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**By John Mauldin**

Be careful what you ask for, the ancient wisdom says, because you just might get it. The world markets are asking for a return to balance, where the US trade deficit shrinks, the US saves more and we balance our government budget. All laudable goals, and ones I would applaud. But the road to a balanced global market may not seem like a walk in an economic Lake Woebegone, where stock market returns are strong, stagflation does not darken the path and where all our portfolios have above average returns.

Having had the luxury this week to read more than my usual mountain of material, I am struck by the sheer complexity of the world economy. It is a puzzle with seemingly obvious answers yet exceedingly difficult to solve; or a riddle with many answers, none of which are exactly right; or maybe it is more like a great mystery, where there are clues on every page, but it is only when we come to the end that we can recognize that we had been given a clue.

I have been reading an advance copy of a new book by Peter Bernstein called *Wedding of the Waters* (I will review it in late January, when it will (finally!) be out. Any book by Bernstein is a must read, and he is on the top of his game in this one.). In it he details the building of the Erie Canal and its powerful impact not only on just the fledgling colonies but on the world economy. Perhaps it is just his brilliant analytic artistry, but he makes me think I can understand how it all fit together back then. It seems a lot more complex to me today. I am blessed to be able to have dinner with him in a few weeks, and I will pose a few questions along that line.

It just seems like there are so many more pieces to the puzzle. And like some puzzle out of a Harry Potter movie, the pieces change shape after you fit them together. And some master pieces force other pieces into ever new shapes. Investors want nice, neat puzzles with large pieces and clear pictures, like the kind I gave my young children. Generally they all had happy scenes with bright outcomes. I could be a trifle sarcastic and say something along the lines of "It is not far removed from what Wall Street gives to the average investor" but it is the Christmas season and I will refrain.

I readily confess to having been something of a puzzle junkie all my life. Perhaps it is why I enjoy trying to figure out the markets, as they are a truly challenging puzzle. (I have given up on trying to understand teenagers, after having had six with one more coming up the ranks – some of life's puzzles simply cannot be solved.)

## **Greenspan: Be Careful What You Ask For**

Let's start with a fun puzzle that you can in fact solve, and with which I will make a point at the end of the letter. One of my pleasures every morning is reading Art Cashin's take on what happened in the market's the previous day (Art is head floor trader of UBS and NYSE muckety-muck, but you know him from being on CNBC every day where he comments from the NYSE floor). He always ends his commentary with a mind-teaser of some fashion. In keeping with the season, he sent this riddle along: "Santa sent his special elf Sanjo down to the basement to fetch some green ribbons for bows. Sanjo discovered that the ambitious elf, Lanzro had switched the labels on the 3 ribbon drawers. They were labeled: 'Red,' 'Green' and 'Red and Green.' Since every drawer was incorrectly marked, how can Sanjo pick just one ribbon out of one drawer and know which drawer held which?" (Answer at the end of the letter.)

If only the riddles of the market were so easy. Today, we are going to see if we can find a few clues, and maybe even an insight or two into what they mean. If we can get an insight into the true nature of a problem, then we can begin to solve for what might be the likely solution. It may not be a solution we like, but if we can see something coming, it is likely we can avoid the worst of the consequences, and possibly even profit.

### **Greenspan said WHAT?**

I have read and re-read a quote from a Greenspan speech in Germany of three weeks ago. It is remarkable in its clarity, especially from a Fed Chairman who is the master of speaking at length and saying nothing of real import. Let's use it as our jumping off point:

"The insatiable foreign demand for dollar holdings would eventually fall as investors diversify," said Greenspan. He told a banking conference in Frankfurt the United States should cut its record budget gap to help narrow the shortfall in its current account and avoid a need to offer higher rates of return to retain foreign investment and painful economic consequences.

"Current account deficits, even large ones, have been defused without significant consequences, (but) we cannot become complacent," Greenspan warned. Greenspan said cutting the U.S. budget gap would be the best way to boost domestic saving and lessen America's reliance on foreigners to fund the huge shortfall in the current account, a broad trade measure that includes investment flows.

"Alternative approaches to reducing our current account imbalance by reducing domestic investment or inducing recession to suppress consumption obviously are not constructive long-term proposals."

Greenspan said an eventual desire by foreign investors to cut the risk of holding too many dollars may lead them away from U.S. assets or lead them to seek higher rates of return. He warned this would elevate the cost of financing of the U.S. current account deficit and render it 'increasingly less tenable.'

