Bruce Mehlman
May 10, 2023
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Q2 2023

THE FOUR ADDICTIONS

The Challenge of Breaking Hard Habits in the 2020s

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The Four Addictions

Over the first two decades of the 21st Century, the U.S. (and world) grew increasingly dependent on:

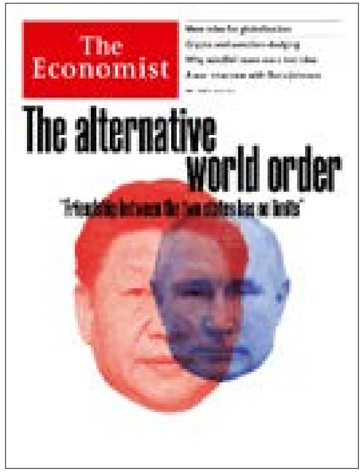
- **China** (for manufacturing, supply chains & deficit financing)
- **Digital** (as everything digitized, networked & automated)
- **Easy Money** (as low interest rates & QE persisted without serious inflation)
- **Debt** financing (as institutions spend more than they took in)

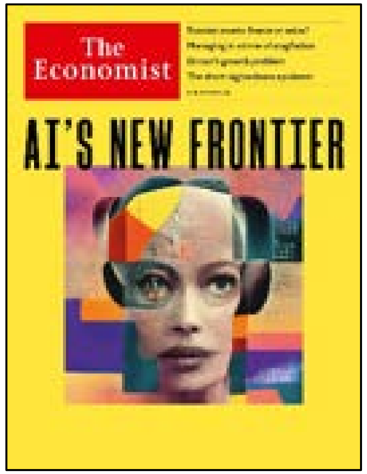
While each trend offered significant upsides, unaddressed downsides are increasingly problematic. **These dependencies are becoming unsustainable,** but they're hard habits to break. Policies to address any one could worsen the other three.

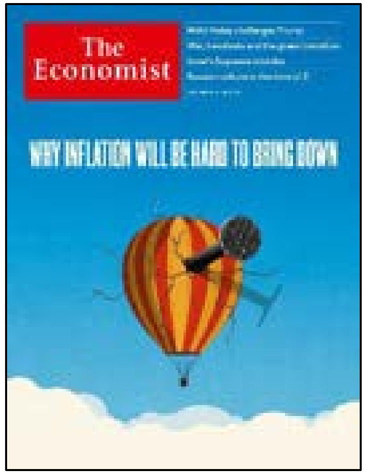
The central policy & political challenge of this decade is kicking these four addictions without crashing economies, stifling innovation or provoking wars. Solutions exist, but they're not easy.

THE FOUR ADDICTIONS

Addiction:	CHINA	DIGITAL	EASY MONEY	DEBT
Upsides:	Disinflationary / new markets, faster growth	Faster innovation, productivity, efficiency	Depressions-avoided / asset values protected	Hard choices avoided, spend AND cut taxes
Downsides:	Dangerous dependencies	Ignored externalities	Excessive risks / asset bubbles	Mortgaging the future
Why Unsustainable:	U.S.-led world order in peril	Weapons of mass disruption ubiquitous	Inflation crushes growth & savings	High interest payments starve other spending



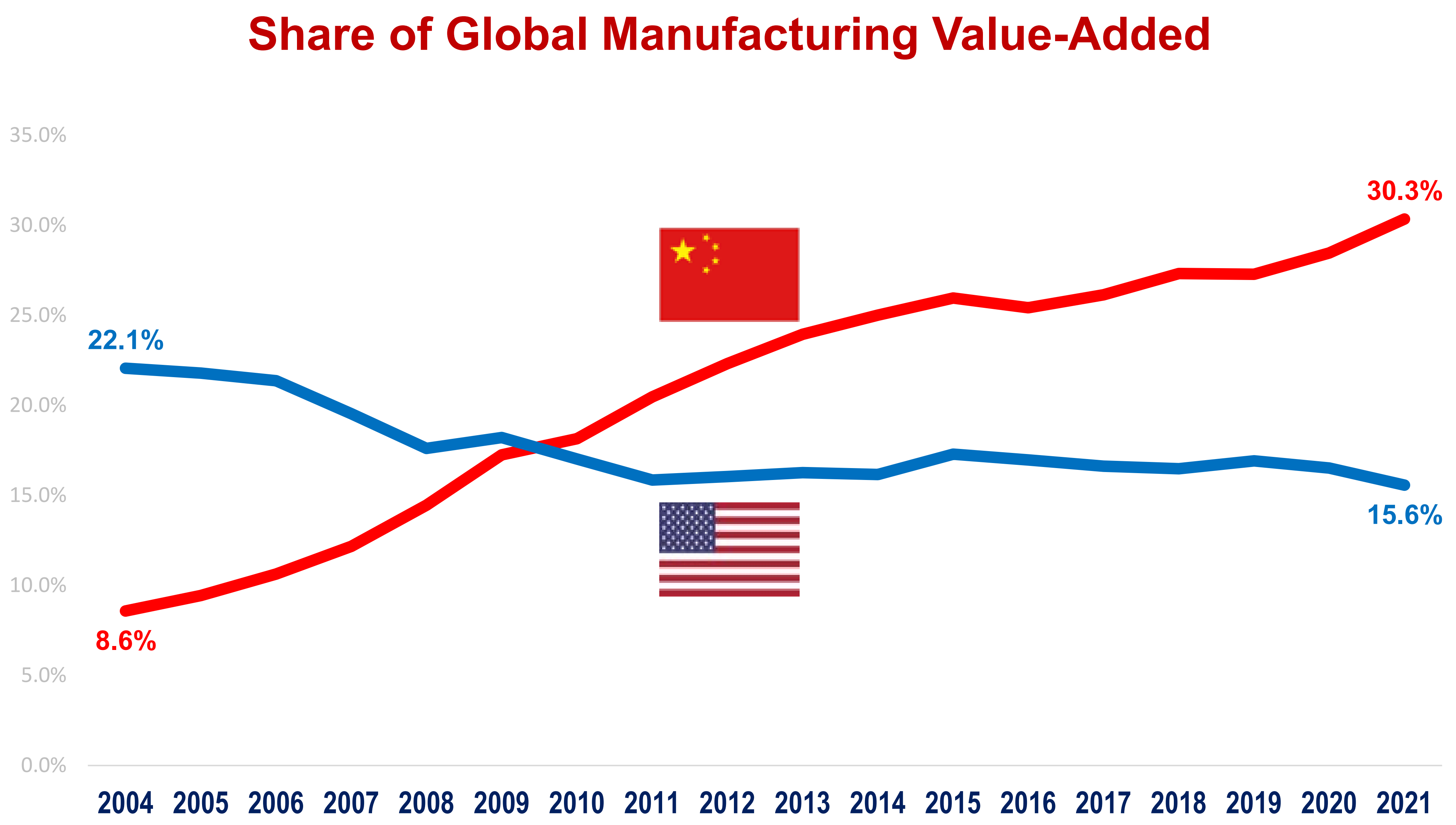




CHINA

Excessive Dependencies on an Increasingly Unreliable Competitor

THE TREND: CHINA BECAME THE WORLD'S FACTORY



Source: World Bank, US & China

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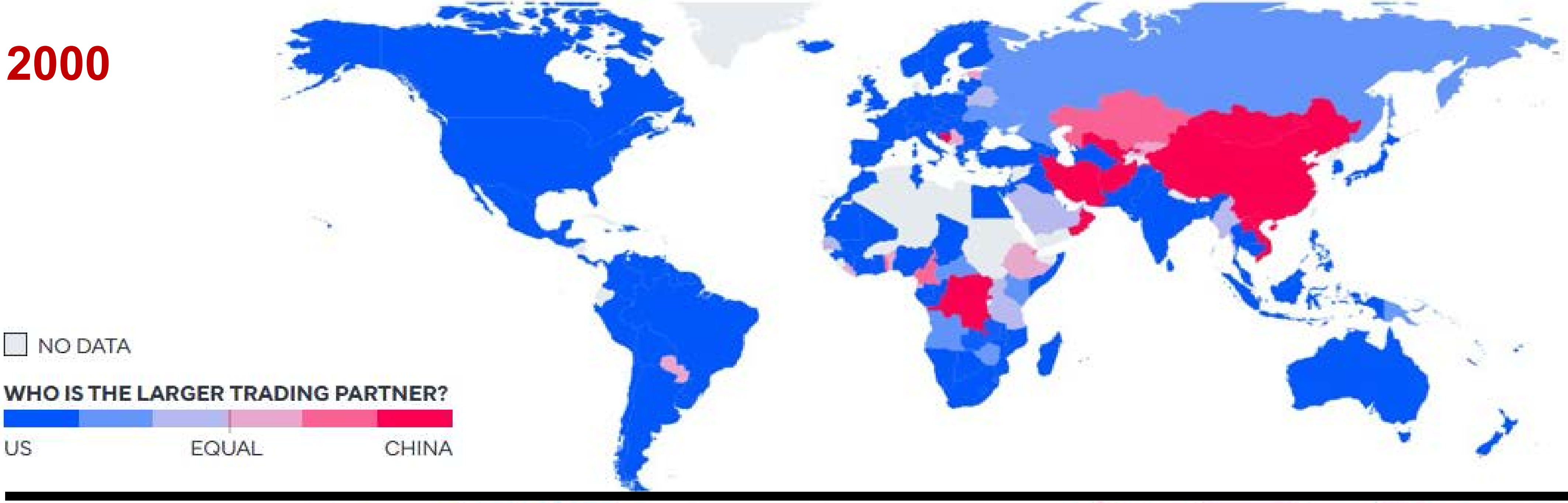
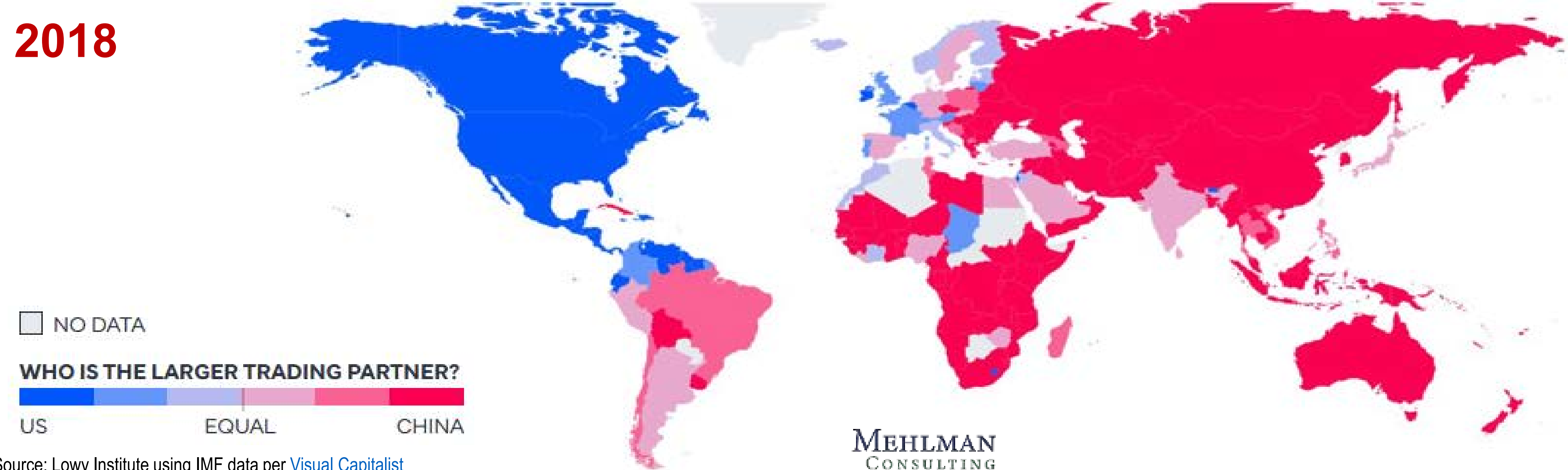
THE TREND: CHINA BECAME WORLD'S TOP TRADING PARTNER



