and will soon bring Japan to ruin.

We have a fundamentally different economic scenario than at any time for the last 66 years. Why then should we expect the same outcome? EVERY indicator (employment, GDP, ISM, sentiment, etc.) is far below its average result two years after the official end of a recession. That should speak volumes.

So why does what the CBO says mean anything? Because Congress is making projections for future deficits, based on what appear to be wildly optimistic assumptions. That means future deficits are likely to be worse than expected. If we enter recession, as I expect, then revenues will be down (as unemployment will be up and profits down) and expenses will go up. That de minimis deficit reduction currently being negotiated by the “Gang of 12” will disappear in a cloud of smoke and maze of mirrors. This will mean that more pain in the terms of future spending cuts and/or tax increases will be needed. (I know a fair number of congressional staffers read this letter. Please pay attention here – your bosses need to be given a “heads up.”)

If we are in for a slow-growth, Muddle Through decade, then the deficit projections by CBO are dismally off. Get the spreadsheets. Factor in slower growth and higher unemployment and two recessions by the end of the decade (typical for the aftermath of a banking/debt crisis), and see what those deficit projections look like.

Given the large amount of data coming next week, as the month ends, I will stop here and get back to the US next week.

The End of the World, Part 1

In trying to decipher Europe it is hard to know where to start, but let's begin with some assumptions:

For the euro to survive, one of two things must happen. Either the Germans (and the Dutch and Finns and French) decide to back the concept of some sort of eurobond financing of

the balance sheets of the peripheral countries, OR there need to be massive write-downs of insolvent-country debt and the various countries need to backstop their banks, because bank losses will be massive.

The former needs buy-in from German voters. Polls show Germans are against the idea of eurobonds by something like 5-1 (75% against, 15% for). (More on Germany below.) The latter option assumes the peripheral countries will lose access to the private bond markets, thus forcing sudden and enormous austerity (read Depression levels or worse). Will they simply throw in the towel and leave the euro on their own, remaining in the free-trade zone but with their own currencies, much as Denmark, the Czech Republic, or Sweden are now? Or opt to suffer and remain in the euro?

Germany could decide not to back the peripheral country debt, and leave the Eurozone. But this would be painful for Germans. If you think the Swiss franc trade is crowded (and way overvalued) because people are looking for a safe haven, what would a new Deutschmark look like to investors? Switzerland is a country (and one of my favorite in the world, so no slight intended – I will be in Geneva for my birthday in October) of just over 7 million people, only somewhat larger than the population of the greater Dallas-Fort Worth, Texas area where I live (although with much better weather!).

Germany, on the other hand, is the world's 4th largest country by GDP, with a population of over 82 million. It is well-run and respected. The new mark would climb to far higher levels against the remaining euro countries and other currencies, which for an export-driven nation would not be very helpful. Mercedes and BMWs cost a lot now (and don't forget tool parts and other things Germany excels in making). Double the value of your currency in a short time? Watch your market share drop. Painful is perhaps an inadequate word.

So, what to make of the remarks this week by respected German leaders? Let's fire up a few quotes here (<http://www.telegraph.co.uk/finance/financialcrisis/8720792/Germany-fires-cannon-shot-across-Europes-bows.html>):

“German President Christian Wulff has accused the European Central Bank of violating its treaty mandate with the mass purchase of southern European bonds. In a cannon shot across Europe's bows, he warned that Germany is reaching bailout exhaustion and cannot allow its own democracy to be undermined by EU mayhem.

“ ‘I regard the huge buy-up of bonds of individual states by the ECB as legally and politically questionable. Article 123 of the Treaty on the EU's workings prohibits the ECB from directly purchasing debt instruments, in order to safeguard the central bank's independence,’ he said. ‘This prohibition only makes sense if those responsible do not get around it by making substantial purchases on the secondary market,’ he said, speaking at a forum of half the world's Nobel economists on Lake Constance to review the errors of the profession over recent years.

“Mr Wulff said the ECB had gone ‘way beyond the bounds of their mandate’ by purchasing €110bn (£96.6bn) of bonds, echoing widespread concerns in Germany that ECB

intervention in the Italian and Spanish bond markets this month mark a dangerous escalation.”
(*London Telegraph*)

Who Will Rescue the Rescuers?

