

Empire of Debt

Empire of Debt Evening in America America as Empire The Grinch, Disrupting Paradigms and a New Element Found

By John Mauldin

“The economy in its entirety must continue to decline so long as more is being consumed than produced, and some part of consumption therefore takes place at the expense of the existing capital stock.” - Friedrich August von Hayek

For the past few weeks we have looked at the argument for the case “This time it’s different,” made eloquently in a 130 page book called “Our Brave New World” by the very bright minds behind GaveKal Research. The trade deficit of the US does not matter, they aver. For the next few weeks we turn to look at the opposite view, made by Bill Bonner along with Addison Wiggin in their new 370 page book, Empire of Debt. Not only do they tell us that things are not different, but that the end result will be the same as it has always been. And for the curious, the end result is not a pleasant thing.

Where GaveKal sees a rising dollar, Bonner and Wiggin see the Demise of the Dollar (the title of a separate book by Wiggin). Where GaveKal sees promise and positive benefit in a negative balance of trade, Bonner and Wiggin see hubris and peril. Is it an Empire of Debt about to go the way of all empires, or a Brave New World? Let us make no mistake, these are polar opposite views. And where you come down makes a large difference in how you manage your investment portfolio, not to mention how you order your future. This will make for an interesting, if not altogether fun, letter. Warning: you are about to enter a major doom and gloom zone.

Just One Thing

But before we get too deep in Bill’s book, let me mention my latest book, Just One Thing and Christmas shopping at the same time. Or let Ole Bredberg from Spain do it for me:

“What a brilliant publishing idea! It’s a page turner and each contribution is priceless. A great idea for many disciplines. Also, it took care of my Christmas book gift campaign for this year. Congratulations!” - Ole

Just One Thing is a collection of 11 of the world’s best investment minds (as well as your humble analyst, to make 12 chapters in all) writing about the one thing they are most passionate about. Richard Russell, Gary Shilling, George Gilder, Bill Bonner, Andy Kessler and seven other equally brilliant minds give you their one best shot. The reviews have been quite good overall. It seems that everyone has a different favourite chapter. Just the top two from Amazon:

Empire of Debt

“Excellent collection of investment wisdom, with each chapter written by a different person. One can pick up the book and read the chapters in any order. I liked the style and the fact that the contributing authors have different perspectives and approaches to the market. There is a lot of information in this book that can be gleaned without committing to reading a few hundred pages by any one of the individual contributors. Well worth the time. – Kendra Loomis”

“I love finance but have a hard time understanding the hard core stats that get tossed around in typical literature. Just One Thing puts the best, most concise concepts and packages them so that I can understand and benefit. I can look for ways to put the concepts into practice by searching for the basic idea put forth, rather than a specific trend. – Kenneth Lynch

You can get the book by going to www.amazon.com/justonething or from your local store. If you want an autographed copy, just reply to this email and my staff will get back to you with details, in time for the holidays! And now back to our regularly scheduled program.

Empire of Debt

For readers new to this series, let me start at the beginning. It was in a restaurant in London that Charles and Louis-Vincent Gave (the Gaves of GaveKal) invited me to dinner. Always one to enjoy a little dinner theatre, I invited good friend Bill Bonner (and besides, they were picking up Bill’s bar tab). Louis proudly handed Bill and me a copy of their new book. He did not know Bill had his own tome coming out in a few weeks containing the anecdote to such unbridled optimism.

It only took a few questions and the fun began. Bill was fascinated, the way one is fascinated when meeting a long lost cousin come to help divide the inheritance, to meet someone who could so joyously proclaim that this time it’s different. “But it never is,” he said. (You can read those letters by clicking on the archives and reading the November 11 and 25 editions of Thoughts From the Frontline.)

Now, just to keep the record straight, the following is my review of Bill’s argument in Empire of Debt. I do not necessarily agree with every point. In fact, I have serious reservations about some of them. That holds true with the two letters I did on GaveKal’s book. Some readers assumed that the views of GaveKal in the above two letters are my own. Wrote one irate reader,

“I think you are truly an odious individual. While the rest of us with more spine (including your so-called ‘friend,’ Bill Bonner - God knows why that intellectual giant would want to be friends with you) stick our necks out and predict the obvious.” There was more. It went seriously downhill from there. He was evidently not amused. I was. I have never been called odious before. Many things, but not that. It is nice to have readers with such original and fair-minded flair. You gotta love it. It is why your humble analyst stays humble. Keep those cards and letters coming.

