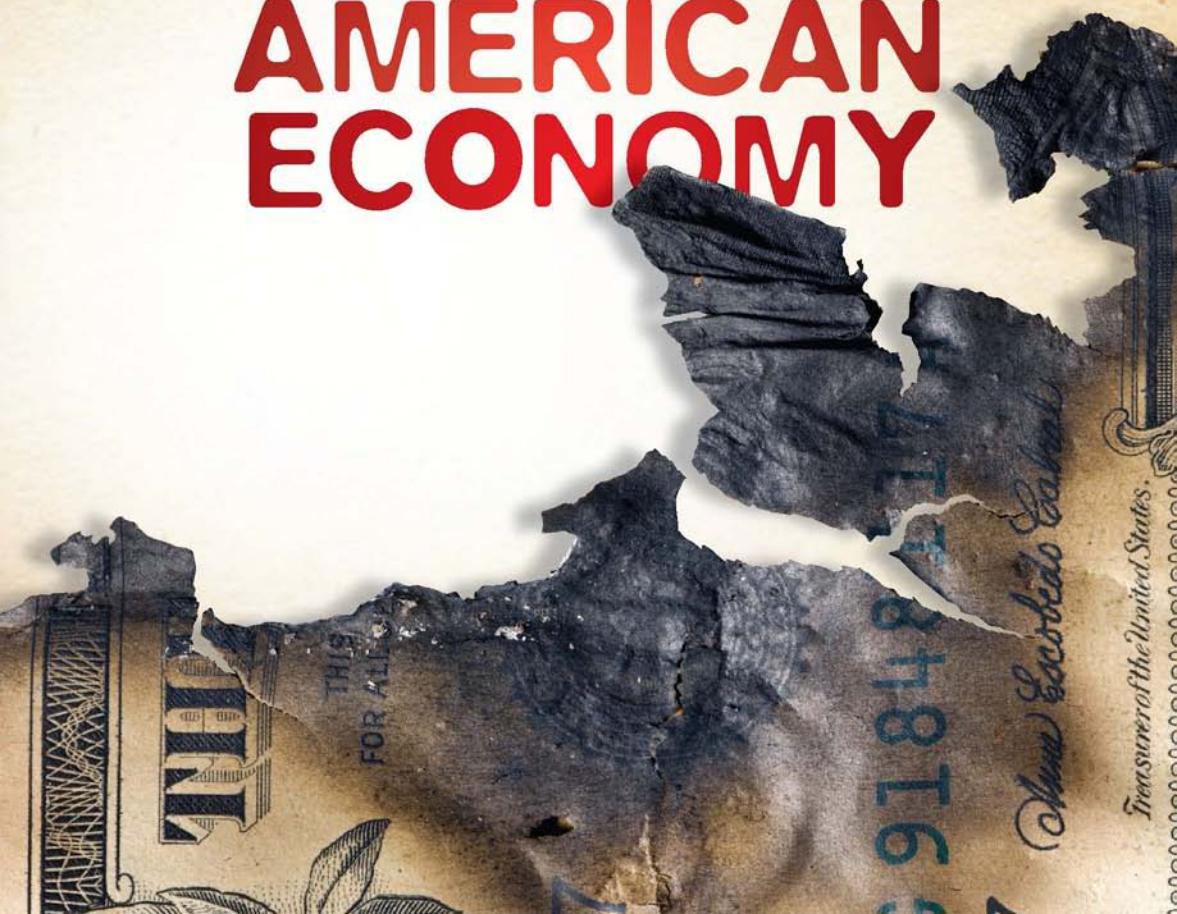


PETER TANOUS AND JEFF COX

FOREWORD BY RICK SANTELLI OF CNBC

**DEBT,
DEFICITS,
AND THE
DEMISE
OF THE
AMERICAN
ECONOMY**



**Debt, Deficits,
and the
Demise of the
American Economy**

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Peter Tanous
Jeff Cox



WILEY

John Wiley & Sons, Inc.

