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By John Mauldin

From ghoulies and ghosties
And long-leggedy beasties
And things that go bump in the night,
Good Lord, deliver us!
--Old Scottish Prayer

There is something that is bumping around in my worry closet. The bond market is not behaving as if there is deflation in our future, and the dollar is getting weaker. Unemployment keeps rising, but most of all, the US government deficit looks to be spinning out of control. This week we look at all of this and take a tour around the world to see what is happening. There is a lot of interesting material to cover.

But first, I am proud to announce that thanks to your donations the net proceeds from the Richard Russell Tribute Dinner totaled **$17,000**! A donation was made in that amount to the Autism Society of America, San Diego County Chapter, in Richard Russell's name.

The evening was captured in both video and photographs, and we would like to share those with you. We have put together a DVD that captures all the wonderful moments, including tributes from Richard's longtime friends and family, an entertaining skit by Richard's daughter Daria, and another touching tribute by Richard's daughter Betsy. Perhaps the best speech, however, came from Richard himself – which is of course included on the video. For those who could not attend in person, we have already made copies of the video and will mail it to you as soon as you order it. The cost is $29.95, and that includes shipping. You may order as many copies as you like.

To order the video, please visit: http://johnmauldin.com/russell-tribute-dvd.html

The photographs were placed on Shutterfly, an online gallery where you may view them and choose the ones you would like to order. We have created a web page specifically for these photos. To access that page, please use this link: http://richardrusselltributedinner.shutterfly.com or you can link from the page above. Now, let's jump right into the letter.

A Trillion Dollars as Far as the Eye Can See

As of this week, total US debt is $11.3 trillion and rising rapidly. The Obama Administration projects that to rise another $1.85 trillion in 2009 (13% of GDP) and yet another $1.4 trillion in 2010. The Congressional Budget Office projects almost $10 trillion in additional debt from 2010 through 2019. Just last January the 2009 deficit was estimated at “only” $1.2 trillion. Things have gone downhill fast.

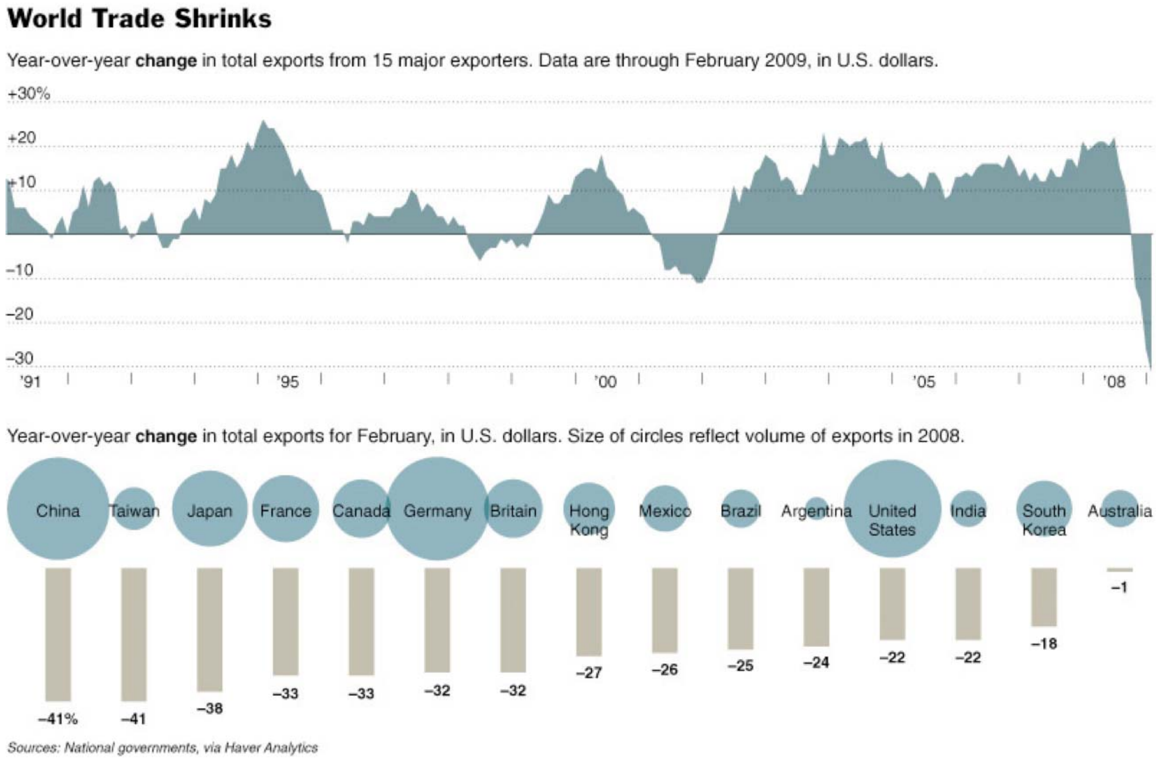
But there is reason to be concerned about those estimates, too. The CBO assumes a rather robust recovery in 2010, with growth springing back to 3.8% and then up to 4.5% in 2011. Interestingly, they project unemployment of 8.8% for this year (we are already at 8.9% and rising every month) and that it will rise to 9% next year. It will be a strange recovery indeed where the economy is roaring along at 4% and unemployment isn’t falling. (You can see their spreadsheets and all the details if you take your blood pressure medicine first, at www.cbo.gov.)