Empire of Debt

What I did the last few weeks, and will the next two weeks, is to try and present their arguments as well as I can. I can guarantee you that just as the Gaves and Anatole Kalinsky really upset some readers, Bonner will do so in spades. Both books address deeply held beliefs in which many people have invested a great deal of emotion. They have bet their investments and retirements on such ideas, as well as their politics and do not like to be told they might be wrong.

Bill acknowledges he could be wrong, even though he believes strongly in his ideas. He enjoyed the open give and take at dinner. GaveKal clearly acknowledges the danger of saying this time it's different. But an equally clear danger, and one far more common, is to say I am not interested in ideas which differ from my own belief system, or to hold on to ideas which the market is rejecting. The market can be wrong longer than you can remain solvent.

I will take up the task of offering my own view after we review both positions. I think it is both different this time and yet I see a rhyme that tells me that old dangers are still present. I suspect that things will unfold quite differently than in the past. This is a world where change will come faster and faster, altering the old patterns just enough to both frustrate and tempt us to bold, albeit wrong, actions. Only the curious, those who adapt to the new realities playing out in old patterns, will survive. Investing today in the same things that worked in the 80's or 90's, or betting on a repeat of the 70's, is going to be a very frustrating game.

(Bill publishes and writes for the Daily Reckoning, which is a free investment e-letter. You can sign up for free by going to <http://www.dailyreckoning.com/Sub/JMauldin.html> .)

Evening in America

There are two stories in Empire of Debt. The first is the traditional argument of the Austrian economic school. You cannot forever run trade deficits. Eventually your currency will collapse, as people will not want any more of it. To repeat the quote at the beginning of the letter:

“The economy in its entirety must continue to decline so long as more is being consumed than produced, and some part of consumption therefore takes place at the expense of the existing capital stock.” - Friedrich August von Hayek (Nobel Laureate, 1974)

But the evidence of that decline is not yet present. America and its currency seem to continue to prosper, even when no other nation has ever run such huge deficits without seeing a major, if not disastrous, currency revaluation. How can this be?

Can we in fact borrow our way to success? Rather than save and invest in new capital production, we ship production of our goods and now even our services offshore, and hope other nations will finance our debt.

Empire of Debt

“As the Anglo-Saxon economies lost their competitive edge in manufacturing, they tried to make up for it by encouraging consumption. This is the biggest fraud of all. At first, higher consumption feels good. It is like burning the furniture to keep warm; it feels good for a moment. But the sense of well-being is extremely short-lived. When people borrow and spend, they feel as though they are getting richer—especially when their houses are rising in price. The increased consumption even shows up, indirectly, in the GDP figures as growth. But you don’t really become wealthier by consuming. You become wealthier by making things you can sell to others—at a profit. The point is obvious but, at this stage of imperial finance, it was inconvenient.” – Empire of Debt, page 224.

You cannot borrow and consume your way to riches. Yet our national debt - private, corporate and public - just keeps soaring. However you want to measure it, in absolute terms or as a percentage of GDP or income, debt is up and continues to climb. This has been encouraged by a Federal Reserve which has engineered low interest rates, encouraging consumers to take on more debt.

“The continuous injection of additional amounts of money at points of the economic system where it creates a temporary demand, which must cease when the increase of money stops or slows down, together with the expectation of a continuing rise in prices, draws labor and other resources into employments which can last only so long as the increase of the quantity of money continues at the same rate—or perhaps even only so long as it continues to accelerate at a given rate . . . would rapidly lead to a disorganization of all economic activity.” F. A. Hayek

So, one of the main themes in the book details how the increase in debt in America, combined with both trade and government deficits, must end in tears. One cannot spend oneself into riches, whether as an individual or as a country.

