

## **The Next Bush Recession**

### **The Next Bush Recession? An Open Letter to Karl Rove There's a Storm Cloud On the Horizon The Mid-Term Recession The 2008 Election–It's the Economy, Stupid Really Thinking About the Future**

**By John Mauldin**

This week we enter the realm controversial. The election is over, and now reality will impinge its often unpleasant odor over the political landscape of the hopes and dreams of all sides of the debates. I explore the world of Republican political reality and how it will be affected by the economy over the next four years. We look at Bush's national agenda and muse upon whether it can come to pass. This will, of course, be guaranteed to annoy most of my readers, as those who oppose Bush will not like my suggestions and those who align themselves with him will not enjoy my raining upon their parade before they have had a reasonable time to bask in the glow of victory, or reminding them of real potential problems in 2008.

A quick caveat. I will style this as an open letter to Karl Rove. Although not active in the last few years due to time constraints, I was quite active in Texas politics in the 80's and 90's, working on numerous committees and campaigns, finally serving on the Texas State Republican Committee where I served on a small committee that represented the party to the governor's office when Bush was governor of Texas. You cannot run in such circles in Texas without bumping into Karl Rove from time to time, and we bumped often. I like the man, as do most people who have met him. He is currently the finest political mind in the country – a verifiable second coming of Lee Atwater, the architect of Reagan's victories and the Republican Renaissance of the 80's. I have not always liked how he runs a race (especially if I had a "horse" he was not backing), but I always admired his skills. His horses tended to win.

Now, however, there will be no re-election campaign to run. Now it is about legacy and the future of our country. Next week we return to our usual non-partisan commentary, but this week, I think it will serve our purpose to think about how politics will affect our economy and our future. With that, let's begin.

### **There's a Storm Cloud On the Horizon**

Dear Karl,

A simple "congratulations" seems so small considering what you accomplished. In the face of one of the most powerful campaigns ever waged against an incumbent, with so much money spent, with everything going wrong in Iraq, prison scandals, growing body counts, with the constant barrage of media suggesting a poor economy and employment picture, Florida hurricanes hurting employment surveys, with a mainstream

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media overtly aiding the opposition, you managed to marshal the resources necessary to win. You controlled the debate and ended with the fight in your home base, right where you wanted it. And you did it without getting seriously negative. There was no scorched earth. Kerry had some real personal issues, and you simply did not go there. In the face of Michael Moore and that obscene crowd, that shows some remarkable restraint.

Friends have been calling me all year from around the country worrying about the election. My answer was always the same. "Those of us in Texas know to trust Karl. He knows better than anyone how to put together the right campaign to get enough votes. If there is anyone who can pull this off, it is Rove." And you did.

I remember sitting in your office, many years ago, arguing about something. I can't remember what exactly, but I am sure it was vital to the future of human progress. It was also a losing issue at the polls. "If you don't win," you told me, "you can't get any of your agenda accomplished."

Well, now we've "won." There are no more re-elections. Yes, we need to try to insure that we can win again in 2008, but that may be harder than it looks now, as I will outline below. We have a window of time to work on that agenda. It is time to get down to business on some major problems. It is time to stand and deliver.

I was really happy to hear the President come out with a short list of major agenda items with re-forming the tax system and fixing Social Security at the top of the list. He told us, "We will continue our economic progress. We will reform our outdated tax code. We will strengthen the Social Security for the next generation. We will make public schools all they can be, and we will uphold our deepest values of family and faith [as] we help the emerging democracies of Iraq and Afghanistan."

The President says he has political capital and he plans to spend it. It may be wise to do so sooner rather than later. There's an urgent reason why, besides the fact that he will be a lame duck in two years and besides the "history and legacy" thing. Time is not on our side.

President Bush is likely to have the misfortune of entering his presidential career with a recession (compounded by 9-11) and also having a recession in his second term. Not his fault, of course, but unfortunate timing nonetheless. Let me present a brief case for a recession, what it might look like and then we can examine the political consequences.

### **The Mid-Term Recession**

Bush did the right thing for the economy during the last recession. He lowered taxes again and again. Luckily, the Fed had plenty of ammunition to fight the recession, aggressively lowering interest rates and avoiding deflation. The consumers helped by refinancing against their home values, resulting in the very positive twin combination of lower mortgage payments and cash-out borrowing, allowing them to spend more than

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they made. Even in the face of 9-11 and massive debt and trade imbalances, the combination of such massive stimulus helped engineer a very shallow recession.

