

## CHAPTER 1

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# WELCOME TO THE TWENTY-FIRST CENTURY

The Lessons of the First Decade  
and the Historical Precedent for Today's  
“Unprecedented” Crisis

It was a crazy year.

In 12 short months, the world's ruling empire saw a widespread mortgage crisis, shocking the financial system and sending interbank lending rates through the roof. Complex financial instruments collapsed like a house of cards, and overleveraged businesses suffered. If their short-term loans came due and they couldn't refinance, that was it. Locks appeared on the doors, and the windows were papered.

Through it all, however, a handful of new countries shone. These nations were growing thanks to lower wages, cheaper commodities, and looser regulations. Financial supremacy started to shift as the world looked for a new center of power. Across the ocean they found one.

We're not talking about 2008, by the way.

We're talking about 1873, at the beginning of what some historians call the *real* Great Depression. And that promising new center of power was the United States.

## HISTORY MAY NOT REPEAT . . .

. . . But it certainly rhymes.

And in this case, it's rhymed pretty closely so far. The similarities are staggering, even though the participants may have changed. And while the Great Depression brought about a revolution in big government and interventions, the Crash of 1873 embodied the end of an era—something we're almost certainly witnessing now. Let us explain.

In the decade leading up to 1873, Europe saw the rise of the Austro-Hungarian Empire and the unification of the German states. Combined with France, it was believed that these countries would help Europe retain its status as financial center of the universe.

In reality, the continent's financial system was already overstretched.

Thanks to the amiable political atmosphere, new lending institutions were sprouting like weeds. Much like the decades leading up to 2008, these lenders relaxed terms and issued obscene amounts of mortgages, leading to a building boom and soaring prices in residential and municipal real estate. The capital cities of Berlin, Paris, and Vienna were at the center of the boom.

Fast forward to the United States, 2008. For many years prior, mortgages were readily handed out, and as home prices began to skyrocket, speculators began to use other houses—some even yet unbuilt—as collateral for more loans in the years leading up to the correction.

In both 1873 and 2008, the panic was touched off by a rash of bank insolvencies.

By May 1873, the Viennese stock market had crashed. British investors started pulling back their funds, for fear that any or all of these continental banks might themselves soon be insolvent. Entire markets for complex, principal-guaranteed derivatives collapsed overnight. Interbank lending rates soared to impossibly high levels, and the world's financial markets became a ticking time bomb.

American railroad companies, much like the overleveraged private equity firms of today, were the first to feel the pinch. Their dependence on the short-term credit markets, now frozen by the crisis in

Europe, meant that it was only a matter of time before the cash would run out for many firms. In September of that year, the bankruptcy of Wall Street mainstay Jay Cooke over a failed railroad bond auction was all it took to send America's stock market crashing.

## WHY THE EVENTS OF 1873 REALLY MATTER

You see, the developments and events of 1873—and their striking similarity to 2008—are merely quirky anecdotes compared to what followed.

It had vast implications. The panic would lay the groundwork for America's global dominance in the twentieth century.

At the time, the cheap grain and kerosene exports coming from the United States were equivalent to the cheap goods from China we depend on today. Thanks to a number of factors, including weak government regulation, low taxes, and some of the lowest wages in the global economy, American producers could undercut domestic alternatives in most countries. In the case of Britain, for example, almost the entire country was dependent on cheap grain exports from the United States.

As the United States grew into its new role as global supplier of basic consumer goods, Americans began building a mountain of savings. This was in stark contrast to the mountain of debt being built in Europe, where the “financial center of the universe” allegedly resided. The difference became more apparent as the years rolled on, though most people only minded the short term, not understanding the commonsense implications of what was playing out in the long term.

When the crash finally came in 1873, it was too late for Europe to do much, if anything, to stop it. In the long term, the continent's status as financial capital of the world slowly shifted overseas, to where American savings could restore global growth without the aid of fickle credit, and to where an honest, hard-working economy was creating real wealth that would lead the world into a new century.

If history rings true, the same global shift is under way now.

## AMERICA'S AGE AS A SUPERPOWER

If history is our guide, then 1873 and 2008 may well be the bookends of America's story as a global superpower: financially, politically, and militarily. Each historic crisis signaled a much deeper, centuries-long shift in global dominance from one nation to another.

But you will recall that power wanes slowly. The Austro-Hungarian Empire didn't descend into ruin immediately after the crash. Europe's fortunes would wane slowly in the wake of 1873, but the continent was never reduced to a global backwater.

In comparison, 2008 saw the U.S. federal government issuing unprecedented fiscal and monetary stimulus that has stemmed the short-term consequences of the recent crash, yet at the risk of making some of its long-term consequences far worse. Indeed, the U.S. government has been so successful—and gone to such great expense at maintaining appearances—that it may for years continue to appear that nothing has changed. But the reality is that the power shift will already be well under way.

