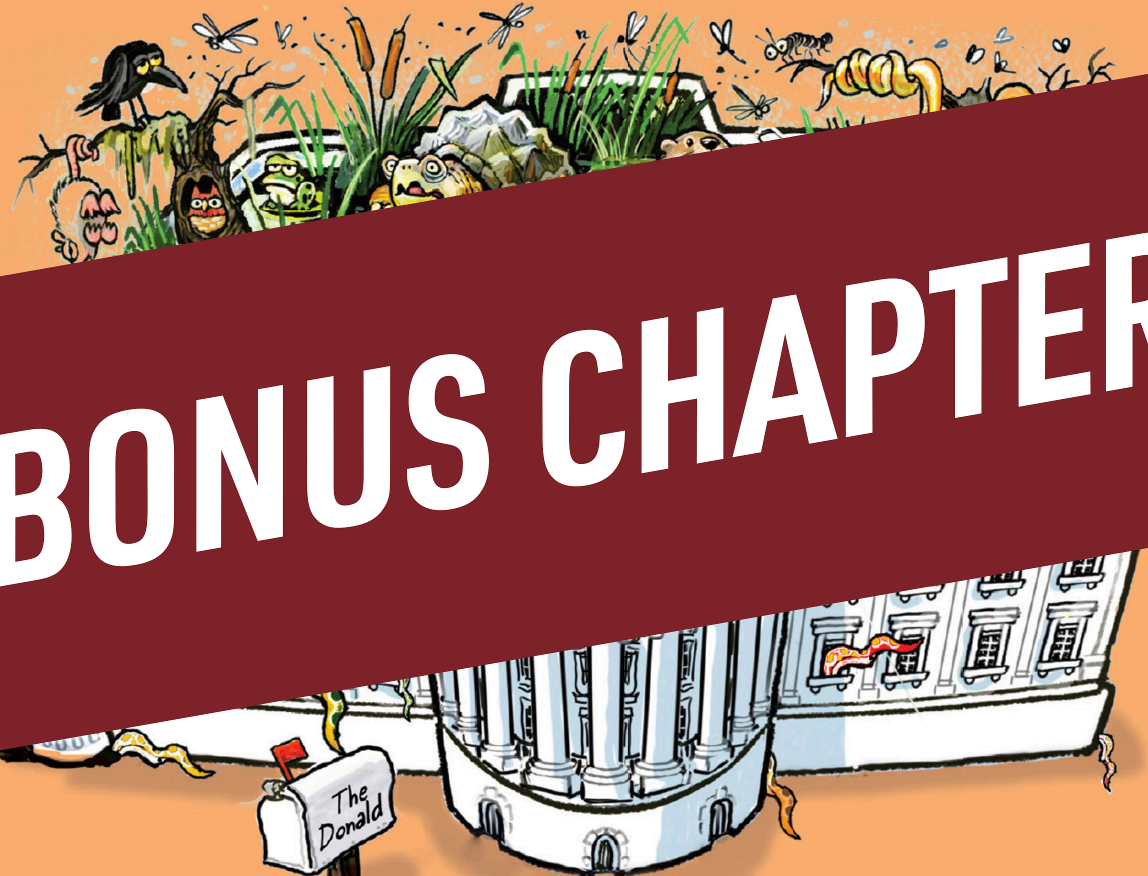
#1 *NEW YORK TIMES* BESTSELLING AUTHOR

PEAK TRUMP



BONUS CHAPTER

THE FED AND THE CRISIS TO COME

DAVID A. STOCKMAN

Bonus Chapter: The Fed and the Crisis to Come

By David Stockman

A little more than 10 years ago, I wrote a book called *The Great Deformation: The Corruption of Capitalism in America.* I had a very unusual experience with its release.

The Great Deformation came out right after the Global Financial Crisis. My goal was to put the whole thing in context via a revisionist history of everything that had happened since 1914, when the Federal Reserve was created, through the Great Depression and the good period of America under Eisenhower, when we balanced the budget and had an honest central bank, and then how we went to hell in a handbasket afterwards.

The point was to help people understand what happened in the fall of 2008.

The Great Deformation ended up being a 730-page tome. I was quite proud of it because I worked on it for two years. But my editor, one week before the thing was to be released, said, "Now, I want to get your expectations right: Nobody is gonna buy this book. It's too long. It's 730 pages."

So, I didn't expect much. The book came out, and the very next day, Paul Krugman, the great authority on all economic matters in America, wrote a blog post denouncing it as "the ravings of a cranky old man." I said, "Oh, my God, it's gonna go from bad to worse." But that's not what happened.

By the end of the day, the thing had shot up to No. 4 on the Amazon best-seller list. They rank them by the hour, and there were only three titles ahead of my book, two diet books and a novel from *The Walking Dead.*

It ended up No. 3 that week on the *New York Times* best-seller list. I've never bragged about it because to this day – four years later – they still haven't told me whether that was the fiction or the non-fiction list. I think a lot of people would like to believe it was the fiction…

So, with that perspective, I understand the blurring of "non-fiction" and "fiction" when it comes to the economy and the Donald. I'll start by laying out my bias, because when you talk about Donald Trump, you're going to be biased.

I voted for him. I voted for him because I believed he was the Great Disruptor.

My fondest wish that he would wreck Leviathan have actually – slowly – started to come true if you look at where we've been and where we're going. We needed a leader to call attention to the non-viability of the Warfare State-Welfare State system, the duopoly that supports it, and the massive deficits it creates.

The whole thing must be called into question. Trump had the ability to do that. But he had no program whatsoever to fix it, and I don't expect that it's going to be "fixed" on his watch. There's no program to "make America great again." If anybody has made the mistake of embracing it, now is an excellent time to sell the "Trump Bubble."

He's taken a bad deficit and exploded it. And he started a trade war with China, thinking that somehow protectionism and massive tariffs will boost growth and help Main Street.

Finally – crucially – he's taken a Federal Reserve that's printed way too much money, held interest rates way too low for way too long, and bully-tweeted it into backing off from the baby steps it had taken toward "normalization" of monetary policy.

He is indeed a "low interest man." But this isn't all about Donald Trump. He's merely a symptom of a larger problem that affects our economy, our financial system, our government, and our society. The problem is way beyond his ability – even his desire – to solve it.

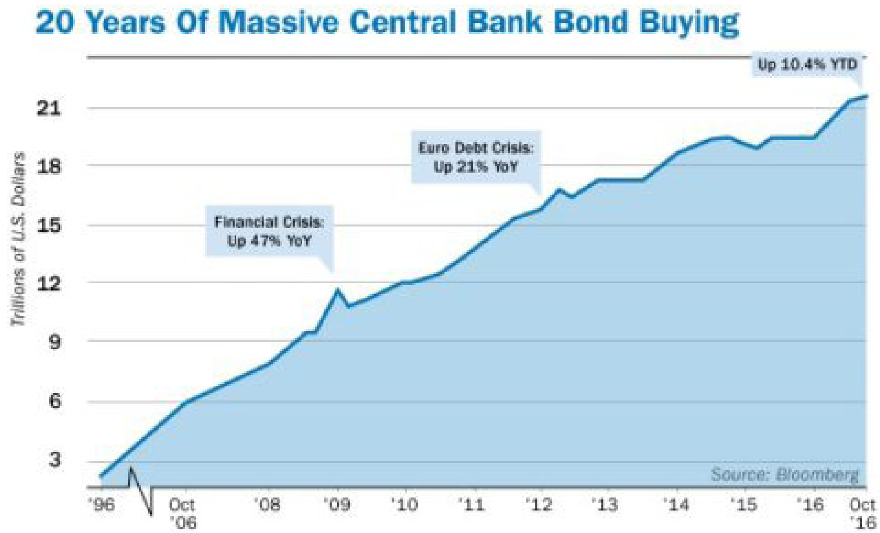
What's brought us to the point of crisis is monetary central planning. Global central banks are utterly out of control. Policymakers and too many investors take money-printing for granted. They either don't know or don't care that it's simply unsustainable.

Things that can't go on forever won't. And this "everything bubble" will end with the biggest bust anybody ever saw.

The Anatomy of Bubble Finance

The world's central banks accumulated $2 trillion of balance-sheet footings during their first several decades of operation. That includes the Federal Reserve, the European Central Bank, the Bank of England, the Bank of Japan, the Peoples Bank of China, and all the lesser fry.

After an initial boom in the early part of the 21st century, then the Global Financial Crisis, and, finally, the descent into "extraordinary" efforts such as "quantitative easing," we now see $22 trillion on the balance sheets of the world's major central banks.



That represents an explosion of fiat credit. Say a central bank – through the Federal Open Market Committee here in the U.S. – buys a $1 billion of asset-backed securities. It pays with credits it put in the dealer's bank account with the stroke of key. It's purely made up, make believe, digital money.

Under any traditional standard, those balance sheets would've grown by 4% or 5% to maybe $3 trillion or $4 trillion. That's under appropriate, sustainable policy. So, there's $18 trillion of excess floating the financial system. And it's had an enormous effect on all asset prices.

Bonds are up, yields are down, and stocks are beyond any reasonable measure. It's a complete distortion.

The pricing of financial assets in open, honest markets is the heart of the capitalist system. If we don't have a true expression of supply and demand at this foundational level, we're going to have big trouble spreading through the entire economy.

This is exactly what's happened over the last 20 years.

It's an $18 trillion "everything bubble."

