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and friends

CONVERSATION 5

TRANSCRIPT

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John Mauldin is a prolific writer, financial expert and *New York Times* best-selling author of three books, including *Just One Thing* and *Bull's Eye Investing*. As a frequent guest on television and radio shows worldwide, he is also editor of the widely popular free economic letter, "Thoughts from the Frontline," which is read by more than 1,000,000 readers each week at www.frontlinethoughts.com. Based in Dallas, Mauldin is president of Millennium Wave Investments, and focuses primarily on helping high-net worth investors analyze and invest in alternative investments for absolute returns. The father of seven children, Mauldin and his oldest daughter Tiffani recently started the largest millionaire study done in over 15 years; those anecdotal conversations and interviews will eventually be compiled into a book. Investors can visit his website at www.johnmauldin.com.

Guests

David A. Rosenberg is Chief Economist & Strategist for Toronto-based independent investment firm Gluskin Sheff + Associates, Inc. Prior to joining Gluskin Sheff, David was Chief North American Economist at Bank of America-Merrill Lynch in New York and prior thereto, he was a Senior Economist at BMO Nesbitt Burns and Bank of Nova Scotia. Mr. Rosenberg has ranked first in economics in the Brendan Wood International Survey for Canada for the past seven years and was on the U.S. Institutional Investor All-American All-Star Team for the last four years.

Michael E. Lewitt co-founded Harch Capital in 1991. Mr. Lewitt has functioned as a research analyst, investment strategist and portfolio manager for HCM Group's high yield, fixed income and bank loan portfolios. Mr. Lewitt has worked in the securities business since 1987 and has substantial experience and knowledge of the legal, tax and financial issues involved in complex corporate transactions, corporate securities and hedge funds. Mr. Lewitt authors The HCM Market Letter, a monthly review of the financial markets and political world. He is one of John Mauldin's favorite writers, and an extremely savvy market observer.

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John Mauldin: I want to start out, Rosie and Michael, thinking about what the New Normal looks like. I've talked about it and we've all started borrowing Muhammad El-Arian's term and the concept that we are going to go to some New Normal. We are going to get back to normal, but it's not going to be the normal like we thought of in the past. Or it's not going to be the normal recovery. It's going to be something new that we're all going to have to adjust to. And the more I think about that, the more I think that is really a profound insight, but the harder part is trying to determine what the New Normal will actually look like. I mean is it just that we lop off seven percent of consumer spending and then kind of work our equations back into there? We keep reducing real estate; does that change the equations of businesses? It's a conundrum because an entire world has built itself around the Old Normal and now we've got too much stuff that we've built in terms of malls and factories, not just in the US and in Europe, but in China and Asia. We've got too much stuff that we have to rationalize and we've got to either take it out of production, put it off-line or whatever. And that's a different concept, a different way to come out of a recession than we've ever done before. So I'm interested in talking with you guys and just in theory getting some idea. Michael why don't you jump in and give us some of your ideas.

Michael Lewitt: Well I think the adjustment is going to be very difficult. Because I think that what we are seeing now is people are paying a lot of attention to the surface of things. And if you look under the surface — and David has been really excellent at pointing this out — things are still not particularly good. The stock market and the credit markets have certainly improved significantly. They've backed off a real Armageddon scenario. I think they've taken that scenario off the table and so they've rallied from significantly over sold levels. But if you

look under the surface, if you look at the constituents of the economy and so on, you know the problems have not been solved by a long shot. It also says that when things looked really good, the so-called Goldilocks Economy was not really as good as it seemed. So much of this is perception. So I think the New Normal, in many ways, is adjusting ones focus to a reality that's probably been there a longer time than people are recognizing, which was that growth was fueled largely or significantly by debt, by speculation, by activities that were not sustainable, that were not adding to the productive capacity of the economy. Now we are adjusting to that. We are in a period right now where much of the growth — and David pointed this out in his last writing I think before his vacation about a week ago — much of the growth or whatever you want to call it, the lack of things slowing down more right now is entirely attributed to the government and no one can really figure out where growth is going to come after that, when the government is done. So I think the New Normal is going to be — that's even putting an optimistic picture on what we could be dealing with.