Just a few quick thoughts. This year the proposed administration plan is to borrow 50% of every dollar spent. The CBO projects than nominal GDP will grow by about 50% over the next 10 years (which is historically reasonable), but also that revenues will double, which suggests massive tax increases in relation to GDP. Interestingly, the International Monetary Fund says growth next year will be tepid at best (more below). The deficit in 2010 is almost 10% of GDP. The average proposed deficit is almost a $1 trillion average for the next ten years. Ten years from now, the deficit is projected to be $1.2 trillion. And that is if government costs do not go up and inflation only averages 1.1% for the next six years.

The Global Recession Gets Worse

Let’s take a quick trip around the world. In the first quarter, the German economy fell by 14%, Japan by 15%, Mexico by 21%, and England was down almost 8%.

Global trade is simply collapsing. The chart below is the ugliest it has ever been. Chinese exports are down 41%, Japanese exports down 38%, Germany’s down by 32%, and so on. (chart courtesy of www.variantperception.com)



Let me quote from the very interesting study the team at Variant Perception did.

"As we have repeatedly said, Spain is set for a long, painful deflation that will manifest itself via a spectacularly high unemployment level, a real estate collapse and general banking insolvencies. Consider this: the value of outstanding loans to Spanish developers has gone from just €33.5 billion in 2000 to €318 billion in 2008, a rise of 850% in 8 years. If you add in construction sector debts, the overall value of outstanding loans to developers and construction companies rises to €470 billion. That's almost 50% of Spanish GDP. Most of these loans will go bad.

"Spanish banks are now facing a very bleak outlook. Spain's unemployment rate reached over 17% last month; there are now four million unemployed Spaniards and over one million families with not a single person employed in the family. Spain and Ireland had the worst housing bubbles in the world and now Spain has as many unsold homes as the US, even though the US is about six times bigger.

"Why are Spanish banks not insolvent? Spanish banks are not marking their real estate loans to market. We've often wondered how it is that our thesis for Spanish real estate and industrial collapse has not created more victims. The answer is simple according to an article in Expansion, the Spanish equivalent of the Financial Times, from the 19th of April titled 'Spanish banks control half of all real estate appraisals.' You can't make this stuff up. We haven't even begun to see the worst in Spain yet."

European banks are in far worse shape than their US counterparts. That is because they utilize far more leverage, on an average about 30 times leverage. How can that be, in what is supposed to be a conservative industry?

"European banks were only restricted on the basis of risk-weighted assets, unlike the US where it is the total leverage ratio that matters, so most European banks bought assets that were rated by Moody's and S&P, who couldn't rate their way out of a paper bag, and for anything that wasn't highly rated, they bought credit default swaps or guarantees from AIG and MBIA. Because of that European banks were able to lever up a lot more than their US counterparties. Given the much higher leverage levels and general worsening of collateral values, we think that all the shoes in Europe have not dropped."

European banks have assets of about 330% of their GDP, compared to US banking assets, which are about 50%. They have over $700 billion in loans to Asian businesses (which are watching their exports collapse) and $1.3 trillion in loans to Eastern Europe, which is in a very serious recession, and so many of those loans are simply not going to be worth anything. Simply put, there is going to be a need for massive amounts of money to bail out European banks, or we'll watch their economies simply implode.

Where is the money for the bailouts going to come from? Germany? That will be a tough sell politically in a country that is in a much worse recession than the US. How do you tell your citizens you need to bail out banks in other countries with their tax dollars? Italian and Austrian banks are going to need a lot of capital, more than their governments can pay. It is going to be a very tough problem.

