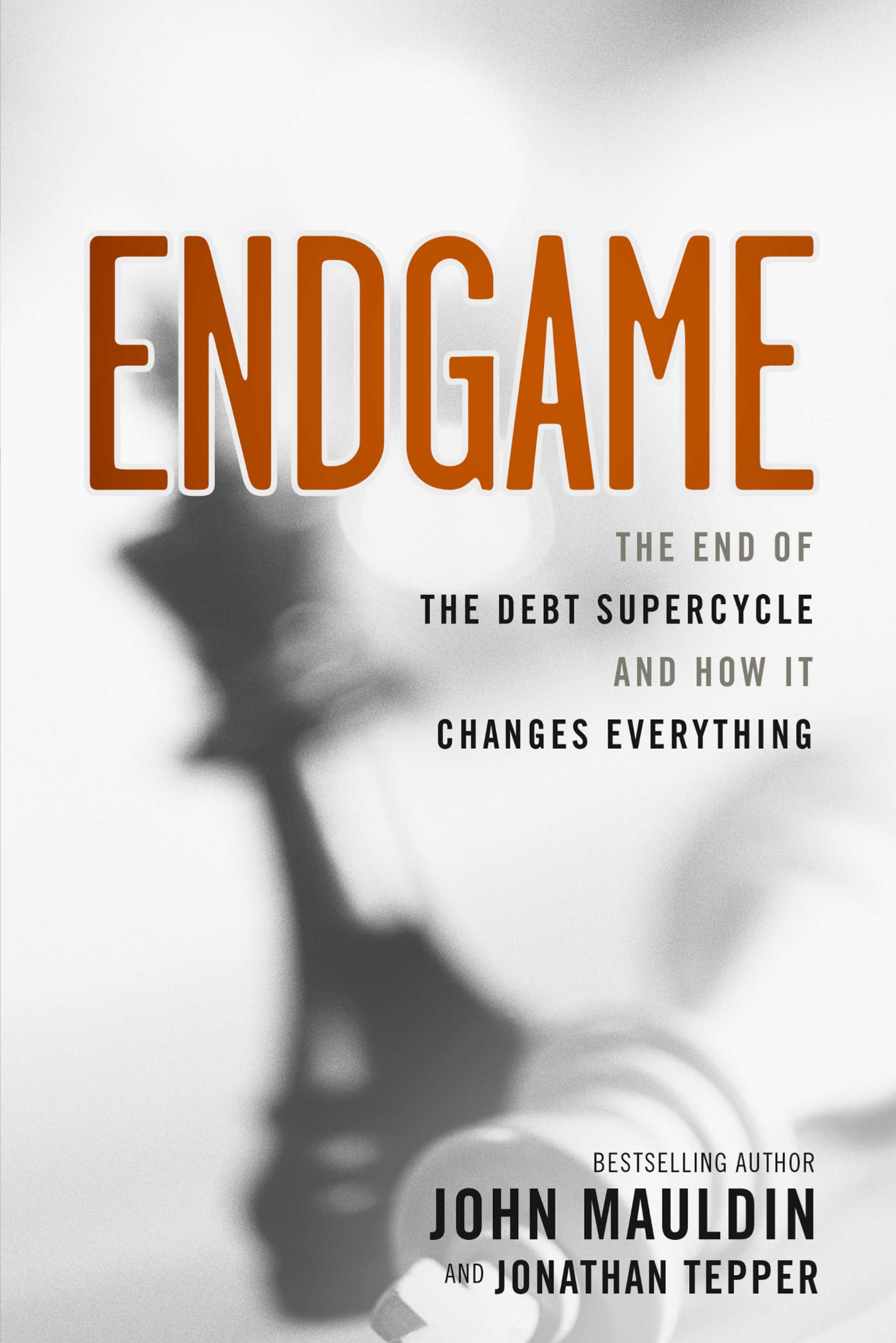

ENDGAME

THE END OF THE DEBT SUPERCYCLE AND HOW IT CHANGES EVERYTHING

BESTSELLING AUTHOR
JOHN MAULDIN
AND JONATHAN TEPPER

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"There's clearly something important going on in the world economy. Something big. Something powerful and dangerous. But something as yet undefined and uncertain. We are all feeling our way around in the dark, trying to figure out what it is. John Mauldin must have night-vision glasses. He does an excellent job of seeing the obstacles. You should read this book before you knock over a lamp and stumble over the furniture."