This is a fairly straight-forward subject, and one with which many readers will find themselves nodding in agreement. It has been the way of the world since the Medes were trading with the Persians. If you do not produce more than you consume, eventually you will end up in poverty or at the very least in lesser economic circumstances.

America as Empire

But how did we get here? How did we get to a place where we run \$700 billion(!) trade deficits? How did we arrive at a time when foreigners own an ever increasing percentage of US debt, where savings in the US is negligible and we consume some 70-80% of the rest of the world’s saving so that we can continue to consume? We are beholden to the kindness of strangers, and more specifically China and Japan. The authors contend that if they pull the plug – if they stop buying our debt - our currency will collapse, our interest rates soar and our housing market collapse, sending us into a deep recession.

Empire of Debt

And thus we arrive at the second theme in the book. However, this is one which is far more troubling. It pricks at our national conceits, at the very value and beliefs that we as Americans hold about ourselves. We (or most of us) see ourselves as the good guys. Bonner and Wiggin see that view .

Bonner sees the United States as an empire. That in and of itself is not exactly a new thought. Many hold that line of thinking, and do so proudly. Pax Americana makes the world a better place. Niall Ferguson contends that it is all that holds the world back from another Dark Ages. Someone has to order the world and make people and countries play nice. If there is a real problem, who you gonna call? The French? Get real.

For Bonner, being an Empire is not a good thing, even though he readily admits that America is not the traditional empire of old. All empires must come to an end. So how will the American Empire end? For Bonner, it is in debt.

Full disclosure: Bonner and Wiggin are libertarians. They are advocates of a minimalist government. And they also do not believe in nation building. They believe that government intervention into problems causes more problems, rather than solves them. And that specifically includes military and central bank intervention. But let's look at several paragraphs from their introduction. This is rather long, but it sets the stage properly. Be warned that this is going to upset many readers (especially Texas Republicans like your humble analyst!).

“...Let us begin by noticing that this is a comic opera that seems as though it might veer into tragedy at any moment. The characters on stage are familiar to us—consumers, economists, politicians, investors, and businessmen. They are the same hustlers, clowns, rubes, and dumbbells that we always see before us. But in today's performance they are doing something extraordinary, they are the richest people on the planet, but they have come to rely on the savings of the world's poorest people just to pay their bills. They routinely spend more than they make—and think they can continue doing so indefinitely.

“They go deeper and deeper in debt, believing they will never have to settle up. They buy houses and then mortgage them out—room by room, until they have almost nothing left. They invade foreign countries in the belief that they are spreading freedom and democracy, and depend on lending from Communist China to pay for it.

“But people come to believe whatever they must believe when they must believe it. All these conceits and illusions that we find so amusing in the Daily Reckoning come not from thinking, but from circumstances. As they say on Wall Street, “markets make opinions,” not the other way around. The circumstance that makes sense of this strange performance is that the United States is an empire — whether we like it or not. It must play a well-known role on the world stage, just as you and I must play our roles, not because we have thought our way to them, but simply because of who we are, where we are, and when we are.

Empire of Debt

“Primitive people play primitive roles. They are no less intelligent than the rest of us, but they would be out of character if they began doing calculus. They have their parts to play just as we do. Sophisticated people play sophisticated roles. They are no smarter than anyone else, but you still don’t expect them to wear bones through their noses. We, citizens of the last great empire, have our roles to play too, and the empire itself, must do what an empire must do.

“Institutions have a way of evolving over time—after a few years, they no longer resemble the originals. Early in the twenty-first century, the United States is no more like the America of 1776 than the Vatican under the Borgia popes was like Christianity at the time of the Last Supper, or Microsoft in 2005 is like the company Bill Gates started in his garage.

“Still, while the institutions evolve, the ideas and theories about them tend to remain fixed; it is as if people hadn’t noticed. In America, all the restraints, inhibitions, and modesty of the Old Republic have been blown away by the prevailing winds of the new empire. In their place has emerged a vainglorious system of conceit, deceit, debt, and delusion. The United States Constitution is almost exactly the same document with exactly the same words it had when it was written, but the words that used to bind and chaff have been turned into soft elastic. The government that couldn’t tax, couldn’t spend, and couldn’t regulate, can now do anything it wants. The executive has all the power he needs to do practically anything. Congress goes along, like a simple minded stooge, insisting only that the spoils be spread around. The whole process works so well that a member of Congress has to be found in bed “with a live boy or a dead girl” before he risks losing public office.