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

Published simultaneously in Canada.

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Library of Congress Cataloging-in-Publication Data

Tanous, Peter J.

Debt, deficits, and the demise of the American economy / Peter J. Tanous and Jeff Cox.

p. cm.

Includes index.

ISBN 978-1-118-02151-4 (hardback); 978-1-118-07202-8 (ebk);
978-1-118-07203-5 (ebk); 978-1-118-07204-2 (ebk)

1. Investments—United States. 2. Stock price forecasting—United States.
3. Business forecasting—United States. 4. Financial crisis—United States. 5. United States—Economic conditions—2009– I. Cox, Jeff, 1951– II. Title.

HG4521.T319 2011

330.973—dc22

2011007560

ISBN 978-1-118-02151-4 (cloth); 978-1-118-07202-8 (ebk); 978-1-118-07203-5 (ebk);
978-1-118-07204-2 (ebk)

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

*To: Ann, Chris, Helene, Will, Paul, Julie,
Olivia, Isabella, Lilly, & Ringo*

—Peter Tanous

*To: MaryEllen, for always believing;
and Mom and Dad, for always being there*

—Jeffrey Cox

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Foreword

Americans historically have always risen to meet every challenge. The issues of debt and deficits necessitate substantial changes in how our economy is managed. Many of the changes that need to be made are known to our political class. Many politicians, past and present, have not exhibited the will to tackle our looming budget crisis. Political careers last longer when the truly difficult issues are kicked down the road to future leaders. But as evidenced by the huge fiscal conservative movement spreading across the country since February 2009, Americans have the will to make sacrifices to strengthen our country and thus guarantee a prosperous future for our children and grandchildren. *Debt, Deficits, and the Demise of the American Economy* will better arm the reader to understand the corrective measures we need to insist on by our political leaders to address the issues that challenge our legacy of exceptionalism.

Peter Tanous and Jeff Cox in *Debt, Deficits, and the Demise of the American Economy* afford the reader a concise, easy-to-read account of how the United States—and much of the globe—has arrived at a tenuous crossroads of debt and unsustainable spending. The reader takes a journey through the history of how years of misguided and underfunded policies, here and abroad, have caused an historic addiction of central banks to low interest rates and easy-money “cures” for bubbles caused by low rates and easy money.

What I enjoyed most about *Debt, Deficits, and the Demise of the American Economy* is the use of unvarnished facts to quantify how

mountains of debt will be an insurmountable obstacle to Americans' most cherished dynamic, a higher standard of living for successive generations, if not addressed expeditiously. Messrs. Tanous and Cox illustrate how flawed policies in banking, housing, taxation, and regulation all contributed to the credit crisis of 2008. More importantly, how the growing gap between what government collects and what it spends has created a negative spiral of corrosiveness that threatens the financial solvency of global economies big and small.

The methodologies of the Office of Management and Budget, used by our leaders to handicap solutions to lowering long-term deficits, are broken down into easy-to-understand assumptions. The reader is given a simple view of how "guesses" of future inputs like growth, inflation, and interest rates may not reflect future realities. Even small miscalculations of such variables can lead to much larger deficits.

Simple questions like how an average American defines inflation versus a how a central banker does are broken down and addressed not only in terms of pricing realities but also in terms of investing realities. Is gold a good hedge against policies that weaken the purchasing power of our currency? How does the risk of a weaker dollar affect investment strategies? Can we invest during times of economic crisis profitably, effectively? All these questions are addressed in a fashion that strips away the nonessential economic jargon, leaving the readers better armed to protect their personal finances during these trying economic times.

—Rick Santelli

CNBC On-Air Editor and former member of the
Chicago Board of Trade and Chicago Mercantile Exchange

Introduction

*The problem we now face is the most extraordinary financial crisis
that I have ever seen or read about.*

—Former Federal Reserve chairman Alan Greenspan
(August 7, 2010, interview in the *New York Times*)

At age 84, Mr. Greenspan has been around the block a few times and is drawing on a lengthy history.