The problem is that we will not have these recession fighting tools when we enter the next recession. Interest rates will likely be no more than 3%. Even cutting rates to zero will not be much stimulus, as the last 1% is mostly psychological. If a deal can't get done with interest rates at 1%, it is unlikely to get done at 0%. As much as I would like, there are no more tax cuts available which would provide any significant stimulus. Mortgage rates would have to drop to 4.5% or lower to allow home owners to re-finance and lower their costs. However, such low rates would indicate that we would already be in a much worse recession than last time.

Yes, I know that the economy is growing at a 3% plus rate. Let's look into those last GDP reports. Third quarter GDP at 3.7% was less than the consensus 4.3%. But there is a problem with that number. Those handy economists which figure such things first look at nominal growth and then subtract inflation to get the "real GDP." This number, the one they subtract, is called the GDP deflator. Interestingly, we find that number falling from 3.2% in the second quarter to 1.3% in the third quarter – the quarter in which energy and industrial commodity prices soared, as well as health care and other labor costs.

1.3% looks suspiciously small. Of course, if it was higher, then the economy grew less. If it was the same as in the second quarter, that means the economy would only have grown a coincidental 1.3%. Not exactly robust for an election period. Oh, well, there are two more revisions to get it right.

But let's suppose that deflator thingie (a technical term) is right. That might be a worse problem. That would indicate that not only is inflation very benign, but deflation is "coming back." Being close to zero would not be good going into a recession. In order to keep us out of deflation, the Fed would have to use what they call "unconventional methods." Basically, that means "moving out the yield curve" and fixing longer term rates. No one really knows whether or not that would work, but you can bet the Fed will use that and other unconventional methods to avoid allowing the US economy to slip into Japanese disease. The likely result is a serious drop in the dollar and stagflation.

You might read a paper by Dr. Ben Bernanke of the Fed and then call him up for lunch and get his private take. Oh, and ask about how they would deal with the potentially massive losses of money by the Fed when they fix ten year rates and rates eventually go back up. Who pays? The US Treasury as one Fed paper suggested? The conspiracy crowd will go nuts over that one.

Today's job number was the first really good one in some time. A lot of economists think it was due to those who lost jobs from the Florida hurricanes coming back on board.

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But there are signs of a weakening economy. Of course, high oil and energy prices are not good for the economy. Unemployment as an average over the last six months is not outstanding for a 3% plus economy. We are not producing enough jobs to simply keep up with population growth. Eventually this halts growth in consumer spending. Real incomes are rising slower than spending. Corporate earnings are decelerating, which suggests a slowing stock market after we get past the usual post-election boomlet. The Index of Leading Economic Indicators is looking soft. If you adjust the yield curve for a "normal" (not Fed controlled) rate, it is flatter than is comfortable, which is a prelude to an inverted yield curve.

(You probably know Dr. Lacy Hunt of Hoisington Management from your Austin days. He's one of the best and brightest economists around. Call him up and ask him for a few thoughts on what the yield curve is saying about the economy.)

Interest rates are not rising. Some think this is the bond market telling us that things are softer than they look. Oh, and please do not trot out the rosy predictions of some group like the Blue Chip Economists. They have never predicted a recession in advance. You could bring a recession up to them and introduce it personally and they still wouldn't have a clue.

While we are dealing in such dark thoughts, let's look at one side effect of a recession. It always results in a significant drop in the stock market. On average, the market drops about 43%. An aging boomer population would see its retirement accounts once again hit hard, and have to face postponing retirement. Not a good environment for a mid-term election, let alone getting Congress (and especially the Senate) to cooperate on anything substantial. Everything, especially risk-taking by politicians on legislation, tends to freeze in the face of problems with getting re-elected.

(Well, not everything. Rhetoric, blaming and posturing tend to increase dramatically.)

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The coming recession is no one's fault, and especially the President's, just like the boom of the 90's was not caused by Clinton. It is part of the normal business cycle, but the Dem's will call it the Bush Recession no matter what. Now you and I know that there is very little government can do about the business cycle. Congress cannot repeal it. All they can do is try and reduce regulations and laws which hurt business and then get out of the way. (More on that later.)

