Leithner Letter No. 151-154
26 July - 26 October 2012

The objective of credit expansion is to favour the interests of some groups of the population at the expense of others. … The idea … is to channel the additional credit in such a way as to concentrate the alleged blessings of credit expansion upon certain groups and to withhold them from other groups. The credits should not go to the stock exchange, it is argued, and should not make stock prices soar. They should rather benefit the "legitimate productive activity" of the processing industries, of mining, of "legitimate commerce," and, first of all, of farming.

However, all such schemes are vain. Discrimination in lending is no substitute for checks placed on credit expansion, the only means that could really prevent a rise in stock exchange quotations and an expansion of investment in fixed capital. The mode in which the additional amount of credit finds its way into the loan market is only of secondary importance. What matters is that there is an inflow of newly created credit. If the banks grand more credits to the farmers, the farmers are in a position to repay loans received from other sources and to pay cash for their purchases. If they grant more credits to business as circulating capital, they free funds which were previously tied up for this use. In any case they create an abundance of disposable money for which its owners try to find the most profitable investment. Very promptly these funds find outlets in the stock exchange or in fixed investment. The notion that it is possible to pursue a credit expansion without making stock prices rise and fixed investment expand is absurd.

Ludwig von Mises
Human Action: A Treatise on Economics (1949)

A report from the Federal Reserve Bank of New York suggests that the bulk of equity returns for more than a decade are due to actions by the US central bank. Theoretically, the S&P 500 would be more than 50% lower – the 600 level – if the bullish price action preceding Fed announcements was excluded, the study showed.

Posted on the New York Fed's web site Wednesday, the study sought to explain why equities receive such a high premium over less risky assets such as bonds. What they found was that the Federal Reserve has had an outsized impact on equities relative to other asset classes. For example, the market has a tendency to rise in the 24-hour period before the release of the Fed's statement on interest rates and the economy, presumably on expectations Chairman Ben Bernanke and his predecessor, Alan Greenspan, would discuss or implement a stimulus measure to lift asset prices.

Market Savior? Stocks Might Be 50% Lower Without Fed
(CNBC, 12 July 2012)

Of the State's Manipulation and Market Participants' Overoptimism

Charles Maurice de Talleyrand-Périgord, 1st Prince de Bénévent (1754–1838), was a senior French diplomat who survived the sudden and sometimes drastic gyrations of political life in his country during the late 18th and early 19th centuries. He served – not always faithfully – Louis XVI, the Committee of Public Safety and other régimes of the Revolution, Napoleon I and the restored Bourbon monarchs Louis XVIII, Charles X and Louis-Philippe. Of the Bourbons, Talleyrand reputedly remarked: "they have learned nothing and forgotten nothing."

The same failing applies to the Western economic and financial mainstream – that is, to senior politicians and bureaucrats, journalists and corporate executives (particularly bankers) and market participants. Virtually all of them blindly worship the state. Long before mid-2007, powerful insiders enthusiastically (and preposterously) believed that the state (with them, of course, at the rudder) could and should steer the economy. "Macroeconomics was born as a distinct field in the 1940s as a part of the intellectual response to the Great Depression," declared Robert Lucas, winner of the 1995 Bank of Sweden Prize in Economic Sciences in Memory of Alfred Nobel (which is commonly but quite erroneously called the "Nobel Prize in Economics"), in his Presidential Address to the American Economic Association (2003). He continued:

> The term [macroeconomics] then referred to the body of knowledge and expertise that we hoped would prevent the recurrence of that economic disaster. My thesis in this lecture is that macroeconomics in this original sense has succeeded: its central problem of depression-prevention has been solved, for all practical purposes, and has in fact been solved for many decades …

Like The Great Helmsman, Mao Tse-Tung, the anointed duly crashed into the rocks. What have they learnt from this experience? Since mid-2007, Western élites have been chastened – but still champion the intervention of the state (particularly its central bank) and its alleged ability to ignore, amend, suspend or even repeal the laws of economics. For decades the establishment's policies have privileged some (i.e., debtors and spendthrifts, particularly governments), and punished others (namely savers and the provident and prudent). In order to combat a malady whose cause escapes them and whose major symptom is massive and growing debt and an inability to live within one's means, our masters have prescribed – without a hint of shame – massive doses of additional debt and profligacy.

How stupid is that? More to the point, and as Dan Denning asks, How Can Anyone Possibly Take Ben Bernanke Seriously? Perhaps a few members of the establishment have begun to doubt him;[1] without question, however, insiders continue

[1] For decades before mid-2007, mainstream macroeconomists assured their supposed inferiors that interventionist policies would avoid shocks; and if shocks nonetheless occurred, they added, addi-

to demand that the state in general and the central bank in particular intervene on their behalf and continue to underwrite their many privileges. In short, they insist, When Governments Won't Govern, Central Banks Must. The mainstream also remains blithely dismissive – or should that be haughtily contemptuous? – of logic and history. As far as they're concerned, their models have not failed the test of reality. Quite the contrary: reality has failed their models! (see also Why Economic Models Are Always Wrong by David Freedman).

Surely, though, the chasm between overoptimism on the one hand and subsequent reality on the other, which has become steadily more apparent since 2007, might cause the anointed to stop, think and reassess? When you've dug yourself into a hole, surely stubbornness avails nothing and it's sensible to stop digging? Not a chance, the mainstream in effect retorts. They might – but then again, may well not – inwardly confess that they are a privileged minority that is usually mistaken and occasionally catastrophically misguided. Outwardly, however, neither the state's agents nor its mascots doubt that their interventionist ideals and policies are correct. Indeed, they stridently insist that they are not just right but also righteous – and that the benighted outsiders who suffer at their hands are reprobates who should be ignored, smeared and punished further.

Above all, despite the growing volumes of logic and evidence that speak otherwise, élites continue resolutely and stridently to insist that higher consumer and government expenditure, aided by artificially low (manipulated by the central bank) rates of interest – in a word, "stimulus" – will eventually put things right. In his Testimony to the Senate Banking Committee on 18 July, for example, Ben Bernanke asserted – with a straight face – that Operation Twist (whereby the Fed has rotated its portfolio of government bonds from shorter-dated to longer-dated securities) has been "effective in easing financial conditions and promoting strength in the economy." Further, the Fed's large-scale purchases of assets (that is, its financing of the U.S. Government's gargantuan budget deficit) have "also contributed to economic growth."

The trouble, in their eyes, isn't their crazed interventionism: it's the lack of sufficient intervention (see, for example, Not Enough Inflation and How Did We Know the Stimulus Was Too Small? by Paul Krugman). Like General William Westmoreland, who repeatedly requested that the numbers of American troops in Vietnam be increased in order to achieve victory, who oversaw 16,000 when he arrived in 1964 and 535,000 at the peak in 1968 – and who proceeded to win eve-

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tional interventions would attenuate them to tolerable levels. In short, they claimed, intervention and particularly "stimulus" would successfully manage the economy.

Today, growing numbers of mainstream macroeconomists figuratively shrug their shoulders and say, in effect, "there's nothing more we can do" (see, for example, Does the Fed Have Any Bullets Left?). After years of pathetically weak and largely false "recovery," our masters tell us that this is the best that they can do – and therefore that this is the best that can be done. To them, it's just an inscrutable mystery why the economy remains so feeble. Their trump card against critics remains: "it's either our interventionist failure or a global depression." Note that these declarations are almost invariably followed by assertions that "the gold standard is stupid" and "only a jerk would want to ditch the Fed," etc.

ry major battle but lose the war – too much stimulus is never enough. Hence Bernanke assured Senators on 18 July that the Fed is "ready to take further action as needed to boost the recovery." But if previous intervention hasn't, what grounds have we to believe that further intervention will? (see On the Evidence, Stimulus Programs Aren't Working, Romulus, Remus, Stimulus: A Brief History of Monetary Madness and Stimulus Won't Save the Economy by Bill Bonner).

According to the élites, too, their doctrine of stimulus is righteous because immorality is something that only afflicts agents other than the state's. Outsiders (i.e., private individuals and businesses) are potentially evil, but insiders (namely politicians and bureaucrats) apparently wear halos. As a result, if you and I do it, it's theft (which is clearly bad); but if the state's agents do it, it's taxation and fiscal policy (which, the establishment stridently insists, is even more obviously good). Further, if you and I undertake it, it's counterfeiting and fraud (bad); but if central bankers do it, it's monetary policy (good). If you and I do it, it's mass murder (and an unspeakable evil); but if soldiers, sailors and airmen wearing the state's costumes do it, it's the collateral damage of foreign policy (which is necessary to promote and protect "national security"). In short, if you and I harm others, that's obviously bad; but if the agents of state command and control, that's unarguably good – and anybody who says otherwise is clearly stupid or dangerous or both.