John Mauldin: Well and I would jump in before David gets in there, because you've made a good point. I wrote last week about how the headlines said, "Incomes have risen", but if you looked at the data, salary and wages are actually down and the entire rise — and it was a pretty good rise — was basically all due to government spending. This morning — I didn't get a further breakdown — this morning I got a piece from somebody that says the bulk of it was \$250 dollar one-time payments as part of the stimulus and the emphasis on "one-time," now maybe some of it will appear in June as well, but these are payments that are not coming back. So we are likely to start seeing the deflating of incomes and it will be interesting to see, Rosie, what you think. We've watched savings go up to 6.9 percent. Well some of that is stimulus coming in, so we are going to see savings go back down to a more normal trajectory, because 6.9 percent that's pretty damn fast to go from 0 to 6.9 [percent] in something like 18 months. So jump in, David.

David Rosenberg: Well you are a 100 percent right. I think that probably the savings rate could go through a bit of a dip in the next few months, but the trend in the savings rate is certainly going to be up not down. And a lot of that is reflecting the reality that we can no longer rely on asset inflation to fund our living standards when we retire. We have to keep in mind that — and this sort of transcends the green shoots which is just noise on, a fundamental downtrend — but the Boomer population suffered two gargantuan burstings of an asset bubble seven years apart. I think that there is a growing realization now that the median age of the Boomers heading into their mid-fifties and retirement staring them in the face that we're going to have to save the good ol' fashion way now which means putting more money in the cookie jar as opposed to going out and buying more cookies. So the savings rate is certainly on a rising trend. It's been exaggerated as you folks had mentioned about the gargantuan transfer of income to the household sector from the Obama economics team. What I found fascinating — and this is just a flip-side of what happened to the savings rate — was how little of this wind-fall is going into consumer spending. When you actually take a look at the total tax reduction and increased benefits from Washington, say in the month of April, it was a \$121 billion dollars at an annual rate. Consumer spending on nominal terms was up to the grand total of a billion dollars. You fast forward to May, which is the data that we just got, and the combined stimulus was a \$163 billion dollars in annual rate and we saw the consumer spending go up by a measly \$25 billion dollars. So I think the big story here is that for every \$1 of this stimulus coming into the household sector, really more than .8 cents of it is going into incremental consumer spending growth. And I think that's really the big story if you are talking about the New Normal. What the New Normal after an epic credit collapse? This was a 20 year secular credit expansion that came to a thundering stop almost 2 years ago and the transition to the next cycle, if you look at other countries who have endured this, the transition to the next economic expansion is usually fraught with fragility, double-dip risks, and it indeed is deflationary

because not withstanding the attempts by the Federal Reserve to balloon its balance sheet and all the attempts by fiscal policy makers to stimulate the economy, let's face it, there is no bigger balance sheet on the planet then this \$50 trillion dollar beast called the US household balance sheet. The Old Normal was the whole world and domestic producers in the states relying on the US consumer to carry the ball. Over 70 percent of the US GDP is still in consumption and 17 percent of global GDP is still in consumption and one of the reasons why the global decoupling didn't work so well was because, once again, we all were relying on the US consumer. I think that story is over. The New Normal is going to be living within our means, because the old normal since the mid-1980's — and this is how you got to the 0 percent savings rate — is when you live beyond your means. So that is the new normal and you know what, it's not Armageddon. It's not the end of the world. It is going to mean shifting consumer spending patterns and especially what it is going to mean to the retailing landscape and discretionary spending. But my sense is that, you know, when you have a situation where 1 in 8 American households are either in arrears or in the foreclosure process, 1 in 8, what it tells me is that the memory of this experiment and this experience with excess leverage, primarily from 2002 to 2007 during that ownership society period where a lot of that ownership was fueled by credit, has proven to be a nightmare for the marginal household. So what I'm seeing in the data, and this again transcends the green shoots which are just improvements in the second derivative, but what I am noticing in terms of a pattern and I'm talking about a secular pattern that's going to last years, not just cyclical, is that consumer attitudes towards discretionary spending, towards credit and towards home ownership have changed. Have changed fundamentally and on a secular basis, not just cyclical. So this is going to be a period of sub-par economic growth and more risks of deflation and inflation I would say for at least the next five years.

