



## **Reality Check—Facts vs. Cheerleading**

**M. Piepenburg**

### **The United States:**

- ✓ Since 2009, the Fed has expanded the money supply by 400%—more in the last six years than in the past century, combined.
- ✓ Having taken over 200 years to accumulate a national debt of \$8.5 trillion; we've doubled that amount since 2009.
- ✓ Despite this massive debt and money printing, our *compound* GDP growth since the 2008 crisis is 1.8%—the weakest rate in 100 years. In short: no reward for the risk, just historically inflated market bubbles.
- ✓ The US has over \$200T in unfunded liabilities (Medicare, Social Security, etc.) that it *cannot* pay—this number is over 12X GDP. It is an appalling figure, the largest in history.
- ✓ More than two-thirds of Americans live paycheck-to-paycheck. Over 50 million Americans are on food stamps (invisible food lines), and more than half of American workers earn less than \$30,000/year.
- ✓ Celebrated employment reports from the Fed and Bureau of Labor Statistics omit the discouraged employed (i.e. those who left the work force in despair) and wage growth stagnation from the data. The distorted 5.6% unemployment rate is thus frankly inaccurate as it lacks context. The full story is more to the point: today, only 44% of employable people (age 18-65) have *full time* jobs. There are 2 million *less* full-time jobs now than in 2007, and household income is 4% below pre-crisis levels. Such U6 numbers mirror the Great Depression and make a mockery of the “employment good news” permeating the media, the White House and the PWM teams at all the “elite banks.”
- ✓ The very TBTF/Dodd-Frank banks bailed out in 2008 are 35% larger today; their collective balance sheet has soared by nearly \$11T—mostly by loaning money to hedge funds rather than Main Street borrowers. Bank of America, for example, faces over \$100B in fines (tax avoidance schemes, Countrywide's sins etc), has a balance sheet of \$2T, yet has deposits of only \$1.1T. It reported \$11B in distorted earnings/profits for 2014 only because the Fed had pegged the cost of institutional borrowing to \$0.0. (Historic/normal pricing would have made that cost \$30B, rendering that bank, like the others, profitless and in the red.)
- ✓ Recent sins—from the 2000 dot.com mania to 2008's sub-prime confidence—are being repeated with no regard for lessons learned; banks are more levered than pre-2008 and there are IPO's and companies (over 20) worth billions despite showing *no* revenue. Regulatory agencies permit traders to execute nine figure trades on 2% margin. Does all this sound familiar? We've simply continued the same patterns of the past and solved none of the underlying problems from 2008.

- ✓ The notional value of the derivatives market (essentially, leveraged instruments) comprise over 9X global GDP, and yet their risks (which complexity theory places beyond the scope of any regression model) are not reported on bank balance sheets.
- ✓ \$3.5T in printed money has gone from the Fed to Wall St in the form of over-night/repo/credit markets which feed the derivatives, equity and fixed income trades—*now consummate bubbles at all-time over-valuation metrics*. Easy money promotes poor investments—i.e. exaggerated allocations to such plays as shale or real estate, or internal LBO's (such as the \$49B bond deal by Verizon, *deeply* in the red, or the recent Actavis purchase--\$66B-- of Allergan, a *botox* provider). Shale Patch enterprises could not hit positive free cash flow at \$100.00/barrel, yet those same enterprises (when oil is half that price) are expected to back bonds which they can't repay. Again, wasteful investment, caused by promiscuous lending, fuels a desperate search for yield which always precedes a bust.
- ✓ The bullish spin of the industry sell-side is driven primarily by the unprecedented corporate earnings strength to explain our "recovery." Nothing could be less true. For market experts (rather than market salesmen) reality is the very opposite, as the quality of those earnings has completely deteriorated and given a false indicator of market viability. S&P companies have used the Fed's printed money and zero-interest loans to pay for \$2.5T in stock buy-backs since QE1 began, thus dramatically shrinking the size of the share count (*and hence artificially raising EPS calculations*). Thus the stock market touts higher and higher earnings without mentioning the hidden fact that those same companies have steadily deteriorating balance sheets and growth numbers. What we now have is a market of surface shine yet internal rot and an equity bubble (time bomb) trading at 20.5X LTM profits. We have not seen such a broad ratio since 2007. Only now it's worse. Unlike the 07-08 crash, the next crash will be in the back drop of twice as much debt and no more fuel in the monetary rescue tank...
- ✓ The historically low and prolonged interest-rate policy (73+ months of ZIRP) has created an unprecedented carry-trade environment and "bid" for almost every existing fixed income asset—from quality to junk, driving bond yields to rock-bottom levels not seen in over 600 years, effectively erasing regard for credit risk or price discovery. This is a massive bond bubble.
- ✓ The markets are so addicted to zero-interest rate support that even the *hint* of a .25% rate hike from 0% creates panic. Yet the historic over-night Federal Funds Rate for 50 years has averaged 5.7%. In short, the market thinks a .25% rate is too scary...That's how weak, addicted and artificially "recovered" these markets/bubbles are.
- ✓ ZIRP is further proof that despite sell-side cheerleading, the U.S. economy is in deep peril; media, pundits and officials boast of job and GDP growth (false), yet can't explain why monetary policy is in full and continued 'zero-bound emergency' mode. Why this juxtaposition of policy and propaganda? Simple answer: we are operating on spin rather than reality.
- ✓ The Fed has carried and inflated the markets since 2009, removing all price discovery and risk, causing the major hedge funds to ride the bubble via the simple leveraging of indexes, which is now the majority/core trade of the top portfolio managers in the US...Collusion, group-think, leverage and an inability to short a "short-less"/Fed-supported market is the new normal—until, of course, the monetary party comes to an abrupt end.

