The Economic Singularity

The 2014 Strategic Investment Conference: Investing in a Transformational World
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Los Angeles, Miami, Washington DC, Argentina, and South Africa

By John Mauldin

I fully intended to write today about a recently released academic paper that illustrates nearly every bad idea currently being bandied about in the field of economics. The insidious part is that the paper is considered mainstream and noncontroversial. Simply reading it required me to up my blood pressure medicine dosage. It is going to take me a little longer to finish that letter, and I realized that it needs a certain setup – one that coauthor Jonathan Tepper and I conveniently wrote a few months ago and included in the book *Code Red.*

So next week we'll take a deep dive into the most dangerous economics paper written in a long time (that is perhaps only minor hyperbole on my part); but today, by way of setup, let's think about central banks and liquidity traps and see if we agree that central bankers are driving the car from the back seat based upon a fundamentally flawed theory of how the world works. That theory helped produce the wreck that was the Great Recession and will have its fingerprints all over the next one. So this week we'll have a preliminary round before putting on the sparring gloves next week.

Here is a part of chapter 7 from *Code Red*. By the way, the book has done very well and is getting great reviews, with 49 readers giving us five stars. And three people who apparently didn't read the book gave it one star anyway. Check out the reviews on Amazon.

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But before we turn to the chapter, I want to note that this year for the first time we are not requiring Strategic Investment Conference attendees to be accredited investors. A change of venue that gives us a little more room and a shuffling of the speaking schedule allow us to open the event to everyone. If you are from outside the United States, you will not have as much trouble getting accepted into the conference as you may have encountered in the past. I am really excited about this change and hope that we have a significant contingent of non-US citizens at the conference. The speaker lineup is certainly international in breadth.

We sent out a note earlier this week encouraging you to register for the Strategic Investment Conference, which is coming up in mid-May. This is our 11th conference (cosponsored by Altegris Investments), and it will be our biggest and most comprehensive yet. Our attendees regularly say it is the best investment conference they attend anywhere. Click on this link to learn more. Rather than simply listing the names as we normally do, I have provided a little color about who the speakers are and what we can expect to hear. Register now to get the early-bird discount, which lasts for only a few more days.

Stuck in a Liquidity Trap

From *Code Red,* by John Mauldin and Jonathan Tepper

Like a car, an economy has lots of moving parts; everyone thinks they know how to drive it when they're in the back seat; and it crashes too often. But on a more serious note, the analogy of a car works especially well when you think of where large parts of the global economy are.

Today central banks can make money cheap and plentiful, but the money that is created isn't moving around the economy or stimulating demand. They can step on the accelerator and flood the engine with gas, but the transmission is broken, and the wheels don't turn. Without a transmission mechanism, monetary policy has no effect.

This has not always been the case, but it is today. After some credit crises, central banks can cut the nominal interest rate all the way to zero and still be unable to stimulate their economies sufficiently. Some economists call that a "liquidity trap" (although that usage of the term differs somewhat from Lord Keynes's original meaning). The Great Financial Crisis plunged us into a liquidity trap, a situation in which many people figure they might just as well sit on cash. Many parts of the world found themselves in a liquidity trap during the Great Depression, and Japan has been stuck in a liquidity trap for most of the time since their bubble burst in 1989.

Economists who have studied liquidity traps know that some of the usual rules of economics don't apply when an economy is stuck in one. Large budget deficits don't drive up interest rates; printing money isn't inflationary; and cutting government spending has an exaggerated impact on the economy. In fact, if you look recessions that have happened after debt crises, growth was almost always very slow. For example, a study by Oscar Jorda, Moritz Schularick, and Alan Taylor found that recessions that occurred after years of rapid credit growth were almost always worse than garden-variety recessions.

One of the key findings from their study is that it is very difficult to restore growth after a debt bubble. Central banks want to create modest inflation and thereby reduce the real value of debt, but they're having trouble doing it. Creating inflation isn't quite as simple as printing money or keeping interest rates very low. Most Western central banks have built up a very large store of credibility over the past few decades. The high inflation of the 1970s is a very distant memory to most investors nowadays.

And almost no one seriously believes in hyperinflation. The United Kingdom has never experienced hyperinflation, and you'd have to go back to the 1770s to find hyperinflation in the

United States – when the Continental Congress printed money to pay for the Revolutionary War and so started a period of extremely high inflation. (That's why the framers of the Constitution introduced Article 1, Section 10: "No state shall ... coin money; emit bills of credit; make any thing but gold and silver coin a tender in payment of debts....")

