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Well, hello and welcome to this week's Dividend Cafe. You may be able to tell that I'm not sitting in my studio in New York. I am in the office in New York and yet our studio, which is right here in the office, is having some tech difficulties. And so we decided just to go old school and have me come sit right here at my desk and record Dividend Cafe for you as if we didn't have our big fancy studios that we use so much. I don't think you care much. And those you listening to the podcast, really don't care. I want to talk to you today about pretty sober subjects, something much more important than our studios and where we record and things like that. And that is the subject of the US' debt issue.

And there's a kind of fascinating angle on this where I make an argument as I've been making for some time that the US faces a real systemic problem of low, slow and no growth. That, and I call this problem apanification, and the basic kind of setup goes something like this, that an asset bubble forms. And that could be from a combination of circumstances. You can have government policy feeding a bubble, excessive overly accommodative, easy money, government stimulus. You can have just general investor euphoria, human nature doing what it does. There's a lot of things that create a bubble and yet a bubble that forms eventually of course pops. It bursts and then great economic damage is done. And if the bubble that burst led to enough economic damage by which profits decline in the economy, wages decline, jobs decline, that's basically what generally we call recession. And those economic difficulties, either some or all of them put together become the situation that policymakers try to respond to because people's standard of living is declining. Their quality of life is declining. It can become very politically toxic. People don't like bad things happening in the economy. It's all pretty simple so far on a real severe basis. When you have an asset bubble form and then it burst, you can be susceptible to what we call debt deflation. A debt deflation spiral was something that the great Irving Fisher wrote about after the Great Depression, whereby things are declining enough and are bad enough that one is to liquidate debt. They're selling assets to get rid of debt, but the assets are declining in value. The income is declining in value. The net worth is declining at a faster pace than one can sell off assets. Therefore, you get into a spiral where by reducing debt, you're actually increasing your leverage because the very process of reducing debt is putting downward pressure on that denominator. The asset value, a little wonky I suppose.I hope you understand what I just said. It's not really a very controversial thesis and economics anymore. And it can be one of the worst experiences for an economy to go through. And it's more or less what the Federal Reserve and other central banks were put on earth to do was avoid these debt deflation spirals. Generally that can come about because some sort of illiquidity crisis creates a solvency crisis. And that's where this idea of lender last resort came from.

Well anyways, a severe downward turn in the economy from a bubble bursting can be a debt deflation spiral. But even if it's just a run of the mill recession, generally the problems of that bubble burst are treated with Keynesian stimulus, increased fiscal spending disorder, counter punch the decline in real wages and in corporate profits. And the sentiment concern that because wages are down, people will start spending less, which makes wages go down further and rinse and repeat. That's this the concept behind Keynes' notion of stimulating aggregate demand. And of course the only way that they can do that is by using the balance sheet of the government, which we're going to talk about here in a moment.

So all this right now is set up and yet by definition to do that from the government very likely means deficit spending. It means adding to the national debt, which the future service of that debt takes away from future national income. Easy enough. So while you are in the midst of trying to treat the effects of downward pressure on asset prices, downward pressure on wages bubble bursting, so you're stimulating with essential bank, you're stimulating with fiscal Keynesian spending, you're trying to lower your cost of capital with easier money then you end up getting more people borrowing because the cost of capital's cheaper. So that obviously incentivizes people to borrow more, which then a few bigger drag on future growth because there's now more debt and more borrowing. More spending means that there's less savings and investment. And if there's less savings in investment, then there's downward pressure on growth. And this is sort of the chain of events that I've talked about for years that I've kind of dedicated much of my professional academic study to is the effects and the interactions of these different components in a complex economy. And what I would say is that at the root of all of, this "Japanification" result always comes from some form of excessive debt and leverage. And that the end result ends up being downward pressure on growth. That's really the name of the game here.