## THE GENERATIONAL WEALTH PHENOMENON

There is Chinese proverb that extols the reality of building real wealth.

It says, "*Wealth does not pass three generations.*" The first generation of wealth will be lucky and perseverant, hardworking and diligent in saving for their family. The second generation will not face the same challenges. While it enjoys the fruits of the first generation's hard work, it will fail to appreciate the work that goes into building wealth. And by the third generation, the wealth will be squandered. This is a phenomenon that is all too common and one that we will focus on throughout the book.

Look not only to the wealthy American families, but to America's auto industry or even the *New York Times*, and you will see this effect playing out on an epic scale. But for the purposes of this book, let's take a quick look at America as a whole, in the three generations between 1873 and 2008. Skewing the usual topics of politics, industry, and the economy from this perspective will help to focus your own long-term thinking, helping you appreciate the

appropriate scale and depth of an investment horizon of 30 years or more.

## THE FIRST GENERATION: PRIOR TO THE 1920s— LIVING THE AMERICAN DREAM

In the time between 1873 and FDR's New Deal in 1933, it might appear that Americans were still chasing the American dream. But, in reality, they were living it.

The American dream isn't about the suburbs, cookouts, and family sedans of the 1950s. It isn't about home ownership. These things are the trappings of the American dream, the fruits of it. The real American dream is free enterprise.

You see, this generation of Americans cleverly understood the importance of peace of mind. When you don't have to worry about protecting the spoils of your labor from some other party, you can work that much harder. Free of distraction and impediments, you can truly have full dedication to your pursuits—the unvarnished incentive to be the best you possibly can be. And if your labors are fruitful, you can use the resulting wealth and your own keen insight to contribute to the growth of the economy at large. You can innovate, create jobs, and effect vast changes to the landscape that will ensure your place in history.

That's the kind of freedom at the heart of the real American dream. And that freedom was alive and well in the years after 1873. Americans saw the invention of the light bulb, the assembly line, the first manned flight, and the first stages of a national energy and communications infrastructure. Its country was a bustling new superpower, eagerly rushing into the transformative twentieth century.

The turn of the century saw the birth of many recognizable companies that still dominate the marketplace today: Eastman Kodak, Firestone Tire and Rubber Company, Hershey's, U.S. Steel, Monsanto Chemical Company, Ford Motor Company, JCPenney Corporation, and Pepsi.

At the time, the government was receptive to growth and didn't present any roadblocks. Before the New Deal, government spending scarcely comprised more than 10 to 15 percent of the economy and was vastly overshadowed by the dominance of the private sector.

Likewise, prior to 1915, tax rates were lower at this time than any other point in the twentieth century, with a top marginal tax rate of 7 percent for those with incomes in excess of \$500,000. The exception, of course, was during World War I, when taxes were raised to more than 70 percent.

But things were not perfect.

Workers enjoyed very few protections or entitlements, and in especially competitive labor markets, people were often abused or exploited. There were few regulatory bodies monitoring or ensuring the safety of manufactured goods, financial products, or loan activity. By the booming 1920s, this generation was hitting its peak on the heels of a massive real estate and infrastructure explosion that helped bring about the indebtedness pivotal to the Great Depression. Nonetheless, this is the generation where real wealth was made.

## THE SECOND GENERATION: 1920s–1970s—KILLING THE GOLDEN GOOSE

Thanks to the prosperity created by the first generation, the second generation spent years living comfortably or, at the very least, watched their neighbors do so. And then, much like now, they counter-intuitively demanded a government that could help them protect and preserve that comfort level, even when faced with common economic cycles and disruptions. They became so accustomed to the *trappings* of the American dream that, to them, the dream was almost meaningless without them.

In short, they had it good—and they had the clout to demand even better, even if it was unsustainable.

### Out of Crisis: A New Breed of Leader

It was around this same time that, in a number of ways, the job of the American politician changed significantly.

The role of a politician became remarkably similar to any other top executive of the twentieth century. The executive risked losing his job if he didn't keep the shareholders happy, and the politicians had to please voters or risk losing them. They both faced extreme pressure

to generate a constant stream of consistent short-term results. And the stiffer the competition, the more outstanding and effective those results had to be.

Thus, as Americans faced catastrophe, they continuously urged the government to step in and make life a little easier for themselves and their fellow man. During the hard times, citizens insisted on increased government spending to stimulate the economy—an idea ushered onto the political stage by John Maynard Keynes, and one that would have a lasting impact on the way politicians deal with the economy even today.

Consequentially, some of America's most successful executives *and* politicians make similar kinds of decisions. In general, they tended to favor fast results at the expense of unknown implications—a kind of “buy now, pay later” mentality. To show you what we mean, let's start with one of the first examples of this new kind of political mentality: the New Deal.

