FINANCIAL PREPAREDNESS

"One of life's most painful moments comes when we must admit that we didn't do our homework, that we are not prepared." ~ Merlin Olsen

Issue #125
June 30, 2023

The Coming Inflation Storm

I just finished reading The Great Money Bubble: Protect Yourself From the Coming Inflation Storm (4.5 stars) by David Stockman, which was published in 2022. He was the budget director during the first Reagan administration. Few commentators are as plainspoken as he is. I have also read (and recommend) his books The Great Deformation: The Corruption of Capitalism in America and Trumped! A Nation on the Brink of Ruin…and How to Bring It Back.

Stockman is a harsh critic of the central planners in Washington, and notes that the received wisdom is that the U.S. economy "is always badly functioning and forever falling short of its potential, thereby requiring constant external stimulus from Washington via its fiscal and central banking branches."

Stockman warns about the dangerous and unprecedented $86 trillion in total debt (370% of GDP) in the U.S. (which I have also warned about), which "now represents the highest leverage rate against national income in U.S. history. Debt at this level guarantees that growth of the Main Street economy and American living standards will grind to a halt while dead ahead loom a fiscal apocalypse and the thundering collapse of the greatest financial market bubbles in history."

Stockman really gets down into the weeds about how the Bureau of Labor Statistics calculates the (fraudulent) Consumer Price Index, and notes that—shockingly (or not?)--one third of the CPI is *imputed*, "a fancy economics word for 'guessed at' by the BLS." He also exposes the fraudulence of the Fed's favorite measure of inflation (the Personal Consumption Expenditures deflator), the weightings of which are: "53% hedonically adjusted prices from the CPI basket, 17% homeowners' guesses about the fictional rental value of their homes, and 30% BLS guesses about the cost of government goods and intermediate business purchases."

Stockman notes (as I have) that China is in even worse financial shape than the U.S. China's total nonfinancial debt rose from $500 billion in 1995 to $3.9 trillion by 2006, to $22.9 trillion by 2014 and to $42.5 trillion in 2020. "That's an 85-fold gain in the course of just 25 years, and there is nothing remotely like it in recorded history."

Stockman is incredulous about the valuations of FANGMAN stocks (Facebook, Apple, Netflix, Google, Microsoft, Amazon and NVIDIA): Nearly 30% of the entire gain of all the stocks in the Wilshire 5000 since mid-2012 was attributable to the $9 trillion gain by these seven stocks alone, and they accounted for 38% of the gain from the S&P 500.

Stockman writes that "Tesla is surely the poster boy for the kind of mindless, unadulterated speculation that has taken over Wall Street. On the single most important metric of valuation—free cash-flow multiple—Tesla's market cap has soared from 29 times as of June 2019 to an out-of-this-world 470 times...in September 2021." (As I write this, the ratio stands at 150, for an implied forward return of 0.67%. What a deal!) During the past two years, Tesla's free cash flow barely doubled to $2.6 billion, but its market cap exploded by 2,300%--from $50 billion to $1.2 trillion.

Stockman notes that Tesla doesn't really have any net income because all of the paltry net income it has reported during the past decade is the result of "regulatory credits, the greenmail [that the non-electric car makers] are forced to pay to Tesla to obtain carbon credits needed to maintain the privilege of selling to the American public the internal combustion engine vehicles they actually want. The irony is mind-boggling." As of October 2021, Tesla's market cap was 170% of the combined market cap of the rest of the entire global auto industry.

Today, most U.S. investors are invested primarily (or completely) in index funds or ETFs, nearly all of which are weighted by market capitalization. So the greater the valuation of a company (relative to its underlying fundamentals), the more shares of it a market-cap weighted fund buys. This investment strategy is called Buy High, Sell Low. Stockman highlights the two dangers of this.

First, when the Great Financial Crisis of 2008 hit, there was $1 trillion in ETFs; now there is more than $7 trillion. So yes, this time it really is different. Once it becomes apparent that stocks don't go up forever, "it's possible that many of those once-passive investors will wake up and decide to 'do something' about their losses [i.e., sell]. Millions of people at or near retirement age could find that assumptions that worked for decades are suddenly a danger to them personally. The chaos would increase exponentially."