(Printing) Money Is (Printing) Power

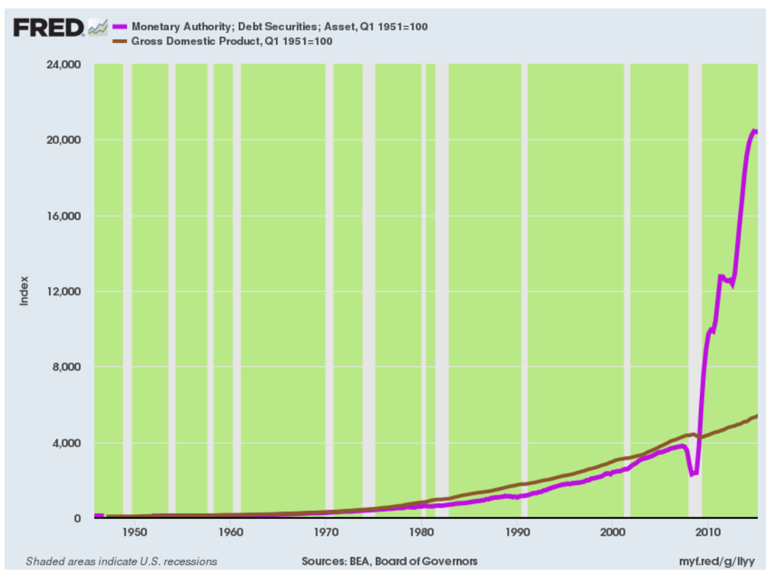
For nearly 50 years after the so-called Treasury-Fed agreement of 1951, the U.S. central bank's balance sheet expanded at roughly the rate of gross domestic product (GDP).

We had good Fed chairs, like William McChesney Martin. We had bad Fed chairs, like Arthur Burns. We had idiots, like G. William Miller. And we had a great one, Paul Volcker.
Volcker was well on his way to fixing the whole thing. And he would have succeeded if not for statist politicians arguing to Ronald Reagan that "Tall Paul" was the wrong guy at the wrong time.

What they meant was he wasn't the right guy for their version of the revolution. Their arguments swayed the Gipper, and they threw him out. It was a huge mistake.

In the first 94 years of the Fed's existence, its balance sheet slowly grew to $900 billion. Ninety-four years, $900 billion.

In the 94-day panic that followed Lehman Brothers' meltdown in September 2008, the Fed, under Bernanke's leadership, boosted its balance sheet by $1.4 trillion. Ninety-four days, $1.4 trillion… That's 150% of what had taken 94 years to accumulate.



And, obviously this caused a reflation for financial markets and Wall Street. But it did nothing for the real economy and Main Street.

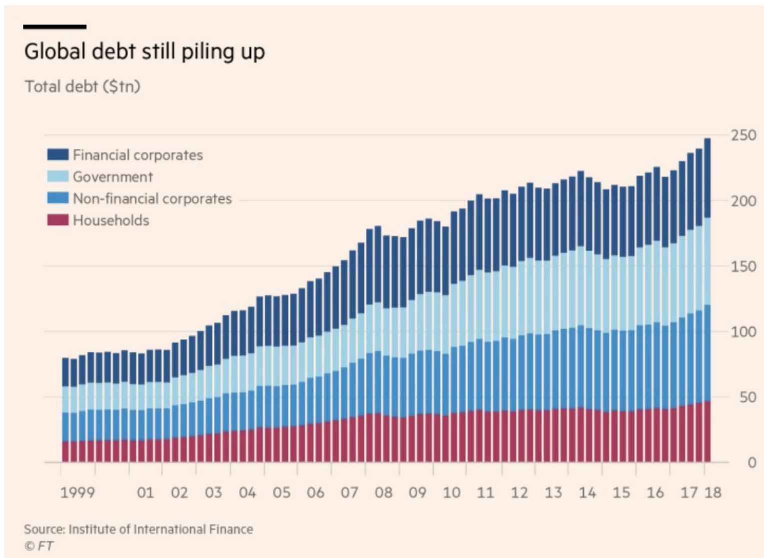
It wasn't part of anybody's monetary theory, nor did it appear in economic textbooks. But this is what our monetary central planners did in the panic of 2008, and it fundamentally reshaped how our entire system works. It explains the widening wealth disparity that threatens the fabric of American society.

That's what happens when all the central banks of the world pump money in unison: It distorts the fundamentals of the global economy.

The Never-Ending Debt Story

At the turn of the 21st century, there was less than $100 trillion of total debt outstanding in the world economy. That includes governments, businesses, households, and financial entities.

Today, total global debt is up to $250 trillion. It's almost impossible to get your mind around that number. But that's what's driven the economy the last 20 years, as a result of this breakout of radical monetary central planning.



We'd seemingly reached a critical pivot point with the Fed's commitment to "normalization."

Key decision-makers and their senior staff at the world's central banks had decided they'd fixed everything; that the global economy was back on track; that systemic cracks of 2007 to 2009 were sufficiently mended…

With its balance sheet at $4.5 trillion, the Fed started taking bows for reaching the nirvana of full employment, as inflation remained serene by its measure. It was time to not only get interest rates back to normal but to shrink that balance sheet.

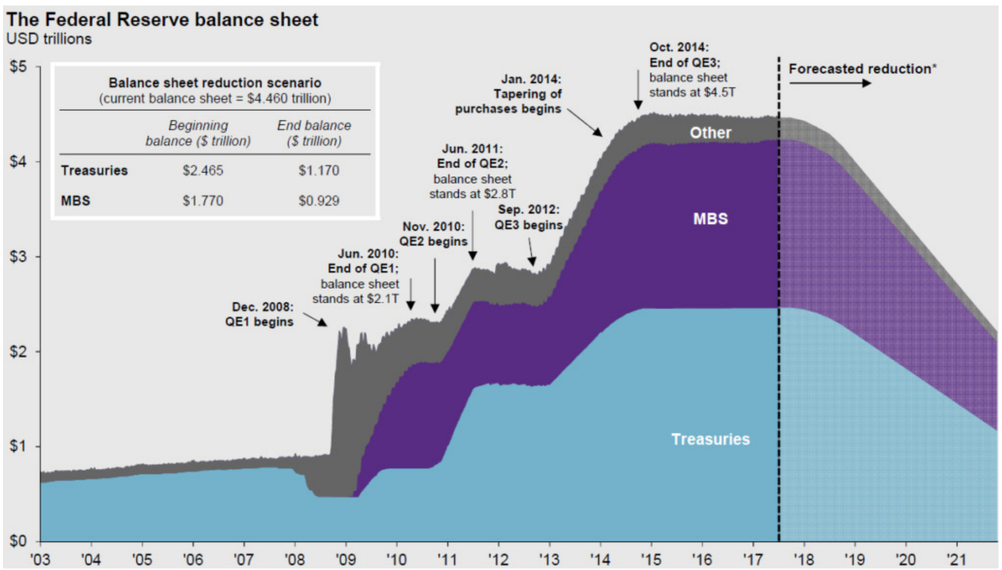
It was never about sound monetary policy, though. The Fed was only trying to create "dry powder" so it would have something to fire once the inevitable next crisis arrives.

Only they didn't understand the magnitude of the problem. Raising interest rates 25 basis points at a time off the zero bound over a period of more than three years? The shrinkage of the balance sheet is the difference-maker. They're cash out of the bond market at a $600 billion annual run rate.

Like “quantitative easing,” “quantitative tightening” had never been contemplated before. They got all the way down to about $4.0 trillion before Wall Street threw a fit in late 2018.

The Donald – the “low interest man” in the Oval Office – successfully bully-tweeted his Fed Chair Jerome Powell into calling off further interest rate hikes for the foreseeable future and scaling back QT so it stops in the fall of 2019 with the balance sheet at about $3 trillion.

They’re scrambling because the data is always lagging. And, now, it’s coming in relatively weak. The “dry powder” plan now includes negative interest rates and the resumption of asset purchases. What was “extraordinary” in 2009 is “normal” now.



But our monetary central planners are going to break something, something big, with their increasingly radical policies. They probably already have. In fact, the damage was probably done when Benjamin Bernanke went nuts in December 2008.

Here’s some perspective. In April 2002, the entire balance sheet of the Fed was $590 billion. It took 88 years to get there. That represents one year of the balance-sheet runoff plan; $600 billion was one year of “quantitative tightening.”

Draining $600 billion out of the market every year is going to have a huge impact. In other words, there's symmetry in the financial markets. On the way up, with these balance-sheet expansions, monetary central planners were adding to demand. That drove prices up and yields down.

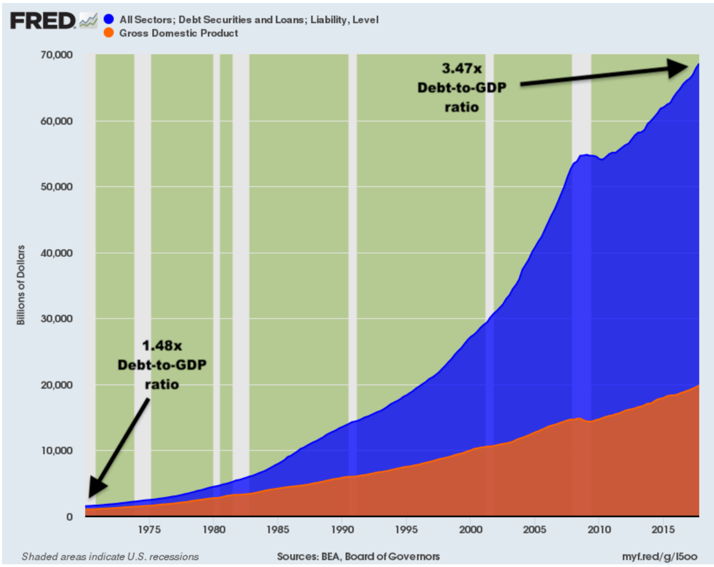
The problem with "quantitative easing" is that it's fraud.