The United States is heading toward a financial catastrophe that will paralyze the country and lead to an extended period of economic mayhem and distress. The problems are not about politics anymore, not about Republicans and Democrats, not about the Fed or the Treasury or the shaky euro. It is too late for any practical initiative to stop it.

To reduce this to its simplest elements, the pending economic catastrophe is about debt, deficits, and inflation. We hope to demonstrate that the rising and unsustainable debt in Europe and the rising deficits in the United States will lead to potentially catastrophic consequences. At the top of the list is our contention that severe inflation lies ahead. We also intend to point the way to some investment strategies to help counter the negative effects of the financial crisis that is coming.

This book tells a story about what has happened to get us where we are, how the crisis is unfolding, and how it will likely end with a stock market crash. The timing is always difficult to predict, but the direction of the crisis is not. The trend is predictable because the crisis is proceeding along a linear path.

This is not the first book about predicting some event in the unknowable future. Indeed, most predictions are wrong simply because no one has come up with a good way to predict the future. That said, some events are more predictable than others.

Many of you have read the book *The Black Swan* by trader and philosopher Nassim Taleb, who one of us (Tanous) happens to know and respect enormously. At a gathering we both attended, Nassim made some brilliant comments about what is predictable and what isn't. Let's consider something that is predictable. Nassim pointed out that the maximum amount of calories most humans can consume in a single day is about 4,000. With that knowledge, he pointed out that we can safely predict how much that individual would weigh at the end of the day. At that same rate, a hungry person would eat about 28,000 calories a week. We might also predict just how much that person would weigh at the end of a week given his level of physical activity. There is little the individual could do on any given day that would make a difference in the weekly outcome. So we can predict events like how much a person will weigh in a day or a week given an intake of a known number of calories because the progression is knowable and linear.

Can we similarly predict with accuracy what the stock market will do tomorrow? No.

In the case of investments, there are no shortages of predictions of what the market will do tomorrow, next week, next month, and next year. But how accurate can they be? Not accurate at all. Taleb recounts the story of his early days as a trader when one of his colleagues pointed to another trader on the floor who had been very successful, accumulating a portfolio of \$7 million over seven years. But in the crash of 1987, he lost it all in one day.

We can put a man on the moon; we cannot predict tomorrow's stock market.

In writing a book that involves predicting the future—and a stock market crash, no less—we are trying as best we can to adhere to what

Nassim Taleb refers to as *epistemic humility*. Most so-called stock market experts and economists engage in *epistemic arrogance*, which is the tendency to think you know more than you really do. By adhering to the principle of epistemic humility, we try to stick to predictions that are logical, visible, and linear so that the reader will readily sign on to where we are going and to the points we are making.

We have taken the liberty to write a book about the future because, as we will demonstrate, much of the information that leads to the future of the world's economies is indeed linear, and therefore predictable to some degree. For example, a nation that continues to accumulate debt will reach a level of total indebtedness where that nation's options become very limited, and also predictable. An analysis of the country's financial situation may well reveal that there is no reasonable prospect for repaying the debt. The available solutions are dire—devaluation, rescheduling, or some other form of default. And the financial mayhem that follows those events is also, sadly, predictable from history.

The crash will result from the piling on of events that will occur in the chronograph we will provide. The crash will occur as the world finally realizes that we have boxed ourselves into a financial corner with no way out.

