

Be careful what you wish for

Be Careful What You Wish For The Lights of Myanmar A Stable Disequilibrium A Few Thoughts on Consumer Debt Merry Christmas, Family and Friends

By John Mauldin

We are awash in debt, assert numerous authorities. And they point to the charts which show debt mounting seemingly to the sky. But not all debt is bad. Some of it is good. We should save more and spend less. But if we do, there are consequences that we may not like. What's good for an individual may be a problem for a global economy. We continue with our series on trade balance and debt, with the thought going through our minds "Be careful what you wish for."

But before we get into that, let's look at something far more important.

The Lights of Myanmar

For the last two years, I have asked readers to help Knightsbridge International fund a project to bring solar power to various medical clinics with no electricity in the villages of the Karen tribe of Myanmar. This is a group of people forgotten by the world who are persecuted because of their religious beliefs (they are Christian, for those who want to know). You have responded graciously and generously, and we were a big part in funding over 20 solar power systems for health clinics. It has made a difference in the lives and health to a people who are in dire straits. There are children who are alive because of your generosity.

My good friend, Walt Ratterman, personally, and at his own expense, travels to Thailand bringing the systems with him. He helps train the doctors and health workers, and sometimes actually goes into Myanmar to help set up the systems. This is at no small personal risk, as the Karen tribe is in a zone that has been under siege for the past several decades. The Burmese (Myanmar) military has been burning villages, raping women, forcing people into slavery and killing the indigenous people of the area. There is no local embassy to appeal to for aid if he is caught inside the country. He wrote me this note last year:

"The project in March went very smoothly. The medics and technicians from the clinics inside Burma traveled for up to two weeks through the jungle, using various modes of transportation to get to the training. The distance between the clinics was about 600 km.

"During the training, each team built and dismantled many times their solar electric systems. They wanted, and needed, to know how to take them down quickly in case the Burmese military was spotted heading towards their camp. So, all of the

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connections and equipment were designed specially to be disassembled and reassembled quickly.

“Special power plugs on the system were used immediately to provide power to the communication equipment so the various forces could stay in touch with each other. The same power receptacle is used by the medics so they can power their laptops and receive instructions on various medical procedures they need to perform.

“During the training, we received a question we have not heard before. We were asked that if the clinic was under attack, did they have to waste a whole grenade to destroy the system (if they could not disassemble it quickly enough), or would one bullet do the trick?

“Since the project began, five of the villages were attacked, and all the clinics were burned down. But, the medics saw the attacks coming enough in advance to be able to hide all of the medicine and the solar equipment. After the attack, they rebuilt the clinic quickly and re-installed the solar equipment, so they could treat the wounded.

“Some of our students there have been in the camp without being allowed to leave for over 10 years. One young woman of 20 something was born there. In this camp – Mae La – where we conducted our class for 50 students, the population of the “camp” is 50,000 people. This is one of seven camps. (The others are smaller.) We will be teaching in one or two more camps this coming February.

“We have asked the manager of the medical clinics in Burma what he needs most for this February training and equipment installation program. Besides the additional systems that he needs for the clinics in Burma, he wants to bring a group of his medics and technicians to a common central area for additional training. They are maintaining their systems well, but he thinks that with more training, and the ability to keep a store of spare parts, they will be able to do a better job of keeping the lights and systems going in their remote clinics. We are going to find a good central location to conduct these trainings.

Of course, he neglected to mention the rowboats across the border at midnight when the guards were asleep and a day time crossing with one team creating a diversion so the other team can sneak across. Not to mention wading through streams to hide tracks, jungles, and a host of “minor” problems. If they got caught, it was lights out, pardon the pun.

The solar power systems allow medics to address nighttime emergencies, have proper lighting for medical procedures, and use electric medical devices. It also allows them to power laptops and communication devices so they can get instructions when they are confronted with a medical situation with which they are not familiar.

The Karen, with the help of refugee groups in Thailand, have over the years built up a network of medics and clinics operating inside Burma. There are now over 28 clinics

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with a roster of approximately 75 surgeons, medics, and nurses. The medics treat landmine victims and other casualties of the conflict as well as patients affected by malaria and other illnesses resulting from the harsh conditions.