Central banks are buying real assets that represent real resources, and they're paying for them with keystrokes that create credits out of thin air. In the U.S., it's bonds issued by government-sponsored entities. In Japan, they're buying exchange-traded funds (ETFs), securitized commercial real estate, and a lot of other stuff. It's a slippery slope.

It's changed the whole process of price discovery. And it's caused almost every developed country in the world to do a leveraged buyout of its own economy.

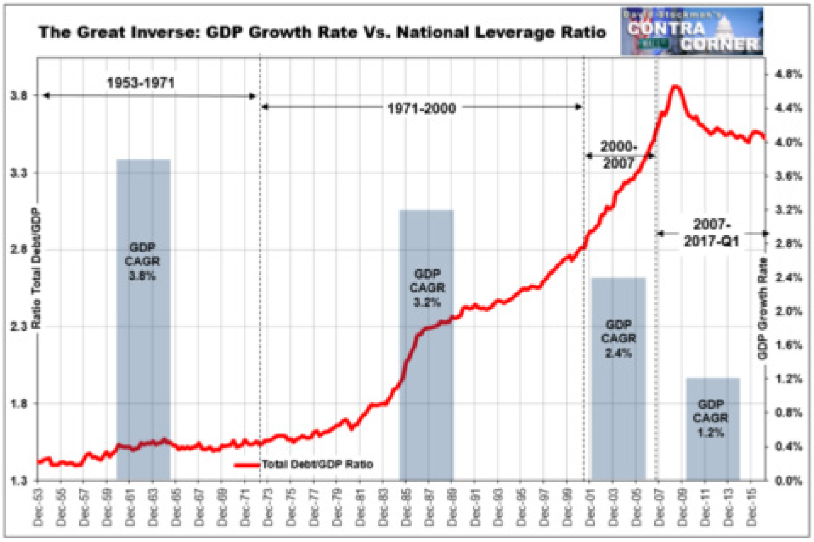
Crisis and ~~Opportunity~~Crisis

"Total debt" includes all debt incurred by governments, businesses, and households. The ratio of total debt to gross domestic product (GDP) is a basic gauge of national economic health.



Historically, the debt-to-GDP ratio for the U.S. economy was 1.5 times. In other words, there was 1.5 times debt to national income. This "Golden Mean" has prevailed since 1870. There is, of course, fluctuation owing to disasters such as what happened in the 1930s. But, come peace or war, boom and bust, it held for nearly a century and a half.

Today, the U.S. debt-to-GDP ratio is 3.5 times. We have $69 trillion of debt on GDP of $20 trillion. Now, the simple way to think about this is whether it makes a difference.



Had we stayed at the golden mean of 1.5 times leverage, we'd have about $30 trillion of debt. In other words, the U.S. economy is carrying around $40 trillion of excess debt compared to where we would've been had we allowed the honest pricing of debt, equities, and all the other securities traded on financial markets.

The U.S. economy has struggled to come out of this so-called Great Recession – and the reason why we've had the weakest recovery on record – is that we're lugging $69 trillion of debt.

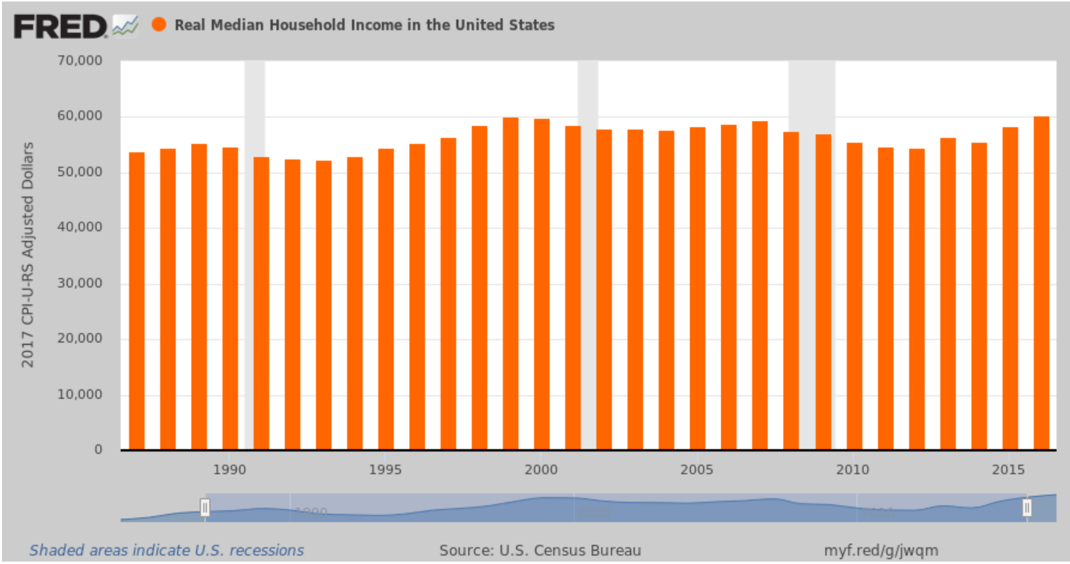
Think back to 2008 and 2009… Do you remember that everybody at the time was saying, "There's way too much debt in the system. We overdid it. We've got to de-lever it." Well, there was $52 trillion of debt on the economy when the Global Financial Crisis almost brought about the end of the world in September 2008.

Today there's $69 trillion. So, we've essentially doubled down on debt. And it's weighing on growth.

The U.S. GDP growth rate has been falling on a trend basis, from 3.9% in the 1950s and '60s to 3.2% in the '80s and '90s to 2.4% during the Greenspan mortgage boom after the turn of the century. We're down to 1.2% for the 11 years from the peak prior to the Global Financial Crisis/Great Recession.

This is the story of what's wrong with the U.S. economy. It will not grow when it's carrying $69 trillion of debt. Imagine what happens when interest rates inevitably rise from historically low rates. Servicing that debt – for governments, households, businesses, and financial entities – will amount to literal hell to pay.

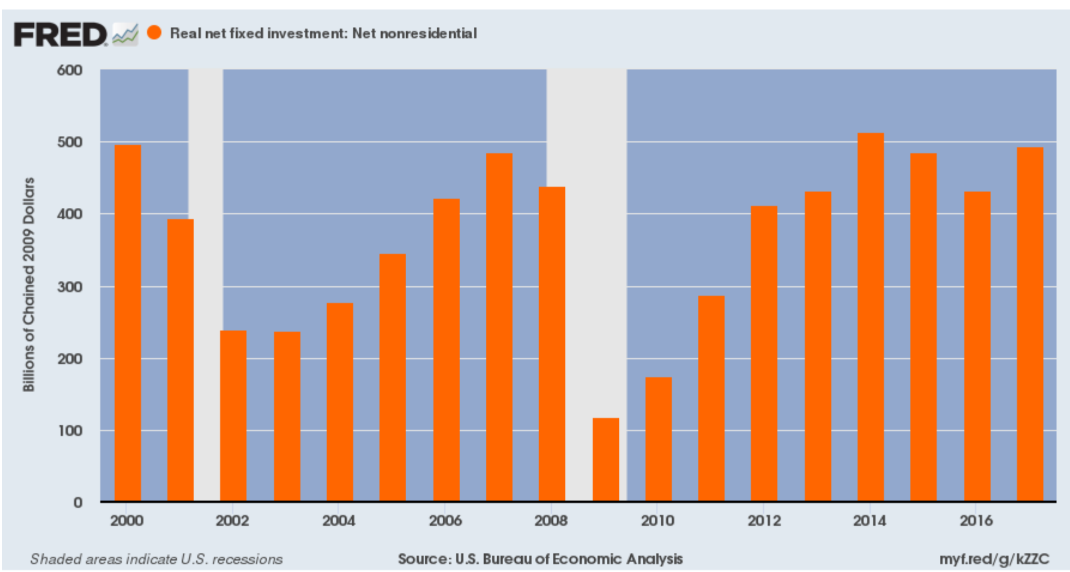
In the here and now, the rewards have been sparse – at least for Main Street. Despite all the stimulus, real household median incomes are dead in the water.



Business borrowed a lot of money, but it didn't invest in growth.

The bars on the chart below show you something that you never see on Bubblevision; they detail capital expenditure after depreciation. Every year, the U.S. economy consumes $2.4 trillion of capital. That's how much depreciation and amortization of technology and equipment and plant happens.

When they show you the investment number – "fixed asset investment" – you must subtract from it the capital consumption during the current year to see where you're going on a net basis over time. That's what this chart does. In 2017, real net fixed investment was $493 billion in constant-dollar terms. That's lower than it was in 2000.

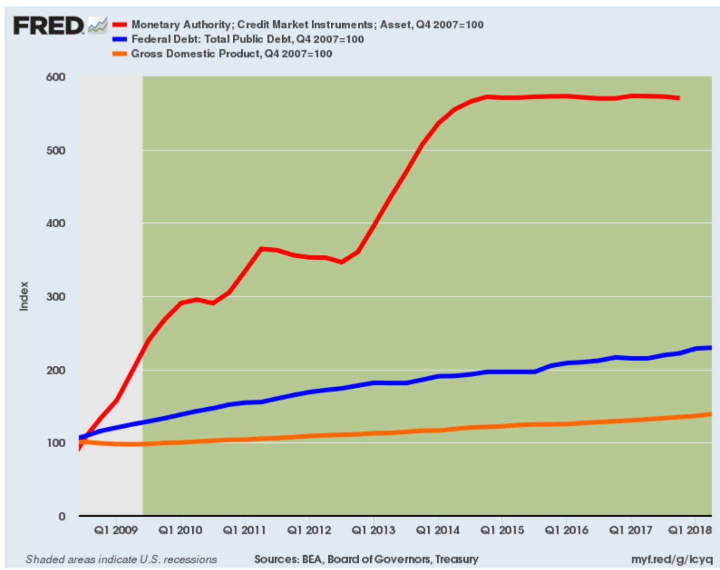


That's another reason why the economy is not growing: We're not investing. We've doubled down on debt, and we haven't fixed anything.