So I would prefer to not have to get overly technical in the way we treat this. But the problem when we talk about excessive debt, excessive spending is sometimes we're not all, we're not talking about governmental debt. So I'll give you an example. The household sector was really at the heart of what created the great financial crisis. The households of America had levered up so much primarily with mortgage borrowing. There was other borrowing on their balance sheet, credit card debt, student debt, auto debt. But for the most part it was residential debt that households were comfortable hovering up because they saw the asset growing with it. And then of course we know that whole story, but there was something in the range of, oh, let's see what was it? 13 trillion dollars of household debt. And after the financial crisis it got down to 11 trillion because there was that de-levering. And so you had throughout 2001 to 2006 a buildup of excessive absolute debt and a buildup of leverage, meaning the ratio of debt to income got to be ridiculous. But see, the Keynesian idea would then be to say, okay, well let's have government spending now offset. In other words, the economy is screwed up because households have to delever, but the government will counter punch with fiscal spending and offset it. But that presupposes a sort of equilibrium that the government itself is not overindebted, overlylevered. And you will recall going into the new century new millennium that we're in now that we had something in the range of 5.6 trillion of national debt pre-9/11. And by the time we got to the financial crisis we were at 9 trillion in debt. And so it now look, people can say the Afghanistan War and the Iraq War, and some people could say those were bad wars. Other people could say, no, we had to do it. Others could say maybe there was some understanding to the war, but they did it in a way we don't like. I'm not making the comment right now about what I think about the wars and the cost of the war at all. I'm just simply saying they cost trillions of dollars. And then on top of that, you also had No Child Left Behind and the Medicare Part D, which was passed in the first half of that new century, of that new decade. You hardly were talking about a period of government austerity.

But of course the debt to GDP wasn't going up that much. I believe it had gone up let's see here from something in the range of 50% debt to GDP to about 60%. So even though they added trillions of dollars, they added 60% to the debt level. The leverage went up about 20% because why the GDP was growing so much through the housing boom and all of that kind of stuff. We entered the financial crisis with a governmental sector that was really quite heavily indebted, but nowhere near as levered as the household sector. And it's one of the great ironies of what we face now is that at the time the idea was, well, the government is less levered, let's have them fill the capital hole. So yeah, households had 2 trillion of bad debt to wipe away. They had to sell off real estate and pay off bad debt. Really that debt bond in the banking sector, I mean for the households were primarily walking away and they had to get that debt off their balance sheet, which removed the asset off the balance sheet. And that's what a debt deflation cycle is, the selling off bad debt and therefore having a lot of asset impairment while you do it. And the government was going to have to plug that hole. And if it was just Bill Smith down the street and Nancy Jones down around the corner, it would've been bad for Bill and Nancy, but it wouldn't have been real bad for the whole country or the whole. But because it was so many people and the real indebtedness lied inside as an asset inside the banking sector, Bill and Nancy owed the bank money. So it's a liability to them, an asset to the bank. And now that asset's going away. Therefore, the government came in to plug the hole that the was created as a capital hole in the balance sheets of our banking system. So I hope you don't mind me spending so much time to set this up, but I just think it's a very important topic. This was a conscious, policy oriented, Keynesian, academically defended idea. I don't believe in it. There's certain things about what they had to do in the financial crisis. I don't want to get into right now, but I'm saying this was the concept that you need that government balance sheet to fill in for when there's weakness in the corporate balance sheets or in this case household balance sheets. And when I right ,ow, refer to "Japanification", this is the irony is I'm referring to excessive indebtedness from the governmental sector that households did a pretty successful de-levering process post-financial crisis. And yet I just want to give you the real numbers of what we're referring to.

