<u>BARNUM, BAILEY, AND BERNANKE- TAKING STOCK</u>
<u>("DESPERATE HOUSEWIVES", EPISODE 3)</u>

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In "Love Over Gold", Dire Straits sing:
"You walk out on the high wire
You're a dancer on thin ice
You pay no heed to the danger
And less to advice".

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OVERTURE

Ringling Brothers and Barnum & Bailey offer their wonderful circus to eager spectators, calling it "The Greatest Show on Earth". The long-lasting easy money performance displayed by the Federal Reserve over the course of the worldwide economic crisis surely ranks as a close second. The Federal Reserve does not have a formal directive to manage equity or real estate prices. In general, it claims that its economic maneuvers do not target these prices. Yet much of the Fed's orchestration has sought to propel stocks and home values skyward and to keep them airborne. The Fed often has played in concert with other fearful central bankers around the globe, and sometimes in harmony with stimulating politicians. Since "Desperate Housewives (Episode 2): The Home Front" (11/3/10) surveyed the home horizon, let's focus on aspects of Fed policy and the US stock neighborhood.

OPENING PARADE

Consumers are about 70 percent of American GDP. Their net worth levels and trends obviously affect their spending. Consequently what happens to equity prices is relevant to "The Economy" and thus to inflation (deflation) and employment levels and trends. The S+P 500 reached its summit October 10, 2007 at 1576. Real estate playgrounds peaked in 2006-07. United States household (and nonprofit organization) net worth tumbled over twenty-four percent in nominal terms from end 2007 to the end of first quarter 2009. The net worth collapse from about $64.2 trillion to $48.8 trillion, a devastating $15.4tr decline, exceeds America's nominal GDP of just over $14.7 trillion (third quarter 2010 annualized). Of that elephantine loss, about $10.0tr, or about 64.9pc, came from carnage in equities (Federal Reserve, "Flow of Funds" Z.1, B.100, B.100.e; equity shares directly and indirectly held; 9/17/10).

Homes and stocks are not stages separated from debt marketplaces, policies of sustained low interest rates, and money printing spectaculars. Neither are they off-scene from US dollar and other currency levels and movements or commodity arenas. See "Goldilocks, Green Shoots, and the US Dollar" (9/7/10), "Petroleum Overview: Crosscurrents and Crossroads" (9/27/10), and "Desperate Housewives- 21st Century Economic Housekeeping" (10/20/10).

Nevertheless, acting inside the big tent of its broad and not well-defined mandate to stabilize prices and deal with employment issues, the Federal Reserve has wide scope to dance around. Even if it masks its intentions regarding equities and real estate prices behind smoky rhetoric, its wordplay and actions can influence them significantly. All else equal, sustained monetary easing via money printing and low interest rates tends to boost nominal GDP. All else equal, this tends to assist nominal corporate profits. Higher profits- or expectations of them- helps to rally equity prices, which in turn repairs (in nominal terms) the consumer balance sheet.

REGULATORY CARTWHEELS

"Houdini: Art and Magic" is a current exhibition at The Jewish Museum in New York City. The gallery details the colorful life and remarkable exploits of that famed performer and escape artist. Neither handcuffs nor straitjackets could confine him for long. Perhaps the Federal Reserve and its allies likewise will show flexibility and dexterity in using their beloved toolkits to help America (and the world) escape treacherous traps.

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Brian Sack is the executive vice president of the Federal Reserve Bank of NY's Markets Group and the manager of the System Open Market Account for the Federal Open Market Committee. This luminary recently made a sparkling confession about the nimble Fed ("Managing the Federal Reserve's Balance Sheet", 10/4/10). He murmurs: "The effect of asset purchases on the economy remains a point of ongoing debate, with some uncertainty about the channels through which such purchases operate and the magnitude of those effects. My own perspective is aligned with the view expressed by Chairman Bernanke in Jackson Hole- that the effects arise primarily through a portfolio balance channel. Under that view, our asset holdings keep longer-term interest rates lower than otherwise by reducing the aggregate amount of risk that the private markets have to bear. In particular, by purchasing longer-term securities, the Federal Reserve removes duration risk from the market, which should help to reduce the term premium that investors demand for holding longer-term securities. *That effect should in turn boost other asset prices, as those investors displaced by the Fed's purchases would likely seek to hold alternative types of securities*." (Italics supplied).