None of the clinics had any electricity until August 2003, when a group from Knightsbridge International (led by Walt) was able to raise the funds to provide small solar power systems for two of the clinics. They have added 16 since then. They desperately need to bring power systems to the rest of them.

You can understand the need when you see a picture of a doctor doing an amputation holding a flashlight in his mouth. A system can be brought to Thailand and then on to Myanmar for about \$3,000. Walt, a true world class expert on solar power, will once again be going.

Just a quick word about Knightsbridge. These are the really, really good guys, but with a twist. They just like to do their good deeds while getting a “small” adrenaline rush. They were the first group into Afghanistan bringing medical supplies and a massive truck convoy of food to the Northern Tribes, long before any of our troops went in. Because they had been in before on other emergency supply runs, they had the contacts needed. Ed Artis, who led the mission, and Walt Ratterman also had \$50,000 price tags put on their heads by the Taliban, and had to move very quickly from time to time as the CIA would call on the sat phone and “suggest” they not work in a particular area. I was talking to Ed at one point and you could hear the carpet bombing in the background. And they do this for no salaries, just the love of helping. It also helps to be a little crazy.

“Going into Rwanda during the mass killing to rescue nuns, parachuting into Afghanistan, working in areas where terrorists operate in the Philippines, Zamboanga, Cambodia, Nicaragua, the list of vacation spots they visit is long, the needs are great and there is never enough money and men.

“You can learn more about Knightsbridge by going to www.kbi.org. (You can donate using a credit card on the website.) And most importantly, you can send a check for a tax deductible donation to:

Knightsbridge International
PO Box 4394
West Hills, CA
91308-4394

100% of your money will go to the equipment. No salaries or overhead here. I know some of you can write big checks, and some of you can find smaller amounts. Some of you may be on boards or churches looking for ways to help those less fortunate. If you write a check for \$1,000 or more we will make sure you get an engraved plaque on the solar system with your name, and a picture back to you! But all donations will be a great help, as every little bit counts. If you need any more information let me know. Walt or Ed will be glad to talk with you. I will get you in touch. And yes, I personally know and vouch for these guys. I am just not crazy enough to do some of the things they do.

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Bad back and all, you know? But I can write a check, and you can, too. So, in the Spirit of Christmas, to help those who simply need a chance to live, get out your checkbook.

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The world of economics is a very complicated space. Far too often we poor analysts seize upon some fact or trend and extrapolate that trend, suggesting that something is going to happen in the future because of it. The problem is that we look at that trend in isolation.

Take the lack of saving in the US. This is generally thought of as largely negative. Or what about the enormous trade deficit the US is running? How can it be a good thing that we are living on debt borrowed from the rest of the world to finance our conspicuous consumption? Something, all seemingly agree, must be done, or it will come to no good end.

The problem is that we look at the piece of the puzzle in isolation. It is what I have called the Super-Trend Puzzle. I am a big fan of jig-saw puzzles. (If you like online jig-saw puzzles, you can go to www.jigzone.com. There are hundreds of them with varying degrees of difficulty, and it is free.)

But the economic Super-Trend Puzzle is not as easy as the regular kind. In our economic puzzle, there are pieces which when played change the shape of the other pieces around them. The nice neat analogy we made, showing you, gentle reader, the future, now becomes murky and the picture is no longer clear. Things which “fit” last week now no longer can be forced together.

