22nd Annual Hyman P. Minsky Conference on the State of the U.S. and World Economies
*"Building a Financial Structure for a More stable and Equitable Economy"* April 17-19, 2013

# Bubble Risks And Macro Prudential Policy

Frank Veneroso

# Part I:
# The Hopeless Past Present And Future State of Regulation

Our regulators have been hopeless. Elizabeth Warren reminds us they remain hopeless.

# Senator Elizabeth Warren, Massachusetts

"If you're caught with an ounce of cocaine, chances are good you're going to jail. If it happens repeatedly, you may go to jail for the rest of your life, but evidently, if you launder nearly $1 billion for drug cartels and violate our international sanctions, your company pays a fine and you go home and sleep in your own bed,"

"How many billions of dollars do you have to launder for drug lords and how many economic sanctions do you have to violate before someone will consider shutting down a financial institution like this?”

Why no indictments? Because, Geithner said, they will rattle the markets. Attorney General Holder admits to something similar.

# U.S. Attorney General Eric Holder, Jr.

"I am concerned that the size of some of these institutions becomes so large that it does become difficult for us to prosecute them when we are hit with indications that if you do prosecute, if you do bring a criminal charge, it will have a negative impact on the national economy, perhaps even the world economy. And I think that is a function of the fact that some of these institutions have become too large."

In April 2008 Justice told us they knew commodity markets and especially oil were being manipulated.

Remarks Prepared for Delivery by Attorney General Michael B. Mukasey on International Organized Crime at the Center for Strategic and International Studies

Washington, D.C. Wednesday, April 23, 2008 - 1:30 P.M.

# Mukasey On Commodities, April 2008

Criminals target energy, financial markets, Mukasey says

•Attorney general: International organized crime is a growing threat to U.S. security
•Criminals have penetrated portions of the international energy market, Mukasey says
•Groups also trying to corrupt financial service providers, he warns

WASHINGTON (CNN) -- Attorney General Michael Mukasey warned Wednesday that organized criminal networks have penetrated portions of the international energy market and tried to control energy resources. The first threat we identified was that international organized criminals control significant positions in the global energy and strategic materials markets. They are expanding their holdings in these sectors, which corrupts the normal functioning of these markets and may have a destabilizing effect on U.S. geopolitical interests. In a speech at the Center for Strategic and International Studies in Washington, he said similar efforts have targeted the international financial system by injecting billions of illicit funds to try to corrupt financial service providers.

Justice Knew All, Because These Guys Know All.

# Attorney Mukasey Speech, April 2008

"U.S. intelligence agencies provided "vital input" into the threat analysis that underpinned the strategy, said a U.S. intelligence official authorized to speak to the media.“

If you know commodity markets you know the manipulators Mukasey was referring to.

# Overview Of The Law Enforcement Strategy To Combat International Organized Crime, April 17, 2008

http://www.justice.gov/ag/speeches/2008/ioc-strategy-public-overview.pdf

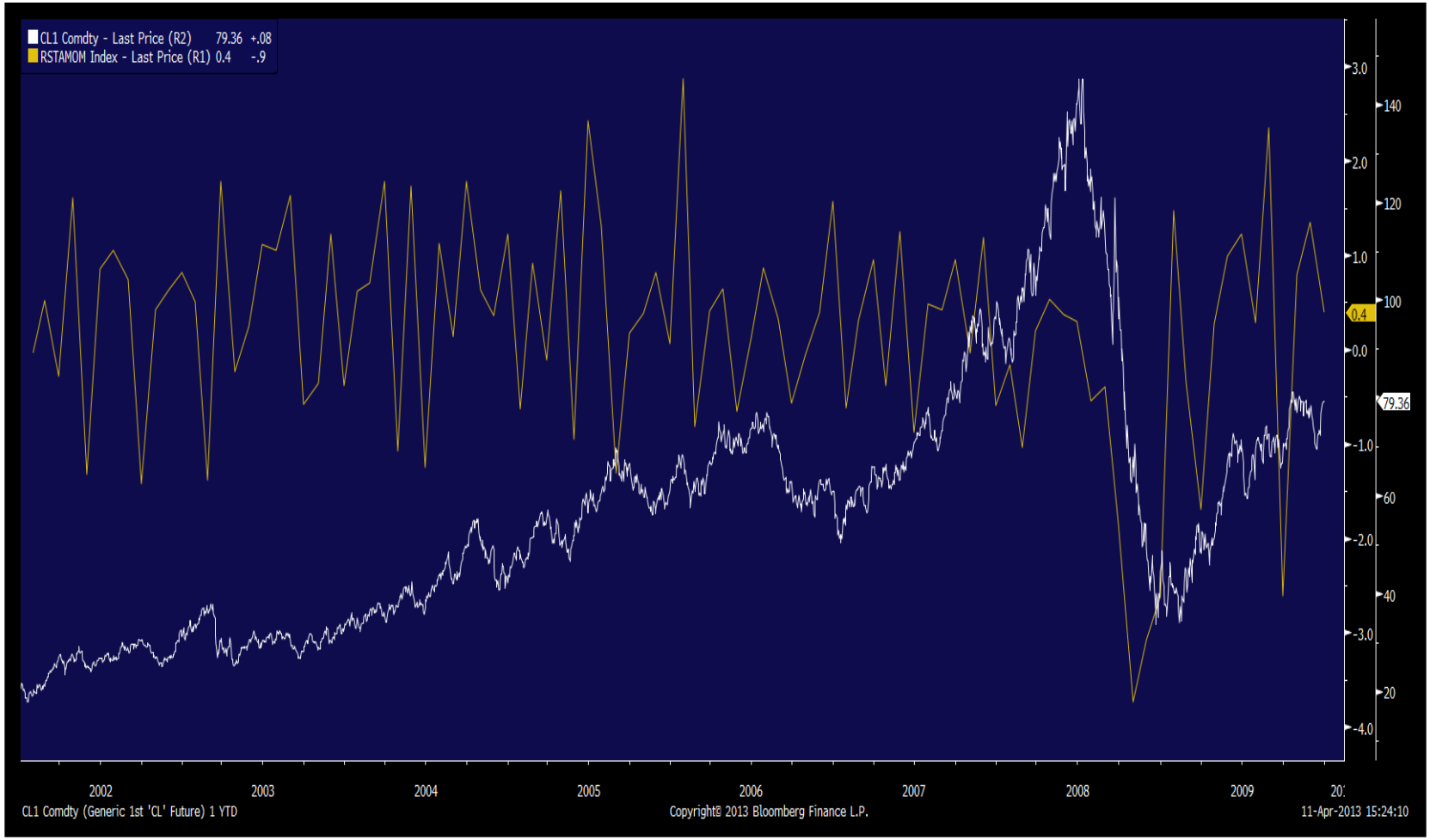
"International organized criminals do not need to reside in the United States to engage in criminal activities targeting the United States, its interests and its people. With the advent of globalization, the Internet, international banking and modern technologies, international organized criminals can remain in countries that provide them with safe haven from arrest while perpetrating criminal activities targeting the United States and its people.

The most powerful international organized crime groups benefit from the symbiotic relationship that their leaders have developed with corrupt public officials and business tycoons. The three elements combine forces to form strategic alliances.

International organized crime in its highest form is far removed from the streets. These groups are highly sophisticated, have billions of dollars at their disposal, are highly educated, and employ some of the world's best accountants, lawyers, bankers and lobbyists. They go to great lengths to portray themselves as legitimate businessmen and even advocates/benefactors for the local populace and others."

Just as the global economy was descending into recession and indebted consumers were under pressure, non economic forces sent the price of oil skyward. Immediately after the spike in oil prices, the indebted consumer collapsed.

# The Oil Price versus U.S. Retail Sales (QoQ Change)



No matter the administration, Justice will not act to protect us. Thanks to the GOP, the CFTC has no money to protect us.

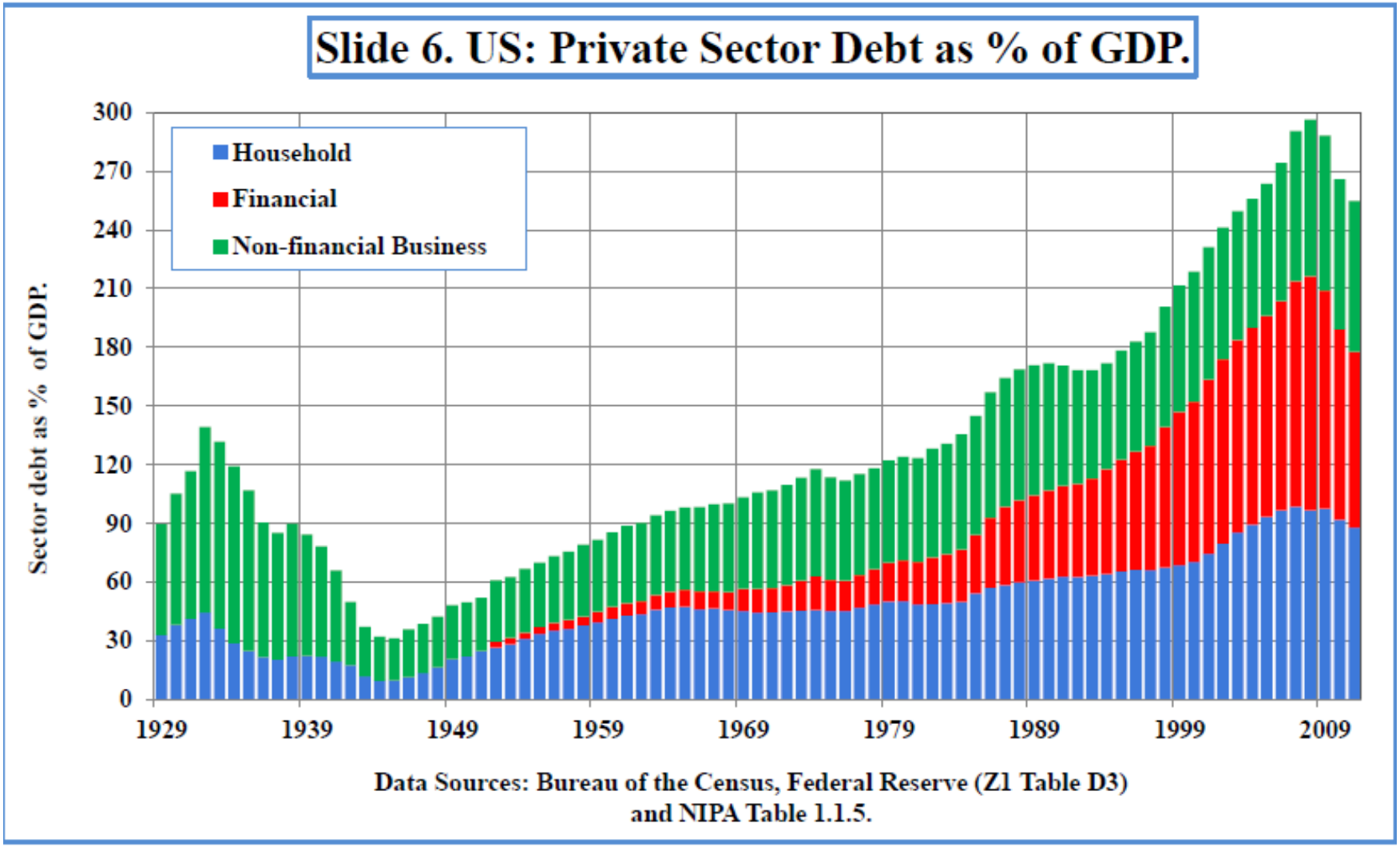
# Gary Gensler, CFTC Chairman

The nation cannot be assured this agency can closely monitor for the protection of customer funds and utilize our enforcement arm to its fullest potential to go after bad actors in the futures and swaps markets.

