An Unstable Equilibrium

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Concepts of Equilibrium

- Flow
- Stock
- Robust
- Fragile
- Stable
- Unstable
- Static
- Dynamic

Common element:

A state of balance between forces, however temporary

Insights

- No such thing as “more buyers than sellers”
- Every share of stock issued must be held at all times
- Every bond certificate must be held until it is retired
- There is no such thing as money moving “into” or “out of” a secondary market
- Every dollar of monetary base created by the Fed remains a bunch of bits and bytes on some bank computer – that someone has to claim as an asset – until those bits and bytes are retired (though a small amount fluxes from reserves to currency and back)

Quantity Theory and “Multipliers”

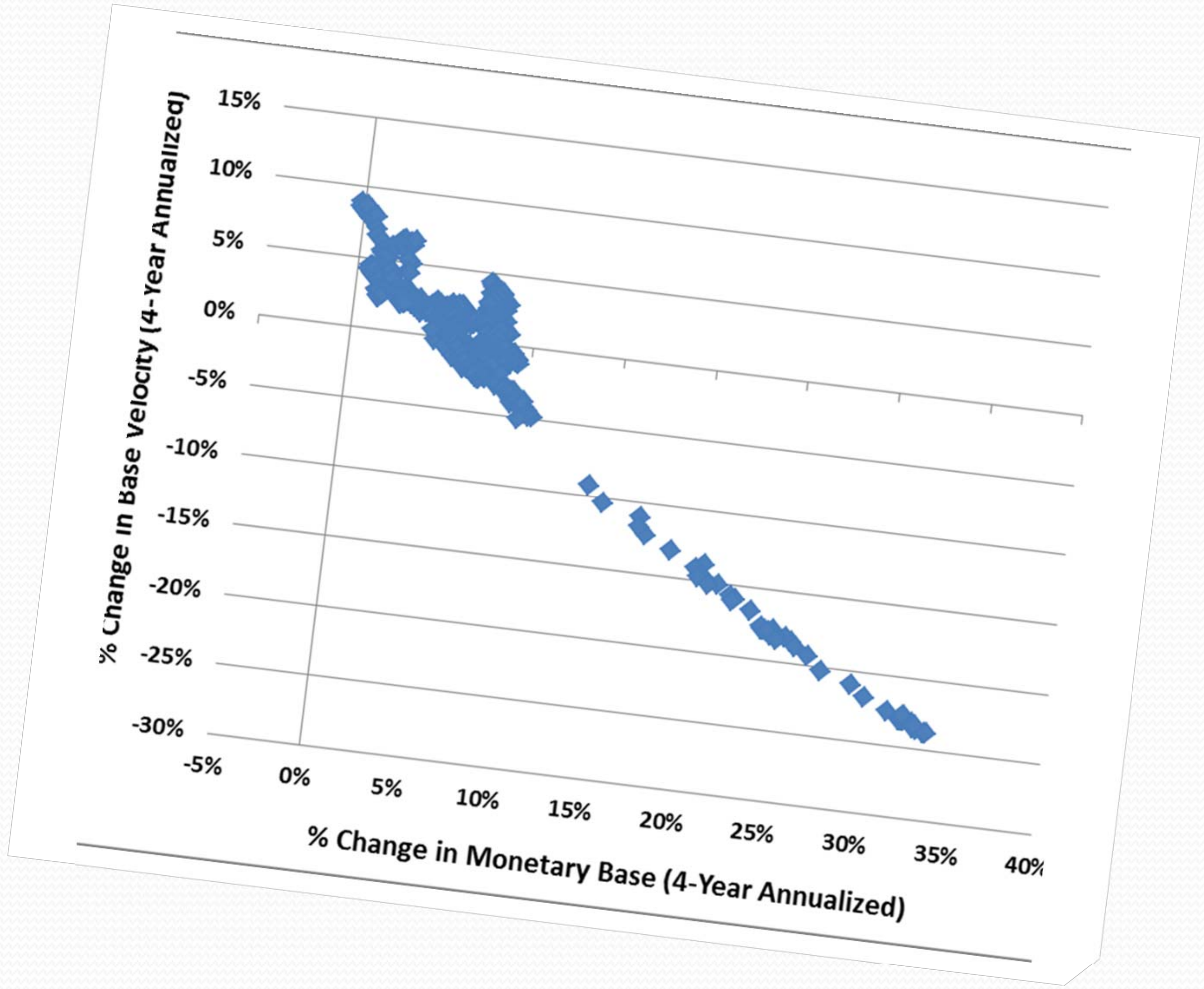
Assume away the economic issues that matter

