Bubbles, Booms and Busts

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Economics

- Economic forecasting is like trying to drive a car blindfolded and following directions given by a person who is looking out of the back window.
- The First Law of Economics: For every economist, there exists an equal and opposite economist.
- The Second Law of Economics: They're both wrong
- A student was taking a class taught by Milton Friedman at the University of Chicago. After a late night studying, she fell asleep in class.
  - This sent Friedman into a little tizzy, and he came over and pounded on the table, demanding an answer to a question he had just posed to the class. Michelle, now awake, said, "I'm sorry, Professor. I missed the question, but the answer is increase the money supply."

John Kenneth Galbraith

- The free-enterprise economy is given to recurrent episodes of speculation. These great events and small … over the years and centuries, part of history."
- "The more obvious features of the speculative episode are manifestly clear [in which assets] when bought today, are worth more tomorrow. This increase and the prospect attract new buyers; the new buyers assure a further increase. Yet more are attracted; yet more buy; the increase continues. The speculation building on itself provides its own momentum."

John Kenneth Galbraith

- ”At some point in the growth of a boom all aspects of property ownership become irrelevant except the prospect for an early rise in price.”
- “Thus the rule, supported by the experience of centuries: the speculative episode always ends not with a whimper but with a bang. There will be occasion to see the operation of this rule frequently repeated.”

Momentum Buying

- The essence of the boom is **momentum buying**.
- Whether stocks or real estate, the issue is no longer one of "value"
- T**he whole notion of "value" becomes irrelevant.**
- **Momentum buying involves:**
  - **(1) identify an upward trend**
  - **(2) pay almost any price to get aboard the trend**
  - **(3) wait a bit for someone ("a bigger fool") to come along and drive up the price further**
  - **(4) sell to him. Who has not received a circular urging purchase of a common stock at 50 that not so long ago was at 1 or 2?**
- By investing further into the boom, they create more demand, driving prices further up.
- As this upward momentum spiral expands, the lure of quick wealth becomes enormous.
- Those who held back in the beginning are sucked in toward the end of the boom as by a gigantic vacuum.

Why Booms Re-occur

- The ignorance of the history of booms and busts is a theme that was oft repeated by JKG. He suggested that there are many characteristics in common between boom/bust cycles over the past 400 years
- Another factor is the realistic expectation that the Government and central banks will "bail out" speculators through with monetary, fiscal policies and active intervention if and when the bubble pops.

Basis for Bubble Formation

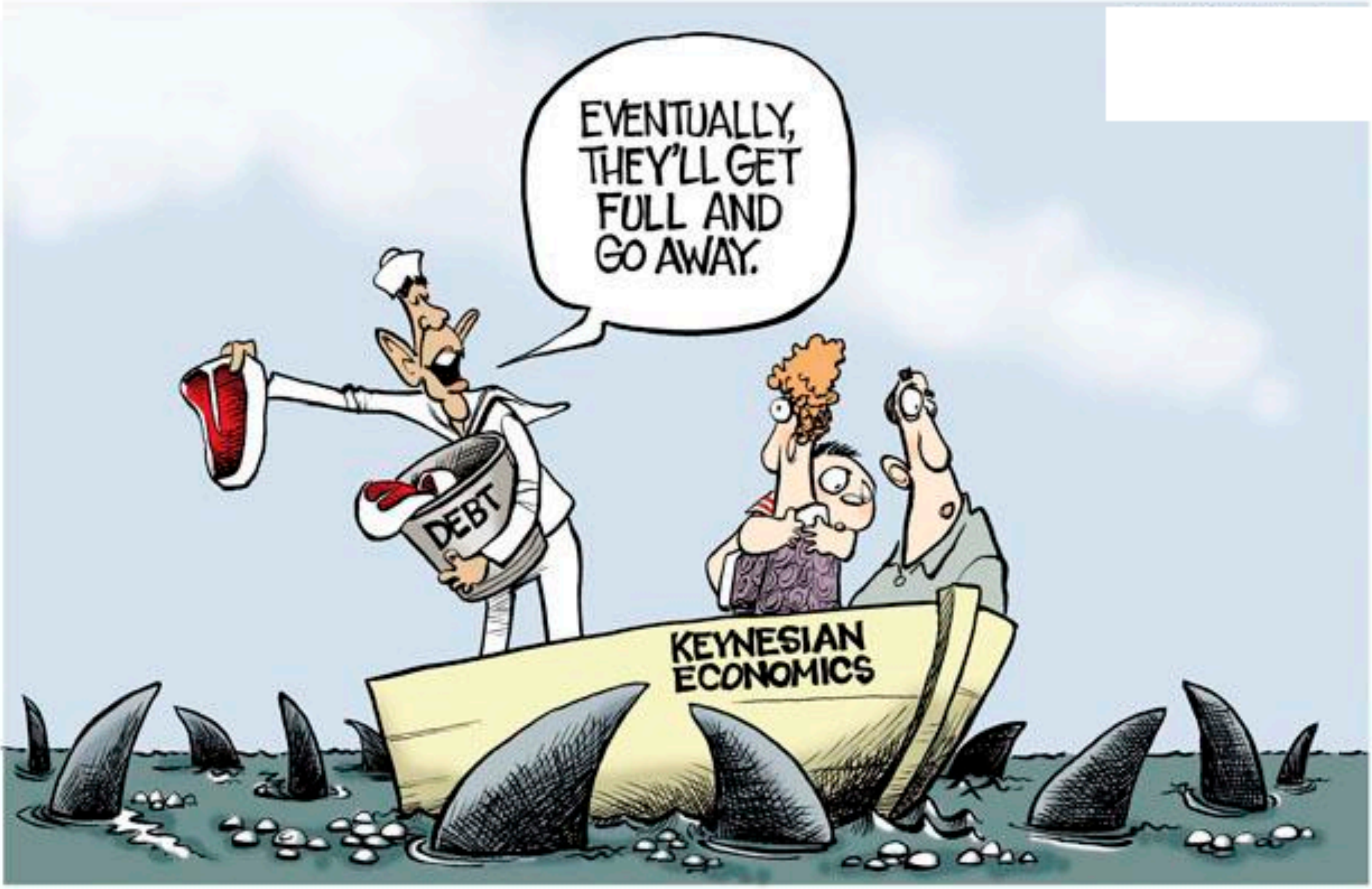
- In general, most bubbles begin with an idea that has some merit
  - New World markets in the 1700s
  - Rapid expansion of automobile production and highways with electrification of much of the country in the 1920s
    - Access to warmer climates like Florida
  - New financial media: Holding companies in 1920s; mutual funds in 1980s – 2000s
  - Wide use of computers, robotics, automation, satellites in the 1980s
  - Development and expansion of Internet in the late 1990s
  - Expectation for great expansion of renewable energy in the 2000s
- The problem is that expectations for quick returns outrun reality
  - Many of the initial hot investments burn out
  - Only stronger ones persist after inevitable collapse (e.g. Amazon.com)