Testimony of Chairman Gary Gensler Before the US Senate Committee On Agriculture, Nutrition & Forestry,
Washington, DC February 27, 2013

# Part II:
# Can There Be Another Credit Bubble?

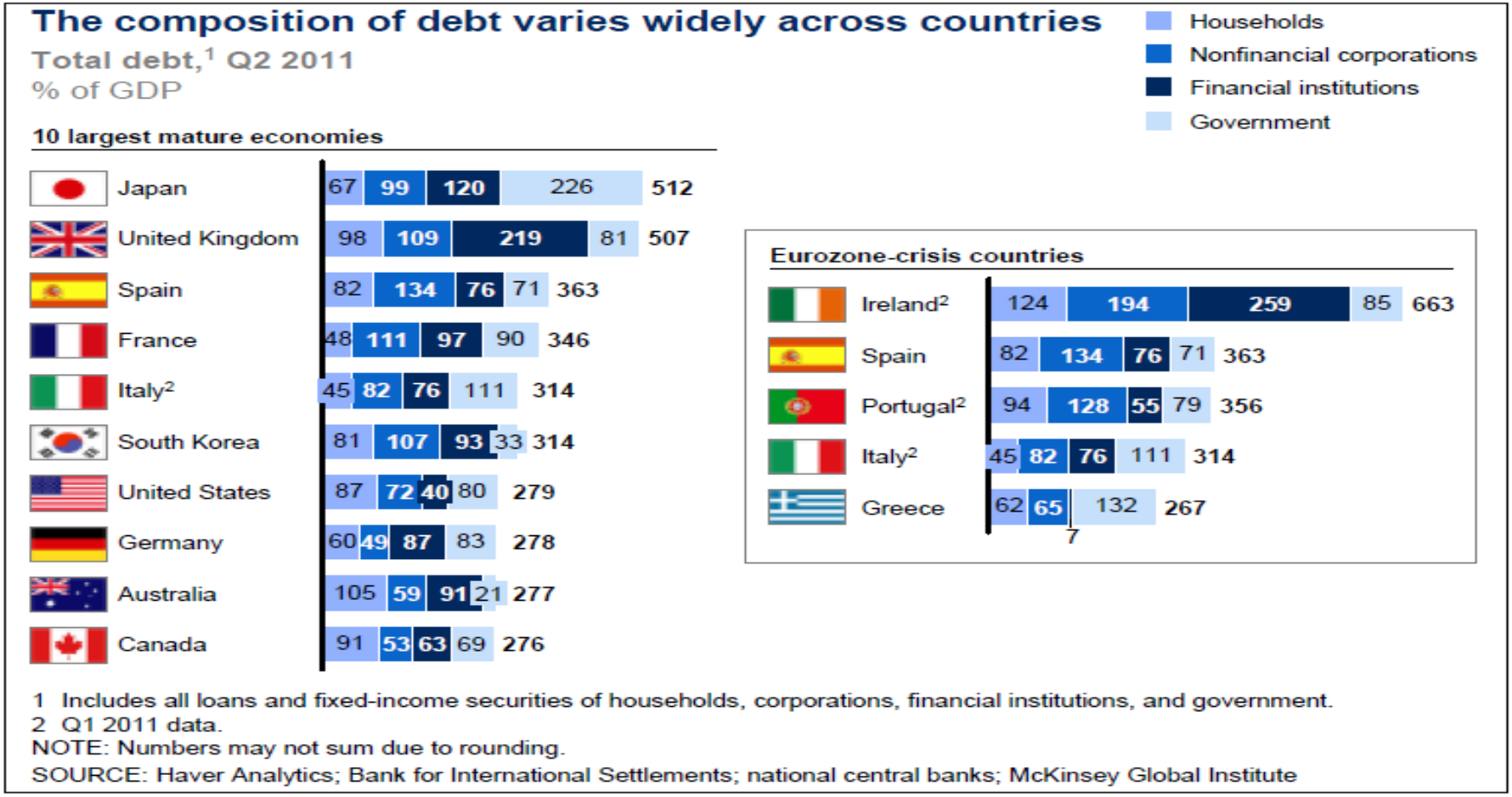
The ratio of private debt to GDP has come down, but only by a small amount. It remains very high. The U.S. household debt to GDP ratio is one of the highest in an indebted world. Contrary to common wisdom, corporations are highly indebted. Based on U.S. history and global comparisons any significant increase in this ratio should prove dangerous.




Andrew Smithers, Smithers & Co.

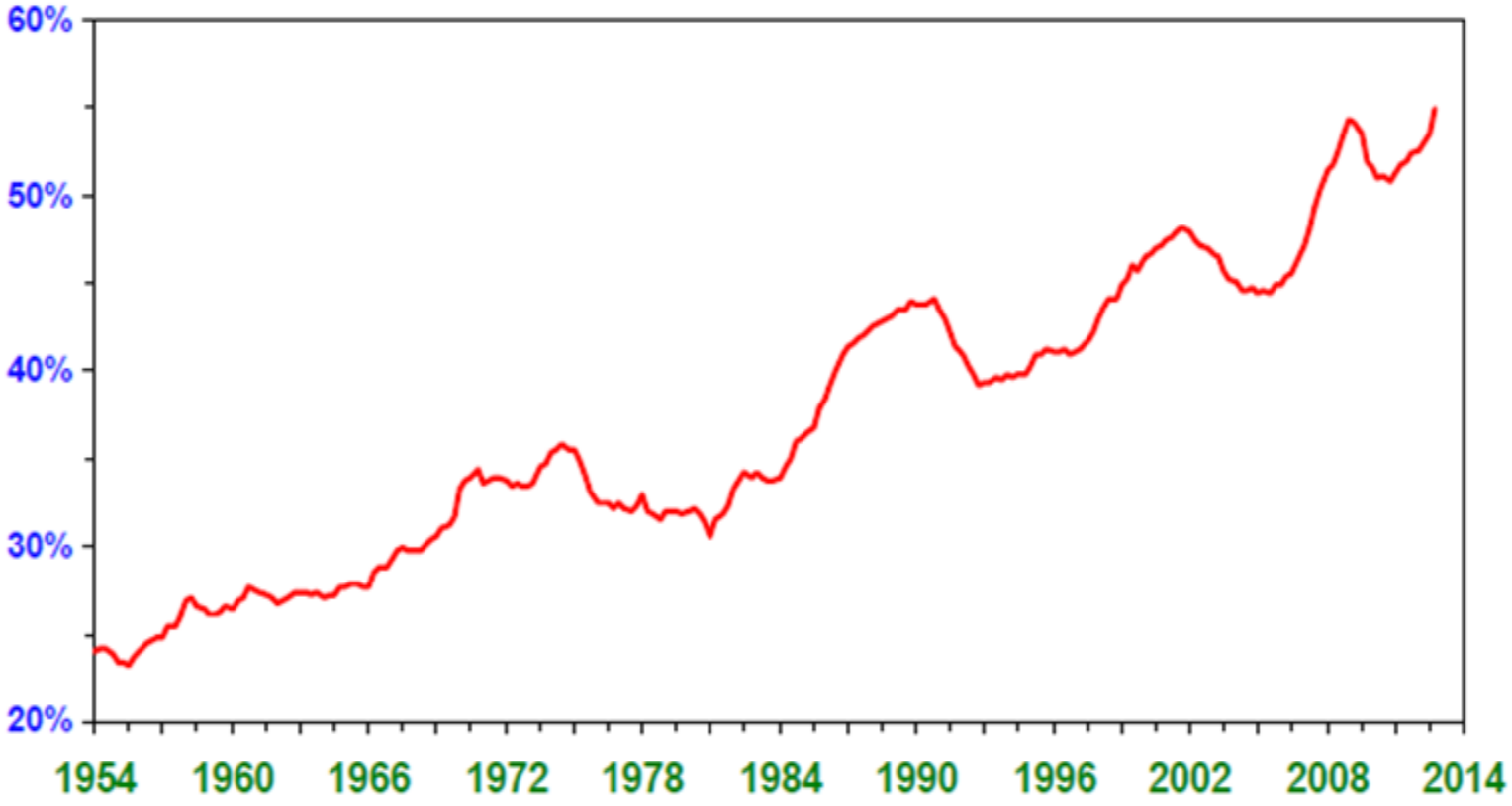
There are many ways of measuring corporate debt. What follows are several calculations. Corporate debt is high relative to U.S. history. Global corporate debt is high. The U.S. level is in the middle of the global range.

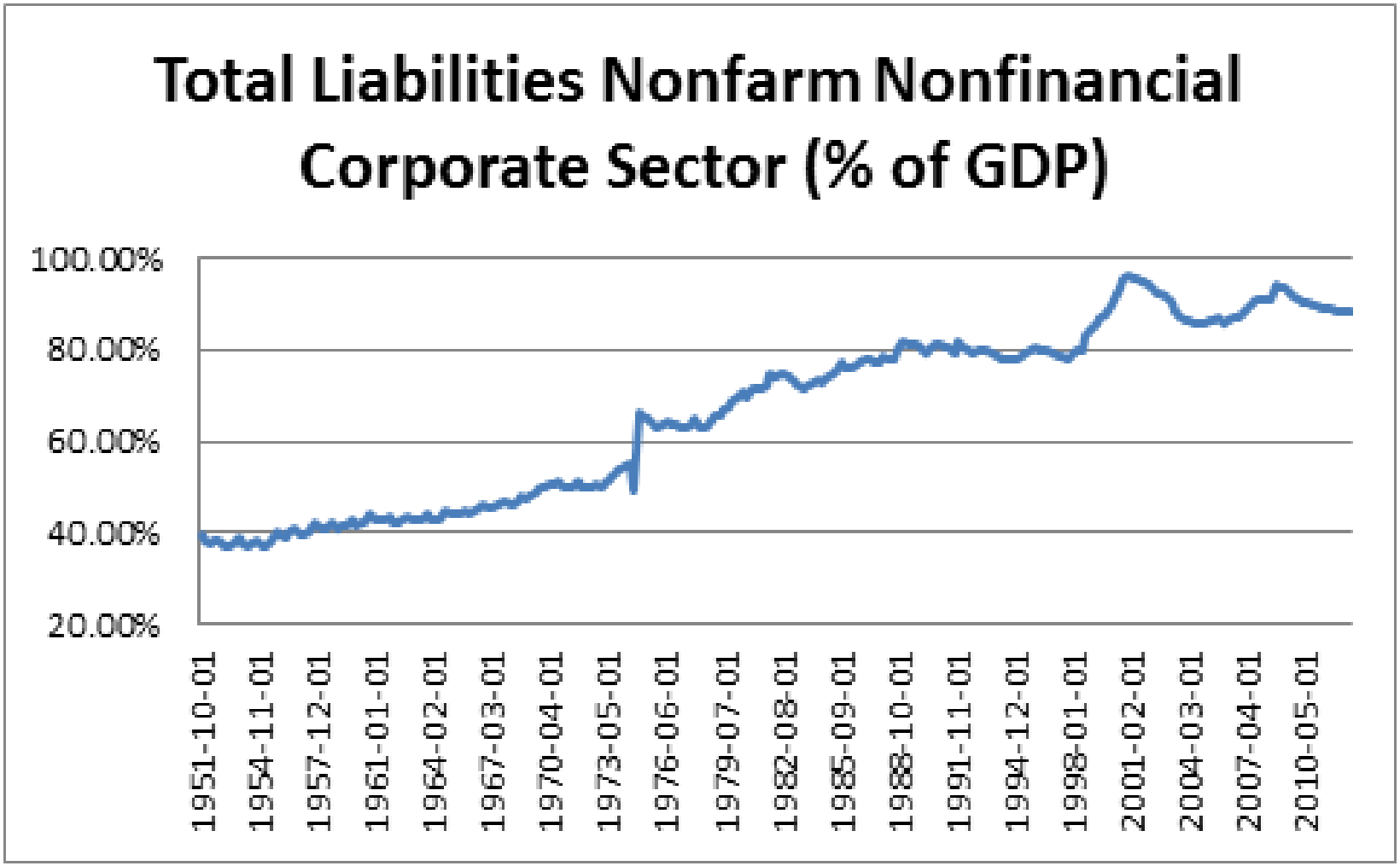
# Relative To A Europe In Crisis, U.S. Households Are Highly Indebted.