He adds more regarding the consequences intended by the Fed's agile acrobats: "[Federal Reserve] balance sheet policy can still lower longer-term borrowing costs for many households and businesses, and *it adds to household wealth by keeping asset prices higher than they otherwise would be. It seems highly unlikely that the economy is completely insensitive to borrowing costs and wealth, or to other changes in broad financial conditions*."

Translated, such asset price boosts can occur in stocks. As US government interest rate yields fall and fall further, other corporate and mortgage debt yields may plummet too. Sack did not address commodity issues. However, in recent years, marketplace trends in US equities generally have marched alongside those in commodities. Thus the stock ascent since spring 2009 has paralleled upward swings in many commodities and encouraged buying (and "investing") in commodities.

Share buy backs by US nonfinancial corporate business have been substantial. They were at a seasonally adjusted annual rate of about $318bb in 4Q09, $201bb in 1Q10, and about $183bb in 2Q10 (Z.1, F. 213). Note recent Financial Times headlines trumpeting "Cheap borrowing costs boost buy-backs" (11/12/10, p21) and "Cheapness of bonds helps fuel rebound in share buy-backs" (10/6/10, p27).

STOCKS CLAW BACK

Not surprisingly, stock owning audiences and corporations (and those who serve them) applaud rallies in nominal stock prices. In general, don't substantial equity rallies tend to bolster consumer confidence and thereby prod them to spending a bit more? Most company and media reports on earnings emphasize nominal profits and losses. For stocks, most people watch- and make trading decisions and recommendations relative to- headline prices. Apart from researchers burrowed in their dens, few avidly talk about the real price of the Dow Jones Industrials or the S+P 500 relative to some base year.

By the end of 1Q10, after a ferocious rally, equities on the consumer balance sheet had retrieved about $5.8 trillion (53.2pc) of their loss. The S+P 500 at about 1200 rests 7.6pc over its end 1Q10 level. Not all shares in the consumer balance sheet inhabit the S+P 500, or are even US issues. Yet adjust the first quarter value of equity shares via the move to 1200. This makes the current value of stocks at the consumer box office around $18.0tr. This equals over 86pc of the end 2007 level. Thus the net damage in equities since end 2007 has dwindled to a relatively modest $2.9tr versus end 2007.

What about 2010 nominal after tax profits? US after tax corporate profits (all companies) first and second quarter 2010 were about $1376 billion (annualized, without inventory and capital consumption adjustments; Bureau of Economic Analysis). This is almost 52 percent above 1Q09's low annual rate. If sustained, current profits will exceed calendar 2006's $1350bb level slightly.

The remaining equity injury is not trivial. Yet given the awesome rebound in stocks and the tremendous leap in corporate profits why do Fed ringleaders continue to worry? Why isn't the Fed joyously prancing around the financial circus in celebration? Why are they treating the grandstand to further theatrics of quantitative easing (money printing)? Why risk noteworthy inflation sometime down the road? Given that the broad real trade-weighted US dollar is close to the edge of all-time lows, why risk further dollar depreciation? Why aren't consumers happier?

DISGUISES

"I try to keep my sadness hid, smilin' in the public eye
While in my lonely room I cry
The tears of a clown
When there's no one around." Smokey Robinson & The Miracles

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At end 2Q10, US consumer net worth was still down $10.7tr (about 16.7pc) from its end 2007 level. The rally in stocks since end June 2010 has not substantially repaired the household financial fabric. The US housing marketplace has not been fixed. The Fed and other central bankers seem nervous about further real estate weakness. Moreover, the Fed's new round of money printing indicates that it probably is not highly confident about the sustainability of recent soaring corporate profitability. Or, even if the Fed has some faith in the durability of these earnings, it may believe the profits will not do enough to sufficiently speed the economy. Recent real GDP growth derived substantially from inventory restocking and assistance from stimulus packages. The Fed guardians expect little assistance from these two bandwagons anytime soon.

The longer and more substantial the weakness in consumer balance sheets, whether from stocks, real estate or elsewhere, the more contortions the Fed will make. Unhealed wounds to nominal household net worth due to the ongoing housing slump increases the need for equity rallies or other rescue efforts. All else equal, the more money flying around, the more inflation (or less deflation), and therefore the more likely corporate earnings will remain steady or even rise in nominal terms. Even if equities do not rally much from current levels, maybe money printing will resuscitate house prices further!