Our overlords' conceit is ancient. Throughout recorded history, the most significant "somebody" threatening liberty and stealing property has not been the common thief: it has been the Leviathan state. Secular rulers, as St Augustine famously described them in *The City of God*, are "gangs of criminals on a grand scale." Augustine noted the state originated not through some fictitious "social contract" or voluntary arrangement but rather through force, robbery and murder:

> A gang is a group of men under the command of a leader, bound by a compact of association, in which the plunder is divided according to an agreed convention. If this villainy wins so many recruits from the ranks of the demoralised that it acquires territory, establishes a base, captures cities and subdues peoples, it then openly arrogates to itself the title of kingdom, which is conferred on it in the eyes of the world, not by the renunciation of aggression, but by the attainment of impunity. For it was a witty and truthful rejoinder which was given by a captured pirate to Alexander the Great. The king asked the fellow, "What is your idea, in infesting the sea?" And the pirate answered, with uninhibited insolence, "the same as yours, in infesting the earth! But because I do it with a tiny craft, I'm called a pirate: because you have a mighty navy, you're called an emperor."

Greenspan's Put – and Bernanke's Crisis

How else but through Augustinian lenses can one make sense of the LIBOR scandal? On 27 June 2012, the U.S. Commodity Futures Trading Commission fined Barclays Bank $200m. The U.S. Department of Justice imposed a fine of

$160m, and the Financial Services Authority of the UK fined it £59.5m. Barclays attempted to manipulate certain rates of interest (known as LIBOR and EURIBOR). The Department of Justice and Barclays agreed that "the manipulation … affected the … rates on some occasions." Apparently routinely and for years, traders at Barclays sought to derive financial benefits from these manipulations; and during 2007-2012, Barclays' artificially-low bids caused it to appear healthier than it actually was.

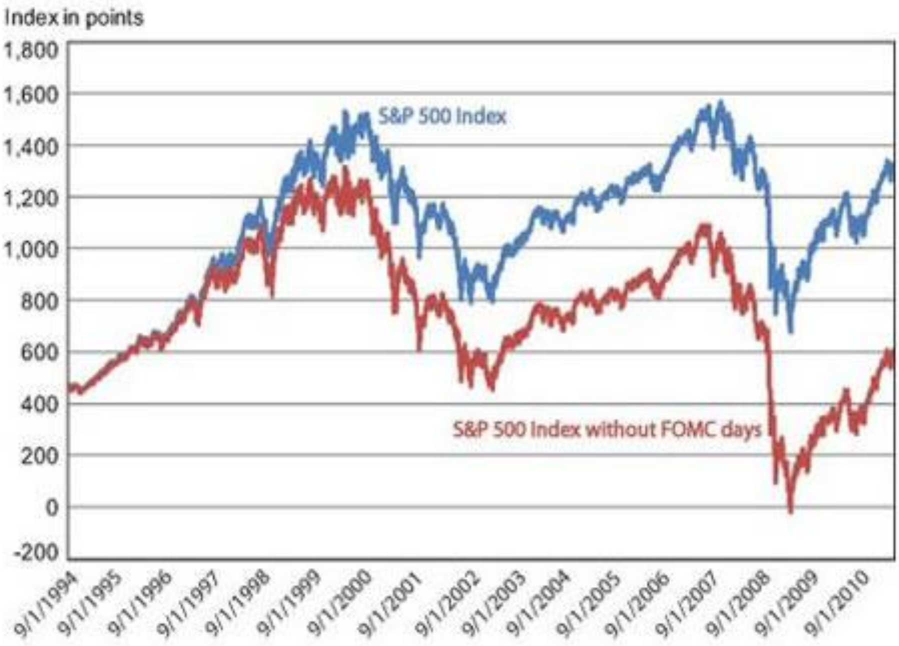
But what do central banks, including the Bank of England, Federal Reserve and Reserve Bank of Australia, do if they do not manipulate rates of interest? If the manipulation over the past decade of LIBOR by Barclays is a scandal, then why isn't the manipulation since 1913 of the federal funds rate by the Federal Reserve a vastly greater outrage? And what if the bulk of the gains on the Standard & Poor's 500 Index since 1994 has been the consequence of the Fed's machinations? In other words, what if the Fed has rigged the U.S. stock market? If that's a criminal offence when individuals or corporations attempt it, then what is it when the state's agents actually achieve it?

David Lucca and Emanuel Moench (The Pre-FOMC Announcement Drift, Federal Reserve Bank of New York Staff Report No. 512, June 2012) analyse the "equity premium puzzle." The expected return of a class of asset (e.g., stocks or bonds) should, over the long term reflect its risk: the higher is the risk, the greater is the return that you will require in order to purchase it. After all, why would you buy a more risky asset if on average it returned no more than a less risky one? Under those circumstances, you could reduce the risk you incur without reducing the return you receive. Given free and unfettered market and rational economic actors, the higher an asset's risk, the higher, on average, will be its return. The "equity premium puzzle" refers to the fact (mainstream researchers, at any rate, regard it as a fact) that the average return of stocks is – given their riskiness – unduly large. By their way of thinking, if you invest in stocks then to some extent you get a free lunch. In their world (they refuse to regard their very tenure as a free lunch at taxpayers' expense), that's not supposed to happen.

Lucca and Moench analyse the major index of American stocks' prices, the Standard & Poor's 500 Index, since 1994. In that year the Fed commenced the practice of proclaiming (on pre-announced days eight times a year at 2.15pm) its policy regarding the level of the federal funds rate. They found that stocks moved reliably and significantly higher during the 24 hours before the Fed's announcement. Specifically, "more than 80% of the annual equity premium has been earned over the 24 hours preceding scheduled Fed announcements." They helpfully provide a chart of the S&P 500 Index (see Figure 1) that shows the extent to which the Fed has rigged the stock market since 1994. The blue line shows the Index and the red line shows it with each 24-hour "pre-Fed meeting" period excluded. *The disparity is dramatic: if not for the Fed's manipulation, the S&P 500 would today struggle to hold the 600 mark rather than wrestle with 1,300.* Interestingly, the Fed's decisions also affect stocks in other countries. In the Old Country, for example, Lucca and Moench find that the Fed's policies have more impact upon the FTSE 100 than does the

Bank of England. Only the Fed's decisions exert this dramatic impact; other macro-economic phenomena don't create the same sort of waves. Also, the Fed's influence occurs only in the market for stocks – not commodities or currencies.

Figure 1: S&P 500 Index With & Without 24-hour pre-FOMC Returns



Source: Thomson Reuters Tick History. Note: The sample period is 1994 to 2011.

Although Lucca and Moench are unable to explain these findings, no doubt other mainstream researchers will concoct some innocuous reason or another. But they needn't bother: as ne'er-do-well commentators have already noted, Lucca and Moench have confirmed (after all, nothing is official unless agents of the state say so) the existence of the Greenspan Put. This phrase refers to the suspicion that former Fed chief Alan ("Easy Al") Greenspan would always slash the federal funds rate, which in turn suppressed other rates of interest, whenever anything was the matter, i.e., if it looked as though the S&P 500 was going to fall too much, and in particular if Wall Street in general and banks in particular might suffer. Lucca and Moench have confirmed that one of the Fed's unwritten but nonetheless major objectives is to protect banks and other speculators against the consequences of their recklessness. Greenspan's successor, Ben Bernanke, has displayed a similar tendency.

Lucca and Moench show that the stock market rises *before* the Fed decides – not after; it reliably increases *in anticipation of* the Fed's action. That temporal order demonstrates that market participants play the same role as Pavlov's dogs[2] – that

[2] In the 1890s, Ivan Petrovich Pavlov (1849-1936), a Russian physiologist, investigated the gastric function of dogs, and later of children, by collecting, measuring and analysing their salivation and its response under different conditions to food. He noticed that the dogs tended to salivate *before* he placed food in front of them. In 1904 Pavlov was awarded the Nobel laureate "in recognition of his work on the physiology of digestion, through which knowledge on vital aspects of the subject has been transformed and enlarged."

is, they place enormous faith in the Fed's ability and desire to rig the market. They presumably evince so much faith in the Fed because they're convinced that it hasn't, doesn't and won't fail to support them – as far as they're concerned, it always has, does and always will ease whenever the stock market threatens to slide. That the effect appears only in the stock market suggests that the level of the S&P 500 (as opposed to commodity indices, currency markets, etc.) is uppermost in the Fed's mind.

