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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Endgame

We are hurtling irreversibly toward a budgetary crack-up that will generate the mother of all crises in global bond and currency markets. ~ David Stockman

Hyperinflation is not an economic event; it is a political choice....It would be the worst of all possible bad choices. ~ John Mauldin

I recently finished reading the book Endgame: The End of the Debt Supercycle and How It Changes Everything by longtime financial commentator John Mauldin. I actually started it years ago, before I started writing this newsletter, but it wound up languishing for years in my Haven't Finished Yet pile along with dozens of other books. I can't fully recommend it simply because it's dated (published in 2011), but I found a lot of timeless gems I'd like to share with you.

First, Mauldin points out that all hyperinflations but one occurred in the 20th Century—a period of paper fiat currencies due to war, communism and the end of the Bretton Woods monetary regime that linked foreign currencies to a gold-backed U.S. dollar. The lone exception was revolutionary France, which also used fiat currency. In the case of the UK, where there is plenty of historical data, "inflation was relatively stable for about 600 years. It was only after the UK moved toward paper money that inflation has really taken off."

The book Monetary Regimes and Inflation by professor Peter Bernholz--which Mauldin calls "the bible on hyperinflations"--examines 12 of the 29 hyperinflationary episodes where ample data exist. Every hyperinflation looked the same. Quoting Bernholz, "Hyperinflations are always caused by public budget deficits which are largely financed by money creation....the figures demonstrate clearly that deficits amounting to 40% or more of expenditures cannot be maintained. They lead to high inflation and hyperinflations." Mauldin stresses that even smaller deficits can cause inflation: "20% deficits were behind all but four cases of hyperinflation." According to the Congressional Budget Office, as of February, the projected deficit of $1.6 trillion for FY 2024 is 24.6% of projected expenditures of $6.5 trillion.

Mauldin asks, "...in the [Fed's] attempt to get mild inflation [2%], is it possible the controlled fire it hopes to kindle could get out of control...[which would] bring about a recession"? I think the Fed has a brushfire on its hands with no way to put it out. If it raises interest rates (those that it controls), it will crash the economy and the government, both of which are heavily indebted to a record degree.

Mauldin writes, "Hyperinflations are all very similar. At first, bad money drives out the good. Under the Greeks and Romans, when gold coins were debased...older good coins disappeared as people [hoarded] them. This is called Gresham's law: Bad money drives out good money. In modern hyperinflations where gold coins [aren't an option], people begin to barter...to avoid having to use [rapidly depreciating fiat currency]."

"Then, if they can get their hands on a foreign currency that is perceived to be hard and unlikely to lose its value, like dollars or deutschmarks [decades ago], they will start to use the foreign currency." Once enough people do so, "Gresham's law reverses itself....The good foreign money drives out the bad, and the inflating currency becomes totally worthless. This is called Their's law....The consequences [of] this are dreadful. Hyperinflation completely destroys the purchasing power of savings....Investors refuse to invest, unemployment skyrockets, and savings flee the country."

Mauldin notes a consequence of the federal government using inflation to decrease the real value of its liabilities: "Nearly half of federal outlays are linked to inflation, so higher inflation means higher deficits....The [Congressional Budget Office] estimates that if inflation is one percentage point higher over the next decade than the rate the CBO has projected, budget deficits during those years would be roughly $700 billion larger."

Mauldin stresses the importance of debt structure, which he thinks may be much more important than the amount of debt: "Not all debt is equal. [One] has to distinguish between inverted debt and hedged debt. With inverted debt, the value of liabilities is positively correlated with the value of assets, so that the debt burden and servicing costs decline in good times and rise in bad times. With hedged debt, they are negatively correlated."

Short-term debt [BTW, roughly one third of federal debt has to be refinanced each year] and debt denominated in a foreign currency "are examples of inverted debt. This makes the good times better and the bad times worse. Long-term fixed-rate local-currency borrowing is an example of hedged debt....Highly inverted debt structures are very dangerous because they reinforce negative shocks and can cause events to spiral out of control....Contagion is caused not so much by fear...but by large amounts of highly leveraged positions....." However, the ability of the U.S. government to borrow exclusively in its own currency "creates an incentive to use devaluation and inflation as a means of financial repression."

Mauldin quotes the CBO: "...a growing level of federal debt would...increase the probability of a sudden financial crisis, during which investors would lose confidence in the government's ability to manage its budget, and the government would thereby lose its ability to borrow at affordable rates....as other countries' experiences show, it is also possible that investors would lose confidence abruptly and interest rates on government debt would rise sharply."

Mauldin reminds us that "Collapses happen suddenly and unexpectedly. They happen because of underlying instability, and they can be triggered by even small events....it is not the [snowflake] that's the real cause for the avalanche, but the level of instability in the overall system."

Mauldin quotes economic historian Niall Ferguson: "Imperial collapse may come much more suddenly than many historians imagine. A combination of fiscal deficits and military overstretch suggests that the U.S. may be the next empire on the precipice....most imperial falls are associated with fiscal crises....Alarm bells should be ringing very loudly" in the U.S.

Mauldin notes that since the 1970s, "While workers' earnings have gone nowhere, federal employees' average compensation has grown to more than double what private-sector workers earn." This explains why the counties around Washington, D.C. have the highest average income in the U.S (and why there is such a disconnect between the ruling elite and its subjects).

Mauldin points out that the long-term, off-balance sheet liabilities (such as the unfunded liabilities for Social Security, Medicare and the military and civil service pension systems, which are well over $200 trillion) are much, much higher than the national debt: "The official U.S. deficit and debt numbers are based on cash accounting," which tracks money that comes in and goes out. "Companies and complex institutions...use accrual accounting, which...measures income and expenses when they occur," which gives a much more accurate representation of an institution's financial condition.

Mauldin notes that "The supreme irony is that federal law requires companies that have revenue of $1 million or more to use accrual accounting. If any private company used cash accounting...its executives would be prosecuted by the government. It is illegal for businesses to keep their books the way the government does, hiding long-term obligations the way the government hides its indebtedness from voters."

Finally, Mauldin explains why U.S. Treasuries should no longer be considered a "risk-free asset": "...because U.S. debt is growing with no end in sight, we're not paying down our debt....We issue new debt to pay off the old and borrow a little more each time....this violates the transversality or no-Ponzi condition. Without any meaningful fiscal reform, the only reason to hold a government bond is because someone else might pay more for it than you bought it for; that is, there might be a greater fool out there somewhere. The problem is that eventually markets run out of fools." Don't be the last fool.

Recommended

Dark Horse: Achieving Success Through the Pursuit of Fulfillment This was a thought-provoking book.

News You Can Use

Privacy Experts Sound Alarm on Spying Bill

NSA Just Days Away from Taking Over Internet

The Freedom That Once Was the Internet

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