“American businesses are still capitalistic. They operate, as everyone knows, in the most dynamic, free, and open economy in the world. A recent press item reports, that General Motors will never be able to compete unless it ditches its crushing health care costs. Why does it not just cut the costs? It seems to lack either the nerve or the right, but the journalist proposed a solution: Nationalize health care!

“Meanwhile, CEO pay has soared to the point where the average chief executive in 2000 earned compensation equal to 500 times the average hourly wage. Stockholders, whose money was being squandered, barely said a word. They were still under the illusion that the companies were working for them. They had not noticed that the whole capitalist institution had been trussed up with so many chains, wires, red tape, and complications, it no longer functioned like the freewheeling, moneymaking corporations of the nineteenth century.

“Meanwhile, corporations in China—a communist country—had their hands and feet free to eat our lunches and kick our derrieres. The entire homeland economy now depends on the savings of poor people on the periphery to keep it from falling apart. Americans consume more than they earn. The difference is made up by the kindness of strangers — thrifty Asians whose savings glut is recycled into granite countertops and flat-screen TVs all over the United States.

Empire of Debt

“... If you deny that the United States is now an empire, you are as big a fool as we were. For a very long time we resisted the concept. We did not want the United States to be an empire. We thought it was a political choice. We liked the old republic of Jefferson, Washington, the U.S. Constitution . . . the humble nation of hard money and soft heads; we didn't want to give it up. We thought that if the United States acted as though it were an empire it was making an error.

“What morons we were. We missed the point completely. It didn't matter what we wanted. There was no more choice in the matter than a caterpillar has a choice about whether to become a butterfly.

“This was an important insight for us. Until then, all of the blustering and slapstick pratfalls on stage seemed like “mistakes.” Why would the United States run such huge trade deficits, we wondered. It was obviously a bad idea, the nation was ruining itself. And why would it launch an invasion of Iraq or begin a war on terror—both of which were almost certain to be costly blunders. It was as if the United States wanted to destroy itself—first by bankrupting its economy, and second by creating enemies all over the globe.

“Then, we realized, that of course, that is exactly what it must do. We repeat, people come to believe what they need to believe when they need to believe it. America is an empire; its people must think like imperialists. In order to fulfill their mission, the homeland citizens had to become what George Orwell called “hollow dummies.” An imperial people must believe that they deserve to be the imperial power—that is, they must believe they have the right to tell other people what to do. In order to do so, they must believe what isn't true—that their own culture, society, economy, political system, or they themselves are superior to others.

“It is a vain conceit, but it is so bright and so big it exercises a kind of gravitational pull over the entire society. Soon, it has set in motion a whole system of shiny vanities and illusions as distant from the truth as Pluto and as bizarre as Saturn. Americans believe they can get rich by spending someone else's money. They believe that foreign countries actually want to be invaded and taken over. They believe they can run up debt forever, and that their debt-laden houses are as good as money in the bank. That is what makes the study of contemporary economics so entertaining. We sit at our telescopes and laugh like a divorce lawyer looking at photos of a rich man in flagrante delicto; we know there's money to be made.”

But America is not an empire in the traditional sense. The Mongols or Romans conquered and demanded taxes, (a rapacious 10% or so). The British and French took commodities and cheap goods. Americans send an army and then pay hundreds of billions to the conquered.

How did we become an Empire? Bonner points to its beginning in 1913, when both the income tax and the Federal Reserve were created. These were the building tools

Empire of Debt

which could finance an empire. What tribute does the American Empire require? If you use our dollars, you have had a depreciating asset over time. The dollar will buy a mere nickel's worth of what it did in 1913.

The second major event on the road to empire was Nixon closing the gold window, allowing the Fed and the government room to manipulate the currency as they saw fit. And of course, the New Deal, deficit financing and a host of other government solutions all contribute.