U.S. was #1 trading partner to over 80% of nations



China was #1 trading partner to over 67% of nations
(U.S. ~30%)

Source: Lowy Institute using IMF data per Visual Capitalist

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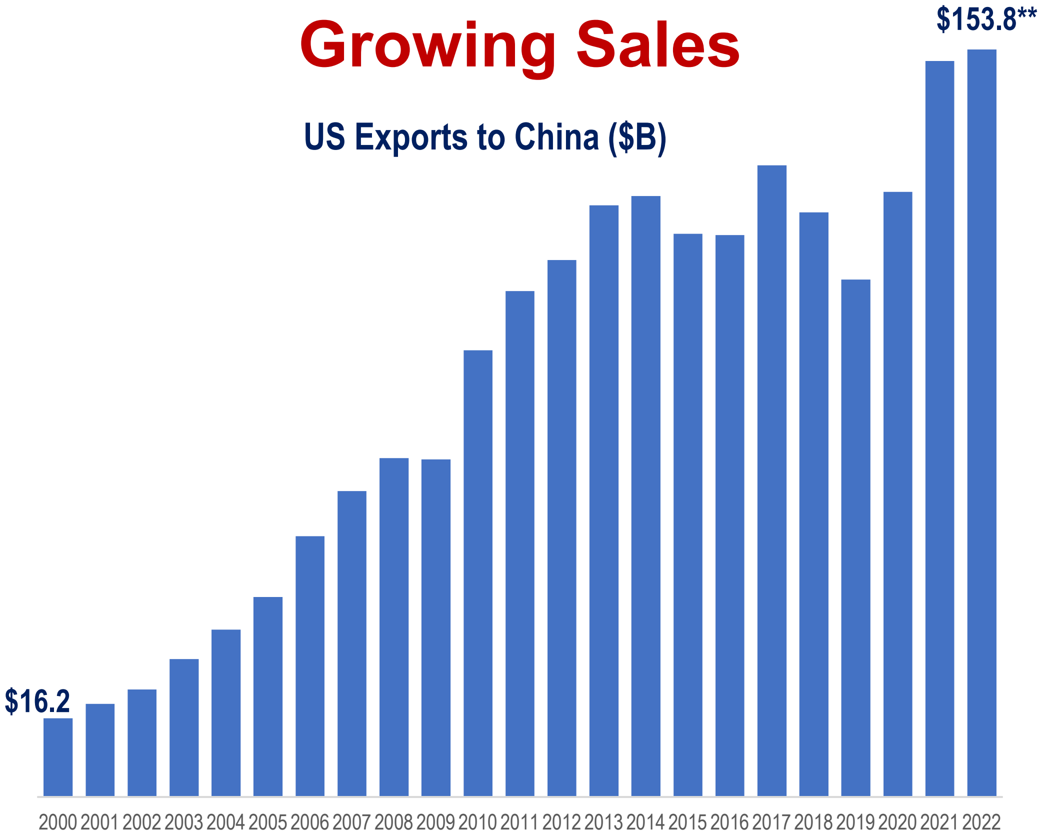
UPSIDES OF ENGAGING WITH CHINA

Cheaper Goods / Lower Inflation

Market Access / Growing Sales



** Only Canada & Mexico bought more from the U.S. in 2022

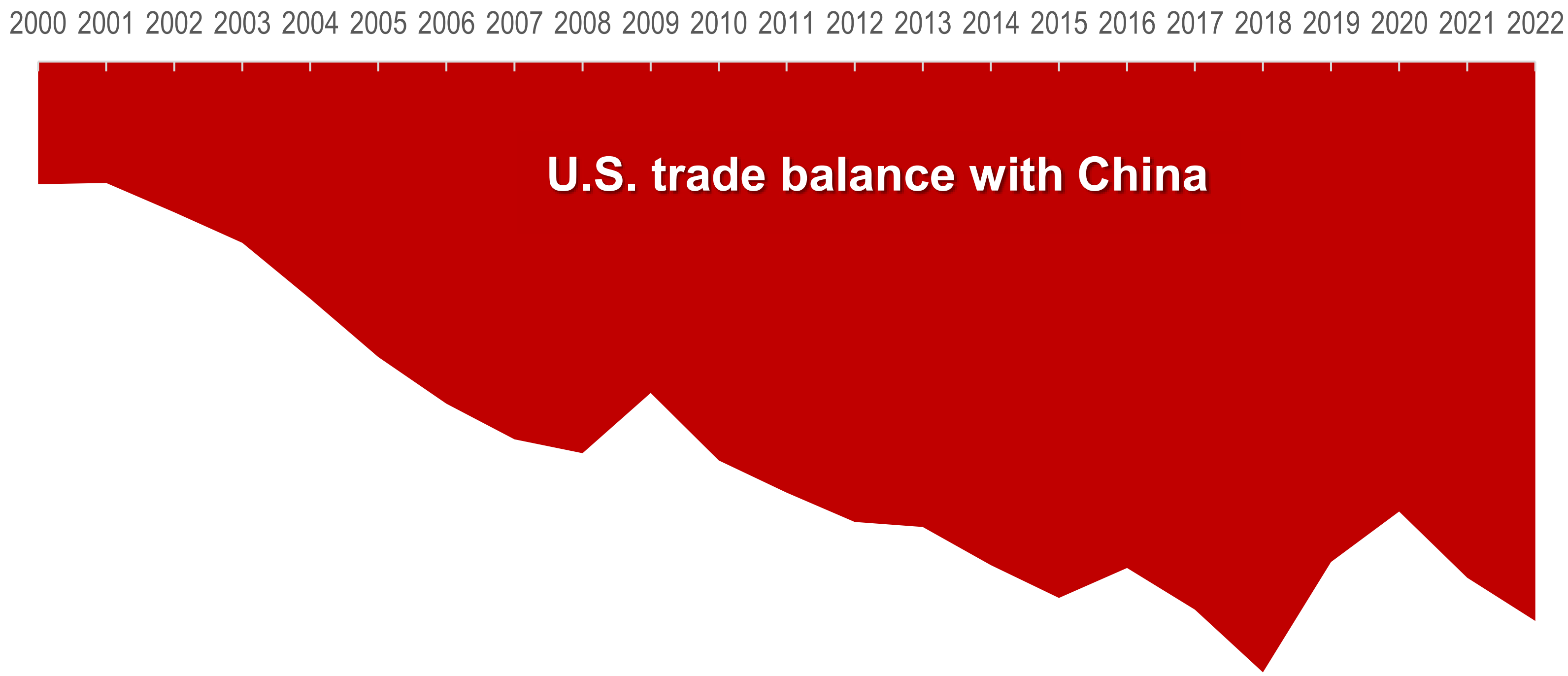
Big Workforce / Efficient Production

Source: [Census]

DOWNSIDES: DEPENDENCIES, DEFICITS & DISREGARDED VALUES

Dangerous Dependencies Grew

Bilateral Trade Grew Extremely Unbalanced



Basic Values Disregarded

Source: Census

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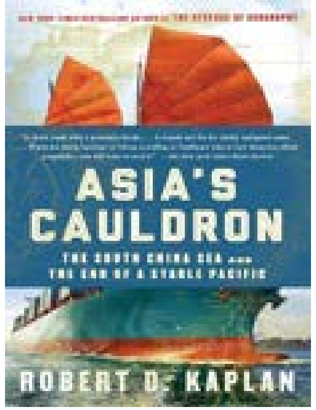
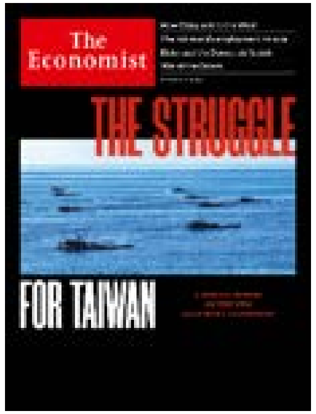
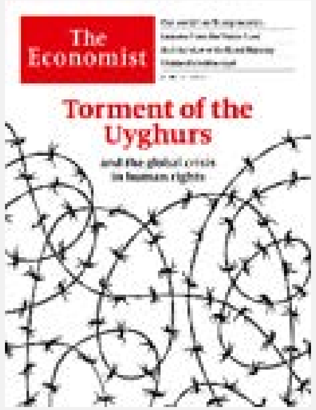
WHAT CHANGED / WHY UNSUSTAINABLE