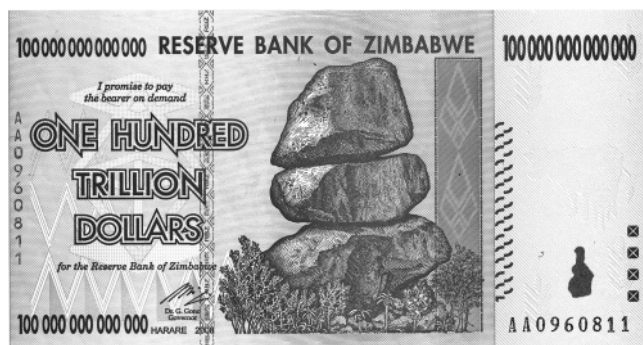
What might happen? The stock market will decline by 2,000 to 3,000 points. A run on banks perceived to be weak will snowball into a banking crisis. Liquidity in the markets will come to a halt. Inflation will be rampant as the United States prints money to pay our debts and avoid a technical default.

In this work, the plan is to take you through the steps that got us here so you can judge the logic that leads to the conclusions we will reach. Please keep in mind that this book is not an economic treatise. The authors are versed in economics, finance, and the stock market, but neither of us is a professional economist. We will explain the crisis that is upon us in clear, understandable terms. You will not need to be an economist to follow the points and conclusions in this book.

Here's the payoff: If in the course of reading this book you are persuaded, as we are, that we are heading toward a financial calamity, you will want to prepare yourself financially to deal with the perils that lie ahead. We intend to point to specific investment strategies to

counter the effects of higher inflation and the mounting fear that lurks in the not-too-distant future.

A final word about inflation (which will be covered in a separate chapter): Lest we think of inflation only in terms of our experience in the 1970s or, more drastically, in Germany's Weimar Republic, where wheelbarrows of cash were rolled down the sidewalk to buy a loaf of bread, look at this Zimbabwean banknote from 2008:



Yes, it is for 100 trillion dollars. Yes, it is real.
And it is worthless.

Chapter 1

It's the Deficit, Stupid

It is common knowledge that the United States owes a lot of money and that our debt is growing. No arguments about that. Where the debate starts and ends is how we are going to manage our debt. Will we be able to repay it? Will we choke on it? Or perhaps we will grow out of it and move into a surplus, much like we did during the Clinton administration.

First, the simple answer: The mounting U.S. deficit, i.e., the amount we spend over and above what we take in revenue and taxes, is a major problem that will result in a financial calamity soon. How soon? We don't know, but soon enough that we need to be prepared for it. Politicians often rail about the massive federal debt we are leaving to our children and our grandchildren. They are right about the debt and wrong about the timing. Our children and grandchildren will not have to deal with the problem; we will! The crisis is approaching at alarming speed, and that is what this book is about.

Let's back those statements up with some facts. Here again, we want to be conscious of the difference between epistemic humility and epistemic arrogance. Epistemology is a branch of philosophy that is about the study of knowledge. In our book, we try to distinguish between what is knowable and what isn't. The future by its nature is not knowable, but some things are easier to predict than others. Linear

events are easier to predict than random events, which are unpredictable. For example, if you have a stack of books and you add a new book to the stack every day, it is fairly easy to predict how high your stack will be a month from now. As you read this book, we want to make the case that our predictions are solidly grounded. This will constitute epistemic humility. Epistemic arrogance, on the other hand, is to us the practice of predicting events that are not supported by existing facts or trends. That would indeed be epistemic arrogance.

It would be arrogant to proclaim exactly when our rising national debt will turn into a financial debacle and a stock market crash, but it will likely occur sooner than we think. The national debt consists of all of the securities, bonds, notes, and bills issued by the United States Treasury. As of December 31, 2010, the “total public debt outstanding” of \$14.03 trillion was approximately 94 percent of annual gross domestic product (GDP) of \$14.9 trillion.¹

How High the Debt?

If today’s national debt is at a scary high of nearly 100 percent of GDP, how does that compare to the levels of debt in our nation’s history? As Figure 1.1 shows, we have come this close only once in the past. During World War II, the debt reached 120 percent of GDP. The debt was, of course, the result of the massive cost of World War II, and we spent quite a bit of time paying that down. After the war, expenses declined dramatically in the absence of the high cost of waging the war. As a result, the debt also came down. According to the president’s budget for fiscal year 2010, the national debt will pass 100 percent of GDP in 2011, something that hasn’t happened since the end of World War II.