If dollar depreciation and inflationary dangers increase due to monetary easing- and lack of genuine progress by political stagehands in fixing the federal deficit (and mending state and local ones), so be it. To some extent, and all else equal, the magic of dollar depreciation (up to some point) helps to levitate dollar denominated asset values. Thus maybe the consumer balance sheet will balloon nicely from this source. And substantial additional dollar depreciation and lower real wages may help to cure some US unemployment woes.

PROPHETS AND PROFITS, CONJURING UP CONJECTURES

Marketplace gurus differ in their opinions as to which entangled factors influence a given equity level or trend and why. Corporate profitability is only consideration that affects stock prices and trading decisions. History suggests that the relationship between nominal GDP growth, corporate profits, and equity prices is a rather broad one. Yet scanning these variables offers some guidance regarding equity benchmarks such as the S+P 500 and Federal Reserve policies. People present profits in various ways. The analysis below uses nominal after tax profits without inventory or capital consumption adjustments.

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During the dreary Depression, from 1929 through 1933, United States nominal GDP withered 45.56 percent. However, in the post World War 2 period through 2008, US nominal GDP dropped only twice on a year-on-year basis, and then less than one percent. Nominal GDP slipped .36pc lower in 1946; 1949 dipped .71pc. The past sometimes casts a long shadow. The rarity and ancient occurrence of such declines hint at why the 2009 nominal GDP drop of 1.74pc worries financial guardians terribly (and consequently inspires them to print lots and lots of money).

Since 1929, US nominal after tax profits in absolute terms are negative (losses) only in 1931 and 1932. From 1945 through 2009, after tax profits declined relative to the prior year 22 times, or four out of 10 years. Substantial declines on a one year basis have been around 17 to 20pc: 1945's 19.13pc, 1949's 17.45pc, and 1982's 17.13pc. The Fed has in mind 2008's fearful 20.74pc profit nosedive versus 2007 (as well as 2007's 4.19pc year-on-year descent from 2006).

The average percent year-on-year change for after tax profits from 1929-2009 is an 8.98pc increase. Over this historical long run, the 2004 and 2005 jumps of 39.96pc and 32.98pc capture attention.

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From calendar years 1929 through 2009, the average of US nominal after tax profits relative to nominal GDP is 5.76pc. Over this long run, 2006's 10.07pc holds the record high, with 2007's 9.19pc and 2005's 9.71pc close to that. These recent years are historically high. Prior to 2005, the ratio never exceeded nine pc, so the Federal Reserve watchdogs may be skeptical regarding the sustainability of such high levels. The other levels over eight pc were rare- only five times (the last was 8.61pc in 1950). Between seven and eight percent also was uncommon- only six times; prior to 2004's 7.78pc, the last level over seven pc was 1979's 7.11pc.

What is a low level for this ATP/GDP ratio? The Depression demonstrates that nominal corporate losses occur, even in the United States. Over the entire Depression Era, say 1930-39, though two years were negative, the ratio averaged about 3.41pc. Since WW2, the low was 1986's 3.06pc. The 4.95pc level of 2001 during the last recession was fairly low.

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From 1929 through 2009, the ratio of nominal after tax profits to the S+P 500 (using yearly closes for the S+P 500 index) varies widely, with the average for the eight decades at 73.78pc**.** 2008's 113.45pc was the loftiest since 1981's 130.07pc and 1984's 102.31pc. The record was 1979's 168.70pc. Since 1950's 123.84pc (1948's 154.61pc was a nearby top), the ratio did not exceed one hundred pc again until 1974 (and stocks were low in December 1974). Besides the Depression, low levels are 1999's 35.51pc and 1961's 40.11pc.

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Now, suppose economic gatekeepers succeed in keeping nominal GDP for the foreseeable future around $14.6 trillion. Assume the 1929-2009 average ratio for after tax profits relative to the S+P 500 (73.78pc). Then based on assorted full year assumptions for after tax profit levels relative to nominal GDP, one can generate a range of hypothetical S+P 500 levels. This does not mean equity benchmarks will or should touch or be sustained at one or more of these points.