From the same article: “The blistering attack follows equally harsh words by the Bundesbank in its monthly report. The bank slammed the ECB’s bond purchases and also warned that the EU’s broader bail-out machinery violates EU treaties and lacks ‘democratic legitimacy’. The combined attacks come just two weeks before the German constitutional court rules on the legality of the various bailout policies. The verdict is expected on September 7.”

Yet “Nobel laureate Joe Stiglitz told the forum that the euro is likely to fall apart unless Germany accepts some form of fiscal union. ‘More austerity for Greece and Spain is not the answer. Medieval blood-letting will kill the patient, and democracies won’t put up with this kind of medicine.’ ”

His solution? Germany will either have massive banking losses (see below) or assume some debt. Why give up the dream of a united Europe over a few trillion and your credit rating? Yet (Ambrose Evans-Pritchard writing in the *Telegraph*):

“Marc Ostwald from Monument Securities said Germany is drifting towards a major constitutional crisis. ‘This has all the makings of the revolt that unseated Helmut Schmidt [in 1982], and indeed has political echoes of the inefficacy of the Weimar regime,’ he said.

“Mr. Wulff said Germany’s public debt has reached 83pc of GDP and asked who will ‘rescue the rescuers?’ as the dominoes keep falling. ‘We Germans mustn’t allow an inflated sense of the strength of the rescuers to take hold,’ he said.

“ ‘Solidarity is the core of the European Idea, but it is a misunderstanding to measure solidarity in terms of willingness to act as guarantor or to incur shared debts. With whom would you be willing to take out a joint loan, or stand as guarantor? For your own children? Hopefully yes. For more distant relations it gets a bit more difficult,’ he said.”

The final option is for the peripheral nations to eschew austerity and leave the Eurozone, launching their own currencies again. This would mean long and painful bank holidays and massive losses for European banks and local citizens, depending on how many countries left. And the lawsuits would last for decades – nothing short of a full-employment act for lawyers all over the world.

And Merkel was not helped by her own Labor Minister, Dr. Ursula von der Leyen. Rather than simply hand over further loans to Athens – money many Germans believe they will never see again – Dr. von der Leyen suggests Berlin should ask for collateral. Gold, preferably. From the *Irish Times*:

“One month after euro zone leaders agreed a bailout reform package, and a month before the package goes to vote before national parliaments, a senior German minister appeared to be calling for a renegotiation.

“On an aircraft back from Belgrade, a thin-lipped chancellor Angela Merkel reportedly told advisers: ‘I’m going to have to have a word with Ursula.’

“Even before she landed, German officials were in full damage limitation mode, working the phones and issuing statements denying the minister spoke for the government. ‘This is sub-optimal,’ groaned a senior government source. ‘No one is amused.’ ”

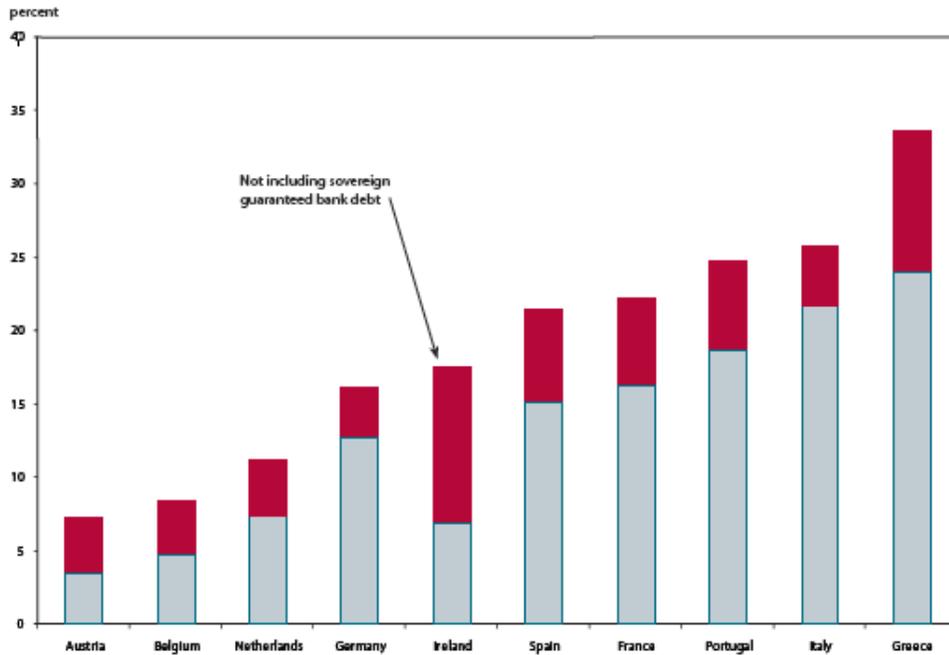
Some back-bench minister? Hardly. Dr. von der Leyen, a 52-year-old mother of seven, is one of Dr. Merkel’s most ambitious ministers and one of two names regularly mentioned as a possible successor.