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"*Endgame* not only is a highly readable and informative account of the causes of the recent global economic and financial meltdown, but it also provides investors with a concrete investment strategy from which they can benefit while this final act in financial history is being played out."

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"I think the book is brilliant. It is well written, crystal clear, and hits the spot. My favorite chapters are the ones on fingers of instability (which I think everyone in finance should read and reread each year lest they forget), and the one on Eastern Europe as both a leading indicator for what's in store and a potential land mine that could yet do for the euro what Credit Anstaldt did for the gold standard. But it's a tough call. Lots of very good stuff in here."

—Dylan Grice, Global Strategy Team, Societe Generale

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JOHN MAULDIN
JONATHAN TEPPER

WILEY

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This book is dedicated to Peter Bernstein.

Peter Bernstein 1919–2009
Amazing author, devoted husband, loving father
Mentor to generations of investment professionals
A man whose wisdom was always welcome
And who saw The Endgame clearly before everyone

You are missed, my friend, now more than ever
when your wisdom is most sorely needed.

In order to improve your game, you must study the endgame before everything else, for whereas the endings can be studied and mastered by themselves, the middle game and the opening must be studied in relation to the endgame.

Jose Raul Capablanca,
Cuban chess player who was world chess champion from 1921 to 1927
and one of the greatest players of all time

Contents

Acknowledgments xiii

Introduction: Endgame 1

Part One: The End of the Debt Supercycle **11**

Chapter 1: The Beginning of the End 15
Chapter 2: Why Greece Matters 31
Chapter 3: Let's Look at the Rules 45
Chapter 4: The Burden of Lower Growth and More Frequent Recessions 73
Chapter 5: This Time Is Different 91
Chapter 6: The Future of Public Debt: An Unsustainable Path 109
Chapter 7: The Elements of Deflation 133
Chapter 8: Inflation and Hyperinflation 157

Part Two: A World Tour: Who Will Face Endgame First? **175**

Chapter 9: The United States: The Mess We Find Ourselves In 181
Chapter 10: The European Periphery: A Modern-Day Gold Standard 215
Chapter 11: Eastern European Problems 233
Chapter 12: Japan: A Bug in Search of a Windshield 247
Chapter 13: The United Kingdom: How to Quietly Inflate Away Your Debt 261
Chapter 14: Australia: Could It Follow in Ireland's Footsteps? 273
Chapter 15: Unintended Consequences: Loose Monetary Policies and Emerging Markets 283

Conclusion: Investing and Profiting from Endgame 293
Epilogue: Some Final Thoughts 297
Notes 301
About the Authors 309
Index 311

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ENDGAME

INTRODUCTION

Endgame

People only accept change in necessity and see necessity only in crisis.

—Jean Monnet

Every child learns about the Great Depression in school, but economists, historians, and commentators have not agreed on what we will call the turbulent economic period we are currently living in. Some do call it a depression. Others call it the Great Recession. And some refer to it as the Great Financial Crisis. The Great Financial Crisis is particularly apt, because crises force us to make difficult choices. And one thing that everyone can agree on is that this new era of turbulence will impose difficult choices on governments and voters around the world.

I (John)* am somewhat of an expert on bad choices—not only my own, but I have had the joys of seven teenage children. As our family grew, we limited the choices our kids could make, but as they grew into teenagers, they were given more leeway. Not all of their choices were good. How many times did Dad say, "What were you thinking?" and get a mute reply or a mumbled "I don't know."

Yet how else do you teach them that bad choices have bad consequences? You can lecture, you can be a role model, but in the end you

*Throughout the book, when the first-person *I* is used, the name in the following parentheses will be the person speaking. When we use the word *we*, it refers to John and Jonathan.

have to let them make their own choices. And a lot of them make a lot of bad choices. After having raised six, with one more teenage son at home, I have come to the conclusion that you just breathe a sigh of relief if they grow up and have avoided fatal, life-altering choices. I am lucky. So far. Knock on a lot of wood.

