Retirement Lifestyle Advocates

RADIO PROGRAM

Expert Interview Series

Guest Expert: Karl Denninger
Market-Ticker.org

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Dennis Tubbergen:

Welcome back to RLA Radio. I'm your host, Dennis Tubbergen. Joining me once again on today's program is our returning guest, Mr. Karl Denninger. Karl is a prolific commentator. You can read his work at market-ticker.org. I do frequently. I would encourage you to do the same. And Karl, welcome back to the program.

Karl Denninger:

Thank you for having me on, Dennis.

Dennis Tubbergen:

Karl, we were chatting a bit before we started recording this conversation, and we were chatting a bit about the health of the US economy. I use the term prosperity illusion to describe what's happened over the past few decades, and that was in response to a comment you made. Give us your assessment of the health of the US economy. Where are we now? And to what would you attribute this seemed success over the past couple decades?

Karl Denninger:

Well, I think it's a little more complicated, and yet at the same time, a little more simple. We can take this in a personal fashion. Consider that, let's say that you were to buy a brand-new house that has just been built, so everything in it is new. The refrigerator, the air conditioner, the roof, the driveway, the doors, everything. So, you do that, you move in, and you pay the money. Then you enjoy life for the next 20 years, and you never put anything aside. So normally, what you would do in any kind of reasonable commercial enterprise is, you'd have this thing called a sinking fund. So, if your air conditioner, for example, is expected to last 10 years, you would put 1/10th of the cost of an air conditioner into this fund every year, because on average, about every 10 years, it's going to blow up and you're going to have to buy another one.

You'd do the same thing with your roof. Maybe your roof lasts 20 years, so every year you put in 1/20th of the cost of a roof. Same thing for your refrigerator and your washer and dryer, your major appliances, and things like this. Well, that's money that has to come out of your operating cash flow, whatever you run your house on. So that is not money that you can go spend on a trip to Disneyland or an RV or a boat or whatever have you, or whatever kind of fun you happen to enjoy.

Well, instead, we as a nation, we haven't done any of that. We haven't put any of that aside. And so we've cranked up this free money machine, but we've put nothing back for this sort of thing. And every time that there is some kind of an expense like this that has to be budgeted for and looked at, we found ways to try cheapen it. So, we've taken the skilled labor with short supply lines that are within the United States, and we sent them to China, we sent them to Mexico, we sent them to India. Therefore, we've put an ocean in the middle and an uncertain political environment that's not under our control. The Chinese government is its own politics. It's its own political and social system, may or may not deliver things that we want delivered when we want them delivered. We should have learned this in the 1970s with the Arab oil embargo, but apparently, we didn't learn it very well.

Now, this is all coming back to roost because the roof is old, it's leaking. The air conditioner isn't working very well. It comes on most of the time. It's making some really weird noises out there in the backyard. And the doors and the locks don't work anymore. And by the way, there's more burglars around than used to be 20 years ago because everybody else has been doing the same thing. So, some number of our fellow citizens have decided that crime is a better way to make a living than by going out and getting a job. And oh, by the way, we sent a lot of their jobs over to China and India and Mexico anyway, so in some cases, it's not that they don't want a job, it's that they can't find one that pays enough to actually put the roof over the head.

And we wonder why, gee, this looks great. Well, then Jerome Powell comes along who says, "Oh by the way, our inflation situation is not so wonderful." And people are getting very imbued with the idea that this isn't going to get fixed in the space of six months or a year anymore. What the Fed really worries about is inflation expectations. It's not so much the inflation today, it's what you believe it'll be tomorrow because that drives your behavior. And those expectations continue to go up. Even though if you look at the data, there are all sorts of people, Joe Biden is saying that inflation has peaked.

So, by the way, is Janet Yellen, who used to be in charge of the Fed, but the data says that the American public doesn't believe it. And so, we've got the squeeze of incoming capital on one side and the squeeze of increasing expense on the other. These are things that we enjoyed by intentionally deferring and being stupid about for the last 20 years. And now they're coming home to roost.

Dennis Tubbergen:

And Karl, couldn't we even make the argument that not only have we outsourced and really gotten rid of a lot of these essential manufacturing processes, but we've also borrowed against future production. I mean, we're spending money we don't have. We actually ran the credit card up to the limit, and now we've funded this through quantitative easing. So, haven't we just exacerbated this problem by the Fed's monetary policy?