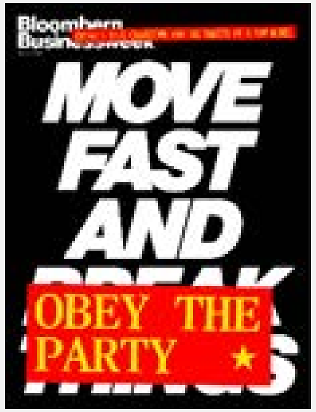
China Became More Aggressive



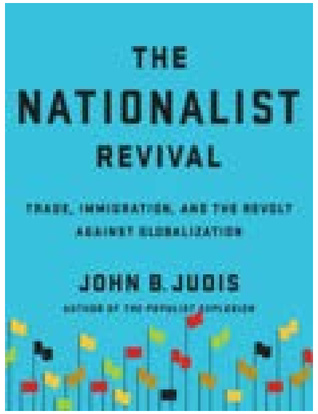


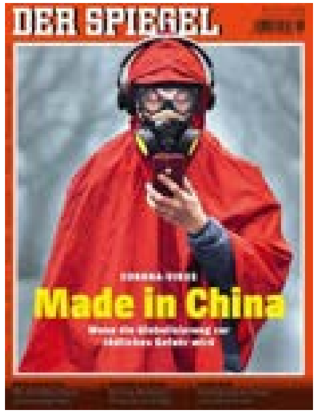
China Became More Repressive



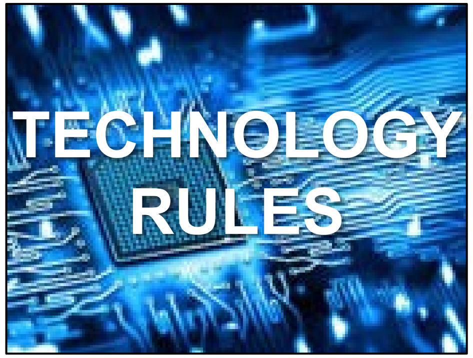


Frictions Rose Amid Global Events





Battlefields of the New Cold War



THE POLICY: U.S. CHINA CRACKDOWN WILL DRIVE PAIN… AND OPPORTUNITY

BUSINESS PAIN

- Tighter Tech Export Controls
- Outbound Investment Restrictions
- Limits on Cross-Border Data
- Propaganda Transparency & Ban
- Supply Chain Decoupling
- Defense Deals & Strategy
- Human Rights Liability
- Retaliation by China in China

BUSINESS OPPORTUNITY

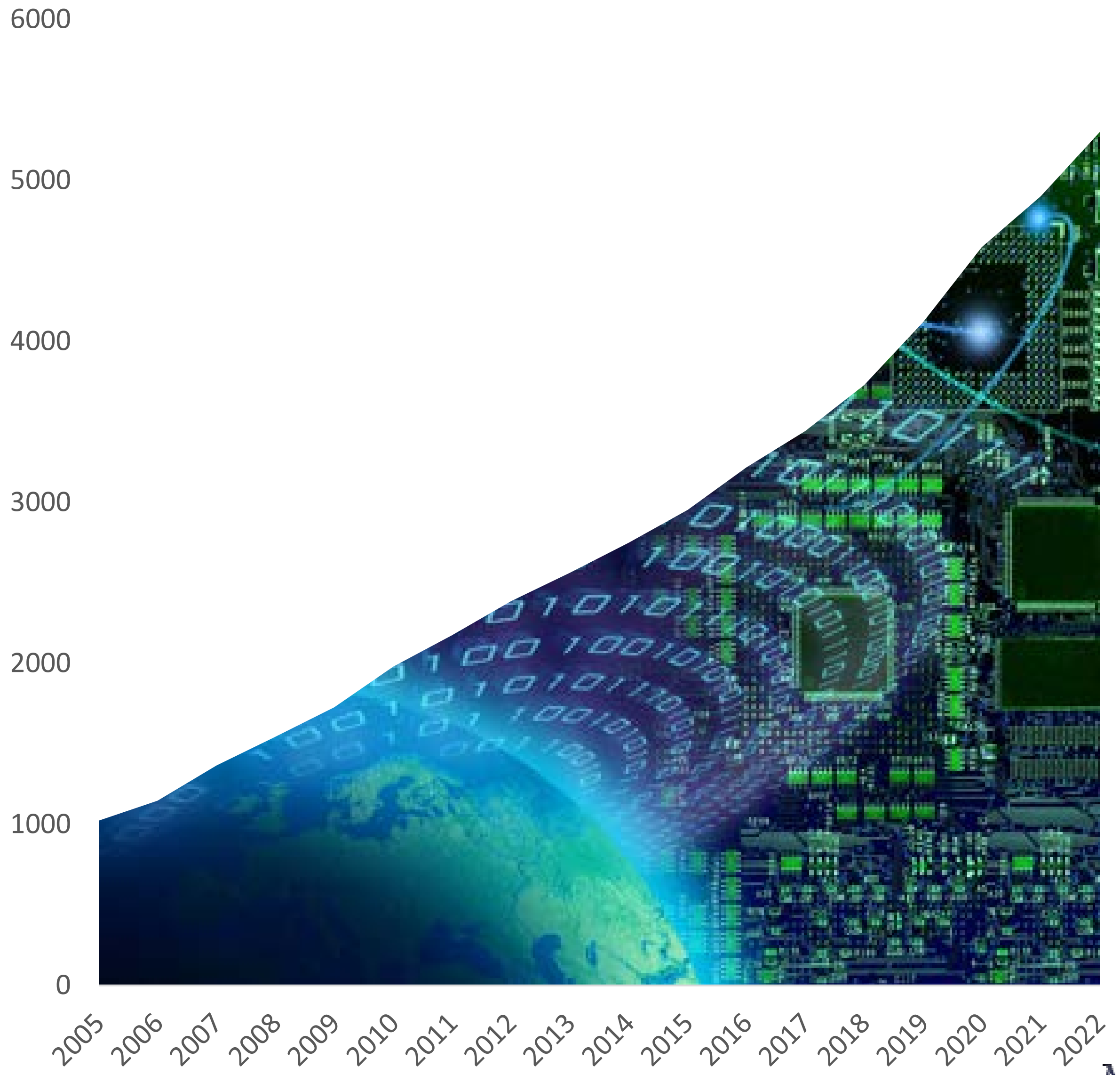
- Domestic Supports (eg CHIPS)
- On- / Near-Shoring Incentives
- Help vs Unfair Competition
- New Regional Economic Alliances
- Military Buildup & Contracts
- Infrastructure Improvements
- Stronger IP Enforcement
- Return of Manufacturing Base

DIGITAL

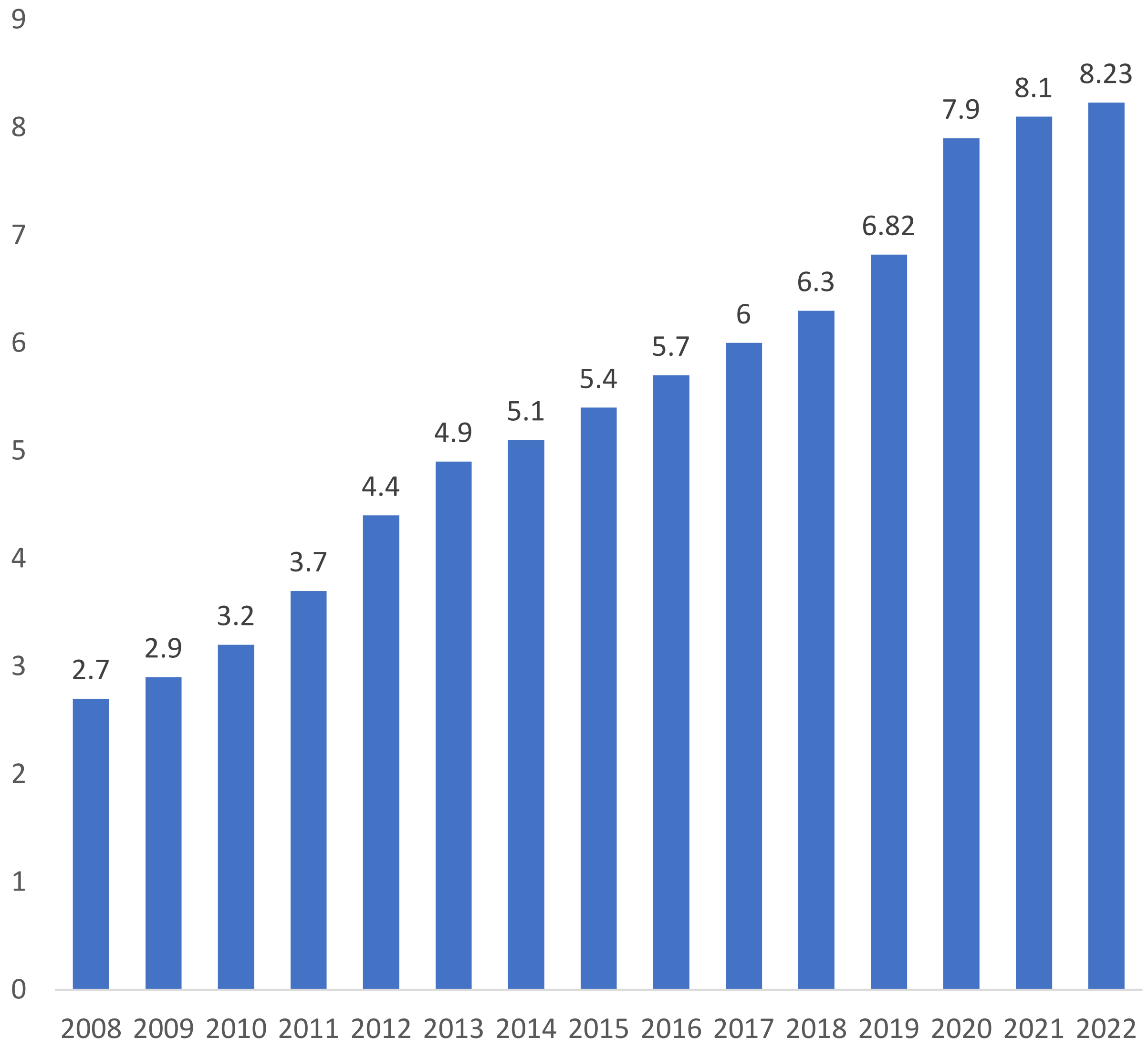
Growing Power & Availability of Emerging Tech Make Risks Too Big to Ignore