Japan and Germany have not had hyperinflation for over sixty years. Today's central bankers want inflation only in the short run, not in the long run. As Janet Yellen recognized, central banks with established reputations have a credibility problem when it comes to committing to future inflation. If people believe deep down that central banks will try to kill inflation if it ever gets out of hand, then it becomes very hard for those central banks to generate inflation today. And the answer from many economists is that central bankers should be even bolder and crazier, sort of like everyone's mad uncle or, more politely, to be "responsibly irresponsible," as Paul McCulley has quipped.

In a liquidity trap the rules of economics change. Things that worked in the past don't work in the present. The models of economies that we mentioned above become even less reliable. In fact they sometimes suggest actions that are in fact actually quite destructive. So why aren't the models working?

Sometimes the best way to understand a complex subject is to draw an analogy. So with an apology to all the true mathematicians among our readers, today we will look at what we can call the Economic Singularity.

The Economic Singularity

Singularity was originally a mathematical term for a point at which an equation has no solution. In physics, it was proven that a large enough collapsing star would eventually become a black hole, so dense that its own gravity would cause a singularity in the fabric of spacetime, a point where many standard physics equations suddenly have no solution.

Beyond the "event horizon" of the black hole, the models no longer work. In general relativity, an event horizon is the boundary in spacetime beyond which events cannot affect an outside observer. In a black hole it is "the point of no return," i.e., the point at which the gravitational pull becomes so great that nothing can escape.

This theme is an old friend to readers of science fiction. Everyone knows that you can't get too close to a black hole or you will get sucked in; but if you can get just close enough, you can use the powerful and deadly gravity to slingshot you across the vast reaches of spacetime.

One way that a black hole can (theoretically) be created is for a star to collapse in upon itself. The larger the mass of the star, the greater the gravity of the black hole and the more surrounding space-stuff that will get sucked down its gravity well. The center of our galaxy is thought to be a black hole with a mass of 4.3 million suns.

We can draw a rough parallel between a black hole and our current global economic situation. (For physicists this will be a very rough parallel indeed, but work with us, please.) An economic bubble of any type, but especially a debt bubble, can be thought of as an incipient black hole. When the bubble collapses in upon itself, it creates its own black hole with an event horizon beyond which all traditional economic modeling breaks down. Any economic theory that does not attempt to transcend the event horizon associated with excessive debt will be incapable of offering a viable solution to an economic crisis. Even worse, it is likely that any proposed solution will make the crisis more severe.

The Minsky Moment

Debt (leverage) can be a very good thing when used properly. For instance, if debt is used to purchase an income-producing asset, whether a new machine tool for a factory or a bridge to increase commerce, then debt can be net-productive. Hyman Minsky, one of the greatest economists of the last century, saw debt in three forms: hedge, speculative, and Ponzi.

Roughly speaking, to Minsky, hedge financing was when the profits from purchased assets were used to pay back the loan; speculative finance occurred when profits from the asset simply maintained the debt service and the loan had to be rolled over; and Ponzi finance required the selling of the asset at an ever higher price in order to make a profit. Minsky maintained that if hedge financing dominated, then the economy might well be an equilibrium-seeking, well-contained system. On the other hand, the greater the weight of speculative and Ponzi finance, the greater the likelihood that the economy would be what he called a deviation-amplifying system. Thus, Minsky's Financial Instability Hypothesis suggests that over periods of prolonged prosperity, capitalist economies tend to move from a financial structure dominated by (stable) hedge finance to a structure that increasingly emphasizes (unstable) speculative and Ponzi finance.

Minsky proposed theories linking financial market fragility, in the normal life cycle of an economy, with speculative investment bubbles that are seemingly part of financial markets. He claimed that in prosperous times, when corporate cash flow rises beyond what is needed to pay off debt, a speculative euphoria develops; and soon thereafter debts exceed what borrowers can pay off from their incoming revenues, which in turn produces a financial crisis. As the climax of such a speculative borrowing bubble nears, banks and other lenders tighten credit availability, even to companies that can afford loans, and the economy then contracts.

"A fundamental characteristic of our economy," Minsky wrote in 1974, "is that the financial system swings between robustness and fragility and these swings are an integral part of the process that generates business cycles."

In our previous book, *Endgame,* we explore the idea of a Debt Supercycle, the culmination of decades of borrowing that finally ends in a dramatic bust. Unfortunately, much of the developed world is at the end of a 60-year-long Debt Supercycle. It creates our economic singularity. A business-cycle recession is a fundamentally different thing than the end of a Debt Supercycle, such as much of Europe is tangling with, Japan will soon face, and the United States can only avoid with concerted action in the next few years.

