A PEEK AT THE WEEK THAT WAS - September 21, 2013

Patient Capital.... Positioned for Profit

Economics is extremely useful as a form of employment for economists.
- John Kenneth Galbraith -

Last week, we peeked at war and oneupsmanship masquerading as diplomacy. We're sorry, but just because the Main St. media find something else to engross them doesn't mean the conflict in sad, sadistic Syria is over. It's simply in stalemate as both sides ponder their next move. Stay tuned.

Over in Europe, we looked at how the Poles have started to rediscover the "joy" of the state owning and controlling their lives. Even the legendary Lech Walsea is encouraging closer ties with Mother Russia. Valiant Vlad's influence is growing indeed. That's probably not a good thing.

We also looked at gold and the Fed...again. We can't help it...they are such diametrically opposed forces.

Speaking of the Fed, during the week, Slumbering Larry Summers dropped out of the race for the Fed Chairmanship. Given Larry's laughable record at money management, it's probably just as well...but it would have been fun to watch. In fact, if laconic Larry spent more time doing exactly what he was doing while heading Obamus Caesar's National Economic Council (see picture below) he could have been an excellent Fed chairman. The more these folks sleep, the less damage they can do.

For our part, we have long predicted Janet Yellen to be the logical successor to Bartender Ben. This week, we'll take a slightly closer peek at Ms. Yellen and wonder...can she pour the fabulous Wealth Effect cocktail as well as Bartender Ben? After all, he has such a knack for intoxicating concoctions. But you know what they say about drinking and driving...especially when it's the economy you're driving. Watch out for those deer, Janet.

And speaking of Club S&P, the "1700" sign is once again proudly hanging outside the front entrance for all the giddy guests to see. On Wednesday, Bartender Ben announced that the generous pours would continue for at least another month. Well done Ben. The partygoers whooped and hollered as Mr. Market went bananas, dancing on a chair, plonked atop a table in the middle of the club.

Unfortunately, towards the close of trading on Friday, the chair got a bit wobbly as one of Ben's bus boys in St. Louis, Jim (Bully) Bullard, hinted that Ben might actually cut back the pours in October.

We've said it before and we'll continue to express our doubts that Bartender Ben will curtail his generous servings anytime soon. He would prefer to see out his shift in full throttle and maintain his reputation as a fun guy.

And while the 1700 sign still hangs proudly, if not with a slight lean after Friday's late sell off, we'll take a look at Club S&P and report on a couple of signs that worry us.

After all, isn't it a wee bit odd that if everything is so good in the economy, Ben must keep pouring stiff drinks to keep Mr. Market from a bad does of depression. In fact, nothing seems to matter any more except how much vodka is in the punch bowl. Maybe Mr. Market can drink himself sober, but we doubt it.

This week we'll also take a quick look at how well the Fed has done in maintaining the value of the US dollar since it's inception. As you can guess, another failing grade for the creature from Jekyll Island.

Finally, our chart(s) of the week tie in nicely with our discussion of the current state of Club S&P. As the charts portray, with the next earnings season looming large, we wonder how long the cunning accountants of corporate America can maintain their mirage?

An economist is an expert who will know tomorrow why the things he predicted yesterday didn't happen today.

- Laurence J. Peter -

Janet Yellen is just what we DON"T need more of in central planning...an "interventionist". That means she willl intervene, which is typically not good. The worst part is that she really believes that she needs to intervene. In fact, way back in 1999, she had this to say....

> *Will capitalist economies operate at full employment in the absence of routine intervention?* ***Certainly not.***

Bartender Ben is an interventionist too and many suggest that some of his interventions were inspired by Janet herself. That's why she is one of Bartender Ben's favorite cocktail servers.

But while she is unquestionably smart, she is certainly not clairvoyant.

Let's take a look at some of her former prognostications. In so doing, we've resisted the temptation to add snide comments...it would be just too easy. We think both her lack of true observational skills and understanding of surrounding circumstances speak loud enough for themselves.