- ✓ The same QE/ZIRP monetary policy has directly and artificially inflated equity asset classes (the S&P having nearly tripled since 2009), creating historically unmatched (and co-linked) market bubbles rather than objectively measurable levels of economic productivity. *This is a mega bubble. History has seen nothing like this in the capital markets.*
- ✓ Every fundamental, time-tested and traditionally honored market indicator—median PE ratios, q-ratios, price to book ratios and dividend yields—show historical levels of stock market over-valuation, greater than pre-crash 1929 or 2008. Yet the Fed keeps pumping up the bubbles.
- ✓ Stock market capitalization to GDP is 203% (in 1929 it was 84%).
- ✓ Every example (over 30 since 1790 France) of great nations attempting to solve debt problems by printing money and expanding national debt has failed, leading toward deflation/inflation collapse.
- ✓ Despite such data, the bubble-induced “animal spirits” (as well as classic psychological/herd patterns of recency and normalcy bias) have created an unprecedented misperception (eradication) of risk, with the VIX at all-time lows and consumer confidence at all-time highs.
- ✓ Despite unequivocal evidence of distorted markets, current leadership, financial experts, Fed governors and media pundits are daily proclaiming economic recovery, as if to convince/sell hope rather than facts, sustaining grossly inflated markets (bubbles) on adjectives rather than numbers, the natural laws of markets or a rudimentary respect for history.

### ***The World:***

- ✓ The world is at an historical peak debt of \$200T, up \$60T since 2008, with global GDP increasing by only 16T in the same period. In the past decade, global debt has *doubled*. In short: the world is borrowing time, not economic productivity.
- ✓ The global debt to income ratio is now a staggering 3:1. Productive recovery in such a backdrop is the equivalent of swimming with an anchor chained to your ankle.
- ✓ In 2008, China reported \$7T in outstanding debt; today it stands at \$28T (assuming this is even accurate...); yet for \$21T in new debt, they’ve gained only \$5T in GDP for the same period. And as China’s growth (40% of global GDP) slows, so too goes the commodities it once demanded (oil, iron ore etc).
- ✓ Global sovereign bond markets have systematically gone into more debt (rather than default), creating a mega bubble and expanding that market (at \$100T) to 3X’s its 2000 level—and back stopping a \$555T derivative trade.
- ✓ Central banks around the world follow the U.S. lead of printing and ZIRP’ing their way to short term pain relief without consideration for long term repayment or inflation. \$4T of the sovereign debt instruments of the world are trading currently at negative yields. Today’s cap rates are so compressed that bond market valuation has been effectively lost. The remaining half of the world’s government bonds, yield less than 1%. This is extraordinary.

- ✓ European private banks, like U.S. banks, are grotesquely casino-like in their operations: speculating at mass leverage while spreading the risk to their shareholders. In 2010, Deutsche Bank had \$34B of equity yet a \$1.9T balance sheet—levered at 56X... BNP-Parisbas had \$60B in equity for \$2.1T in outstanding loans and bond exposure, essentially using depositor funds to gamble into big bonuses.
- ✓ *Our own former Fed Chairman, Alan Greenspan*—the unexpected godfather of easy credit (ZIRP) and printed money (QE)—having exited the Eccles building, is finally speaking frankly. He recently admitted that such monetary policies led to market bubbles and now point toward a severe market crash. Gold, he admits, will go “measurably higher” in the next five years. One would think such a confession from the very architect of today’s mega-bubble would stir the markets, but the markets aren’t stirred. Instead, they cling to expectations that current Fed leadership will “accommodate” them with new fairytales about the economy and policies that keep the punch bowl flowing.

***But in this environment, investors deserve strategic advice, not fairytales and punch bowls.***

---