John Mauldin: I think that the psyche of the American consumer has been seared just as much as the psyche of my grandparents — and

in my case my dad — during the Great Depression. And that those who think that we are going to revert to patterns, that we are going to go back to the 2000's or the late 90's, really just don't get it. One of the most telling things to me when you look at the unemployment data, there is only one group who has seen their employment increase during the last 18 months, and by a substantial amount, and that's people over 55. People over 55 have gone back to work and they've gone back to work in large numbers. It's just not they're holding their own type situation. That tells me a generation, at least till the Boomer generation is through, and my suspicion is it is at least a generation after that, is going to become more cost conscious, more spending conscious and that the consumerist society is not dead, but it is going to be altered. Go ahead and jump in Michael if you have any thoughts on that.

Michael Lewitt: Well no, I think that may very well be the case and maybe because I spend too much time in the financial markets — I see the financial markets at least trying to shrug off what's happened and try to go back to where they were before the crisis happened and that concerns me a great deal. I think that the banks, well they're not lending, but they are spending a lot of time trying to figure out how to get rid of the TARP money and resume pay practices that they engaged in before. I think that the President's reform plan leaves out some very significant parts that need to be addressed, such as dealing with the credit rating agencies such as dealing with credit default swaps much more thoroughly than simply putting them on exchanges. So again, I think there is this very large split between Wall Street and Main Street that is going to be perpetuated. I agree with you. I think that looking around locally here and I was in New England last weekend, and so on, consumers are clearly changing their spending patterns and I think that is going to be a somewhat permanent phenomenon. But in the financial world, I remain to be convinced that people have really learned their lessons and that the people who at least survived what happened really are prepared to behave in a much more responsible way, and that concerns me a great deal.

John Mauldin: If you are out in Middle America and you are an employer and you've got to adjust your expectations. You are a retailer, you manufacture widgets. We are clearly seeing businesses trying to adjust, because they are laying off employees, they are shutting down factories; they are doing all sorts of stuff. But how does this process work itself through? I've talked about a long — and I agree with you on this Rosie — taking a long time to recover. A very slow growth, Muddle Through recovery. How long do you think we're talking about David?

David Rosenberg: I think that if we are lucky, five years. It could be as long as ten years. As I said before, this is just a realization as to what happens after an asset deflation and credit collapse. These cycles play out differently. Like I've said before, we can go to Japan and understand what the differences were and they work both ways. Japan might have had a real estate bubble and a credit bubble, but they never had a consumption bubble like we did here. Consumer spending never got above 55 percent of GDP and here it got over 70 percent of GDP. And we can talk about the 1930s and that was the Great Depression. You know we have deposit insurance today and we have social security and we have welfare and unemployment insurance, so a lot of the things that were born out of the Great Depression are actually the things in place today that have certainly made this less unstable of an environment than we had back in the 1930s. But we have to understand this is not the traditional manufacturing/inventory cycle. You know that stuff that Allan Greenspan cut his teeth on, the Business Cycle Theory when he was a private economist before he was Fed Chairman. This is not playing out as a plain vanilla, garden variety recession. The recovery is not going to be the same, it's going to be much more sluggish. I like the operative word that you both used was "a sense of permanence." And the sense of permanence is this, that the amount of leverage to support any given level of GDP is going to be much smaller than it's been in the past quarter century. The amount of debt, the amount of credit outstanding is going to be anywhere from

4 to 6 trillion dollars lower than what it had been. We created a shadow banking system and we created a very fancy credit backdrop to fund profit employment and ultra growth for a period of decades. And the one parabola from 2002 to 2007, as I mentioned before, and what companies are indeed doing, is they are responding to the reduced size of the credit markets. They are doing that in their order book and they are doing that in terms of their production schedules and they are doing that in terms of adjusting their staff requirements. So, what makes this cycle different is that three quarters of the workers that were let go over the past year were fired on a permanent basis, not just a temporary cyclical basis. And we have a situation on our hands now and frankly it is going to be interesting to see how as an economist I can forecast through this. That we have a record 53 percent of the unemployed today who are displaced permanently. Not just temporarily, because of the vagaries of the traditional business cycle. And what that means —

John Mauldin: I want to interrupt you here Rosie and just talk about that, because I don't know if you saw the paper that the San Francisco Fed did when they were talking about unemployment coming back and what does it look like. And it was a fairly pessimistic paper and they actually use the word pessimistic, which for a Fed economist, you don't normally see that. But they were talking about that this is the lowest cycle in the recorded history of temporary layoffs and the highest cycle of part-time work, not by choice, that we've ever had. Which says that when business does start coming back, that they are going to just use the part-time workers that they've got who are not part-time by choice, but would like more hours, rather than hiring new people. And that more and more jobs, like you said, because we've had so many jobs that were displaced permanently — that's also a record — that we are just going to think the Bush recovery was a jobless recovery. We are getting ready to see a real potential jobless recovery and the San Francisco Fed was talking about unemployment being as high as 11 percent next summer. That's going to be tough to run an election in as an incumbent in

either party. Because that's not just something — it's been 30 years since we've experienced those type of numbers.

