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Return to Crisis: Things Keep Getting Worse

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Had the economy been fundamentally sound in 1929 the effect of the great stock market crash might have been small…. But business in 1929 was not sound; on the contrary it was exceedingly fragile. It was vulnerable to the kind of blow it received from Wall Street. Those who have emphasized this vulnerability are obviously on strong ground. Yet when a greenhouse succumbs to a hailstorm something more than a purely passive role is normally attributed to the storm. One must accord similar significance to the typhoon which blew out of lower Manhattan in October 1929. Extracts from *The Great Crash: 1929,* John Kenneth Galbraith, First Published 1955, Chapter 10: "Cause and Consequence", Page 204.

The virus that spread to stock markets around the world and nearly destroyed the global financial system in 2008 has reemerged with a vengeance sending global equities deep into the red and wiping out more than $5 trillion in market capitalization in less than two weeks. On Tuesday, before the opening bell, major market index futures in the US plunged more than 400 points signaling another violent day of selling ahead. Worries that a slowdown in China will impact global growth pushed Asian and European markets deep into negative territory while US futures indicate that the Dow Jones is headed for its ninth triple-digit day in ten sessions. The deluge of bad news has battered confidence in the Fed and "sent global equities to their worst monthly slump in more than three years". Millions of Mom and Pop investors have sold out already and are headed for the exits. Here's a recap from Bloomberg:

> Mom and pop are running for the hills. Since July, American households — which account for almost all mutual fund investors — have pulled money both from mutual funds that invest in stocks and those that invest in bonds. It's the first time since 2008 that both asset classes have recorded back-to-back monthly withdrawals, according to a report by Credit Suisse.
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> Credit Suisse estimates $6.5 billion left equity funds in July as $8.4 billion was pulled from bond funds, citing weekly data from the Investment Company Institute as of Aug. 19. Those outflows were followed up in the first three weeks of August, when investors withdrew $1.6 billion from stocks and $8.1 billion from bonds, said economist Dana Saporta.
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> Anytime you see something that hasn't happened since the last quarter of 2008, it's worth noting," Saporta said in a phone interview. ….Withdrawals from equity funds are usually accompanied by an influx of money to bonds, and an exit from both at the same time suggests investors aren't willing to take on risk in any form. ("Fed Up Investors Yank Cash From Almost Everything Just Like 2008", Bloomberg)

While the slowdown in China may be the spark for recent volatility, it certainly isn't the cause. There's a growing consensus that the real problem originated in 2008 when the Fed refused to write-down the debts from the insolvent banking system thus creating the conditions for another calamitous financial crisis sometime in the future. And while the Fed's zero rates and titanic doses of liquidity might have helped to ease the symptoms by flooding the system with cash, the underlying issues remain the same. Thus, as the medication has worn off, the virus has reappeared stronger than ever revealing the ineffectiveness of the Fed's remedies and the urgent need for alternate therapies.

Stocks are massively overpriced due to the setting of interest rates below the rate of inflation which creates a subsidy for speculators. The policy has had the precise effect that the Fed intended, it has generated a humongous asset bubble in stocks and bonds transferring trillions of dollars to Wall Street banks and financial institutions. According to Yale economist Robert Shiller, the only time stocks have been this "high or higher were in 1929, 2000, and 2007—all moments before market crashes."

Robert Shiller: "…Bonds, and increasingly real estate also look overvalued. This is different from other over-valuation periods such as 1929, when the stock market was very overvalued, but the bond and housing markets for the most part, weren't. It's an interesting phenomenon."

At the same time bankers and hedge fund managers have been raking in record profits on financially-engineered products that neither add to overall productivity or improve the broader economy, ordinary working people have seen their wages stagnate, incomes plunge and their prospects for a comfortable retirement vanish along with their ever-dwindling 401-K. According to investment guru John Hussman:

> U.S. wages and salaries have plunged to the lowest share of GDP in history, while the civilian labor force participation rate has dropped to levels not seen since the 1970s. Yet consumption as a share of GDP is near a record high.

The problem is that the Fed must prevent the real economy from growing, otherwise, workers wages will improve, prices will rebound, inflation will rise, and the Fed will be forced to raise rates. And, of course, higher rates are what Wall Street fears most, in fact, the six year bull market was built entirely on cheap, plentiful liquidity that has inflated historic bubbles in financial assets across-the-board. Even the slightest uptick in rates will bring the whole fake edifice crashing to earth, which is why any talk of "normalization" sends stocks into a nosedive.