Diminishing Returns

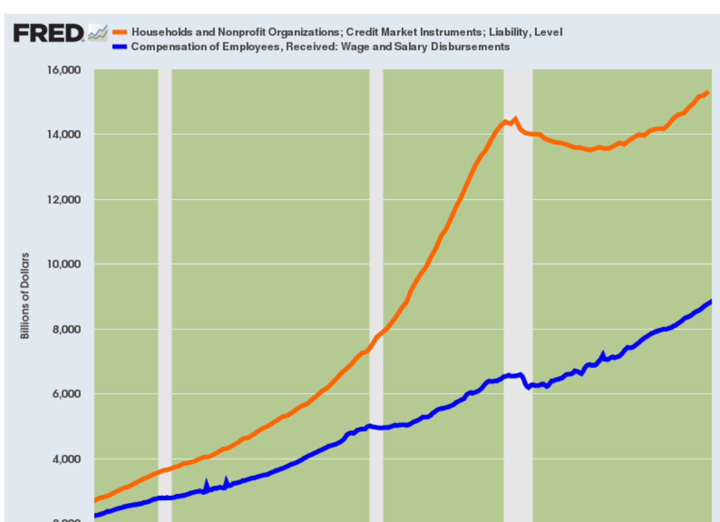
Over the last 10 years, the Federal Reserve's balance sheet has expanded by six times. The federal debt has grown by 2.2 times. Cumulative growth in nominal GDP growth is lagging.

When you grow only 60% in nominal terms over 11 years, you're not really thriving in any sustainable way. All the debt that they generated to revive the economy didn't revive the economy. That's because the household sector was already at peak debt when the crisis started in 2007.

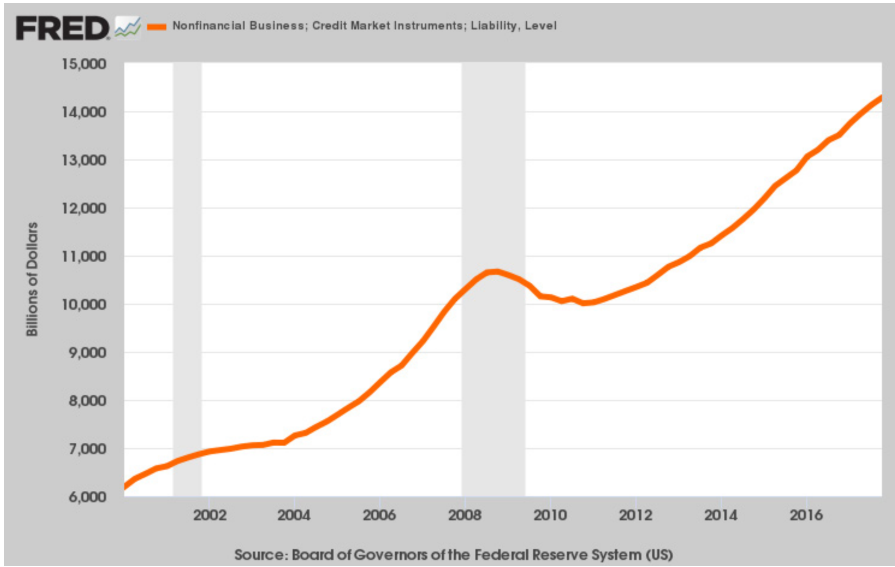


Household debt was about $14 trillion in 2007. The ratio of debt to income went from 80% historically to 220% at the peak.

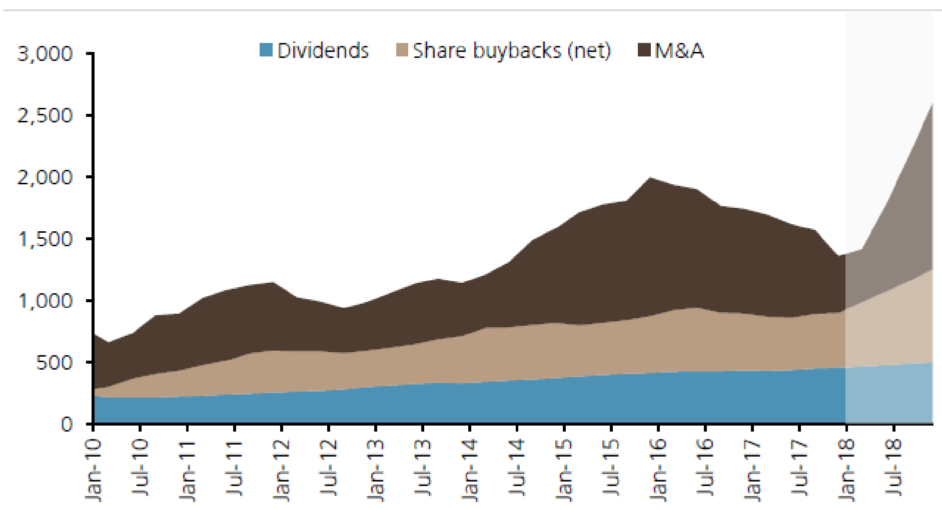
We've had a small amount of deleveraging, particularly with the mortgage blowout that we had after 2008. But we're basically back to where we started: There's $15 trillion of debt on the household sector, and they've only de-levered it down to about 180% or so, and we're still way off the charts historically.



The household sector is tapped out. They're just drawing down savings now.
But businesses borrowed like hell. There was $6 trillion of debt on the business sector at the turn of the century. That was up to about $10.5 trillion by the time of the crisis. Today, it's $14.2 trillion.



What's important is what Corporate America did with all that borrowing.
Overwhelmingly it went into financial engineering. It was cycled back to Wall Street in the form of stock buybacks, dividends, M&A deals… We reached an all-time peak in 2018: $2.5 trillion, and none of it added to the productivity of the economy.

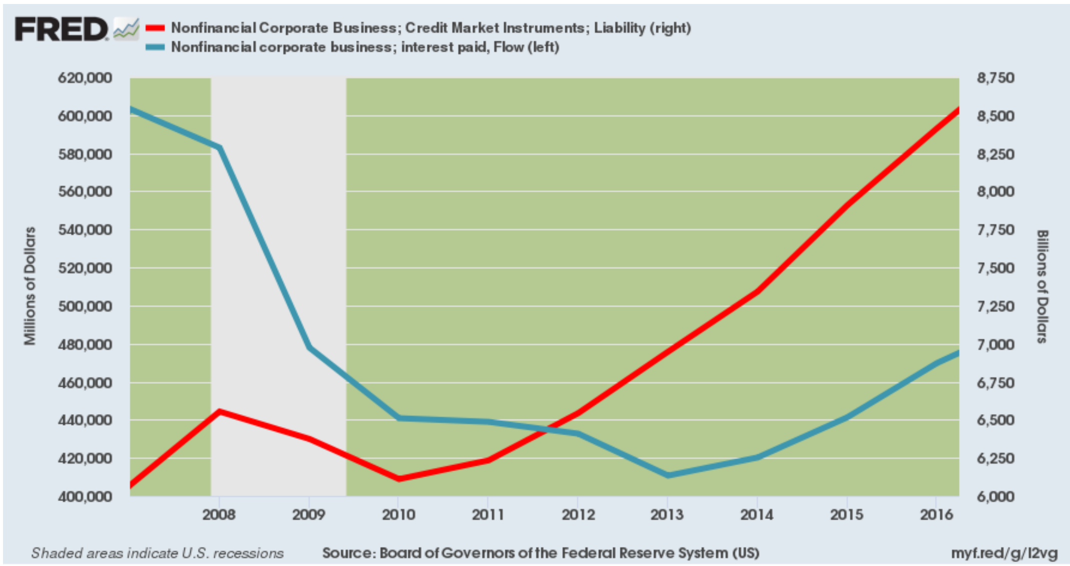


Source: CompuStat, FactSet, Bloomberg, Dealogic, UBS

If all of that borrowing at cheap interest rates had gone into new assets that drive higher output and faster growth, that would be one thing. But what we have in the morning after is interest rates rising and carry costs soaring on debt that didn't do anything but make the 1% and the 10% even more affluent than they already were.
We're heading for an unprecedented crisis because we've massively expanded debt at the same time

monetary central planners are repressing interest rates. That creates a false picture of the sustainability of balance sheets going forward.

Business debt has grown from $6 trillion in 2000 to $8.3 trillion. Even though it was growing at a solid pace, the actual interest expense paid by corporations on an annual basis was trending down for a while.



In 2007, we had $6 trillion of debt. Corporations paid $600 billion of interest. The weighted average carry cost was 10%.
By the time we got through this massive barrage of low interest rates and debt expansion, the debt was $8.3 trillion. The interest carry cost last year was only $445 million on all corporations in the U.S. – big, small, public, and private. The weighted average carry cost was 5.4%.

The difference between the 10% that we came in with and the 5.4% we're going out with is another indicator of how bad the day of reckoning is going to be. As interest rates normalize with a much bigger debt level, the carry cost is going to explode.