### Short-Term Solutions that Never Went Away

We are not going to discount the severity of the Great Depression or the necessity for the government to find short-term solutions to do something about it. In fact, we won't even argue the need for those types of programs. Faced with unemployment rates near 30 percent, thousands of banks failing, and millions of Americans who had lost everything, the actions the government took *were* necessary to provide relief to an affected generation. What wasn't necessary, however, was the continuation of those programs toward their inevitable demise.

For example, in 1938, FDR's administration had a simple goal. They needed a short-term solution to get people back on their feet. As borrowers defaulted on mortgages en masse and banks found themselves strapped for cash, President Franklin D. Roosevelt and Congress created Fannie Mae in order to buy mortgages from lenders. Fannie would give lenders, such as banks, cash for loans conforming to Fannie Mae guidelines, thus keeping mortgage rates low and the lenders flush with cash. This would then free up capital that could go to other borrowers to keep the economy moving.

Times were tough for many Americans following the Depression, and Roosevelt wanted to make it easier for middle- and low-income families to participate in the American dream of home ownership. (Keep in mind that home ownership is one of the great *trappings* of the American dream.) Fannie Mae seemed to solve this problem. But not quite.

Fannie Mae would fundamentally alter the workings of the financial system in which it operated.

Rather than making loans with the bank's capital only when they were confident the loan would be repaid, "entrepreneurial" lenders looking for a profit started to focus on giving loans that the government-sponsored entities would buy—with little, if any, attention to the quality of the borrower or their ability to repay the loan.

*Securitization*, to use the correct term, started in earnest with Fannie and continued with Freddie Mac's creation in 1970. But securitization wouldn't make its appearance onto center stage until the mortgage markets started to peak in 2007–2008. Only then could people finally appreciate the damage Fannie and Freddie had done to the system.

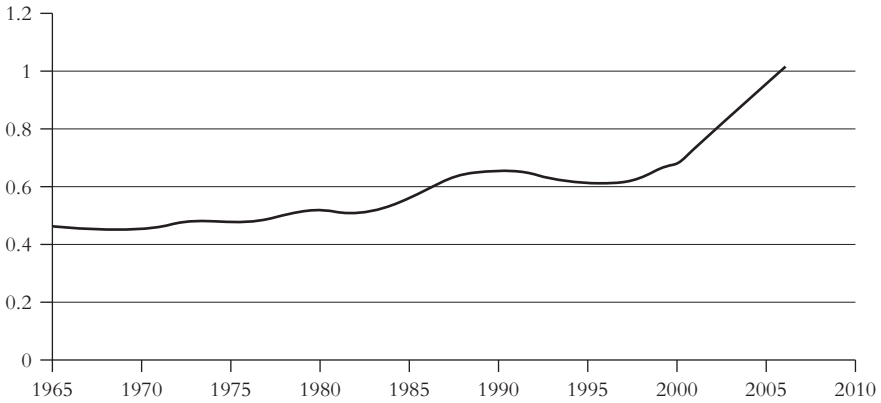
You see, while providing lenders with extra liquidity might keep the rates down, it ultimately boils down to throwing a big pile of cash into the mortgage market. And what happens when the amount of cash chasing houses is distorted and grows faster than it should?

You end up with an artificial rise in home prices. And you also have a large portion of the population assuming debt because money is easy and cheap to access.

From Fannie's inception in 1938 to 2006, home prices rose by 150 percent (adjusted for inflation). And mortgage debt continued to climb.

In 1949, mortgage debt was equal to 20 percent of total household income; by 1979, that number was 46 percent; and by 2001, it had reached 73 percent. Figure 1.1 shows the sense of the problem's scale in relation to the U.S. economy.

While this was an effective short-term response to keep homes affordable and within reach of Americans, it only succeeded in making home ownership more expensive for the average American (not to mention the American economy as a whole), thus making mortgage debt one of *the* chief contributors to the country's overwhelming indebtedness.



**Figure 1.1** Mortgage Debt as Fraction of GDP

Source: [www.econbrowser.com/archives/2008/01/mortgage\\_gdp.gif](http://www.econbrowser.com/archives/2008/01/mortgage_gdp.gif).

### The Social Insurance Snowball—Sold as the Answer to Poverty

Another example of a short-term fix that has given us long-term problems takes us back again to the 1930s. Poverty rates for senior citizens started to exceed 50 percent. It was a political nightmare, and FDR was forced to take action. He implemented Social Security in 1935, as a means of social insurance to handle his—and the country's—current situation. It was sold as America's answer to poverty, even though it had to be clear from the beginning that the program would not be sustainable in the long term.