McKinsey & Company. January 2012

# Non-Financial Corporate Debt To GDP




Total Liabilities Nonfarm Nonfinancial Corporate Sector (% of GDP)
100.00%
80.00%
60.00%
40.00%
20.00%
1951-10-01
1954-11-01
1957-12-01
1961-01-01
1964-02-01
1967-03-01
1970-04-01
1973-05-01
1976-06-01
1979-07-01
1982-08-01
1985-09-01
1988-10-01
1991-11-01
1994-12-01
1998-01-01
2001-02-01
2004-03-01
2007-04-01
2010-05-01

Nouriel Roubini is more concerned about a credit bubble than I am. He argues that risky corporate debt is already on the rise. Existing financial fragility holds the Fed hostage. As a result, the Fed will move too slowly. There will be a 2-3 year credit bubble that will end in tears. I respect his argument.

# Nouriel: The Fed Will Respond Too Slowly

Well this time around, like last time around, the unemployment rate is very high. Actually higher than the previous cycle. Growth is even more anemic. And on top of it right now you have high levels of private and public debt so if the Fed made a mistake and exited too slowly in 2004 and took them two years to normalize the interest rate, the fed funds, so this time around their gonna go even more slowly because the economy is weaker, unemployment is higher and high interest rates are gonna kill the bond market and going to increase the debt burdens for the private and public sectors so they will be forced to exit even more slowly and if last time around we had a bubble this time around we're gonna have a bubble for longer than otherwise.

Roubini Says Austerity Backlash Big Economic Risk
Bloomberg TV Interview with Mark Burton
March 8, 2013

# Nouriel: So We Will Repeat The Last Cycle

So the beginning of the asset bubble has already been seen in credit markets in the United States high yield payment in kind covenant light is now spreading to emerging markets to commodities to U.S. and global equities. I wouldn't call it yet a bubble but another 2 or 3 years of very easy money of additional quantitative easing and very slow exits from zero policy rates could be the repeat of the cycle that led first to the bubble in 2004 and 2006 and eventually to the crash of 2006 and 2008. So that is going to be the scenario. Probably a repeat of what we have seen.

Roubini Says Austerity Backlash Big Economic Risk
Bloomberg TV Interview with Mark Burton
March 8, 2013

# Nouriel: Macro Pru Regulation Won’t Be Enough

Now the Fed is saying we’re going to use the interest rate to stabilize inflation and growth and we’re going to use macro prudential regulation of the credit system as a way of controlling the asset bubble but the recent critique by Jeremy Stein of the Fed board that said that the interest rate policy tool is the only one that can go in all the cracks and using macro prudential regulation is not going to do the job because when you have too much liquidity and you control one part of the credit market and liquidity is gonna go to another part is a valid critique so macro pru is not going to do the job, interest (rate) is going to rise very slowly and going to create another huge credit bubble ... asset bubble and is going to end up, eventually a couple of years from now, in tears.

Roubini Says Austerity Backlash Big Economic Risk
Bloomberg TV Interview with Mark Burton
March 8, 2013

# Part III:
# Keynes: The Irrational Casino Stock Market

I have heard Jeremy Grantham (GMO) say to Charlie Rose that Keynes' chapter 12 of the General Theory was the greatest piece ever written on the stock market. And that all of economics and finance has yet to catch up with Keynes. For a little less than 20 years Keynes was an incredibly aggressive leveraged speculator in all markets including stocks, and he was amazingly successful. Keynes account of risk asset market behavior is today's overwhelming market reality. The academically dominant body of efficient market theory and modern portfolio theory has NOTHING to do with reality. The next 6 slides quoting Keynes say it all.

# Extreme Uncertainty Blinds Us To The Future

The outstanding fact is the extreme precariousness of the basis of knowledge on which our estimates of prospective yield have to be made. Our knowledge of the factors which will govern the yield of an investment some years hence is usually very slight and often negligible. If we speak frankly, we have to admit that our basis of knowledge for estimating the yield ten years hence of a railway, a copper mine, a textile factory, the goodwill of a patent medicine, an Atlantic liner, a building in the City of London amounts to little and sometimes to nothing; or even five years hence.

The State Of Long Term Expectation
The General Theory of Employment, Interest and Money,
John Maynard Keynes

# So We Extrapolate The Present And Past

In practice we have tacitly agreed, as a rule, to fall back on what is, in truth a convention. The essence of this convention – though it does not, of course, work out quite so simply – lies in assuming that the existing state of affairs will continue indefinitely except in so far as we have specific reasons to expect change.

The State Of Long Term Expectation
The General Theory of Employment, Interest and Money,
John Maynard Keynes

# So Expectations Are Adaptive, Not Rational

# And All The More So In Liquid Stock Markets

As a result of the gradual increase in the proportion of the equity in the community's aggregate capital investment which is owned by persons who do not manage and have no special knowledge of the circumstances, either actual or prospective, of the business in question, the element of real knowledge in the valuation of investments by whose who own them or contemplate purchasing them has seriously declined.

The State Of Long Term Expectation
The General Theory of Employment, Interest and Money,
John Maynard Keynes

# So Investors Feel Comfortable With The Prevailing Trend

For if there exist organized investment markets and if we can rely on the maintenance of the convention, an investor can legitimately encourage himself with the idea that the only risk he runs is that of a genuine change in the news over the near future, as to the likelihood of which he can attempt to form his own judgment, and which is unlikely to be very large. For, assuming that the convention holds good, it is only these changes which can affect the value of his investment, and he need not lose his sleep merely because he has not any notion what his investment will be worth ten years hence. Thus investment becomes reasonably 'safe' for the individual investor over short periods, and hence over a succession of short periods however many, if he can fairly rely on there being no breakdown in the convention and on his therefore having an opportunity to revise his judgment and change his investment, before there has been time for much to happen.

The State Of Long Term Expectation
The General Theory of Employment, Interest and Money,
John Maynard Keynes

# Keynes: Expectations Are Not Well Anchored

A conventional valuation which is established as the outcome of the mass psychology of a large number of ignorant individuals is liable to change violently as the result of a sudden fluctuation of opinion due to factors which do not really make much difference to the prospective yield; since there will be no strong roots of conviction to hold it steady.

# Keynes: Professional Investors Game Those Loosely Anchored Expectations

It might have been supposed that competition between expert professionals, possessing judgment and knowledge beyond that of the average private investor, would correct the vagaries of the ignorant individual left to himself. It happens, however, that the energies and skill of the professional investor and speculator are mainly occupied otherwise. For most of these persons are, in fact, largely concerned, not with making superior long-term forecasts of the probable yield of an investment over its whole life, but with foreseeing changes in the conventional basis of valuation a short time ahead of the general public. They are concerned, not with what an investment is really worth to a man who buys it 'for keeps', but with what the market will value it at, under the influence of mass psychology, three months or a year hence.

# The Professional Investor Is All About Gaming The Other Guy

This battle of wits to anticipate the basis of conventional valuation a few months hence, rather than the prospective yield of an investment over a long term of years, does not even require gulls amongst the public to feed the maws of the professional; -- it can be played by professionals amongst themselves. Nor is it necessary that anyone should keep his simple faith in the conventional basis of valuation having any genuine long-term validity. For it is, so to speak, a game of Snap, of Old Maid, of Musical Chairs – a pastime in which he is victor who says Snap neither too soon nor too late, who passed the Old Maid to his neighbor before the game is over, who secures a chair for himself when the music stops. These games can be played with zest and enjoyment, though all the players know that it is the Old Maid which is circulating, or that when the music stops some of the players will find themselves unseated. . . .

The actual, private object of the most skilled investment today is 'to beat the gun', as the Americans so well express it, to outwit the crowd, and to pass the bad, or depreciating, half-crown to the other fellow. …

John Maynard Keynes, "Chapter 12: The State Of Long Term Expectation",
The General Theory of Employment, Interest and Money,

Larry Summers On His Hedge Fund Experience: I was surprised at how self referential were today’s markets

# Keynes: Speculation Is Universal. Here Is The Former World Bank Chief Economist On The Chinese Stock Market

When the stock market was established in 1991, only individual investors were allowed to buy stocks. It was believed then that investors would concern themselves with the value of the stocks they bought. It turned out that those investors cared very little about the operation of enterprises. Their only concern was to speculate on the rise and fall of stocks, so the turnover of stocks was very high. In 1998 investment funds were introduced so that china could learn from foreign experience. The result was even worse. Some fund managers attempted not only to speculate but even to manipulate stock prices.

Demystifying the Chinese Economy
Justin Yifu Lin

# Part IV:
# Minsky On Moral Hazard

# For Minsky, Like Keynes, Uncertainty Rules

"Since investment deals preeminently with decisions that involve time, in order to explain investment it is necessary to come to grips with the meaning and significance of uncertainty in economics. Uncertainty deals with that class of events for which the outcome of actions cannot be known with the same precision as the average outcome at a roulette table, or even of a mortality table, is known. In a word, uncertainty in economics does not deal with risks that are insurable or analogous to gambling risks. Uncertainty is largely a matter of dealing today with a future that by its very nature is highly conjectural. In a world with uncertainty, units make do with and react to the often surprising fruits of past decisions as they ripen."

*"Stabilizing An Unstable Economy"*
Hyman P. Minsky, 1986

# Expectations Are Adaptive

# Minsky On Euphoria

Minsky tells us that “for enterprises there is a pattern of how the business cycles of history have affected their gross profits”. There have been the profits of prosperity, the profits of recessions, and the profits of recoveries. Obviously, the profits of prosperity are high and the profits of recessions are low or negative. As a business cycle matures businessmen come to believe the depressed profits of recessions and recoveries are less likely. For Minsky, the “euphoric state” is simply one in which businessmen come to expect the relatively robust profits of the boom to persist indefinitely.

# Minsky: Stability Begets Instability

In his later writings Minsky borrows the term “tranquility” from Joan Robinson to describe those long periods of economic expansion when such experiences of distress and loss have faded from memory. It is then that entrepreneurs and their bankers let down their guard and take greater risks.

“Success breeds a disregard of the possibility of failure; the absence of serious financial difficulties over a substantial period leads to the development of a euphoric economy in which increasing short-term financing of long positions becomes a normal way of life. As a previous financial crisis recedes in time, it is quite natural for central bankers, government officials, bankers, businessmen, and even economists to believe that a new era has arrived. Cassandra-like warnings that nothing basic has changed, there is a financial breaking point that will lead to a deep depression, are naturally ignored in these circumstances”.

*“Stabilizing An Unstable Economy”*
Hyman P. Minsky, 1986

According to Minsky, If Fed Projections Of 2-3 Years Of Moderate Stable Economic Growth Materializes With Still Very Low Interest Rates, Nouriel Roubini's Forecasted Credit Bubble Will Materialize As Well. Remember, the 2007 Indebtedness Peaks Are A Mere Stone's Throw Away.

# Minsky On Moral Hazard

Repeated Fed and Treasury interventions to preserve economic and financial stability reduce private perceptions of risk and beget instability. According to Minsky, market participants do, in fact, behave rationally when they continually pursue risky financial practices even as the level of financial fragility rises. This is because deficit spending and lender-of-last-resort interventions, and the potential costs associated with risky financial practices are, to a considerable extent, socialized - government rather than firms absorbs these costs. Indeed, the socialization of financial market risk promotes fragility since, as Minsky says, "once borrowers and lenders recognize that the downside instability of profits has decreased, there will be an increase in the willingness and ability of business and bankers to debt finance. If the cash flows to validate debt are virtually guaranteed by the profit implications of big government, then debt financing of positions in capital assets is encouraged. (Minsky 1986).

Financial Conditions And Macroeconomic Performance:
Essays In Honor Of Hyman P. Minsky,
Gary Dymski and Robert Pollin

# Minsky And Moral Hazard

Unlike Keynes, Minsky did not focus on the stock market. But his model is transferrable to such asset markets.

With increasing stability comes a lower precautionary demand for money and higher asset valuations.

If Big government and the central bank distort profoundly the perceptions of risk, then everyone is a buyer of stocks and no one is a seller. Then asset prices must levitate.

