

## **JOHN MAULDIN'S THOUGHTS FROM THE FRONTLINE THIS TIME IS DIFFERENT**

In this week's *Thoughts from the Frontline* John Mauldin comments on the surprisingly strong US GDP number released last week. He then refers to the book, *This Time is Different*, by Carmen M. Reinhart and Kenneth Rogoff to explain the economics behind market cycles. The focus for this week is confidence and how quickly it can change. The oversubscription of the Greek bond issuance is also discussed and previous defaults investigated.

Enjoy the read.

"Our immersion in the details of crises that have arisen over the past eight centuries and in data on them has led us to conclude that the most commonly repeated and most expensive investment advice ever given in the boom just before a financial crisis stems from the perception that 'this time is different.' That advice, that the old rules of valuation no longer apply, is usually followed up with vigor. Financial professionals and, all too often, government leaders explain that we are doing things better than before, we are smarter, and we have learned from past mistakes. Each time, society convinces itself that the current boom, unlike the many booms that preceded catastrophic collapses in the past, is built on sound fundamentals, structural reforms, technological innovation, and good policy."

- *This Time is Different* (Carmen M. Reinhart and Kenneth Rogoff)

When does a potential crisis become an actual crisis, and how and why does it happen? Why did most everyone believe there were no problems in the US (or Japanese or European or British) economies in 2006? Yet now we are mired in a very difficult situation. "The subprime problem will be contained," said now controversially confirmed Fed Chairman Bernanke, just months before the implosion and significant Fed intervention. I have just returned from Europe, and the discussion often turned to the potential of a crisis in the Eurozone if Greece defaults. Plus, we take a look at the very positive US GDP numbers released this morning. Are we finally back to the Old Normal? There's just so much to talk about.

But first, I want to give you a chance to register for my 6th (where do the years go?!) annual Strategic Investment Conference, cosponsored with my friends at Altegris Investments. The conference will be held April 22-24 and, as always, in La Jolla, California. The speaker lineup is powerful. Already committed are Dr. Gary Shilling, David Rosenberg, Dr. Lacy Hunt, Dr. Niall Ferguson, and George Friedman, as well as your humble analyst. We are talking with several other equally exciting speakers and expect those to firm up shortly.

Comments from those who attend often run along the lines of "This is the best conference we have ever been to." And each year it seems to get better. This year we are going to focus on "The End Game," that is, on the paths the various nations are likely to take as they try to solve their various deficit problems, and how that will affect the world and local economies and our investments. We make sure you have access to our speakers and get your questions answered, and you'll come away with excellent, practical investment ideas.

This conference sells out every year, and you do not want to miss it. There is a physical limit to the space.

Every year I have to tell people, including good friends, that there is no more room. Don't wait to sign up. There is an early-bird discount of \$200. And while it pains me to say it, you must be an accredited investor to attend the conference, as there are regulations we must follow in order to offer specific advice and ideas. Click on the link and sign up now. <https://hedge-fund-conference.com/2010/invitation.aspx?ref=mauldin>

At the end of the letter I am going to comment on my latest Conversations with two of the leading lights in the biotech world and give you a link to my recent Outside the Box on biotech, which has had more response than almost any letter I have posted. If you missed it, you should read it, as I outline why I am actually buying stocks in the biotech space, even as I think we are headed for a double-dip recession and a rather sharp bear market. But now, let's jump into today's letter.

### **The Statistical Recovery Has Arrived**

Before we get into the main discussion point, let me briefly comment on today's GDP numbers, which came in at an amazingly strong 5.7% growth rate. While that is stronger than I thought it would be (I said 4-5%), there are reasons to be cautious before we sound the "all clear" bell.

First, over 60% (3.7%) of the growth came from inventory rebuilding, as opposed to just 0.7% in the third quarter. If you examine the numbers, you find that inventories had dropped below sales, so a buildup was needed. Increasing inventories add to GDP, while, counterintuitively, sales from inventory decrease GDP. Businesses are just adjusting to the New Normal level of sales. I expect further inventory build-up in the next two quarters, although not at this level, and then we level off the latter half of the year.