But, as with many other forms of entitlement, Social Security became ingrained in the public's expectations. Having contributed their own tax money to the program, Americans felt they had a right to benefit from what was originally intended to help one hard-luck generation bridge the gap in their personal finances. The problem snowballed over the years, with President Johnson revising the program and adding Medicare in 1965. By then it would have been political suicide for anyone to try to fix this unsustainable situation. Thus, Social Security has lived on years after it served its original purpose.

Today, Social Security and Medicare together add over \$40 trillion in unfunded liabilities to the country's balance sheet. According to the

*Washington Post*, the two programs alone could consume upwards of 12 percent of America's gross domestic product (GDP) by 2024. That figure is about as much of the economy as the entire government represented just 100 years earlier, which is coincidentally within about a decade of the fund's anticipated insolvency.

### Keeping up with the Joneses

When success spreads throughout the population, it's easy to get caught up in the material wealth accumulated from so many years of hard work. Buying your family's first house or your first car represents concrete proof that you've been successful; that you've done a good job. But by the 1950s and 1960s it became a matter of "keeping up with the neighbors," with housewives swearing under their breaths as they saw the Johnsons' new Chevrolet rolling down the street.

Even worse, the seeds of an entitlement culture that had been planted during the New Deal were nurtured alongside America's budding materialism.

Entitlement culture preyed on Americans' propensity for tolerance, generosity, and diversity, and subtly infiltrated an institution that for over 150 years had diligently and rigorously preserved the free enterprise of all American citizens.

And that's what really matters. It was not about the car or the house or the pension—it was about freedom. Freedom, above all else, to express yourself, to enjoy the fruits of your labor, and to be the captain of your own destiny. But such lofty ideals hardly translate smoothly into daily life, no matter how critical they may be.

### Government Growth Spreads to the Judicial System

The 1950s are remembered as some of America's happiest years. And the 1960s are often remembered as a time of social reconstruction, of integration and civil rights. The 1960s were an emotionally charged decade that signaled a shift in what the masses thought about their government.

And it was a major shift—one where the U.S. government wasn't expected to *follow* the expectations and culture of the populace, but was now expected to *lead* it.

## Tort Law is Born

After the war, the regulatory state was expanded, and courthouse doors were open to new claims that caused litigation to explode. Federal and state courts abandoned their historical view of hearing narrowly focused claims and expecting the plaintiff to be able to show proof of the damages. Plaintiff attorneys pushed hard for broader cases to be heard because this allowed them to profit handsomely.

The ongoing wave of new litigation was a change for the U.S. judicial system, and it resulted in an upsurge in the number of people attending law school. Lawyers were in greater demand, and the job was very lucrative.

The increase in litigation didn't only pack law schools and fill up courthouses. It had an impact on businesses and business owners, who had to deal with increased litigation from business partners, employees, vendors, customers, suppliers, and even the surrounding community. With more lawyers ready and willing to bring more cases to court, the direct costs associated with lawsuits increased. In many cases, the plaintiff wasn't sure to win, but many times the defendant would settle for a lesser amount out of court rather than spending more money to fight the claim.

Armed with the hope of quick settlements—where their case would not need to be proven in court—we have seen a rise in frivolous lawsuits targeting individuals, as well as companies, deemed wealthy enough to pay out.

Look where it has put us today.

In 2009, there were over 1.1 million lawyers—nearly half of all the lawyers in the world—at work in the United States of America. That's 1.1 million highly paid, often highly skilled legal professionals in need of constant work. And do they ever work! One study estimates that nearly 50,000 new lawsuits are filed in the United States *every single day*. Many of the lawsuits attack the wealth of unsuspecting victims.

It's critical to realize the costs of these suits. It is estimated that the U.S. legal system costs roughly a \$252 billion (that's "billion" with a "b") a year, which is a fivefold increase since 1930. Rolled up in these costs are legal fees, court costs, judgments, and so on.

Currently, tort law costs total nearly 2 percent of the entire U.S. gross national product, the highest such figure among 12 industrialized

Western nations. And those costs are passed on to us. The costs for such litigation are passed directly on to consumers in the form of higher insurance rates and increased product prices.

A 2007 study by the Pacific Research Institute, a San Francisco “free-market” research group, alleges that the U.S. legal system imposes “a cost of \$865 billion a year on the U.S. economy, or \$9,800 a family.” They claim that the costs associated with civil lawsuits and guarding against them is 27 times more than the federal government spends on homeland security, 30 times what the National Institutes of Health dedicates to biomedical research, and 13 times the amount the U.S. Department of Education spends to educate children.

In recent years, a proliferation of new laws and an unparalleled number of lawyers have begun to wear on the patience of American citizens and businesses. It’s not hard to understand why, with recent cases like a group claiming an allergic reaction to Wi-Fi signals or a packaging company being sued for the unintended use of its product when a nightclub owner used polyethylene foam for soundproofing. The lure of easy money from quick settlements has become the norm.