So Minsky's historical dialectic of mounting moral hazard ends with the Bernanke put.

# Minsky And Moral Hazard

The great bailout of 2008-2009 was unimaginable. Now market participants believe central banks will “do whatever it takes” to maintain stability. According to Minsky, such “insurance” should foster new heights in risk taking. The risk of credit and asset bubbles should be as high as ever.

# Minsky And Moral Hazard

Unimaginable big central bank support is a global phenomenon.

- Fed QE3 is open-ended and bigger than before
- ECB Mario Draghi says he will do “whatever it takes” to preserve the euro.
- Karoda’s mega QE at 30% of GDP in a mere 2 years makes Helicopter Ben look timid.

# Part V:
# A Coming Stock Market Bubble?

# New York Fed President Dudley:

# How To Spot A Bubble

There is typically an innovation that changes the fundamental valuation in a meaningful, but uncertain way.

Common to many asset bubbles is a surge in economic activity in the particular sector associated with the innovation.

There is often a positive feedback mechanism that tends to reinforce the belief system that underpins the extreme valuations associated with the boom.

The proportion of market participants who believe that a particular episode of asset price increases are justified by the innovation tends to rise

Casual investors see the large rise in prices and jump in.

So, For The Fed Identifying A Bubble May Involve Seeing A Displacement, A Profit Bonanza, And High Emotions Incited By The Prospect Of Quick Riches.

# Fed: No Bubble In Sight

“I don’t think we’re in that kind of territory that obviously makes these asset prices unsustainable and at a bubble level,” Bank of England policy maker David Miles said today during a panel discussion at the Boston Fed.

While “this is something we have to keep monitoring” at the Fed, “I don’t see” these risks now, Minneapolis Fed President Narayana Kocherlakota said at the  same forum.

Chicago Fed President Charles Evans “We’ve looked at a lot of things and there’s nothing in that horizon that causes me great angst.”

# Fed: No Bubble In Sight

“But, in the stock market, you know, we don’t see at this point anything that’s out of line with historical patterns. In particular, you should remember, of course, that while the Dow may be hitting a high, it’s in nominal terms, it’s not in real terms. And if you adjust for inflation and for the growth of the economy, you know, we’re still some distance from the high. I don’t think it’s all that surprising that the stock market would rise, given that there has been increased optimism about the economy and the share of income going to profits has been very high. Profit increases have been substantial, and the relationship between stock prices and earnings is not particularly unusual at this point.”

Chairman Ben Bernanke’s Press Conference
March 20, 2013

# But Fed QE Does Target Higher Risk Asset Prices

"A primary channel through which this effect takes place is by narrowing the risk premiums on the assets being purchased.

The purchases bid up the price of the asset and hence lower its yield. These effects would be expected to spill over into other assets that are similar in nature, to the extent that investors are willing to substitute between the assets. These patterns describe what researchers often refer to as the portfolio balance channel."

The Fed's Expanded Balance Sheet, Brian Sack, New York Fed, December 2, 2009

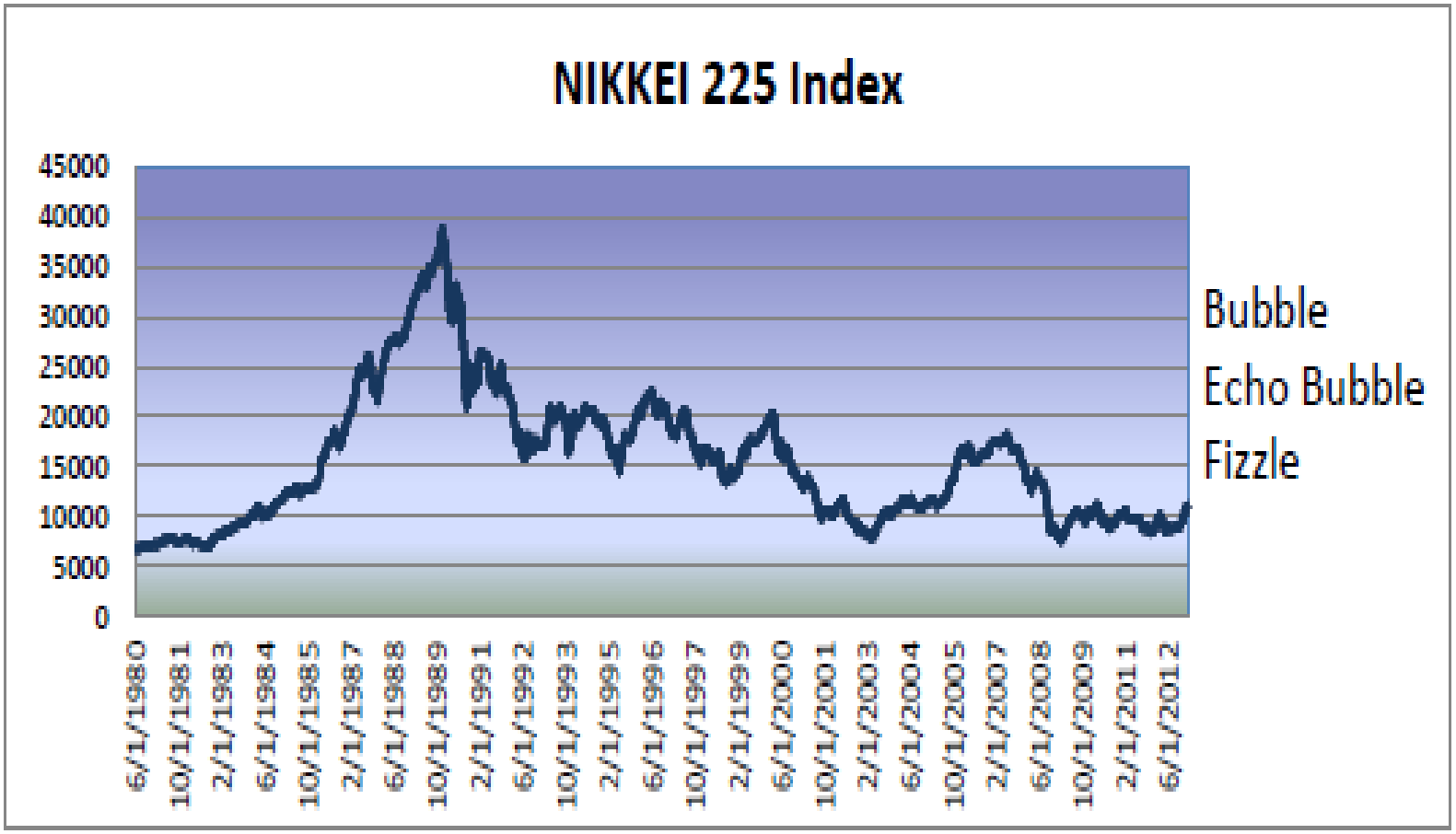
# The Bernanke Put As Bubble Machine

If every ratchet up in risk assets (wealth) is insufficient, each new level must be protected. In effect, the strike price on the Bernanke put keeps getting raised. In an overindebted world with consequent weak aggregate demand, the Bernanke put becomes a bubble machine.

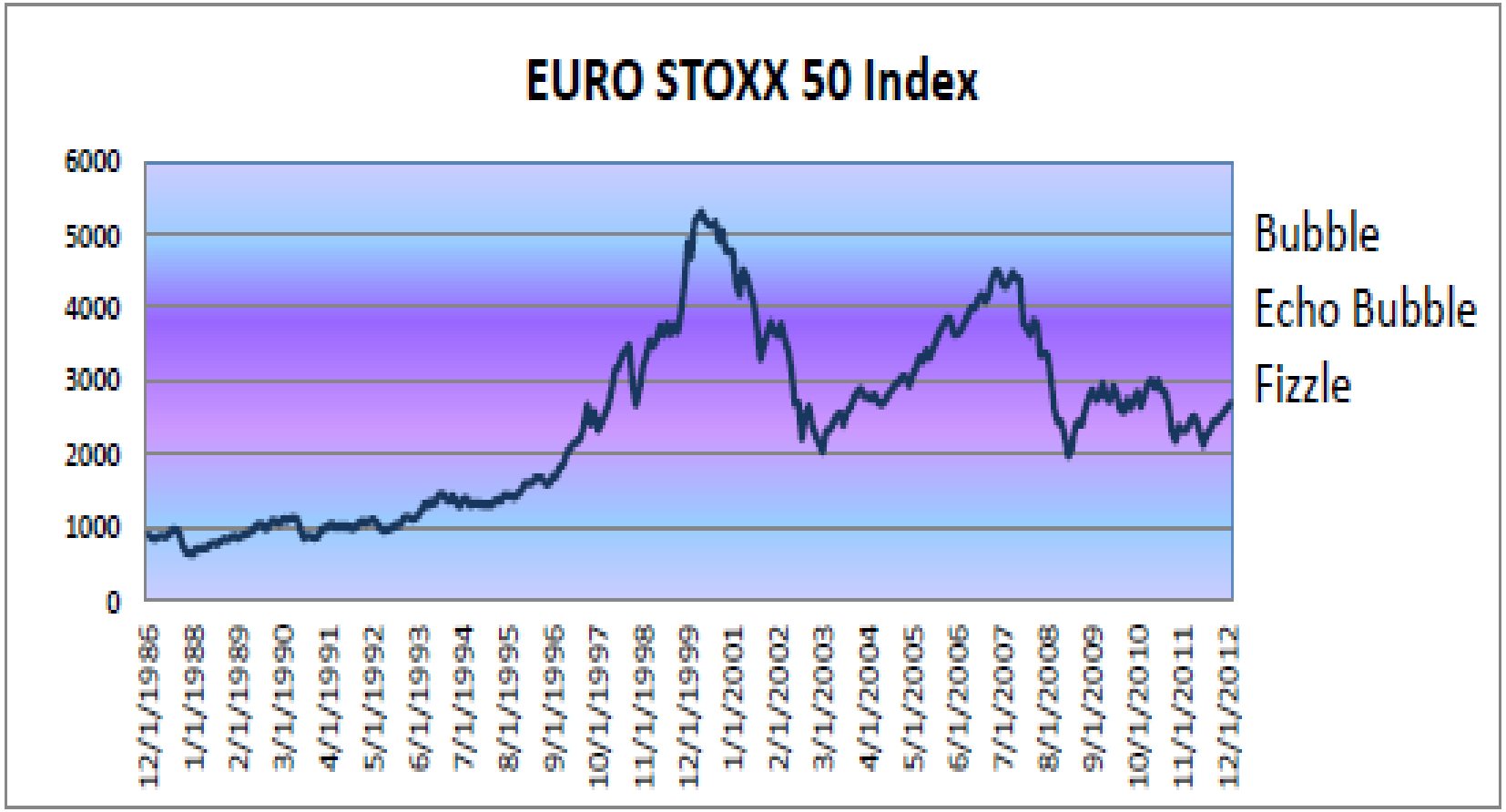
In lab experiments among subjects with certain knowledge of fundamental value Nobel Laureate Vernon Smith has found a trading pattern of bubble formation, echo bubble formation, and then fundamental trading with zero bubble formation.

In a study of 14 stock market bubbles in history Ed Chancellor found the same pattern always prevailed.