David Rosenberg: We also have the work week is at a record low and you are quite right, this cycle 8 million full-time jobs have been lost and 2 million of those people were pushed into part-time work, as you suggested. What's going to happen, and this comes right out of that San Fran Fed paper of course, is that what companies are going to do when things do turn on a more sustained basis — and that day will happen — they are going to lift the hours of the people whose hours they cut and they will push the people who are part-time into full-time. But what happens is that the 100,000-150,000 people that come into the labor force every month, they are going to be frustrated because they aren't going to find a job. And you already have a youth unemployment rate in this country that's roughly 20 percent; it doesn't get a lot of attention. But yeah we are talking about that this is going to be the mother of all jobless recoveries. There may be job growth in the future in healthcare and infrastructure and energy technology and the like, but I can tell you that we've lost — you take a look at residential construction and durable goods production and you take a look at real estate and the financial services industry, retail and the leisure hospitality, these are sectors that will be in secular decline. Collectively we've lost 4 million jobs in these sectors combined during this recession. They aren't going to be coming back after the recession is over and to show you how big a number 4 million is, we didn't create that many jobs in the prior expansion, till it reached it's fourth birthday, towards the tail end of 2005. So we are going to have an extended period of time indeed where the economy is no longer contracting, but the unemployment rate is still going up to new highs in the post-World War II period.

John Mauldin: And you make a good point, if we are trying to bring in 150,000 new people into the job market each month because they get old, you know I got a son who is 20 and is bouncing around in the employment market now, and that's 2 million next year between now

and the end of next year that's another million. That's 3 million people by the end of 2011 that are going to be looking for jobs in addition to the people who are already off and are looking for jobs. That is a daunting task and as you said, we didn't create 4 million jobs till the fourth anniversary of the last recovery. It's kind of like we're digging a hole and we can't stop digging.

Michael Lewitt: Well also a lot of the jobs we created, I believe, were probably in the finance area.

David Rosenberg: That's right.

Michael Lewitt: Which is now shrinking. I think that's part of the problem that we need to come to grips with as a lot of the growth we saw was in areas that weren't particularly — for lack of a better word — productive. You know they were mortgage brokers and investment bankers and people in finance and related ancillary areas. So that's something that we're going to have to come to grips with. And there is still a great deal of leverage in the system that still has to be squeezed out, wiped out, written off, whatever you want to call it. So the debt destruction cycle is not over. So I completely agree with David that this is a 5 to 10 year phenomenon that's going to continue. High levels of unemployment have real societal consequences, political consequences. They affect crime, they affect health, they affect culture, they affect everything. The New Normal, we talk about it in terms of the economy, but it is also going to affect our entire way of life. I think the changes are going to be very profound and I hope one of the lessons we learn is that things weren't as great as they were cracked up to be. And we need to look at that to really understand what the nature of the growth was, and hopefully how we can make future growth better or more sustainable because another boom, that's not based on solid foundations, will not create a robust future either.

John Mauldin: Where's the boom going to come from Michael?

Michael Lewitt: Well listen I've spoken to a lot of people and read a lot of people who are a lot smarter than I am, and I will tell you that no one has really been able to tell me where they think growth will come. One possible answer I've gotten is exports, you know, growth from abroad. From emerging markets, that's one possibility. People talk about China. I'm not so convinced that China is all it's cracked up to be either. I don't know. Tom Friedman yesterday had a column in the New York Times about [how] we need to innovate our way out of this. And again, theoretically that makes sense.

John Mauldin: Easier said than done.

Michael Lewitt: It's all easier said than done.

John Mauldin: "Well you guys go out there and innovate" and that's what entrepreneurs and marketers will do and the correct answer to the question on where will the jobs come from is, "I don't know but they will."