THE TREND: EVERYONE, EVERYWHERE, ALL THE TIME

Global Internet Users (M)



Americans' Daily Hours Online



Sources: ITU per Statista; eMarketer (insiderintelligence) & BOND Internet Trends

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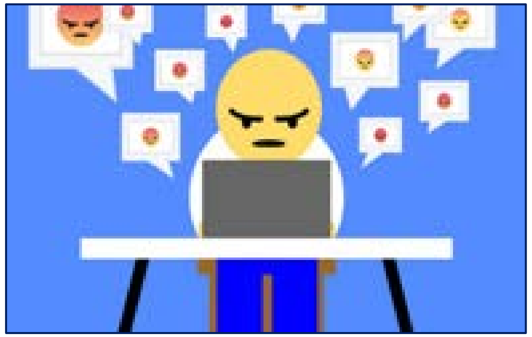
UPSIDES: BETTER, SMARTER, FASTER

The Digital Revolution Continues to Drive Immense Benefits

DOWNSIDES: GROWING NEGATIVE EXTERNALITIES

Spreading Misinformation

Monetizing Outrage



Increasing Vulnerability

Displacing Jobs

Destabilizing Markets

Invading Privacy

Depressing / Addicting Kids

Emerging Tech (esp. AI) Is Both Ubiquitous & Powerful

UBIQUITOUS TECH
(Power restricted)

VERY POWERFUL TECH
(Access restricted)

POWERFUL & UBIQUITOUS
(Minimal restrictions)

WHAT'S NEXT / POLICY: PUSH TO REGULATE… EVERYWHERE, ALL THE TIME

Regulatory Posture

🔴 Aggressive

🟡 Moderate

🟢 Minimal

Efforts to Regulate Tech by Government Expanding

ISSUES	EU	US Agencies	Blue States	Congress	Red States	China
CONSUMER PROTECTION *(Privacy; Kid safety; Content moderation/230; Crypto; Addiction)*	🔴	🔴	🔴	🟡	🔴	🔴
COMPETITION POLICY *(Antitrust laws & merger reviews; App stores; data porting)*	🔴	🔴	🔴	🟡	🟡	🔴
NATIONAL SECURITY *(Export / import controls; Cyber; FDI limits; Supply chain)*	🟡	🔴	N/A	🔴	N/A	🔴
SOCIAL COMPACT *(AI rules; Tax; Digital divide; Labor / Gig economy; Bias)*	🔴	🔴	🔴	🟡	🟡	🔴

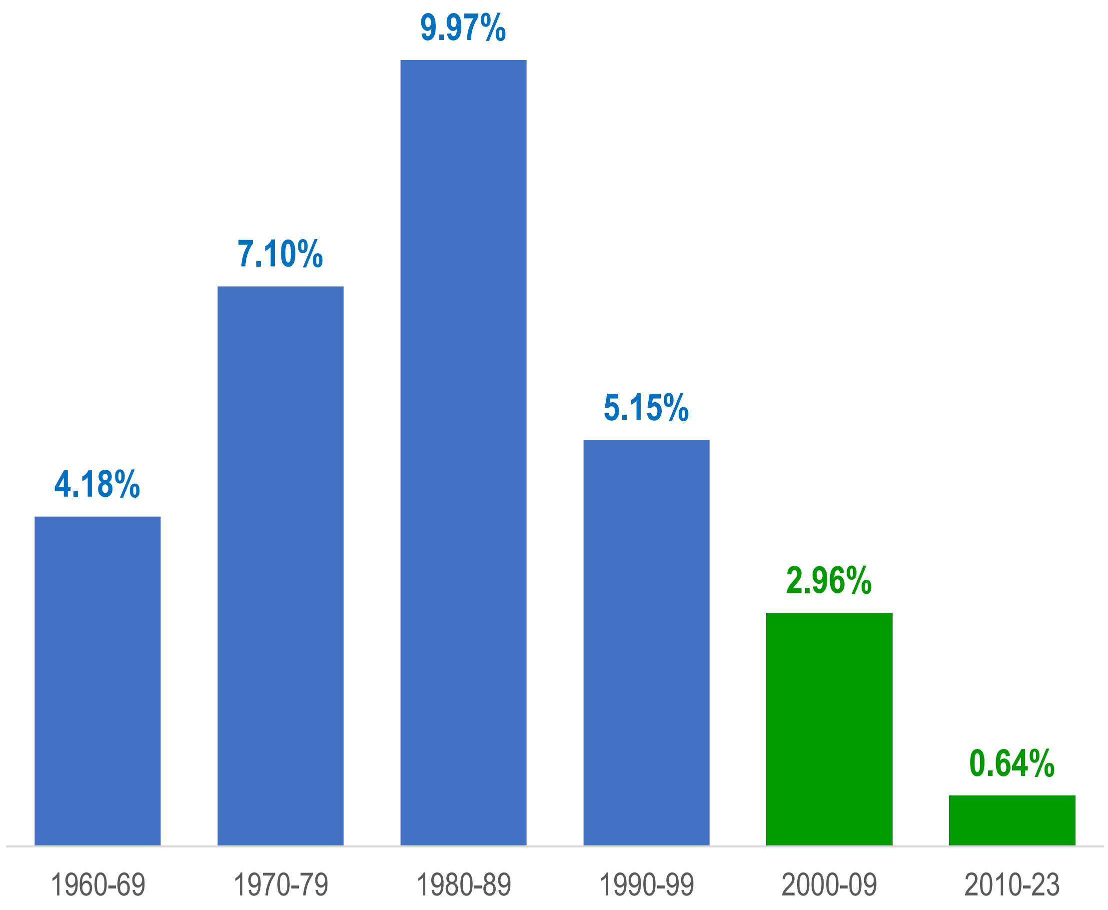
EASY MONEY

Return of Inflationary Forces Portends a Long Unwinding Road

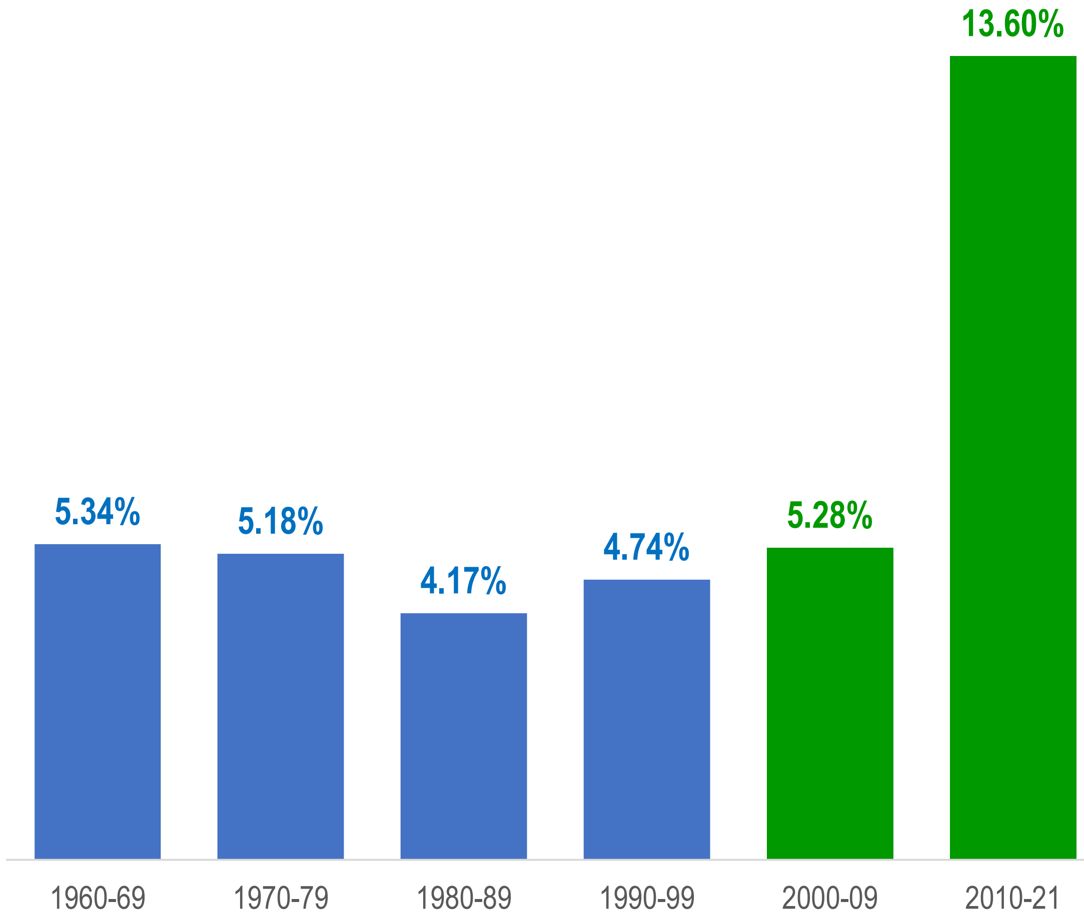
THE TREND: HISTORICALLY-LOOSE MONETARY POLICY

Low Rates + Quantitative Easing = Unprecedented Era of Easy Money

Federal Funds Rate



Central Bank Balance Sheet (% GDP)



Sources: The Fed (FRED) [Rate](#) & [Balance Sheet](#)