This is why policymakers will continue to slash budget deficits and implement other austerity measures to cut off the vital flow of fiscal support to the real economy. A thriving

economy with low unemployment, rising incomes and wages, and positive inflation is the death knell for zero rate shenanigans, like stock buybacks, where a company repurchases its own shares to push prices higher to boost executive compensation and reward shareholders. Buybacks are type of stock manipulation that used to be banned but are presently, all the rage. Interestingly, Barron's attributes the recent turnaround in the market to a surge in buybacks that staunched the bloodletting on Wall Street. Take a look:

> Like the Wizard of Oz, who was revealed as nothing more than a man behind a curtain working some cool special effects, stock buybacks might not be the great and powerful market force they were thought to be.
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> What do I mean? Two weeks ago, the Standard & Poor's 500 began to sell off as concerns about China, commodities, and emerging markets made headlines. But just as the popular benchmark looked like it was entering free fall, it suddenly reversed. Who was the mysterious savior rescuing the markets? Articles published soon after the remarkable rebound were quick to point out that trading desks at Goldman Sachs and Morgan Stanley had seen the most corporate buying on record, suggesting it was share buybacks that kept the market afloat. ("Pushback on Buybacks," Barron's)

So, a surge in buybacks actually turned the markets around and stopped a selloff?

Indeed. This is how buybacks distort pricing, by countering normal supply-demand dynamics with infusions of capital that would normally be directed towards improving productivity. Weak regulations and cheap cash have changed the incentives structure so that easiest way to enrich stakeholders is by piling on more debt, raking off hefty profits, and leaving the wreckage for someone else to clean up. This is nihilistic rationale that drives buybacks. Keep in mind, the Fed's low rates were sold to the public as a way to stimulate investment in the real economy. As it happens, hiring for full-time jobs is still at depression era levels while business investment (Capex) has collapsed. The bulk of earnings are being devoted almost-exclusively to goosing stock prices to reward insatiable CEOs and their do-nothing shareholders. Check it out:

> The allocation of corporate profits to stock buybacks deserves much of the blame. Consider the 449 companies in the S&P 500 index that were publicly listed from 2003 through 2012. During that period those companies used 54% of their earnings—a total of $2.4 trillion—to buy back their own stock, almost all through purchases on the open market. Dividends absorbed an additional 37% of their earnings. That left very little for investments in productive capabilities or higher incomes for employees…
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> Why are such massive resources being devoted to stock repurchases? Corporate executives give several reasons, which I will discuss later. But none of them has close to the explanatory power of this simple truth: Stock-based instruments make up the majority of their pay, and in the short term buybacks drive up stock prices. In 2012 the 500 highest-paid executives named in proxy statements of U.S. public companies received, on average, $30.3 million each; 42% of their compensation came from stock options and 41% from stock awards. By increasing the demand for a company's shares, open-market buybacks automatically lift its stock price, even if only temporarily, and can enable the company to hit quarterly earnings per share (EPS) targets…
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> If the U.S. is to achieve growth that distributes income equitably and provides stable employment, government and business leaders must take steps to bring

> both stock buybacks and executive pay under control. The nation's economic health depends on it…." ("Profits without Prosperity", William Lazonick, Harvard Business Review)

There's no chance the Fed will raise rates in the current environment. Corporate earnings and revenues have been shrinking since the forth quarter of 2014 which will make it harder for CEOs to justify adding to their debtload to repurchase more shares. As the appetite for buybacks wanes, stocks are bound to dip even lower putting more pressure on bank balance sheets and forcing corporations to divert more cash to debt servicing. The Fed's threat to raise rates is merely a bluff to attract foreign capital to US markets and to prevent the dollar from falling off a cliff.

While it's always possible that the markets could stabilize or stocks could rebound sharply, it's more likely that we have reached a tipping point where the excesses are about to be wrung from the system through an excruciating downturn followed by an inevitable currency crisis. We expect the six year-long fake recovery to end much like it did in 1929, where one demoralizing selloff followed the other, and where the crashing of stock prices fueled the publics distrust of the central bank, the government and all of the nations main institutions. Here's a brief summary from Galbraith's masterpiece:

> The singular feature of the great crash of 1929 was that the worst continued to worsen. What looked one day like the end proved on the next day to have been only the beginning. Nothing could have been more ingeniously designed to maximize the suffering, and also to ensure that as few as possible escaped the common misfortune. The fortunate speculator who had funds to answer the first margin call presently got another and equally urgent one, and if he met that there would still be another. In the end all the money he had was extracted from him and lost. The man with the smart money, who was safely out of the market when the first crash came, naturally went back in to pick up bargains. The bargains then suffered a ruiness fall. Even the man who waited out all of October and all of November, who saw the volumne of trading return to normal and saw Wall Street become as placid as a produce market, and who then bought common stocks would see their value drop to a third or a fourth of the purchase price in the next twenty-four months. The Coolidge bull market was a remarkable phenonmemon. The ruthlessness of its liquidation was, in its own way, equally remarkable." (Extracts from "The Great Crash: 1929″, John Kenneth Galbraith, First Published 1955, Page 130 Things Become More Serious)

As of this writing, the Dow is down 317, the S&P 500, down 37, the Nasdaq, down 71.

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