In the same way that investors think that tech stocks would only go up in 1999, or gold in 1979, Bonner and Wiggin see a country which thinks that its stock will only rise. Since that has been the case for 225 years, why should it be different now?

Yet, they quote, "The U.S. suffers from . . . structural deficits that will limit the effectiveness and duration of its crypto-imperial role in the world," explains Niall Ferguson. "The first is the nation's growing dependence on foreign capital to finance excessive private and public consumption. It is difficult to recall any empire that has long endured after becoming so dependent on lending from abroad." (Niall Ferguson, "The End of Power: Without American Hegemony the World Would Likely Return to the Dark Ages," *Wall Street Journal*, June 21, 2004.)

And thus we come to it. To Bonner and Wiggin, America is on a course to a soft depression brought on by debt precisely because we have become an empire. We have spent the income of future generations in order to consume today, amassing a staggering debt that grows ever larger. We have obligated our children to pay a Social Security and Medicare burden that they simply will not have the means to pay as things currently stand. The generational contract will be broken because it cannot be paid.

This is not your ordinary run of the mill doom and gloom. It captures a whole new level, for it is an inevitable doom. We are slouching toward an evening in America, unaware of our own fate. Thus have all empires ended, either with a whimper or a bang. They make a good case. The question is, can we ignore it? Are they wrong, or will somehow things be different?

Next week, we will look at the numbers surrounding our debt, and the not surprising answer that Empire of Debt offers: buy gold. Plus, they have a few more thoughts on ways to profit and enjoy the ride.

You can get Empire of Debt at www.amazon.com/empire. You can also get a copy of Our Brave New World at www.gavekal.com. I suggest you get the book which you think will most upset you, if not both.

The Grinch, Disrupting Paradigms and a New Element Found

Reviewing today's letter makes me feel somewhat like the Grinch that stole Christmas. This is not the season for such hard news. Better to write of visions of family,

Empire of Debt

friends and food. This is actually a very hard thing for me to do. I am not used to simply providing other viewpoints without jumping in and quickly offering my own commentary. I have a number of thoughts about both books and look forward to the time when I will put them to computer screen. We will try to enter the New Year on a more positive note. Stay tuned.

This week I had the opportunity to look at a small private firm which is developing a new wireless platform. “Everyone” knows we will someday be wireless everything – cable, phones, internet, TV, video, etc. What I saw says that someday is just around the corner. I look forward to sharing with you what I learned. It is one of the most disruptive, in a positive sense of the word, technologies I have seen. I had no idea we were “almost there.”

About a month ago, I wrote that before the end of the year I would be developing a web site recommending money managers for the average (if any of my readers can be said to be average) investor. Unfortunately, the close friend I was working with developed a very serious illness. We have re-grouped and should be online shortly after the first of the year. Mac, I wish you a very quick recovery.

In the meantime, if you are an accredited investor (meaning more or less a net worth of \$1,000,000 or more, see the actual definition on the web site below) and live in the US, Canada or Europe, let me suggest you go to my website www.accreditedinvestor.ws. If you are interested in hedge funds, commodity funds and private offerings, we offer information and access to managers we like. (“We” being my partner firms in the various countries or regions.) The information is on the web site.

(In this regard, I am president and a registered representative of Millennium Wave Securities, LLC, member NASD.)

And finally, my friend Gary Halbert sent me the following item. It seems to fit today’s theme, and I offer it for your amusement.

NEW ELEMENT FOUND!

The recent hurricanes and skyrocketing oil and gasoline prices helped to prove the existence of a new element. In early October 2005, a major research institution announced the discovery of the heaviest element yet known to science. The new element has been named “Governmentium.”

Governmentium (Gv) has one neutron, 25 assistant neutrons, 88 deputy neutrons, and 198 assistant deputy neutrons, giving it an atomic mass of 312. These 312 particles are held together by forces called ‘morons’ which are surrounded by vast quantities of lepton-like particles called ‘peons.’ Since Gv has no electrons, it is inert. However, it can be detected, because it impedes every reaction with which it comes into contact. A minute amount of Gv causes one reaction to take over four days to complete, when it would normally take less than a second!