While rebuilding inventories is a very good thing, that growth will only continue if sales grow. Otherwise inventories will find the level of the New Normal and stop growing. And if you look at consumer spending in the data, you find that it actually declined in the 4th quarter, both annually and from the previous quarter. "Domestic demand" declined from 2.3% in the third quarter to only 1.7% in the fourth quarter. Part of that is clearly the absence of "Cash for Clunkers," but even so that is not a sign of economic strength.

Second, as my friend David Rosenberg pointed out, imports fell over the 4th quarter. Usually in a heavy inventory-rebuilding cycle, imports rise because a portion of the materials businesses need to build their own products comes from foreign sources. Thus the drop in imports is most unusual. Falling imports, which is a sign of economic retrenching, also increases the statistical GDP number.

Third, I have seen no analysis (yet) on the impact of the stimulus spending, but it was 90% of the growth in the third quarter, or a little less than 2%.

Fourth (and quoting David): "... if you believe the GDP data - remember, there are more revisions to come - then you *de facto* must be of the view that productivity growth is soaring at over a 6% annual rate. No doubt productivity is rising - just look at the never-ending slate of layoff announcements. But we came off a cycle with no technological advance and no capital deepening, so it is hard to believe that productivity at this time is growing at a pace that is four times the historical norm. Sorry, but we're not buyers of that view. In the fourth quarter, aggregate private hours worked contracted at a 0.5% annual rate and what we can tell you is that such a decline in labor input has never before, scanning over 50 years of data, coincided with a GDP headline this good.

"Normally, GDP growth is 1.7% when hours worked is this weak, and that is exactly the trend that was depicted this week in the release of the Chicago Fed's National Activity Index, which was widely ignored. On the flip side, when we have in the past seen GDP growth come in at or near a 5.7% annual rate, what is typical is that hours worked grows at a 3.7% rate. No matter how you slice it, the GDP number today represented not just a rare but an unprecedented event, and as such, we are willing to treat the report with an entire saltshaker - a few grains won't do."

Finally, remember that third-quarter GDP was revised downward by over 30%, from 3.5% to just 2.2% only 60 days later. (There is the first release, to be followed by revisions over the next two months.) The first release is based on a lot of estimates, otherwise known as guesswork. The fourth-quarter number is likely to be revised down as well.

Unemployment rose by several hundred thousand jobs in the fourth quarter, and if you look at some surveys, it approached 500,000. That is hardly consistent with a 5.7% growth rate. Further, sales taxes and income-tax receipts are still falling. As I said last year that it would be, this is a Statistical Recovery. When unemployment is rising, it is hard to talk of real recovery. Without the stimulus in the latter half of the year, growth would be much slower.

So should we, as Paul Krugman suggests, spend another trillion in stimulus if it helps growth? No, because, as I have written for a very long time, and will focus on in future weeks, increased deficits and rising debt-to-GDP is a long-term losing proposition. It simply puts off what will be a reckoning that will be even worse, with yet higher debt levels. You cannot borrow your way out of a debt crisis.

### **This Time Is Different**

While I was in Europe, and flying back, I had the great pleasure of reading *This Time is Different*, by Carmen M. Reinhart and Kenneth Rogoff, on my new Kindle, courtesy of Fred Fern.

I am going to be writing about and quoting from this book for several weeks. It is a very important work, as it gives us the first really comprehensive analysis of financial crises. I highlighted more pages than in any book in recent memory (easy to do on the Kindle, and even easier to find the highlights). Rather than offering up theories on how to deal with the current financial crisis, the authors show us what happened in over 250 historical crises in 66 countries. And they offer some very clear ideas on how this current crisis might play out. Sadly, the lesson is not a happy one. There are no good endings once you start down a deleveraging path. As I have been writing for several years, we now are faced with choosing from among several bad choices, some being worse than others. *This Time is Different* offers up some ideas as to which are the worst choices.

If you are a serious student of economics, you should read this book. If you want to get a sense of the problems we face, the authors conveniently summarize the situation in chapters 13-16, purposefully allowing people to get the main points without drilling into the mountain of details they provide. Get the book at a 45% discount at [Amazon.com](http://Amazon.com).

Buy it with the excellent book I am now reading, *Wall Street Revalued*, and get free shipping.

### **A Crisis of Confidence**

Let's lead off with a few quotes from *This Time is Different*, and then I'll add some comments. Today I'll focus on the theme of confidence, which runs throughout the entire book.