The good news is that right now 2005 looks like it will be ok for the first three quarters at the very least. We may be able to dodge the bullet until mid-to-late 2006, but any longer is problematic. That's not being a Cassandra. That's being realistic. The market will probably anticipate a recession and turn into a real bear, cutting down the time to act.

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That gives “us” one year in which to effect fundamental changes that will make the world better for our kids.

Social Security must be reformed. Now. Let’s be realistic. If we do have a serious recession, it is quite possible we will see a Democrat in the White House in 2008. That means 2012 at the earliest for any real reform, and it will cost hundreds of billions (if not a few trillion) more. This is one we must do for the kids.

Now I will suggest a heresy. The think tanks you and I trust suggest true Social Security reform is going to cost about \$1 trillion. Privatization is not cheap, but it lets our kids have a chance to retire in a world where the government will not be bankrupt and gives them actual cash for their retirement. Guarantee the current system for those who are older or want to stay in the system. (Hey, I’m 55 and would opt out in a heart beat if I could. Give me 20 years of my SS payments and see what I turn it into. A lot more than I would get from any future SS payment. But then again, I am not planning on retiring.)

If you could tie a small directed tax on upper income types like me which would specifically pay for reform (no funny accounting games) and would go away once the bill was paid in a few decades, you might be able to get that through with the voter base and Congress. As much as I think taxes are too high, I would be willing to pony up a few points if it keeps our kids from having to deal with a much worse problem down the road.

If you tie it in with fundamental tax reform it might help bring enough Dems on board to get some real changes. (They get a chance to tax the “rich” for this one purpose and we get reform.) Getting rid of the income tax and going to a national sales tax would be even better. Such a structural change would power the economy into the next big wave. Think of the hundreds of billions (literally) that would be saved on tax preparation and filing, not to mention the management and personal time lost. It would also help unemployment and soften the blow of the next recession. If there was ever a time it could be done, it will be in the next two years.

Now that would be a major legacy.

Frankly, spending a little now to avoid a real crisis later is a good investment. In a future crisis over social security, whatever my assets are will not do well, and we both know our taxes will rise even more.

Speaking of employment, it is time to pull out all the stops now. As an example, there is a real telecom reform bill winding through Congress. Put it on the front burner. It is a jobs bill, as long as you can keep the old dinosaur telecoms from watering it down. Tort reform and litigation control would bring down costs and allow business to hire more people. Everything that can be done to better the employment picture should be done now.

How many free trade zones can we get done in the next two years? I know there is one under way with Thailand, but we need to expand the concept. Free trade is good for

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US jobs. [Note- The US has added for more jobs because of our free trade agreements than we have lost. Yes, a few industries have been hurt, but many more have been helped.]

Why not do something radical and help the world at the same time? Why not propose a free trade zone with all of Africa and the next 20 poorest countries who will reciprocate?

It should go without saying that those embarrassing steel tariffs, bra tariffs, lumber tariffs and such should never again be broached in polite company. Those that still exist should quietly be done away with. The steel tariffs cost more jobs than the few they saved, are obviously (in hindsight) completely unnecessary, and didn't help us carry Pennsylvania anyway. It hurts our credibility when we talk free trade and then turn around and impose tariffs.

This is the time to deal with the national deficit. Putting an absolute hold on increased spending is a no-brainer. Run fixed, no increase budgets for a few years and the deficit drops quickly.

In a recession, tax receipts are going to go down. If we do not simply clamp down on spending now, then deficits will explode in during a recession. We do NOT want to be running a campaign of four more years of eye-popping deficits in 2008.

The outrageously high farm subsidies have got to go – phase them out or cut them out if possible. We simply can't afford them. If an expenditure is not nailed down, then cut it as well. Remember when we used to talk about how less government was better? Now is the time to actually enact some of that agenda.

And while we are reforming taxes, let's reform the corporate taxes as well. Simplify the structure and close the loopholes. It can be revenue neutral, but it should get simpler.

The only way we are going to get control of healthcare is by wider use of Medical Savings Accounts. Expand the program. It is probably asking too much to get a real handle on this problem (which is worse than all the others combined), with the rest of the things that need to be done, but we can put a down payment on it.

