September 28, 2012

"The fact that the Keynesians...are in total disarray just shows that their global explanation of how the world works is simply wrong. If Keynesian policies worked France should be booming today."
-CHARLES GAVE

The game that will live in infamy. Silly me—after all these years I thought CNBC was actually a financial news network. But all it took was the for the Seahawks to be on the beneficial end of a highly questionable call—rather than our typical sad-sack victims—for Cramer and Co. to devote hours of coverage to the game's wild ending. Even the riots in Spain seemed to get less airtime, but more on that in a moment.

Before I move on to more impressive—not to mention more explosive—subjects, I feel compelled to explain to relatively new EVA readers that one of my regular sources of humor is Seattle sports teams. Our athletic warriors have a time-tested ability to snatch defeat out of the jaws of victory and they are invariably aided and abetted by the officials.

Lest you think that is just sour grapes from a bitter and long-suffering fan, let me briefly take you back to Super Bowl XL (for those of you who think that is a shirt size, it actually stands for 40). In 2006, for the first time ever, the Seahawks made it to the Main Event, forty years after the NFL Packers had crushed the AFL Chiefs. But as Seahawk luck would have it, they endured a series of horrible calls that ended up costing them the game. And these bizarre rulings came not from backup refs, and not in an early season game, but from the crème de la crème of officiating in the most important sporting event on the planet (sorry World Cup fans).

Again, in case you feel I'm just a sore loser (probably true), the head referee of that game now admits he and his crew blew it and that it will haunt him to his grave (talk about some serious guilt!) He even concedes he didn't fully understand the rules! Call me a hopelessly biased Seahawk fan but I don't believe the Super Bowl is the right venue for on-the-job training.

Yet, somehow it's totally fitting given Seattle sports' cursed karma—which includes losing our beloved Supersonics to, I can hardly write it, Oklahoma City—that our typically obscure NFL franchise would be thrust into the global spotlight by "stealing" this game. Actually, serious Seahawk followers realize that when Golden Tate truly craves something--say, for example, a Top Pot maple bar--he's nearly unstoppable. (If you don't get that inside joke might want to google Golden Tate and Top Pot). And, true to form, once Monday night's scrum ended, he did wind up with the ball.

Moreover, NFL fans everywhere owe the Golden one a thunderous thank-you for single-handedly (ok, double-handedly) forcing the NFL to settle the zebra strike. The least you could do is send a maple bar or two.

Ok, enough about football—I don't want to become the financial newsletter equivalent of CNBC, though perhaps it's too late. Let's move on to one of the planet's other perennial losers--Europe. With each passing day, it's plain the pain in Spain is a relentless refrain (boy, maybe I've had one too many maple bars!)

Return to reality. A few months ago, I conveyed my belief to readers that the summer just ended was likely to be an incendiary season in southern Europe. Frankly, I was amazed by how uneventful it turned out to be, but this month is a much different story.

Between lengthy segments on the Seahawk-Packer game, viewers have seen some fairly alarming footage of civil strife from Spain, one of Europe's most important countries. On that note, the first part of this month's guest EVA is a brief but stinging indictment of the "europhoria" that has dominated the scene over there for the last eight weeks or so.

The author of this is Frank Veneroso. Grant Williams, publisher of *Things That Make You Go HMMM*, and one of Evergreen's newest and brightest allies, is an ardent admirer of Frank's work. (As a side note, Grant just inked a deal with John Mauldin; consequently, Grant's weekly essays will now be transmitted to John's approximately 1,000,000 subscribers.)

As you will soon read, Frank shares our view that Spain is in much worse shape than the popular press--and their government--would lead you to believe. In a brief email to me on Wednesday, he pointed out that recently in Catalonia, which generates 17% of Spain's economic output, an estimated1.5 million citizens hit the streets. This represents 20% of the region's population, equivalent to a protest by 60 million US citizens! No wonder dumpster-diving is becoming their new national sport.

Following Frank's overview is a fascinating piece on demographics and the implications for inflation (or lack thereof) as well as their impact on the financial markets. It was written by one of the more renowned demographic experts, familiar to many of you, Harry Dent.

Finally, we've attached a link to one of Simon Hunt's latest essays on how he sees the world evolving over the next decade. EVA readers may recall we've previously run some of Simon's work and he's quite concerned about the immediate future (as are we). However, his longer view is actually fairly sanguine and he also has some absorbing views on demographics, especially the US vis a vis China. For all of you feeling down on our country right now, you will want to read what this Simon says.

Now let's get to the good stuff…

David_Hay_Signature

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EXECUTIVE SUMMARY
By Frank Veneroso

If the following is correct, then the euro crisis is going to come back. If past correlation trading persists, then "risk off" is going to come back.

Given the amazing amnesia of the market, I have no idea about the timing.

1. Spanish bank deposits have declined by 224 billion euros in the twelve months ending July 31st. That is equal to more than 20% of Spanish GDP.