## Greenspan: Be Careful What You Ask For

“We see only limited indications that the large U.S. current account deficit is meeting financing resistance,” Greenspan said. “Yet, net claims against residents of the United States cannot continue to increase forever in international portfolios at their recent pace.”

“It seems persuasive that, given the size of the U.S. current account deficit, a diminished appetite for adding to dollar balances must occur at some point,” Greenspan said. (from Reuters)

It is not so much that anything he said was some new insight, some novel idea, but that he said it at all is the surprise. The second most powerful man in the world was trash-talking the US dollar! Since then, the dollar has tumbled in a rather breath-taking manner, only catching itself in the last few days.

(Side note: this upward correction in the spiraling dollar could also surprise with its intensity. The dollar could rise quite a bit and still be in a long term down-trend. I might hold off a little bit before I deployed any more US dollars into foreign currencies, or at least average in. The same goes for gold. Gold is still in a long term bull, but it went too far, too fast and needs to moderate a little.)

### **An Associated Compression of Equity Multiples**

Richard Berner of Morgan Stanley in a debate with his colleagues (including Stephen Roach) on the dollar said today (emphasis mine): “... it can be a dangerous and risky game for Fed officials even implicitly to talk down the dollar. Chairman Greenspan, himself, is often guilty of believing that he can wave his magic wand to manipulate markets to produce the desired result. History shows that even he is sometimes humbled by the collective wisdom of millions of investors.

“I believe that Fed officials would like to promote — if they can pull it off — a shift in the mix of financial conditions that will facilitate rebalancing. **That shift entails higher US rates, an associated compression of equity multiples, a tightening of domestic borrowing costs, and a weaker dollar.** Officials must have decided that the risks of the current mix of financial conditions, with all of its potential consequences for growing imbalances and prospective abrupt asset price adjustments, were greater than those entailed in a strategy aimed at letting the air out of the dollar in a more orderly way.”

(The full and very fascinating debate will be the subject of next Monday’s Outside the Box.)

It is almost a lock that the Fed will raise rates at its December meeting next week. It is also a lock that it will be only 25 basis points. Greenspan and numerous Fed officials have signaled “a measured pace” for so long that the markets would throw up if they did anything else.

## Greenspan: Be Careful What You Ask For

But let me be a little contrarian here. Many observers think the Fed will pause at some point before moving forward with ever higher rates. I think it is entirely possible the Fed will keep raising rates at every meeting for the first half of next year and maybe on into the second half. The Fed, as many serious Fed watchers know, often goes much farther and for far longer than the market thinks when it starts to raise rates.

If the Fed (through Greenspan) is going to trash talk the dollar, and yet at the same time they want to slowly let out the air and somehow manage a decline, is going to need to raise rates more than another mere 50-75 basis points. At least, that's the way it looks from this corner.

Now, look at the first thing that Berner said the new Fed policy implies (and I strongly agree with him): "an associated compression of equity multiples." That is an economic euphemism for bear market. At the least, it is a sideways market even if earnings rise. Be careful for what you ask.

For the next few weeks, we will be inundated with various forecasts for the stock market for next year. They will all almost invariably be up. "Look," we will be told, "earnings are going up and therefore stocks must go up as well." Look hard at the forecasts. I bet most of them will include a healthy dose of multiple expansion. (By expansion we mean that price to earnings ratios (P/E), or the multiple the market applies to earnings to arrive at a value for a stock, will rise.)

Secular bull markets are characterized by expanding and rising multiples. Secular bear markets are characterized by falling P/E ratios. We started a secular bear market in 2000, and we have not yet seen the bear do its work of taking us well below the mean. (As I detail at length in *Bull's Eye Investing*, once a secular bear starts, it always finishes the job. As an average secular bear is 12 years long, we have some way to go.) The unintended consequence of trying to manage an orderly retreat of the dollar from our unsustainable trade deficit will be falling stock market.

Of course, if "they" let things progress for a few more years until the deficit gets completely unsustainable, the drop in the stock market will be much more violent. The problem is the world is dangerously out of balance. We are now absorbing 83% of the world's savings to pay for our trade deficit.

Most projections show that deficit getting worse in 2005. How much more of the world's savings can we absorb? The limit, of course, is 100%. The world is going to come into balance. It is just a question of how.

"We need to spend less and save more" say some. We are dependent upon the kindness of strangers. What if the central bankers of the world decided to stop financing our deficit? Be careful for what you ask. The world is also dependent upon the US consumer. As Stephen Roach pointed out somewhat whimsically, what if the US consumer decided to stop borrowing and start saving? Exactly who is dependent upon which stranger?