I have watched good kids from good families make bad choices, and kids with no seeming chance make good choices. But one thing I have observed: Very few teenagers make the hard choice without some outside encouragement or help in understanding the known consequences, from some source. They nearly always opt for the choice that involves the most fun and/or the least immediate pain and then learn later that they now have to make yet another choice as a consequence of the original one. And thus they grow up. So quickly.

But it's not just teenagers. I am completely capable of making very bad choices as I approach the beginning of my seventh decade of human experiences and observations. In fact, I have made some rather distressing choices over time. Even in areas where I think I have some expertise, I can make appallingly bad choices. Or maybe particularly in those areas, because I have delusions of actually knowing something. In my experience, it takes an expert with a powerful computer to truly foul things up.

Of course, sometimes I get it right. Even I learn, with enough pain. And sometimes I just get lucky. (Although, as my less-than-sainted Dad repeatedly intoned, "The harder I work, the luckier I get.")

Each morning is a new day, but it is a new day affected by all the choices of the previous days and years. My daughter Tiffani and I have literally interviewed in depth more than a hundred millionaires and talked anecdotally with hundreds more over the years. I am struck by how their lives, and those of their families, come down to a few choices: sometimes good choices and sometimes lucky choices; often, difficult ones. But very few were the easy choice.

What Were We Thinking?

As a culture, the current mix of generations, all over much of the developed world, have made some choices—choices that, in hindsight, leave the adult in us asking, "What were we thinking?"

In a way, we acted like teenagers. We made the easy choice, not thinking of the consequences. We never absorbed the lessons of the depression from our grandparents. We quickly forgot the sobering malaise of the 1970s as the bull market of the 1980s and 1990s gave us the illusion of wealth and an easy future. Even the crash of Black Monday seemed a mere bump on the path to success, passing so quickly. And as interest rates came down and money became easier, our propensity to acquire things took over. In Europe, the advent of the euro gave southern Europe the interest rates of the German Bundesbank, and the Germans got a southern European currency in return.

And then something really bad happened. Homes and other assets all over the world started to rise in value, and we learned through new methods of financial engineering that we could borrow against what seemed like their ever-rising value to finance consumption today. Everybody was responding to incentives—the problem was that the incentives were misguided, and the regulators were not doing their job.

We became Wimpie from the Popeye cartoons of our youth: "I will gladly repay you Tuesday for a hamburger today."

Not for us the lay-away programs of our parents, patiently paying something each week or month until the desired object could be taken home.

As a banking system, we made choices. In the United States, we created all sorts of readily available credit and packaged it in convenient, irresistible AAA-rated securities and sold them to a gullible world. We created liar loans, no-money-down loans, and no-documentation loans and expected them to act the same way that mortgages had in the past. What were the rating agencies thinking? Where were the adults supervising the sandbox? (Oh, wait a minute. That's the same group of regulators who now want more power and money.)

It is not as if all this was done in some back alley by seedy-looking characters. This was done on TV and in books and advertisements. I (John) remember the first time I saw an ad telling me to call this number to borrow up to 125 percent of the value of my home and wondering how this could be a good idea.

It turns out it can be a great idea for the salesmen, if they can package those loans into securities and sell them to foreigners, with everyone making large commissions on the way. The choice was to make a lot of money with no downside consequences to you. What teenager could say no?

In the United States, Greenspan kept interest rates low, which aided and abetted the process. The Bush administration started two wars and pushed through a massive health care package, along with no spending control from the Republican Party, thereby running up the fiscal deficits.

The financial industry's regulators allowed credit default swaps to trade without an exchange or supervision. A culture viscerally believed that the McMansions they were buying were an investment and not really debt. Yes, we were adolescents at the party to end all parties. And as our friend Paul McCulley said, the ratings agencies were handing out fake IDs to this underage drinking party.

Not to mention an investment industry that tells its clients that stocks earn 8 percent a year in real return. Even as stocks have gone nowhere for 10 years, we largely believe (or at least hope) that whatever the latest uptrend is will be the beginning of the next bull market.