Today, politicians and pundits rail about the massive deficits and the need to increase revenue and cut spending. Increasing revenue means raising taxes, something no politician wants to be accused of. Lowering expenses is an equally formidable challenge. Where do you cut?

Figure 1.2 shows where the money went in 2010. The shaded area to the right shows that over 50 percent of our budget expenditures are “mandatory” for things like Social Security, Medicare,

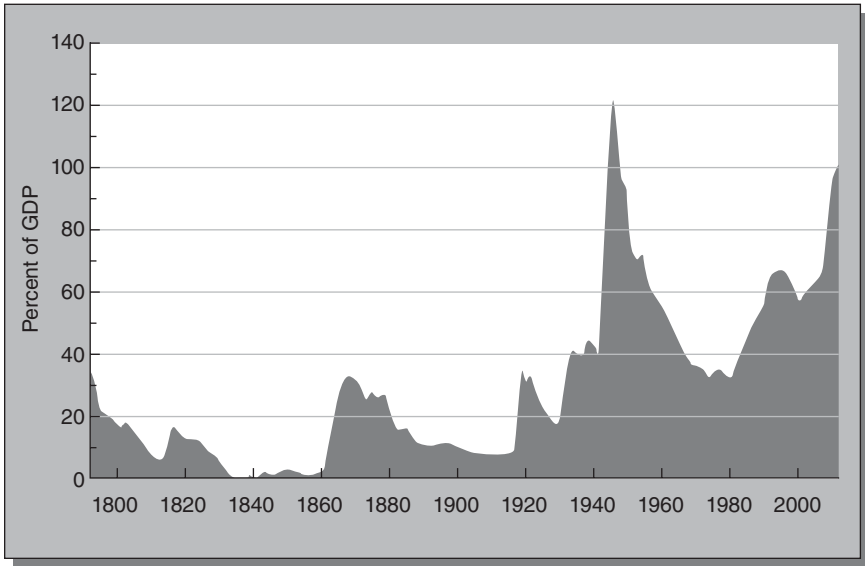


Figure 1.1 U.S. National Debt as Percent of GDP (Government Spending in the United States from 1792 to 2012)

SOURCE: usgovernmentspending.com.

Medicaid, and the interest on the national debt. These simply can't be cut. Of course, we can tinker with Social Security—by raising the age limit for retirees for example—but most politicians still treat Social Security as the third rail of politics: Touch it and you die.

The largest budget expenditure among the so-called discretionary spending categories is defense. Few politicians are eager to justify major cuts in defense spending, particularly in the aftermath of 9/11. That leaves very little room for making significant cuts.

So what about raising taxes? Here the debate gets heated. There is the constant reminder by Dr. Arthur Laffer (with whom one of us [Tanous] coauthored a book) that within certain limits raising taxes actually *decreases* tax revenue and lowering taxes *increases* tax revenue. The idea is that taxes are about incentives, so if you raise taxes, there is less incentive to take risk and if you lower taxes there is more incentive to work hard and take risk; hence more people working and building businesses results in higher tax receipts even if they are at a lower rate.² But no matter which side of that argument you take,

