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By John Mauldin

People only accept change when they are faced with necessity, and only recognize necessity when a crisis is upon them.

- Jean Monnet, father of the European Union

This week we turn our attention to the elections and their aftermath. Long-time readers know I am a Republican, but I offer some sobering advice to my friends on my side of the aisle: Be careful what you wish for. It's one thing to get a few votes. It's quite another to live up to promises that simply can't be kept. We will start our analysis by looking at the GDP numbers that came out today, and we will end by pointing out that there will be no easy choices. And then we can turn our attention where it should be, to the World Series here in Texas.

But first, let me congratulate Jon Sundt and his team at Altegris Investments, who last week announced they had been bought by Genworth Financial, a Fortune 300 company, for a rather tidy sum. It is a tribute to their hard work and the quality of their team that Genworth not only bought them but required management to stay on with no changes in direction or purpose, simply adding distribution and financial backing. In a real sense, they bought the people and not the company.

And that is the same reason I am proud to have been their partner for over seven years. We have a common sense of purpose in helping investors find quality alternative investments in this turbulent world. And let me say that every one of my partners around the world have that same purpose and quality team. If you are known by the quality of people with whom you associate, then I am not in a bad league at all. You can learn more by going to www.accreditedinvestor.ws and signing up. That is for accredited investors (net worth $1.5 million or more) in the US, Canada, Europe, and Latin America. If you are not an accredited investor and in the US, you can see about alternatives available for you at http://cmgfunds.net/public/mauldin_questionnaire.asp. (In this regard, I am president and a registered representative of Millennium Wave Securities, LLC, member FINRA.) And now to our letter.

It's Softer Than It Looks

The GDP number came in at a rather soft 2% growth, up slightly from last quarter's 1.7%. From the standpoint of creating new jobs, 2% just doesn't cut it.

We need about 100,000-125,000 new jobs a month just to keep up with population growth, and a 2% GDP will not give us half that, as we saw last quarter. Most economists say you need about 3.5% GDP growth to get solid job reports.

And the prospect for getting that robust a number any time soon is not looking good, as the soft number mentioned above looks even softer when you delve into the details. 70% of the total growth in GDP came from growth in inventories, up by over 40% from the second quarter. Now normally a build in inventories is a positive, as it shows confidence on the part of businesses. But business confidence surveys have not been all that good, which suggests that businesses may be cautious, as this cycle does not seem to resemble past cycles.

(Well, except for Apple. Everyone's going to get an iPad for Christmas. You haven't got one? It is so way cool. My new favorite toy and fast becoming an indispensable business tool.)

How likely are we to see that same type of growth in inventories in the last quarter? Not very, I think.

Sidebar: For the non-geek reader, when inventories are increasing, that is a "plus" for GDP. When those inventories are sold, that reduces GDP. That may seem backwards, but that is just the way the math works. So if inventories are sold in the 4^{th} quarter (think Christmas sales), that will be a drag on the GDP numbers.

In every previous post-recession cycle, GDP growth would typically be around 5% at this time. But this is not a business-cycle recession; it's a deleveraging, credit-crisis recession. Thankfully, those do not show up all that often, but sadly one has come home to roost in much of the developed world this decade. The aftermath of credit-crisis recession is a slow growth period of 6-8 years, punctuated by more volatility and more frequent recessions.

What economists call the "final sales" portion of GDP has just been growing at less than 1% over the last 18 months. That is a lukewarm number, to say the least. That is not the stuff of a strong GDP.

And export growth is slowing, which rather surprises me, as the dollar has been weaker. If imports rise and exports do not rise as much, as has been the case, that is a drag on GDP. State and local governments reduced GDP by 0.2%, and this12 % of the economy is likely to be under continued pressure, not adding to GDP for quite some time.

It would not surprise me to see GDP growth be closer to 1% in the 4^{th} quarter, unless we start to see evidence of more inventory building. That is not good for jobs, personal income, tax collections needed to cover deficits at all levels, or consumer confidence. My worry is, what if we get some kind of shock to our economic body when growth is so anemic?

Not Finer for the "99er"

I had dinner last Sunday night with David Rosenberg. He is beginning to look at the possible effects from what he calls the "99ers" going off extended unemployment benefits. I knew this was coming but had not really looked into the fine print. He wrote me later:

"The looming expiry of the emergency unemployment benefits in the U.S. poses a very large risk to aggregate personal income over the next few quarters. Currently, combined with state programs, someone who loses their job is entitled to 99 weeks of unemployment benefits (a "99er"). However, the extended benefits are set to expire on November 30th, and our back-of-the-envelope calculations shows nearly a million 99ers will be cut off in December alone, with the remainder (about 3 to 4 million) falling off the rolls by April.

"Given that the average weekly unemployment cheque is about $300/week, this amounts to nearly $80 billion (annualized) loss of aggregate income over the next few quarters. This means that personal income could fall by 1.0% QoQ annualized for each of the next three quarters, starting in Q4. The 2% QoQ real GDP estimates pencilled in for Q4 2010 to Q2 2011, will look far too optimistic if such a loss of income does occur. Given that material downside risk to growth going forward, we intend to do more detective work on this file."

Government checks of one form or another are about 20% of total personal income in the US. Will the lame-duck Congress extend those benefits? Will they extend the Bush tax cuts? I just (literally) got off the phone with Suze Orman. She said she thinks they should raise the limit to $500,000 or $1 million. That higher number would be a reasonable compromise, in my humble opinion. Will the Republican Congress and Senate agree when they come back?

I don't want to get into the small-business person making $300,000 and living in a very volatile business climate where they feel the need to save rather than invest and create new jobs. These guys need all the working capital they can get. And let's be clear, this year's "profits" becomes next year's working capital when you are a small business owner. Your credit line at the bank just isn't cutting it anymore.