It was not that there were no warnings. There were many who wrote about the coming train wreck that we are now trying to clean up. But those warnings were ignored.

Derision, scorn, laughter, and dismissal as a nonserious perpetual perma-bear were heaped on these commentators. The good times had lasted so long, how could the trend not be correct? It is human nature to believe the current trend, especially a favorable one that helps us, will continue forever.

And just like a teenager who doesn't think about the consequences of the current fun, we paid no attention. We hadn't experienced the hard lessons of our elders, who learned them in the depths of the depression. This time it was different. We were smarter and wouldn't make those mistakes. Didn't we have the research of Bernanke, the ECB, the BIS, and others, telling us what to avoid?

In millions of different ways, we all partied on. It wasn't exclusively a liberal or a conservative, a rich or a poor, a male or a female addiction. We all (or most of us) borrowed and spent. We did it as individuals, and we did it as cities and states and countries.

In the United States, we ran up unfunded pension deficits at many local and state funds, to the tune of $3 to $4 *trillion* and rising. We have a massive (multiple tens of trillions of dollars) bill coming due for Social Security and Medicare, starting in the next 5 to 7 years, that makes the current fiscal crisis pale in comparison. We now seemingly want to add to this by passing even more spending programs that will only make the hole deeper.

Europe has even larger underfunded social programs and banking systems that are quite suspect and heavily overleveraged with massive loans made to countries that will not be able to pay them back in full. Japan has taken the savings of two generations to amass the largest debt to GDP of any country in history, with little hope of avoiding serious pain as their population ages, needs to stop saving, and will begin selling their bonds to be able to live comfortably in retirement.

Now, we are faced with a continuing crisis and the aftermath of multiple bubbles bursting. We are left with massive government deficits and growing public debts, record unemployment, and consumers who are desperately trying to repair their balance sheets.

We are left with no good choices. For some countries, it is more a case of difficult choices such as reforming the tax system and entitlement programs. These are good things to do, not bad things, but are not easy because of entrenched special interests and political disunity. Some countries (like Greece and its compatriots) must choose between very, very bad and disastrous choices. No matter what they choose, they will have significant economic pain. Merely bad choices would be a luxury. But without making the difficult choices today, many other countries will soon be faced with Greek-like choices.

We have created a situation that is going to cause a lot of pain. It is not a question of pain or no pain; it is just when and how we decide (or are forced) to take it. There are no easy paths, but some bad choices are less bad than others.

At the beginning of this introduction, we quoted Jean Monnet. It bears repeating: *People only accept change in necessity and see necessity only in crisis.*

Each country will face its own moment of necessity. Whether forced by crisis or chosen as the best path, that moment is coming.

Think of the amount of pain that we must accept as in the shape of a wine bottle. Each country has its own wine bottle of pain it must endure. Some bottles are bigger then others. Some are magnum size, and some are jeroboams. You could say Greece has a melchizedek-size bottle of pain (40 times the size of a regular bottle of wine!).

Think of that wine bottle as part of a graph with time along the bottom. You can take the pain all at once, or (using our metaphor) you can take the wine bottle and lay it on its side and spread out the pain over time. But the amount of pain is not reduced. In fact, the longer the hard decisions are put off, the more pain (the bigger the bottle!) a country (or state or city) will have to endure in the end.

But as we will see, taking all the pain at once is no real answer. Such a path, unless it is forced on a country, can quickly morph into a deflationary depression with extremely high unemployment, low tax receipts, and an even worse situation. But as governments all over the world are learning, avoiding making the difficult choices results in a moment when the bond markets simply stop funding your deficits. As we will see in Chapter 6, there is no set point for that loss of confidence. It seemingly happens all at once and is a surprise to the government of the country.

Overcoming Human Nature

Philip G. Zimbardo, Professor Emeritus of Psychology at Stanford University, has studied how we as humans perceive time.[1] It seems that humans live in six psychological time zones: two in the past, two in the present, and two in the future. He divides the past into positive (those who are nostalgic, but also the keepers of family records, etc.) and negative (those who are focused on their regrets).