The court systems were not alone in inspiring this revolution of abusive litigation. During this era, as you may recall, the executive and legislative branches were also hard at work expanding their roles and their rosters, and today’s politicians have continued down this path. And with big-league benefits come big-league price tags.

### THIRD GENERATION: 1970s—TODAY—PAYING THE PIPER IS OFTEN HARD

It wasn’t long after the entitlements started flowing that the voting public started to indulge in “soak-the-rich” taxes in an effort to redistribute and best position the nation’s wealth. This effectively brought about the demise of the first, most prodigious generation of the American economy and subsequently the second.

All the levels of government, which had once represented less than 15 percent of the national economy, began to blossom all at once. With new services and new benefits came new taxes. With new entitlements and types of mandatory government insurance came consistently rising rates.

But at least the taxes then were plainly visible on the surface. The more subversive element of the “buy now, pay later” era of politicians is that of inflation—the “stealth tax.”

It’s pretty simple, really.

It began in 1913, with the introduction of the United States’ third central bank. (The first central bank failed, and the second was controversially dismantled by Andrew Jackson.) By setting benchmark interest rates, the Federal Reserve could affect growth in the money supply. It allowed the necessary control for the volatility of a *fiat* (debt-based) economic system, but it also incorporated an element of political expedience.

As we might expect, politicians promised increased spending, while cutting taxes. It was a great strategy that worked for a great many politicians. It allowed them to pay for their spending by increasing the money supply instead of collecting more taxes. They didn’t have to “ask” the public for their money—they could just create more.

For years, all major countries used a fractional reserve system that limited how much money the government could print by how much gold or silver they held in reserve. Under this system, you could easily exchange U.S. dollars for physical gold at a local bank.

This system worked well for decades until the U.S. government had to find a way to pay for the ever-growing public debt as well as finance an unpopular Vietnam War.

In 1971, without enough gold to back the dollars needed to pay the current debts, the United States officially abandoned the link between gold and the U.S. dollar. A brave new world of free-floating currencies was ushered in and the rest of the world quickly created their own fiat money systems. Here at home, it gave the Federal Reserve the ability to inflate or deflate the money supply as it saw fit.

Total Amount of Federal Spending per Family:

More Spending = More Inflation

The strength of the “stealth” tax is in the fact that most people don’t understand purchasing power and how quickly you can lose it in a fiat economy.

It’s simple, really. An inflation rate of 25 percent means that for every dollar you have, there’s now \$1.25 in the economy, and prices

will adjust accordingly. That \$1 pretzel will now cost \$1.25, whether you have that extra quarter in your pocket or not. Gradually, this theft of purchasing power will diminish the power of your savings and income, unless they can keep up with the rate of inflation.

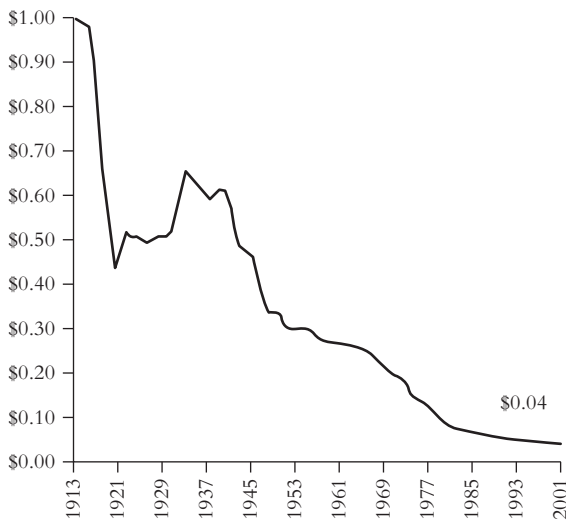
The inflation rate is marginal most of the time, often 2 to 5 percent or less. But it builds up over time.

Figure 1.2 shows the declining purchasing power of the dollar in the twentieth century. By 2001, the amount of goods you could buy with a dollar were about as same as the amount you could've bought with four cents at the beginning of the century. Or think of it like this: you could have bought a basket of assorted goods for \$1 back in 1913. By 2001, that same basket cost you \$25.

Unraveling the stealth tax takes you back to the days when a movie cost a nickel or a dime, a soda or an ice cream would set you back about as much, and cigars went for 50 cents.

Granted, some of this growth is justified.

Just like everything else, populations and wages have increased significantly. Our economy has become more robust, and consumer



**Figure 1.2** Purchasing Power of the Federal Reserve Note in 1913 Dollars

Source: [www.norfed.org/graphics/home/purchasepower.jpg](http://www.norfed.org/graphics/home/purchasepower.jpg)

goods more abundant. Thus, some of the inflation is absorbed by these increases.

But for the last decade, that simply hasn't been the case.

### Mortgaging America's Future (and the Future of Your Wealth)

Just like any other top executive, the politicians in Washington and the White House have faced decades of extreme pressure to generate short-term results.