2. Spanish banking system borrowings from the ECB rose from 82 billion euros to 412 billion euros in the twelve months through August. This amounts to lender of last resort financing equal to over 30% of GDP in a mere year.

3. There can be no doubt that the run on Spanish banks has been ongoing, massive, and most likely devastating.

4. Spanish real estate prices fell 14.4% year on year in the second quarter -- the fastest rate since the real estate bubble burst in 2007.

5. Amidst all this the Spanish government reports that its economy is almost stable. It claims its GDP has fallen only 1% over the last year.

6. I am extremely skeptical of this benign Spanish economic data.

7. I pour through the Spanish economic data series. They tell me the Spanish economy is falling hard.

8. The market place now seems to believe that it can ignore Spain's untenably high private indebtedness, the effects of its bank run, and the strain on its political and social fabric – all because Super Mario has a wondrous double barreled bazooka.

9. The market place now seems to believe that if the Spanish government says the Spanish GDP is almost stable it can ignore all the rest of the Spanish economic data and the ominous Spanish financial data.

10. I think the marketplace's bizarre complacency after so many failed ECB and EU policy measures in the past will not hold.

11. At some point the market place will wake up to the fact that Spain, the domino too big to fall, is falling.

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A DECADE OF VOLATILITY: DEMOGRAPHICS, DEBT, AND DEFLATION
By Harry S. Dent, Jr., author of *The Great Crash Ahead and editor of Boom & Bust*

Most of you reading this expect inflation in the years ahead, right? Well, I don’t. In fact, I am firmly in the deflation camp.

Just think about it. What has happened after every major debt bubble in history? What happened after the 1873-74 bubble? Or after the 1929-32 bubble? Did prices inflate or deflate?

We got deflation in prices… every time.

This time around, with the latest bubble peaking in 2007/08, the outcome will be exactly the same. There is deflation ahead. Expect it. Prepare for it.

But the bubble-bust cycle that history has allowed us to see is not the only reason I’m so certain we’re heading for deflation and a great crash ahead. I have other, irrefutable evidence…

For one, there is the most powerful economic force on Earth: demographics. More specifically, the power of the number 46. You see, that’s the age at which the average household peaks in spending.

When the average kid is born, the average parent is 28. They buy their first home when they’re 31… after they had those kids. When the kids age into nasty teenagers, the parents buy a bigger house so they can have space. They do this between the ages of 37 and 42. Their mortgage debt peaks at age 41. And like I said, their spending peaks at around 46.

From cradle to grave, people do predictable things… and we can see these trends clearly in different sectors of our economy, from housing to investing, borrowing and spending, decades in advance.

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This demographic cycle made the crash in the ‘30s and the slowdown in the ‘70s unavoidable. Now it is happening again... with the biggest generation in history – the Baby Boomers.

Consumer spending makes up more than two-thirds of our gross domestic product (GDP). So knowing when people are going to spend more or less is an incredibly powerful tool to have. It tells you, with uncanny accuracy, when economies will grow or slow.

Why Deflation Is the Endgame

Think of it this way: the government is hellbent on inflating. It's doing so by creating debt through its quantitative easing programs (just for starters). But what's the private sector doing? It's deflating.

And the private sector is definitely the elephant in the room. How much private debt did we have at the top of the bubble? $42 trillion. How much public debt did we have back then? $14 trillion.

That looks like a no-brainer to me. Private outweighs public three to one. And the private sector is deleveraging as fast as it can, just like what happened in the 1870s and 1930s. History shows us that the private sector always ends up winning the inflation-deflation fight.

Now, I will concede that this is an unprecedented time. Today governments around the world have both the tools and the determination to fight deflation. And they are desperate to keep it at bay because they know how nasty it is (they, too, are students of history).

How bad is it? Think of deflation like what your body would do with bad sushi. It would flush it out as fast as possible. That's what our system is trying to do with all the debt we accumulated during the boom years. It's what the system did in the 1930s. Back then we went from almost 200% debt-to-GDP to just 50% in three years. It hurt like hell. The government doesn't want this painful deleveraging.

The problem is, the longer the government tries to fight this bad sushi, the sicklier the system becomes. I know this because it's what happened to Japan…

Japan's bubble peaked in the '80s. When the unavoidable deleveraging process began, the country did everything in its power to stop it. How is Japan doing today, 20 years after its crash? It is still at rock bottom. Its stock market is still down 75%.

Japan has gone through everything we'll go through in the next few years. Does Japan have an inflation problem? That's a rhetorical question. Did its central bank stimulate frantically? Also a rhetorical question.

Think of it another way: what is the biggest single cost of living today? Is it gold? Oil? Food? It's none of these. It is housing. And what is housing doing? Dropping like a rock. It can't muster a bounce, despite the lowest mortgage rates in history and the strongest stimulus programs anywhere… ever.

The Fed is fighting deflation purposely. It will fail.

Why the Fed Will Fail in All Its Efforts

There is simply no way the Fed can win the battle it’s currently waging against deflation,because there are 76 million Baby Boomers who increasingly want to save, not spend. Oldpeople don’t buy houses!