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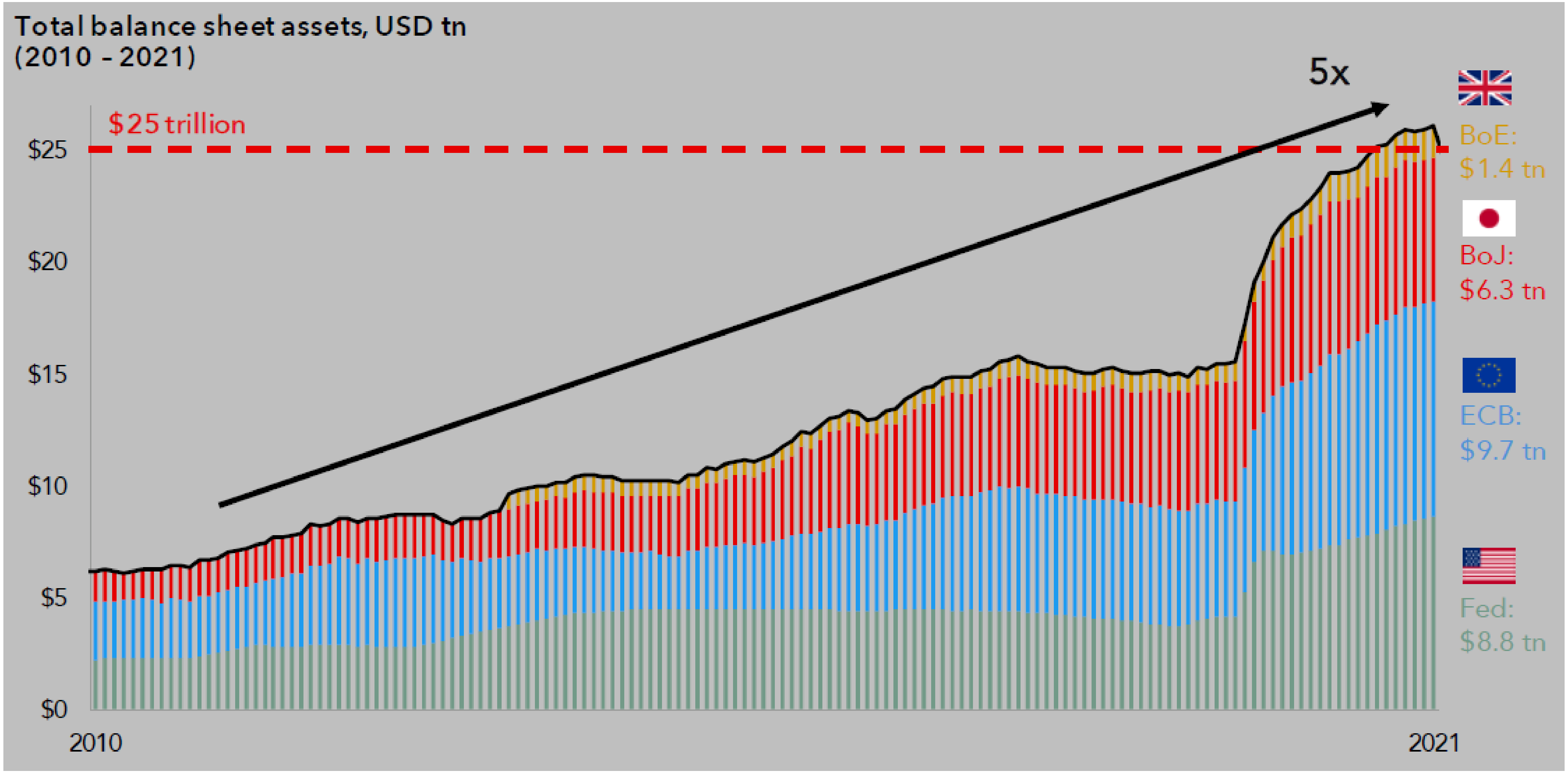
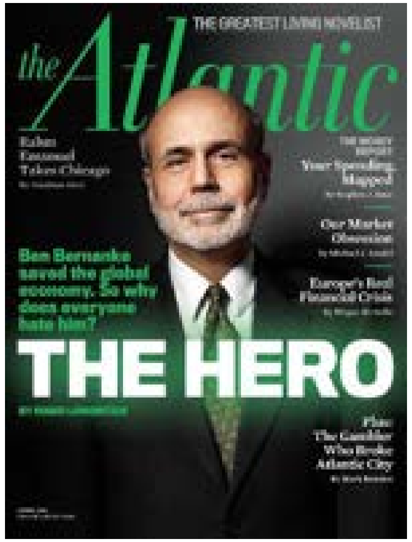
Top Central Banks' Balance Sheets Up 500% Since 2010

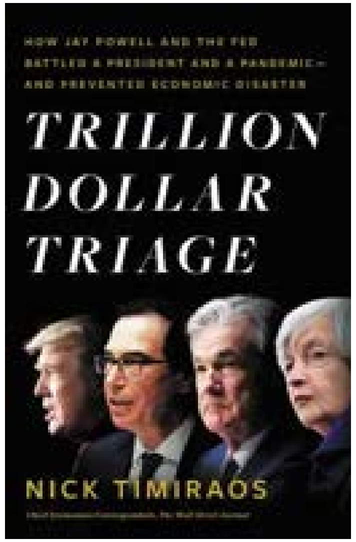


Source: MUFG, Tom Joyce

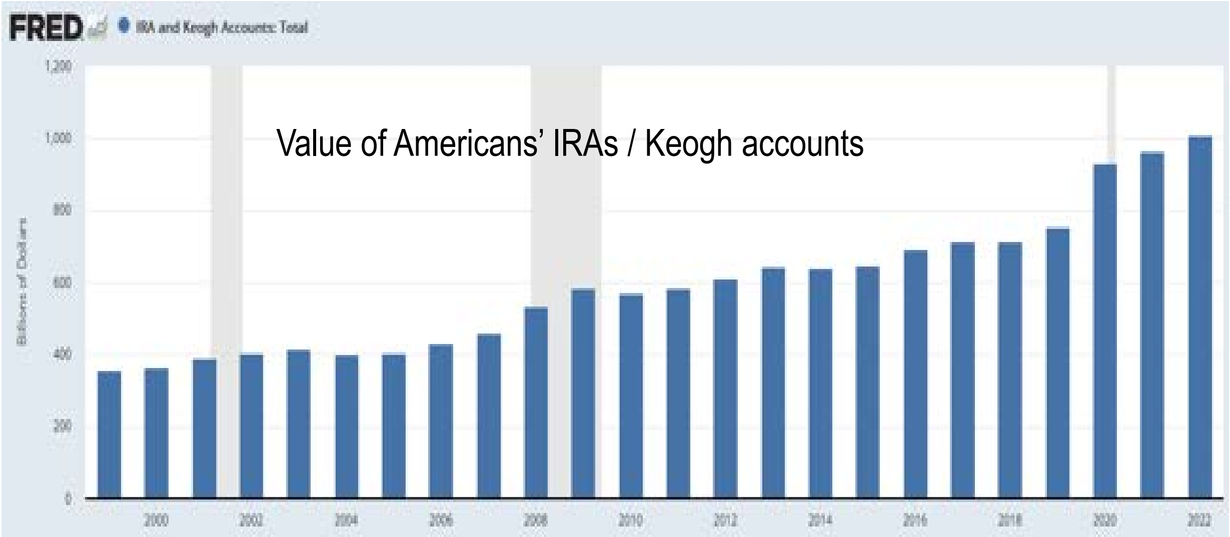
UPSIDES: DISASTERS AVOIDED (OR JUST DEFERRED?)

Prevent Depressions





Protecting Investors



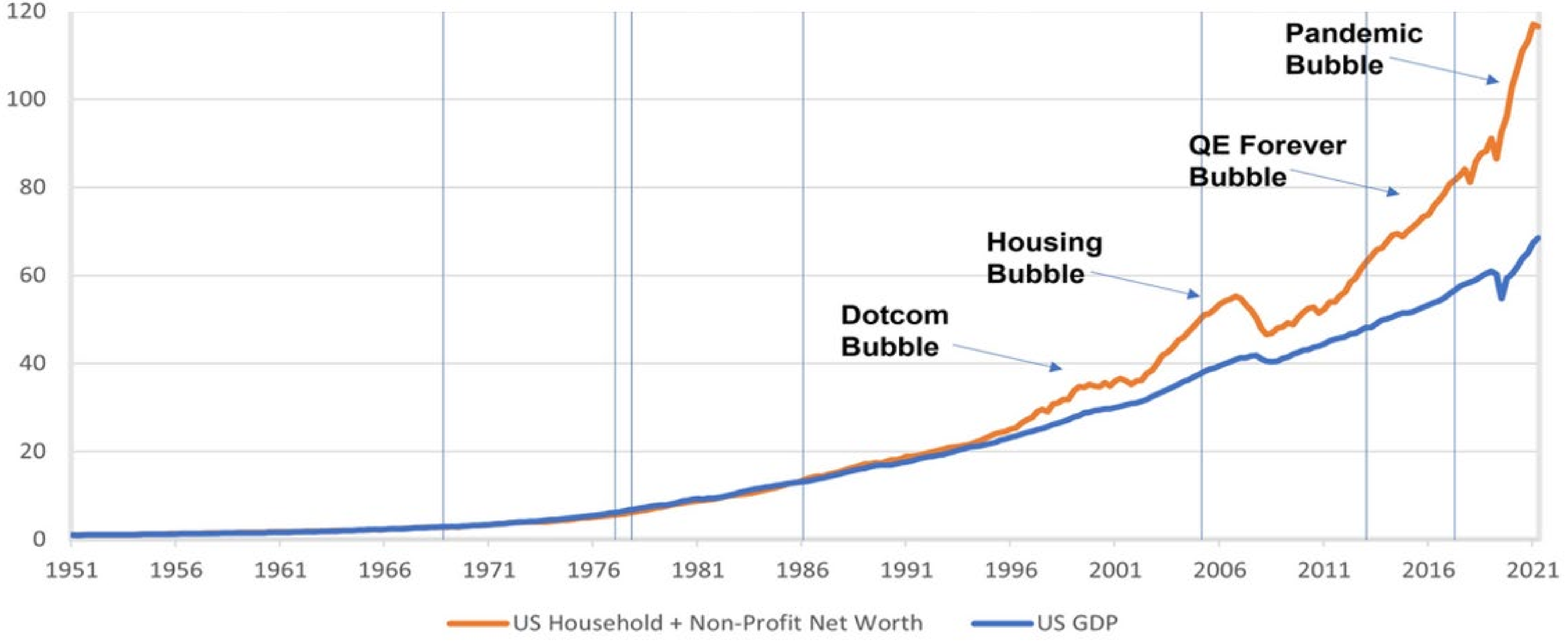
Source: The Fed (FRED)