Second, Apple alone now comprises almost 8% of the value of the S&P 500. This one company is a $3 trillion market cap behemoth that powers the stock indices, index funds and ETFs ever higher. "It has sucked in the fast-money hedge funds and the millennial naifs alike to join the single most crowded trade in modern history." Apple now has a price/free cash flow ratio of 30.9.

Stockman notes that of the $347 billion of operating free cash flow that Apple earned between Sept. 2015 and June 2021, it spent nearly all of it (a staggering $339 billion) on stock buybacks, plus $77 billion on dividends, thus pumping $416 billion (120% of its free cash flow) back into the stock market. But it borrowed most of the $69 billion cash shortfall. Stockman point out that China could nuke Apple by closing its Foxconn factories "and be not much worse for the wear" since Foxconn's revenue from Apple is less than 0.2% of China's GDP, and Apple's 8% market share in China is steadily falling.

Stockman blames massive currency printing by central banks for this orgy of speculation. In 2012, Fed Chairman Ben Bernanke promised to normalize the Fed's balance sheet after it exploded following the Great Recession, and newly arrived Fed Governor Jerome Powell publicly insisted on it. Instead, they doubled down, and its balance sheet grew at an annual rate of 13.2%—the highest level ever (by far) for a nine-year period. Central bank balance sheets are now more than 40% of global GDP, and until recently, they were increasing by about $400 billion per month. Such an "accommodative" monetary policy must have really helped the economy, right? Instead, the real GDP growth rate was just 2%, the lowest 10-year growth rate in modern history.

Stockman writes that the increase in assets under management from $3.3 billion to $45 billion in one year of ARK (a series of eight highly speculative ETFs managed by Cathie Wood), is "surely a flashing red warning sign and clanging horn combined." Four of ARK's largest holdings in 2020 had a 12-month combined net loss of $1 billion, giving them a *negative* price/earnings ratio of 117. As of August 2021, the individual P/E ratios were 330 for Tesla, 129 for Zoom, 230 for Roku, and essentially infinite for Teladoc.

Stockman warns that "because the Fed's inflationary credit emissions have seeped into the price of virtually everything that can be traded or wagered on…there are no bargains or safe havens left. When the Fed's inflationary storm breaks, there will be exceedingly few places to seek refuge….all financial assets are so radically mispriced that when the imminent inflationary blowoff and panicked Fed retreat send markets into a tailspin, the correlation of one will work in reverse as well. [Read the book The Fearful Rise of Markets.] Virtually all financial asset prices have overperformed income growth by orders of magnitudes during the last several decades and therefore are now slated for an extended era of deep correction and persistent underperformance….Preservation of capital will be all that matters because it will take years, and likely decades, for incomes and profits to catch up with even radically marked-down asset values."

Regarding the Fed's policy of financial repression (keeping interest rates near zero) for most of 2008 through 2021, Stockman writes, "There is no other word for this than expropriation, the unconstitutional taking of property from tens of millions of households that needed to keep their funds liquid and didn't wish to roll the dice on junk bonds and stocks....the [average] after-inflation yield during the 11-year period was negative 1.4%. Thus upward of one-fifth of the real wealth of depositors has been seized by Fed-enabled bankers during the last decade alone....We doubt a more perverse reverse-Robin Hood redistribution could be imagined....that policy literally turned everyday depositors into the indentured financial serfs of the banking system."

But at least your money in the bank is safe, right? In the fourth quarter of 2009, banks owned $1.4 trillion in U.S. Treasury and federal agency debt; now they own $4.2 trillion. "In effect, the Fed midwifed a $2.8 trillion or 195% gain in bank holdings of government paper, thereby enabling Washington" to spend more money. This is the same problem that financially crippled Greece (which led to austerity and limits on ATM withdrawals): its banks were stuffed to the gills with worthless government debt. And Goldman Sachs helped engineer this in both countries.

Stockman highlights the acronym TINA, which means There Is No Alternative to stocks (due to low interest rates), "so close your eyes and buy the present value of a risk-adjusted earnings stream that cannot possibly justify its purchase price....Investing has finally been reduced to trusting in the Fed....In truth, there is no alternative over the long run to a real return on society's pooled savings. Without that, capitalism will wither on the vine, and prosperity as we have known it will, at length, perish from the earth."