"But highly leveraged economies, particularly those in which continual rollover of short-term debt is sustained only by **confidence** in relatively illiquid underlying assets, seldom survive forever, particularly if leverage continues to grow unchecked."

"If there is one common theme to the vast range of crises we consider in this book, it is that excessive debt accumulation, whether it be by the government, banks, corporations, or consumers, often poses greater systemic risks than it seems during a boom. Infusions of cash can make a government look like it is providing greater growth to its economy than it really is. Private sector borrowing binges can inflate housing and stock prices far beyond their long-run sustainable levels, and make banks seem more stable and profitable than they really are. Such large-scale debt buildups pose risks because they make an economy

vulnerable to crises of **confidence**, particularly when debt is short term and needs to be constantly refinanced. Debt-fueled booms all too often provide false affirmation of a government's policies, a financial institution's ability to make outsized profits, or a country's standard of living. Most of these booms end badly. Of course, debt instruments are crucial to all economies, ancient and modern, but balancing the risk and opportunities of debt is always a challenge, a challenge policy makers, investors, and ordinary citizens must never forget."

And this is key. Read it twice (at least!):

"Perhaps more than anything else, failure to recognize the precariousness and fickleness of **confidence**-especially in cases in which large short-term debts need to be rolled over continuously-is the key factor that gives rise to the this-time-is-different syndrome. **Highly indebted governments, banks, or corporations can seem to be merrily rolling along for an extended period, when bang!-confidence collapses, lenders disappear, and a crisis hits.**

"Economic theory tells us that it is precisely the fickle nature of **confidence**, including its dependence on the public's expectation of future events, that makes it so difficult to predict the timing of debt crises. High debt levels lead, in many mathematical economics models, to "multiple equilibria" in which the debt level might be sustained - or might not be. Economists do not have a terribly good idea of what kinds of events shift **confidence** and of how to concretely assess **confidence** vulnerability. What one does see, again and again, in the history of financial crises is that when an accident is waiting to happen, it eventually does. When countries become too deeply indebted, they are headed for trouble. When debt-fueled asset price explosions seem too good to be true, they probably are. But the exact timing can be very difficult to guess, and a crisis that seems imminent can sometimes take years to ignite."

How confident was the world in October of 2006? I was writing that there would be a recession, a subprime crisis, and a credit crisis in our future. I was on Larry Kudlow's show with Nouriel Roubini, and Larry and John Rutledge were giving us a hard time about our so-called "doom and gloom." If there is going to be a recession you should get out of the stock market, was my call. I was a tad early, as the market proceeded to go up another 20% over the next 8 months.

As Reinhart and Rogoff wrote: "Highly indebted governments, banks, or corporations can seem to be merrily rolling along for an extended period, when **bang!** - confidence collapses, lenders disappear, and a crisis hits."

*Bang* is the right word. It is the nature of human beings to assume that the current trend will work out, that things can't really be that bad. Look at the bond markets only a year and then just a few months before World War I. There was no sign of an impending war. Everyone "knew" that cooler heads would prevail.

We can look back now and see where we made mistakes in the current crisis. We actually believed that this time was different, that we had better financial instruments, smarter regulators, and were so, well, modern. Times were different. We knew how to deal with leverage. Borrowing against your home was a good thing. Housing values would always go up. Etc.

Now, there are bullish voices telling us that things are headed back to normal. Mainstream forecasts for GDP growth this year are quite robust, north of 4% for the year, based on evidence from past recoveries. However, the underlying fundamentals of a banking crisis are far different from those of a typical business-cycle recession, as Reinhart and Rogoff's work so clearly reveals. It typically takes years to work off excess leverage in a banking crisis, with unemployment often rising for 4 years running. We will look at the evidence in coming weeks.

The point is that complacency almost always ends suddenly. You just don't slide gradually into a crisis, over years. It *happens!* All of a sudden there is a trigger event, and it is August of 2008. And the evidence in the

book is that things go along fine until there is that crisis of confidence. There is no way to know when it will happen. There is no magic debt level, no magic drop in currencies, no percentage level of fiscal deficits, no single point where we can say "This is it." It is different in different crises.

One point I found fascinating, and we'll explore it in later weeks. First, when it comes to the various types of crises with the authors identify, there is very little difference between developed and emerging-market countries, especially as to the fallout. It seems that the developed world has no corner on special wisdom that would allow crises to be avoided, or allow them to be recovered from more quickly. In fact, because of their overconfidence - because they actually feel they have superior systems - developed countries can dig deeper holes for themselves than emerging markets.