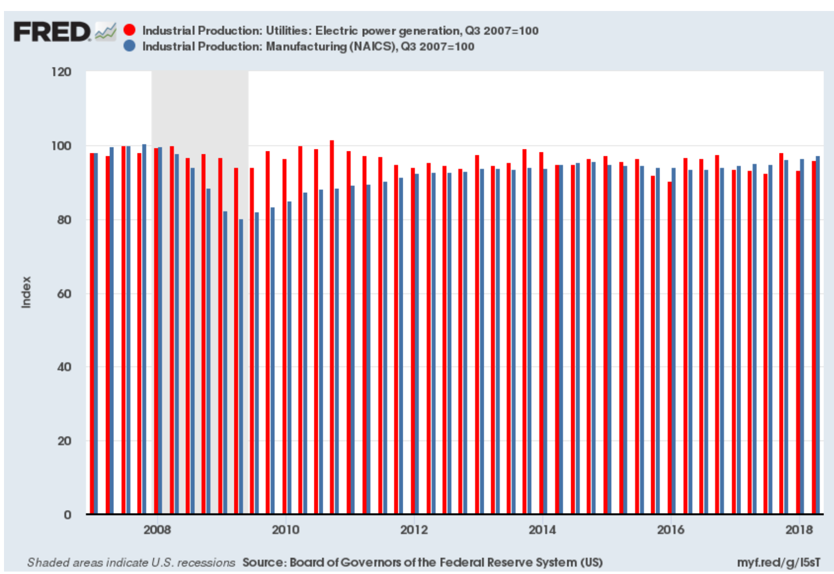
What happens a U.S. economy with $69 trillion of debt starts to experience interest rates that are 30, 50, 100, 200 basis points higher is a big question to ponder.

Wither Capitalism?

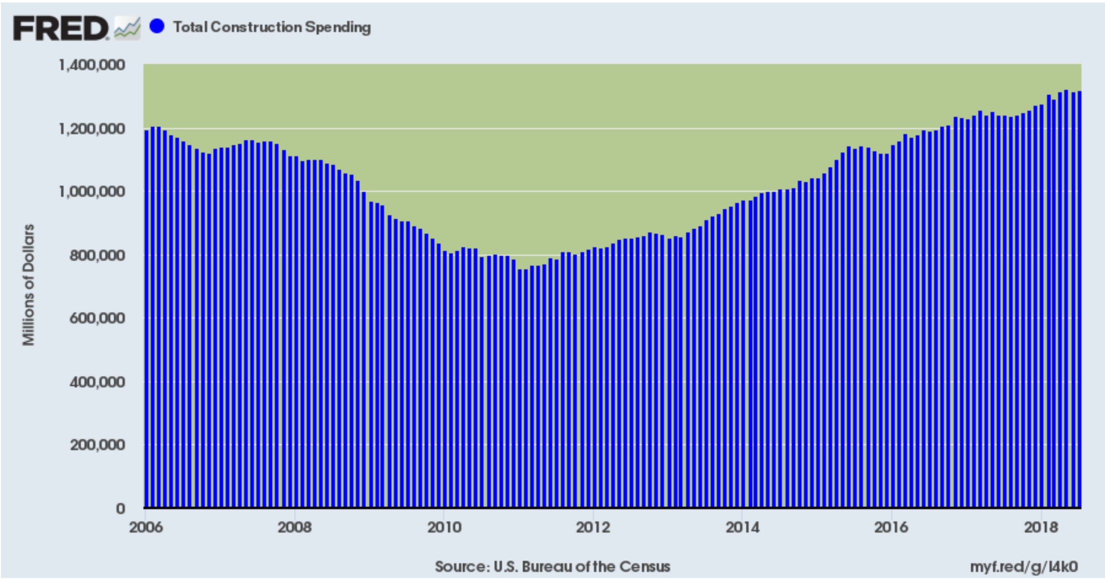
The capital market is are supposedly a place where you raise capital. Over the last two decades, there's not a year in which net equity was actually raised in the U.S. economy.

Financial engineering has shrunk the equity base of the U.S. economy and made debt the basis of the balance sheet. It's another illustration of how twisted and distorted our entire system is by monetary central planning. And it hasn't led to growth.

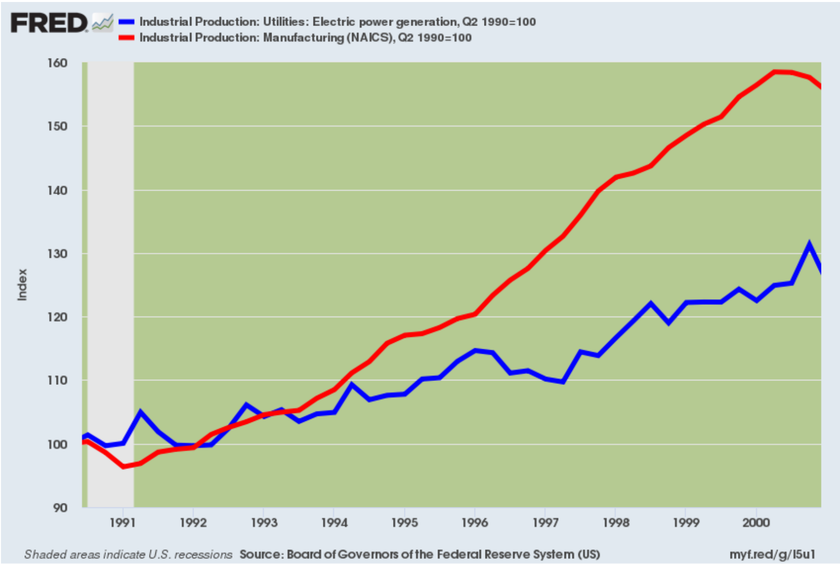
Industrial production and electrical power output are reasonable proxies for core economic activity. They've changed very little in the aftermath of the crisis – and the Fed's "extraordinary" measures.



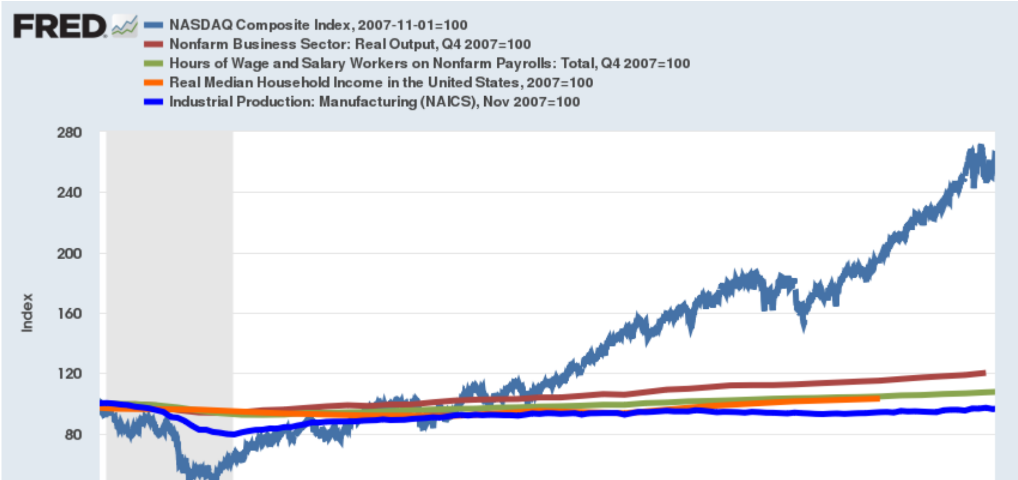
Housing and construction activity are similarly punk.



During the 1990s, manufacturing responded, with output up 55%. Electric power production was up 25%. That's 110 months of real recovery.



It's been good for Wall Street, though. The Nasdaq Composite is up 120% from its pre-crisis peak.

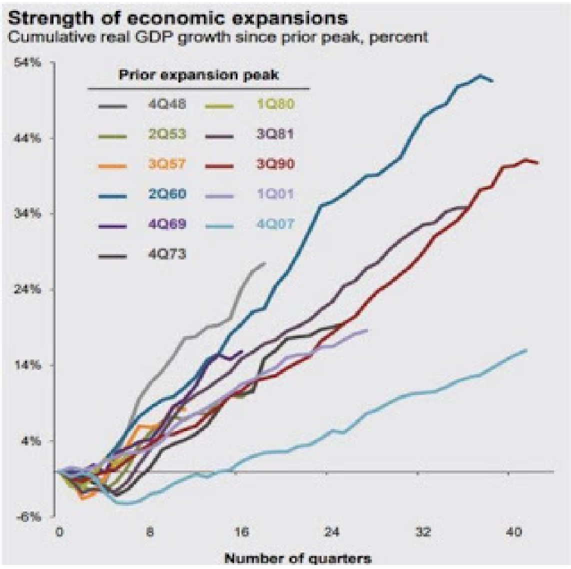


But total business output is up less than 20%. Total labor used has expanded by only 6% in the last 11 years. The U.S. economy is not growing.

We've inflated Wall Street. And we've abandoned Main Street.

Labor Pains

We're now over 40 quarters out from the pre-crisis peak. Economic health is a function of time and level, and we've gone nowhere for the last 40 quarters.



As bad as the economy was during the Obama administration, there were three quarters of more than 4% GDP growth and 11 quarters of growth of more than 3%. But, for the period as a whole, the U.S. economy barely grew at 1.5%. We did not have a sustainable expansion.