Observers can and should add a procession of other warnings and qualifications. One can vary the assumptions. Corporate profits may rise or fall a lot. Nominal GDP may jump or slump a lot. What accounting and tax regimes were, are, and will be in place? Not only do ratios of ATP relative to the S+P 500 (and Dow Jones Industrial Average) show wide swings over time. All sorts of factors influence equity prices. Besides, America is not an island, even though this sketch focuses on the US.

(1) Assume US full year 2010 calendar year after tax profits are $1376bb (the actual average of first and second quarter 2010) and that 2010 nominal GDP is $14.6 trillion (the average of the first three quarters). Then ATP are 9.43pc of nominal GDP (1376/14600). This ratio decisively exceeds the long run average of 5.76pc. It compares favorably with the lofty ones of 2005-07. Have we permanently returned to the enchanted Goldilocks era, or a fabulous new version of it? Has the financial leverage of such past years been completely abandoned to the scrap heap? Is cheap money in nominal interest rate terms still an enjoyable treat?

How real and durable are current corporate profits? Is another round of money printing essential to maintain them?

For the S+P 500, 73.78/100=1376/X. X equals a hypothetical S+P 500 around 1865, far above the 2007 pinnacle. Unbelievable!? Again, the historical relationships (ratios; leads and lags) between profits, GDP, and equity prices vary widely. Moreover, this essay is not forecasting such a rally in the S+P 500. Besides, look at actual 2Q10 statistics, thus replacing the 73.78 in the numerator. Take 2Q10 actual ATP of 1382.6 (annualized) and divide them by the S+P 500 end-quarter close of 1030.7 to produce 134.14. Relative to end 2Q10 levels, in order to achieve the long term 73.78 average for ATP relative to the S+P 500, couldn't profits fall, with equities staying at 1030?

Calculations such as these do hint at the benefits, however, of continually boosting nominal GDP levels in the hopes of sparking and sustaining equity price rises.

(2) Suppose US calendar year profits relative to nominal GDP return to the historical average of 5.76pc. Compare the ATP/GDP ratio for several individual years in the inflationary era of the 1970s. In 1973 it was 6.15pc, 1974 6.34pc, 1975 5.73pc, 1976 6.28pc, and 1977 6.70pc; the five year average was 6.24pc, well above the 4.95pc of the 2001 recession.

In any event, at 5.76pc, nominal after tax profits then would be $841bb, way below the current heights (5.76/100=X/14600). Hence the Fed may be somewhat worried about the sustainability of current profits.

The S+P 500 would then equal 1140 (73.78/100=841/X). This perspective permits many to crow that the rally (or at least much of it) since the 3/6/09 lows (S+P 500 around 667, Dow Jones Industrial Average at 6470) is "reasonable".

(3) Imagine the nominal ATP/GDP ratio falls to the 2001 recession level of 4.95pc.

Nominal ATP then equal about $723bb: 4.95/100=X/14600. What is the S+P 500 with this set of assumptions? If 73.78/100=722.7/X, the S+P 500 is about 980.

MORE FINANCIAL CIRCUS HISTORY AND MYSTERY

"Sweet dreams are made of this Who am I to disagree?" ask the Eurythmics in "Sweet Dreams (Are Made of This)"

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Toss some financial chronicles from the 1970s into the ring regarding current Federal Reserve talk and action. That past era hints that quite a few current financial bandleaders probably perceive merit in inflationary policies. Economic situations obviously change. Economic history is subjectively perceived and not destined to repeat itself. Yet players need not walk back only to the Depression to identify what policy makers may do to set and keep the economy on the path to prosperity.

The inflationary track record from the 1970s, when viewed alongside the eventual economic and stock marketplace recoveries, suggests that current policy wizards will risk creating real inflation to rescue the economy. Whether the present inflationary effort generates sustained substantial nominal inflation, or even therefore much real inflation (or even really bad inflation), remains to be seen.

Just as lots of factors affect corporate profitability, potential inflationary sources are diverse. Some inflationary influence may seem more harmful (or helpful) than others. Money printing is not the only fount of inflation (or the sole method to try to breed GDP growth), but it is one avenue for seeking to generate it.

Let's start the procession and recall the recession of November 1973 to March 1975 and the 46.6pc smash to the Dow Jones Industrials from its January 1973 height to its dismal December 1974 bottom.