> February 2007...obviously channeling Bartender Ben:
> *The bottom line for housing is that the concerns we used to hear about the possibility of a devastating collapse—one that might be big enough to cause a recession in the U.S. economy—while not fully allayed have diminished. Moreover, while the future for housing activity remains uncertain, I think there is a reasonable chance that* ***housing is in the process of stabilizing****, which would mean that it would put a considerably smaller drag on the economy going forward.*
>
> December 2007
> *To sum up the story on the outlook for real GDP growth, my own view is that, under appropriate monetary policy, the economy is still likely to achieve a relatively smooth adjustment path, with real GDP growth gradually returning to its roughly 2½ percent trend over the next year or so, and the unemployment rate rising only very gradually to just above its* ***4¾ percent sustainable level.***
>
> November 15, 2010, in a taped interview with the Financial Crisis Inquiry Commission
> *For my own part, I did not see and did not appreciate what the risks were with securitization, the credit ratings agencies, the shadow banking system, the S.I.V.'s —* ***I didn't see any of that coming until it happened.*** *[woops...my bad]*

Sorry, we just couldn't resist one snide comment. If you suffer from insomina or just have a masochistic instinct, you can listen to the whole taped interview session here.

And while you have to appreciate her candor, one can hardly hold Janet responsible for

missing the last disaster of 2008. After all, Ben missed it. In fact, every Fed chairman before him for the past 100 years also missed their respective calamities. The reality is, these folks will never see it coming until it's banging them....and us...over the head. They're just not good at it.

We're sure Ms. Yellen is a smart enough individual. PhD from Yale, teaching time at Harvard, London School of Economics, Berkeley, etc. The usual stuff. She even spent some time as head of Billy Clinton's economic advisory team (presumably she remained awake during Bill's meetings). Just for a change, however, we think it might be nice to have someone in the position who actually worked in the private sector at least for a while...you know...outside academia and related public service and free coffee in the cafeteria.

Given her background and lack of real world experience, we just wonder if our Janet would even see, let alone know how to deal with, something as routine as a looming derivatives disaster, After all Janet, that is the shadow banking system you missed last time and those SIVs...Special Investment Vehicles...are often the stealth missiles used to deliver the bank's off balance sheet wagers. They have not gone away. They are not readily transparent and they have a nasty habit of jumping out of the bushes when you least expect. We suggest you study the road and drive carefully.

Now, on the other hand, Larry might understand derivatives a bit better. He, at least, has had experience with them. Presumably you learn something when you lose $1.8 billion in a busted trade, as he did while President of Harvard. And he knows how to deregulate derivatives about as good as any banker...in fact, if a disaster strikes, much of it will be his fault.

But coming back to Janet and a potential disaster, we suspect she would not see it coming and then would reactively throw money at it...rather than be alert and take evasive action. That's what interventionists do. They react...and usually not well.

We can't wait to see how that turns out.

Actually we can wait and we hope we never will have to witness something as calamitous as a derivatives meltdown. But you know bankers. They just can't help themselves, especially when they think that Ben and Janet will always have their back.

The public is wonderfully tolerant. It forgives everything except genius.

- Oscar Wilde -

While we are having such a good time poking fun at the Federal Reserve System, let's refresh on what they are supposed to do...the so-called Fed Mandates. In 1977, the Congress established the statutory objectives for monetary policy --maximum employment, stable prices, and moderate long-term interest rates-- in the Federal Reserve Act. We know that preventing booms and busts is not their speciality and we can look at employment and interest rates some other time. But how about stable prices for a start?

In this case, they have done a pretty good job of keeping prices stable...if you ignore the diminishing value of the dollar. We are not sure if this is chicken or egg but one thing we do know is that it takes a lot more eggs these days to buy that same chicken. Let's face it. If you keep producing something...in this case...paper dollars, they will simply lose their value over time. Unfortunately, one thing the Fed does know how to do is print money.

They are genius at it...and we are forgiving. Silly us.

Take a look at the chart below and it appears very likely that this is another failing grade for the Fed.