Empire of Debt

Gv has a normal half-life of 4 years; it does not decay; but instead undergoes a reorganization in which a portion of the assistant neutrons and deputy neutrons exchange places. In fact, Governmentium's mass will actually increase over time, since each reorganization will cause more morons to become neutrons, forming 'isodopes.' This characteristic of moron promotion leads most scientists to believe that Gv is formed whenever morons reach a certain quantity in concentration. This hypothetical quantity is referred to as 'Critical Morass.'

When catalyzed with money, Gv becomes "Administratium" (Am) - an element which radiates just as much energy as Gv, since it has half as many peons but twice as many morons.

Have a great week. My weekend will be fun, with Maverick basketball, Christmas decorations, a little shopping and some much needed workouts. Ok, just one quick thought from my future comments. We will Muddle Through. No depression, soft or otherwise.

Your not quite ready for the holidays analyst,

John Mauldin

PAST RESULTS ARE NOT INDICATIVE OF FUTURE RESULTS. THERE IS RISK OF LOSS AS WELL AS THE OPPORTUNITY FOR GAIN WHEN INVESTING IN MANAGED FUNDS OR ANY ALTERNATIVE INVESTMENT PRODUCT.

WHEN CONSIDERING ALTERNATIVE INVESTMENTS, INCLUDING HEDGE FUNDS, YOU SHOULD CONSIDER VARIOUS RISKS INCLUDING THE FACT THAT SOME PRODUCTS: OFTEN ENGAGE IN LEVERAGING AND OTHER SPECULATIVE INVESTMENT PRACTICES THAT MAY INCREASE THE RISK OF INVESTMENT LOSS, CAN BE ILLIQUID, ARE NOT REQUIRED TO PROVIDE PERIODIC PRICING OR VALUATION INFORMATION TO INVESTORS, MAY INVOLVE COMPLEX TAX STRUCTURES AND DELAYS IN DISTRIBUTING IMPORTANT TAX INFORMATION, ARE NOT SUBJECT TO THE SAME REGULATORY REQUIREMENTS AS MUTUAL FUNDS, OFTEN CHARGE HIGH FEES, AND IN MANY CASES THE UNDERLYING INVESTMENTS ARE NOT TRANSPARENT AND ARE KNOWN ONLY TO THE INVESTMENT MANAGER.

The Accredited Investor E-letter is not an offering for any investment. It represents only the opinions of John Mauldin and Millennium Wave Investments. It is intended solely for accredited investors who have registered with Millennium Wave Investments and **Altegris** Investments at www.accreditedinvestor.ws or directly related websites and have been so registered for no less than 30 days. The Accredited Investor E-Letter is provided on a confidential basis, and subscribers to the Accredited Investor E-Letter are not to

Empire of Debt

send this letter to anyone other than their professional investment counselors. Investors should discuss any investment with their personal investment counsel. John Mauldin is the President of Millennium Wave Advisors, LLC (MWA), which is an investment advisory firm registered with multiple states. MWA is also a Commodity Pool Operator (CPO) and a Commodity Trading Advisor (CTA) registered with the CFTC, as well as an Introducing Broker (IB). John Mauldin is a registered representative of Millennium Wave Securities, LLC, (MWS), an NASD registered broker-dealer. Millennium Wave Investments is a dba of MWA LLC and MWS LLC. Millennium Wave Investments and **Altegris** Investments are independent firms that cooperate in the consulting on and marketing of private investment offerings. Funds recommended by Mauldin may pay a portion of their fees to **Altegris** Investments, who will share 1/3 of those fees with MWS and thus with Mauldin. Any views expressed herein are provided for information purposes only and should not be construed in any way as an offer, an endorsement, or inducement to invest with any CTA, fund, or program mentioned here or elsewhere. Before seeking any advisor's services or making an investment in a fund, investors must read and examine thoroughly the respective disclosure document or offering memorandum. Since **Altegris** and Mauldin receive fees from the funds they recommend/market, they only recommend/market products with which they have been able to negotiate fee arrangements.