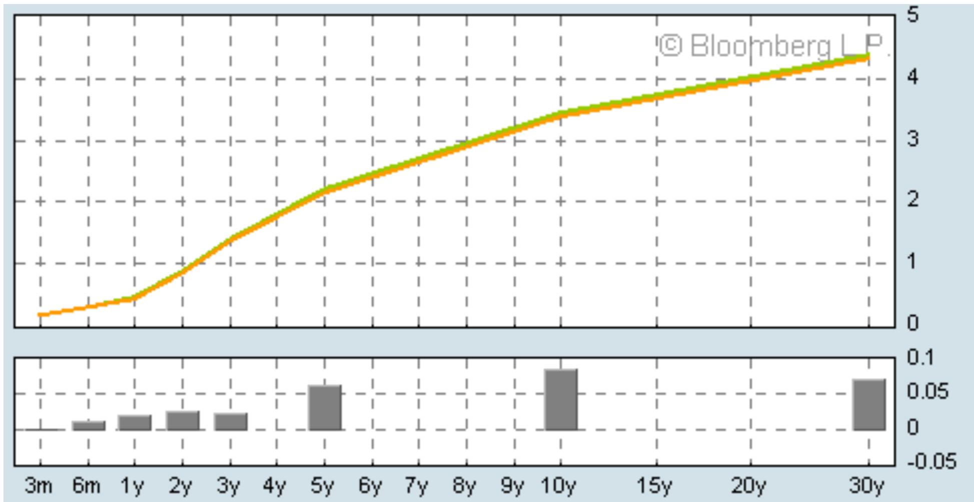
Governments around the world are responding to the global recession by running massive deficits. In addition to the US, the UK, Japan, Russia, Spain, and Ireland are all running deficits of over 10%.

And, as in the case of the US, these are not going to be one-time deficits. The IMF predicts that England will shrink again next year and the recovery in the US will be modest at best. The US economy is expected to grow by 0.2% (far from the optimistic projections of various US government agencies), the 16-nation eurozone will eke out a modest gain of 0.1%, and the Group of Seven (G7) leading industrial economies will, as a whole, only grow by 0.2 percent. They project that Japan's economy will stagnate next year.

Where Will the Money Come From?

And now let's look at what is bumping in my worry closet. The world is going to have to fund multiple trillions in debt over the next several years. Pick a number. I think $5 trillion sounds about right. $3 trillion is in the cards for the US alone, if current projections are right.

Just exactly where is that money going to come from? The US trade deficit is now down to under $350 billion a year. The Fed can monetize a trillion. Maybe. Look at the yield curve on US government debt below (Bloomberg). US savings are going to go up, but where is the incentive to buy ten-year debt at 3.5%? Four-year debt under 2% doesn't do much for your savings growth. Even with monetization and the Chinese buying our debt with the dollars we send them, that still leaves the bond market about $1.5 trillion short, give or take $100 billion.



The world is deleveraging. Debt is being drawn down. Securitization of various types of debt has seriously slowed. Banks are cutting back on lending. Home prices are dropping all over the world. Commercial real estate is rolling over, and banks all over the world are exposed. "Recession turns malls into ghost towns" is the headline in today's *Wall Street Journal.* Personal savings are rising and retail sales are flat to down. Unemployment is rising.

All this should be massively deflationary. Interest rates should be falling or at least not rising. But a funny thing is happening. In the past two months, the yield on the ten-year bond has risen by 1%. It has moved 0.38% or almost "4 big handles" in just two weeks. Look at the chart below. What is happening?

According to Merrill Lynch, the size of the world bond market is estimated to be approximately $67 trillion, with the shares of US, Euroland, and Japanese securities each representing less than 50 percent of this total. (PIMCO)

England has been put on negative watch for its debt rating. Bill Gross said yesterday that it is not unthinkable that the US could lose its AAA rating. I think the bond market is looking at the mountain of debt that will have to be somehow sold and wondering where such a colossal sum will come from. Where do you find $10 trillion in the next ten years for US debt?

And that is just for US government debt. $5 trillion for new global debt in the next two years? In a deleveraged world? How much will the other countries need? What about money needed for businesses and mortgages and credit cards and so on?

If you add $10 trillion to the current $11.3 trillion (including Social Security trust funds, etc.), that totals $21 trillion in 2019. Let's be generous and suggest that interest rates will only be an average of 5%. That would be an interest-rate expense of over $1 trillion. That is 25% of projected revenues and 20% of expected expenses. And that assumes you have nominal growth of over 4% for the next ten years. If growth is less, tax revenues will be less. It also assumes massive tax increases from carbon credits.