Michael Lewitt: Well yes. Look, it's great, I think he was speaking with Greg Barrett who used to run Intel — maybe still does I don't know, I'm not a tech guy so I don't follow that as closely — about how we need to put more research into basic science, and I completely agree with that. I think that there are many things that need to be invented and many problems in this world that need to be solved in terms of education, science, disease, all that, you know that's a possibility, but that is very long-term. It doesn't solve 11 percent unemployment in 2010. I think part of it is the struggle between taking a very long-term view of this and dealing with the societal and political pressures of trying to help people now. So I think we're short-term oriented society with a very long-term problem, and that's going to be part of the struggle. Because you are tempted to make short-term decisions or offer short-term solutions that don't necessarily make the long-term better.

David Rosenberg: Yeah, if I can just add to that, employment isn't going to zero. Nothing is going to go to zero. At some point jobs will level off, the question is, will we create enough

jobs in the growth industries to off-set the lingering contraction in the declining industries and then on top of that, the natural entry into the labor force. This is critical because what it comes down to is what we talked about which is the unemployment rate, is probably going to continue to go up, maybe for the next several years, even if the economy stops contracting. That's problematic and it's not sustainable because the unemployment rate going up is going to put downward pressure on way trades. And when I went to University back the late 70's early 80's, you always learned about, "Oh, you can't have deflation because of rigidities in the labor market." Well take those rigidities and take that part of the Economic 101 textbook and we can just put it in the waste paper basket because we are seeing rigidities, sector by sector, being broken down. And it's not just about salaries, but look at benefits and 401k matching plans. And we have a situation where we started off the call by talking about how the government doesn't create income, but it can certainly transfer income from future tax payers to current recipients which is what the Obama economics team is doing, be it organically and that's the key. How does the economy operate when forced to stand on its own two feet without the crutch from Uncle Sam? Wages and salaries are deflating at their fastest rate than at any other time in the past 50 years, which is how far the data goes. So I'll tell you what I get back from the green shoot crowd is, "Oh, well the unemployment rate is a lagging indicator." You see, so many people live in the old paradigm, the unemployment rate is a lagging indicator in the manufacturing/inventory cycle, true. It's not inventory cycle. This is not housing inventories. This is credit cycle and a credit cycle to unemployment rate is actually a coincidental leading indicator because what it means for consumer default delinquency rates in the future.

John Mauldin: And it's also different in that we're not going to see the housing construction market come back into anything close to what it was for 3 years? 4 years? We just built a lot of excess houses. 2011 and 2012 will probably be the earliest we can see it, kind of, normalize. Well, we're going to end up normalizing at a lot fewer houses per year and what homes are being

built now are much smaller less expensive homes. The \$180,000 to \$220,000 "starter homes" that people were qualifying for is just not working anymore. And we've got too many malls. We've got too many offices. Whatever this new level of GDP, whatever it settles down to, we're not going to be building a lot of new stuff, new buildings, for quite some time. When global trade is down 20 percent, it's hard to talk about exporting your way out of a problem. I said global trade, global trades off more than that, but just US shipments in trains and planes and trucking is down. That's just a staggering amount of reduction in the economy. It's going to take a lot longer to get back to some semblance of growth. But it's going to be tough if you keep losing jobs and people go off the 39 week extended unemployment benefits, because we're at the highest levels of time it takes to get a job now. So we are pushing more and more people each month out into a world without any unemployment benefits at all. Whatever small lifeline they had is being taken away. You're right David, as incomes go down, it's hard to see a return for consumerism. I just don't see a new bubble. The Fed can ante up another trillion, but I don't think it will make that much difference out in the real world.

David Rosenberg: Well, you are a 100 percent correct and the Fed has dramatically boosted its balance sheet and created all these excess reserves and what we are left with is a trillion dollars in cash sitting on bank balance sheets when in fact the latest move by the commercial banks has been to continue to cut back in credit expansion. Although we don't know, are the banks tightening credit guidelines or is it a reality that, especially in the household sector, people actually moving to pay down debt, and that's happening as well. I guess back to the New Normal, back to where is the growth industry going to come from? It may well be that Asia is going to develop an autonomous growth that will help out our exporters, but that is going to have just a minor impact on overall US economic activity, which for so long has been dominated by the US consumer. But I think that the growth is going to come from the government sector. I think that is what the New Normal is going to be. The new normal is going