A business-cycle recession can respond to monetary and fiscal policy in a more or less normal fashion; but if you are at the event horizon of a collapsing debt black hole, monetary and fiscal policy will no longer work the way they have in the past, or in a manner that the models would predict.

There are two contradictory forces battling in a debt black hole: expanding debt and collapsing growth. Raising taxes or cutting spending to reduce debt will have an almost immediate impact on economic growth. But there is a limit to how much money a government can borrow. That limit clearly can vary significantly from country to country, but to suggest there is no limit puts you clearly in the camp of the delusional.

The Event Horizon

In our analogy, the event horizon is relatively easy to pinpoint. It is what Rogoff and Reinhart call **the Bang! moment**, when a country loses the confidence of the bond market. For Russia it came at 57% of debt-to-GDP in 1998. Japan is at 240% of debt-to-GDP and rising, even as its population falls – the Bang! moment approaches. Obviously, Greece had its moment several years ago. Spain lost effective access to the bond market last year, minus European Central Bank intervention. As did Italy, with other countries to follow.

As an aside, it makes no difference how the debt was accumulated. The black holes of debt in Greece and in Argentina had completely different origins from those of Spain or Sweden or Canada (the latter two in the early '90s). The Spanish problem did not originate because of too much government spending; it developed because of a housing bubble of epic proportions. 17% of the working population was employed in the housing industry when it collapsed. Is it any wonder that unemployment is now 25%? If unemployment is 25%, that both raises the cost of government services and reduces revenues by proportionate amounts.

The policy problem is, how do you counteract the negative pull of a black hole of debt, before it's too late? How do you muster the "escape velocity" to get back to a growing economy and a falling deficit – or, dare we say, even a surplus to pay down the old debt? How do you reconcile the competing forces of insufficient growth and too much debt?

The problem is not merely one of insufficient spending; the key problem is insufficient income. By definition, income has to come before spending. You can take money from one source and give it to another, but that is not organic growth.

We typically think of organic growth as only having to do with individual companies, but we think the concept also applies to countries. The organic growth of a country can come from natural circumstances like energy resources or an equable climate or land conducive to agricultural production, or it can come from developing an educated populace. There are many sources of potential organic growth: energy, tourism, technology, manufacturing, agriculture, trade, banking, etc.

While deficit spending can help bridge a national economy through a recession, normal business growth must eventually take over if the country is to prosper. Keynesian theory prescribed deficit spending during times of business recessions and the accumulation of surpluses during good times, in order to be able to pay down debts that would inevitably accrue down the road. The problem is that the model developed by Keynesian theory begins to break down as we near the event horizon of a black hole of debt.

Deficit spending is a wonderful prescription for Spain, but it begs the question of who will pay off the deficit once Spain has lost the confidence of the bond market. Is it the responsibility of the rest of Europe to pay for Spain or Greece? Or Italy or France, or whatever country chooses not to deal with its own internal issues?

Deficit spending can be a useful tool in countries with a central bank, such as the US. But at what point does borrowing from the future (and our children) come to be seen as a failure to deal with our own lack of political will in regards to our spending and taxation policies? There is a difference, as I think Hyman Minsky would point out, between borrowing money for infrastructure spending that will benefit our children and borrowing money to spend on ourselves today, with no future benefit.

The deficit has to be controlled, of course. To continue on the current path will only feed our Black Hole of Debt even more "mass," making it that much harder to escape from. But to try and power away (cutting the deficit radically) all at once will blow the engines of the economy. Suddenly reducing the deficit by 8% of GDP, either by cutting spending or raising taxes, is a prescription for an almost immediate depression. It's just basic math.

As we outline in *Endgame* (shameless plug), each country has to find its own path. But it's clear that Spain, like Greece, is simply going to have to default on part of its debt. So will Ireland and Portugal. Japan will resort to printing money in amounts that will boggle the imagination and terrify the world, as they finally come to grips with the fact that they must deal with their deficit spending.