That makes sense: Bernanke has admitted explicitly and publicly that the Fed's second batch of quantitative easing ("QE2") sought to boost the stock market. Just as authorities understand that home ownership is a key to the "American Dream," and that rising house prices underpin the "feel-good" factor, so too do they recognise that a rising stock market begets a wealth effect. When the prices of stocks rise, their owners feel richer; and when people feel richer, they're more willing to spend money – and spending, the mainstream erroneously (and laughably) believes, causes wealth to grow. (Of course, the mainstream has things exactly back to front: an increase of wealth causes an increase of expenditure.)

Hence the establishment's fervent desire to rig the stock market. "Rig" is a strong word, but a few prominent observers are beginning to use it. "Markets are so rigged by policymakers that I have no meaningful insights to offer," said Nomura International's Investment Strategist, Bob Janjuah, in February 2012. He continued:

> It's starting to feel like the financial markets are all rigging and no ship. I am simply stunned that our policymakers seem so one-dimensional, so short-termist, and so utterly bereft of courage or ideas. It now seems obvious that in response to the financial crisis that has been with us for five years and counting, we are being told to double up on these same policy decisions [that have failed].
>
> The crisis was caused by central bankers mispricing the cost of capital, which forced a misallocation of capital, driven by debt/leverage, which was ultimately exposed as a hideous asset bubble which then collapsed, destroying the lives and livelihoods of tens of millions of relatively innocent people.

"Since then," adds Eric Fry (Market-Rigging and Price-Fixing on Financial Markets), "policymakers have stepped up their market-rigging, while new revelations of past market-rigging have also come to light … Therefore, rigging LIBOR is a little like rigging magnetic north ... or its modern-day equivalent, the Global Positioning System (GPS). Every compass in the world would point to a deception. More importantly, your Paris-bound jet might touch down in Tripoli. And even if your Paris-bound jet touched down in nearby Lyon, you'd still be a little annoyed." Extending Fry's analogy, if your misdirected aeroplane landed in the Mediterranean or the Atlantic, or collided into Mont Blanc, you'd not be so much annoyed as terrified – and perhaps grievously injured or dead.

"Politicians Hold Key to Global Recovery, IMF Says," a headline in *The Globe and Mail* declared on 16 July 2012. Similar headlines incessantly pollute newspapers and the airwaves. Translated in light of Janjuah's insights, the International Monetary Fund (which is a part of the problem and no part of any resolution) asserts that the biggest threat to the financial markets is a lack of sufficient rigging. "Downside risks continue to loom large," it declared, "importantly reflecting the risks of delayed or insufficient policy action." "If you listen to the [policymakers in the U.S. and Europe]," Janjuah said in February,

> it seems that the only solution they can offer up is to yet again misprice the cost of capital, in the hope that, yet again, through increased leverage/debt, we are yet again greedy enough to misallocate capital, which in turn will lead to yet another round of asset bubbles.
>
> Such asset bubbles are meant to delude us into believing that we are now "richer." When – as they do by definition – these bubbles burst, those who have been suckered in will realize that their "wealth" is instead an illusion, which in turn will be replaced by default risk ...

The Fed's interventionism (which is a more polite word than "rigging," but lacks its zest) creates rampant moral hazard. Because the Fed strives to cover their losses, borrowers and investors take bigger risks than they otherwise would. Borrowers, ranging from governments to mortgagees, borrow artificially-cheap money in order to finance projects that make no financial sense and which they cannot afford (such as the welfare-warfare state and dream homes). Observing the resultant increase of prices, investors willingly and even enthusiastically pay inflated prices for stocks and bonds – on the perilous assumption that, thanks to the central bank, rates of interest will continue to fall and prices will continue to increase. Time passes, and in order to keep one "special" rate of interest artificially low, and a "special" market in a continually bullish frame of mind, the whole economy becomes distorted. Like an alcoholic or drug addict, so too the economic stimulus junkie: as time passes ever more of the narcotic is required to achieve the same effect. Alas, the greater the economy's distortion the riper it becomes for correction. In *Human Action*, Ludwig von Mises described the inevitable consequence:

> The final outcome of the credit expansion is general impoverishment. Some people may have increased their wealth; they did not let their reasoning be obfuscated by the mass hysteria, and took advantage in time of the opportunities offered by the mobility of the individual investor. Other individuals and groups of individuals may have been favored, without any initiative of their own, by the mere time lag between the rise in the prices of the goods they sell and those they buy. But the immense majority must foot the bill for the malinvestments and the overconsumption of the boom episode.

Australians and Westerners more generally are aware of the long-term harm that awaits binge drinkers. This harm is physical (liver disease and various forms of cancer), cognitive (memory loss and depression) and social (unemployment, financial strain and damage to family and other relationships). But the Western mainstream is utterly oblivious to the long-term harm of binge economic policy. Babbling incessantly about "stimulus," Australian journalists cheer to the rafters the RBA's sudden and drastic reduction of the Overnight Cash Rate and the Rudd and Gillard government's belated determination to "do whatever it takes" (except, of course, repeal its myriad stupid laws and regulations, slash its bloated budget and cut its onerous taxes). Like a crazed chemist who has only one drug to prescribe, whatever the ailment, the effect of the RBA's policy is to reward debtors and punish savers; and like a pusher on the street corner, the Rudd and Gillard government (like the Howard government before it) peddles an addictive substance – dependence upon the state – that inevitably harms those who consume it.

Many people, particularly politicians, claim that they're angry that 18 banks can set one of the world's most important interest rates in such a poorly supervised and ill-understood manner. But why aren't they even more angry that 12 people sitting in a room in Washington, DC can set the world's single most important interest rate to suit the needs of bankrupt welfare-warfare states, improvident mortgagees and speculators in the stock market – all under the absurd pretense that they are controlling rather than creating inflation? (see also How the US Feds Feed the Rich by Bill Bonner). Alas, the frenzied interventionist policies of central banks around the world trouble the élites not at all. Quite the contrary: they enthusiastically applaud central banks' manipulation of rates of interest. And why shouldn't they? Absent this manipulation, welfare-warfare states' financial bankruptcy – and thus the mainstream's intellectual bankruptcy – would be plain for all to see.

Central Banks' Meddling Breeds Market Participants' Overconfidence

Lucca and Moench inadvertently shed light upon another oddity of behaviour in financial markets: the lemming-like overoptimism of "experts." Has it ever occurred to a segment of the mainstream – namely funds managers, strategists and market economists – that their forecasts since mid-2007 have repeatedly been far too sanguine? Indeed, funds managers and the like have long been a bullish bunch, and their predictions have long tended to be overly positive.[3] Funds managers, strategists and market economists seem intuitively to know what Lucca and Moench effectively admit – namely that central banks rig the market in the insiders' favour. *Because* politicians and bureaucrats will move heaven and earth to rescue them whenever anything is the matter, funds managers apparently but erroneously reason, *therefore* a perpetually bullish attitude is sensible. Alas, strategists and their ilk are clearly oblivious to the insights of Mises and Janjuah – namely that central banks' manipulation avails nothing and eventually costs dearly.

As dependably as the phases of the moon, at the beginning of each calendar and financial year the establishment's minions and mouthpieces utter bullish, upbeat and optimistic prophesies. In The Bull Case for Shares (ASX Investor Update,

[3] Chap. 4 of David Dreman, *Contrarian Investment Strategies: The Next Generation* (Simon & Schuster, 1998) provides a somewhat dated but very thorough and readable overview of research in this field.