DOWNSIDES: ASSET BUBBLES GREW AS INVESTORS SOUGHT YIELD

U.S. Wealth Growth vs. U.S. GDP Growth

Oct. 1951-Jan. 2022

(Nominal USD, Oct. 1951 = 1)



Source: Ben Hunt, Epsilon Theory

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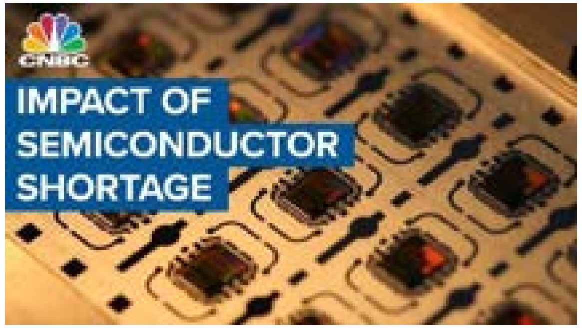
WHAT CHANGED

Supply Shocks



Demand Shocks

Source: U.S. Department of Commerce and Wells Fargo Economics

WHY UNSUSTAINABLE: BRAVE NEW INFLATIONARY WORLD

Macro Trends Enabling Easy Money (2000-2020) Are Reversing (2020-2030)

Disinflationary Trends 2000-2020		Inflationary Trends 2020-2030
Millennials join; China cheap	**LABOR**	Boomers quit; China pricier
Fracking revolution; Nat Gas	**ENERGY**	Fossil fuels discouraged; Russia
Fewer regs, more connectivity	**TECH**	More regs, data localization
Offshoring; Globalization	**TRADE**	Reshoring; Deglobalization
Just in Time	**MINDSET**	Just in Case

Two Decades of Easy Money Built a Fragile World

THE POLICY: DEFINING THE NEW NORMAL (AND STICKING TO IT)

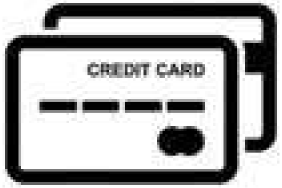
Reducing Moral Hazard

Reassessing Systemic Risk

Managing Higher Rate Fallout


Home mortgages


Health care debt



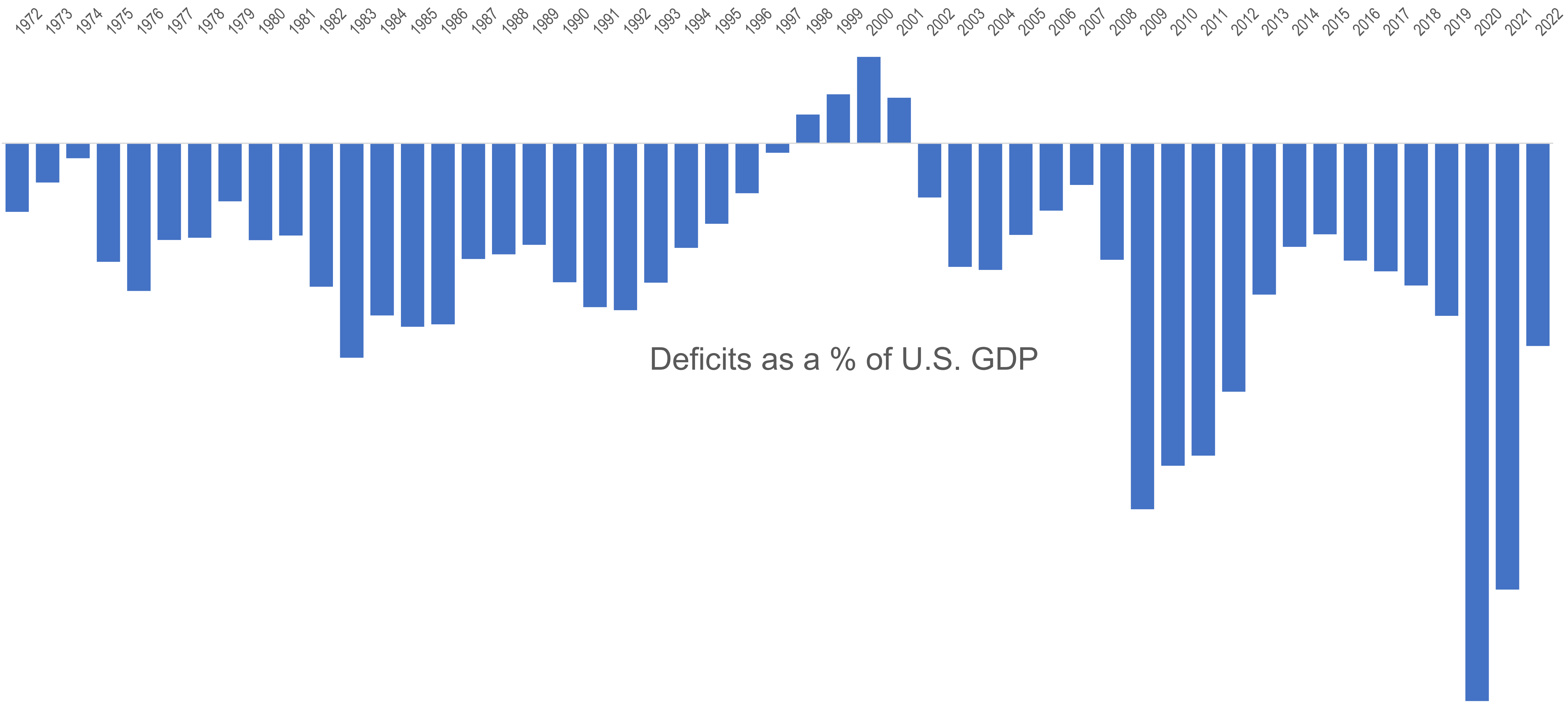

Student debt

DEBT

Unsustainable Economics May Soon Force Hard Choices

THE TREND: U.S. HAS NOT LIVED WITHIN ITS MEANS

50 Years of Deficits Under Democrats & Republicans, in Peace & at War



Source: The Fed (FRED)

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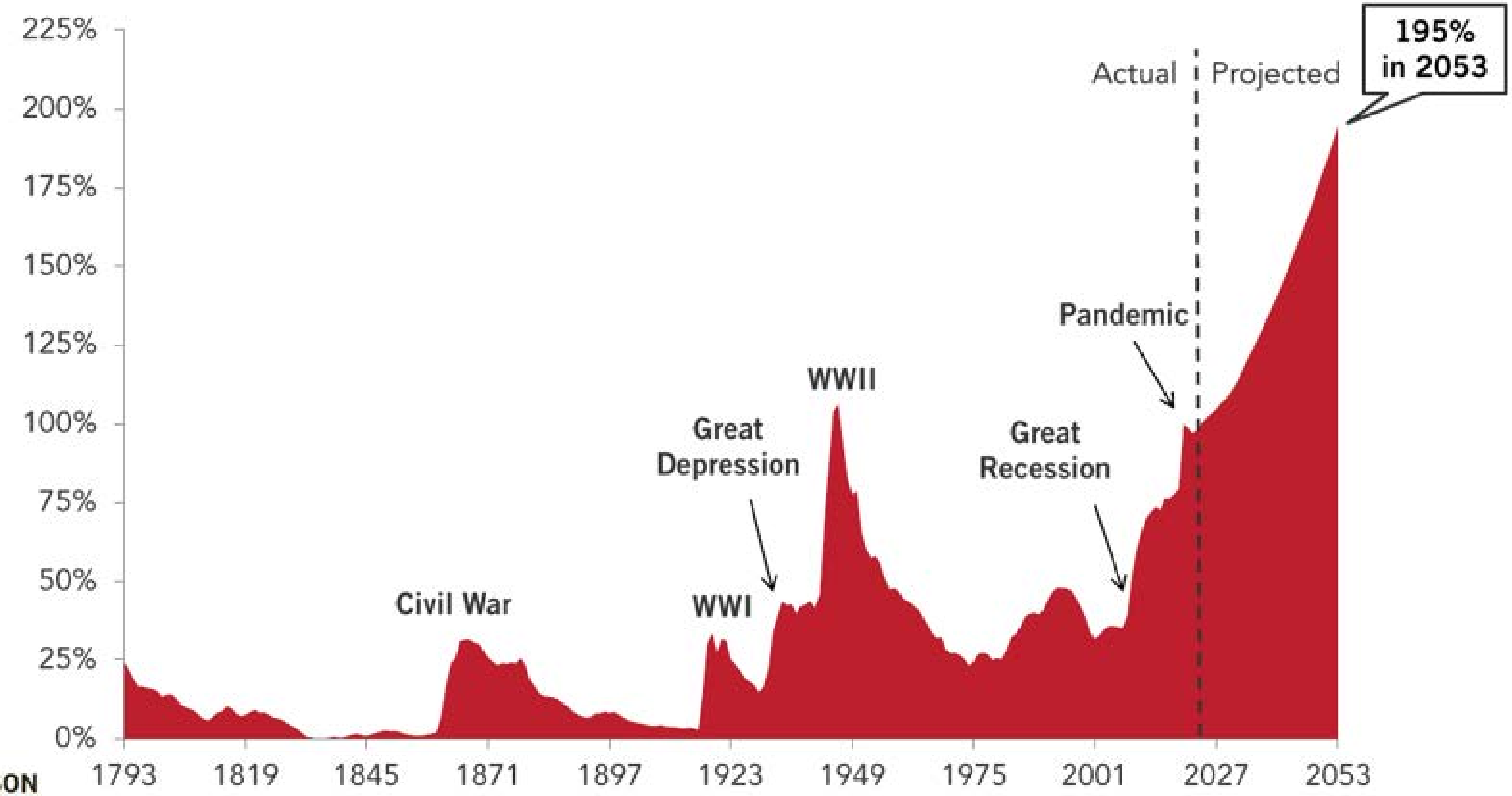
THE TREND: FEDERAL DEBT NOW EXCEEDS WARTIME LEVELS

Debt Held by the Public (% GDP)



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SOURCES: Congressional Budget Office, The Budget and Economic Outlook: 2023 to 2033, February 2023; and The Budget and Economic Outlook: 2020 to 2030, January 2020.