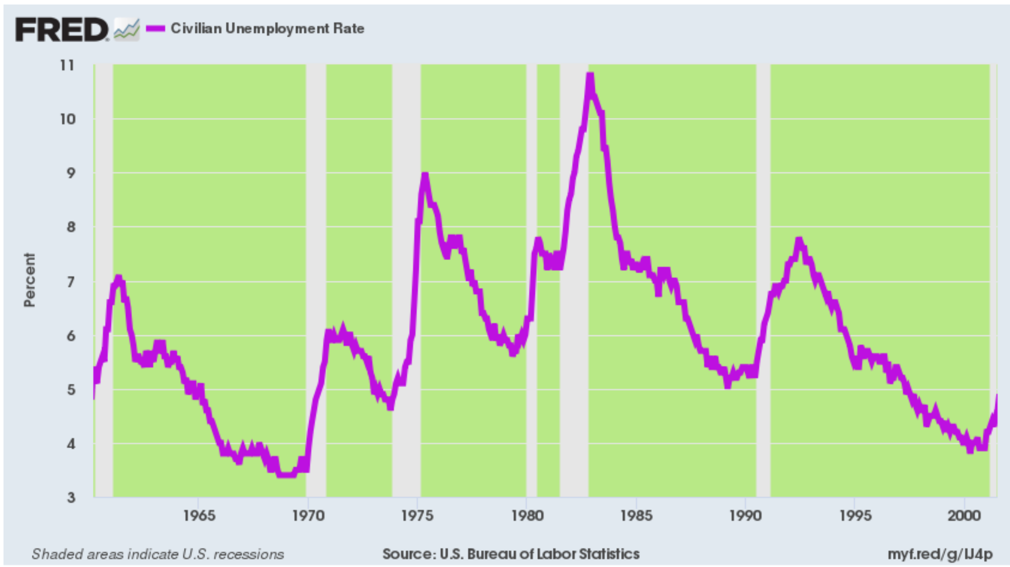
The Donald and Bubblevision like to point at that the unemployment rate is just 3.8%, having dropped as low as 3.7% last October. That's the lowest rate in half a century.

But the idea that because the unemployment rate has reached rock bottom everything is smooth sailing is belied by history. We haven't abolished the business cycle. And the current expansion is really, really long in the tooth.

Besides, the "headline" unemployment rate is essentially worthless. The best way to measure labor activity is on an "hours worked" basis.

In December 2000, there were 175.5 million adults aged 20 to 69 – so the implied potential labor force amounted to 351 billion labor hours per year. That's 2,000 hours per year per workers.

During that same month, the Bureau of Labor Statistics (BLS) measured 229.5 billion hours actually employed in the non-farm economy at an annual rate – so unemployment amounted to 121.5 billion hours, or 34.6% of the potential available hours.



Today, the 20-to-69 population is 213 million, and available hours total 426 billion per year. The BLS's most recent measure shows 256 billion hours actually employed. So, that's 170 billion unemployed labor hours. And that's a 40% comprehensive unemployment rate.

The rest of these labor hours are hours on disability; hours on early retirement; hours in school; hours for "students" playing video games in Mom's and Dad's basement or selling used beer bottles on eBay. The point is, 3.7% is meaningless.

We have a huge potential labor force. But we're not using it. Our economy isn't performing.

A Mother of a Yield Shock

It's a mistake to look in the rear-view mirror anyway. It tells you where you've been, not where you're going. And where we're going is a bad place. We now have an unprecedented collision of monetary and fiscal excess in Imperial Washington.

The federal government has become utterly fiscally irresponsible. We'll have a deficit in fiscal 2019 that requires new borrowing of $1.2 trillion – and this isn't at the bottom of a recession. This is after more than 10 years of expansion. It's unprecedented. Nothing like this has ever happened.

The Federal Reserve's process of "normalizing" its balance sheet meant dumping another $600 billion of existing issues onto the bond market. That threatened additional upside pressure on yields – $1.8 trillion of homeless debt that, sooner or later, would have to clear the market.
The market will clear – despite even the Fed's recent reversal. And we'll be left with yields far higher than what we see today. That's the skunk in the wood pile.

Absent total monetization, market yields will be driven by supply and demand. Monetary central planners will have to shrink at some point, and it will happen at the same time. When they dump, bond pits will overflow. And yields will soar to 4% and more.

That's a very difficult world ahead.

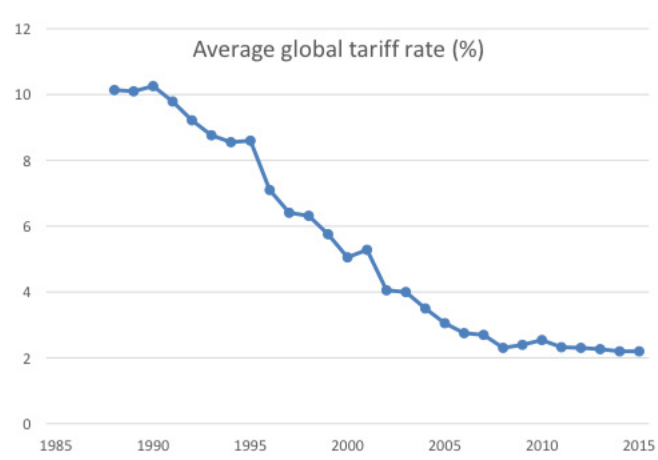
Ask Yourself, "Who Benefits?"

As I previously noted, "We've inflated Wall Street. And we've abandoned Main Street." The clearest illustration is that money-market funds were made available at negative real rates for nearly a decade.

History shows that negative real rates in the money market are the mother's milk of speculation. It's the basis of the "carry trade." It's the foundation for options prices. Negative real rates in the money market have fueled a tremendous level of speculation. That's why stock markets are at out-of-sight valuations.

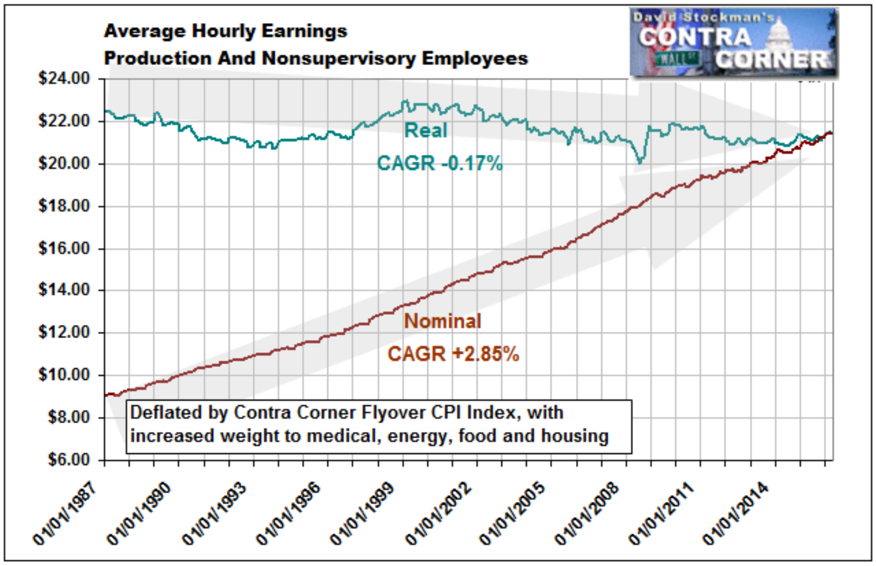
Bad money shows up in other ways. Let's talk about global trade.

The average global tariff rate has been steadily declining since 1985. Our problem with global trade is not tariffs. It's not bad deals or even cheating by foreign countries.

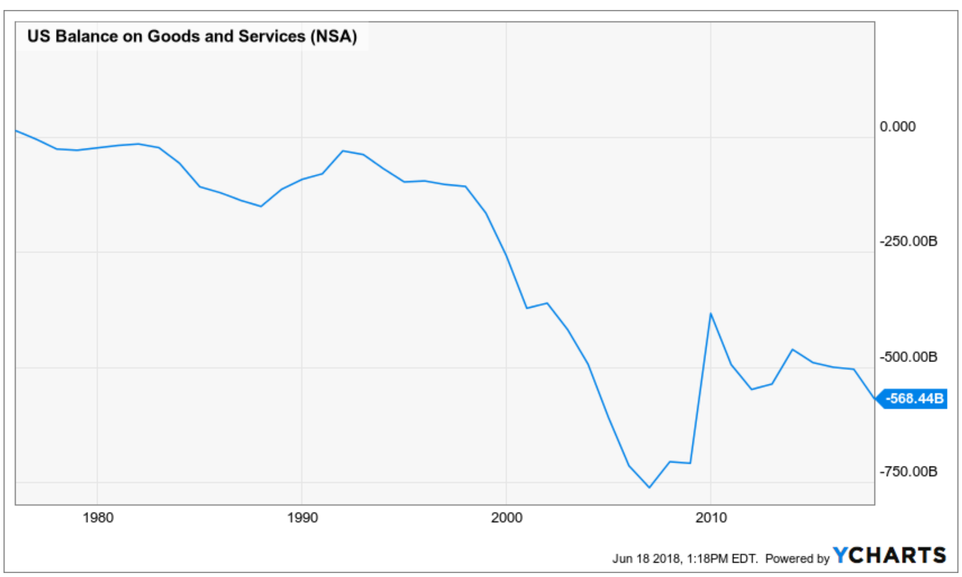


Our problem – an $800 billion trade deficit – is bad money.