January 2012), for example, Ian Huntley asserted (without bothering to cite or even allude to any evidence) that "the important areas of earnings per share (EPS) and dividends per share (DPS) are on the rise." Further,

> Where the top 20 companies by market capitalisation go, so does the Australian share market. Our estimates for the top 20 give 12.3% upside for 2012 earnings per share and a further 5.0% for 2013; our dividend forecast sees the market's average yield increasing from 4.9% in 2011 to 5.8 per cent in 2012 and 6.2% in 2013.
>
> Those numbers support a potential rise in the S&P/ASX 200 index, possibly [20% chance] an increase to 5500. But I expect offshore-generated fear to keep the indices down and give investors wonderful dividend yields. … We kick off with the top-20 index at a 25% discount to our estimate of "fair value" …

Similarly, in an interview on ABC Radio on 4 January 2012, CommSec's chief economist, Craig James, asserted that the Australian equity market "clearly looks undervalued at the moment." He forecast that the AOI would increase ca. 13% during 2012 and finish the year at 4,650 points. "Whichever way you cut it, the share market looks as though it's pretty cheap. One way of valuing the share market is the price-earnings ratio, and it's currently sitting at 12 times historic earnings; now the longer-term ratio's around about 15," James said. Moreover, the resources sector would lead the market's gains. "2011 was very much a year for the safe havens, for places like telecoms, utilities stocks, food, beverages and tobacco." "So," he concluded (apparently without recognising his *non sequitur*), "I don't think the defensives are going to win out in 2012. I think it's going to be a case of areas like the resources sector, the materials or energy sectors that are going to be doing well."

On 4 January 2012, the National Australia Bank's senior market economist, David de Garis, told the ABC that he was confident "because markets have already priced in expectations of more bad news." He elaborated: "if you're looking at things like the forward price-earnings ratio for the Australian stock market, you can certainly tend to think that the market has got some provision in there for negative impact from … events such as Europe for the year ahead." De Garis expected that "many of the worst of these risks" were fading; on that basis, he predicted that the market would rise ca. 10-15% to 4,600 by the end of 2012.

On 13 January 2012, when the AOI stood at 4,255, *The Australian* ("Oversold Share Market Primed to Bounce Back") asked a dozen funds managers and stock brokers to predict its level – as well as that of the Dow Jones Industrial Average (DJIA), the price of an ounce of gold and a barrel of oil, the RBA's overnight cash rate and the $A-$US exchange rate – one year hence. The most bullish member of the group prophesied that during 2012 the AOI would rise by 19% to 5,050; the most bearish forecast that it would increase by 1% to 4,300; and the mean of their predictions was a rise of 10% to 4,687. *None* predicted that it would be lower on 31

December than it was on 1 January. As *The Australian* crowed, "shaken and stirred but unvanquished after a perilous year on the bourse [that is to say, the possibility that markets might fall in 2011 utterly escaped them], our panel of expert stock tipsters unanimously expects the market to bounce this year." If at first you don't succeed, try, and try again. At the calendar year's half-way point of 29 June 2012, the AOI closed at 4,135. If the group's mean prediction (4,687) is going to be accurate, then during the next six months the AOI must rise by 13%.

How Likely Is the Experts' Consensus Market Forecast?

Mainstream funds managers, strategists and the like ignore and perhaps detest logic and evidence. At any rate it seems to me that they do, for they seldom bother to substantiate their assertions with either reasoning or data, and they disregard those who do. It's useful to ask the question "what are the chances that the AOI will rise 13% by 31 December 2012? Given some roughly reasonable (never mind the underlying probability distribution's rather fat tails) and certainly tractable assumptions,[4] it's also a simple question to answer precisely (which is hardly the same thing as accurately).

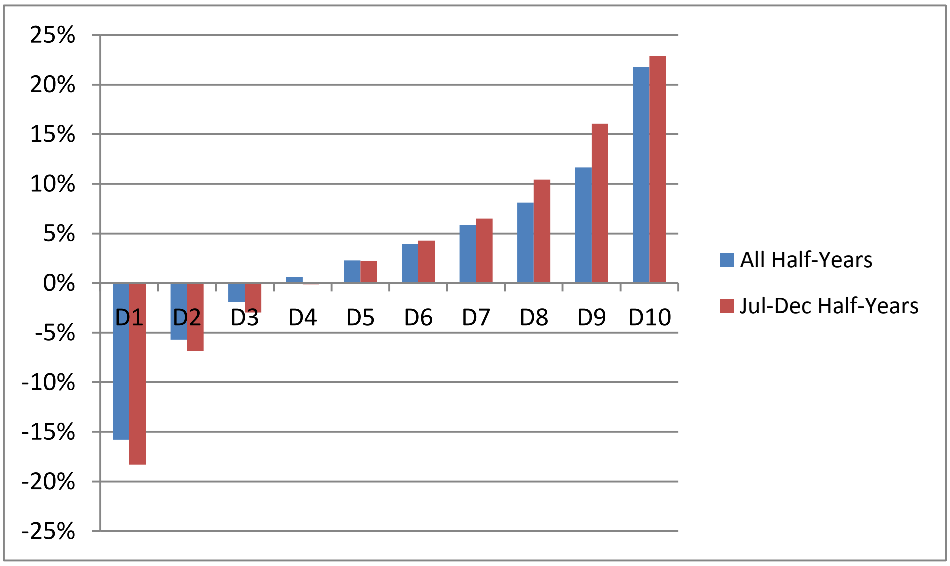
The AOI has been back-dated to 1875. Using monthly measurements begets ca. 1,640 half-yearly intervals since January 1871 (i.e., 1 January-1 July 1871, 1 February-1 August 1871, … 1 December 2011- 1 June 2012). We can compute the percentage change of the AOI during each of these six-month periods. The mean of this series of ca. 1,640 observations is + 0.03. (This return includes neither the cost of buying and selling securities nor the other expenses typically incurred by large investment managers; nor does it include distributions and dividends.) In other words, if we have nothing other than these data at our disposal, and if we're willing to make some imperfectly realistic assumptions and also to assume that these assumptions will hold in the future, then our best guess about the AOI's return during the next six months – indeed, our best guess about its return in any six-month period – is 3.0%. That's a far cry from 13%, and immediately puts the average prediction of the "experts" into doubt – unless of course, they substantiate it with convincing or at least plausible reasons, which of course they don't.

In order to provide some simple and justifiable probabilities, let us rank the series from lowest to highest, stratify this ranked series into ten roughly equal (ca. 164 observations) portions ("deciles"), and compute the mean of each decile. The blue bars in Figure 2 show the result. What do they mean? The lowest decile (that is, the one with the lowest mean, D1) has a mean of -16%. If we select a half-year period at random, there's a ca. 10% chance that during this interval the AOI will fall by ca. 16%. There's also a 10% chance that it will fall by ca. 6% (which is the mean of the next lowest decile, D2), and there's a 10% chance that it will fall by ca. 2% (D3). Accordingly, the probability that during any given six-month period the AOI

4 We assume, in short, that the half-yearly percentage change of the AOI is an independent and identically-distributed random variable. We assume that six-month returns will in the future continue to derive from a distribution with the same central tendency and dispersion.

falls by at least 2% is ca. 10% + 10% + 10% = 30%. That's almost one in three. Isn't it funny that this key fact seldom passes upbeat experts' lips?

Figure 2: Half-Yearly Percentage Changes, All Ordinaries Index, 1875-2012



The mean of D4 is less than 1%; simplifying, let's infer that there's a 10% chance that the AOI remains flat. Deciles D5-D10 have positive means: in other words, there's a ca. 60% chance that during any randomly-selected half-year period the index rises. What's the probability that it rises 13%? The mean of the ninth (next-highest) decile, D9, is 12%, and the mean of the highest, D10, is 22%. The probability that the AOI rises by at least 12% is therefore ca. 10% + 10% = 20%. The chance, in other words, that the average prediction (uttered in January 2012 by the "experts" assembled by *The Australian*) comes to fruition is ca. one in five. That's hardly impossible; still, it's unlikely. Valid and reliable data, namely monthly measurements of the AOI since 1875, tell us that "experts" – as they have been for years – seem to be improbably optimistic.

But what if the 1 July-1 January periods since 1875 have been systematically different from the others (i.e., the August-February, March-September … and June-December periods)? The red columns of Figure 2, which depict the results of the analysis described above for the 137 July-December periods, are similar to the blue columns. The mean of this entire sub-series is +2.0%: on average since 1875, the AOI has risen 2% between 1 July and 1 January. There's a 30% chance that it falls, a 10% chance that it remains flat and a 60% chance that it rises. Our best guess is that it rises 2%; there's a 20% chance that it rises 16% or more; extrapolating a bit, there's a roughly one-in-four chance that the AOI rises 13% or more.