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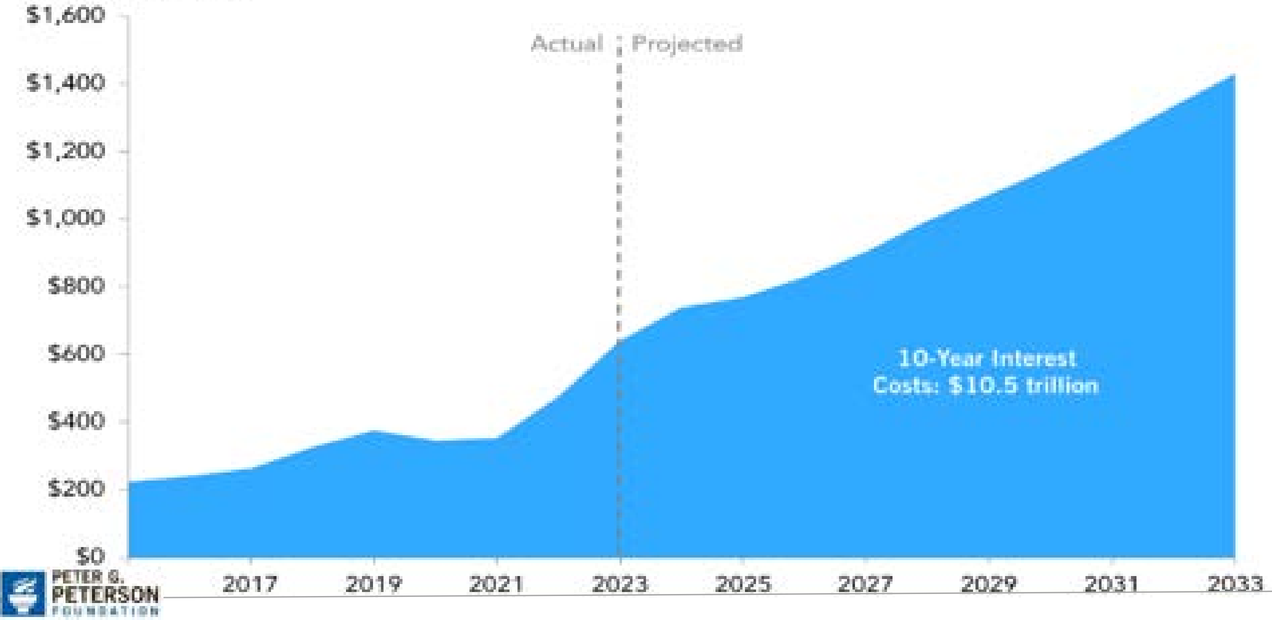
UPSIDES: HARD CHOICES AVOIDED (DEFERRED)

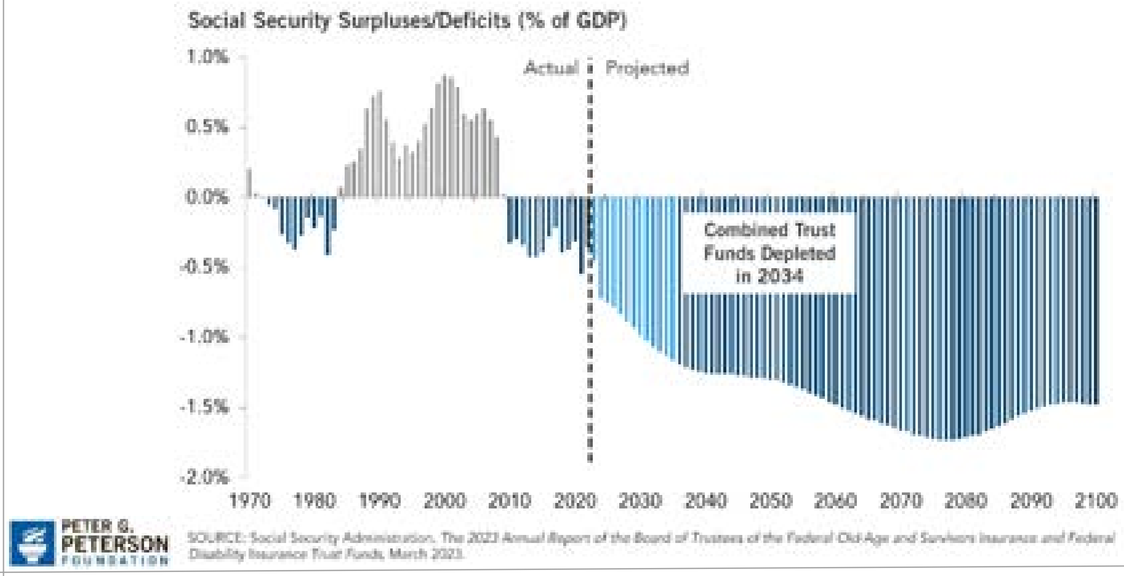
Two Decades of Funding Military, Expanding Entitlements, Rescues & Tax Cuts