Karl Denninger:

Oh, absolutely. But remember, it's not the Fed's monetary policy. It's Congress's monetary policy. The Fed, if you look at the data from the St. Louis Federal Reserve, and I brought this up a hundred times, and people, when they first look at it, they go, "What?" And it's absolutely true. You look at the Fed funds rate and you look at the T-bill, the short-term T-bill, the four week or 13 week, take your pick, and graph the two on a continuous basis, and you will see that the market moves first every time. In virtually every single case, the market moves first. So, the idea that the Fed controls these policy rates is absolute nonsense. What controls the policy rate is the response in the economy from what Congress does. Congress is the one that passes the bills to spend money that we don't have. The Fed doesn't spend money, we don't have. The Fed can't spend anything.

Dennis Tubbergen:

But now Karl, so we've got one, Congress spending money that we don't have to the tune of a deficit that's approaching a couple trillion, has been as high as three trillion. That's continuing. The Fed is essentially funding that, and now interest rates are going up. So, when you take a look at what it's costing the US government to service its debt, I mean, only in Washington would you have long term interest rates at low rates and finance all the debt over a really short timeframe. I think I read a stat that is taking now about 29% of tax revenues just to service debt, just to pay the interest.

Karl Denninger:

Oh, yeah. But that's not the worst of it. All right. I mean, if you take a look at where the money actually goes, CMS, Medicare and Medicaid crossed the two trillion-dollar threshold this last fiscal year ending in September. That report just recently came out for the last month for September, which is the end of the government's fiscal year. That was a threshold that I expected was going to happen about two years from now. And in the problem with that threshold being crossed, and the percentage of the total budget that it represents, is that it's an exponential cycle, which I identified back in the 1990s and said, "This is going to blow up the federal budget and destroy the country if we don't stop it." It's the medical system. It's gone from 4% of GDP to 20%.

But rather than deal with this because that's hard. You got to tell, now, it's one person in five. And when you think about it, $1 in five in the economy means that about one person in five is making their living off essentially taking care of people. And healthcare at its best, is a symbiotic relationship. At its worst, it's parasitic because it produces nothing. It allows other people to produce things that couldn't without it, which is the symbiotic side of it. But we've gone from that 4% overhead to 20% overhead, and it's continuing to grow.

And at the same time, you have the government incentivizing through their policies and the way they handle taxation, taking things that we ought to be doing and not doing them. Saying about putting money aside for a roof. Well, in many states, the states have tax systems that tax inventory. So, we just had an incident in North Carolina where the power has been out for a couple of days and they say it's going to be a couple more. It's substation that apparently was shot at. Now you would think, "Okay, somebody shot a transformer, go get the spare one out of the barn, bring it over here, put it in." I mean, these things get hit by lightning. This kind stuff happens through acts of God that have nothing to do with somebody being a criminal.

There's a problem, they don't have another one. You would think, "How could you not have one of these within the county?" I mean, come on. How long does it take to drive across to any county in America with a truck? Couple hours. So, the storm happens, the bad thing happens, whatever. The storm is gone. The guys show up with a couple of trucks in 20 minutes and then four, five hours later back on because they just replaced the blown-up thing, whatever it is. No, not this time. Four days is their estimate from when it occurred because they presumably have to go get this thing from somewhere else. Well, what happens when there isn't a somewhere else? What if you got to order this thing, and it comes from China, and it takes 18 months to make it?

Dennis Tubbergen:

Karl, we've got a couple minutes left in this segment. When you look at all these factors. The fact is that manufacturing's overseas. We've got a huge deficit spending. We're financing it through, essentially, currency creation. And behind the scenes, debt levels are continuing to rise in the private sector and the public sector. Aren't we headed for a deflationary collapse that will have to be the mother of all deflationary collapses?

Karl Denninger:

Well, that's what I've been expecting for a while. I thought we'd get something like that after the '08 mess with the housing market. And it was of course put off by more money printing. But the problem with doing this is that it's kind of like your roof's leaking, so you go up there with a blue tarp and put a couple of tires on it so it doesn't blow off the next time it rains. And oh, it's all good. Well, no, it's not all good. All we've done is make it worse. You look at what has occurred in the housing market over the last couple of years, prices in many areas have doubled. And now mortgage rates have gone from sub 3% to somewhere around six and a half or seven, which, by the way, is still historically not very bad. I mean, that's historically about average.

That's an average rate over the last 30 years. If you get a 6% mortgage, that's really not all that bad for 30-year money, but it's still lower than the rate of inflation. And you should never be able to borrow money for less than the inflation rate, ever. So, what does this do to the price of houses over time?

Dennis Tubbergen:

Right.