So we get into the financial crisis now with 9 trillion of debt. We only had 5.6 starting off the new century, 9/11 and then we're at nine. And then by the time they were kind of done with all the medicine, they were giving the economy post-financial crisis. So let's call it about 2013. And they've done QE 1, 2, and 3 and they've done zero interest rates on the Fed side and they did the stimulus bill and they've just kind of tried everything governmentally and within this sort of Keynesian policy toolbox to address things. Then the debt levels were at $17 trillion, 17 trillion. So we went the households de lever 13 to 11, they take 2 trillion off their debt, and the Federal government levers from 10 to 17, one pocket add 7 trillion, the other pocket reduces 2 trillion. Anyone have any problems with this math so far? Alright, I hope you see the point I'm making. It wasn't a matter of $1 filling in a hole that was caused by another dollar. We were adding on an aggregate national basis, massive amounts of debt. And then this is the whole point I want to make. I wouldn't have supported it, believed in it, found it productive, don't think it's a good idea to pay someone to dig a ditch that doesn't need digging. I wouldn't have believed in any of that, even in the point of an emergency, a crisis, whatever. But that's how those things are generally defended. And then there's totally legitimate arguments to be had as to whether or not that's a good thing. But from 2013 to 2020, we're now post-financial crisis and we're pre COVID and we basically added another trillion dollars per year. So by the time President Obama left office we're at 20 trillion of national debt, when he came in, it was at 10 trillion, about 7 trillion of that was in that post-crisis era. Then we added another 3 trillion. Then President Trump comes into office and before COVID we add another several trillion to national debt so that before COVID even begins, we're sitting at 23 trillion of debt. And that is more or less explained by rewind the first 20 years of this new century, we basically added three to 4 trillion, let's call it 4 trillion of debt before the financial crisis starts post nine 11. Then we add 7 trillion during the financial crisis and the aftermath. Then we add another 3 trillion after financial crisis, excuse me, another 7 trillion. And then we go into the COVID moment. You follow me?

So if your head is not spinning yet this is when it all gets really started. Big numbers, I mean who no child's play stuff of 600 billion here and a trillion and a half there. Then we proceed to take that 23 trillion national debt to 28 trillion in one year. And now we're sitting at 31 trillion. We've added another three since the initial COVID year. The CARES act alone was about 5 trillion and the aftermath from there. And plus you had some declining revenue and other things. But yeah, so we're at 31 trillion of debt and that is in 23, 22 years we went from 5.6 trillion to 31 trillion.

All right, so does anyone believe that that happens without downward pressure on future growth? Well, my argument is that downward pressure on future growth started at the point of financial crisis. And I believe it will continue to play out this way for many years to come. And you say, okay, well this is really bad. You've really depressed me. But at least now we're somber, we're sober, and we're ready to deal with this. The problem is my whole story hasn't even started. Cause we're not done at 31 trillion there. We're debating if we want to add a trillion or 3 trillion more per year. There are a couple different charts, first of all, I'm going to start right now with a chart showing you what we spend money on because this is always the problem that people think, okay, fiscal conservatives like David, they just want us to cut this excess of spending. And we all know those famous stories about the Pentagon spending $10,000 on toilet seats back in the 80's, let's cut off all that stuff and we can deal with this. But if you look at the chart, 60% of our outlays go to transfer payments. That's the combination of the Medicare. We're calling safety net spending, food stamps other entitlements, social security, Medicaid. All of these could be very legitimate and necessary. Some of them could be. Again, I don't need to right now for our purposes get into an argument about what size of a social safety net we want to have. My point is there's 60% of our outweighs that are highly unlikely to be touched for the very nature of what they are. 12% goes to military spending. Now people can say they wish we spent more or they wish we spent less. But do you think with the state of NATO, Ukraine, Russia, China, Taiwan, should we be cutting from that? Will we be? I don't think so. And so the 12% of military outlays are not likely going anywhere. 8% goes to national debt service, just interest expense. That number is not likely going much lower anytime soon. It could be going higher, it has gone higher. You're going to see another chart later that will speak to that and then you'll at some of the discretionary things and so forth. There's just very little wiggle room as you see and how we've spent money as to how they can really do much politically and just in terms of the will of the people. I remain at a total loss as to what people are willing to cut here. Now you could do cross the board spending cuts and that that's kind of what I would do, but I assure you I'm not being elected anytime soon, which is to say ever.