Be Careful What You Wish For

Everyone by now is predicting the Republicans to take the House and pick up anywhere from 6-8 Senate seats. We'll see. This is going to be a very interesting election, as there is a whole new dynamic in place.

Let's look down the road. I think we will at best be in a Muddle Through Economy for the next two years. Unemployment is going to be above 8%, best-case, in 2012. If the Bush tax cuts are not extended, in my opinion it is almost a lock that we go into recession next year, unemployment goes to 12%, and underemployment gets even worse. That is not a good climate for Obama and the Democrats in 2012. It is especially bad when you look at the number of Democratic Senate seats up for re-election that are in conservative states. The Republicans could take a serious majority in the Senate.

And then what? Right now Republicans are running on promises that they will not cut Medicare and Social Security, but are going to reduce spending and get us closer to a balanced budget. But everyone knows that the only way to get the budget into some reasonable semblance of balance will be to either cut Medicare benefits or increase taxes.

There are only the two options. Yes, you can reform medical care, and I think much of Obamacare should certainly be repealed, but that does not get us anywhere close to dealing with the real issue, and that's a fact. There are tens of trillions of unfunded liabilities in our future, which must be dealt with.

Let me be very clear on this. I am not really worried about the supposed $75 trillion in unfunded Medicare liabilities in our future. That is an impossible number. If something can't happen it won't happen. Long before we get to that apocalypse, we find a bond market that simply refuses to fund US debt at anywhere near an affordable cost. Crisis and chaos will ensue. Remember the quote that led this letter?

> ***People only accept change when they are faced with necessity, and only recognize necessity when a crisis is upon them.***
>
> ***- Jean Monnet***

The simple reality is that if We the People of the US want Medicare, in even a reformed and more efficient manner, we must find a way to pay for it. It will not be cheap. Raising income taxes on the "rich" is not enough. You have to go back and raise income taxes on the middle class, too. Oh, wait, that will be a drag on the economy and consumer spending. And in any event it will not be enough.

The only real way to pay for those benefits will be a value-added tax, or VAT. And while it could be introduced gradually, let there be no mistake that it will be a drag on economic growth. Government spending does not have a multiplier effect on the economy. It is at best neutral. What creates growth is private investment, increases in productivity, and increases in population. That's it. Tax increases have a negative multiplier.

A significant VAT along with our current income taxes will give us an economy that looks more like the slow-growth, high-unemployment world of Europe. Can we figure out how to deal with that? Sure. But it is not growth-neutral.

Republicans in 2013 will be like the dog that caught the car. What do you do with it? The last time they (embarrassingly, *we)* really screwed it up. The defining political question of this decade will not be Iraq or Afghanistan, or the environment or any of a host of other problems. The single most important question will be what do you do with Medicare? Cut it or fund it? Reform it for sure, but reform is not enough to pay for the cost increases that will come from an increasingly aging Boomer generation.

There is no free lunch. At some point, you cannot run on “no cuts in Medicare” and “no new taxes” and be honest. At least not this decade. Maybe when we have cured cancer and Alzheimer’s and heart disease and the common cold at some future point, medical costs will go down, but in the meantime we have to deal with reality.

You may be able to fool the voters, but you will not be able to fool the bond market. Not dealing with reality will create a very vicious response. Ask Greece.

And that is the national conversation we must have with ourselves. There is a cost to government. There is a cost to extended Medicare benefits. (I am blithely assuming we deal with all the “easy” stuff like Social Security, and make real cuts in other areas.)

And for my international readers, this is an issue that the entire developed world must deal with. We all have our problems created from years of very poor choices, overleveraging, and deficits. It will not be easy. I must admit to smiling when I see the protests in France over raising the retirement age from 60 to 62. Really? Amazing.

And while France causes me to smile and shake my head, the refusal on the part of the US leadership to give more than lip service to solutions that might disrupt their slim majority of voters is maddening.

This election next week will change very little in real terms, the things that matter, like whether the US economy can grow or will face a very real crisis and a true depression. That potential is in our future, and it is coming at us faster than you think.

Philly, London, and the Rangers

This is a sports- and family-filled weekend. Tonight I go with good friend Barry Habib (who hosted us at the Yankees-Rangers playoffs) to a Dallas Mavericks game. Then I have tickets near my old outfield offices for family and a few friends on Saturday and Sunday for the Rangers-Giants World Series. I admit I was very privately hoping sweep, so I could see the final game in Texas on Sunday, but so far the sweep is not going the way I hoped! I am really pulling for my Rangers to turn it around for the next three games.

Then it's off to Philadelphia for a speech on Tuesday morning for my partner Steve Blumenthal and CMG, then the train to New York, a few meetings, and a midnight flight to London, where I will spend the next four long days with co-author Jonathan Tepper of Variant Perception, finalizing our book, *The Endgame,* which will be out early next year from Wiley. And maybe we'll throw in a few fun dinners. But when I get back on the plane on Sunday, I intend to have the book finished. It will be good to have this two-ton gorilla off my back.

The book will deal with the realities we face all over the world. We are trying to write a book that even politicians can understand. The choices we face are not fun, and not without costs, but to avoid making them means that we really do drive the car into the ditch.

My bet? We figure out how to Muddle Through. Maybe that makes me a Pollyanna, but I think that here in the US we will get through. The choices are tougher if you are Greece or Spain. But even then, individual responsibility must take over.

Time to hit the send button. For once, it is not midnight and some fun awaits me before I go to bed. I will have to find out how the World Series ends when I wake up in London. The election results, too. Here's hoping we take the Series back to San Francisco. Have a great week!

Your hoping to see his first World Series win tomorrow analyst,

John Mauldin