The Paradox of Deficits

I think the bond market is looking a few years down the road and saying that $1-trillion deficits are simply not capable of being financed. And if the debt is monetized, then inflation is going to become a very serious issue.

When you run deficits that are 4-6-8% or more than nominal GDP, at some point things simply back up. Can we ride along for a few years? Certainly. Japan is getting ready to see its debt-to-GDP ratio rise to almost 200%. But everybody can't do it all at once.

Call it the Paradox of Deficits. We have been running a large trade deficit in the US for years, because the people (China, Japan, and the Middle East) who wanted to sell us "stuff" were kind enough to turn around and invest the money in our bonds. This in turn created Greenspan's conundrum, as it helped keep down US (and global) interest rates. Combine that with a massive increase in leverage, a few bubbles, and we now arrive at a true crisis.

Deficits are not necessarily a bad thing if kept in check and restraint is shown. But everyone cannot run deficits at the same time. If we don't buy $700 billion in goods, then that money cannot be recycled back to our debt. It is that simple.

(Sidebar: And now, China and Brazil are moving to do their trades in their own currencies rather than dollars. Very smart on their part.)

Europe, Japan, and the US cannot try to borrow $5 trillion in the next two years without a serious distortion of the bond market, not to mention the entire economic landscape.

I have long thought that "crunch time," the end game, would show up around 2013-14. But I never in my wildest imaginings thought we could run an almost $2 trillion deficit. That crazy guy on the corner telling us "The end is nigh"? He may be right.

Long before we get to 2015, let alone 2019, I think the bond markets will have called a halt to $1 trillion deficits. There will be a real crisis. The deficits will not be funded at anywhere close to an interest rate that will not break the budget. Taxes will get raised beyond what they were in the Clinton years. And Obama's budget makes some very optimistic judgments about how much will be saved in medical costs, as if no one has tried to rein in medical costs before. The crisis may come much sooner if his universal health-care bill is passed as proposed without offsetting cuts somewhere else.

Watch the bond market. Rates should be going down, not up. The bond market is telling us the deficit simply can't be financed down the road. Now, maybe a few cool heads in the Democratic Party will prevail in the US Senate and the deficits will be brought under control. (The Republicans have so far seemed as clueless as they are impotent.) We could (theoretically) run $400 billion deficits for a very long time, as GDP would be growing somewhat faster.

It would be best to run budget surpluses, but the game does not end if there are reasonable deficits. It ends with deficits that cannot be funded except by monetization. And that will tank the dollar, except against all the other countries that are monetizing their debt.

I am increasingly inclined to think that as the world comes out of its current malaise – and it will – US investors should think more globally with their investment portfolios. That is something we will explore over the coming year. But that's enough for today.

Naples, London, and Eastern Europe

Next Friday I go to London to speak at a conference for my friends at Jyske Bank. International investing expert Gary Scott will be there, as well as my friend and business associate Steve Blumenthal. It should still be possible to attend, if you would like. You can see more at www.jgam.com. And then, in theory, I will be home all of June.

The plan now is for me to return to London on July 15th. I will co-host CNBC London Squawk Box on July 17th, see clients, and then be with London business partner Niels Jensen for his 50th birthday party on the 18th. (And here's wishing him a speedy recovery from his back surgery last week!)

And then I am actually going to take a vacation. I am slowly trying to expand the list of countries I have been to. This year I am thinking of venturing further into Eastern Europe. Romania and Bulgaria are on the top of the list, and perhaps Slovenia? I would love to hear from readers in those countries, or from others who have visited them. I will have about 12 days and want to be able to see the sights and relax as well.

Then I come back, go to Maine with young son Trey for our annual get together with all the guys at the Shadow Fed fishing trip run by David Kotok, and get back in time for daughter Amanda's wedding on the 22nd. It is going to be a full, fun summer.

And speaking of Trey, he turns 15 on Wednesday. He is the last of my seven in the house. The rest are all out and (more or less) on their own. But then I get three new grandkids between now and the end of the year, so the next generation is starting.

These are interesting and serious times we find ourselves in, but we should all try and remember to enjoy life as much as possible. I am grateful that I am so busy, and count it as a blessing when so many are not. Have a great Memorial Day, and take a few moments to remember those who have sacrificed so that we can be free.

Your looking forward to summer analyst,

John Mauldin