Karl Denninger:

What does it do to the price of stocks and assets? Yeah. There's a deflationary collapse coming because the cost of capital is going to revert to being positive in real terms. It has to.

Dennis Tubbergen:

Agreed. Yeah. Well, my guest today is Mr. Karl Denninger. His website is market-ticker.org. You can read his writing there. I would encourage you to do that. I will continue my conversation with Karl when RLA radio returns. Stay with us.

Welcome back to RLA Radio. I'm your host Dennis Tubbergen. Joining me once again on today's program is returning guest Mr. Karl Denninger. I love reading Karl's work. I love his perspective. You can read it at market-ticker.org. I would encourage you to do that. So, Karl, as we ran out of time in the last segment, we were talking about the fact that this has to, at some point, evolve into a deflationary collapse. And as we were talking, I was reminded of the words of Thomas Jefferson who said that if the American people ever allow private bankers to control the issue of their currency first through inflation, then by deflation, the banks and corporations that will grow up around them will deprive the people of the very continent their father's conquered, or some variation of that. Isn't that exactly what we're seeing?

Karl Denninger:

Yeah, except I think that one of the things that I have a problem with that quote, is that the assumption is that all of this is being driven by the private sector. And perhaps back before the 16th Amendment, and back before federalization of senators, when the Senate was the representatives of the state legislatures, which was the original design of the Constitution of the United States. So, we had the people's House and then we had the state's House in the form of the Senate, in that each state was free to choose how to collect and remove during terms their particular senators. So, a state legislature could recall their senators if they wanted to.

This of course went away with the 17th Amendment, and we went to the direct election process that we have today. Prior to that, this was almost certainly something that was true and was not going to change. And you had boom and bust cycles that it could be very, very easily argued in the 1800s were deliberately engineered by the various banking cartels. They were engineered to produce booms and busts, and the intent was to steal all the property. It gets you to borrow money and get something that collapses in value, and you lose it. They seize it because you can't make the payments.

Now though, it's the federal government that's doing most of this. We as consumers and as individuals, get caught up in the middle of this. And so, you see the kind of craziness that goes on, where we're putting immense amounts of money on credit cards right now to try to stay up with a highly inflationary environment. But the reason the inflation is happening is because the federal government takes in three trillion dollars and spends five. So, I mean, that's not happening because you and I are going out and putting our groceries on our visa card.

Dennis Tubbergen:

Karl, when you look at the fact that there's massive deficit spending at the federal level. And certainly, I agree with you, that's the root cause. So, if that's the root cause, you have to see a balanced federal budget to begin to get this problem under control. I don't see that happening, at least on a proactive basis. Doesn't that mean that eventually markets take over, and this has to happen on a reactive basis, which is probably going to be pretty ugly?

Karl Denninger:

Yeah. And what likely comes out of this is a stagflationary environment that's extremely nasty. And by the way, the worst possible scenario from an economic perspective, I mean, people say deflation is terrible, deflation is not terrible if you hold cash. If you don't own a house and you would like a house and you have cash, deflation is your best friend that has ever happened. Same thing if you're trying to start a business and you have capital and you don't own any equipment or property, plant, whatever, have you. You love deflation because it makes everything cheaper. That's fantastic.

On the other hand, if you're in debt, deflation is hideously destructive. But the worst possible environment is a stagflationary environment where you have inflation that's there, that's going on in prices, not really in assets, but in operating expenses, and of course, interest is an operating expense. But at the same time, you're not getting any productivity improvement. You're not getting a better output.

Dennis Tubbergen:

Karl, in your view, drill down a bit on what you think this stagflationary environment ultimately looks like. And how is it going to affect someone in your view that has money in an IRA or 401K that's thinking they want to retire like their parents did?

Karl Denninger:

Well, I don't know that anybody's going to be retiring like their parents did. Unless if you're in the top 10th of 1% of American households, or even the top 1% perhaps of, and maybe none of this stuff. I mean, yeah, it's going to matter, but it's the difference between having Lear Jet and settling for first class. You're still going to do most of the things you want to do.

For the average Joe, it's an entirely different game because the premise that we would essentially promote the younger generation when things got difficult. And if you think about it, that's a perfectly logical perspective. Why? Because it is the young person who ultimately goes off to work and therefore pays taxes. And they pay the taxes that you wish to consume when you're older. We have turned that on its ear. We have taught two generations, at least, worth of individuals now, that there is no corporate loyalty. There is nothing to be earned other than a paycheck. At five o'clock when you punch a clock and go home, you owe them nothing.

