FINANCIAL PREPAREDNESS

"One of life's most painful moments comes when we must admit that we didn't do our homework, that we are not prepared." ~ Merlin Olsen

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The Balance Comes Due Someday

If you've been listening to me for the last two decades, you're familiar with the federal government's rapidly deteriorating financial condition: debt of over $28.8 trillion and unfunded liabilities of anywhere from $157 trillion to well over $200 trillion (depending on what assumptions you use).

But it's not just the amount of debt or the insane amount of new spending that's the problem, it's also the term structure of the debt. Just like Bear Stearns and the Greek government, in recent decades, the federal government has increasingly sold short-term (four weeks to 1-3 years) bills and notes instead of longer term (10 to 30 years) bonds. Apparently it did so to reduce its current interest expense, since interest rates on shorter-term debt are almost always lower than those on longer-term debt. Although reducing one's expenses is usually prudent, this was irresponsible and dangerous. As a result, the federal government has created the mother of all adjustable-rate mortgages (ARMs) and is now heavily reliant on short-term funding and being able to refinance it continually.

It has been able to get away with this so far because since 2008, the so-called Federal Reserve (a cartel of the largest banks) has been creating trillions of dollars out of thin air (i.e., counterfeiting) and using them to buy U.S. Treasuries, mortgages (from Fannie Mae, Freddie Mac, etc.) and even corporate and municipal bonds (!), which has kept interest rates extremely low since the price has been artificially high (bond yields and prices are inversely related). (In recent years, Japan's central bank has even been buying stocks, which I predict will happen in the U.S.) The U.S. Treasury now has to roll over (refinance) about a third of its debt every year at then-prevailing interest rates, whatever they may be at the time. What could go wrong, especially if prices always go up? That's what Bear Stearns, the Greek government, and investors who bought houses using ARMs before 2008 thought.

Although the Fed can heavily influence interest rates (especially for Treasuries and short-term debt), the market has the final say on what the price of money (i.e., interest rates) will be. And once the market has determined that you can no longer pay your bills, the discipline it imposes (in the form of usurious interest rates) is harsh and unforgiving. Suddenly, your only options are austerity (slash your expenses and increase your revenue) or default. So as soon as interest rates spike, **the game will be over**. The bond market (which is about twice as large as the stock market) will collapse, and so will the U.S. dollar, just like every other fiat currency that has existed for the last two millennia. The yield on the 10-year U.S. Treasury bond is now rising rapidly (see below). Could it be because Congress is considering a discretionary spending bill of $3.5 trillion even as it hits the debt ceiling (which many politicians want to remove) and runs out of funding?

But wait, you say, *Ben Bernanke said that the Fed has a magic technology called a printing press that can create an unlimited number of dollars that can be used to pay for everything* (especially government spending and bailouts for its bank owners). The idea that one could use small, colorful pieces of paper that can be created at no cost to pay for scarce resources could only come from either a second grader or an MIT economics PhD. The naiveté is shocking. (As I may have mentioned before, I often feel like aliens have secretly put me into their earthling terrarium and just do things like this to mess with me, like a boy poking his pet scorpion with a stick.)

Has that ever been tried before? And if so, what was the result? Answer: destruction of the economy and wealth, lack of basic necessities, hunger/starvation, crime and violence, political extremism, revolution, tyranny, and war. America is a land of extremes, so maybe we can best the former records for inflation in modern times. Yugoslavia in 1994: 313 million percent. Hungary in 1946: 41.9 quadrillion percent. Zimbabwe in 2008: 89.7 sextillion percent. Did the magic technology work for them?

