

How a Stock Bubble Could Unwind America's National Security

By Sam J. Tangredi

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On Jan. 7, Tesla Inc. became the most highly valued automobile manufacturer in U.S. history. A nearly fourfold increase since July brought its stock to \$471, carrying its market cap (\$85 billion) far beyond those of General Motors (\$50 billion) and Ford (\$37 billion). Since then, Tesla has surged past Volkswagen AG to trail only Toyota as the world's most highly valued automaker. Its stock rose past \$900 last week and has at this writing retreated to the high \$700s — still an unprecedented valuation for a 15-year old company that has never turned an undisputed profit.

Investors who bought Tesla shares on the rise are undoubtedly ecstatic. Those who shorted Tesla shares are likely depressed. Technophiles and true believers are enthusiastically trumpeting Elon Musk's vision of the future. The cautious who invest based on economic fundamentals are shaking their heads, but with a certain degree of grudging amazement.

National security professionals should be afraid.

A Bubble is Building

My purpose is not to denounce Tesla, but to point out that it is providing national security professionals with a case study in the making. The company has both a reputation as one of America's most innovative companies and a valuation reminiscent of some public corporations of the late 1920s. Last year, Tesla lost \$1 billion in what was ostensibly its most profitable year. Despite a whole variety of subsidies/environmental tax credits (expired or gradually expiring) and what can only be called creative accounting techniques (such as charging warranty expenses to "good will"), it has lost money every year of its existence, even as it has piled up increasing billions in corporate debt.

On an aggregated basis, it loses \$3,000 on every car it sells. Some might claim this representation is simplistic (it is), that the figure counts costs associated with other corporate activity (it does), and that such losses can be turned around through an "inevitable" increase in sales volume or through the much-promised development of autonomous driving. That is, until they recognize that every other auto manufacturer in the world is developing electric vehicles, others are also (very publicly) working on autonomy, and that it is thoroughly improbable that Tesla will increase (or even maintain) its market share against companies that produce ten times the number of cars. In short, based on all rational measurements, it is unlikely that Tesla ever have earnings that justify its valuation.

OK, so Tesla might be a risky stock. It might crash. But has that to do with national security?

Everything. The crash—which will also affect other high-valuation stocks—will hurt defense industry, the U.S. dollar, and add weight to the building wave of deglobalization.

What's the Problem?

Before we discuss national security directly, let us take another look at immediate financial and political effects. Even if one accepts the technophile claim that "Tesla is a technology company, not a car company" (although cars are over 90

percent of its business), the economics of the situation does not look good. As *Barron's* recently put it: "It Makes No Sense."

The company's stock crash would not be a mere Wall Street adjustment; a hard landing is a foregone conclusion. In any supply-and-demand situation, what goes up must eventually come down. At a certain point, investors will determine there is little prospect in more gains. Then they stop buying. If nobody buys the stock, its value falls, investors bail, and those who bought near the top end of the rise—particularly those who leveraged their investment (i.e. owe money)—will sustain severe losses. If it sounds like musical chairs, it's only because it is.

But Tesla will not go down alone. This is a company valued beyond companies ten times its size that earn steady, year-after-year profits. It is the most talked-about, most hyped, and most praised, most damned company in the world. Only Google, Apple, or Microsoft can compete for media headlines—and they all make an actual profit. In what can understatedly termed a "correction," the losers, particularly if they are politically connected investment banks—the too-big-to-fail crowd—will call for some form of governmental offset. A "so shocked" media, a sweating Congress, populists who decry the dominance of Wall Street over Main Street, progressives who see the Market as symbolizing all the greed and exploitation of rich white males (albeit, not necessarily Anglo-Saxon and Protestant) are going to make the current political division of America even greater than it is today. There's the potential political effect.

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What drove the stock to dizzying heights? Social media, the celebrity of the CEO, the perceived environmentalism of its product, and the gradual loosening of basic accounting requirements are all viable reasons. However, the greater reality is that with interest rates held artificially low by the Fed (and national banks everywhere), there is simply so much—too much—money available to invest. Large and institutional investors are willing to make wild risks in the competitive search to turn the highest profits.

So, again, what is the national security problem if one astronomically overvalued stock fails and Wall Street has a very bad year? What does that have to do with defense?

Bubbles and the Defense Industry

There are four such problems. First, bubbles depress investment in defense companies. Second, is the increased cost of the U.S. government deficit. Third is the effect on the U.S. dollar as world reserve currency. Finally, and perhaps more importantly, it brings us deeper into the growing cycle of deglobalization.

The effect on defense industry is under the radar, but cumulative. The greater the attraction of the bubble, the less investors are willing to back the 'staid' companies dependent of continuous capital reinvestment. That includes practically all defense companies, even those specializing in software and AI. Their profits are long-term, not short. They do not provide the instant gratification that chasing a stock bubble—and beating the Market—can provide. As a defense industry CEO said at a recent conference: "When I need more capital to modernize plant infrastructure, not only do I have to persuade my board that the modernization is needed for us to adapt to emerging technologies, but also that the company can make more profit that way than by putting its free capital into the [stock] market."