# As Chancellor and Smith Found Out:



# As Chancellor and Smith Found Out:



# As Chancellor and Smith Found Out:

# With The U.S. Market Now Above The Prior Bubble High Let Us Listen To Keynes.

# Keynes: Wall Street Is Different

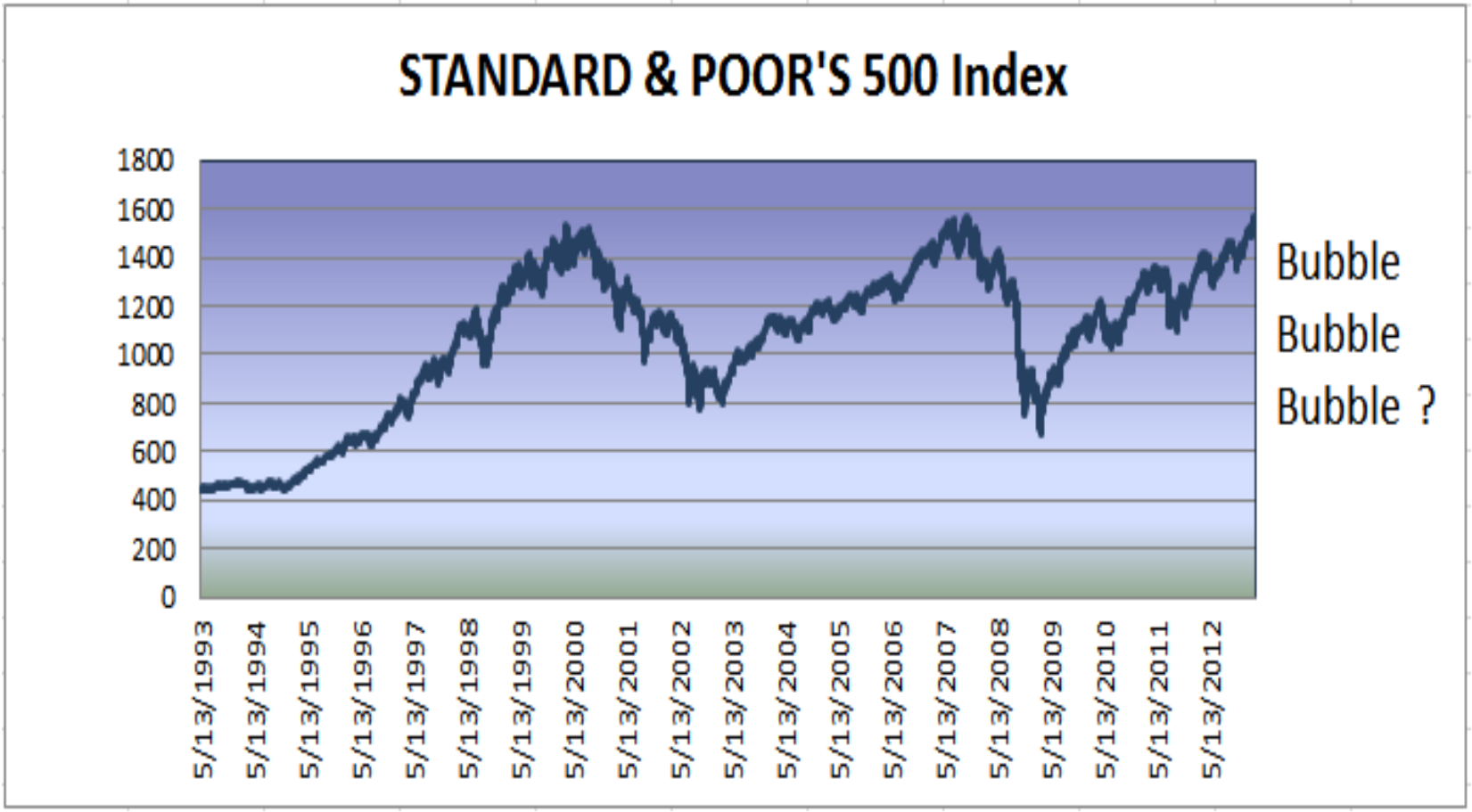
If I may be allowed to appropriate the term *speculation* for the activity of forecasting the psychology of the market, and the term *enterprise* for the activity of forecasting the prospective yield of assets over their whole life, it is by no means always the case that speculation predominates over enterprise. As the organisation of investment markets improves, the risk of the predominance of speculation does, however, increase.

Americans are apt to be unduly interested in discovering what average **opinion** believes average opinion to be; and this national weakness finds its nemesis in the stock market.

Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done.

The measure of success attained by Wall Street, regarded as an institution of which the proper social purpose is to direct new investment into the most profitable channels in terms of future yield, cannot be claimed as one of the outstanding triumphs of *laissez-faire* capitalism – which is not surprising, if I am right in thinking that the best brains of Wall Street have been in fact directed towards a different object.

# Note Messrs.' Bernanke, Evans & Kotcherlakota



Today the Fed, the Treasury, and the regulatory bodies are poisoned by the perverse virus of efficient market theory and modern portfolio theory and cannot accept Keynes' model of a financial market driven by extrapolative (non-rational) expectations in which market participants simply game the other guy about mere conventions which are weakly held. This above all is why macro prudential policy will not prevent new bubbles and may inadvertently foster them.

Bernanke: "*The relationship between stock prices and earnings is not particularly unusual at this point*".

**Oh yeah?**

# David Stockman On Inflated U.S. Corporate Profits

For the 2007-2010 market cycle the Wall Street "ex-item" number for S&P net income during that period overstated honest accounting profits by an astonishing 30 percent. Stated differently, the time-weighted PE multiple on an ex-items basis was already at an exuberant 17.6X. In truth, however, the market was actually valuing true GAAP earnings at nearly 23X.

This was a truly absurd capitalization rate for the earnings of a basket of giant companies domiciled in a domestic economy where economic growth was grinding to a halt. It was also a wildly excessive valuation for earnings that had been inflated by $5 trillion of business debt growth owing to buybacks, buyouts, and takeovers.

The Great Deformation: The Corruption of Capitalism In America,
David A. Stockman, 2013

# David Stockman: The "Earnings Ex-Items" Smoke Screen

One of the reasons that the monetary politburo was unconcerned about the blatant buoying of earnings through financial engineering is that it fully subscribed to the gussied-up version of EPS peddled by Wall Street. The latter was known as "operating earnings" or "earning ex-items," and it was derived by removing from the GAAP (generally accepted accounting principle) - based financial statements filed with the SEC any and all items which could be characterized as "one-time" or nonrecurring."

The Great Deformation: The Corruption of Capitalism In America,
David A. Stockman, 2013

# Survey Data Reveals Intentional Earnings Inflation

In this academic study 10,300 companies, both public and private, were asked if they managed their earnings and, in particular, managed them upward. Not surprisingly, only 17.9% opened the email. Only 5.4% of all those queried provided responses. Of those 5.4%, roughly half were public companies and half were private companies. Twenty percent of the public company respondents indicated that they managed their reported profits upward.

Now there is an obvious bias in this survey. Almost assuredly most of those companies that are very aggressive in managing their profits upward did not respond to the survey. Therefore, for the universe of all public companies the incidence of “inflating” reported earnings could be much higher than what this survey shows.

*Earnings Quality: Evidence From The Field,*
Dichev, Graham, Harvey, Rajgopal, September 9, 2012

# S&P : “Inflated” Operating Earnings vs. “Real” Reported Earnings

| QUARTER END | OPERATING EARNINGS PER SHR | AS REPORTED EARNINGS PER SHR |
|---|---|---|
| 12/31/2012 | | |
| 9/28/2012 | $24.00 | $21.21 |
| 6/29/2012 | $25.43 | $21.62 |
| 3/30/2012 | $24.24 | $23.03 |
| 12/30/2011 | $23.73 | $20.64 |
| 09/30/2011 | $25.29 | $22.63 |
| 06/30/2011 | $24.86 | $22.24 |
| 03/31/2011 | $22.56 | $21.44 |
| 12/31/2010 | $21.93 | $20.67 |
| 09/30/2010 | $21.56 | $19.52 |
| 06/30/2010 | $20.90 | $19.68 |
| 03/31/2010 | $19.38 | $17.48 |
| 12/31/2009 | $17.16 | $15.18 |
| 09/30/2009 | $15.78 | $14.76 |
| 06/30/2009 | $13.81 | $13.51 |
| 03/30/2009 | $10.11 | $7.52 |
| 12/31/2008 | -$0.09 | -$23.25 |
| 09/30/2008 | $15.96 | $9.73 |
| 06/30/2008 | $17.02 | $12.86 |
| 03/31/2008 | $16.62 | $15.54 |

| QUARTER END | OPERATING EARNINGS PER SHR | AS REPORTED EARNINGS PER SHR |
|---|---|---|
| 12/31/2007 | $15.22 | $7.82 |
| 09/30/2007 | $20.87 | $15.15 |
| 06/30/2007 | $24.06 | $21.88 |
| 03/31/2007 | $22.39 | $21.33 |
| 12/31/2006 | $21.99 | $20.24 |
| 09/30/2006 | $23.03 | $21.47 |
| 06/30/2006 | $21.95 | $20.11 |
| 03/31/2006 | $20.75 | $19.69 |
| 12/31/2005 | $20.19 | $17.30 |
| 09/30/2005 | $18.84 | $17.39 |
| 06/30/2005 | $19.42 | $18.29 |
| 03/31/2005 | $18.00 | $16.85 |
| 12/31/2004 | $17.95 | $13.94 |
| 09/30/2004 | $16.88 | $14.18 |
| 06/30/2004 | $16.98 | $15.25 |
| 03/31/2004 | $15.87 | $15.18 |
| 12/31/2003 | $14.88 | $13.16 |
| 09/30/2003 | $14.41 | $12.56 |
| 06/30/2003 | $12.92 | $11.10 |
| 03/31/2003 | $12.48 | $11.92 |

Inflated Earnings Greatly Exceed Reported Earnings Now, Especially In Recessions. Check 2008.

# S&P : “Inflated” Operating Earnings vs. “Real” Reported Earnings

| QUARTER END | OPERATING EARNINGS PER SHR | AS REPORTED EARNINGS PER SHR |
|---|---|---|
| 12/31/2002 | $11.94 | $3.00 |
| 09/30/2002 | $11.61 | $8.53 |
| 06/30/2002 | $11.64 | $6.87 |
| 03/31/2002 | $10.85 | $9.19 |
| 12/31/2001 | $9.94 | $5.45 |
| 09/30/2001 | $9.16 | $5.23 |
| 06/30/2001 | $9.02 | $4.83 |
| 03/31/2001 | $10.73 | $9.18 |
| 12/31/2000 | $13.11 | $9.07 |
| 09/30/2000 | $14.17 | $13.71 |
| 06/30/2000 | $14.88 | $13.48 |
| 03/31/2000 | $13.97 | $13.74 |
| 12/31/1999 | $13.77 | $12.77 |
| 09/30/1999 | $12.97 | $11.93 |
| 06/30/1999 | $13.21 | $12.51 |
| 03/31/1999 | $11.73 | $10.96 |
| 12/31/1998 | $11.47 | $8.56 |
| 09/30/1998 | $10.45 | $8.99 |
| 06/30/1998 | $11.43 | $9.87 |
| 03/31/1998 | $10.92 | $10.29 |

| QUARTER END | OPERATING EARNINGS PER SHR | AS REPORTED EARNINGS PER SHR |
|---|---|---|
| 12/31/1997 | $11.29 | $8.94 |
| 09/30/1997 | $11.03 | $9.87 |
| 06/30/1997 | $11.13 | $10.44 |
| 03/31/1997 | $10.56 | $10.47 |
| 12/31/1996 | $11.01 | $9.86 |
| 09/30/1996 | $9.92 | $9.78 |
| 06/30/1996 | $10.31 | $10.13 |
| 03/31/1996 | $9.39 | $8.96 |
| 12/31/1995 | $9.78 | $7.13 |
| 09/30/1995 | $9.78 | $8.69 |
| 06/30/1995 | $9.50 | $9.26 |
| 03/31/1995 | $8.64 | $8.88 |
| 12/31/1994 | $8.80 | $8.35 |
| 09/30/1994 | $8.03 | $7.94 |
| 06/30/1994 | $7.75 | $7.38 |
| 03/31/1994 | $7.17 | $6.93 |
| 12/31/1993 | $7.16 | $5.08 |
| 09/30/1993 | $6.92 | $5.81 |
| 06/30/1993 | $6.57 | $4.89 |
| 03/31/1993 | $6.25 | $6.11 |

Fifteen Years Ago The Discrepancy Was Not So Great.