Likewise, the present is divided into two groups, one hedonistic, who live for the present, which includes babies and others who just simply don't worry about the future and prefer to enjoy the present as much as possible in whatever way they define *enjoy*. Then there are those whose present time orientation is fatalistic. They have little or no control over their lives due to poverty, religion ("my life is fated by God"), or local conditions.

Then there are those who are future oriented. Again, there are two groups, those who, like the ants in the story of the ant and the grasshopper, work today and put off current pleasures and spending, and those who believe life doesn't really start until you are dead.

Studies show that the closer you are to the equator, the more present oriented you are. The more you are in a place where the weather does not change all that much, the more you get a sense of sameness. Interestingly, there are words for *was* and *is* in the Sicilian dialect, but no *will be*. Present oriented indeed!

The purpose of school, Zimbardo notes, is to turn present-oriented little beasts into responsible future-oriented children. The problem in the United States is that a child drops out of school every nine seconds. Everyone is all upset about such a lack of future orientation.

But adult voters show a similar lack of future orientation. We much prefer to vote for benefits that increase our deficits. Even in good times, we do not pay down the debt but accumulate more.

Our friend Dylan Grice of Societe Generale writes:

> Voters don't go for long-term gain when it costs short-term pain. They'll certainly consider the guy who frowns and earnestly tells them that if they don't put down the snacks, go to the gym and work off some of the flab they've been piling on there will be serious consequences *one day,* but they'll only vote for him if he also tells them that they can go ahead and eat cheeseburgers and fries in front of the TV a little bit longer.[2]

One of the reasons Dr. Zimbardo cites for the epidemic of dropouts is the increased use of game devices. It seems the average teenager has played about 10,000 hours of video games and TV (some of it not so wholesome). It is an instant feedback, instant gratification society. And when we send that kid to school, he is in an old-style lecture (*boring!*) with no way to feed back into the system. No dopamine rush from killing yet another zombie or enemy soldier. No thrill of the hunt.

Yet voters all over the world act just like teenagers. We get frustrated when it takes more than a minute for our computers to boot up (thanks, Bill Gates!) or when it takes too long to download a file. And we want our economic and political fixes to be the same: quick and easy. The problem is that the political and economic cycles are not the same. It is difficult for politicians to respond to the longer-term problem when they face voters often.

As we will see, whether you call it the Great Recession or the Great Financial Crisis, what we are in is not a typical business cycle recession. It is a balance sheet recession. It is the end of the debt supercycle that started more than 60 years ago. The recovery time in much of the developed world is going to be measured not in months but in years, perhaps decades for some. It will be a much more volatile economy with more frequent recessions. For some countries, this will be very deflationary; for others, not so much. And for some, the risk of high inflation is very real.

But it will mean that the typical short political cycle will become even more volatile if voters do not understand that there are no easy fixes, no easy choices. There is no magic wand that politicians can wave to make it all disappear and bring back the boom times.

And yet, if we continue to train our politicians and leaders to be short-term thinkers rather than acting as forward-thinking adults, we will end up in a blind canyon where there are dragons of our own making. Think Greece.

Ultimately, that is what *Endgame* is about. In the first half of the book, we look at the basics of economics and recent research to try to understand the situation. Don't get nervous about a little economic study. This book is written (hopefully) so that even a politician can understand the nature of the crisis that is unfolding all around us.

In the second part of the book, we will go around the world, country by country, laying out the problems they face. Admittedly, some are more daunting than others. The real problems, as we will see, are mostly in the developed world. But that means even emerging market countries will feel the pressure as global trade to the developed world (which is two-thirds of the global economy) will suffer. The credit crisis is not yet fixed. We have shifted the crisis from homebuyers to banks and then finally to governments. There is no one else to step in. We are at endgame.

We outline the nature of the problems in each country, hinting at some solutions—but only hint. Each country must conduct its own national conversation as to what is important for it. In the United States, clearly we cannot afford the level of national expenditures at the current tax levels. But increasing taxes has consequences. It is all connected. Do we reduce our levels of Medicare costs, reform Social Security, reduce our defense spending, or increase taxes? Or do we make some combination of other cuts? There are no easy choices. As with teenagers who have put off making the hard choices, when they must be made, it is with great difficulty.

