

Thinking the Unthinkable

BY ROBERT KLEINSCHMIDT ON NOVEMBER 28, 2022

In a thoughtful and wholly outside the box column, Alex To, an analyst with Cross Current Research, LLC, contemplates Nuclear War and how to survive it. His conclusions are surprising. It would be terrible beyond words for the world to experience a nuclear war, of course. Nothing surprising about that. What is surprising is that the tragedy would not be unprecedented and the world, indeed, civilization would survive, just as it has when previous holocausts, the Black Death, the Bubonic Plague ravaged the global population. With Europe and the U.S. losing between a third to a half of its inhabitants, the damage would be incalculable, but much would still survive, including the technological prowess to recover.

How can this be?

The main reason is that the major powers have significantly reduced the number of missiles and warheads they once held. Perhaps as much as 90%. (A corollary reason is that missile defense systems are far superior to what they were at the height of the Cold War). This means not only less initial destruction, but also less radioactive fall-out.

Mr. To goes on to touch upon industries and products which could benefit because of a disaster of such enormous magnitude. This is investment research at its very best, particularly if the goal is wealth preservation not short-term trading to best this or that index the next quarter. In a thoughtful and wholly outside the box column, 'Think Aloud #25: Surviving a Nuclear War – an Epidemiological and Medical View', Alex To, an analyst with Cross Current Research, LLC, posted a commentary on October 16, 2022 that contemplates Nuclear War and how to survive it.

Unfortunately, investors face another nuclear option equally threatening, perhaps, to long term wealth preservation. Only, in this case the enemy isn't "them," it is "us."

For far too long, many decades in fact, we have elected governments who have paid little regard to the basic budgetary principles that guide every other enterprise and family in our economy. Worse, because of a forty-year decline in interest rates propelled by the tight money and free market philosophy that began under the Carter administration and then continued more emphatically with the Reagan administration, the cost of this reckless profligacy has been well hidden from the public, even as it was complacently ignored by our elected officials and the fourth estate which was meant to be keeping an eye on them. As a result, as the national debt mounted to unheard of heights, the actual cost of servicing that debt remained unchanged, declined even, until very recently.

How can this be?

The main reason is that the United States has, and has had, the world's reserve currency. It is the only nation that can borrow huge sums abroad in its own currency. And, with the power of the printing press, it can, of course, always pay off these international debts with newly printed dollars. (A corollary reason is that central banks and governments of most of the large global economies have behaved even worse than our own, putting the dollar in the position of the one-eyed man in the land of the blind).

The long delayed, but inevitable inflation that these policies have ordained is now upon us. The ultimate cost is still unknown, but the bill to service our national debt, quiescent for many years, is rising

exponentially. The United States has nearly \$31 trillion in debt and rising, which is up from \$21 trillion at the beginning of 2019.¹ Debt as a percentage of GDP is more than 120%. It will take some time to work through the system, of course, but 4% of \$31 trillion is \$1.2 trillion which compares with \$400 billion of interest expense last fiscal year. The current rate on the two-year U.S. note is well above 4%, as it is on the 10-year and the 30-year Treasuries. (TIPS are also increasing the debt servicing costs). Interest expense was the 6th largest budgetary line-item last fiscal year and is greater than what the U.S. spent on housing, education, and transportation combined.² It is only a matter of time, a very brief matter of time, before interest costs are the single largest budget item

This is ominous indeed for too many reasons to go into detail here, but mainly because for the past five hundred or more years (probably much longer when one considers the Roman Empire or the reign of the Pharaohs in Egypt) the world's reserve currency has belonged to its major military power, a proxy, perhaps, for its strongest economy. With Medicare and Social Security increases on automatic pilot, and with interest costs soaring, there are few places to go to reign in the budget. The biggest of these is Defense.

This spiraling maelstrom could bode very badly for America's position as the world's dominant military and therefore the dollar's future status as the reserve currency, and, hence, our ability to borrow from foreigners, (as well as from our own public and private pension plans) to fund our budget.

What happens then?

Like Mr. To's nuclear war scenario, the demise of the U.S. dollar would be catastrophic, but not the end of the world. The result would mean the end of the post WWII world order, which is already under attack on several fronts. A realignment of alliances would occur, but it would not be the end of Western Civilization, nor would it be for the opportunity of discovering rewarding investments. Even like a default, a la Peronist Argentina, or like a period of hyper-inflation, like Weimar Germany, even if the unthinkable occurred, investors would eventually return to markets where they saw value and opportunity. Although not an encouraging example, because of its ill-fated flirtation with Socialism after the war, Great Britain survived and eventually prospered after the Pound lost its reserve currency status. A possible silver-lining, along with the pain of adjustment, loss of that status would most likely bring with it the offsetting benefit of budget discipline.

Navigating a transition period in a dramatic scenario like this would be the key. However, remaining disciplined to buying good companies, with strong balance sheets, dependable free cash flow, growing markets, healthy margins, high and defensible market shares, prescient managements, etc. will continue to be a source of wealth creation and preservation. Debt of any kind, but particularly U.S. government bonds would not.

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Source:

¹<https://www.statista.com/statistics/187867/public-debt-of-the-united-states-since-1990/>

² <https://www.crfb.org/blogs/just-how-big-are-federal-interest-payments>