NEW YORK TIMES BESTSELLER

ENDGAME

THE END OF THE DEBT SUPERCYCLE AND HOW IT CHANGES EVERYTHING

NEW INTRODUCTION

BESTSELLING AUTHOR
JOHN MAULDIN
AND JONATHAN TEPPER

Contents

Preface

Acknowledgments

Introduction : Endgame

Part One : The End of the Debt Supercycle

Chapter 1 : The Beginning of the End

How Did the Debt Supercycle Come About?
Private Deleveraging and Public Leveraging Up

Chapter 2 : Why Greece Matters

What Does Greece Mean to Me, Dad?

Chapter 3 : Let’s Look at the Rules

Six Impossible Things
Delta Force
Killing the Goose
But It’s More Than the Deficit
Not Everyone Can Run a Surplus
Pity the Greeks
The Competitive Currency Devaluation Raceway

Final Thoughts . . .

Chapter 4 : The Burden of Lower Growth and More Frequent Recessions

Three Structural Changes
Lower Growth, Fewer Jobs, Bigger Deficits, Lower Returns

Chapter 5 : This Time Is Different

A Crisis of Confidence
It’s the Deleveraging, Stupid!
Some Parting Words from Rogoff and Reinhart

Chapter 6 : The Future of Public Debt: An Unsustainable Path

A Bit of Background
Drastic Measures
The Future Public Debt Trajectory
Debt Projections
The Challenge for Central Banks
Bang, Indeed!
The Center Cannot Hold
Who Takes the Loss?

Chapter 7 : The Elements of Deflation

The Supertrend Puzzle

- The Elements of Deflation: What Deflation Looks Like
- The Velocity of Money
- A Slowdown in Velocity
- The Roadmap Ahead: Bernanke’s Helicopter Speech
- There Are No Good Choices

Chapter 8 : Inflation and Hyperinflation

- A Dose of Inflation
- The Characteristics of Hyperinflations
- The Dangers of Inflation
- The Problems of Inflation
- Hyperinflation in the United States?

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

Chapter 9 : The United States

- Yes, We’re Screwed
- Congress: Blind, Ignorant, and Indifferent
- What Does It All Mean?
- The Kindness of Strangers
- Endgame for the United States
- The Present Contains All Possible Futures
- Some Policy Suggestions

[Chapter 10 : The European Periphery]

[The Euro: A Suboptimal Currency Union]
[Some Countries Recover; Others Don’t]

[Chapter 11 : Eastern European Problems]

[Hungary: Damned If They Do, Damned If They Don’t]
[The Baltics: How to Destroy Your Economy and Keep Your Peg]

[Chapter 12 : Japan]

[The Mother of All Bubbles]
[Japanese Government: Spending Money Like There Is No Tomorrow]
[Japan’s Endgame]

[Chapter 13 : The United Kingdom]

[The United Kingdom Economy: Not as Safe as Houses]
[Northern Rock: A Modern Bank Run]
[The United Kingdom’s Endgame: Higher Inflation Ahead]

[Chapter 14 : Australia]

[The Lucky Country]
[A House of Cards]

Chapter 15 : Unintended Consequences
- Bubbles in Emerging Markets
- Difficult Choices

Conclusion: Investing and Profiting from Endgame

Epilogue: Some Final Thoughts

Notes

About the Authors

Index

Additional Praise for Endgame

"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."

—William Bonner, President and CEO of Agora Inc.; author of *Dice Have No Memory* and *Empire of Debt*

"*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."

—Marc Faber, Managing Director, Marc Faber, Ltd.; Editor, *Gloom Boom & Doom Report*

"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

ENDGAME

THE END OF THE DEBT SUPERCYCLE AND HOW IT CHANGES EVERYTHING

JOHN MAULDIN
JONATHAN TEPPER

WILEY
John Wiley & Sons, Inc.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.

Published simultaneously in Canada.

For general information on our other products and services or for technical support, please contact our Customer Care

Department within the United States at (800) 762-2974, outside the United States at (317) 572-3993 or fax (317) 572-4002.

Wiley also publishes its books in a variety of electronic formats. Some content that appears in print may not be available in electronic formats. For more information about Wiley products, visit our web site at www.wiley.com.

Library of Congress Cataloging-in-Publication Data:

Mauldin, John.

Endgame : the end of the debt supercycle and how it changes everything / John Mauldin and Jonathan Tepper.

p. cm.

Includes index.

ISBN 978-1-118-00457-9 (hardback); ISBN 978-1-118-05806-0 (ebk.);

ISBN 978-1-118-05807-7 (ebk.); ISBN 978-1-118-05808-4 (ebk.)

1. Debt. 2. Debts, Public. 3. Debts, External. 4. Recessions. 5. Business cycles. I. Tepper, Jonathan, 1976– II. Title.

HG3701.M345 2011

336.3'4—dc

222010051231

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

Preface

It is said that the present is pregnant with the future.

Voltaire

Prediction is very difficult, especially about the future.

Niels Bohr

Endgame is a book about the future of the global economy. When we started writing the book in 2010, we were afraid that by the time it arrived in bookstores many of the things we had predicted or warned about would have already happened. Both of your authors had written extensively about the issues and predicted outcomes we discussed in *Endgame*.

The buildup of debt that caused the financial crisis was still weighing many countries down, and central bankers and governments were responding with unprecedented stimulus. Some countries, such as Greece, were on the verge of defaulting, even though the markets (and European politicians!) were in total denial. We must admit that for us it wasn't rocket science to make the predictions we did, it was simple arithmetic: Greece didn't have enough income to handle its expenses.