to be what is called social engineering. And we are already starting to see the very early signs of that. You're taking a look at the government intervention and incursion to the auto sector, the energy sector, the healthcare sector, the financial sector, you start getting up to almost 40 percent of GDP in terms of the government involvement in the economy. So, the New Normal, and where the growth is going to come from, it's going to come from the government sector to fill in the void vacated by the private sector. I don't think it is going to perhaps be a complete off-set, which is why I have this particular view on the economy as being at best flat over the next several years. Certainly no better than per capita growth and probably a little bit below that. But it's going to be an economy that is going to be fueled by government intervention, or as I said social engineering. It will be a more regulated economy and it will be an economy that will be geared by the government sector. And as an economist, what that tells me is the negative implications that is going to have on productivity growth, and on the economy's non-inflationary potential. For the means is that potential GDP growth is going to come down over time and at the same time we are still left with a record output gap. I really can't think of what could be a worse complication for the equity market than a secular decline in potential GDP growth at the same time that we have a record output gap, which is going to of course affect on an ongoing basis the ability of businesses to raise their prices.

John Mauldin: Is there any way Michael, if you look at the credit markets deeply — that's the world you plow and reap in — we've got to finance at least 1.85 trillion this year, maybe even 2 trillion because governments are always more optimistic about the growth than they are and states have got to raise a hundred couple billion more than what they've got right now. Then they want to run \$1.5 trillion next year and \$1.2 trillion the year after that. Can that be, really scouts-honor, financed by the private market? Europe and the rest of the world wants to raise similar amounts, because they are going into the debt and they need money. Where does all this money come from? Or is the fact that we are deleveraging so much, money is just going to

find a home and they are going to be willing to buy the bonds?

Michael Lewitt: Well that's the multi-trillion dollar question. I think that clearly there has to be every expectation that if it can be financed it's going to cost more. But I think that right now, the deflationary forces are still pretty strong so that's helping keep rates within reason. I couldn't tell you where all the money is going to come from. We used to have a world of mutually assured destruction where the weapons were nuclear. While we still have nuclear weapons, now the mutually assured destruction comes from currencies and from the US dollar, meaning if people were to abandon the dollar standard, all their holdings would become devalued very quickly. So I don't think the dollar is going to go away so quickly with all the — you know you hear these threats that people are going to diversify away. But clearly the US' need for enormous trillions upon trillions of dollars of money and financing, you know, is not a positive sign for American hegemony in the long run.

John Mauldin: But the question I keep coming back to is, when we were running \$750 billion dollar trade deficits, that money had to go off shore and had to come back and find a home. And where it typically found home was from mercantilist nations who bought some type of US dollar debts, government, agencies, whatever. Our trade deficit is down to \$300 billion, \$25 billion a month. We got away with running \$300 billion dollar deficits during the Bush years because we spent so much and borrowed so much, it had to come back in. Well \$300 billion dollars is all that's going to have to come back in this next year. That \$300 billion that is going to China and Saudi and where ever, will come back and it will find a dollar home. Where do we find the other \$1.1 trillion? I mean, US consumers are saving about \$770 billion, they are up to that kind of level now. But are they going to want to put it into 3.5 percent 10 year Treasuries?

Michael Lewitt: Well I don't see it. I don't see it either, I mean, it's a good question. A lot of

the money creation in the last few years — it wasn't simply mercantile nations, a lot of this was derivative technology and a lot of it was CDO's and so on. There is a big factor sopping up this money and creating money that is no longer functioning and that is why they are trying things like TALF and so on to try and restart the securitization mechanism which hasn't restarted yet. So there are other things missing that are of concern if you want to keep the game going, which is not going right now. I think that the rates on what's being offered to finance this stuff is not going to do the trick. So, I don't have an answer. I think it's going to be very difficult. Ultimately what we are seeing now in the corporate credit markets is underwriters are slapping on whatever coupon it takes to move the merchandise. If that means an 11 percent coupon where it used to be an 8 percent coupon, that's what they are doing. Now will the US Treasury do that? I don't know. I don't know what choice they are going to have. But it's certainly not all that attractive and as the balance sheet keeps going up and up and up of the US, it's uncertain what's going to happen. I do think what's not going to happen is that the President's promises to start cutting the deficit going out are going to materialize. I don't see any end in sight to our swelling balance sheet. History suggests that that is just not going to happen. At some point the rubber is going to have to meet the road and I don't know where that is going to be.