And they succeeded—in the short term.

The third generation's ability to create wealth has been eroded. Thanks in great part to the bursting of two separate bubbles—the technology bubble of 2000 and, more recently, the housing bubble—plus the government's growing drag on the economy, recent data indicates that there was zero net job creation in the first decade of the twenty-first century. The past decade also saw household net worth drop by 5 percent, compared to increases of 44 percent in the 1960s and 58 percent in the 1990s.

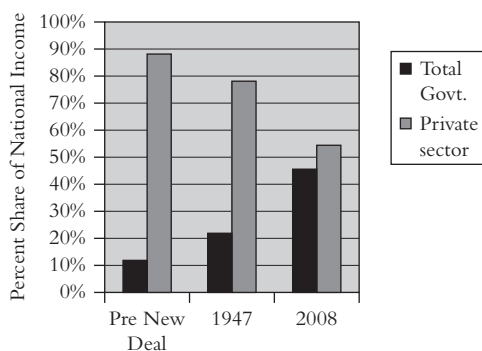
As Ronald Reagan once said, “the nine most terrifying words in the English language are: I'm from the government and I'm here to help.” Looking back, it's no surprise that his words met with such uproarious applause. Today, especially, they ring true.

Since 1999, the government has come to “help” in a big way, adding employees at a rate 40 percent faster than the rate of population growth. And this wasn't a new trend, not by any means.

As you can see in Figure 1.3, the government grew four times faster than the economy for most of the twentieth century and into the twenty-first.

What a racket.

The average government salary is around \$75,000 in recent years, compared to an average of \$45,000 in the private sector. According to a *USA Today* article from 2008, federal employees making salaries of \$100,000 or more jumped from 14 percent to 19 percent during the recession's first 18 months—and that's before overtime pay and bonuses are counted. So while hundreds of thousands of Americans were losing their jobs and their homes, a full 5 percent of federal employees made the leap into a six-figure annual salary. By 2008,



**Figure 1.3** Government (federal + state + local) Grows Four Times Faster than Economy—Depressing Private Sector’s Share

Source: Grandfather Economic Report (<http://mwhodges.home.att.net/>); data: Bureau of Economic Analysis.

the government’s once-tiny slice had grown into 45 percent of the national economy.

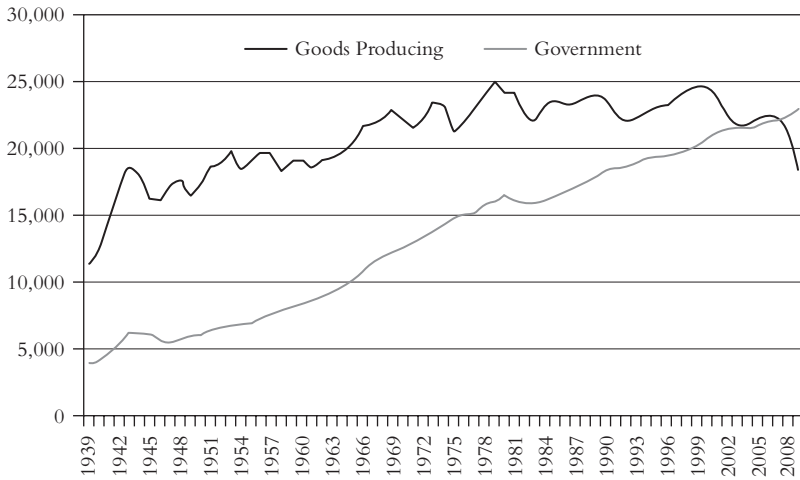
And it shows no signs of slowing down.

In the Bureau of Labor Statistics’ projections for 2008–2018, several categories of government jobs (local government, teachers, etc.) are featured prominently among the fastest-growing industries and occupations in America. Local government payrolls, for example, are expected to grow over 8 percent during that period, while enduring the first major wave of Baby Boomer retirements. These retirees will soon begin to cash in on the bulk of their government entitlements, putting unprecedented stress on everything from Social Security to Medicare and government pension programs.

Meanwhile, in the past two decades another opposite trend has manifested in the private workforce.

For most of the twentieth century, with home prices rising, taxes consuming an average of 40 percent of income, and unions beginning to dominate many traditional industries, American workers demanded more in wages. They demanded more benefits. Attorneys assaulted employers from another angle with a host of lawsuits.

Private business in America became a much more bothersome affair than it had once been. Over time, thanks to the power



**Figure 1.4** Goods Producing vs. Government Payrolls

Source: U.S. Department of Labor.

and speed of technology, production went abroad—Japanese motorcycles, Chinese televisions and toys, and so on. America’s economy, increasingly dominated by the service sector, found itself with less and less of a concrete industrial infrastructure to fall back on.