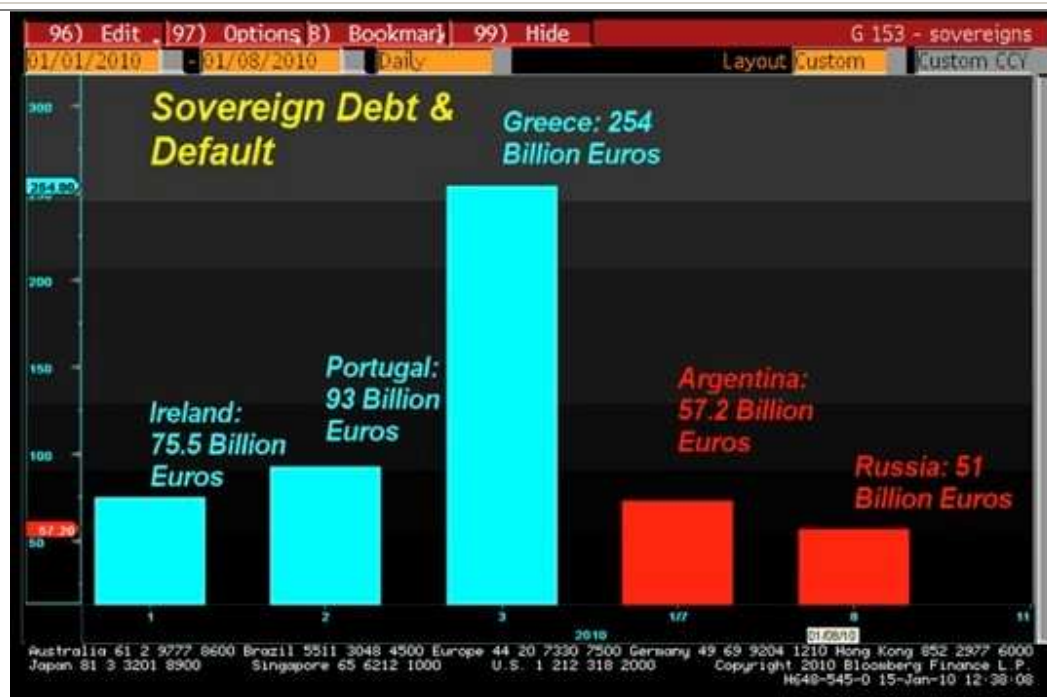
Oh, and the Fed should have seen this crisis coming. The authors point to some very clear precursors to debt crises. This bears further review, and we will do so in coming weeks.

### **Greeks Bearing Gifts**

On Monday, the government of Greece offered a "gift" to the markets of 8 billion euros worth of bonds at a rather high 6.25%. The demand was for 25 billion euros, so this offering was rather robust. Today, those same Greek bonds closed on 6.5%, more than offsetting the first year's coupon. Greek bond yields are up more than 150 basis points in the last month!

Why such a one-week turnaround? Ambrose Evans Pritchard offers up this thought: "Marc Ostwald, from Monument Securities, said the botched bond issue of €8bn (£6.9bn) of Greek debt earlier this week has made matters worse. Many of the investors were 'hot money' funds that bought on rumors that China was emerging as a buyer, offering them a chance for quick profit. When the China story was denied by Beijing and Athens, these funds rushed for the exit."

Greece is running a budget deficit of 12.5%. Under the Maastricht Treaty, they are supposed to keep it at 3%. Their GDP was \$374 billion in 2008 (about €240 billion). If they can cut their budget deficit to 10% this year, that means they will need to go into the bond market for another €25 billion or so. But they already have a problem with rising debt. Look at the following graph on the debt of various countries.



When Russia defaulted on its debt and sent the world into crisis in 1998, they had total debt of only €51 billion. Greece now has €254 billion and added another €8 billion this week, and needs to add another €24 billion (or so) later this year. That's a debt-to-GDP ratio of over 100%, well above the limit of the treaty, which is 60%.