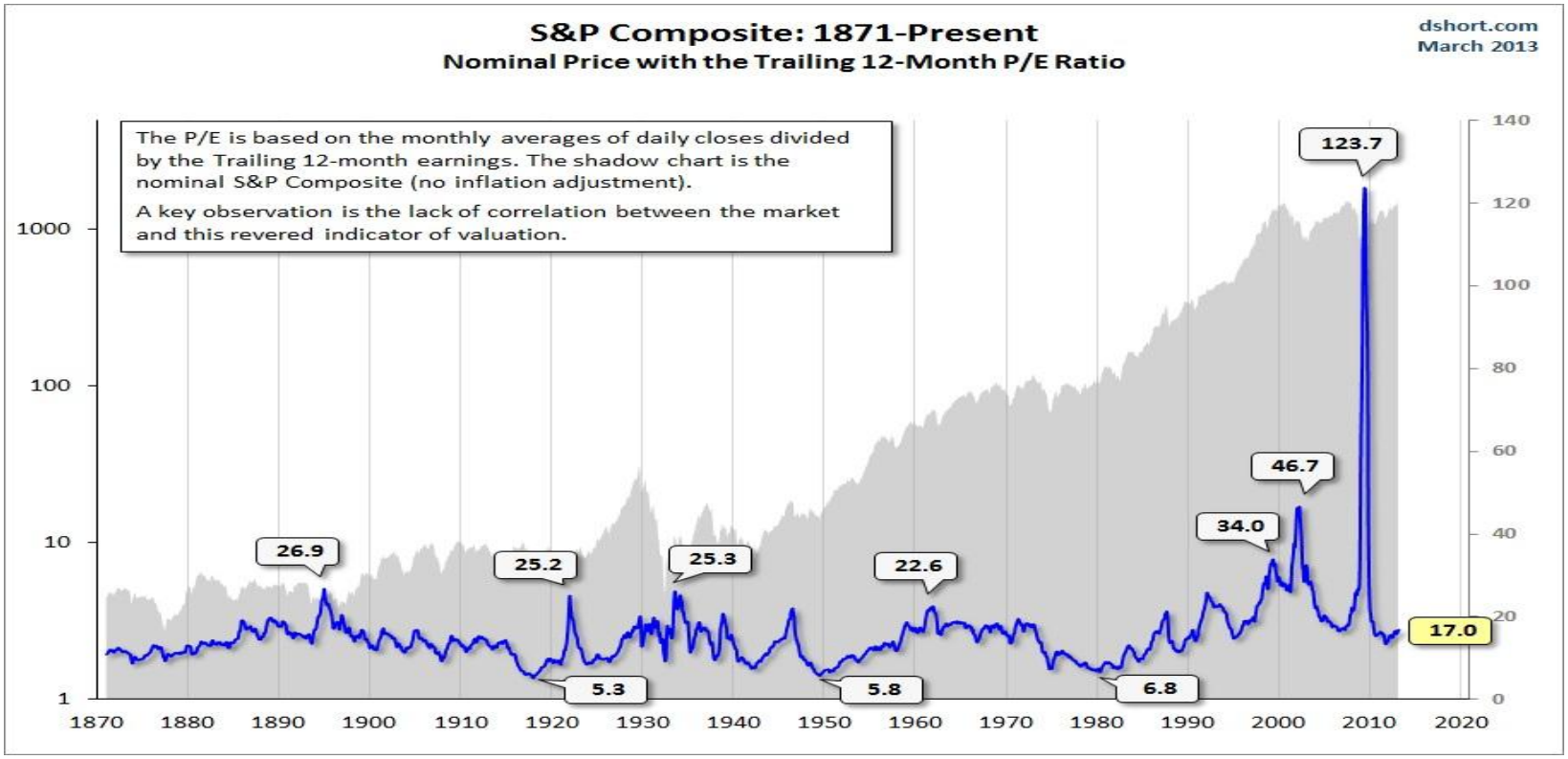
# S&P : “Inflated” Operating Earnings vs. “Real” Reported Earnings

| QUARTER END | OPERATING EARNINGS PER SHR | AS REPORTED EARNINGS PER SHR |
|---|---|---|
| 12/31/1992 | $5.61 | $3.60 |
| 09/30/1992 | $5.12 | $4.73 |
| 06/30/1992 | $5.21 | $5.40 |
| 03/31/1992 | $4.93 | $5.36 |
| 12/31/1991 | $4.63 | $2.55 |
| 09/30/1991 | $5.11 | $3.74 |
| 06/30/1991 | $4.79 | $4.54 |
| 03/31/1991 | $4.77 | $5.14 |
| 12/31/1990 | $5.01 | $4.40 |
| 09/30/1990 | $5.97 | $5.33 |
| 06/30/1990 | $6.06 | $6.07 |
| 03/31/1990 | $5.61 | $5.54 |
| 12/31/1989 | $5.84 | $4.80 |
| 09/30/1989 | $5.54 | $4.85 |
| 06/30/1989 | $6.53 | $6.48 |
| 03/31/1989 | $6.41 | $6.74 |
| 12/31/1988 | $6.37 | $5.62 |
| 09/30/1988 | $6.22 | $6.38 |
| 06/30/1988 | $6.05 | $6.22 |
| 03/31/1988 | $5.48 | $5.53 |

Twenty-five Years Ago The Discrepancy Was Often Minimal.

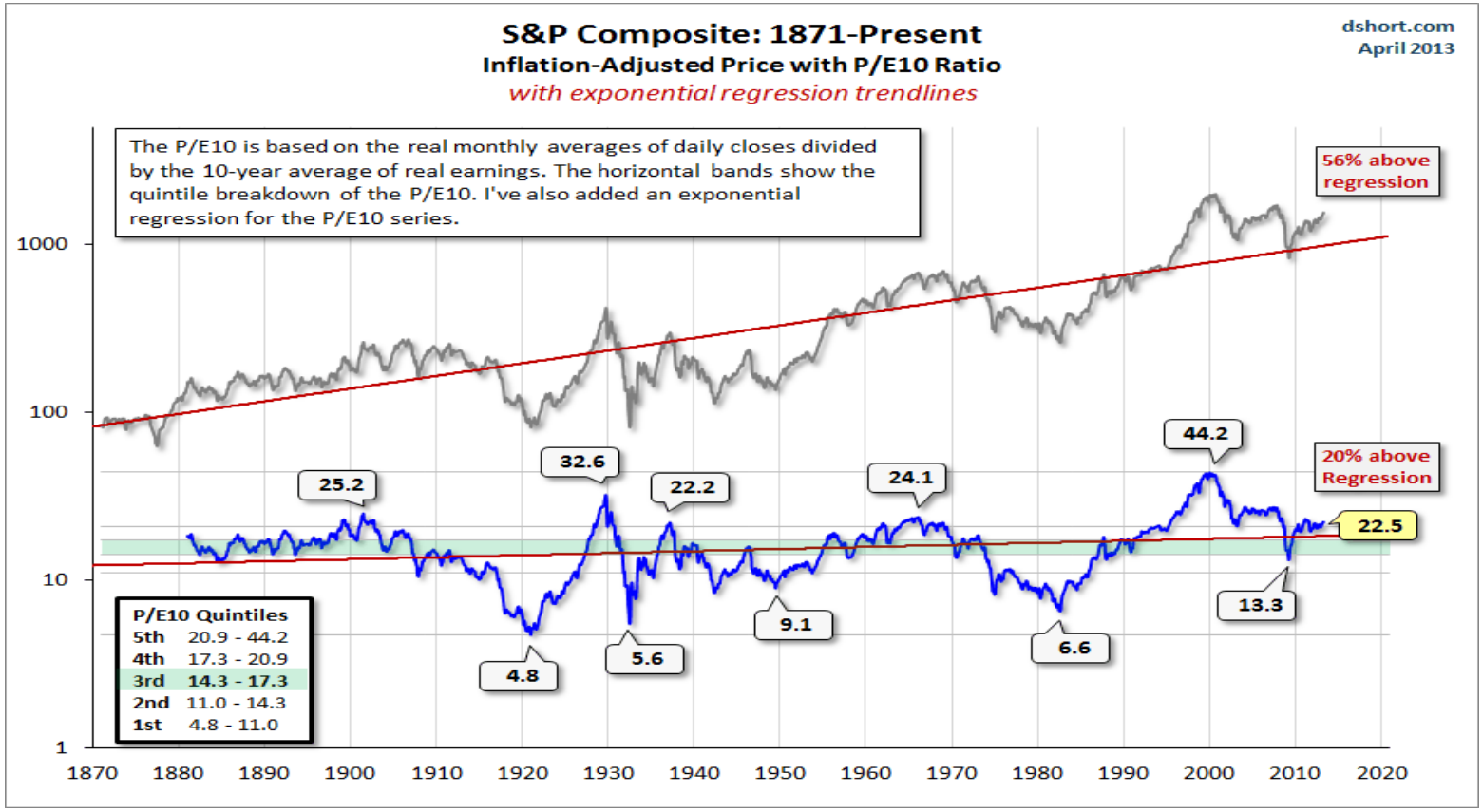
# By This Measure The Stock Market Is In Bubble Terrain

# Earnings Inflation Is Written Off In Recessions. Smooth The PE Ratios Below



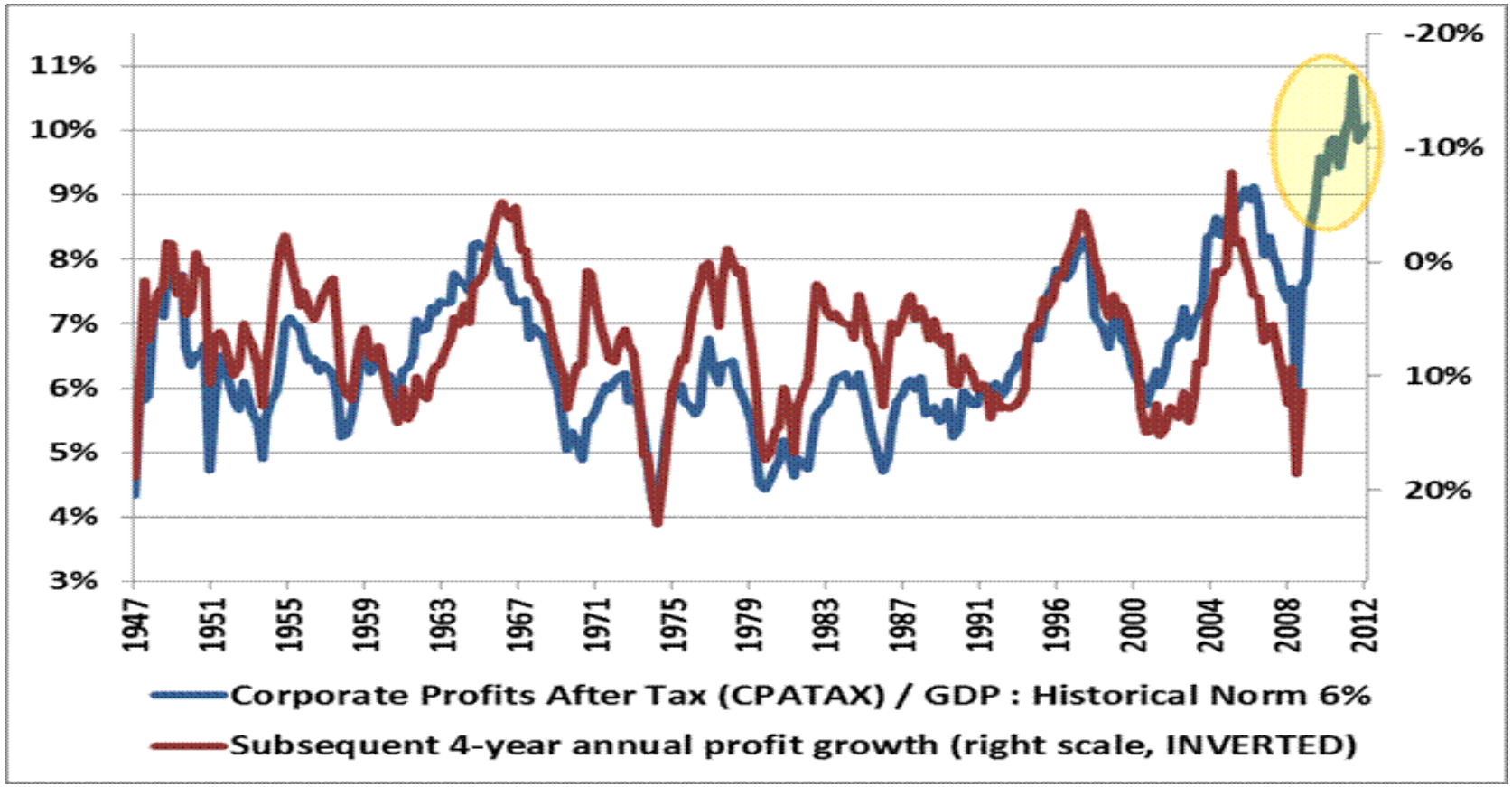

On Smoothed “Real” Reported Earnings The Stock Market Is In Bubble Terrain

# Robert Shiller Captures This With His CAPE – Cyclically Adjusted Inflation Adjusted Smoothed Reported Earnings Based PE Ratio.