Peter Bernstein sent me the following paragraphs which he wrote in 2003, which are even more pertinent today. Peter has a grasp of economic history and investments that those of us who are merely mortal look upon with awe. At 80 plus and still writing and going strong, he is the author of numerous books. If you have not read “Against the Gods, the Remarkable Story of Risk” you are in for a treat. It is easily in the top 2 or 3 books I recommend for anyone to read. And any self-respecting gold bug will have “The Power of Gold” on his bookshelf, if not his desk. (www.amazon.com/gods or www.amazon.com/gold). Now, let’s look at his observations:

“Countless observers complain that the U.S. uses and demands more goods and services than it produces at home and has to make up the difference from abroad. Or they say that Americans save too little: we spend too much on consumption and put aside too little to provide for the future, releasing too few resources to meet the needs of business investment and home construction. Then Americans have to cover that shortfall by using the savings of foreigners. Or people say foreigners have been so eager to put their savings to work in the U.S. economy that they have driven up the value of the dollar, stimulating the demand for cheap imports in the U.S. and frustrating our exporters who are priced out of foreign markets. Or they say the government is the villain of the undersaving because it spends too much relative to the taxes we remit to it, or, perhaps,

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the tax revenues are too small relative to what the politicians want to spend. Indeed, one could argue that the import surplus deserves the blame for the budget deficit, because it contributes to the disinflation that results in the loss of jobs, poor profitability, and an insufficient flow of tax revenue to the IRS.

“All of these definitions of the American problem are correct – taken together. The key to the puzzle is that you cannot separate from the whole picture just one set of imbalances like government spending + taxing or importing + exporting. Private sector saving, private sector investment, household consumption, government spending, government revenues, capital flows, and the trade balance all react upon one another – often in surprising fashion. We live in a complex system: each piece tends to function as both symptom and cause.

“This inescapable truth makes life very complicated. Efforts to restore balance in one sector may accomplish no more than to upset the balance in another. The taxes the Democrats want to restore are likely to cut deeply into household savings rates, already uncomfortably low. Exhorting households to save more will mean lower consumption, which means loss of jobs, and dissaving by the unemployed – to say nothing of lower tax revenues and a widening government deficit. The permutations are endless.

“It is important to emphasize that the data pouring out unmercifully every minute of the day and night are only a record of the past. The measured imbalances between private sector saving and investment, government taxing and spending, or the deficit on international account are only a reflection of how each sector *has* reacted to the ongoing changes in the other sectors, including trading partners outside the U.S. Any resemblance between the data we see and what people anticipated at the beginning of any given time period is purely coincidental. The process is a dynamic one, in which outcomes for each player depend upon decisions made by all the other players and, as a result, almost all outcomes are a surprise and provoke responses of their own.

What of it?

“Of one thing we are certain: current trends are not sustainable. The imbalances are now enormous, far more glaring than at any point in the past. Furthermore, the linkages of the parts are so tightly knit into the whole that reducing any one imbalance to zero, or even compressing them all to a more manageable level, appears to be impossible without a major upheaval. A hitch here or a tuck there has little chance of success. When it hits, and whichever sector takes the first blows, the restoration of balance will be a compelling force roaring through the entire economy – globally in all likelihood. The breeze will not be gentle. Hurricane may be the more appropriate metaphor.” (Emphasis mine)

I suggest you read that last paragraph again and then let’s explore. After last year’s experience with hurricanes, we might all agree that a Katrina like economic gale would be most difficult.

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As an example, today's Wall Street Journal highlights a problem with the trade deficit with China. We have not only exported manufacturing jobs to China, we have also exported our economic volatility. If American consumers start to buy less "stuff," for whatever reason, it is China that would feel the brunt of the blow. The lay-offs in the factories would be over there and not here. Slower growth means China uses less oil and energy and commodities. It would also mean they become more resistant to floating their currency. It could also mean they simply lower prices in order to be able to keep factories running, further hurting what manufacturing we do have.

The world economy today depends upon the American consumer being willing to not save and to borrow if necessary to support their spending habits. It is a burden for which we seem genetically designed and one at which we clearly excel. We spend, they produce. They send us all manner of goods and we send them electronic dollars, which in a twist of irony they have lent to us. It is sort of the ultimate in vendor financing.

A Stable Disequilibrium

This is a remarkably tenuous set of circumstances. It is what Paul McCulley calls a stable disequilibrium. We all know that there are any number of unsustainable trends, which could cause a great deal of disequilibrium. But today these forces are stable, each balancing the other in a most precarious manner. Paul compares it to a marriage before divorce. Outwardly, it may appear stable, but there is clearly a great deal of disequilibrium going on inside.