- Development and availability of productive investment opportunities that initiate borrowing
- Ability of borrowers to service new debt
- Willingness of lenders to finance creditworthy, productive opportunities
- Importance of refraining from loans to unworthy, unproductive speculations

Create more monetary base…

Reduce the turnover of the monetary base

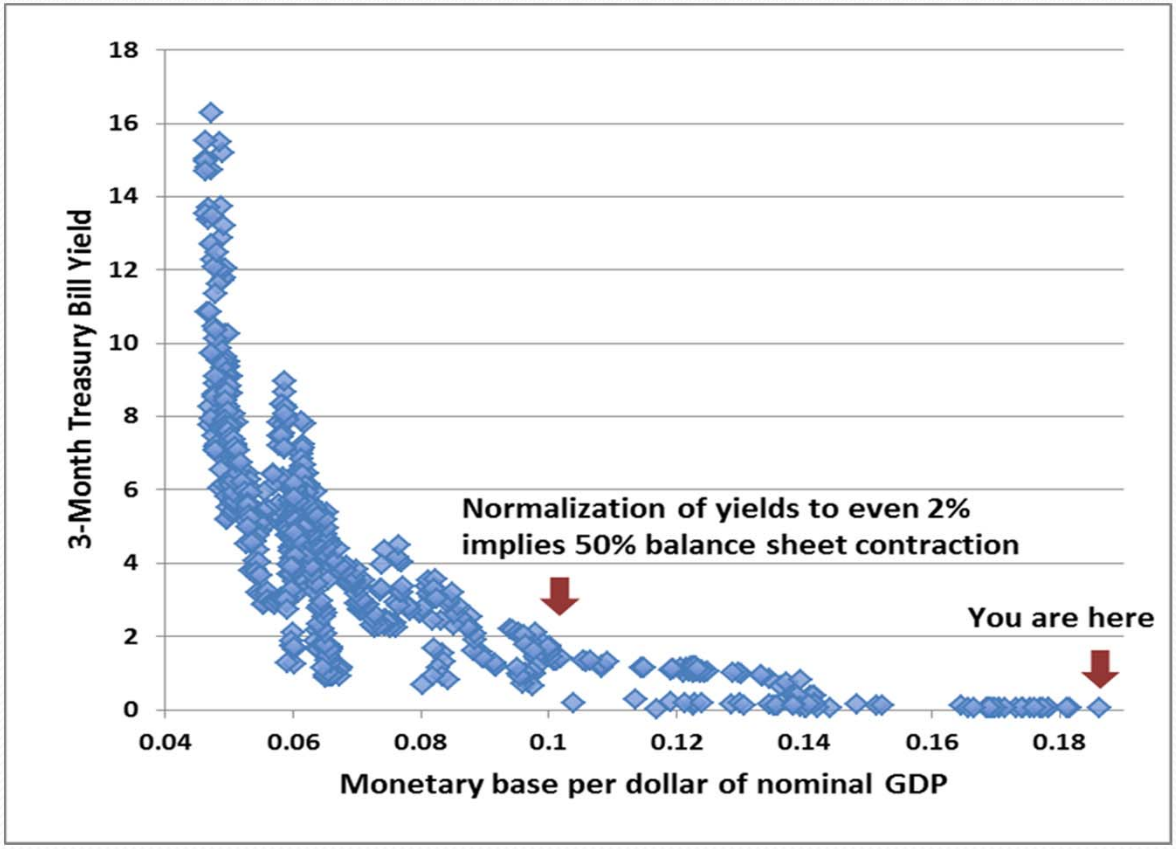
The failure of QE to provoke durable economic growth is not a failure of effort; it is a failure of ideas and understanding