The Glide Path

Indulge us for a moment as we think about our own country. The United States still has the chance to pursue what we call the "glide path" option. We can reduce the deficit slowly, by say 1% a year, while aggressively pursuing organic growth policies such as unleashing the energy and biotechnology sectors, providing certainty to small businesses about government healthcare policies, reducing the regulatory burden on small businesses and encouraging new business startups, creating a competitive corporate tax environment (a much lower corporate tax with no deductions for anything, including oil-depletion allowances), implementing a pro-growth tax policy, etc. We can balance the budget within 5-7 years. If the bond market perceived that the United States was clearly committed to a balanced budget, rates would remain low, the dollar would be stronger (especially as we become energy independent), and we would steam away from the black hole. If something like Simpson-Bowles could be accomplished, with an even more radically restructured tax policy, it would be enormously bullish for the United States in particular and for the world in general. Healthcare is clearly the challenge, but a compromise can be crafted, as has been demonstrated by the several bipartisan proposals that have been sponsored by conservative Republicans and liberal Democrats. The key word is compromise.

The crucial outcome is whether we can achieve the compromise that will be needed to get us on a glide path to a balanced budget. If a compromise is not crafted in the next few years, it will be even more difficult in 2016, which is an election year. That may be too late, as the bond market may be watching Europe and Japan imploding and wonder why the United States is any different. Remember, the event horizon is determined by the confidence of the bond market in the willingness and ability of a country to pay its debts with a currency that has a value that can be maintained. Trillion-dollar deficits will call into question the value of the dollar. That will mean higher interest rates, which will mean a much bigger, more deadly black hole.

We should note that something similar to the glide path was tried during the Clinton administration. Spending growth was controlled and the economy was allowed to grow its way out of debt. While the U.S. economy is fundamentally weaker today than it was then, it should still be possible for the U.S. free-market economy to once again become an engine of growth.

We think the analogy of an Economic Singularity is a good one. The Black Hole of Debt simply overwhelms the ability of current economic theories to craft solutions based on past performance. Each country will have to find its own unique way to achieve escape velocity from its own particular black hole. That can be through a combination of reducing the debt (the size of the black hole) and growth. Even countries that do not have such a problem will have to deal with the black holes in their vicinity. As an example, Finland is part of the eurozone and finds itself gravitationally affected by the black holes of debt created by its fellow eurozone members. And China has recently seen its exports to Europe drop by almost 12%. I would imagine that has been more or less the experience of most countries that export to Europe.

In science fiction novels, a spaceship's straying too close to a black hole typically results in no spaceship. There are also hundreds of examples of what happens to nations that drift too close to the Black Hole of Debt. None of the instances are pretty; they all end in tears. For countries that have been trapped in the gravity well of debt, there is only the pain that comes with restructuring. It is all too sad.

The usual response by central banks when confronted with a debt crisis is to provide liquidity and create more money. But as we'll discover in the next section, not all money is created equal; and central banks don't really control the broad money supply at all.

Los Angeles, Miami, Washington DC, Argentina, and South Africa

A quick housekeeping note. I was autographing about 300 *Code Red'*s late last Sunday night, and – let's just blame it on having taken a sleeping pill earlier – in the process of signing books and looking at emails I somehow managed to fat-finger the delete key on my entire inbox. I was some 200 emails behind, and now they are dispersed among the 50,000 or so deleted emails of the past year. I leave emails in my inbox because I intentionally do not want them to go out of sight, since I intend to act on them in some way. While I remember a few messages that were in there, there are many more that are simply gone from memory. If I owe you something, you might want to shoot it back at me.

It is rather odd to be in Dallas where it is a beautiful 60° day and to see the massive snowstorm on the East Coast. Who knew that we should be holding the Winter Olympics in

Raleigh, North Carolina? I'm enjoying my longer than usual respite from travel, but by the end of the month I will see my schedule pick up aggressively. I will be in Houston for a night, back home for a few days before I go to Los Angeles, and then fly cross-country to Miami. From Miami I will go to Washington DC for a few days of meetings. Then it's back home for almost two weeks before I head to Argentina and then South Africa for a month. Thanks for the recommendations on South African game lodges last week. Based on your suggestions we have booked what looks to be a very nice four days of relaxation prior to a hectic speaking trip around South Africa.

It will be interesting to be in two of the more stressed emerging markets and to see firsthand what is happening. I will report back. It also looks like a trip to Europe is shaping up in early May, prior to my Strategic Investment Conference. And Italy in early June for a little working vacation.

It's time to hit the send button and then head to the gym. It seems that every so often somebody turns the dial down on my metabolism, and it becomes harder and harder to maintain my weight. Since I can't find out who is turning the dial down, my only response is to ramp up my gym time and turn down that second piece of bread. Have a great week, and I hope the weather turns better for those on the coasts.

You're trying to figure out how it all fits together analyst,

John Mauldin

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