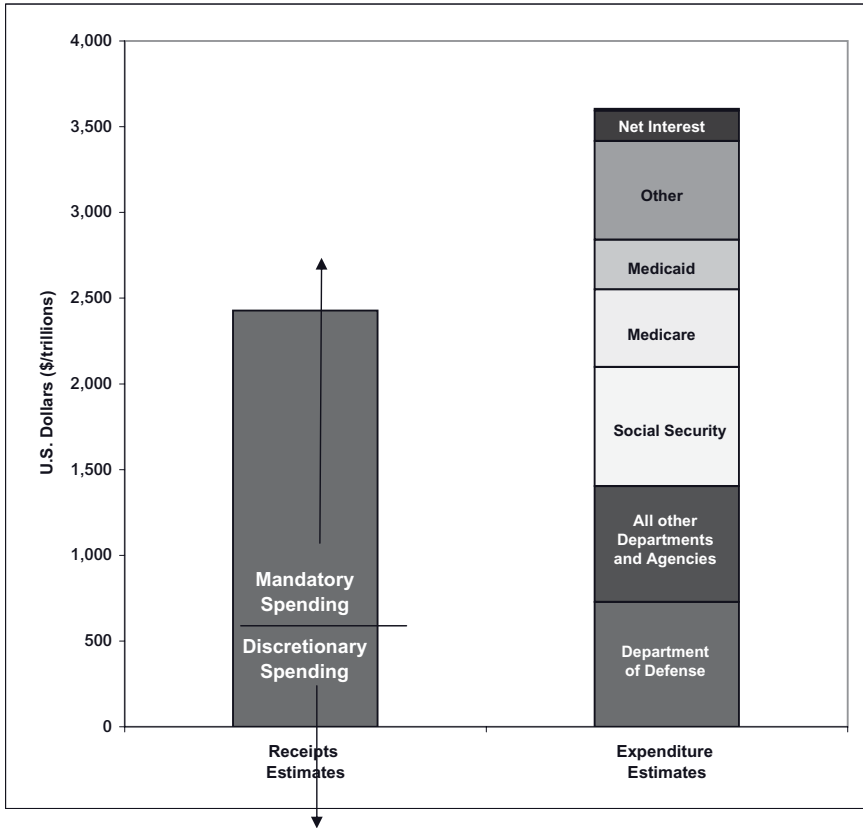


Figure 1.2 U.S. Receipt and Expenditure Estimates for Fiscal Year 2010

SOURCES: Congressional Budget Office and Lepercq Lynx Investment Advisory.

we all agree that raising taxes is hard to do, especially for politicians who have to agree to vote on it. If anything, this explains why it is so difficult to get out of the deficit morass. That is, until the deficit becomes a crisis and forces drastic action.

That is, of course, precisely what we see in our immediate future.

The Ticking Time Bomb

Sovereign debt issues in 2010 are estimated to total \$4.5 trillion.³ This sum is triple the amount of average debt issuance by developed

countries over the preceding five years. U.S. total debt (including debt held by government agencies) has risen 50 percent since 2006 to over \$14 trillion. These numbing numbers start to lose meaning after a while, at least until we put them in some other context.

To that end, let's have a look at the trend of U.S. debt in Figure 1.3. Keep in mind the source of this data, the Congressional Budget Office, which is nonpartisan. Although that doesn't guarantee that its estimates will be right, it does ensure that the projections will not be tainted by political bias.

Clearly, the trend is scary. According to these projections, which may well prove too conservative, U.S. debt (external) as a percentage of GDP will attain 90 percent in 2020. We believe that benchmark will come even sooner. And what happens when a country's debt reaches the level of 90 percent of GDP? (To avoid confusion, let us reiterate that there are *two* ways that federal debt is reported. One includes the internal debt such as borrowings by the government from the Social Security fund, which is essentially internal bookkeeping. The second method involves only the U.S. external debt held by the public and foreign governments.)

Economist Carmen Reinhart, who with Kenneth Rogoff co-authored the highly praised book *This Time It's Different: Eight Centuries of Financial Folly* (Princeton University Press, 2009), made the point of how heavily debt weighs on GDP. In an interview with *Forbes* magazine, Reinhart discussed her finding that a 90 percent ratio of government debt to GDP is a tipping point in economic growth. When government debt crosses that 90 percent line, the economy of the country in question has a growth rate that is 2 percent lower than an economy that has less debt.⁴

This is a significant point. As the United States approaches a debt level of 90 percent of GDP, if history holds and we subsequently have a 2 percent lower rate of growth, our growth *will not be strong enough* to sustain full employment and service our debt. This will further exacerbate and accelerate the debt crisis.