More than two years ago, *The Weekend Australian* (16-17 January 2010) asked its group of "experts" to predict the level of the AOI, DJIA, etc., at the end of 2010. The most bullish member predicted that it would climb to 5,800; the most bearish (who was also the most pessimistic at the end of 2008) predicted that it would fall to 4,417; and the mean prediction was a rise to 5,317. Since then the AOI has fallen almost 30% relative to this mean. Who among these "experts" predicted that? Fortunately, *The Weekend Australian* doesn't request that the members of its panel prophesy more than a year in advance. Perhaps it knows the truth – namely that these predictions are, for any practical purpose, useless. Perhaps it believes that longer-range forecasts are superfluous, i.e., its "experts" would cite even higher – that is, even more laughably erroneous – figures for two and more years hence.

The risible inaccuracy of experts' predictions, which has been demonstrated repeatedly, doesn't embarrass the experts. Accordingly, "analysts," "economists," "strategists" and others mouthed similarly bullish – and unsubstantiated – prophesies at the beginning of the 2012-2013 financial year. The exuberance of "Big Opportunities in Shares: BlackRock" (*The Australian*, 18 July 2012) was typical:

> The head of Asian equities at major global asset manager BlackRock says an "incredible opportunity" has emerged for investors willing to look beyond the current global economic uncertainty and invest in shares. Speaking at the launch of BlackRock's mid-year outlook in Hong Kong yesterday, Andrew Swan said heavy selling and bearish sentiment meant investors willing to put money into stocks could profit handsomely in the event of modest improvement in the economic environment. "In the short term [the market has] gone too extreme, too bearish, so therefore [investors] should be looking for companies and sectors that benefit from a marginal improvement in the environment," Mr Swan said.
>
> "Resources stocks and other sectors that have been heavily sold down in recent months could be particularly attractive … If you take the long view there's an incredible opportunity for investors buying equities and going against the trend," Mr Swan said. He added: "the reason equities are cheap is because of uncertainty. At some point in the next year, perhaps sooner, we will get more certainty and equities will be a great investment."

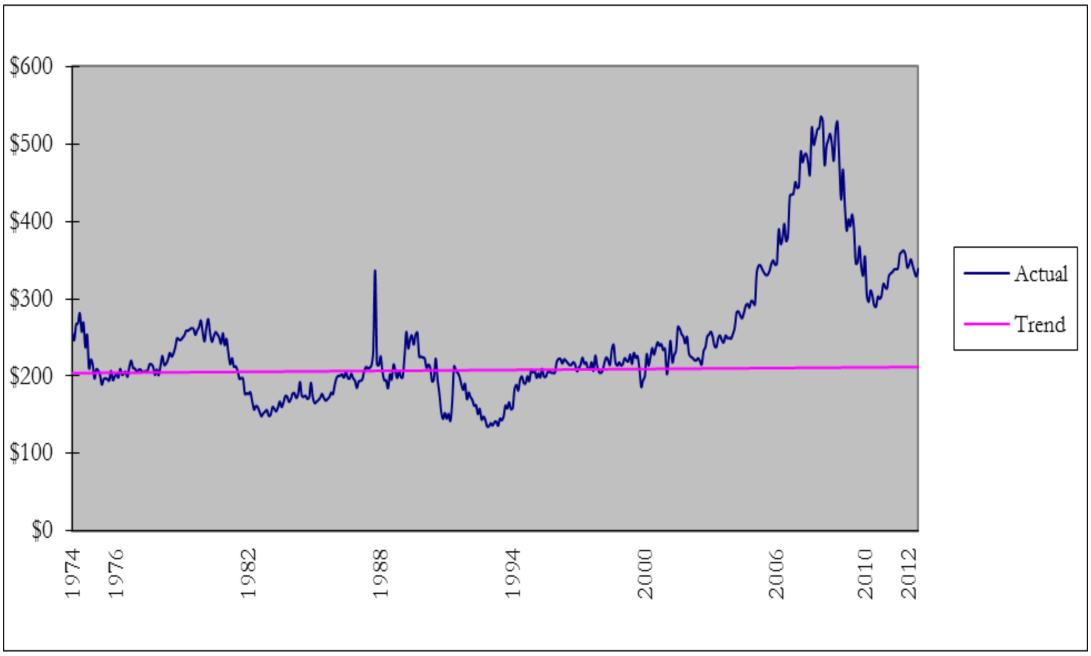
Testing the Mainstream's Claims – and Updating Our Analysis of 2009

How sensible are the mainstream's latest claims? As they currently (and routinely) allege, is the All Ordinaries Index reasonably and even cheaply valued? Are earnings really improving? Or, as they've long been – and certainly been since mid-2007 – does the mainstream remain unreasonably optimistic? To this point, our analysis has relied solely upon monthly observations of the AOI. Clearly, we can bring more information to bear. Most notably, we can compute the earnings per share (EPS) of "All Ordinaries Ltd." In previous years (for example, in Letter 114-116 in 2009, particularly Figures 4-5) I asked: do corporate earnings indefinitely grow? Or do they ebb and flow? Analysis told us five things about the AOI's earnings per share (EPS):

1. As a rule, they rise: their regression (trend) line since 1974 slopes upward.
2. Over shorter periods EPS can rise much more rapidly than – and thus rise considerably above – the overall trend.
3. What goes up eventually comes down. Yes, earnings typically rise year after year; but they can also fall sharply for several years in succession and thereby retrace much or all of their previous gain. EPS, in other words, can also fall below their long-term trend.
4. Phoenix rises from the ashes. Recessions raze EPS, but the firestorm eventually passes, green shoots appear and thicken, and earnings resume their upward march.
5. Over the decades, the AOI's EPS don't grow continuously: they ebb and flow at various speeds along a modestly upward long-term trajectory.

Figure 3, which updates (to 30 June 2012) the data in Figure 4 of Letter 114-116, shows that from 1974-2003 earnings rose above and below – but regressed to – their long-term trend. From 2003-2008 the AOI's EPS exploded far above its long term trend; in 2008-2010 EPS collapsed towards (but did not revert to) its trend; in 2010-2011 EPS rose modestly; and in 2011-2012 they have once again fallen (but remain well above trend). Did the trend of the AOI's EPS change (i.e., increase) significantly in ca. 2003? If you doubt it – that is, if you believe that earnings will again regress towards their long term mean (see Letter 90-92) – then the AOI's EPS – and hence the AOI itself – has considerably further scope to fall.

Figure 3: the AOI's EPS (Net of CPI), 1974-2012 – Can You Spot the Deflating Bubble?



What's the AOI's "Fair Value"?

Any estimate of the AOI's fair value is ultimately the product of two assumptions: (a) its future level and rate of growth of earnings and the (b) multiple at which we capitalise them. Table 1 reproduces Table 2 in Letter 114-116, which detailed and analysed a range of information about these assumptions. It posits a "bullish" assumption (namely that earnings wouldn't subsequently fall from their level in March 2009), a "mid-range" one (that they would fall to a point mid-way between their level in March 2009 and their long-term trend) and a "bearish" one (that they would fall to trend). Note that it ignores the properly bearish possibility – which often becomes a reality during recessions – that earnings fall below their trend. Regarding the earnings multiple, Table 1 posits a "bullish" assumption (that the PE would double from its level in March 2009), a "mid-range" one (that it would rise to 10.1) and a "bearish" one (that it would fall modestly to 7.5).