But she only reflected a rather contentious Bundestag meeting this week, in which one after another representative voiced opposition, invariably noting that the voters disapproved.

Of course, none of this is helped by Finland negotiating a side collateral deal as part of their conditions for approving their portion of the next loan to Greece. And a chorus of countries have jumped on that wagon. How do you explain to YOUR voters that the Finns got actual in-the-bank collateral and you got nothing but Greek promises? But if everyone gets collateral, the whole deal will fall apart. What’s the point if you give back a large chunk of your loan? It just means you need even more!

The Problems of Debt in the Eurozone

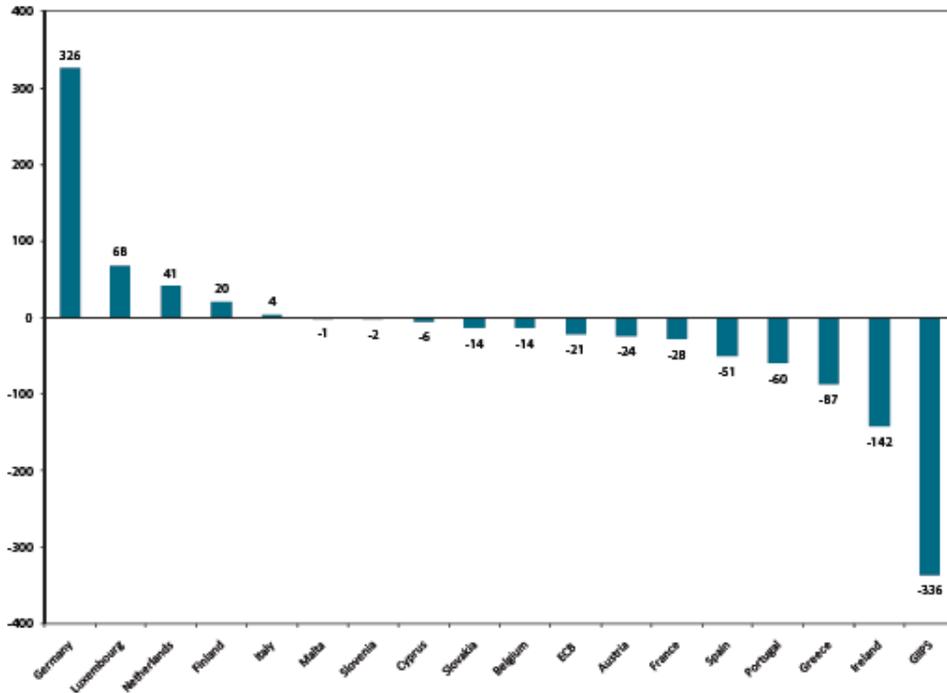
Let’s look at some charts. This first one is the amount of principal debt in terms of GDP from July 2011 to July 2012 (plus budget deficits, in red) needed by ten European countries. Note that France and Italy are well over 20%! Source: Peterson Institute of International Economics (hat tip, Simon Hunt!)



“From the same report this chart illustrates how Germany could become the banker for the Euro Zone. The question is will it? The question will be more clearly defined in September when Germany’s Constitutional Court will rule on the legal complaints against the Euro Zone rescue packages. If the comments being made by the Bundesbank and by the country’s President are a hint as to the outcome of the court then a negative ruling is a real risk. Who then will take the losses?” (Simon Hunt)

Note in the chart that Germany holds the largest percentage of net debt.