Boomers are going to need to be able to save more. Expand the IRA contributions, especially the Roth IRAs. That will also be a boost to the economy in the form of higher savings

### **The 2008 Election – It's the Economy, Stupid**

Let talk about the future, the 2008 elections and the Bush legacy. Let's speculate about the political landscape. We are essentially out of Iraq and Afghanistan. (If we're not, we are in big trouble.) Osama Bin Laden is dead or captured, and we have made a

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lot of progress in the War on Terror. The dollar has dropped another 20-25% and the Chinese have floated their currency, and the trade deficit is coming down. The French still don't like us, but nobody really cares. Thus the focus of the electorate is not going to be foreign policy or war.

We will be coming out of a recession, one that was deeper than anything we have seen in 25 years. (By the way, that probably means a world-wide recession as well.) We probably have mild stagflation. Interest rates are up so housing prices are flat or down. That will not be good for consumer sentiment, which is strongly tied to housing values. By definition, unemployment is up in a recession, and probably higher than it has been since 1991. The market is down and trying to climb back up, but those estimates of 9% compound returns that every pension fund, both public and private, have made has not come true. Many are in deep trouble. The Pension Benefit Guaranty Corporation is in trouble if we did not fix it in 2005-2006.

People, especially boomers, are going to be worried about their retirement. They will be saving more than they ever have, plus paying down debt, but that will cut into consumer spending and slow the recovery. The good times that the next president will enjoy and take credit for (everything goes in cycles) is not yet evident. (Was Clinton lucky to win when he did or what? Or maybe better, was he ever lucky that Perot decided to run?)

Bill King, the bond god over at Pimco, says we will have to deal with Hillary in 2008. We should be so lucky. My bet is the Dems find another Clinton clone without the blue dress and negative history. Someone who can feel their pain and articulate their angst. Even though demographics and the conservative tide are on our side, from time to time that tide goes out.

While we have a better and deeper bench for potential presidential candidates than the Dems (Giuliani, McCain, Frist, Ridge, Condie Rice (!), among others), they only need one person. Couple him (or her) with Barack Obama as VP, and the ir ticket is formidable coming off a recession.

How do we beat it? By first stacking up major and fundamental changes in the next two years. We must make this the party that saved Social Security, that reformed and lowered your taxes, that gave you bigger retirement account deductions, that preserved your freedom in a world of terror, that opened up new markets, saved us from the trial lawyers and helped schools, kept a conservative Supreme Court, etc., etc.

And by talking at all times and in every place we can that government does not create jobs. It just taxes them. The best we can do is to get out of the way. Give ALL the credit, and repeatedly, for the current recovery to American business. No more "we" did anything. If we helped create the jobs, if government takes credit, we will get blamed when they go.

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Can it work? I don't know. We could get lucky and the Dems self-destruct by nominating another Massachusetts (or New York) liberal. But I seriously doubt that will happen. My early bet is that 2008 is even harder and nastier than this election.

The electorate votes their pocket book, except in times of war. If we are still at serious war in four years, there will be questions asked and fingers pointed. But if we are not, then it will be about jobs, retirement and the economy. We need to be able to show some results in the face of economic problems. Tax cuts and the War on Terror (with a few other items) worked this last time, but it won't be enough in 2008. Seven percent unemployment, which is likely in the next recession, will swing a lot of votes if we do not plan now as to what we will do.

I am quite the long term optimist. Life is going to be better over time. But over the short term, we have some problems. We (you guys) need to get as much done this first year as possible. The longer we go, the less that will get done. The less that gets done in terms of reform, the worse the future will be for our kids. Not to mention the legacy thing.

I know you know most of this, and I wish the President and the team the best of luck.

As always, your opinioned friend,

John Mauldin

### **Really Thinking About the Future**

I am in Palo Alto and getting ready to speak at a conference on the future and change this weekend. These guys are thinking about the next 30-50 years, not some four year presidential cycle. I am really looking forward to this. I hope I find something worth reporting about.

Number two daughter has her birthday when I get back. Seems like a birthday or Christmas or something every month in my family, but then again, there are a few of us. She (and the other six) are the real future. They are why we need to deal with our problems now and not leave our debts to them.

It's time to hit the send button. Since you can't join me in Palo Alto, let me suggest you find some friends, your favorite adult beverages and think about the future. It will be a good one if you plan for it and make it happen.

Your happy to have such a great future analyst,

John Mauldin