As luck would have it, we were able to get *Endgame* out before Greece defaulted and the worst of the European crisis came to pass. For other countries, like Japan, we were able to warn about the extraordinary measures the Bank of Japan would end up taking. We didn't get everything right, but we were able to provide a very useful roadmap for readers. *Endgame* was timely, and we're pleased to see that it still reads well and offers a good look at the future.

Parts of *Endgame* are timeless and are intended to provide a fundamental way of viewing the world. In the first part of the book, we looked at the Debt Supercycle and how a very long period of debt buildup in the US, UK, Japan, and Europe would lead to lower growth and a debt-deflationary dynamic. The events of the past few years have borne out that insight. While developed economies appear to be "in recovery," it is the most anemic recovery of the past 60 years. Welcome to the New Normal.

Each country faces different challenges and paths ahead. For most countries, the choices are stark—between bad options and worse ones. Some sadly face a choice between Disaster A and Disaster B. They merely get to choose which path to take in the lead-up to the destruction of their economies, exactly as we wrote about Greece. The worst-off countries of the developed world are still confronted with staggering debt and ageing populations. They are caught in a tug of war between deflation from too much debt and potential inflation from unconventional central bank monetary policies – quantitative easing (QE), large-scale asset purchase programs (LSAPs), and currency devaluations. Other countries, particularly in emerging markets, have lower debt levels and higher population growth, but they are facing the spillover of loose money policies from their developed neighbors. They must deal with the fickle tides of capital flows from the developed world, as money pours in and out. As a result, they have gone from being darlings of the investment world to pariahs.

We anticipated that we would see the US Federal Reserve, the Bank of Japan, the European Central Bank, and the Bank of England take the world in the direction of extraordinarily loose monetary policies. The events of the past few years have only confirmed our view that central bankers would err on the side of doing too much rather than too little. In the manner of Hollywood blockbusters, we've seen QE1 followed by QE2 and now, seemingly, "QE Infinity."

Endgame was particularly accurate in describing the deflationary dynamics in Europe. The euro is very much like the gold standard; and, as Greece and the rest of the Eurozone periphery have discovered, the burdens of economic adjustment have fallen on the weaker members. We were extremely pessimistic about Europe, but as it turns out, our views now have an almost optimistic ring to them. Who would have guessed that Greek and Spanish unemployment levels would rise above 25% and that almost 60% of Greek and Spanish youths would be unemployed? Reality is almost always more interesting than fiction.

Many of the countries we wrote about have experienced the troubles we foresaw. When we wrote *Endgame*, we warned about Australia’s housing bubble; and we are now seeing the Australian dollar fall and the housing market slowly deflate. The chapter on Australia is particularly worth reading in light of that country’s weakening domestic economy, the slowdown of exports to China, and the bursting of the housing bubble. The story is still playing itself out.

The chapter on Japan as “a bug in search of a windshield” was perhaps the most farsighted. We did not say anything that other watchful people had not said, but we did emphasize how unsustainable Japan’s situation was. Time has only proved us right. The Tohoku earthquake and the Fukushima disaster were the not-so-small final grain of sand that caused the sand pile to collapse. The Bank of Japan (BoJ) has embarked on the largest, most adventurous policy of quantitative easing the world has seen. The BoJ makes the Fed and the Bank of England look like sissies. Japan’s ageing population, Godzilla-size government debt, and dismal public finances guarantee that we’ll see the yen weaken considerably as the central bank prints money hand over fist to finance government spending.

We did not get everything right, but we did best we could with our cloudy crystal ball. It is a pleasure for us to reread the book after the passage of several years. We must admit, given the volume of writing we have each done, that we can't say the same about everything we have published. So far, *Endgame* has stood the test of time. We hope that you will enjoy it, as well, and find it instructive.

As we were finishing *Endgame*, we already suspected our next book would have to be on currency wars and unconventional monetary policy. We thought we would be able write it at our leisure during 2014 and that it would come out late that year. But then the Japanese launched the first missile in what we think is the beginning of a full-blown currency war that will dominate the latter half of the decade. We started madly writing this summer. Much like *Endgame*, we wrote *Code Red* to provide a roadmap to what will happen now that Japan has gone nuclear and unleashed the boldest, most forceful devaluation the world has seen since the 1970s. We have yet to see the full effects of Japan's monetary policies.

We hope you like *Endgame*. If you do, we would recommend that you also find *Code Red*. We can only hope that *Code Red* reads as well a few years from now as *Endgame* does today.

John Mauldin and Jonathan Tepper
October, 2013

Acknowledgments

We would like to thank our many reviewers and readers. We have had a lot of feedback from reviewers, which has really helped. Martin Barnes of Bank Credit Analyst was particularly vicious, but he really made us do a lot more homework and think through some of our points. Andrew Wynn, Dylan Grice, and Albert Edwards provided very valuable critiques and insight. Lacy Hunt was particularly helpful in his suggestions and criticisms of our deflation and hyperinflation chapters. Simon White at Variant Perception was invaluable in helping draft some of the chapters on the United Kingdom, Eastern Europe, and Australia, and he helped produce most of the charts in the book. Debra Englander and Kelly O’Connor at John Wiley & Sons helped shepherd this book from its original idea to publication. Claus Vistesen and Edward Hugh offered valuable critiques, saw many of the crises before they happened, and have provided valuable insights into demographics.

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)[1] 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 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.

[1]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.

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.)[1]

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]

I (John) was talking with Martin a few months ago, and the topic turned to the culmination of the debt supercycle. Martin said we are nowhere near the end, as the government is stepping in where private debtors are cutting back. We have just shifted the focus of where the debt is coming from. And he is right, in that the debt supercycle in the United States, Great Britain, Japan, and other developed