In January 2010, in the wake of so many private-sector layoffs and government hirings, the scales finally tipped, and as you can see in Figure 1.4, America’s labor force became dominated by government employees.

### A “Debt-aholic” Government

The legacy of the U.S. federal government is a costly one. What you might not expect is just *how* costly.

If every man, woman, and child in America were asked to pay their share of the U.S. national debt tomorrow, they’d all need to find over \$39,000 *each*. Assume they all paid in \$1 bills (because why not), and you’d have roughly four stacks of \$1 bills, touching the Earth on one side and the moon on the other.

You don’t have to search very far for the trail of a debt-fiend government.

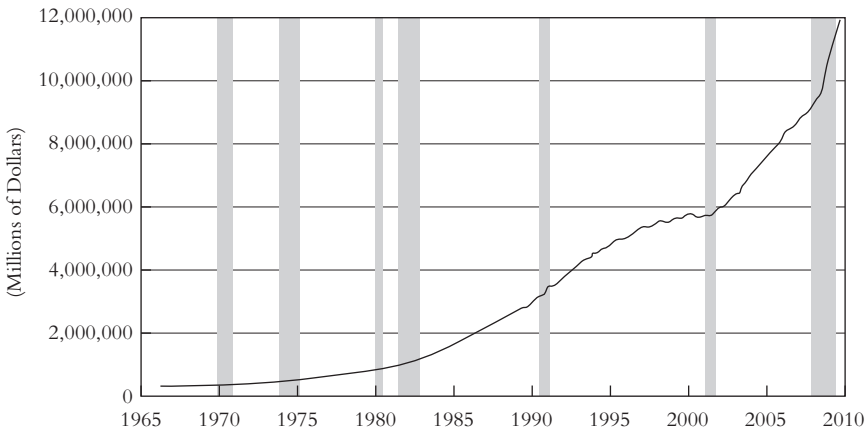
Just this past Christmas Eve, in 2009, Congress voted to raise the debt ceiling and extend unlimited aid to Fannie Mae and Freddie Mac (beyond the \$200 billion already pledged). At the time of this writing, the U.S. federal debt stands at \$12.1 trillion dollars, against an annual national GDP of just over \$14 trillion.

### National Debt Exploded in the Past 20 Years

Throw in the government's unfunded liabilities, like Social Security, Medicare, and Medicaid, and that number rises well above \$54 trillion dollars. With just over \$14 trillion in annual GDP, it is pretty clear that we have overstretched a little (see Figures 1.5 and 1.6).

To be sure, interest rates on long-term debt are some of the lowest we've ever seen. The government's financing costs aren't prohibitive—at least not yet. And as for the \$54 trillion in unfunded liabilities, well, those aren't all due this year. That's the total projected amount of outlays for Social Security and Medicare over an extended period of time.

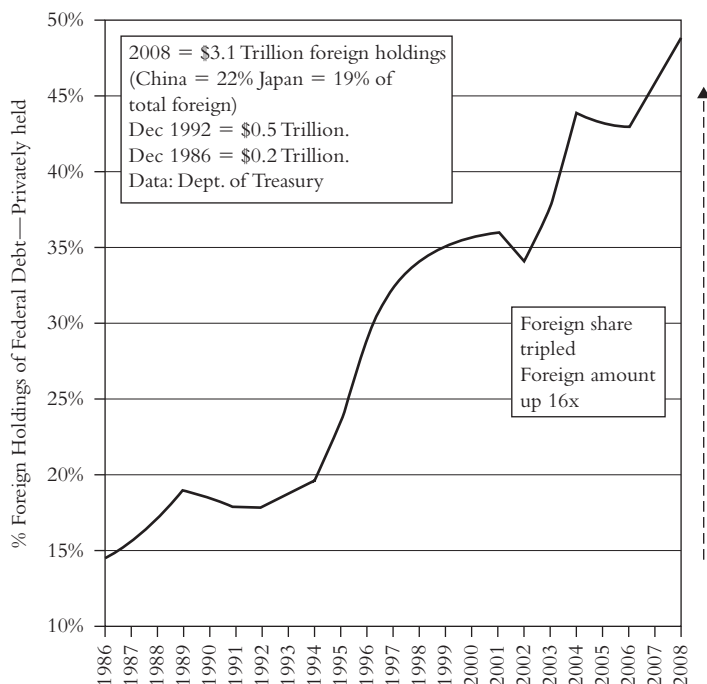
But it takes a bit of a thinker to realize the real implications of such an astronomical number. Namely, there's someone out there who owns \$39,000 in debt for every American man, woman, and child. Now more than ever the person holding our debt is not one of us.



**Figure 1.5** Federal Government Debt: Total Public Debt

Note: Shaded areas indicate U.S. recessions.

Source: U.S. Department of Treasury, Financial Management Service; 2009 research.stlouisfed.org.