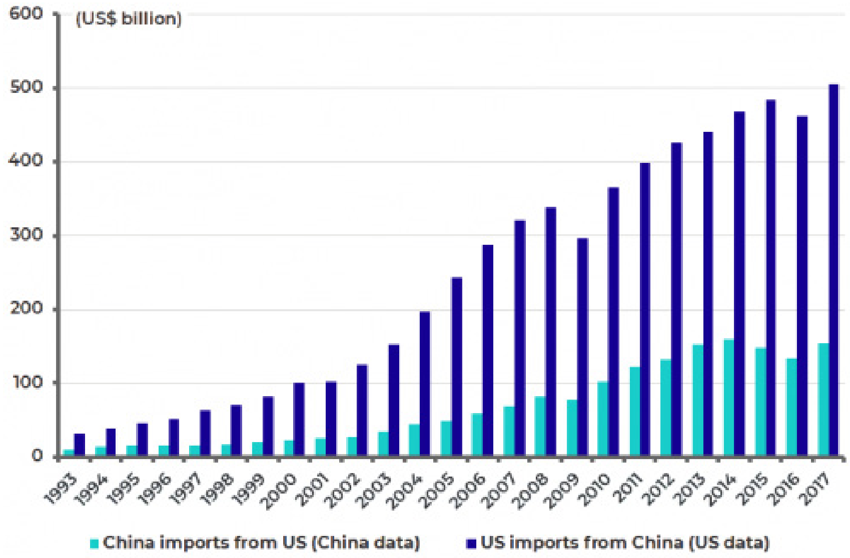
The average nominal wage in the U.S. economy has climbed steadily since 1987, from about $7.00 an hour to $22.00. At the same time, real wages didn't grow at all.



This is a product of the Federal Reserve's obsession with a 2% inflation target.
It's the dumbest, most destructive thing our central bank could have possibly done in the face of China's and other emerging countries' entry into the world labor market.
It continued to inflate U.S. wages and costs as we tried to compete with a whole world's worth of workers being drawn out of the rice paddies onto the global labor market. That's why we got that crazy trade imbalance. That's why we basically borrowed $19 trillion over the last 30 years.

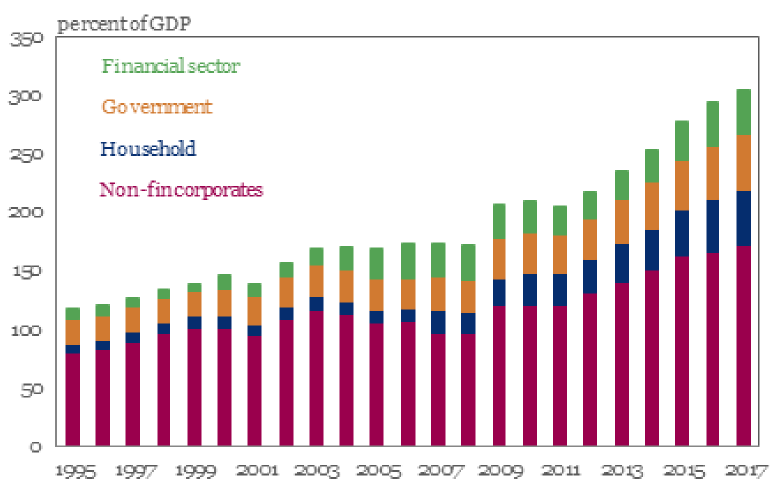


This is total aberration. It's a function of "easy money." But "easy money" is our greatest export, thanks to Alan Greenspan. The Chinese said, "Fine, we'll do it."



They're equally insane. But "easy money" is how they built their own $40 trillion "Red Ponzi."

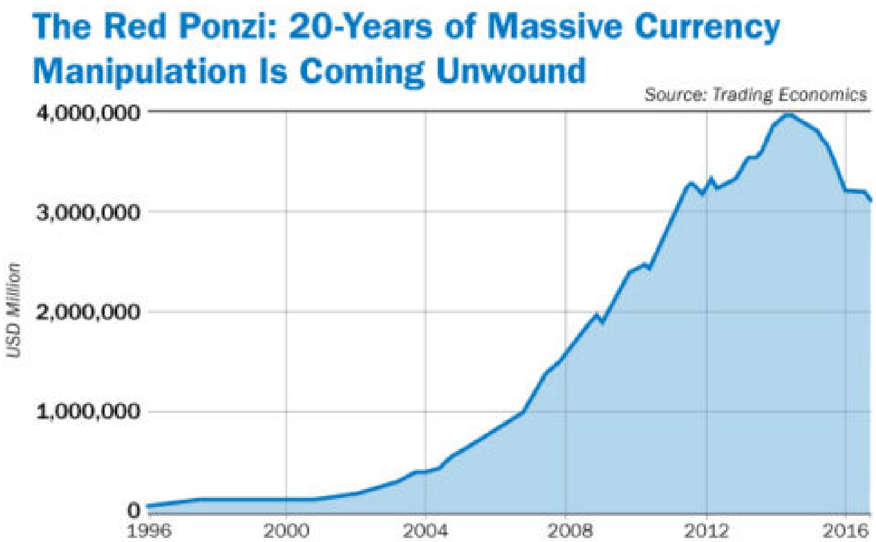
China: Total Debt-to-GDP



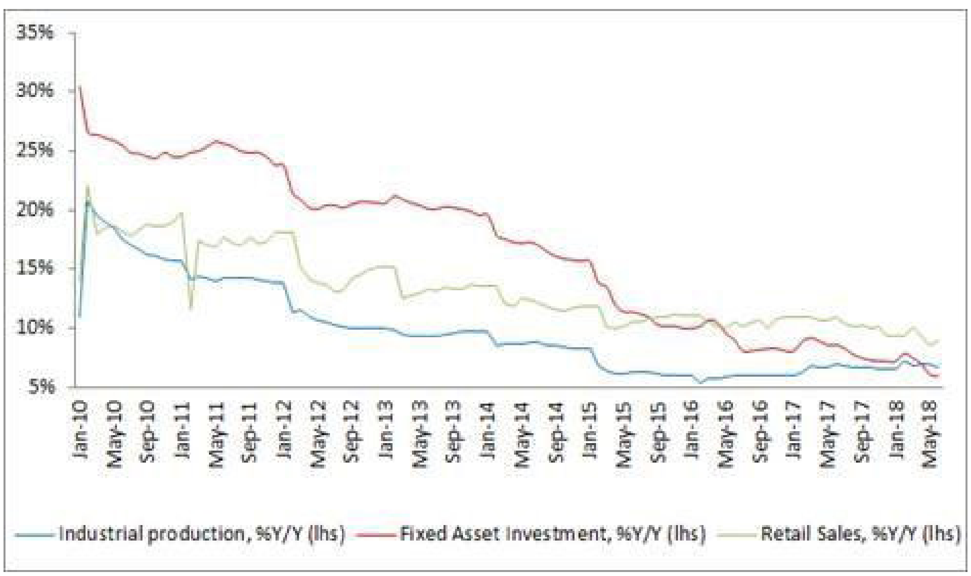
Source: IIF.

The Red Ponzi is a dagger aimed at the world economy.

In 1995, it had $1 trillion of debt. Today, it has $40 trillion. You can't take anything up 40 times in two decades and not have a mess.



China fueled a huge increase in infrastructure and fixed-asset investment. As that investment tapers, it's pulling everything else with it.



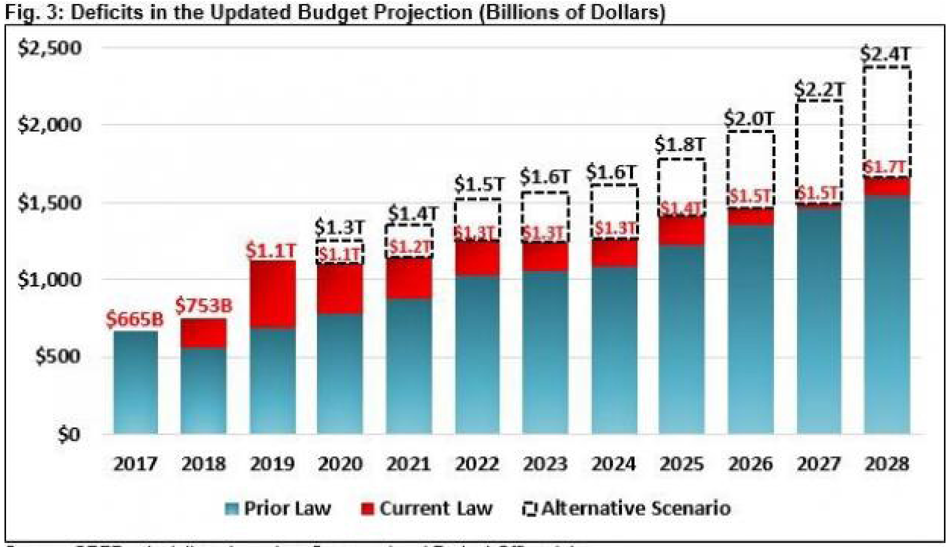
The China story is just about over. A transition to a consumption-focused economy was supposed to bail them out. It's not happening. So, they're getting desperate.

All Bubbles Must Burst

The Chinese miracle is over. And it's beginning to look a lot like the end of our own.

Our debt is out of control, too. There are no "opposition" parties. The Republicans gave up on fiscal responsibility long ago, with the "Laffer Curve."