Monetary Equilibrium

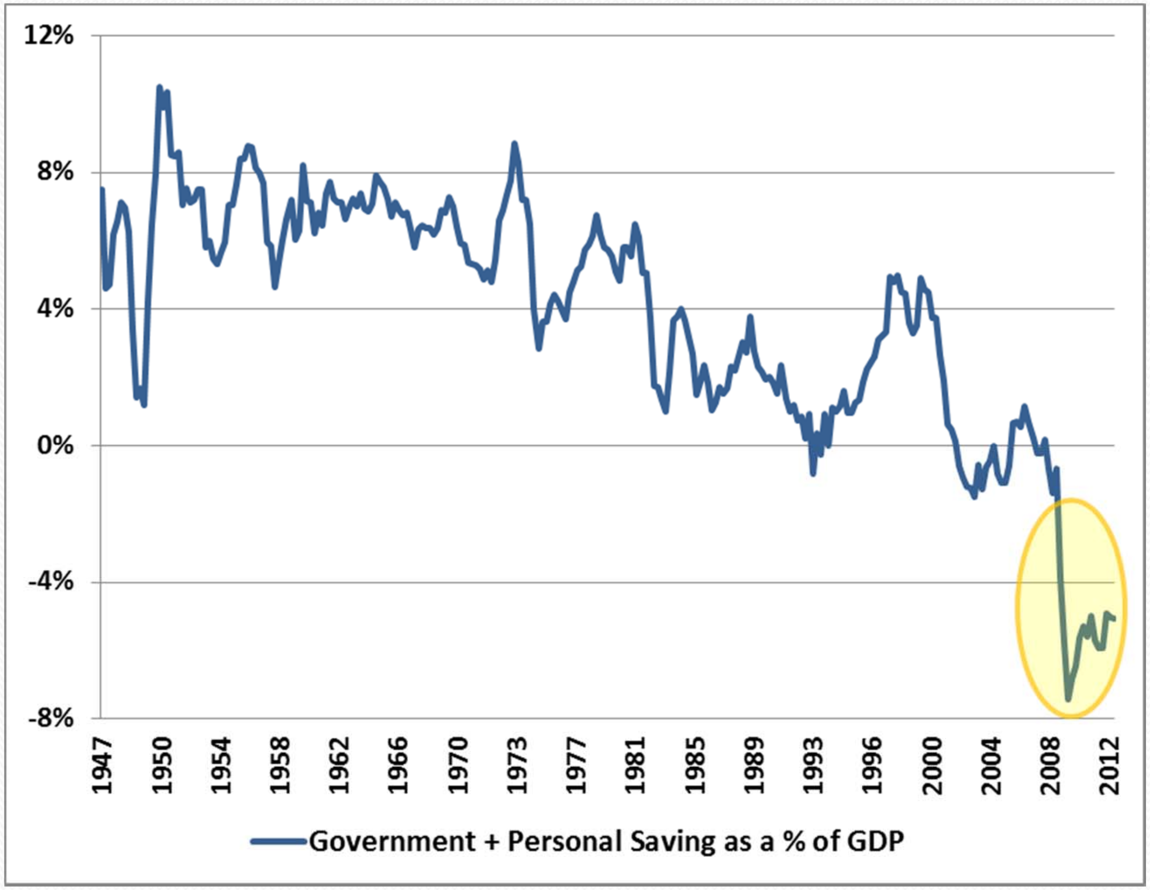
Every zero-interest dollar must be held by *someone* at all times