David Rosenberg: If I can add something into this part of the Conversation, maybe the household sector will be the surprise as the boost of savings rate and where exactly the different ways that could happen. But you know, 3.5 percent 10 year Treasury note yield, I know it certainly sounds extremely low, but then again we have negative nominal GDP, we've got the CTI is running negative 1.3 percent year for year. And I'm not going to sit here and tell you that for the next 10 years, the CTI is going to average negative, but I don't know many people a year ago when they were talking about inflation with oil at \$150 dollars that a year later we would be sitting at a minus 1.3 percent inflation rate. I think that a lot of people they suffer from what a lot of economists call money

illusion. They would rather clip a coupon with a 7 percent with inflation at 5 percent because the 7 percent somehow makes them feel good. Then a 3.5 percent yield when inflation is actually running negative. I mean in real terms, depending on how you want to use your inflation adjustment, you can actually argue that a 3.5 percent Treasuries are a bargain at these levels.

Michael Lewitt: I think that's a very fair point.

David Rosenberg: The one thing that I will say is we moved away from the safety factor. In a matter of six months we've gone from Armageddon to Nirvana. It's really just a total comment on human nature, because you know all three of us are in the financial market business and we can look at the valuation and we can look at the technicals, we can look at the fundamentals, but a lot of this business, let's face it, is driven by emotion and psychology. The Treasury market got deeply over bought at 2 percent on the 10 year note just as the stock market probably got way oversold, obviously, at the lows in March. Nothing is going to move in a straight line. But the one thing I will say is that when you go into this credit contraction, this post-bubble experience which lasts for years, look what happened. This is despite the rampant monetary stimulus. Maybe the Fed acted late in the 1930's, frankly I don't really care; they ultimately brought rates down to zero and they embarked on tremendous monetary reflation. FDR ended up fixing the price of gold and we had 7 years of New Deal rampant fiscal stimulus and it just goes to show that by the end of the 1930's — and at that point, the worst part of the Depression was over in 1932, but see at the end of the 30's the unemployment rate was still 15 percent. The CTI was deflating at 2 percent annual rate and we still haven't even gotten back to the 1929 peak in GDP. It wasn't until 1941, 12 years after the event, that long bond yields got below 2 percent. You go to Japan and their shock was in 1990 and GDP yields bottomed below 1 percent in 2003; 13 years after the event. So you know, nothing is going to be a straight line. Nothing is going to be a straight line. But I think people will be surprised at how

well, what I call, safety in income at a reasonable price, is certainly an enduring secular theme. The household sector only has 7 percent of its assets in government bonds. It only has 7 percent. It still has to this day 30 percent in equities and 25 percent in real estate and then there is another 7 percent in consumer durable goods and you can go through the whole gambit of the household balance sheet, but I still think that Treasury Bonds, Treasury Securities, domestically are still an under-owned asset class.

John Mauldin: Well, that may be. But let's assume that the US consumer starts saving a trillion dollars. So another 33 percent, we are going up to a 9.5/10 percent savings rate. And instead of 5 percent or 7 percent, like you said, in Treasuries, they take it up to 20 percent. That's still only \$200 billion dollars of US money going into Treasuries. Now does that get multiplied through the banks? Do the banks buy more? Just the staggering amount of money it will take to fund \$1.5 to \$2 trillion dollars of government debt without dramatically increasing taxes and reducing spending. And, of course, if you increase taxes that is certainly not good for jump starting the economy. We're painting ourselves into a rapid corner here, I think, that is going to make the New Normal a lot more difficult to work ourselves through. So when you guys start talking about 5 and 10 years — I read a piece where Krugman, whom I disagree with on almost everything and whom I always thought of as more of a cheerleader, when he starts talking about 10 years for the recovery to take place and he is the insider on the other side of the equation, this starts looking like a long, Muddle Through retrenching. We need to re-think our paradigms, because for me as a money manager — and I haven't been doing it, but it makes it even more difficult for me to say to clients, put your money into indexes and stocks because the market always does 7 percent over the long haul. Well that looks increasingly tough in this type of deflationary/deleveraging environment. It makes the choices of where do you put your money more difficult. So let me ask you this question. Where do you guys suggest? You're now working for a wealth management firm David and Michael you run

credit operations, where are you guys telling clients to put money?