DOWNSIDES: BILLS ARE COMING DUE

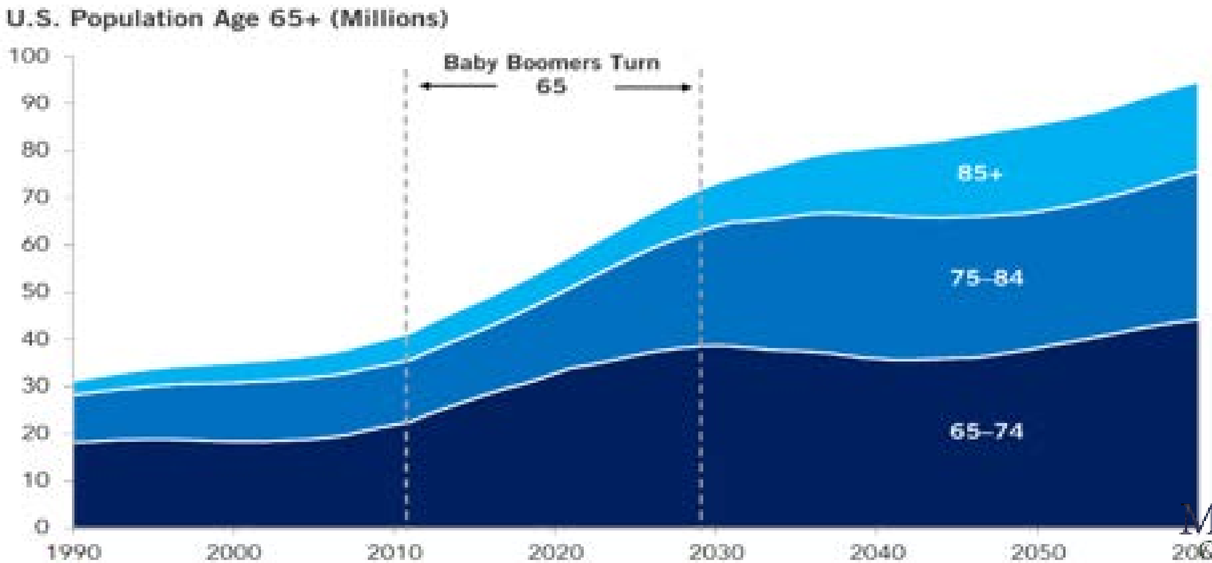
Interest Costs Soaring



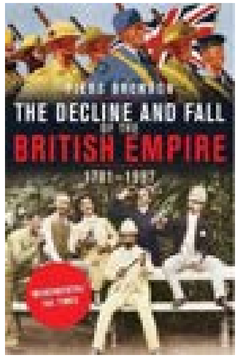
Social Security Trust Fund Depleting

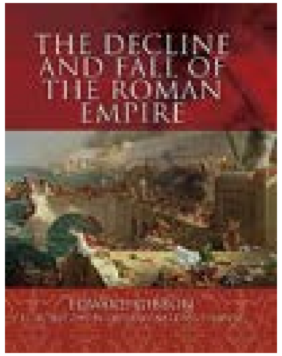


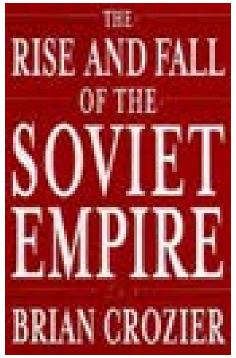
Aging Boomers Will Tax Medicare



Debt Drove Imperial Declines

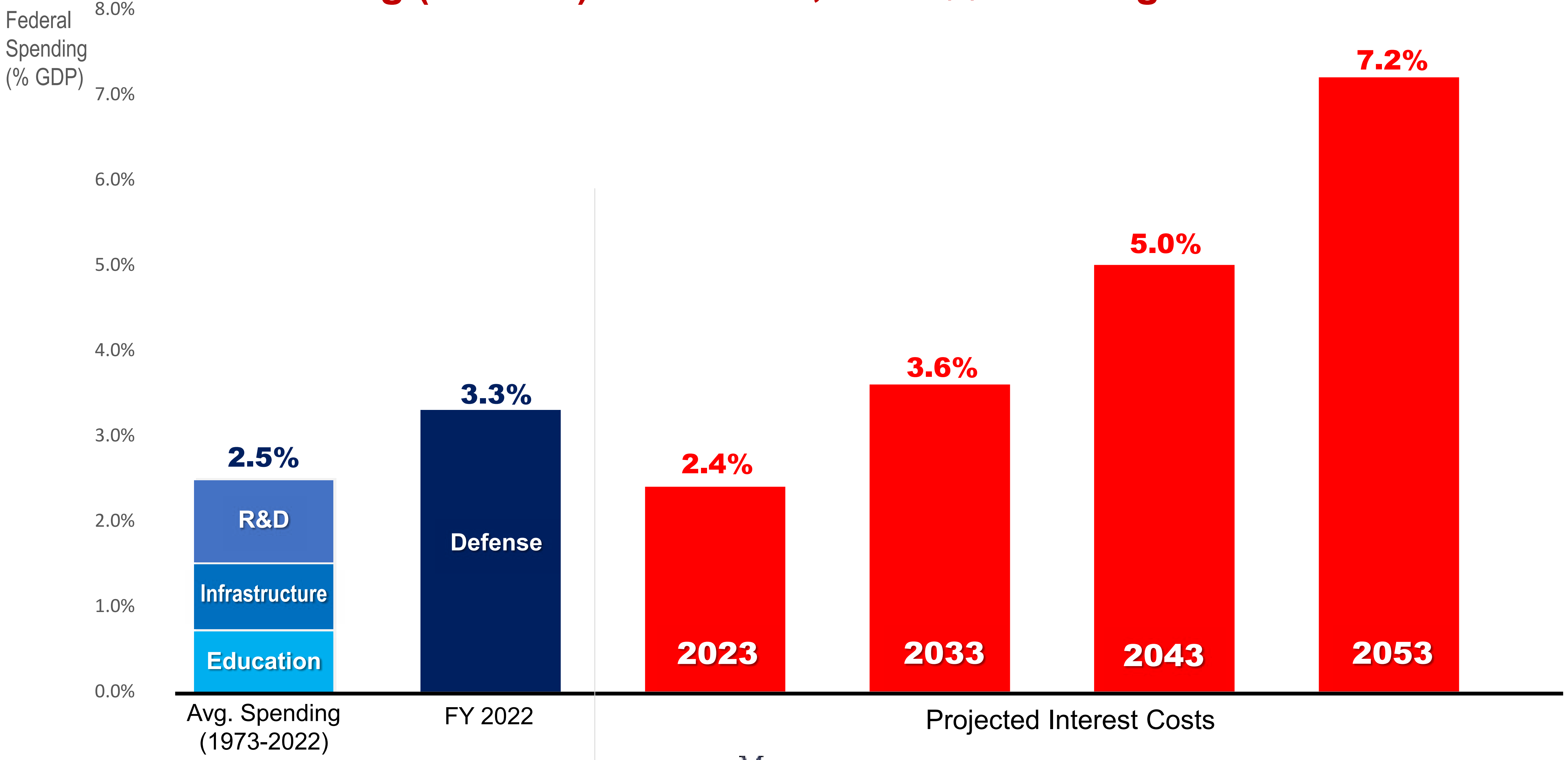






WHY UNSUSTAINABLE? INTEREST COSTS CROWD OUT OTHER PRIORITIES

As Debt Servicing (Interest) Costs Rise, Less $$ for Long-Term Investments



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The 2023 Debt Ceiling Showdown

Both sides believe they're right.

Both sides believe they're winning.

Both sides believe the other will blink.

Both sides believe failure hurts the other worse.

There will be a deal, but…

…before the pain or after?

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Options to Reduce Federal Debt

INCREASE REVENUE

Reduces growth, investment & innovation

REDUCE SPENDING

Shrinks safety nets & investments in the future
(Defense, R&D, Education, Climate)

INFLATE CURRENCY

Crushes savers, reduces investment & increases interest costs on debt

CONCLUSIONS

Reasons for Despair, Reasons for Hope

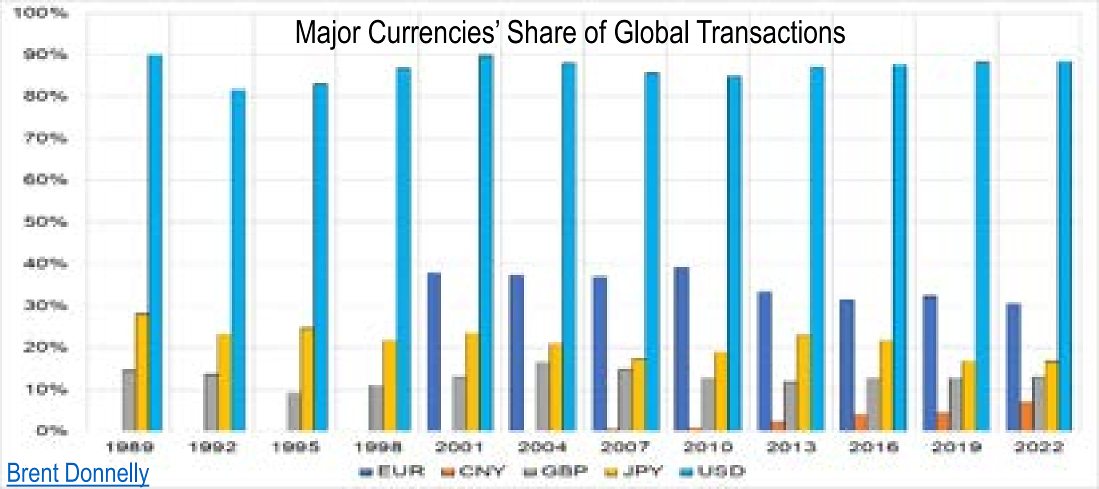
Solutions to Each Challenge Could Make Solving the Others Harder

FIX CHINA	FIX DIGITAL	FIX EASY MONEY	FIX DEBT
• Accelerate tech champions • Restrict trade / decouple • Invest more (DOD, R&D)	**Harder**	**Harder**	**Harder**
Harder	• Slow tech "champions" • Accept lower efficiency • Spend more on govt regs	**Harder**	**Harder**
Harder	**Harder**	• Less decoupling / trade • Maximize productivity • Raise interest rates	**Harder**
Harder	**Harder**	**Harder**	• Invest less (DOD, R&D) • Spend less on govt regs • Slow interest rate hikes

CHINA: Neither Side Wants War, Both Have Lots to Lose

DIGITAL: Productivity Gains Likelier than Robot Enslavement

EASY MONEY: "Exorbitant Privilege" Persists, Dollar Still Dominates



Source: Brent Donnelly

DEBT: Past 6 Presidents cut spending deals with hostile Congresses

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The Solutions Are Known… Just Hard to Implement

CHINA → Constrain & Contain, But Don't Corner

- Limit trading that helps China's military or maintains dangerous dependencies
- Expand trading with allies & regional military coordination
- Maintain communications & economic engagement to make space for reform

DIGITAL → Regulate, Don't Suffocate

- Seek greater transparency & awareness of emerging technologies' benefits & risks
- Push for greater accountability from tech creators & distributors
- Maximize national standards & global harmonization

EASY MONEY → Reset Expectations, Don't Revert

- Reassess & specify what's too systemically-important to fail… add guardrails
- Privatize losses where privatized gains… allow failures

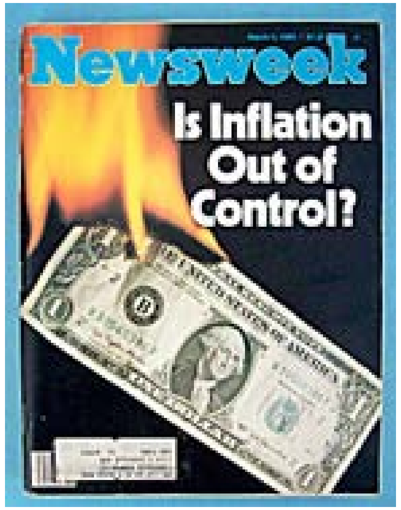
DEBT → Reform Together, Don't Fall Apart

- Compromise to avoid default, economic / market meltdown
- Ensure entitlements are sustainable long-term
- Invest in U.S. workforce productivity

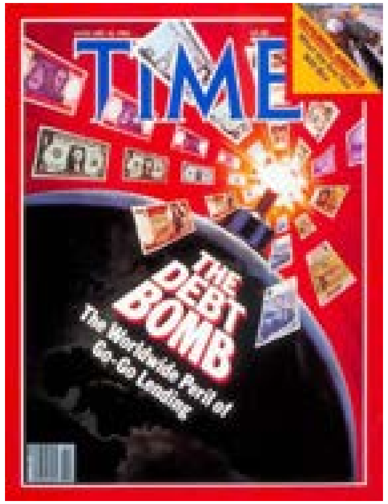
DOOMSAYERS GONNA DOOMSAY

1973

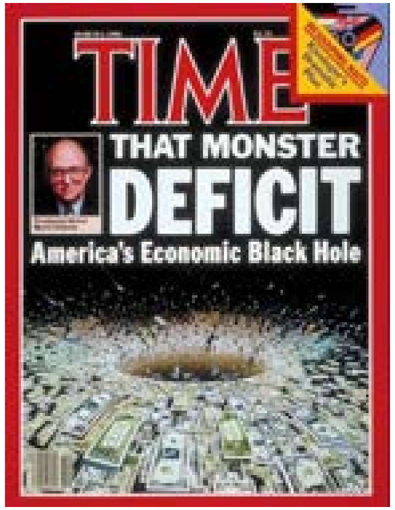
1980



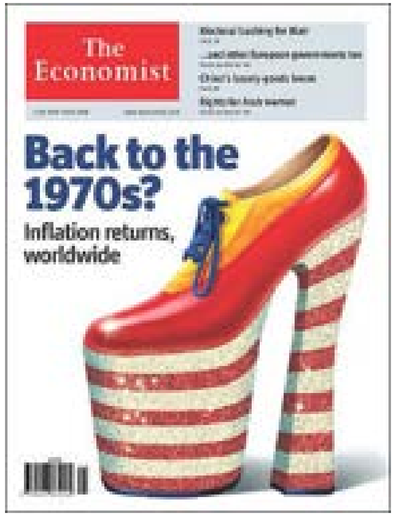
1983



1984



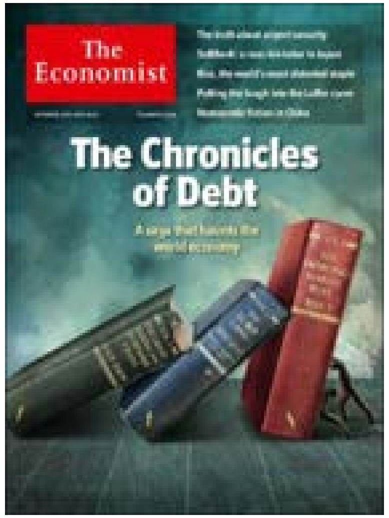
2004



2008

2011

2015



2016

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