But don't worry, the more expensive that chicken gets, the more dollars the Fed will create for us to buy it. Just like that father of modern money creation, Zimbabwe Reserve Bank Governor, Gideon Gono. Gideon was the genius banker and former tea boy who singlehandedly managed to provide insane amounts of inflation in that formerly fair land initally named after Cecil Rhodes. Ben is so envious. Such a pity that Governor Gono's own chicken farm keeps burning up...really! You can read about it here. No kidding. He owns his own chicken farm. Wonder where the original owners ended up?

Back in the good ol' US of A, we wonder how long it will take for our proverbial chickens to come home to roost...especially if Janet decides to "intervene".

One of the funny things about the stock market is that every time one person buys, another sells, and both think they are astute.

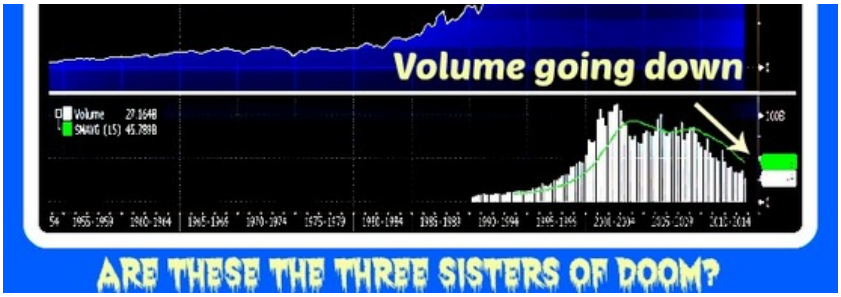
- William Feather -

Club S&P 1700 is rocking again. But will it last this time? As usual, we have no clue. But given that we are short on time and long on travel schedules, we will let a couple of charts do most of our talking this week.

The first one, below, shows the history of the S&P for the past 50 years. We have shown prior versions of this in the past, mainly because we see it as being so dramatic.

But what strikes us on this occasion is that while the market continues to soar to record heights, the volume of trading (which we, rightly or wrongly, believe reflects broad participation by investors) is declining. We suspect that reflects just how much this has become a trader's market and this scares us.

Traders are brave, until they are not. And when they run, they run as a herd. And they are fast. Their super computers are even faster. Take a look.



Back in 2007, the equity markets were quietly confident that Ben had their back too.

Mr. Market then, as he is now, was on fire. On the other hand, Ms. Bond was just a tad concerned as collateral squeezes and forced liquidations had made her bonds more risky when compared to stocks.

Here we are in 2013 and things look a bit too similar for comfort. Does Ben suspect something and that's why he's afraid to pull back on his pours?

Once again, we ask...is history rhyming?

After all, there are far more unemployed and underemployed now than there were in 2007. Real median household income is pretty stagnant. Between this year and last, it actually decreased -- from $51,100 to $51,017. The number is now lower than it was in 1989. The national poverty level is essentially unchanged from last year with 46.5 million people finding themselves below the threshold. Understandably, in the interim, food stamp usage has hit a milestone with 23,116,928 U.S. households enrolled in the Supplemental Nutrition Assistance Program (SNAP) as of June...that's over 20% of all U.S. households. These are worrisome statistics.

Once again, as they did in 2007, the lovebirds on CNBC are chirping about fair value and controlled risk. But we are $8 trillion further in debt and Bartender Ben's balance sheet has ballooned dramatically. How much more hot air can it hold?

Call us crazy but this is disconcerting to us. Perhaps it should be to you too.