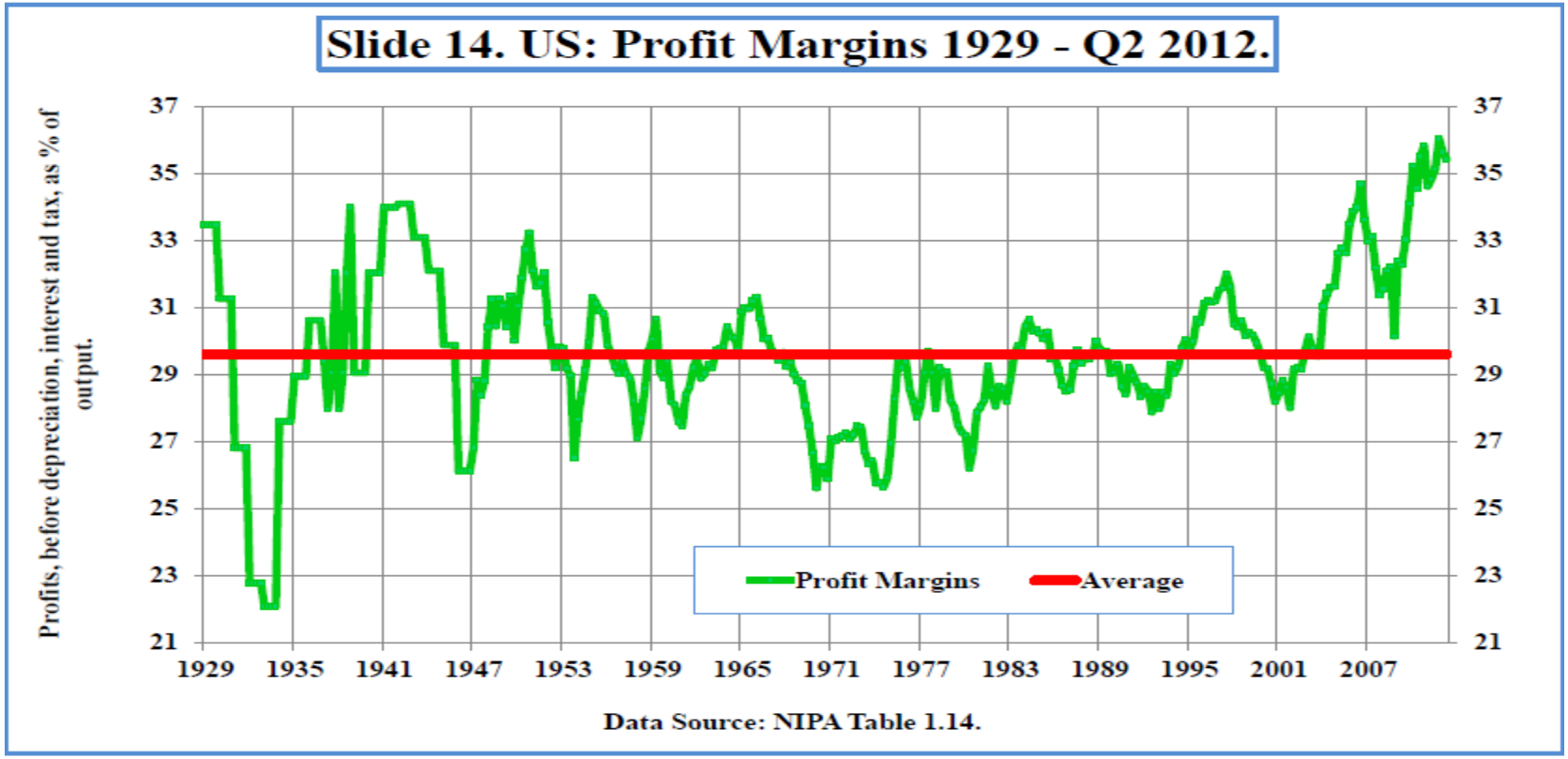


Even national income and accounting (NIPA) profits – and therefore reported profits – may be very overstated.

# Record Profits To GDP



# Reported Profit Margins Are Also At A Record




Andrew Smithers, Smithers & Co.

# Flow Of Funds Savings (A Bottom Up Calculation) vs. NIPA Savings (A Residual)

| | | | | | | 2011 | | 2012 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2008 | 2009 | 2010 | 2011 | 2012 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 |
| NIPA (FOF) DATA | 7.2 | 4.9 | 8.9 | 9.2 | 7.6 | 11.8 | 7.3 | 12.9 | 10.6 | -2.8 | 6.6 |
| NIPA (NIPA) DATA | 5.4 | 4.7 | 5.1 | 4.2 | 3.9 | 3.9 | 3.4 | 3.6 | 3.8 | 3.6 | 4.6 |
| DIFFERENCE | 1.8 | 0.2 | 3.8 | 5.0 | 3.7 | 7.9 | 4.0 | 9.2 | 6.8 | -6.4 | 2.0 |

If Flow Of Funds Savings Are Correct, NIPA Profits May Be Too High By 2% of GDP Or More

The financial balances of government, corporations, households and the rest of the world must sum to zero. Therefore when the government's fiscal deficit contracts, profits tend to contract.

# The Government Fiscal Deficit Has Fallen To 5% Of GDP

**Summary Table 1.**

**CBO's Baseline Budget Projections**

| | Actual, 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | Total 2014-2018 | Total 2014-2023 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | In Billions of Dollars | | | | | | | |
| Revenues | 2,449 | 2,708 | 3,003 | 3,373 | 3,591 | 3,765 | 3,937 | 4,101 | 4,279 | 4,496 | 4,734 | 4,961 | 17,669 | 40,241 |
| Outlays | 3,538 | 3,553 | 3,618 | 3,803 | 4,067 | 4,300 | 4,542 | 4,811 | 5,078 | 5,350 | 5,691 | 5,939 | 20,330 | 47,199 |
| **Deficit (-) or Surplus** | **-1,089** | **-845** | **-616** | **-430** | **-476** | **-535** | **-605** | **-710** | **-798** | **-854** | **-957** | **-978** | **-2,661** | **-6,958** |
| On-budget | -1,151 | -872 | -630 | -433 | -476 | -533 | -598 | -693 | -763 | -799 | -878 | -872 | -2,670 | -6,675 |
| Off-budget[a] | 62 | 27 | 14 | 3 | * | -2 | -6 | -17 | -35 | -55 | -79 | -106 | 9 | -283 |
| Debt Held by the Public at the End of the Year | 11,280 | 12,229 | 12,937 | 13,462 | 14,025 | 14,642 | 15,316 | 16,092 | 16,957 | 17,876 | 18,902 | 19,944 | n.a. | n.a. |
| | | | | | | | As a Percentage of Gross Domestic Product | | | | | | | |
| Revenues | 15.8 | 16.9 | 18.0 | 19.1 | 19.1 | 18.9 | 18.8 | 18.7 | 18.7 | 18.9 | 19.0 | 19.1 | 18.8 | 18.9 |
| Outlays | 22.8 | 22.2 | 21.7 | 21.6 | 21.6 | 21.5 | 21.7 | 22.0 | 22.2 | 22.4 | 22.9 | 22.9 | 21.6 | 22.1 |
| **Deficit** | **-7.0** | **-5.3** | **-3.7** | **-2.4** | **-2.5** | **-2.7** | **-2.9** | **-3.2** | **-3.5** | **-3.6** | **-3.8** | **-3.8** | **-2.8** | **-3.3** |
| Debt Held by the Public at the End of the Year | 72.5 | 76.3 | 77.7 | 76.3 | 74.6 | 73.4 | 73.1 | 73.5 | 74.2 | 75.0 | 76.0 | 77.0 | n.a. | n.a. |

Source: Congressional Budget Office.

Note: * = between -$500 million and zero; n.a. = not applicable.

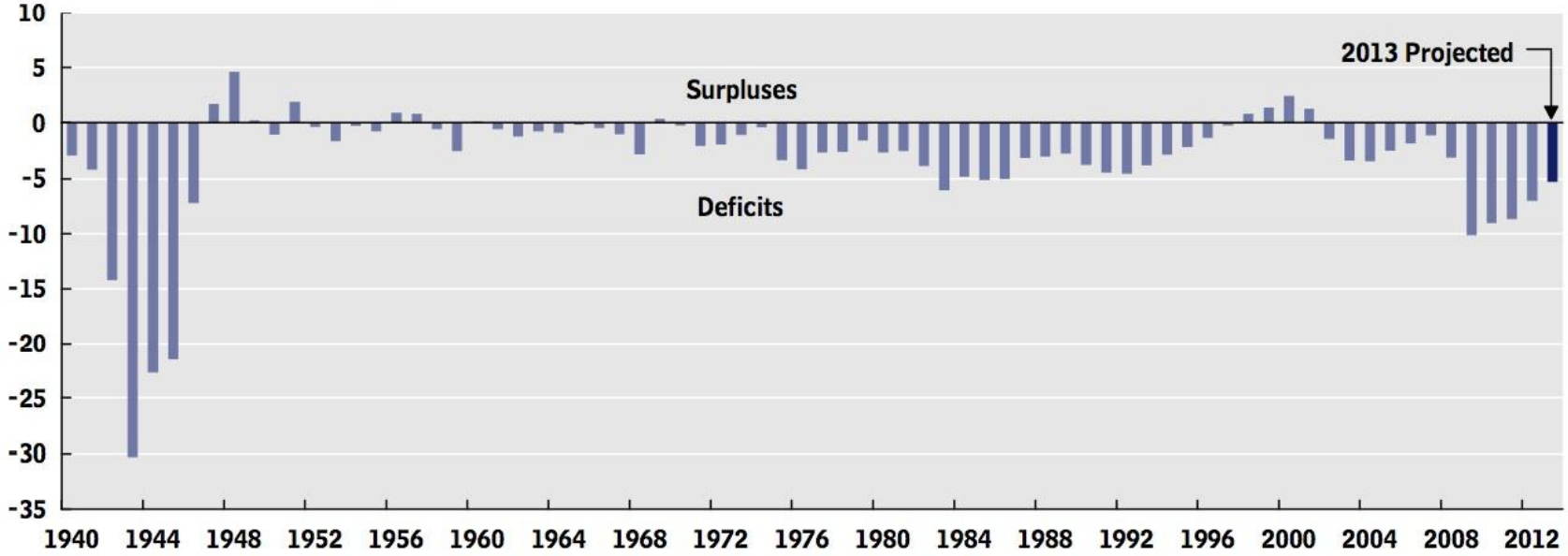
a. Off-budget surpluses or deficits comprise surpluses or deficits in the Social Security trust funds and the net cash flow of the Postal Service.