QE provokes a speculative reach for yield



Fiscal Equilibrium

- The deficit of one sector *must* emerge as the surplus of another

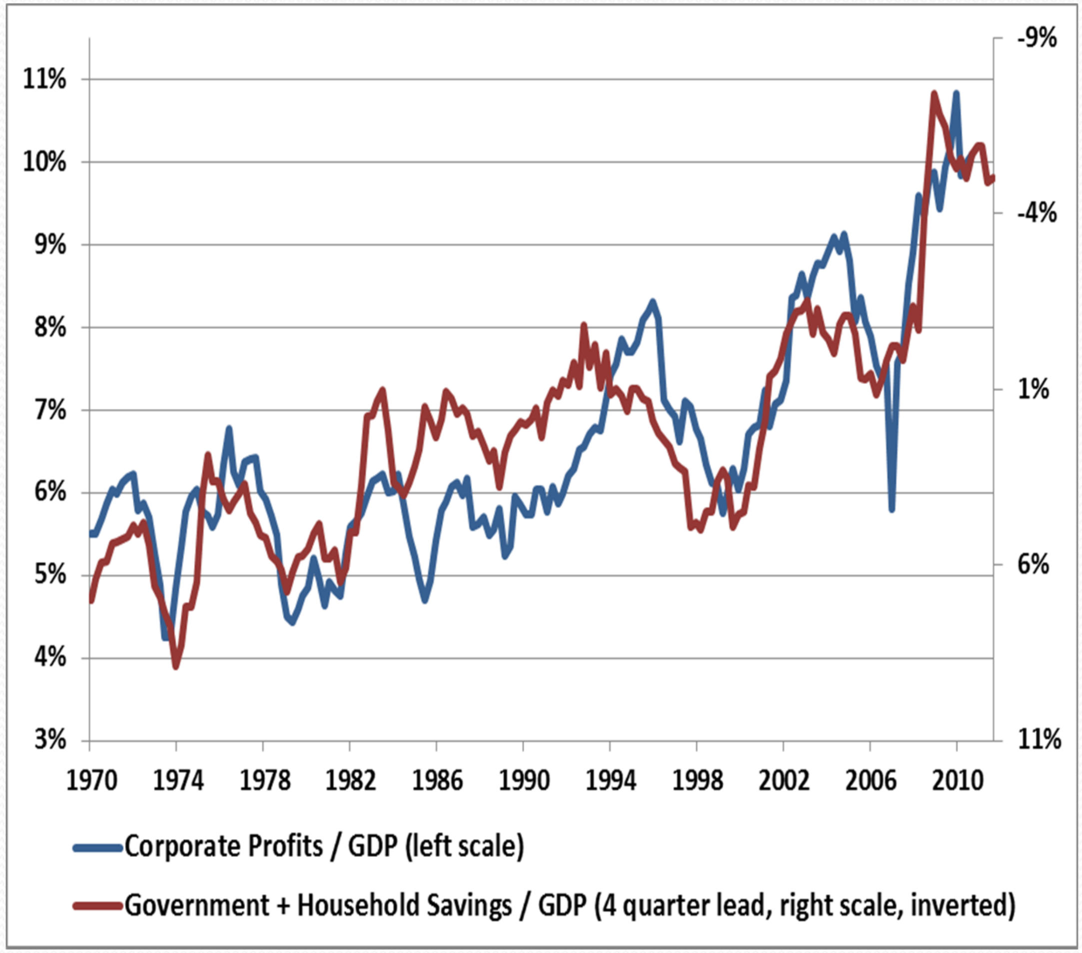


Result: Record Profit Margins

Corporate profit margins are presently 70% above historical norms, precisely because combined government and household savings are in a record negative position.