David Rosenberg: Well I'll just say that in some sense the 3 of us answered the question before when we talked about the fact that the only part of the population that is actually securing positive job growth is people over the age of 55. And, of course, they are the only part of the population that are also garnering more than 1 job. An increasing number of these 55 plus crowd are actually also moonlighting. So what's the story here? Well the story is that these are either people who aren't retiring as early as they thought or they are people who have retired that are coming back in, even at an lower wage, to come in and work because they've seen what they thought was the pot of gold at the end of the rainbow, be not quite what it was. Now that their perceived level of wealth is much lower than they thought it was going to be, they are now going for income. This is all a move to secure income for retirement and the reality is there are a lot of large numbers, there are 78 million Boomers and the median age is 52 going on 53. So there is a push towards securing income and if you are going to do that in a labor market, then you are probably going to pursue a similar strategy in your investments. And that's what I said before, one of the themes I've been espousing all year was called from surp to surp, zero interest rate policy: the safety in income at a reasonable price. I guess the one thing that we really can't be in long-term is cash and the Fed is, I think committed in my opinion, for an extended period of time to keep short-term rates as close to zero as possible. And that's like putting your money in the mattress. But I would say that frankly Treasury yields at 3.5 percent looking at the inflation landscape, doesn't upset me too much. I think that high quality corporates are still a very good place to be. I mean there is always a risk they could widen if the stock market turns bobbily and, of course, they are very directional in terms of when Treasury rally spreads tend to widen out. But I can tell you that when you take a look at the current level of high grade corporate spreads, they've come in a long way. They are at the levels even today where they were at the depths of recessions in the past. So I think that if you are looking at an asset class

that is still priced for bad news where there's protection, I would say high grade corporate bonds. In the equity market, I think again to look for income. To look for reliable dividend growth, it's tougher to secure today than it was before, look at what dividend payouts have been doing. But I think the prevailing focus in a deflationary backdrop — which is what we are going to be in, not every month and not every quarter, but the overall backdrop will be more deflationary than inflationary, — the operative word is just to secure relatively safe income, whether you can get that in the Treasury market, in the corporate market, or even in the mortgage market, or in the equity market, that to me is going to be the enduring theme.

Michael Lewitt: I would agree that the high grade corporates are attractive. We also like bank loans. Again all these have had big moves, but with everything else, as a manager, you have to be credit specific and sector specific and industry specific, but spreads are still pretty wide on a historic basis. We would generally avoid less than investment grade, although there are some what we call 5B or BBB/BB split rated bonds that are very attractive and in general you want to stay in sort of large cap names. The real key is companies that can access capital. There has been a huge refinancing wave and that's really what I think has been most responsible for the narrowing of spreads. I think back after Lehman collapsed, I think everybody felt like there would never be another financing, ever. Of course, that wasn't the case. But the key is for companies to be able to refinance out their short maturities and be able to manage their capital structures. We like the top of the capital structure is very attractive. I think the equity market is more than fully priced for any sort of reasonable economic scenario right now. Again there are individual stocks that are attractive, but on an asset class basis you need to be selective. We are finding lots of things to do in the credit markets. There is no shortage of bond and loan ideas to invest in.

John Mauldin: Let me ask you guys, 4th Quarter will we see a positive number for GDP?

And if so, is it real or will it be a statistical anomaly?

David Rosenberg: I think that we will probably see a negative 4th Quarter. I wouldn't rule out an inventory led temporary 3rd Quarter positive result for GDP that will get the green shooters all excited. You know, take a look at last year, John. We had 2nd Quarter GDP was almost 3 percent growth, people were still debating on whether we would have a recession and it had already started in December of 2007. And you can indeed, by the way, have a recession and still have GDP positive for a quarter here and a quarter there. In fact, more often than not in recessions, GDP's been up at least 2 quarters of a positive GDP print. It's not going to get me overly excited. I think that there's a chance 3rd Quarter could be positive, but I think 4th Quarter will be negative, just as it was in the second half of last year.

Michael Lewitt: Any growth is going to be from government spending anyway, so I don't view it as sustainable and I'm not particularly in the business of projecting GDP, but again, what I look for is what is going to be sustainable going outward, and I'm still in search of sustainable growth. I haven't found it yet.

John Mauldin: Well okay. Well listen guys; I want to thank you for coming and spending some time with me. I would like to do it again some time. Next time we'll try to get up to Toronto, David can find us a good steakhouse up there. And hit the Hockey Hall of Fame also.

David Rosenberg: Yeah, it's not quite as cheap a holiday as it was a year ago, but we'll work it out.

John Mauldin: Okay, you guys have a good day and a good evening and we'll talk to you later.

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