# Fiscal Deficit: From 10% Of GDP To 5%

**Figure 1-1.**

**Total Deficits or Surpluses**

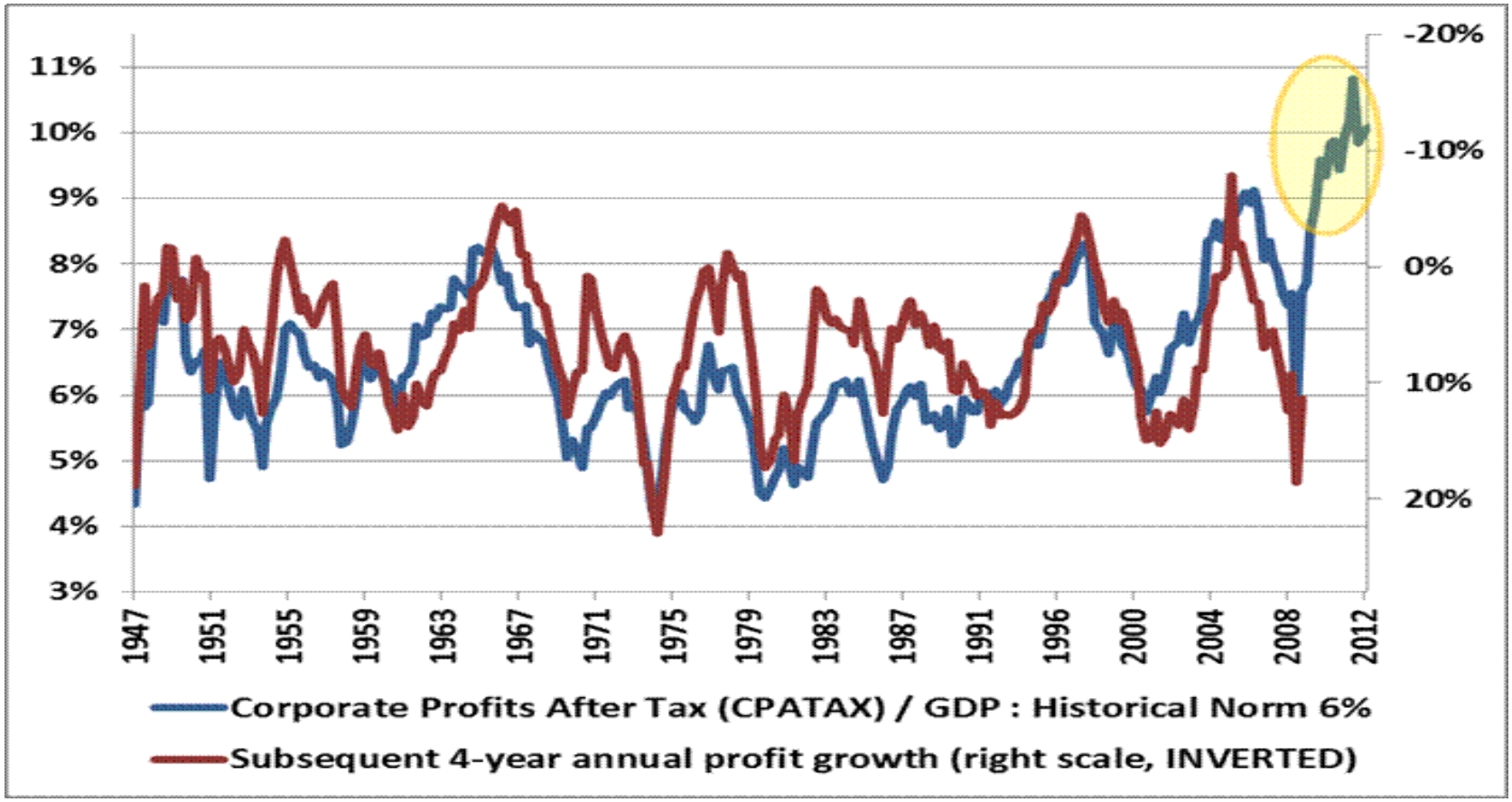
(Percentage of gross domestic product)




Source: Congressional Budget Office.

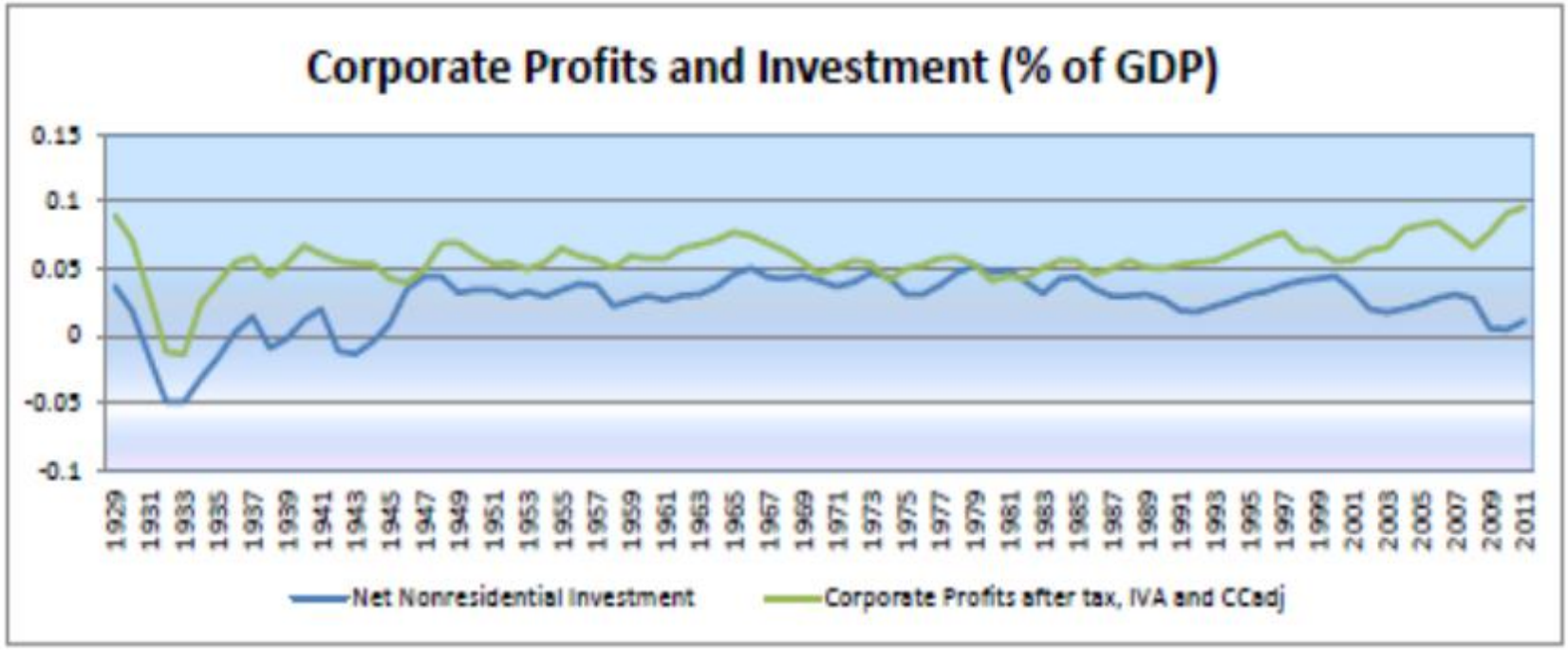
# The Profit Share Of GDP Should Have Fallen

# But It Hasn't. NIPA Profits As A Share Of GDP Have Barely Fallen



Worse yet, according to Wall Street consensus estimates, for 2013 and 2014 corporate profits will rise 8% per annum versus 4% for nominal GDP. In other words, based on what corporations say, the profit share just keeps on rising.

# For Minsky And Kalecki Profits And Investment Are Intertwined




In The Past, True. Today, No Way! So Maybe Those Record Profits Aren't For Real.

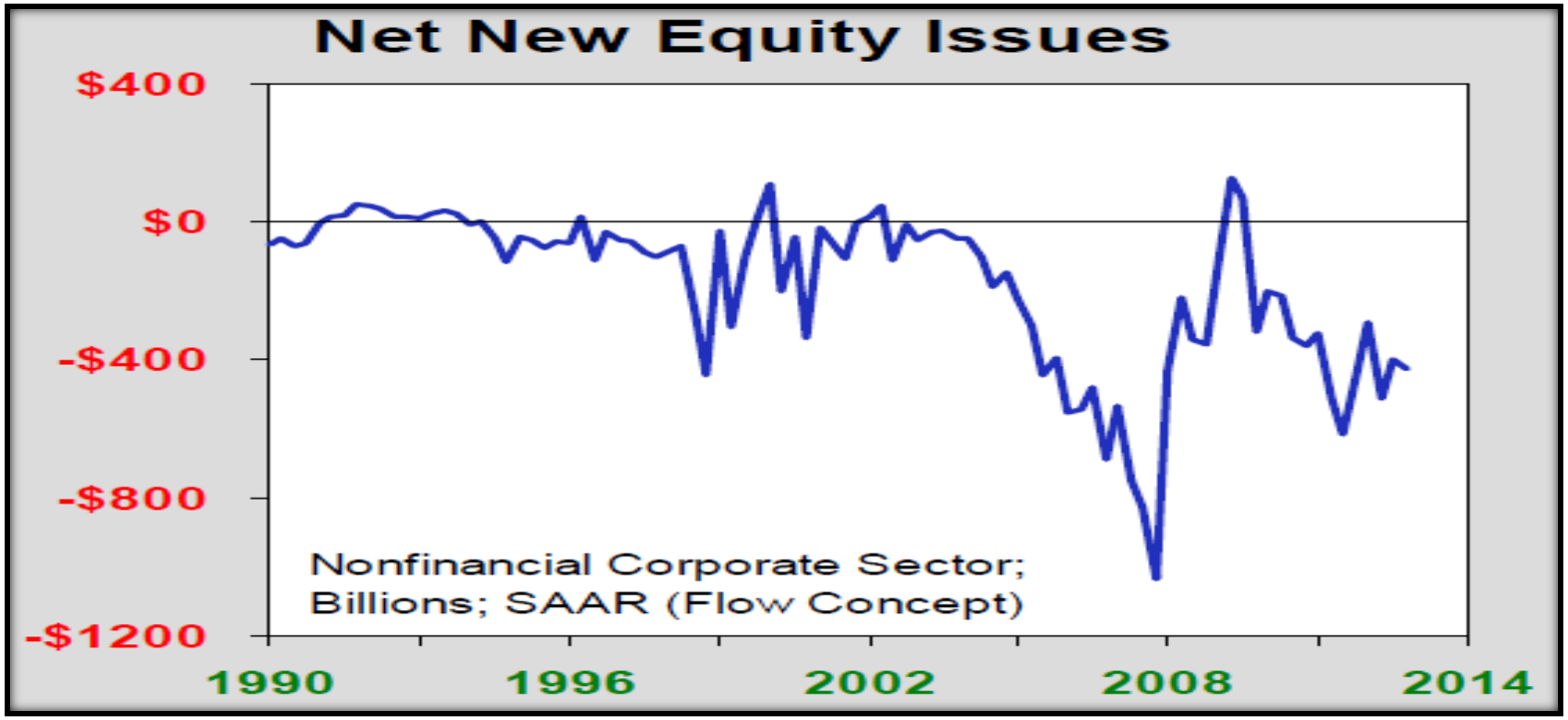
In The Fed Flow Of Funds Accounts, Business Net Investment, Cash Dividend Payments, And Net Stock Purchases Come To Less Than 7% Of GDP.

Corporate Financial Assets Are Growing, But So Are Corporate Debts.

Where Do All Those Record Profits Go?

# So What Goes With Corporate Profits?

James Tobin Theorized: The Higher The Market Cap To GDP, The Higher The Net Issuance Of Corporate Equity And The Higher The Share Of Investment In GDP.




Michael Lewis, Free Market Inc.

In Fact The Higher The Market Valuation, The More Negative The Net Equity Issuance.

Corporate managers have joined Keynes Casino. Their behavior is adaptive. When equity prices rise they expect a further rise. Then it is time to speculate and buy in shares. Then it is time to inflate operating earnings. Then it is time to shower management with options, goose one's stock, and cash in for short term capital gains.

# Bubble Risks And Macro Prudential Policy

We could at least enforce financial reporting practices that keep Wall Street and corporations honest.