OK, you say, *the federal government has a credit rating of AA (formerly AAA), since it says its debt is backed by its "full faith and credit."* Credit ratings from the rating agencies (which have conflicts of interest and bills to pay) are a lagging indicator. Per Wikipedia, "The pools of debt the [credit rating] agencies gave their highest ratings to included over $3 trillion of loans to homebuyers with bad credit and undocumented incomes through 2007. Hundreds of billions of dollars' worth of these AAA securities were downgraded to 'junk' status by 2010, and the writedowns and losses came to over half a trillion dollars. This led to the collapse or disappearance in 2008–09 of three major investment banks (Bear Stearns, Lehman Brothers, and Merrill Lynch), and the federal governments buying of $700 billion of bad debt from distressed financial institutions."

OK, well, *the federal government can always pay its bills since it can impose a tax rate of up to 100%.* How much revenue would be raised from a tax rate of 100%? How much is 100% of zero?

For over a decade, near-zero (and even negative in some countries) interest rates have encouraged and enabled politicians to engage in a final, reckless supernova of spending before the whole system collapses on itself like a dying star. Corporations, consumers, and state and local governments have also gorged on dirt cheap debt, which will leave investors (including shareholders) and taxpayers holding the bag.

Pension funds and insurance companies also invest two thirds or more of their portfolios in bonds, so their pensioners and policyholders will also get vaporized. And finally, artificially low interest rates have misled market participants into believing that there is an excess supply of savings/capital available, which has led to massive malinvestment. In the meantime, savers and investors have been unable to earn competitive real returns, so investors who are normally risk-averse have been driven into a very richly priced and dangerous stock market in search of higher returns.

But wait, it gets better. Since the Bretton Woods agreement of 1944, the U.S. dollar has been the world's reserve currency. About half of all dollars are actually held outside the U.S. The U.S. Treasury market is one of the largest and most liquid markets in the world, and countries like China and Japan own about $1 trillion each. The U.S. dollar has also been the primary currency used in international trade, especially for oil (which explains why the U.S. killed both Saddam Hussein and Muammar Gaddafi after they proposed using another currency for international trade). This artificial global demand for dollars (and thus U.S. Treasury securities) is known as America's "exorbitant privilege." The world is finally catching on to the fact that the U.S. has been abusing it for decades, and they're getting sick of being ripped off by the Fed's counterfeiting. The dollar is also the official or unofficial currency of a number of small countries as well as the global black market. When these foreigners no longer want the dollar, an ocean of them will come flooding back to the U.S., making the inevitable crisis far worse.

I just finished reading The Coming Bond Market Collapse: How to Survive the Demise of the U.S. Debt Market by Michael Pento. It was published in 2013, so of course the numbers are now far worse than they were then. For me, the most insightful part of the book was the few pages where he discusses the Basel banking regulations:

"Basel is an international standard for banking regulators to control how much capital banks need to put aside to guard against the types of financial and operational risks banks face....But as we witness throughout history, regulations not only fail in solving the problem, they too often channel the Fed and the banking systems' excess money creation into favored asset classes, creating a repository for bubbles.

"Basel II encouraged banks to amass collateralized debt obligations (CDOs) and mortgage-backed securities (MBSs) by allowing them to meet reserve requirements utilizing these high-yielding debt instruments. It permitted the outsourcing of financial risk management to credit rating agencies who, enticed by fees, liberally provided AAA ratings. This led AAA ratings to be donned on MBSs and credit default swaps that, in the end, proved to be extremely bad credit risks.

"Now they have concocted Basel III, which...acts as an enormous incentive for banks to purchase and hold sovereign debt [such as U.S. Treasuries]....And when the bubble in sovereign debt explodes in their faces, they will reconvene and formulate Basel IV." This reminds me of the Maginot Line that France built after WWI along its border with Germany to prepare for the next war, which was rendered obsolete by Germany's *blitzkrieg*.

"...Basel III allows banks to purchase sovereign debt without any reserve requirements. In essence, banks have been greatly incentivized to purchase unlimited amounts of Treasuries instead of making 'more risky' loans to the private sector. This has managed to hold the collapse of the bond bubble in abeyance. However, it has also at the same time vastly exacerbated the problem by encouraging yet more monetization of the bubble from private banks. Basel III increases the amount that the banks have to hold in reserves and greatly favors U.S. Treasuries as an asset class."