What if China and Japan decided to stop buying our debt with their excess dollars? Would that not mean US interest rates rise? That would mean fewer homes sold and at the very least a dramatic slowing, if not a retreat on home prices. That would mean there would be much less mortgage refinancings. As we saw last week, that would drop GDP about 3% or more, pushing us to the edge of recession.

It would also mean foreign currencies would rise and the dollar fall. That would mean we would buy less foreign goods, and specifically Chinese, Japanese and Korean goods. Their economies would slow down, and perhaps move into recession, thus dropping the value of their currencies and reducing their already razor thin profit margins. China in recession would not be a very happy dragon. They need to create 20,000,000 new jobs a year. Hard to do that in a recession.

So, the game continues. They buy our debt. We buy their stuff. They know, as we saw last week from the quote from the Chinese banking official, they are going to get screwed (that is a technical economic term) on their dollar holdings. But what else can they do? They are on a treadmill and have to keep running just to stay in place.

Ultimately, in the fullness of time, China and the rest of Asia will have to develop their own consumer spending machines. They are off to a good start, but no where close to where they will need to be. And the fullness of time will take at least a decade, if not longer.

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(You think the Chinese won't be world class consumers given the chance? Read the recent Fortune article on the cosmetics market in China.)

Ultimately, the US is going to spend less and save more. I know, doubting the ability of the US consumer has been a losing call for 50 years, but we are getting closer to the time when consumer spending on "stuff" is going to slow. How can I say this?

For several reasons. First, we are going to see spending on health care rise another 3% in the next 8 years. That is almost \$400 billion dollars. It will still be spent, just not on stuff. We will have to drive the car a year longer, take a shorter vacation, make do with last year's computer. Health care expenses trump computers, Ipod's and cell phones. Folks, a shift of 3% in spending preference is huge. It is a tsunami of change.

Secondly, saving patterns are going to change. When, not if, we see the next economic slowdown, we will see another drop in the stock market. If we get a full blown recession, the average drop is 43%. I think boomers will begin to slowly panic as they watch their retirement dreams drop faster than the NASDAQ 100. It will be the usual process. Denial, anger, despair and finally reality hits and they re-set expectations and start a new plan which will mean more saving and less spending.

The first of the baby boomers reach 62 in 2007. We are looking retirement in the eye. Old age is way too close. Objects in the mirror may be nearer than they appear. As boomers start to retire, they are by definition going to spend less because they will be making less.

Further, a great deal, as much as 3% of GDP growth has come from mortgage refinancing. This was easy when rates were dropping. You could refinance your home, take some cash out and still have lower payments. The easy part of that trade is just about over. We are watching mortgage refinancing applications slow. This simply has to have an impact on consumer spending.

While this slowdown from boomers will be partially offset by population growth (primarily from immigration), inflation and other factors, I do not think it will be enough to offset the effects entirely.

Taken together, what it all means is that growth in consumer spending is going to slow dramatically over the next 5 years. No sudden fall-off-the-cliff experience, just a gradual Muddle Through slowdown as the imbalances are into a more stable equilibrium.

And gradual is what everyone is hoping for. It is the best of all possible worlds. Asia and China in particular need time to build up their own consumer classes while we adjust to saving more and a gradually falling dollar. No sudden shocks, other than the normal ups and downs of the business cycle, is what governments, central bankers, business, investors and consumers all want to see happen.

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In game theory, the **Nash equilibrium** (named after John Nash) is a kind of optimal strategy for games involving two or more players, whereby the players reach an outcome to mutual advantage. If there is a set of strategies for a game with the property that no player can benefit by changing his strategy while (if) the other players keep their strategies unchanged, then that set of strategies and the corresponding payoffs constitute a Nash equilibrium. (ohn Nash, the Nobel laureate in mathematics was featured in the movie "A Beautiful Mind." Highly recommended, by the way.)

While the game can go on for much longer than reason would dictate, there will be an end to it. Will it be the soft landing with nations agreeing to work together to find a sort of Nash equilibrium; or, the hard landing where the "vacuous rhetoric of globalization" (to quote Stephen Roach) masks the reality of each nation going its own way, in a kind of "devil take the hindmost" world?