Alright, so now you look at it. Let's just summarize how bad things are. So far we've built up this huge amount of debt. We've done a lot of it with bad things like wars and financial crisis and COVID. We've done a lot of it and not bad things, just routine, huge growth of government spending programs and routine excessive spending during benign economic periods. So 22 years of 25 trillion of additional debt. It didn't happen easily, but we've done it and we're looking to add more to it with increased deficit spending and we don't have a lot in our Federal budget that looks particularly able to be cut. Okay, so here's the issue. I'm going to put another chart up right now as we sit here with 31 trillion of debt that ratio of debt to GDP I spoke to earlier that in the first decade when we were spending a lot more, we were still growing the economy at such a rate. Remember you had two bush tax cuts, 2001, 2003, there was a lot of juice in the economy. The GDP was growing at a rate that the denominator was moving higher even as debt was moving higher. So even though we added, I think it went from 50% to 62%, but now you can see the debt to GDP ratio has got up above a hundred percent. During post COVID, it got to about 120. And now no one's talking about that coming lower. I would like to think it doesn't have to go a whole lot higher, but my point is that we're now kind of baked into this place of a very high debt to GDP ratio that is clearly in that zone of putting downward pressure on future growth and future productivity.

When you look at the actual deficits now, I want to put another chart up. The spending is not going down, deficits are not coming in. All we're debating about is how much worse it gets at what speed it gets worse. And so whether you're looking at the CBO, which is where these projections come from, the Congressional Budget Office, what you want, what the Republicans say they want, or the Democrats say they want, there isn't anyone who's talking about a balanced budget, we're just simply looking at some level of deficits that is adding to that 31 trillion not taking away. And again, I'm just piling on here on purpose to make the point I'm going to end up closing us with in a few moments.

You really are looking at best case numbers that, I mean, I'm serious. These are best case numbers because right now I'll throw up Social security and Medicare. We're not talking about the unfunded liabilities of what needs to be paid out of the Social Security Trust fund. Over the years, the growth of Medicare entitlements year by year that are owed to the citizens. Social Security and Medicare were basically about 3% of GDP 60 years ago and they're now 10% of GDP. And yet revenues as a percentage of GDP are the same. So revenues to treasury as a percentage of GDP have stayed somewhere around 15 to 18% for 60 years. And yet social security and Medicare have tripled as a percentage of GDP. So there's this ongoing challenge as the growth of transfer payments and entitlements within the economy. And you don't have a way to get more revenues to pay for it because you can say, well, let's get more revenue into the Treasury Department, but only way you can do that is at the cost of economic growth somewhere else. Take a dollar from the private sector to put in treasury, right? They're in a pickle. There's... perhaps there's knobs that can be turned but not very dramatically.

And then the final thing I'll say to pile on, and then we'll bring it to a conclusion is none of this includes states. None of this includes counties and cities. Now, generally speaking, their taxing authority and their spending is different than the Federal government because they can't spend the money out of thin air that the Federal government can. But there is a significant amount of indebtedness that they have and primarily their indebtedness is in the form of unfunded liabilities usually to pensioners. So they can't get out of those obligations. And yet the money that has to be spent in the future generated then diverted to that aim of this buildup of debt represents money that comes out of the private sector, out of economic output, out of growth. And all of these things are part of the argument I'm making for a low growth future. And so I think you could look at it like, okay, the 31 trillion sounds bad enough and what is a real serious sober somber approach we're going to take to deal with that? But what I'm trying to suggest is it's 31 trillion without factoring in how much worse the Social Security

Medicare expense side goes without factoring in the reality of states and local municipalities are already seeing their state, their local tax revenue, state tax revenue decline. This is without a real major bad event. I don't think you have another COVID pandemic tomorrow, but a recession, right? Another shock external shock to the system there crisis there. There's a number of things that could make all this a lot worse, and that's likely where you get to a different point in how we converse about this.