## **Greenspan: Be Careful What You Ask For**

Oh, we can depend upon the US consumer to spend, thinks the world. But in order to maintain the level of spending we now have, savings rates have dropped to the lowest levels in history. It's not like US consumers have this deep well of income that they could divert from savings to spending. It's already been tapped. If the stock market goes flat, or starts on a downward path, it will call into question many a retirement. Could that goad a savings revival?

Look at it from the viewpoint of Asia and especially Europe. A weaker dollar is deflationary for them. Much of Europe is already flirting with recession. It won't take much of a push. If (or more likely when) the US consumer starts to even modestly increase their saving (I resist the use of terms like spree or binge), it will not be good for European and Asian sales to the US. If you save it, you do not spend it.

If the rest of the world does not finance our debt, and I am not saying it should, then we will have to do it ourselves. That means either we save more and/or we see rates rise to attract more savings from both inside and outside of the US. Rising rates, and that is a consequence of current Fed policy, is not necessarily good for either consumers or corporate profits in a deeply financed based economy.

But there is an even deeper problem in asking for a more balanced world. The US consumer is the main source – the ultimate well spring - of liquidity in the world markets. We are taking our savings (or borrowing it from our home equity) and pumping up the world economy.

If a central bank wants to slow up its economy, it simply has to begin to dry up liquidity. If they are not careful, it can cause a recession. Let me quote at length a piece from the really smart people at GaveKal Research ([www.gavekal.net](http://www.gavekal.net)) of Hong Kong.

### **America - The World's Biggest Hedge Fund**

“In recent years, in the financial world, we have witnessed the emergence of thousands of hedge funds (a phenomenon for which we at GaveKal are very grateful). The marketing argument of most hedge funds usually centers on:

“a) its great flexibility in dealing in almost any asset class where an opportunity might lay and

“b) the ability to use debt intelligently (i.e.: leverage up at the appropriate time).

“Thanks to these qualities, hedge fund managers receive a much higher fee than their ‘long-only’ brethren. Why are we recalling these simple facts that everybody knows (especially our clients who have made the jump from the long-only shops to their own hedge funds)? Simply because we once again want to re-iterate the point that the US economy operates as a colossal hedge fund.

## Greenspan: Be Careful What You Ask For

“Consider the following question: If the US is the biggest debtor nation in the world, (as we are so often told) how can it be that the US still has a positive cash flow on the servicing of that debt?”

“The difference between what the Americans pay to foreigners and what the Americans receive from foreigners is a very robust US\$30 billion a year. The irony, of course, is that if the US\$ falls, the net payments on the US\$ denominated debt remains the same, while the receipts, in foreign currencies, go through the roof.

**“So we can confidently forecast that the US net position will improve dramatically in the next few quarters, despite a bigger and bigger inventory of debt owned by foreigners .**

“So how does it work? Well first off, foreigners invest mostly in US Treasuries, yielding 2% to 4.5%. Then, the US financial system takes the money and invests parts of it in the US, and parts of it in foreign countries, earning anywhere from 6% to 12 %. Like any good hedge fund, the US then keeps roughly 4% in the middle for the payment of its service. **And the service is to transform risk adverse capital (central banks) into risk-friendly capital.**

“Today, the US knows how to do this better than anyone else in the world. Needless to say, the manager of the hedge fund is Mr. Greenspan. And one might worry as to who the next fund manager will be. After all, investors usually don’t like a change in manager! Having said this, we remember vividly the anguish as to who could possibly replace Mr. Volcker... The model is robust, and the only risk would be if the ROIC outside of the US were to collapse below short rates in the US (world depression). That seems highly unlikely today. Earnings of US exporters and multinationals are going to go through the roof.”

This is a relatively optimistic view of US trade deficits. But the point is clear. Be careful for what you ask. If the US had to finance its own debt, we would not have the money to finance growth (provide liquidity) to the rest of the world. Of course, if we saved more, we could invest it overseas and provide liquidity that way. And foreign savings would have to find a home rather than US treasuries.

It is all rather complicated. I bring up these issues to make the point that it is not a net and simple world. And the rebalancing will not be neat and simple either, I fear.

### **Insatiable Foreign Demand for Dollars**

But now we come full circle, back to Greenspan’s speech: “The insatiable foreign demand for dollar holdings would eventually fall as investors diversify... net claims against residents of the United States **cannot continue to increase forever** in international portfolios at their recent pace.”