Table 1: A Summary of Our Results:
The "Fair Value" of the AOI in 2009

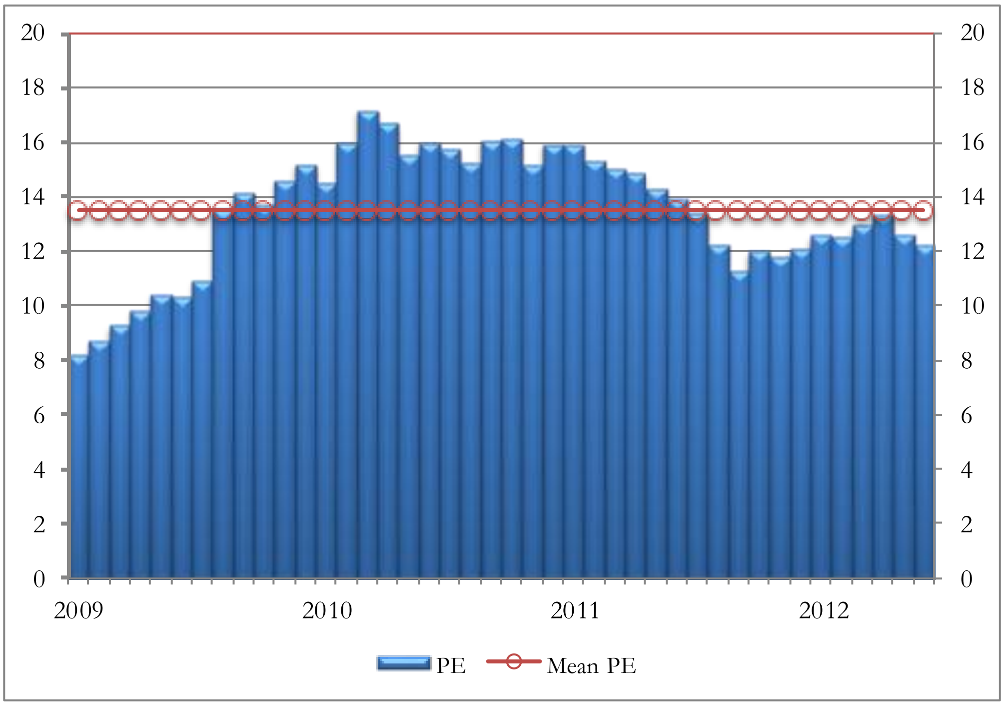
	Bearish Multiple (7.5)	Mid-Range Multiple (10.6)	Bullish Multiple (15.1)	Dividend Discount Model	Mean
Bullish Earnings (i.e., Don't Fall)	2,738	3,869	5,512	3,512	3,908
Mid-Range Earnings	2,213	3,127	4,455	2,838	3,158
Bearish Earnings (i.e., Fall to L-T Trend)	1,688	2,385	3,398	2,165	2,409
Mean	**2,213**	**3,127**	**4,455**	**2,838**	**3,158**

These sets of assumptions yielded nine (twelve, if we include the Dividend Discount Model in the fifth column) estimates of the AOI's "fair value." If in 2009 the AOI's earnings had collapsed to their long-term trend and a bearish (by the standards of the 1970s) multiple had prevailed, then the All Ords' fair value would have been ca. 1,688 – roughly half the level of its low in March 2009. Had earnings remained constant and the "bullish" multiple suddenly emerged, then fair value would have been 5,512 – a modest 67% above the March trough. Mid-range assumptions with respect to both earnings and the multiple generated an estimate of 3,127 – just below the March 2009 low.

Table 1 also shows three estimates derived from the dividend discount model (DDM, for details, see Letter 114-116). Underlying each estimate was the AOI's dividend payout ratio in March 2009 (53%), an indefinite growth rate of 6.5% and a discount rate of 12.5%. The mid-range of earnings generated an estimate ca. 10% below the Index's trough in March 2009. The bullish assumption implied that, at its nadir in March 2009, the Index was undervalued by ca. 6%, and the bearish assumption implies that it was over-valued by ca. one-third.

How have the figures in Table 1 compared to subsequent reality? The assumption of "mid-range earnings" has conformed to subsequent events better than the bearish and bullish assumptions. In Figure 3 we saw that since 2009 the AOI's EPS have fallen considerably. The first assumption ("bullish earnings") has thus not transpired; at the same time, however, nor has the bearish assumption (namely that they would fall to their long-term trend). Figure 4 shows that since 2009 the AOI's PE ratio has averaged 13.5. That's greater than the mid-range multiple but less than the bullish one. Given the mid-range assumption about earnings, the midway point between the fair value assuming the mid-range multiple (3,127) and the bullish multiple (4,455) is 3,791.

Figure 4: the AOI's PE Ratio, January 2009- June 2012



As Figure 5 (next page) shows, this estimate of the AOI's fair value (3,791) is significantly (14%) less than the AOI's mean since January 2009 (4,416), and somewhat (8%) less than the AOI's level (4,136) on 30 June 2012. On this reckoning, since 2009 the AOI has remained overvalued – albeit significantly less overvalued than it was in 2007-2008. Moreover, during the 2011-2012 financial year the extent of overvaluation modestly decreased. That's the good news; the bad news, of course, is that "less overvalued" is not a synonym of "undervalued." On the basis of the analysis presented in 2009, in 2012 the AOI thereby remains ripe for further falls.

Further, if since 2009 the mainstream has been overconfident (that is, reality has fallen short of its rather rosy expectations), it's equally clear that thus far at least it has been less dour than I anticipated. The mainstream's been overly cheerful and I've been overly cautious. Everybody has erred, but which error – that on the side of optimism or that on the side of caution – is the more serious? Which is worse: an error of omission or one of commission?

Figure 5: the AOI, January 2009- June 2012

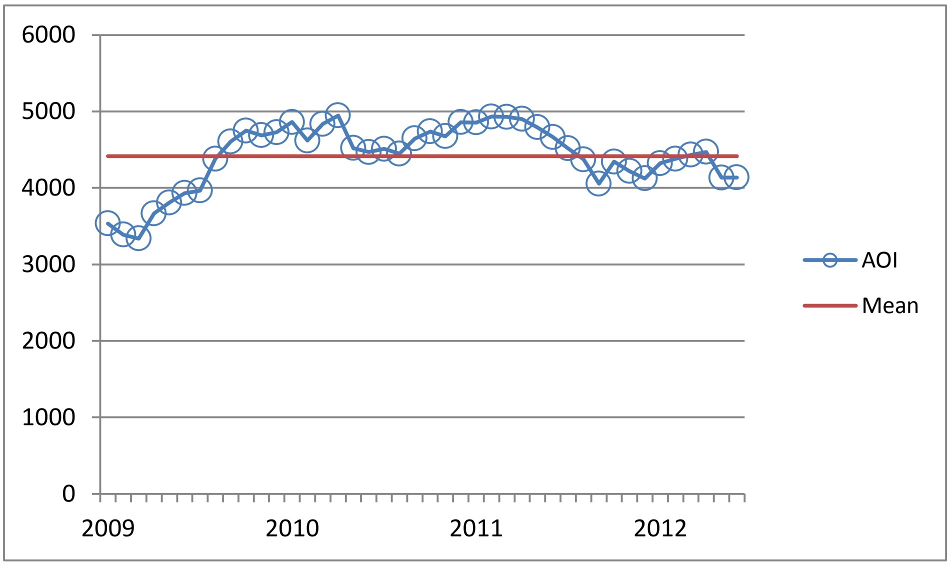


Table 2 updates (using data to 30 June 2012) the analysis conducted in 2009 and summarised in Table 1. Looking down the rows, the bullish assumption posits that the AOI's EPS immediately rises 10% (i.e., to $372 from its value on 30 June ($338). The mid-range assumption is that its EPS fall to a point midway between their current value and the long-term trend, and the bearish assumption is that they immediately regress to their long-term trend ($212). Reading across the rows, the bearish multiple equates to one which prevailed during the bear market of the 1970s; the mid-range multiple approximates the PE's average since 1974; and the bullish multiple approximates one that prevailed before the GFC.

Table 2: A Summary of Our Results:
The "Fair Value" of the AOI in mid-2012

	Bearish Multiple (7.5)	**Mid-Range Multiple (12.5)**	**Bullish Multiple (17.5)**	**Dividend Discount Model**	**Mean**
Bullish Earnings (i.e. Rise 10%	2,790	4,650	6,510	3,547	4,374
Mid-Range Earnings	2,063	3,438	4,813	2,866	3,295
Bearish Earnings (i.e., Fall to Long-Term Trend)	1,590	2,650	3,710	2,187	2,534
Mean	**2,147**	**3,579**	**5,011**	**2,866**	**3,401**

Notice that the bullish assumptions produce an estimate of fair value (6,510) that is almost 60% above the AOI's close on 29 June 2012 – and which is nonetheless far short of the AOI's pre-GFC all-time high. In other words, the AOI is going to take considerable time to recoup the ground it has lost since late 2007. Notice as well that the mid-range assumptions generate an estimate of fair value that approximates the AOI's level early in 2009. That confirms the suspicion I've held for several years: the AOI's level in March 2009 wasn't a nadir which we won't see again; rather, it was a transit point through which we will once again pass before too long. Thirdly, the bearish assumptions continue to generate estimates of fair value that are ca. one-half of the AOI's level at the end of the 2011-2012 financial year. I concede that we're unlikely to see these levels – but hasten to add that anybody who regards them as impossible is a damn fool.