Can you guess how this movie will end? And because banks around the world are loaded to the gills with "safe" sovereign debt, it won't be just a fiscal crisis for the federal government, it will be a global collapse of banks (and their depositors), sovereign debt, fiat currencies, governments, trade, the supply chain and economies (remember that many large corporations rely heavily on the commercial paper market to fund their daily operations). It will be the greatest financial collapse in world history.

Financial markets and political systems are complex systems that have *emergent properties*, which are properties that only emerge after interaction between their component parts and thus cannot be predicted in advance. Debt creates fragility. Nature abhors a monoculture (such as global, identical regulations). As the size, complexity and interdependence of a system increase, the probability of its collapse increases exponentially. We will soon find out what properties *emerge* when you combine unprecedented debt, fiat currency, incompetent central bankers, shortsighted politicians and bankers who believe that they can socialize their losses.

In the movie "The Big Short," hedge fund manager Michael Burry is portrayed as listening to loud rock music as he waits for his short positions in the housing market to work out. One of the most badass songs I've ever heard is "[The Tennessee Kid]" by Steve Earle (BTW, his drummer looks like he should either be in rehab or an old folks home), and I'll be rocking out to it as I watch the U.S. bond market and the U.S. dollar collapse. The lyrics are below:

On Mardi Gras day the Tennessee kid awoke in a puddle of his own worst fears
Haunted by the ghost of vague remembrance no corporeal beast he could name
So the kid invoked Lucifer himself with oaths most grievously discourteous
And charged him submit forthwith to atone
At the crossroads celebrated in song come on

Up jumped the devil in the middle of the thoroughfare
"Who dares to utter my most secret name?" he roared
But the kid yielded not so much as an inch to uncertainty
Steadfast he rejoined the enemy in kind
"Old patch then, Satan, Mephistopheles, Beelzebub
By any other name you ain't nothin' like a rose"
Then he girded his loins for the ensuing onslaught
But the devil only shrugged and the kid shuddered when he hissed he said

Hey hey hey hey
Hey hey hey hey
Hey hey hey hey
The balance comes due someday

Wait just one goddamn minute cried the kid from the Cumberland
You never mention nothin' 'bout no kinda note
Just said, sign here, it's just a soul you'll never miss it
I ain't set foot in a church since I was just a little ol' thang
Reckoned I was headed straight to hell by the highway
No matter how long and how hard that I prayed
So I might as well learn how to make this guitar talk
Somebody said ol' Bob Johnson came down this way
And Devil say

Hey hey hey hey

Hey hey hey hey
Hey hey hey hey
When the balance comes due someday

And the monster raised himself up to the fullness of his stature
Black wings eclipsing a sanguine Mississippi moon
Behold behemoth the trampler of infidels,
He who sweeps away nations with a flick of his tail
Theopolis, Agrrippa, Faustus, Paganini
Lurid and long is the tale of my prey
Question not the ironclad bond of my surety
Set down here in blood in your very own hand

And the Tennessee kid cast an eye on the list where his mark was indeed clearly inscribed
And he fell to his knees but it was too late to pray
And with his very last breath he did say

Hey hey hey hey
Hey hey hey hey
Hey hey hey hey
The balance comes due someday

What You Should Be Doing Now

I plan to cover the why and how of these in future issues (if I haven't already), but here are some actions I recommend you take (or at least start thinking about) now:

1. Silver hit another low of $21.47 an ounce on Thursday. The optimism score was 37, the lowest since March 2020. Shares of precious metal mining companies also hit the lowest price since the COVID panic.

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I would love to hear from you! I thrive on feedback from readers. If you have any comments, suggestions, insight/wisdom, or you'd like to share a link to a great article, please email me.

Generally, I don't have time to answer questions about your specific situation, but if you have a general question that I think other readers also have, let me know and I will provide an answer in a future issue.

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