Stockman notes that real yields "now have reached preposterously unsustainable levels." The real yield on U.S. Treasury bills "went negative in May 2019 and currently stand negative 175 basis points below the zero bound, [which] is an impossibility. At length, it would generate essentially zero new savings, causing the whole capitalist economy to go tilt." Well maybe that's been The Plan all along. I call this "Capitalism Without Capital."

Stockman writes that due to Fed-induced artificially low interest rates, "junk bond yields have essentially hit zero. So the Fed is deep in the zombie breeding business. After all, when you give junk-rated companies long-term capital at rates that leave investors with virtually nothing after inflation and losses...you are going to get a lot of demand from a mushrooming herd of zombie issuers—that is, companies that would otherwise be liquidated and their resources redeployed more productively elsewhere in an honest free market....These fools [the Fed] have driven the junk-bond yield to negative 145 basis points after inflation....We don't know how you could falsify prices any more blatantly than that."

Stockman quotes Larry McDonald, a trader at Lehman Brothers in the run-up to its demise, from his book A Colossal Failure of Common Sense: "Each year that goes by while central banks force investors to reach for yield—any paltry plus return on capital will do these days—complacency builds over time to an extreme—dangerous level. Mark my words—there were dozens of Bernie Madoffs, Al Dunlaps, and Jeff Skillings sipping mint juleps in the Hamptons and the beaches of the south of France this summer. Central bankers are these guys' best friends....As long as central banks do NOT allow the cleansing process of the business cycle to function over longer and longer periods of time—credit risk will continue to build under the surface. Each month, week, and year we allow this charade to move forth—the corners capital flows into are deeper and deeper soaked with moral hazard toxicity. Today's players on the field make Dick Fuld—former Lehman CEO—look like a choir boy walking out of Sunday mass."

Stockman reveals what will cause the Sword of Damocles to drop: "The only thing that now stands between the S&P 500's index level and a thundering crash is the market's BTFD ('buy the f****** dip') muscle memory. The latter has been built up over 12 years of false tutorials by a central bank....But muscle memory can atrophy when it is subject to relentless battering...and it becomes obvious that there is no fiscal or monetary posse riding to the rescue. That's where we are now. Waiting for BTFD to die."

Stockman continues, "One of the reasons that the stock market has become this red-hot gambling casino is the explosion of options trading in both broad indices and single stocks. Since [2000], the increase in average daily volume has been staggering and relentless, rising by 13.3 times. Options volume now far exceeds actual cash transactions in the underlying securities....options activity is on track to surpass activity in the stock market for the first time ever....the fact that homegamers increasingly embrace risky options trading is unmistakable....options trading by individual retail investors has risen roughly fourfold over the past five years." One options trader said, "Everyone is using leverage." Another said, "I had no idea what options were last year."

Regarding cryptocurrencies, Stockman writes that they are "the epicenter of a historic mania....there are now 16,633 different crypto coins trading on 456 exchanges, all of which have sprung up out of nowhere during the past five years or so....If crypto tokens had the essential characteristics that make money what it is—natural scarcity and difficulty of adding to supply—there absolutely would not have been 16,633 of them minted virtually overnight....new cryptos are the very opposite of scarce and hard to mint."

Stockman continues, "the cryptoverse is the radioactive end game of bad money. It's a financial burial ground where hordes of gamblers supported by easy central bank money ultimately are going to die....what we have is internet-based legalized gambling on a global scale....[Cryptocurrencies] are just plain old gambling chips with market caps that depend on greater fools....[they] are just...the leading edge of the global financial asset bubble—places where the most reckless can congregate to swing for the fences....the powers that be are certain to crush [them when they] become even moderately inconvenient for their rule over the financial system."

Stockman concludes, "...cryptos and Tesla stocks alike are not earning assets; they are just vehicles for unadulterated speculation that rise solely because central bankers enable speculators to push the hunt for the last greater fool to the edge of sanity....the full bill for decades of hideous money pumping will arrive out of the blue, shocking the whole market and everyone invested in it."

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