Table 1.1 shows the Congressional Budget Office (CBO) estimate of the projected total deficits through 2020. Its estimates are arguably optimistic. As bad as these estimates look, the reality is that they will

Year	Debt Held by Public
2009	\$7.5 trillion
2010	\$9.2 trillion
2011	\$10.5 trillion
2012	\$11.6 trillion
2013	\$12.5 trillion
2014	\$13.3 trillion
2015	\$14.3 trillion
2016	\$15.3 trillion
2017	\$16.4 trillion
2018	\$17.6 trillion
2019	\$18.9 trillion
2020	\$20.3 trillion

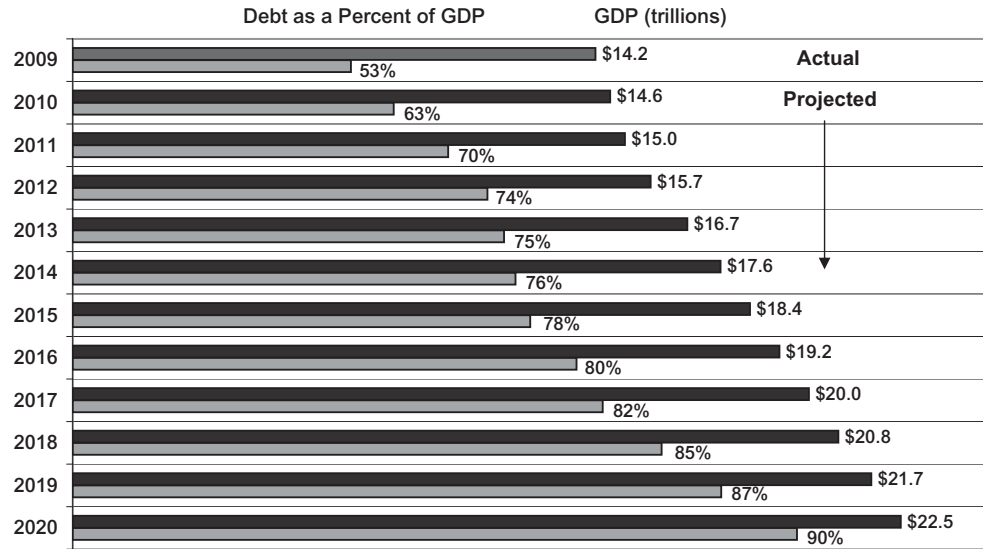


Figure 1.3 Debt Compared with the Gross Domestic Product

SOURCE: Congressional Budget Office.

Table 1.1 CBO’s Estimate of the President’s Budget (billions)

	Actual 2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Revenues	2,100	2,100	2,500	2,800	3,000	3,300	3,500	3,700	3,900	4,000	4,200	4,400
Expenses	<u>3,500</u>	<u>3,600</u>	<u>3,800</u>	<u>3,700</u>	<u>3,800</u>	<u>4,000</u>	<u>4,300</u>	<u>4,600</u>	<u>4,800</u>	<u>5,000</u>	<u>5,400</u>	<u>5,700</u>
Total Deficit	-1,400	-1,500	-1,300	-900	-800	-700	-800	-900	-900	-1,000	-1,200	-1,300

CBO’s Year-by-Year Forecast and Projections

	Forecast			Projected								
	Est. 2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Nominal GDP (billions)	14,200	14,700	15,100	16,000	16,900	17,800	18,600	19,400	20,200	21,000	21,800	22,800
Nominal GDP (% change)	-1.3	3.2	2.8	5.6	5.9	5.3	4.5	4.3	4.1	4.0	4.0	4.1

SOURCE: Congressional Budget Office.