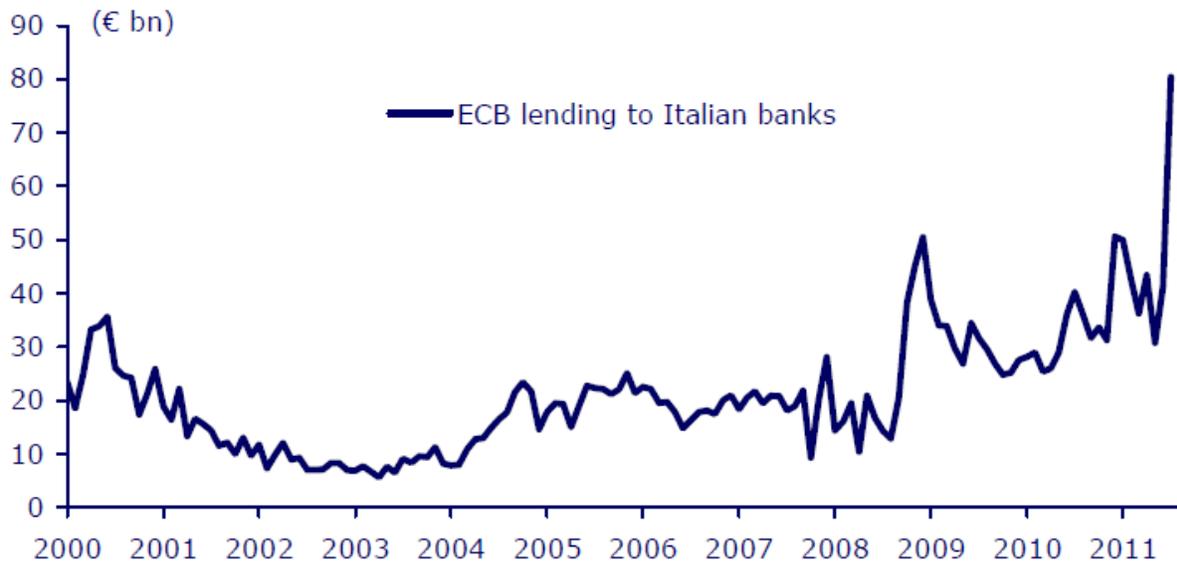
Claims of Euro Area members from netting of Euro System cross-border payments (in billions of Euros):



And then there are the interest-rate issues. Rates were rising rapidly in Spain and Italy until the ECB stepped in. Everyone knows Greece, Ireland, and Portugal are on life support and cannot get debt on their own. The ECB inserted an IV into Spain and Italy and started them on a slow drip. The real question of the moment is, can they get off that support and stand in the markets on their own? The answer a few weeks ago was starting to look like “No.”

And look at the massive growth in ECB lending to Italian banks, which are getting shut out of the “normal” market. It has literally more than doubled in a few months:

ECB lending to Italian banks



Source: Bank of Italy, CEIC Data

Credit spreads at French banks are blowing out. Review how much France has to borrow in the next 12 months, in the first chart. Then look at their deficit-to-GDP (above 10%, according to Charles Gave) and realize that there is no reason why S&P should not downgrade them as well. How do they cut spending? Taxes are already at 50% of GDP. Wealthy French have voted with their feet by moving away.

The list of country woes is long in Europe. Massive unemployment in Spain and Portugal. Deficits everywhere. Voting populations in both creditor and debtor nations are upset.

It is only a matter of time until Europe has a true crisis, which will happen faster – BANG! – than any of us can now imagine. Think Lehman on steroids. The US gave Europe our subprime woes. Europe gets to repay the favor with an even more severe banking crisis that, given that the US is at best at stall speed, will tip us into a long and serious recession. Stay tuned.

Thoughts on Jackson Hole

Jackson Hole often provides fireworks and significant speeches. Bernanke came up with neither this week, which I think is a good thing. But he did forcefully point out that the Fed has done about all it can do and that the forces of civil government need to step up to the plate with credible actions. It was as close to finger pointing as a Fed Chairman can do, and parts of the speech actually sounded as if he was trying to channel his inner Richard Fisher (Dallas Fed President). Basically, he said the Fed has done what it can with as easy a monetary policy as is possible and prudent. Quoting from Joan McCullough's remarks on the speech:

“Yeah, the Fed underestimated the severity of our ills and so this recovery is gonna take longer than expected. But underneath it all, the US still has the capability of generating growth.

Here are the precise words with which he threw responsibility back at Congress and the Administration; he starts out kind of slow:

“ ‘... Notwithstanding the severe difficulties we currently face, I do not expect the long-run growth potential of the U.S. economy to be materially affected by the crisis and the recession if – and I stress *if* – our country takes the necessary steps to secure that outcome.’ ”

“Just in case they didn’t understand that they had just been handed the baton, he continued with this:

“ ‘... most of the economic policies that support robust economic growth in the long run are outside the province of the central bank.’ ”

“With this closing castigation cum zing:

“ ‘... Finally, and perhaps most challenging, the country would be well served by a better process for making fiscal decisions. **The negotiations that took place over the summer disrupted financial markets and probably the economy as well**, and similar events in the future could, over time, seriously jeopardize the willingness of investors around the world to hold U.S. financial assets or to make direct investments in job-creating U.S. businesses.’ ”

As I said, for a Federal Reserve Chairman, that is as close to reading the riot act as you are going to get.