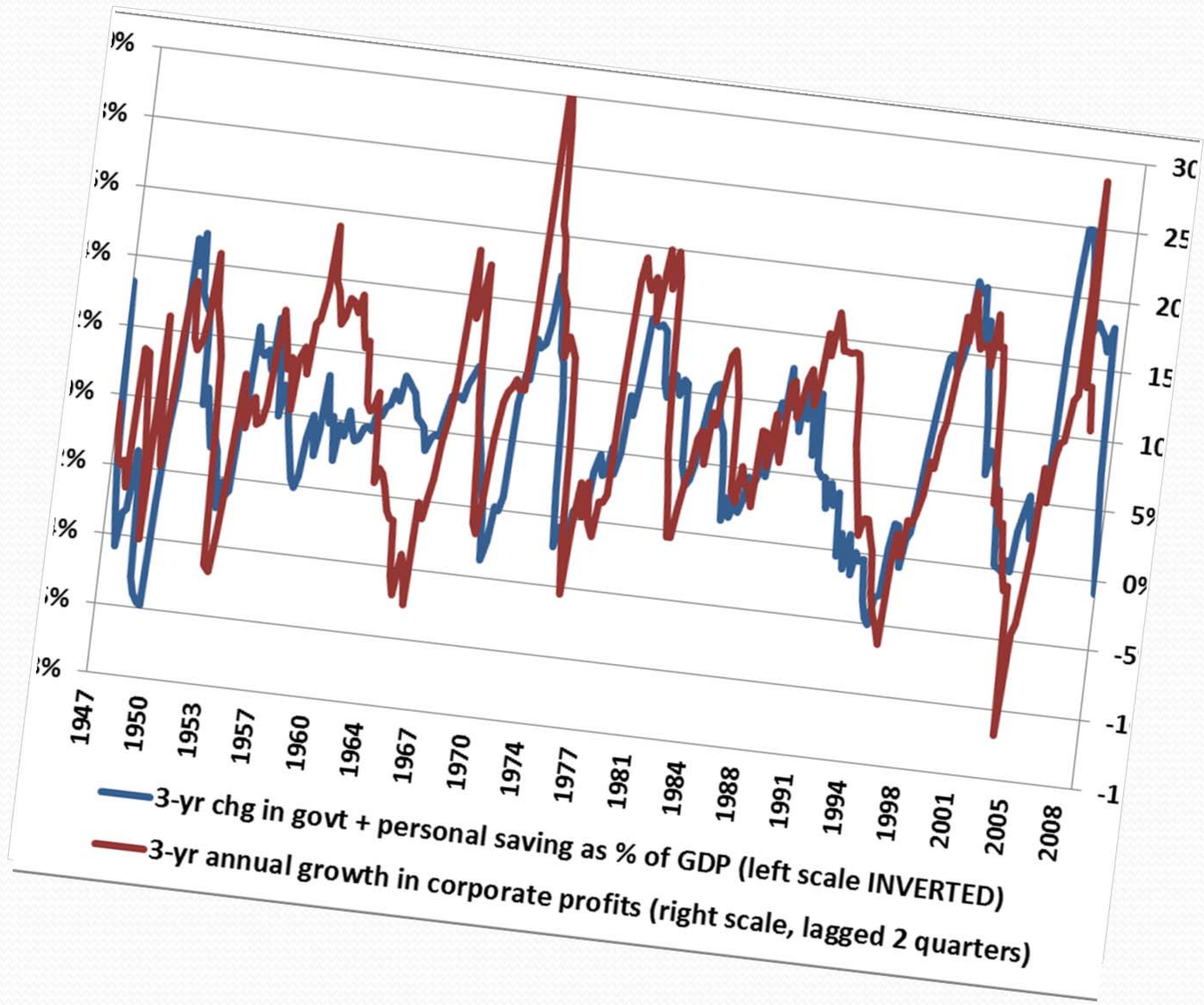
The deficit of one sector *must* emerge as the surplus of another sector

Corporations benefit from deficit *spending* despite *wages* at record lows as a share of economy