And the reason you owe them nothing is because they owe you nothing, and they treat you that way. So, we have sacrificed the young, for the last couple of years for crying out loud, look at education, and everything else has gone on with COVID and all of this, for the sake of the old, which is exactly upside down. Well, what do you think the younger people are doing and are going to do in response to that? We're not a nation of slaves. You can't force people to go out and put their best effort in.

Dennis Tubbergen:

Karl, when do you see this deflationary collapse emerging? I know timeframes are a very difficult thing to predict. But it just seems to me, when you take a look at the number of Americans that are putting living expenses on credit cards, I think the average household or households collectively in the US in last year have increased their debt by 1.4 trillion. It seems like we're on a trajectory that just, you can't continue at this pace much longer.

Karl Denninger:

Well, I think it's starting now. It's kind of funny, when you look at some of the internal indicators and things. The leading economic indicators have been deteriorating now for several months. The job market is interesting because there's a huge divergence between the establishment and the household surveys that have shown up. And there are people that are saying that that implies government malfeasance and intentional distortion of the numbers. I don't buy it that way.

What I think it's showing is that we have an awful lot of people that are taking second and third jobs. And on the establishment survey, they count as two or three people because they call a company and say, "How many people do you have working for you?" On the household survey counts as one because they call you up and say, "Do you have a job?" Okay. So, you're seeing this divergence show up in the data, but that says that people are getting squeezed. And as that squeeze accelerates, I think when we get into the new year, this coming year, you're going to start to see this really come to the fore. But I don't see this clearing. And the people that have the happy face on that say, "Oh, this is going to be short and shallow, whatever." Look, the 1970s and early 1980s were not short and shallow. And I think the best-case scenario we have in front of us looks an awful lot like that.

Dennis Tubbergen:

Well, and its best case because when you look at debt levels in the private sector and debt levels at the federal level and even state and municipal levels, there's no comparison. Debt levels are far higher today than they were during that timeframe.

Karl Denninger:

Oh, absolutely. I mean, the possibility that we break things in such a way that we have a 1930s kind of scenario is very real.

Dennis Tubbergen:

So, what does that mean, in your view, for stocks and real estate?

Karl Denninger:

Well, real estate is at least 50% overvalued in terms of, if you look at where we were in 2019 just before the pandemic, we had very low interest rates, and we had prices that were in many cases, close to half of what they are today. Okay. Now, you have interest rates that are double what they were back in 2019 and prices that are twice. Good lord, that's well more than a 50% wack in terms of what's actually affordable at a given payment.

In terms of stocks, the same sort of leverage games, as I've often commented, if you have a generally declining rate environment, I can take borrowing money, assuming that the debt market will let me do it, and I can run a cash furnace, literally burn hundred dollars bills in the backyard of the company and show good earnings, but I haven't produced anything. That all goes away when you actually have to make something. So, the question is not, what is the price earnings multiple on a forward basis. The question is what are the earnings? Are there any earnings?

If the E number is negative, then well, what's that worth? So, we have this idea that stocks are somehow going to be resilient through this. I think that's absolute lunacy. The one thing that you can say on the other side, on the other counterbalance, is that there's survivor bias in the index. The S&P 500 and the NASDAQ, for example, the companies that fail and get dropped from the index obviously don't count, so there's a survivor bias that's built into the way indexes are computed. But I would be stunned if over the next couple of years, we don't trade through 1576 on the S&P again, which is, that's a 50% cut.

Dennis Tubbergen:

Wow. Karl, assuming you start to see this collapse in housing prices and a further collapse in stock prices, it seems that the Fed's going to go back and go to the only page in the playbook really, that they've used, and that is more currency creation. Can you see this maybe turning into a hyperinflationary type of outcome?

Karl Denninger:

No, because they know they can't do it. They're out of bullets in that regard, because if they do that, then they stoke more inflation. The problem with hyperinflation is that hyperinflation reliably destroys governments, and that means them. And they know that. Deflation gets a lot of people very angry and leads to a lot of upheaval, but it doesn't typically take governments down. Hyperinflation does, in almost every case. In fact, Mugabe is probably the only example it hasn't happened.

Dennis Tubbergen:

Well, my guest today has been Mr. Karl Denninger. His website is market-ticker.org. I would encourage you to check it out. Karl, always get terrific feedback when you're on the program. I appreciate you joining us today and love to have you back early next year for an update.

Karl Denninger:

Thank you much. Anytime.

Dennis Tubbergen:

We will return after these words.