In 2009, US real GDP fell a dreadful 2.6pc year-on-year. What about the mid-1970's economic feebleness? After 1974's comparatively modest .6pc real GDP drop and 1975's .2pc fall, real GDP skyrocketed 5.3pc in 1976, 4.6pc in 1977, 5.6pc in 1978, with a further 3.1pc in 1979 (Bureau of Economic Analysis). Note that (perhaps not by mere coincidence) the broad real trade weighted dollar was chopped down in the mid-70s. Having been around 107.6 in January 1973 and 99.7 in January 1974, it toppled to its major low in October 1978 of 84.1. Incidentally, the TWD's October 2010 level at about 84.5 is around the 1978 depths (and the troughs of April 2008 at 84.4 and July 1995 at 84.0).

The GDP Price Index is one measure of real inflation. From 1929 through 2009, its average yearly increase was 3.03pc. During the inflationary 1970s decade, the year-on-year average rise was 6.61pc. It peaked at 9.07pc in 1974 and 9.49pc in 1975 near the time of low equity prices. These Price Index rises were the highest since 1946's 11.55pc and 1947's 11.08pc. Money supply growth around the 1973-75 recession years was robust. From end December 1973 through December 1976, nominal M2 rose 34.7pc, an average of over eleven pc each year (from December 1972 through December 1978, M2 grew about 58.5pc in total).

Note the year-on-year rises in nominal GDP. It grew 11.66pc in 1973, 8.48pc in 1974, and 9.22pc in 1975. Rapid nominal GDP increases continued; 1976 jumped 11.41pc, 1977 11.26pc, 1978 12.99pc, and 1979 11.70pc. These decisively exceed the average nominal GDP year-on-year change of 6.59pc from 1929 to 2009.

US nominal after tax profits suffered only one minor drop (1.16pc in 1975) during the inflationary years after 1970 (1970 was down 10.12pc). Moreover, nominal ATP raced higher after 1975. In 1976, ATP grew 21.94pc over 1975; 1977 rose 18.86pc, 1978 18.52pc, and 1979 12.90pc.

Thus an inflationary period occurred not only alongside high nominal GDP growth and relatively steady and eventually increasing nominal after tax profits, but also next to a real economic recovery and an associated equity rally from the 1974 basement.

Remember, though, that ATP then fell from 1980-82- three years straight. Stocks had to start a new rally during 1982.

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Could nominal stock price benchmarks exceed 2007 peaks? It probably will take continued rises in nominal GDP from current levels. Not only corporate earnings, but also interest rate and dollar levels and trends, fiscal deficits, commodity prices, and other factors matter.

A fall off the cliff in the broad real trade-weighted dollar (beneath its historic lows around 84.0) will make it difficult for equities to exceed 2007's highs for long. Note the recent unhappy roars regarding the recent dollar dip from foreign holders of US securities and other assets.

William Dudley, the president of the Federal Reserve Bank of New York, recently held a "rare on the record interview" (NYTimes, Business Day, ppB1, 8). He declares that its recent $600 billion of quantitative easing did not intend to affect the dollar's value, but sought to encourage a faster, stronger recovery that will aid international growth. "We have no goal in terms of pushing the dollar up or down…Our goal is to ease financial conditions and to stimulate a stronger economic expansion and more rapid employment growth." The US Treasury Secretary, Tim Geithner, likewise barks that the US is not trying to devalue the dollar to boost its economy (Financial Times, 10/19/10, p5). He told CNBC (Financial Times, 11/12/10, p1): "We will never seek to weaken our currency as a tool to gain competitive advantage or to grow the economy."

However, even though Dudley and Geithner supposedly are not directly seeking to affect the dollar's value, they may be quite willing to let the currency depreciate as a result of their policies. Moreover, should the dollar weaken further, it would be very interesting for these orators to declare what dollar level would agitate them.

Anyway, take a quick look at the yardstick of two other periods with substantial economic weakness. The current downturn is not as horrible as the Great Depression of the 1930s. After the crash from 9/3/29, the Dow Jones Industrial Average for several years at best (see the 3/10/37 high around 194) retraced only about 50pc of the dismal decline. After its free fall from its January 1973 high wire, the DJIA climbed back near to it a few times over the next several years. However, equities generally ambled sideways and took a long time to mount decisively over the top. And many pundits say the recent economic downturn was worse than that of the 1970s.