Which assumptions to choose? In Letter 114-116 I wrote:

> You say that these levels are intolerably low? Then accept Warren Buffett's challenge. On 22 November 1999 (when the S&P 500 stood at 1,391 and the Dow Jones Industrial Average at 9,116 and the best and the brightest could – thanks to the Internet – see naught but financial blue sky and economic sunshine for years into the future) he told *Fortune* Magazine "Maybe you'd like to argue a different case. Fair enough. But give me your assumptions. If you think the American public is going to make 12% a year in stocks, I think you have to say, for example, "Well, that's because I expect GDP to grow at 10% a year, dividends to add two percentage points to returns, and interest rates to stay at a constant level." Or you've got to rearrange these key variables in some other manner. [But] the Tinker Bell approach – clap if you believe – just won't cut it."

Has the Rise of China Meant a Perpetual Bull Market on the ASX?

One is tempted to infer from the mainstream's daily torrent of forecasts that the prices of stocks and bonds depend upon economic conditions. This assumed relationship takes two forms:

1. Stocks tend to rise when economic conditions *are perceived to be – or predicted to become* – strong and expected to remain robust.
2. The quicker (slower) is *the actual pace of economic growth*, the more (less) favourable is the investment climate and hence the bigger (smaller) is the harvest that investors can expect to reap.

To most people these hypotheses are obvious. Indeed, they're so self-evident that the forecasting industry undertakes a constant, expensive and frantic search for new and ever more arcane "insights" into economic and financial market conditions, the relation of one to the other – and their course into the "foreseeable future." (By the way, precisely how far into the future can *you* foresee? So why on earth should you believe anything that anybody who uses this phrase says?) The economics and finance prediction industry – not to mention politicians and finance journalists – encourages people to believe that a strong economy necessarily begets favourable investing conditions.

Accordingly, analysts, brokers, bureaucrats, CEOs and journalists have lost no opportunity to hype the boom in China (which derives from its massive "stimulus") and its implications for Australia. ABC News (Henry Sees Decades-Long Commodity Boom), for example, reported on 22 October 2009: "it might be back to boom-town for Australia, with Treasury Secretary Ken Henry predicting a decades-long run of relatively high commodity prices. He is also forecasting a return to near full employment, although is less optimistic about the prospects for full Government coffers. 'It now appears that the impact of the global financial crisis on the Chinese economy and the Indian economy hasn't been nearly as large as many fear,' he said. 'It seems that that's likely to support high, relatively high commodity prices, that is prices for Australia's export commodities, for a considerable period of time, quite possibly … for some decades.'"

The Australian (Golden Age 'Will Stretch To 2050': Ken Henry, 23 October 2009) went further:

> Treasury chief Ken Henry has outlined a golden age for the Australian economy lasting to 2050 and beyond, as rapid population growth and Asian demand for resources bring a sustained surge of global investment. Dr Henry said the period ahead would impose great challenges on the government to pursue economic reform but "with the right decisions, one can envisage a period of unprecedented prosperity" … Both Ken Henry and [departing BHP Billiton chairman] Don Argus think this has a long way to go, based on growth in per capita commodity consumption. Said Ken Henry: "China and India are only in the early stages of catching up with the living standards of the developed world and this process could have a very long way to run." Said Don Argus: "I believe we stand at the threshold of an era of unprecedented growth [in Australia] due to demand generated by China and, in the future, India."

These assertions, to put it mildly, are laughable. By his own admission, the former Secretary to the Treasury cannot tell us with any reliable degree of confidence the Commonwealth's budget deficit, etc., in one and two years' time. Yet he confidently foresees the course of economic development five decades into the future! Christina Romer, professor of economics at the University of California, Berkeley, reminds us (see Daniel Gross, The Forecast of the Forecasters Is Dismal, *The New York Times*, 4 March 2007) that mainstream economists can't predict recessions for the same reason that conventional stock market analysts can't predict market crashes: "both kinds of events, by their nature, are not predictable events." Almost all the post-war recessions, she reckons, were preceded by a shock, like a spike in short-term interest rates, or a sharp rise in oil prices. "It's impossible to see the shocks coming." But if, as Romer rightly says, mainstream economists can't reliably predict recessions, then how on earth can they reliably predict booms?[5]

A boom in China and India, the crowd insisted in 2009, meant robust growth in Australia; and a growing Australian economy, it was equally convinced, ensured that the ASX would rise. Nonsense! At the time (Letter 11-116), we wrote:

> *Investors, beware: there are ample grounds to question and quite possibly to reject the claim that higher rates of economic growth inevitably cause the prices of stocks to rise.* There's surprisingly little evidence that supports the general linkage between economic growth and investment returns – and much that contradicts it. Elroy Dimson, Paul Marsh and Mike Staunton, for example, studied 16 countries' economies and stock markets during the past century (*The Triumph of the Optimists*: *101 Years of Global Investment Returns*, Princeton University Press, 2002). In each country, they found that returns on the stock market are either unrelated or inversely related with growth of GDP. The correlation is -0.27 for the period 1900-2000 and -0.03 for 1951-2000. Statistically, the rate of growth of GDP explained only about 7% of the fluctuation of stock returns between 1900 and 2000; and this key summary measure of economic conditions explained less than 1% of the variation of returns during the second half of the twentieth century.
>
> [Other analyses cover] much longer periods of time … but [reach] the same conclusion. Jeremy Siegel (*Stocks for the Long Run: The Definitive Guide to Financial Market Returns and Long-Term Investment Strategies*, McGraw-Hill Trade, 2003) found that between 1970 and 1997 the average correlation between stock returns and GDP growth was -0.32 in 17 developed countries and -0.03 in 18 emerging markets. Jay Ritter (Economic Growth and Equity Returns), using the data assembled by Dimson, *et al.*, obtained a correlation of -0.42 for these 16 countries during the twentieth century (see also Alan Wood's column in *The Weekend Australian*, 17-18 July 2004). If anything, then, the more robust a country's overall rate of economic growth, the *lower* its stock market's subsequent rate of return (as these things are conventionally

5 Similarly, meteorologists can tell us a fair bit about tomorrow's weather, but hasten to add that forecasts of conditions more than 72 hours in advance are no more accurate than the toss of a coin. "Climate scientists," however, are stridently confident about climatic conditions decades and even centuries into the future. In a long interview published in the *International Journal of Forecasting* (vol. 14, no. 3, 1 September 1998), Arnold Zellner of the University of Chicago, one of the giants in the development of econometric analysis, related an amusing story: "Steve Peck and I simulated the Federal Reserve-MIT-PENN econometric model of the US economy that had over 170 nonlinear equations. Our simulation experiments showed that the model had very strange properties that were unknown to the model builders. From these results we concluded that the model was not safe for use in analysing serious economic problems." Generalising this point – mainstream economists and "climate scientists," are you listening? – Zellner concluded: "I do not know of a complicated model in any area of science that performs well in explanation and prediction, and have challenged many audiences to give me examples. So far, I have not heard about a single one. Certainly the large scale econometric models and complicated VARs (very awful regressions) have not been very successful in explanation and prediction."

> measured). As a rough rule of thumb, rates of growth explain between 1% and 18% of the variation in stock returns in these countries during the past century.

Adolph Hitler boasted that the Third Reich would last a millennium. In fact, it existed little more than a decade. According to Ken Henry in 2009, Australia's mining boom would last half a century; just five years later, news.com.au (Mining Boom over in Two Years, Deloitte Access Economics Predicts, 23 July 2012) reported

> Australia's mining boom will end in just two years, economists predict. In the sternest warning yet of troubled times to come, Deloitte Access Economics today said: "The strong bit of Australia's two-speed economy won't stay strong for more than another two years or so." Access's Chris Richardson said that the boom continues to do all the heavy lifting on Australia's economic growth, but the peak of the project pipeline is already in sight. Investment in resources projects – the key driver of the boom – is looking "less certain the further out you look."
>
> Access [added]: "Mining companies are making it clear the current spike in investment is due to decisions taken a while back, whereas we are getting few new mining mega-projects across the line." The report also said that costs in the mining industry are rising fast and potential profits are being dialed down on the back of deflating commodity prices and doubts over demand from Asia."

Where Do We Stand in mid-2012? Ten Reasons to Scorn Our Rulers

These days, Australian and other Western politicians risibly promise to "deliver" (that is, to rob Peter to subsidise Paul, and to redistribute from producers to consumers) as much prosperity as possible to as many people as possible. Behind this promise lies the misguided presumption that economic and financial knowledge has developed to such a high and reliable level that governments, ably guided by economists, can competently manage the financial system and overall economy. This presumption has spawned a corollary: voters can legitimately hold governments to account for the results of their economic policies. Since mid-2007, neither politicians nor economists or any other segment of the mainstream show any sign that they will repudiate their hubris (never mind their many privileges); nor do voters show any sign that the scales will fall from their eyes.