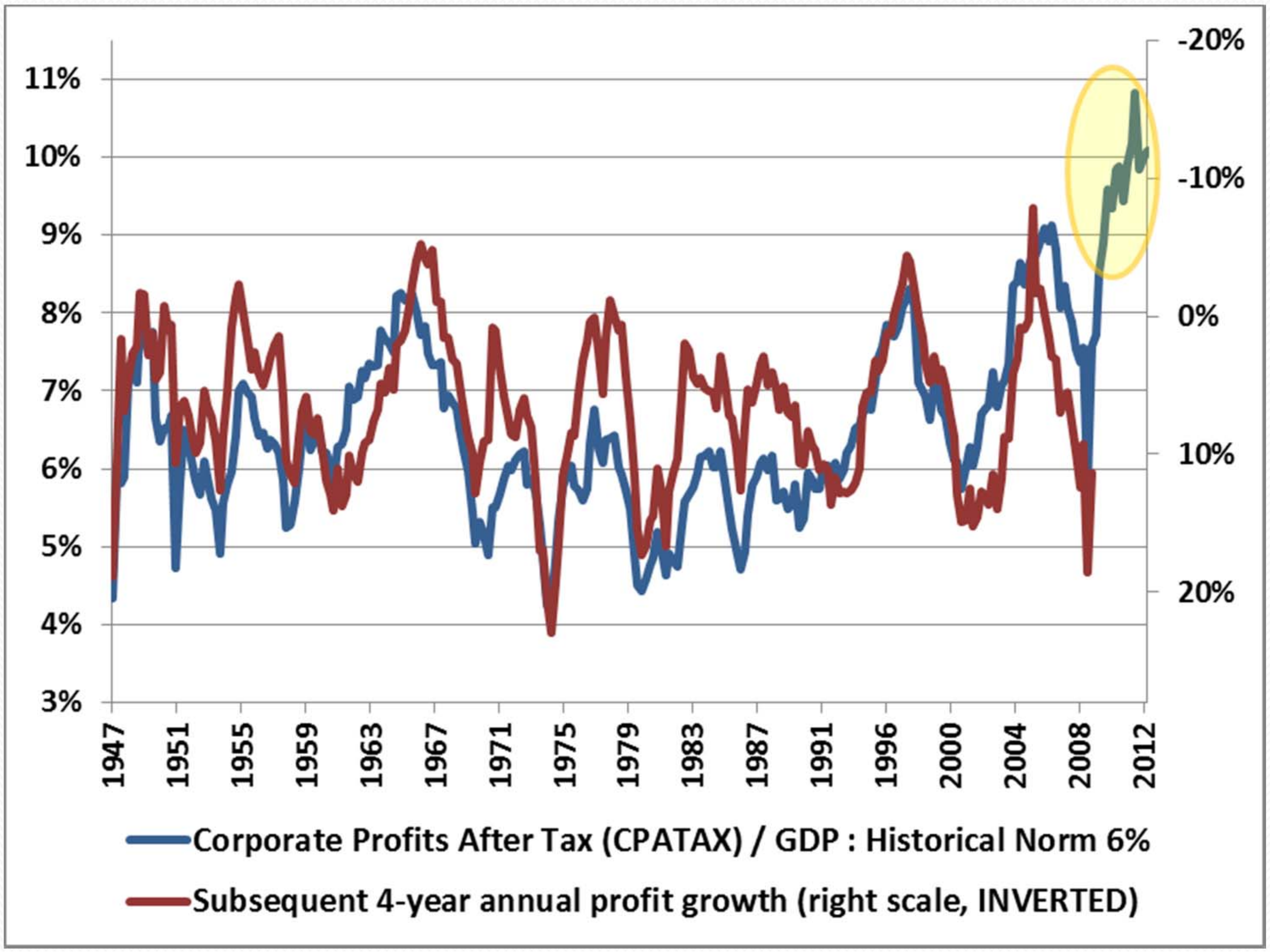


***Changes* in government and household savings lead *changes* in corporate profits**

Even *without* significant mean reversion in margins, we should already anticipate weak profit growth in the immediate future