As each country makes its own choices, there will, of course, be significant implications for investments of all types, and we address these at the end of the book. The investments that work in one country and for one set of difficult choices are different than for other countries.

Endgame is not written in stone. The actual outcomes are path dependent. By that, we mean that the paths we choose will determine the outcome. And for those readers who live in countries that make poor choices, or are already faced with nothing but very bad choices, we hope we can offer you a few ideas on how to make good choices in your own personal investment lives. We will show you the signposts that will help you see what choices your country is making and invest accordingly.

And in the end, both of us are optimists. Even if our countries do not make the wise choices, we hope to be able to do so in our own lives and help you do so in yours. Our parents and grandparents survived a century with two major wars, a depression, and more. As we will see, we think that this era of endgame will itself end, and like the reset button on a computer allows you to start over, we believe that what will follow will be a major era of new prosperity, medical marvels, and wonderful new life-changing technology. Opportunities will abound. And now, let's figure out how to make our own wise choices.

PART ONE

THE END OF THE DEBT SUPERCYCLE

> *My view is that there is an inevitable endgame as a result of all this massive spending of taxpayer money in the West and Japan to bail out bankrupt banking systems, so in my view unfortunately endgame will be a systemic government debt crisis in the western world. It will probably happen in Europe and will climax in the US, and I am expecting on a five year view the collapse of the US Dollar paper standard.*
>
> —Chris Wood, CLSA strategist,
> former *Economist* correspondent,
> and expert on Japan's "Lost Decade"

When we mention endgame, you'll immediately want to know what is ending. What we think is ending for a significant number of countries in the "developed" world is the debt supercycle. The concept of the debt supercycle was originally developed by the Bank Credit Analyst (BCA). It was Hamilton Bolton, the BCA founder, who used the word *supercycle,* and he was referring generally to a lot of things, including money velocity, bank liquidity, and interest rates. Tony Boeckh changed the concept to the simpler "debt supercycle" back in the early 1970s, as he believed the problem was spiraling private-sector debt. The current editor of the BCA, Martin Barnes, has greatly expanded on the concept. (And of course, Irving Fisher talked about the long debt cycle in his famous 1933 article.)*

Essentially, the debt supercycle is the decades-long growth of debt from small and manageable levels, to a point where bond markets rebel and the debt has to be restructured or reduced. A program of austerity must be undertaken to bring the debt back to acceptable levels. While the focus of BCA has primarily been on the debt supercycle in the United States, many of the countries in the developed world are at various stages in their own debt supercycle.

As Bank Credit Analyst wrote back in 2007:

> The history of the U.S. is characterized by a long-run increase in indebtedness, punctuated by occasional financial crises and subsequent policy reflation. The subprime blow-up is the latest installment in this ongoing Debt Supercycle story. During each crisis, there are always fears that conventional reflation will no longer work, implying the economy and markets face a catastrophic debt unwinding. Such fears have always proved unfounded, and the current episode is no exception.
>
> A combination of Fed rate cuts, fiscal easing (aimed at relieving subprime distress), and a lower dollar will eventually trigger another up-leg in the Debt Supercycle, and a new round of leverage and financial excesses. The objects of speculation are likely to be global, particularly emerging markets and resource related assets. The Supercycle will end if foreign investors ever turn their back on U.S. assets, triggering capital flight out of the dollar and robbing U.S. authorities of any room for maneuver. This will not happen any time soon.[1]

*Lacy Hunt wrote the following to us: "But the credit for long debt cycle must go to Fisher in his famous 1933 article. Fisher's work was extended by Minsky and Kindleberger. Rogoff was Kindleberger's student. In Bernanke's *Essays in the Great Depression*, Fisher, Minsky, and Kindleberger (as well as some others) are given the credit for the pioneering work debt, which he then trashes as not being useable because it implies irrational behavior. Extension of debt is not bad if the borrower has the ability to repay. Extension of debt turns into a problem when debt is not repayable. That is the essence of Minsky's Ponzi finance."