Some Thoughts on Getting Older

I turn 62 on October 4 while in Geneva. I don’t feel that old, and hope I don’t look it, but the birth certificate verifies the age. I should note that my mother turned 94 last week and is still quite active. I was talking with a Rice University classmate (of ’72) and old friend, John Benzon, who has recently retired from Price Waterhouse and is trying to figure out what “Act 2” will be. I realized that when we graduated, we had barely lived 1/3 of the lives we now have.

So with that on my mind, two items hit my inbox today. The first was from Lance Roberts of Streettalk Advisors. The San Francisco Fed did a report recently that suggested that we aging Boomers will be a drag on the stock market as we sell to support our retirement (shades of Harry Dent!). From the report:

“The baby boom generation born between 1946 and 1964 has had a large impact on the U.S. economy and will continue to do so as baby boomers gradually phase from work into retirement over the next two decades. To finance retirement, they are likely to sell off acquired assets, especially risky equities. A looming concern is that this massive sell-off might depress equity values.”

You can read his short piece and the link to the Fed piece at <http://www.streettalklive.com/financial-blog/253-boomers-are-going-to-be-a-real-drag.html>.

I am not so sure, though. I think the Boomer generation is a little different from previous generations. I remember going to my grandmother's in my early years, when my aunts and uncles were the age I am now. Even though active – and most lived well into their 90s – they had a far more sedentary lifestyle than many Boomers do today. Boomers are more active and, whether for financial reasons or simply because they don't want to retire (that would be me!), they are going to work longer than previous generations. In fact, the only cohort that has seen their employment rates rise is workers over the age of 55! Good for them (although tough on my young kids, who need those jobs).

Then I got this picture from Jon Sundt, the president of Altegris, a close friend, and my business partner. He is 50, at the tail end of the Boomer Generation. This is a wave he caught at the Mentawai Island Chain, 80 miles off the coast of Sumatra, Indonesia. He goes there every summer. They go into the middle of the Indian Ocean to find these large waves. And it is mostly Boomer surfers. (I'm not sure how much I like the guy who's responsible for a large part of my monthly cash flow taking these risks, but that's another story!)



Go to a gym or running trail: it is not just kids out there any more. There are lots of people my age where I work out. Some of the trainers are over 50! We all have friends who are pushing the envelope – climbing mountains, biking, etc.

And the new biotech that will come out within the next five years is going to offer cures for many of the things that kill us sooner than we simply wear out. Cancer, Alzheimer's, sclerosis of the liver, viruses are all on the short target list. I was talking about this with Scott Burns, noted author and long-time newspaper columnist (and a long-time friend). He calls it "catastrophic success" in his next book, as living longer is a "success," but it makes our

collective pension, Social Security, and Medicare problems even worse. Maybe MUCH worse. I smiled and told him there are worse problems than living longer. I intend to be writing and traveling for a few more decades.

And as my Dad used to say (he made it to 86), “God willing and the creek don’t rise” I intend to do 62 pushups on October 4th, which will be a personal best. I can’t do much about getting older (I will be very disappointed if I do not get a whole lot older!), but I don’t have to go quietly into that dark night. And neither do you, gentle reader. So, make sure you are around to read my musings a whole lot longer, as well. If you hang around long enough, you will even see me turn bullish! It won’t be that long, I promise. It will seem like just a few weeks from now.

And while I was having lunch with Scott, he asked me the question, “How many years of US corn production would the dollar reserves of China buy?” I mused, maybe 40. Wrong. It is only 12. And that is just corn. Not soybeans, wheat or rice or cattle, hogs or chickens. Think about that and stand back in awe at the productivity of the American farmer.

It is time to hit the send button. I stupidly forgot to save this letter and had an unexpected “hard” crash. I thought I lost almost the entire e-letter; but checking the Web, I found a back door to the temporary files where most of it was still store, so only lost a few hours re-creating it – but now it is late, 2 am). That means this letter might not be there Saturday morning, and for that I apologize. Have a great week!

Your looking forward to the next third of this life analyst,

John Mauldin