Elevated margins, weak 4-year profit growth

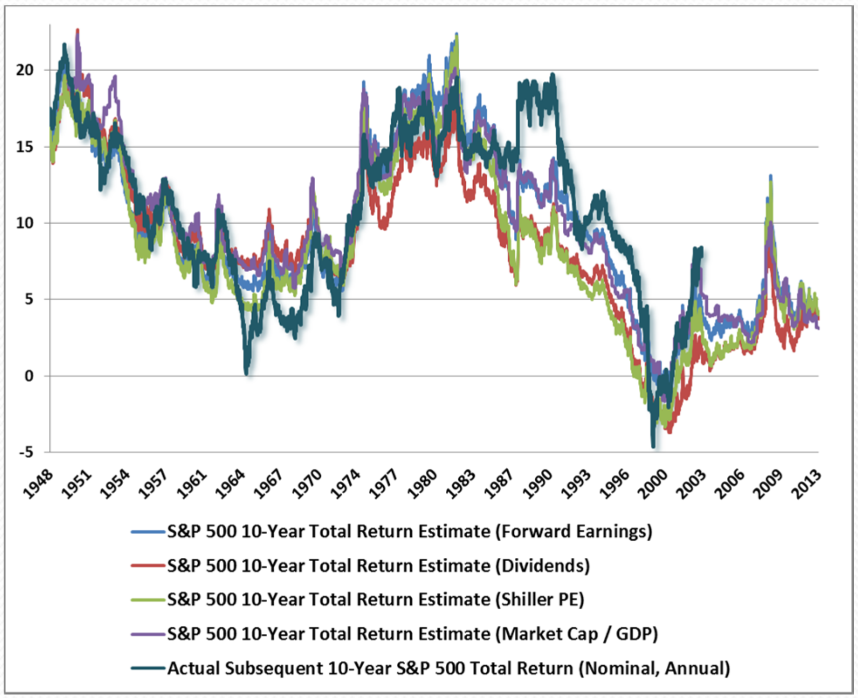


A Distorted, Unstable Equilibrium

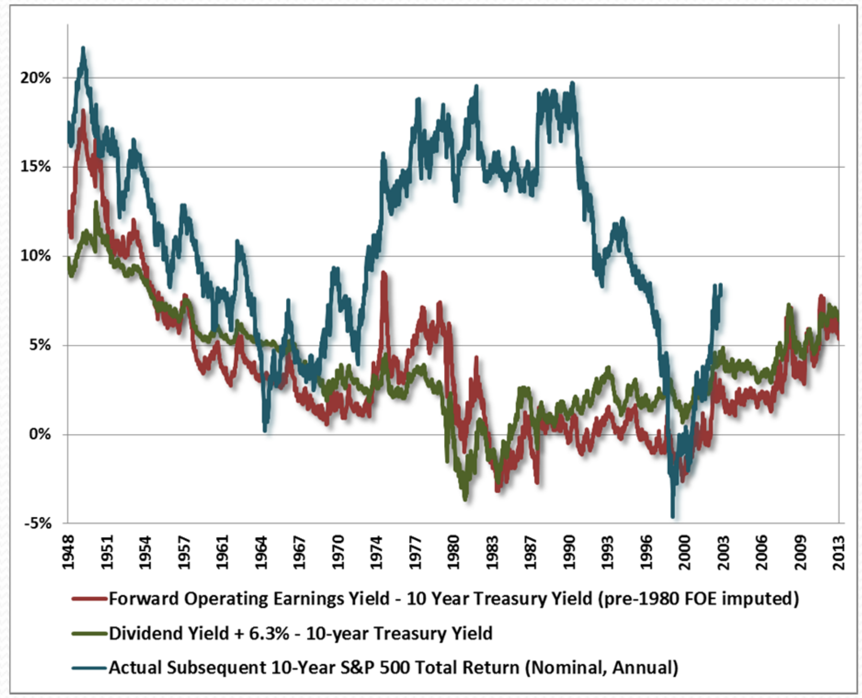
- Monetary Policy: creates an ocean of zero-interest monetary base that must be held by somebody at every moment. Base money is a "hot potato" that encourages a speculative reach for yield.
- Fiscal Policy: creates a deficit that must emerge elsewhere as a surplus – specifically, as elevated corporate profit margins, creating the illusion of "yield" that is not, in fact, durable.

Which approach actually works?

Smooth fundamentals (calculations next slide)



Fed Model and naïve "risk premium" estimates



Hussman's Shorthand Estimates of S&P 500 Expected 10-Year Nominal Annual Total Returns

- **1) Forward Earnings Model – see Valuing the S&P 500 Using forward Operating Earnings:**

(1+g)(12.7 / FOPE)^(1/10) - 1 + Dividend_yield*(FOPE / 12.7 + 1) / 2

g = 1.063 x (0.072 / (FOE/S&P 500 Revenues))^(1/10) - 1

FOE: forward operating earnings. FOPE is the forward operating P/E.
Underlying economic growth is modeled at 6.3% (all of the constants should be revisited over time)

- **2) Shorthand Shiller Model – see The Siren's Song of the Unfinished Half Cycle:**

1.063 * (15 / ShillerPE)^(1/10) – 1 + Dividend_yield (decimal)

- **3) Dividend Model – see Estimating the Long-Term Return on Stocks (1998):**

1.063 * (Dividend_yield / .037)^(1/10) - 1 + (Dividend_yield + .037)/2

- **4) Shorthand Market Value / GDP Model :**

1.063 * (0.65 / (MV / GDP_Nominal))^(1/10) - 1 + Dividend_yield (decimal)

Market value of equities of nonfarm nonfinancial companies from Z.1 Flow of Funds data

An unfortunate menu…
but the menu *will* change