Greece benefitted from being in the Eurozone by getting very low interest rates, up until recently. Being in the Eurozone made investors confident. Now that confidence is eroding daily. And this week's market action says rates will go higher, without some fiscal discipline. To help my US readers put this in perspective, let's assume that Greece was the size of the US. To get back to Maastricht Treaty levels, they would need to cut the deficit by 4% of GDP for the next few years. If the US did that, it would mean an equivalent budget cut of \$500 billion dollars. Per year. For three years running.

That would guarantee a very deep recession. Just a 10% suggested pay cut has Greek government unions already planning strikes. Nevertheless, the government of Greece recognizes that it simply cannot continue to run such huge deficits. They have developed a plan that aims to narrow the shortfall from 12.7% of output, more than four times the EU limit, to 8.7% this year. That reduction will be achieved even though the economy will contract 0.3%, the plan says. The deficit will shrink to 5.6% next year and 2.8% in 2012.

The market is saying they don't believe that will happen. For one thing, if the Greek economy goes into recession, the amount collected in taxes will fall, meaning the shortfall will increase. Second, it is not clear that Greek voters will approve such a plan at their next elections. Riots and demonstrations are a popular pastime.

Both French and German ministers made it clear that there would be no bailout of Greece. But here's the problem. If they ignore the noncompliance, there is no meaning to the treaty. The euro will be called into question. And the other countries with serious fiscal problems will ask why they should cut back if Greece does not. If Greece does not choose deep cutbacks and recession, the markets will keep demanding hikes in interest rates, and eventually Greece will have problems meeting just its interest payments.

Can this go on for some time? The analysis of debt crises in history says yes, but there comes a time when

confidence breaks. My friends from GaveKal had this thought:

"What is the next step? Having lived through the Mexican, Thai, Korean and Argentine crises, it is hard not to distinguish a common pattern. In our view, this means that investors need to confront the fact that we are at an important crossroads for Greece, best symbolized by a simple question: 'If you were a Greek saver with all of your income in a Greek bank, given what is happening to the debt of your sovereign, would you feel comfortable keeping all of your life savings in your savings institution? Or would you start thinking about opening an account in a foreign bank and/or redeeming your currency in cash?' The answer to this question will likely direct the next phase of the crisis. If we start to see bank runs in Greece, then investors will have to accept that the crisis has run out of control and that we are facing a far more bearish investment environment. However, if the Greek population does not panic and does not liquefy/transfer its savings, then European policy-makers may still have a chance to find a political solution to this growing problem.

"What could a political solution be? The answer here is simple: there is none. So if Europe wants to save Greece from hitting the wall towards which it is now heading, the European commission, the ECB and/or other institutions (IMF?) will have to bend the rules massively. In turn, this will likely lead to a further collapse in the euro. But for us, an important question is whether it could also lead to a serious political backlash. Indeed, at this stage, elected politicians are likely pondering how much appetite there is amongst their electorate for yet another bailout, and for further expansions in government debt levels. The fact that the intervention would occur on behalf of a foreign country probably makes it all the more unpalatable (it's one thing to save your domestic banking system ... but why save Greece?)."

If Greece is bailed out, Portugal and Ireland will ask "Why not us?" And Spain? Italy? If Greece is allowed to flaunt the rules, what does that say about the future of the euro? Will Germany and France insist on compliance or be willing to kick Greece out?

A few months ago, the markets assumed that not only Greece but Portugal, Italy, Spain, and Ireland would have a few years to get their houses in order. This week, the markets shortened their time horizon for Greece.

Even so, we get this quote, which may end up ranking alongside Fisher's quote in 1929, that the stock market was at a permanently high plateau, or Bernanke's quote that "The subprime debt problem will be contained."