At the top of the housing boom in recent years, we had the typical upper-middle-class family living in a 4,000-square-foot McMansion. About ten years from now, what will they do? They’ll downsize to a 2,000-square-foot townhouse. What do they need all those bedrooms for? The kids are gone. They don’t visit anymore. Ten years after that, where are they? They’re in 200-square-foot nursing home. Ten years later, where are they? They’re in a 20-square-foot grave plot.

That’s the future of real estate. That’s why real estate has not bounced in Japan after 21 years. That’s why it won’t bounce here in the US either. For every young couple that gets married, has babies, and buys a house, there’s an older couple moving into a nursing home or dying.

I watch this same demographic force move through and affect every other sector of the economy. The tool I use to do so is my Spending Wave. This is a 46-year leading indicator with a predictable peak in spending of the average household.

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Here’s how it works: the red background in the chart above is the Dow, adjusted for inflation. The blue line is the spending wave, including immigration-adjusted births and lagged by 46 years to indicate peak spending. If you ask me, that correlation is striking.

The Baby Boom birth index above started to rise in 1937. It continued to rise until 1961 before it fell. Add 46 to 1937, and you get a boom that starts in 1983. Add 46 to 61, and you get a boom that ends in 2007.

Today demographics matters more than ever because of the 76 million Baby Boomers moving through the economy. That’s why I don’t watch governments until they start reacting in desperation. Then I adjust my forecasts accordingly.

Don’t Hold Your Breath for the Echo Boomer Generation

But all this talk about Baby Boomers inevitably births the question: "Surely the Echo Boom generation is coming up right behind their parents. They’ll fill the holes, right?"

Let me make this clear. If I hear one more nutcase on CNBC say, "The Echo Boom generation is bigger than the Baby Boom," I might go ballistic. They are wrong. The Echo Boomer generation is NOT bigger than the Baby Boom generation. In fact, it’s the first generation in history that’s not larger than its predecessor is, even when accounting for immigrants.

It’s not all doom and gloom, though. We will see another boom around 2020-23. But for now, all the Western countries will slow, thanks to the downward demographic trend sweeping the world. Some are slowing faster than others are. For example, Japan is slowing the fastest (it actually committed demographic kamikaze, but that’s a discussion for another day). Southern Europe is next along in its decline. Eastern Europe, Russia, and Asia are following quickly behind.

Which brings me back to my point: there is no threat of serious inflation ahead. Rather, deflation is the order of the day. The Fed thinks it can prevent a crash by getting people to spend. To that I say, "Good luck." Old people don’t spend money. They bribe the grandkids, and they go on cruises where they just stuff themselves with food and booze.

Do you know how to tell if you’re buying a car from an older person? It’s going to be ten years old and have only 40,000 miles on it. They drive 4,000 miles a year. They just go down the street to get a Starbucks coffee and a newspaper. Then they go back home. How do you know you’re buying a car from a soccer mom? It’s driven 20,000 miles a year, carting the kids around all day… to school, soccer practice, whatever. This is the power of demographics.

So let me tell you what causes inflation. It’s young people. Young people cause inflation. They cost everything and produce nothing. That’s inflation in people terms.

Why did we have high inflation in the ‘70s? Because Baby Boomers were in school, drinking, spending their parents’ money. While this was going on, we experienced the lowest-productivity decade in the last century.

Do you remember the 1970s? We had worsening recessions as the old Bob Hope generation began to save more while the Baby Boomers entered the economy en masse… at great expense. It costs a lot of money to incorporate young people, raise them, and put them into the workforce.

Then suddenly, in the early ‘80s, like some political genius did something brilliant, the economy started growing like crazy, and inflation fell. You know what that was? That was the largest generation in history transitioning en masse from being expensive, rebellious, young people to highly productive yuppies with young new families. It was the move from cocaine to Rogaine.

The correlation between labor force growth and inflation is crystal clear…

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When lots of young people come into the labor force, it’s inflationary. When lots of old people move out of the labor force and into retirement, it’s deflationary. Right now, where is the highest inflation in the world? It’s in emerging countries. Do they have more old people or young people? They have more young people.

We saw it in the 1970s, we see it in emerging markets, and we’ll see it ahead as the Baby Boomers head off into the sunset. First, there was inflation. Ahead is deflation. No doubt about it.

Harry Dent, the editor of Boom & Bust, *has put together a free report for John Mauldin’s readers, called:* Survive and Prosper in This Winter Season: Take These Steps Now... Before Dow 3,300 Arrives. *You can access this free report by clicking on this link: http://www.boomandbustinvestor.com/reports/current/BoomandBustInvestor_WinterSeason.pdf To watch a video version of this presentation by Harry Dent, please click on the following link: http://survive-prosper.com/A-Decade-of-Volatility*

Don’t forget to check out Simon Hunt’s September Economic Report, please click this link: http://www.mauldineconomics.com/images/uploads/overmyshoulder/Economic_Report_September_2012

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