## **Greenspan: Be Careful What You Ask For**

The world is in fact at some point going to have to come to more of a balance. We cannot “continue to increase forever” at the current pace. The US is going to have to balance its government budget deficit and deal with its massive trade deficits. It is an unsustainable trend, and therefore at some point will not be sustained. It will stop. US Consumers are going to have to save more, not just because of the need for world balance, but because they are going to find the markets will not give them the returns and therefore the retirement for which they had hoped.

The world, and especially Asia, is either going to have to become more of a consumer of its own products, or growth will slow. Somehow, somewhere, another source for the liquidity provided by US consumer spending will have to be found, or the world will suffer a serious slowdown.

My best guess (and frankly my hope) is that this process is going to take years. It will not be painless for many, as it will entail, indeed require, much change in the equilibrium of the world.

One final thought. The necessary changes will not come about as a response to some policy of bureaucrats, no matter how highly placed. It will not be balanced by someone pulling on levers. It will be Adam Smith’s invisible hand. It will not be governments getting together and deciding how much a currency is worth. They can only manipulate for so long, and then the market wreaks its vengeance.

A nation that does not save enough will soon be forced into a situation where it needs to save. A nation that depends upon foreign consumption will soon find itself forced to rely more upon its internal resources. A nation that over-regulates will find its economy weaker and that it loses ground to its more free neighbors. This problem of rebalancing will not be solved by more government.

The key for you and me, gentle reader, is to figure out what the market forces – not temporary government interventions - will require in this rebalancing. As an example, a weaker dollar over time seems like a given, and thus higher gold should follow. Contracting multiples means a lower stock market over time. (Remember, there is always an end to a bear market cycle and a new bull is reborn in low valuations. We are not going to some new permanent end of the world.)

But that is enough for today. Except I did promise an answer to the puzzle at the beginning. Sanjo, that clever little elf, knew he should take a ribbon from the drawer marked “Red and Green.” If it is green it must contain all green ribbon (since all drawer labels are incorrect). Therefore, the drawer marked Red will contain red and green while the drawer marked Green will be red ribbon.

### **Your Personally Autographed Bull’s Eye Investing**

In a personal effort to promote intelligent consumer spending here in the good ole USA, we have a Christmas Special Offer. For those of you looking for that perfect

## **Greenspan: Be Careful What You Ask For**

Christmas gift for that investor in your life, or for your clients and customers, I will personally autograph a copy of Bull's Eye Investing, the book that some call the most important investing book of 2004! Just click on the link (<http://www.2000wave.com/pdf/christmasform.pdf>), fill out the form and fax it back (or mail it) to us along with the name of the person you want me to personalize it to. Go to [www.absolutereturns.net](http://www.absolutereturns.net) for more info and reviews on the book. (Note: some international readers may have to pay extra shipping. We will work with you to get the best rates, but with a cheap dollar, you can afford it! Splurge a little.) Or, you can always go to [www.amazon.com/bullseye](http://www.amazon.com/bullseye) and get a 34% discount. Either way, it will make a great gift that will keep on paying dividends for years.

Another fun holiday read is a book by my friend Gary Shilling called "Letting off Steam." For many years, each month he writes a marvelous short commentary at the end of his monthly newsletter. For some of us, it is the part of his letter we read first. It is about the issues of life and can be on almost anything, but is always fun and often thought-provoking. "Letting off Steam" is a collection of the best of these columns. For those of you who know Gary from his Forbes column, you will be delighted with this book. For more information go to [www.agaryshilling.com/partner.html](http://www.agaryshilling.com/partner.html) .

### **CNBC, Mattresses and my 2005 Forecast**

I will be on CNBC on December 30 in the afternoon giving a preview of my 2005 forecast. Details to follow. Mostly, though, I am going to take a little R&R over the holidays. The 2005 Forecast will be in your e-mail boxes January 8.

I have found my readers are a font of knowledge about almost everything. I am in therapy for my back, trying to coax it to loosen up so it does not hurt and especially so I can once again play golf. We are making progress and I am optimistic. Now the question: I am wondering about the claims of the Tempur-Pedic foam mattress. Do they really help your back and make you sleep better?

And I am looking for a new chair. I have the fancy Aeron chair, and I find it uncomfortable. There must be something better. Suggestions for someone who is in a chair in front of a computer too much of the day? I do get up and walk and stretch, but at the end of a long day, my back is still sore. Maybe it is just getting a little older, or an occupational hazard, but I bet more than a few of my readers have dealt successfully with something like this. Thanks.

Your really looking forward to the holidays analyst,

John Mauldin