If chasing a Tesla-like stock—symbolic of chasing an overall Market bubble—provides instant gratification, why invest in a capital and labor intensive industry like shipbuilding? Under the enduring principle that "bad money drives out good," too much money available for investment does *not* mean that the money is being invested in long-term improvements in corporate infrastructure. In fact, it has the opposite effect because investment managers must prove they can get profits faster than their financial competitors.

Capital investment in defense industries seems less appealing in that situation.

Effect on the Deficit

The U.S. government manages its deficit in revenues, effectively, by borrowing money at low rates. This it does by selling and buying its own Treasury bonds. The question is: do interest rates remain low when a stock bubble bursts?

In theory, they should remain low (or even get lower) since investors (those who still have money) are expected to jump out of the stocks and into bonds. This would drive up the price of bonds and drive down the rate of interest that the companies issuing bonds are required to pay investors to entice them to loan them the money. But what if the bursting bubble spooks investors and they prefer to sit on cash or invest in tangible assets, such as gold?

The bursting of a big-enough bubble—with fear fueled by a stock market-fixated media—might drive investors out of bonds as well as stocks. Interest rates rise; the deficit gets more expensive; government spending in “discretionary spending” must be cut; defense spending is viewed as “discretionary,” particularly if China and Russia mute their public reactions and restrain themselves from adventurous activities while this happens.

Even worse might be the long-range effects if investors pour into bonds, interest rates go lower, the federal government gets comfortable in borrowing more money and then has to face the day when interest rates *have* to go up.

What if the government decides it is obliged to bail out the losing “too big to fail” investors? Where will that money come from?

In any of these cases, the consequences for the defense budget will inevitable be negative. Steady growth in the economy allows for growth in the defense budget; bursting bubbles do not.

Why Should the Dollar Remain King?

Global finance presents more and more options, particularly as the economies of China and India—potentially the world’s largest and most valuable markets—have increased. Why should global investors be so tied to Wall Street (and U.S. securities) if it is prone to such a bubble and the U.S. government is unable or unwilling to stop absurd speculation? Why not invest in other stock exchanges, valued in other currencies—particularly where other governments are more likely to step in to ensure stability?

In an insidious way, Beijing-styled managed capitalism is actually more attracted to institutional investors who seek stability more than anything else.

If investment flees U.S. financial markets because of their “irresponsibility” and finds stability elsewhere, the justification for the U.S. dollar remaining the world’s reserve currency becomes ever weaker, particularly with China and Russia pushing to topple it. If the dollar is no longer the world’s reserve currency, what guarantees are there that the U.S. government can still borrow money at low enough rates to fund deficits—and its defense budgets?

If the U.S. dollar is no longer the world reserve currency, the resulting economic waves will crash against the alliance structure we have built over eight decades.

Hastening the Slide

When will the correction happen? That is the great unknown. But when it happens, the repercussions will be felt in U.S. national security, not just in the economy. The effects cascade. The ultimate result will be increasing fear for financial security throughout America and those nations most influenced by America.

Post-Cold War optimism notwithstanding, neither democratization nor continued globalization are inevitable. Contrary events—particularly bad choices, or good choices managed badly—routinely knock perceived trends off course.

Globalization has been more than knocked sideways by the rise of populism, concerns about immigration and emigration, ethic aspirations, trade disputes and the resurrection of authoritarian governments. Its parabolic cycle has started sliding down the downslope.

My research indicates that there are five stages to deglobalization. They consist of: 1) a growing fear for economic and personal security, 2) an increasing sense of disillusionment with the promises and overall value of globalization and a globalized society (which might occur even while economic indicators are generally positive), 3) economic downturns fueled by sporadic but increasingly frequent periods of fear and distrust of current economic conditions or practices, that manifest themselves as financial “bubbles,” 4) the rise of increasingly demagogic political leaders claiming to provide relatively quick—and often radical—solutions to deteriorating conditions, and 5) international conflicts that eventually lead to a system-changing war that ends or greatly reduces the physical and social structure on which the era of globalization was built. At that point, the imperative for cooperative globalization is replaced by national economic self-sufficiency, referred to as “autarky,” or rival regional groupings.

The stages do not necessarily begin sequentially, but they increase in momentum in that relative order.

What stage are we at in deglobalization now? I would argue that the first two have already started. According to mainstream thought, the initial financial bubbles of the third—including the recent tech bubble and housing bubble, are supposedly behind us, but I argue that they will reoccur. My assessment is that Tesla’s current defiance of fiscal gravity will lead to another and sharper burst.

Economists might call my concerns “simplistic.” Yet strategists learn that simple plans generally work while convoluted plans often fail. The starting point of all analysis is to state a problem in its simplest form. The coming stock bubble burst is a problem. The ripple effects will act like an electric vehicle charging station for deglobalization.

In a democracy, if you cannot afford butter, you cannot afford guns. This may not be a problem in authoritarian states. Under this contrast, whose military capabilities will grow in relative terms? Probably not ours. Goodbye, lingering global primacy. Goodbye, credibility. Goodbye, firm alliance structure.

I’m afraid.

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