CHART(S) OF THE WEEK

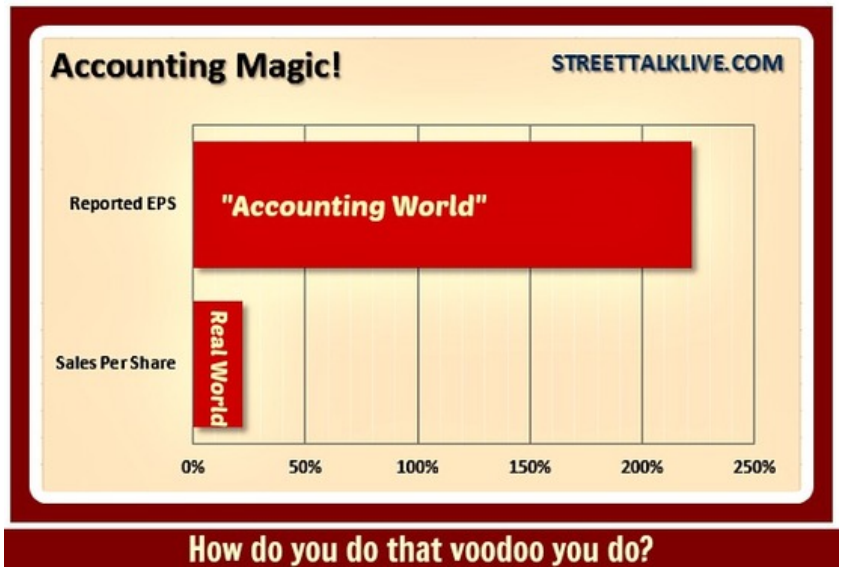
The stock market is filled with individuals who know the price of everything, but the value of nothing.

- Phillip Fisher -

Earnings season is coming up...again...so it may be timely to take a look at a couple of charts which got our attention this week.

The first, courtesy of Streettalklive.com, compares the earnings per share verses the sales per share of the constituent companies of Club S&P. Quoting from the Streettalklive.com article, which you can read in its entirety here [emphasis ours]:

> *What has also been stunning is the surge in corporate profitability **despite a lack of revenue growth**. Since 2009 the reported earnings per share of corporations, the bottom line of the income statement, have increased by a total of **222%** which is the sharpest, post-recession, increase in reported EPS in history. However, at the same time, reported sales per share, which is what happens at the top line of the income statement, has only increased by a marginal **22%** during the same period. This is shown in the chart below.*
>
> *In order for profitability to surge, despite rather weak revenue growth, **corporations have resorted to four primary weapons: wage reduction, productivity increases, labor suppression and stock buybacks**. The problem is that each of these tools create a mirage of corporate profitability. The problem, however, is that each of these not only have a negative economic consequence but also suffer from diminishing rates of return over time.*
>
> *One of the primary tools used by businesses to increase profitability has been through the heavy use of **stock buy backs**.*
>
> *The problem with this, of course, is that stock buy backs create an illusion of profitability. If a company earns $0.90 per share and has one million shares outstanding - reducing those shares to 900,000 will increase earnings per share to $1.00. **No additional revenue was created, no more product was sold, it is simply accounting magic.** Such activities do not spur economic growth or generate real wealth for shareholders. However, it does provide the basis for with which to keep Wall Street satisfied and stock option compensated executives happy.*

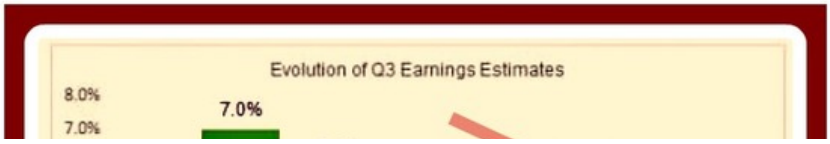


Perhaps it's charts like the one above which inspire the one below. Our final chart for this week shows the decreasing expectations for the upcoming earnings season. Expectations for Q3 have come down materially as the Q2 reporting season unfolded and companies have guided lower.

This chart show how Q3 consensus earnings growth estimates for the S&P 500 have evolved over time and as you can see, those very analytical analysts are not becoming more optimistic as the weeks go by.

Translation: it could be a rough October.

But don't worry, Ben and Janet have it all under control. If then don't, however, lounging Larry may have the last laugh...when he wakes up.



One more reason why Bartender Ben is still pouring?

Til next week...

"Ignorance is the curse of God. Knowledge is the wing wherewith we fly to Heaven."
William Shakespeare

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