So what is it I'm actually saying when all said and done, I mean really, I'm just trying to present facts that you can draw conclusions from. Now, if I was trying to make a political talk here as or recommend a policy prescription, then maybe this would be a great time for me to go into why we want a balanced budget or we want more growth oriented policies to help offset a lot of these things. And I do, by the way, feel pretty strongly about a lot of those issues and I'm very happy to interact with, if you email me ask questions, I'll interact on that stuff all day. It's stuff I'm really quite passionate about. But what I'm now saying in terms how it governs our finances is we could conclude a default is coming, but I really doubt it and we could conclude that a societal collapse is coming. Some people have sold a lot of books saying that and some people have gotten a lot of quick bait and newsletter doom and gloom type subscribers saying that it's a business model that works, but it hasn't been very good for years and years and years and decades and decades and decades of it actually predicting anything accurately. What I would say is that, well, by the way, inflation people say could be the outcome developed market history has kind of shown the opposite. You look at Japan, you look at what the US did coming out of financial crisis. I don't think that you get an overheated economy out of the things I'm talking about. I think you get one that is really deflated and stagnated by these events. Now maybe you get a cure because of some incredible political consensus, a sort of societal unity that allows different tribes and schools of thought to come together to work for consensus and compromise in the better aims of the country. Now, that might be the most ridiculous thing I've said today and I'm sad to say that as one who loves this country a great deal and does believe in what ought to be a more consensus like process in government and just a more unified society to some degree. But I don't think anyone listening and certainly myself as the speaker believe that that's on the horizon. So I'm leaving you with two conclusions as to what I think where this goes. If someone says, well, don't you think that just all the blank hits the fan in 2024/2026, I don't, I don't think it's impossible. I just don't know. I think there are two things I feel comfortable saying. One is "Japanification" low, slow and no growth. That is this whimpering effect of downward pressure on quality of life for a greater number of people less economic growth, less economic opportunity. The things I do talk about quite a bit that force me in a different paradigm in the way I approach quality of investing. And number two is that people need to be prepared for surprises. And another word in economic and financial and investment parlance for surprises is instability rates go higher than people think at times, and they can go way lower than people think. I really believe that those who think we should get to a 5.5% or 6% Fed Funds Rate don't realize that that's what's going to force them back to a 0% rate. Where if they would just stay moderately sensible in the two and a half to 3% range, not as high as five or six, they wouldn't have to go back to zero, but they continue on this very heavy boom bust exacerbation. I also think that we are totally oblivious to the level of creativity that the Fed is willing to take on. And I think that that's a bad thing. I think that you do not want an excessively creative central bank, and yet I imagine there'll be surprises around the creativity of what central bank interventions come. I think certain shoes will drop. I think certain shoes will look like they're going to drop and not drop. There's a lot of instability into the future. I expect that to be a permanent paradigm for years if not decades to come. And that is all attached to this thesis about "Japanification".

I covered so much ground. I know a lot of it was wonky. I really hope you got a lot out of it. This topic's so important to me. There was a lot of economic history in there. It's a bit more succinct and it would probably more, it was delivered a little more tightly in the written Dividend Cafe. If you want to go there now, read it over, look over some of the charts. By the way, I'll close you here with our chart of the week. Just to give you an idea about one of those variables is only 8% of Federal outlays. We were spending about a billion dollars a day in interest expense. Well now it's 2 billion a day. Now it's really sad to say like a billion doesn't seem like that much money, but of course, 365 days you can do the math or you're spending about 350 billion and now it's 700 billion, right? You're getting close to a trillion of rates go up much more. Now of course, they can come down and that can move that lower. And in fact, that's one of my arguments as to why I think they will, because I don't think they'll be able to afford that level of debt service. But if you see this chart how that debt service had gone so much lower and then has creeped higher, here is where we are.

So I don't say any of this to be the bear of bad economic news. I'm not a perma bear. I am an unbelievable bull in the ingenuity innovation of entrepreneurial talent. I believe in America's capacity for economic growth. I believe in the God-given human spirit for entrepreneurial success. I believe in investing in all of those things and capturing risk premium from them. But we're being handcuffed and ankle weighted significantly around excessive indebtedness. And households can go liquidate some of that debt, but they don't have to respond to voters. They don't have to take away entitlement benefits. When you look to the loving hand of government to lever up to help you out with capital holes you end up with "Japanification". This is the moment in history we're living through. It's a moment in history that I very soberly plan to invest through with wisdom and poise. Thank you for listening to watching and hopefully reading the Dividend Cafe. Reach out to mquestions@thebahnsengroup.com. Look forward to talking to you again soon from wonderful New York City.

DIVIDENDCAFE | PODCAST TRANSCRIPTION

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