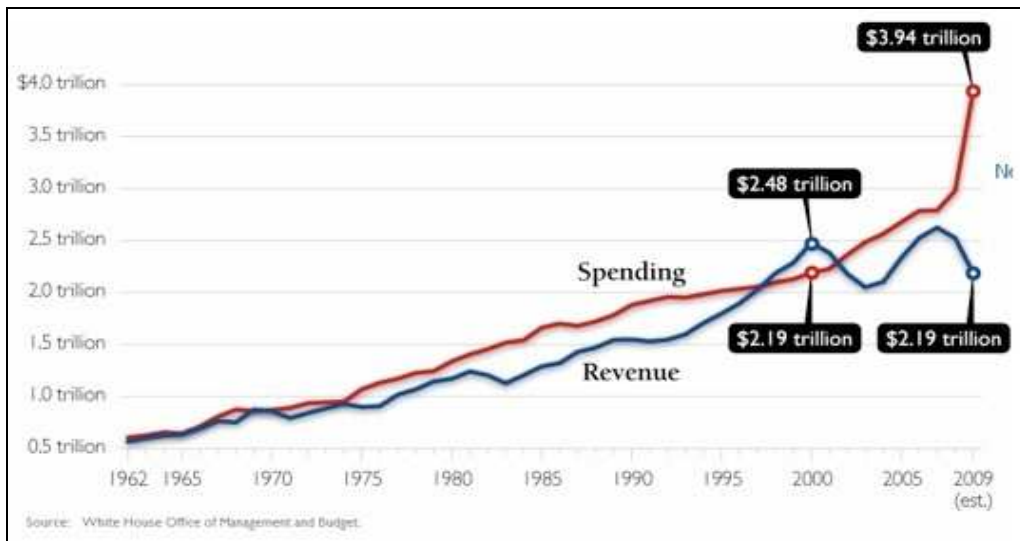
"There is no bailout problem," Monetary Affairs Commissioner Joaquin Almunia said today at the World Economic Forum's annual meeting in Davos, Switzerland. "Greece will not default. In the euro area, default does not exist."

The evidence in *This Time is Different* is that default risk does in fact exist. You cannot keep borrowing past your income, whether as a family or a government, and not eventually go bankrupt.

Are we at an inflection point? Too early to say. It all depends on the willingness of the Greek people to endure what will not be a fun next few years, for the privilege of staying in the Eurozone. And on whether the bond market believes that this time is different and the Greeks will actually get their fiscal house in order.

Oh by the way, did I mention that the history of Greece is not exactly pristine in terms of default? In fact, they have been in default in one way or another for 105 out of the past 200 years. Aristotle, can you spare a dime?

And one last thought. The US is running massive deficits. If we do not get them under control, we will one day, and perhaps quite soon, face our own "Greek moment." Look at the graph below, and weep.



Obama offering to freeze spending by 17% in US discretionary-spending programs, after he ran them up over 20% in just one year, is laughable. Greece is an object lesson for the world, as Japan soon will be. You cannot cure too much debt with more debt.



### Biotech, Conversations, and More

Two quick commercial notes. I mentioned a few weeks ago that I was going to start a stock-buying program for the first time in 15 years (I normally invest in managers and funds rather than specific stocks). I published an Outside the Box last week that talked about why I think biotech stocks could be at the beginning of a decade-long run, and why I wanted to participate directly. You can read that Outside the Box by [clicking on this link](#).

Second, I offer a subscription service called Conversations with John Mauldin, where I hold conversations with people who I think have something important for us to understand. It has been very well received. We provide both audio and a transcript. I just posted my latest Conversations, in which I interviewed two gentlemen who are CEOs of companies that I think are at the very bleeding edge of the biotech revolution. Subscribers have already gotten that posting. Over the year, in addition to the usual economic Conversations we have, I will be interviewing other industry leaders who will be changing the world of medicine in the coming decade. You can subscribe at <https://www.johnmauldin.com/newsletters2.html>.

In addition, George Friedman and Niall Ferguson and I are exchanging emails on a time to get together for another of the series where George and I talk about geopolitics. I guarantee a lively and fascinating Conversation.

It is good to be back from Europe. While it was fun, it was mostly long days and a lot of planes, trains, and automobiles. I arrived home to find baby bottles and other baby paraphernalia around the house. Tiffani and Ryan are starting to come back to work at the house with me, and of course my granddaughter Lively will be here most days with them, along with a nanny so Mom can actually work. It has been a long time since I had a baby around. As I went to bed, I realized that I was going to get to watch this grandchild grow up on an almost daily basis. It was with a sigh of contentment that I went to sleep.

And then today, they came and brought her. She has grown so much in just the week I was gone! Once again, I get to experience the miracle of kids growing up. Only this time I don't have to change the diapers. Life is good.

Your believing my grandkids will have a better future analyst,

**John Mauldin**

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Tel: +27 (0) 21 970 2400 • Fax: +27 (0) 21 975 2248 • E-mail: [info@plexus.co.za](mailto:info@plexus.co.za) • Web: <http://www.plexus.co.za>

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