**Figure 1.6** Foreign Holdings of Federal Government T-Bill and T-Bond Debt (held by “public”)

Source: Grandfather Economic Report, <http://mwhodges.home.att.net>.

Since the mid-1980s, just as the U.S. debt was passing a historic landmark of \$2 trillion dollars, the share of debt owned by foreign nations has tripled. The overall dollar amount they control has exploded—16 times the amount foreign nations controlled in 1986. Currently, the top five foreign holders of our debt include China, Japan, the United Kingdom, oil exporters (countries in OPEC like Iran, Iraq, Kuwait, Libya, Nigeria, Saudi Arabia, and Venezuela), and Caribbean banking centers including Bermuda and the Bahamas.

How exactly will this affect the outcome of the next few decades? Perhaps nothing will come from more and more foreign nations owning U.S. debt. However, there is a risk that those holding our debt may want to have a say in our government policies and practices, especially if they impact any of the involved nations. With China holding

the largest foreign share of U.S. debt, their opinions may impact the U.S. government's decision to implement protectionist steel tariffs. It's possible that the United States could lose its autonomy to make the necessary decisions to revive its economy.

## NEARING THE BOILING POINT

This is very likely to bring about a reckoning day for all levels of government in the United States—probably nothing catastrophic, much more like an uncomfortable readjustment in all likelihood. The state will survive. However, personal fortunes may not be so lucky.

State, local, and municipal governments, facing their own hiring expectations and pension obligations, will soon be prominent default risks. Taxes will no longer be able to cover pension payouts and short-term obligations. They will have two alternatives: to endure a rash of defaults and a spike in rates or seek a federal bailout. Like the financial system, they'll likely see a series of bailouts and initiatives aimed at helping maintain "liquidity."

Underneath it all, the U.S. federal government is making a major long-term play. They're sacrificing the value of the U.S. dollar—or, at the very least, risking it—to smooth over the shock from the massive global transfer of wealth that's once again under way.

In 1873, that shift brought with it the Long Depression, a period lasting over six years. But the U.S. economy would stumble for decades, experiencing a host of economic setbacks from 1873 to 1901. Also, keep in mind what the global backlash was like for Hungary—now considered an emerging market—and Germany, which has just recently become reinvigorated in the past decade after the struggles of reunification.

But this time around, the world is in a unique position.

For the first time in history, we're undergoing a global economic crisis without a single currency backed by anything other than debt. The days of the gold-backed currencies are long gone. So we can expect that policymakers will, without a doubt, make unprecedented use of their powers (and their printing presses) to favor their people.

Indeed, governments throughout the world are enacting bailouts, stimulus, and quantitative easing. These practices and their euphemisms are likely to stay with us for several years, or until this crisis of debt and

value that is still in the works comes to a head. One way or another, we believe it's highly likely that a great many American savers, investors, and wealthy individuals could face a serious "rude awakening" in the relatively near future.

We feel compelled to remind you at this point: these aren't doomsday scenarios we've been talking about.

The projections we've shown you have largely been based on government-prepared data, coming from some relatively trustworthy sources such as the Congressional Budget Office. Looking to the same individuals and think tanks that predicted the largely unforeseen subprime crisis, we hear much more startling projections—those of volatility, of record defaults, and the potential for hyperinflation.

## WITH CRISIS COMES OPPORTUNITY

Regardless which of these futures sounds the most reasonable to you, a few things are clear.

Americans will need more proactive protection for their wealth, more forethought and insight than ever before. The resources are currently at your fingertips, but the challenge is formidable. You'll need protection from frivolous lawsuits. You'll need protection from the continuing erosion of the value of the U.S. dollar, thanks to federal spending and government stealth. You'll need protection from a rapidly growing government that will change the U.S. economy and marketplace, which entails a *new* kind of diversification.

America's prospects might indeed look bleak depending on where you stand. But with each crisis comes opportunity; however, this time you may not find opportunity at home.

## FINDING THE NEW LAND OF OPPORTUNITY AND SAFETY

The financial landscape is changing. While exciting developments and investment breakthroughs are still happening each day, they are happening more and more frequently on non-U.S. shores.

Billions of people will wake each morning to face new challenges and take new risks. It's hard to say which ventures will prove successful—which companies will create the next “big” opportunity—but some things are certain.

The *Les Trente Glorieuses* are over. And the days of a Chevy in every driveway have passed; it's more likely to be a Kia or a Honda. We have entered a decade where economic and market volatility will be the norm, where threats to personal wealth will continue to proliferate, and U.S. government expansion will continue on a course like no other time in history. It also means that for many of us the traditional investment method of American stocks and bonds will simply not suffice. If we do not look beyond our borders, we will miss out on the next decade of revolutionary investment growth, and in doing so, we'll put our hard-earned capital at risk.