Can it happen? Can things go that smoothly? Sadly, probably not. It will probably be, as Bernstein notes, an economic storm. Something will push somewhere on the disequilibrium and the stability that we now sees shifts. The world enters a new Nash equilibrium moment, where all the players begin to adjust and try to secure their optimum situation.

Sounds scary. And it will be. But most people in the world will not notice. How much do you remember of the Asian Crisis in 1998? That was a pretty scary moment for the global economy, yet the world muddled through. It would qualify as a category 4 economic hurricane. Yet we will make it through this next adjustment period as well.

But wishing that we could see our savings rate go back to the mid-teens, or that our trade deficit was zero or any number of seemingly desirable events will mean that the pieces of the puzzle change shape. Getting what we wish for too soon may not be something we will actually want.

A Few Thoughts on Consumer Debt

US consumers owe \$11 trillion, with 8.2 trillion of it being mortgage debt (data source: US Federal Reserve). On a graph it looks monstrous, rising over 20 times in the last 30 years. Yet things are not all that bad.

First, mortgage debt is rising because we have a lot more homeowners, both because of population growth and more people on a percentage basis own homes. Admittedly, some of them are less than prime mortgages, but I contend that is a good thing. What kind of elitist prig would say to someone who is trying to improve their lot in life that they should not buy a home because their credit is less than pristine? In a free market, you let people make their own decisions. And if banks are willing to take the risk, hedging their portfolios? More power to everyone.

Hernando Desoto writes about a 20 year study of the people in a particularly poor part of Peru. They found out that the single biggest factor for financial improvement was

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owning a home. Even if they owned a home in what was essentially a slum, over time their economic lot in life improved as compared to their neighbors who did not own a home.

It should be the policy of this country, and it is, to make home ownership as easy and as affordable as possible. People who own homes have a stake in the community and the system. And if they make those payments over time they have an asset.

Further, on a percentage of disposable income basis, the mortgage and consumer credit debt are not all that out of line with what they were 25 years ago. In 1980 consumer debt service payments was 5.61% of disposable income. Today it is 5.85%. Mortgages have risen from 8.13% to 10.76%. Now, there are clearly a lot of households who are in much worse shape. But as a nation, we are not all that bad. We have a debt load we can now handle. If only we could get the government to balance their budgets.

We will conclude this series next week, looking at more of the pressures on the system and speculate as to how the whole process will play out.

Merry Christmas, Family and Friends,

I love this time of year. All 7 kids and their assorted significant others (wives, boyfriends, girlfriends, etc.) will be in town for Christmas. I will be cooking again and this time will try to get the roast right. I overcooked it at Thanksgiving, much to my chagrin.

And on a personal soapbox, am I missing something? This is supposed to be a season of peace and joy. If you want to say Happy Holidays or Merry Christmas or whatever, then just relax and do it. Fighting about the appropriate greeting just seems to be a little over the top, given the reason for the season to begin with. If you want to get worked up about something, think of all the people in less than pleasant circumstances who are just trying to survive, and figure out how to help them. If not helping the guys at Knightsbridge with a check, then find your own special group to help.

Tonight is a very special occasion, as Peter and Barbara Bernstein are in town to see his grandkids and we get to have dinner with them. I have a special bottle of a 1994 David Bruce Petite Syrah which won best of show out of 1800 wines. For some odd reason, Bruce thought it would be wrong to raise the price and I bought the last two cases at bargain prices. It is now time to open these bottles. I have to say it is like liquid velvet. But who better to share it with than Peter, who is a perfect vintage himself?

Family and friends make life more than Muddle Through. And I consider my Thoughts from the Frontline readers as part of my larger family. I am grateful you let me come into your life each week. It is a privilege to be able to share my musings with you.

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Amidst all the hustle and bustle, let's remember that it was a gift of personified Love that is the reason for our celebration. So let me say Merry Christmas, and may God Bless Us, Everyone!

Your gonna have to get back on his diet soon analyst,

John Mauldin