The superficial result is that a ramshackle collection of buffoons, carpetbaggers, dodgers, grafters, shifters and morons govern Australia, Britain, Canada and the rest of the Western world. Much more seriously, the central precept of the governing class – namely that The Government Knows Best – is utterly bankrupt. Hence the GFC has revealed longstanding crises of economics and democracy. It caught the mainstream completely unawares, and prompted them to panic and to resurrect defective policies that most economists had rightly repudiated decades ago.[6] These policies are now doing no good and considerable harm.

Among the Western mainstream's most stupid deeds and grievous sins is the use the phrase "Global Financial Crisis" in the past tense. The GFC hasn't concluded; indeed, for Australians it hasn't properly begun. Before 2007, the establishment didn't see the storm approaching; after panicking in 2008, since 2009 they have been resolutely upbeat about the future. In sharp contrast, the doughty few who anticipated trouble a decade or more ago remain downcast today.

From a "micro" point of view – that is, our ability to locate and purchase specific mispriced securities – Leithner & Co. is (pardon the cliché) cautiously optimistic (for summary of its results from inception to 30 June 2012, click here). From a broader economic and financial ("macro") perspective, however, we're as bearish as ever. Why are we so glum about the general state of the world? Ten reasons:

1. *Élites have learnt the wrong lessons – or no lessons at all -- from the GFC.* Did Fannie Mae and Freddie Mac *really* cause America's housing bubble? And did the housing bubble really cause the GFC? That's what a growing army of people claim. But if so, then why did a gigantic bubble also inflate in Spain? And what about the housing bubbles in Britain, Ireland – and Australia? Did Fannie and Freddie cause these bubbles, too? If so, how? If not, might these bubbles actually be common consequences of another cause?

2. *The perpetrators of the crisis have not been punished; quite the contrary, they've been rewarded.* The reputations of Alan Greenspan, Ben Bernanke and other central bankers have suffered since 2007. But they don't languish in gaol; indeed, they haven't even been prosecuted. They've escaped scot-free. As a rough rule, the more irresponsibly you acted during the two decades before the GFC, the better you've been treated thereafter. If no bad deed goes unrewarded, then the next crowd will repeat the sins of their forebears.

3. *The establishment remains irredeemably corrupt and their incentives remain utterly crooked.* People looking inside from the outside still don't fully understand the perverse ways of politics, government and finance. They aren't like the rules of Main Street. The politician, bureaucrat and a senior executive at an

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6 On 19 October 2001, *The Wall Street Journal* concluded that "it's pretty much impossible to find an introductory macroeconomics textbook that recommends … fiscal stimulus. If [John Maynard] Keynes appeared in any of the heavy-duty academic centres around the world, he would find his idea referred to as a 'classic fallacy.' Most economists have moved on to other models". Christina Romer, who chairs President Obama's Council of Economic Advisors, has devoted much of her academic career to the analysis of policy responses to post-war recessions. She has found little evidence that fiscal stimulus has helped to end them (a readable review of her research appeared in *The New York Times* on 2 December 2008). John Cochrane, a professor at the University of Chicago Business School, concluded on his blog (3 February 2009): "I've been looking through graduate course outlines and textbooks, and I can find nowhere in the last 50 years that anybody in economics has said that [deficit spending as a] fiscal stimulus is a good idea. What are we doing giving [such] advice … [when] there's nothing [in what] … we teach our graduate students that says fiscal stimulus works?"

investment bank doesn't face the same "risk/reward calculus" as a bloke running a corner dairy or dry cleaner. Take your mental images of traditional free-market enterprise and throw them into the bin. For politicians, bureaucrats and people in Wall Street, it's a case of heads they win, tails they get to flip again – and taxpayers and people of modest means invariably lose. The "rules" of the game behoove elites to behave recklessly, and they suffer little – and usually nothing at all – when things go badly wrong.

4. *The alleged referees, particularly in the U.S., are actually corrupt participants.* Is ours really a system of free enterprise under the rule of law? The problem is that refs egg the players to bribe the refs. In the U.S., banks and the financial services industry more generally lavish huge amounts of money upon Congress, presidents and the entire Washington establishment of aides, advisers and various other leaches and parasites. They do it through campaign contributions, $500,000 fees to speakers and promises of boardroom sinecures upon retirement. If you play nice whilst you're within the Beltway, you too can get a $500,000-a-year lobbying job when you retire. How big are the bribes? According to the Center for Responsive Politics, in 2010 alone the finance industry spent $474 million on lobbying.

5. *In Australia, the U.S. and elsewhere, stocks have rebounded well above their lows of March 2009.* Isn't that good news? Much of that rise results from the Fed's rigging of stock markets. And let's not forget that huge rallies in Wall Street also occurred during the bear markets of the 1930s and the 1970s. Stocks are not cheap, and the risk (to the mainstream) is that they become cheap. The dividend yield on the S&P is just 2%. According to one long-term measure ("Tobin's q"), which compares share prices with the replacement cost of company assets, the prices of shares are now about 70% above their long-term average valuations.

6. *The derivatives time bomb is bigger than ever.* Just before the collapse of Lehman Bros., Wall Street firms carried $183 trillion worth of gross exposure to financial derivatives on their books. That sum was 13 times the size of the U.S. economy. If that sounds insane, it was. Since then we've had panic, alleged reform and – so say our rulers – a return to financial sobriety. So what's the figure now? Try somewhere north of $250 trillion – and that figure only counts the exposure of American banks.

7. *They're all socialists.* Whenever (which is often) I hear an American Republican complain that Barack Obama is a "liberal" or a "socialist," I try to stifle a laugh. It's true – but so, of course, was George W. Bush. Obama is a Bush clone – though perhaps more like the George I than II. And please don't claim that Republicans desire "small government" – in office, no Republican (especially not Ronald Reagan) since Warren Harding in the 1920s has delivered anything that remotely resembles limited and constitutional government (see also Letter 105-107).

8. *Westerners continue to spend beyond their means, and are sinking deeper and deeper into debt.* "Austerity" has become a term of abuse used by people who indignantly refuse to live within their own means. As an imperative of "social justice," they assert the right perpetually to live within others' means. Politicians dearly wish to oblige them, but the financial and moral bankruptcy of the welfare-warfare state constrains them.

   Everyone knows about the debt of the U.S. Government and most other Western governments, and the fact that their indebtedness has accelerated dramatically since 2007. But that's only part of the story. For several years, American corporations have borrowed at the rate of ca. $400 billion per quarter – and at an accelerating pace. Overall, American nonfinancial corporations are in hock to the tune of ca. $8 trillion. That's a record, and has increased by more than one-quarter during the past five years. When you add household debt, on-balance sheet government debt and the debts of the financial sector, the level of debt exceeds $50 trillion – and rising. Growing leverage means rising risk; it's as simple as that.

9. *Not despite "stimulus," but because of it, Western economies remain in a funk.* According to Robert Zoellick, a former head of the World Bank and a scion of the establishment, "the Eurozone is muddling along but is still on the precipice, Japan is shrinking and the U.S. faces a series of uncertainties. The risks for the world economy are on the downside. We are in for a bumpy ride … The danger of a breakdown cannot be ruled out."

10. *The Australian élite remains as dangerously complacent and as utterly delusional as it was in 2007.* The Governor of the RBA, Glenn Stevens (The Lucky Country, Address to The Anika Foundation, Sydney, 24 July 2012) reckons that "the ingredients we would look for as signalling an imminent crash seem, if anything, less in evidence now than five years ago."

    Alas, he omits to remind us today what he said five years ago. "Objectively, it is extremely unlikely that the subprime mortgage exposures [in the U.S.] could significantly damage the core banking system in any significant country," he assured the House of Representatives economics committee on 17 August 2007. And in its *Financial Stability Review* (September 2007), the RBA stated: "the outlook for the world economy remains positive, notwithstanding prospects for slower growth in the United States." In 2007, the RBA was as vigilant as Mister Magoo; why should anybody believe that it's any less clueless today?

Benighted outsiders have been doomed once again to suffer because their rulers – the anointed insiders who never learnt sensible economics and finance – are confidently repeating their errors of the past.

Chris Leithner