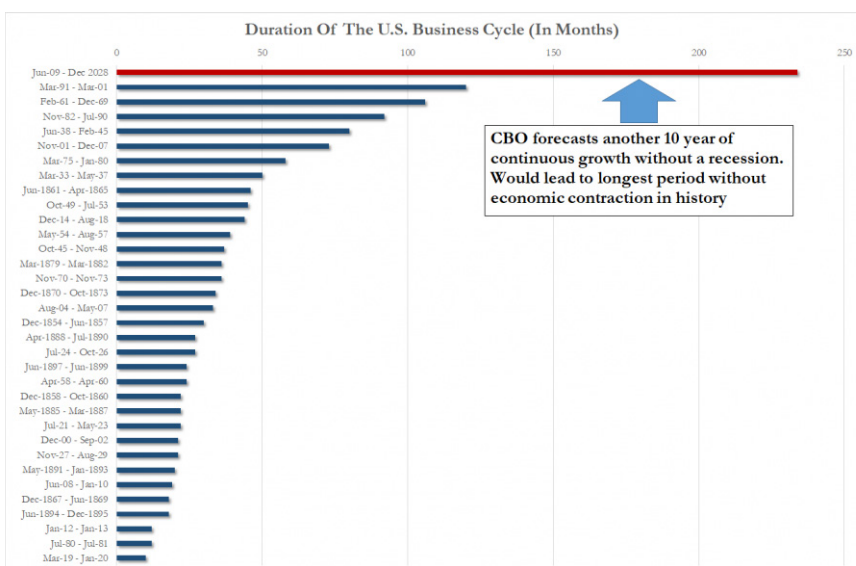
Fig. 3: Deficits in the Updated Budget Projection (Billions of Dollars)



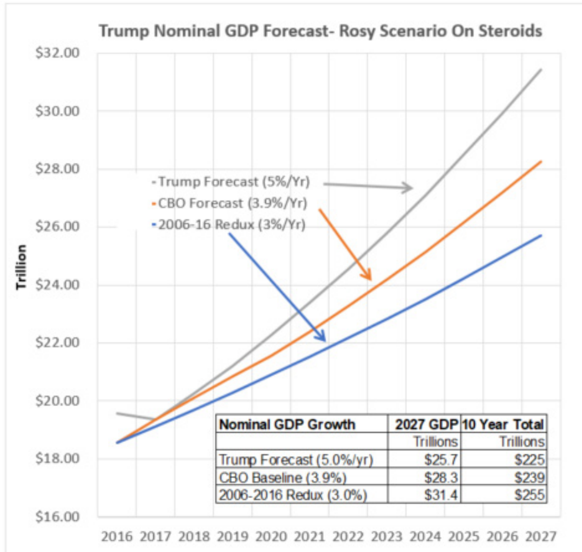
Source: CRFB calculations based on Congressional Budget Office data.

The Democrats never believed in fiscal responsibility. But they have a new theory to back up their own "deficits don't matter" approach, "Modern Monetary Theory."

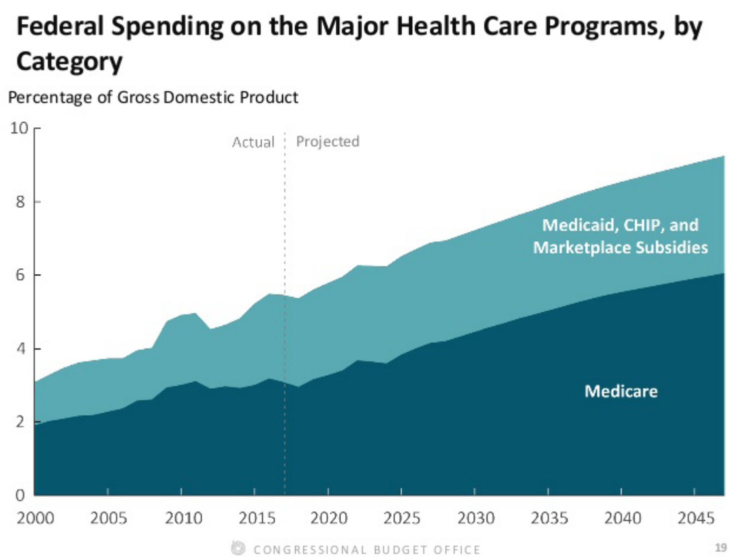
This is all built in. It's all entitlements and automatic spending, $17 trillion. The funny thing is, it assumes a "Rosy Scenario."



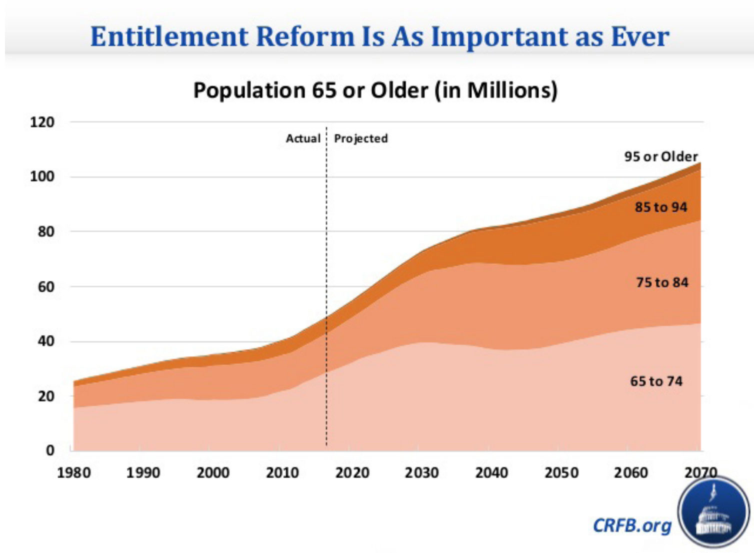
According to the government's most recent forecast, we're never going to have another recession again. Built into that $17 trillion of cumulative debt forecast is 232 months with no recession. That's miraculous thinking.



We've already got the demographics built in. Fifty-five million Baby Boomers are retired now; it's going to be 100 billion within the next couple of decades.



That'll drive the Welfare State monster. There's very little that anybody is proposing to do about it.



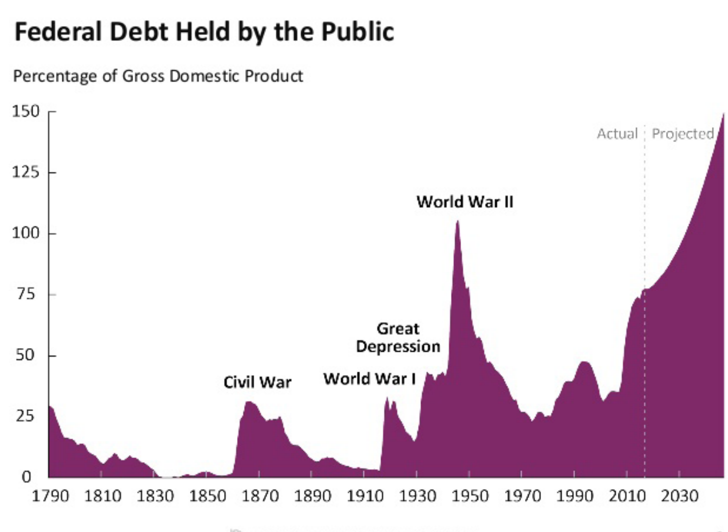
In fact, Trump is saying he won't touch it, so Republicans won't. We can't grow our way out.

We're heading for government spending at 30% of gross domestic product, perhaps 18% in a "best case" revenue scenario.

We're looking at a massive, permanent structural deficit.

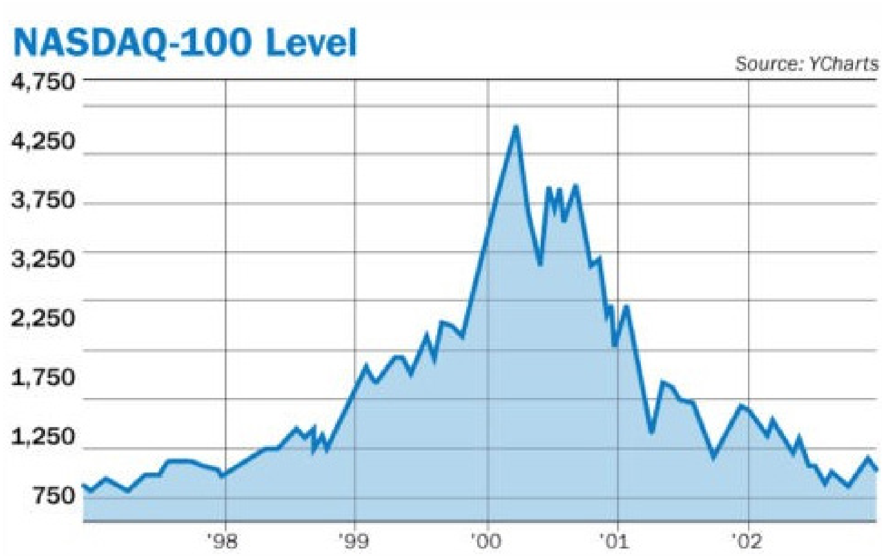
And that will create a crisis like we've never seen before. We've got $21 trillion of government debt today. There's $17 trillion coming under a "Rosy Scenario." That's $38 trillion. Then, allow for at least one recession… an outbreak of MMT-and-AOC-style socialism… maybe a run-of-the-mill crisis… what about the collapse of the Red Ponzi?

It's going to be at least $42 trillion.



If at this point you're still inclined to say, "Well, stay in the market because the 200-day moving average has only been slightly breached, and somehow they'll come back…" here's a parting reminder of complacency's wages…

On March 27, 2000, the Nasdaq 100 Index was cruising above 4,250. They said, "Don't worry, that's a high level, but this time it's different…" They added, "And besides that, it's 13% above its 200-day moving average, so, technically, there's nothing to worry about."



You see what happened with your own eyes. Maybe you experienced it. The Nasdaq 100 ended up cutting through the 200-day moving average like a knife through butter. By April 15, the index was down to 3,200. That's 33% in 15 days. Most investors had no idea what'd hit 'em.

That's what happens with bubbles.

They take eight, nine, 10 years to inflate. But they deflate – especially on the leading edge of big, bad ones – very quickly and very violently… and usually before anybody figures out what's happening.