Role of the Federal Reserve

- While theoretically, the responsibility of the Fed is to stabilize the economy by exercising constraint over budding bubbles through monetary policy
- In actual practice the Fed is beholden to the current political administration that desires to be returned to office at the next election.
- History amply demonstrates that people are much happier when their assets are growing by leaps and bounds, than they are when the Fed constrains the money supply to keep the economy in check.
- As a result, the Fed has actively intervened many times after 1980 to prop up faltering asset markets and perhaps unwittingly, support expansion of bubbles.

Lower Interest Rates

- While the common belief is that reduced interest rates stimulate business by reducing the cost of borrowing,
  - **it seems likely that the major effect of reduced interest rates is mainly to discourage saving, and the funds that would have gone into saving then migrate into paper assets: stocks or real estate.**
- The valuation of these assets rises as demand increases, producing what Mr. Greenspan called the "wealth effect" in which people feel wealthier, spend more, and stimulate the economy.
- Lower capital gains taxes also contribute to such booms.
- Hence, the stimulus for business produced by lower interest rates is mainly a consequence of bubble formation.


EVENTUALLY, THEY'LL GET FULL AND GO AWAY.
DEBT
KEYNESIAN ECONOMICS

Bubbles of the 18th Century

- The British government was in precarious financial condition and its bonds traded at deep discounts.
- The South Sea Co. was created ~ 1719 to reduce payments on government debt in return for exclusive rights to trade with Spanish America.
- Holders of British government bonds could use their depreciated bonds at face value to acquire South Sea shares.
- South Sea Co. agreed to accept lower interest payments from the government on the bonds they acquired.
- Everyone seemed to benefit:
  - The government was able to reduce the interest payments on the public debt
  - Bondholders would receive [what seemed to be] full value for their bonds
  - The new company would presumably be able to reap large profits from future trade with the Americas

South Sea Company

- Wild claims made for demand for luxury merchandise in the New World.
- Frequent references to large deposits of precious minerals in South America.
- It was widely assumed that the South Sea Co. could achieve great profitability from trading with Spanish colonies in the New World.
- SSC loaned shares to high officials in the government, and bought them back when share prices rose, generating profit for politicians based on no investment.
- Meanwhile, the South Sea Company acquired an aura of legitimacy on the claim that all the top government officials had "invested" in the company.
- The stock rose eight-fold from January to June 1720.
- However, the Spanish government forbade foreign nationals from trading with its colonies, a policy that seemed unlikely to change.

South Sea Company

- Success of the South Seas Co. initiative caused a country-wide frenzy as citizens developed a feverish interest in investing;
  - in South Seas primarily, but in stocks generally.
- A number of other joint-stock companies then joined the market, making usually fraudulent claims about other foreign ventures or bizarre schemes, and were nicknamed “bubbles”.
- However, the areas involved were Spanish colonies, and Great Britain was then at war with Spain.
- The bubble popped at the end of the summer of 1720, and the stock price dropped by a factor of eight in September.
- A number of people around the country lost all their money and the South Sea Company Directors were arrested and their estates forfeited.

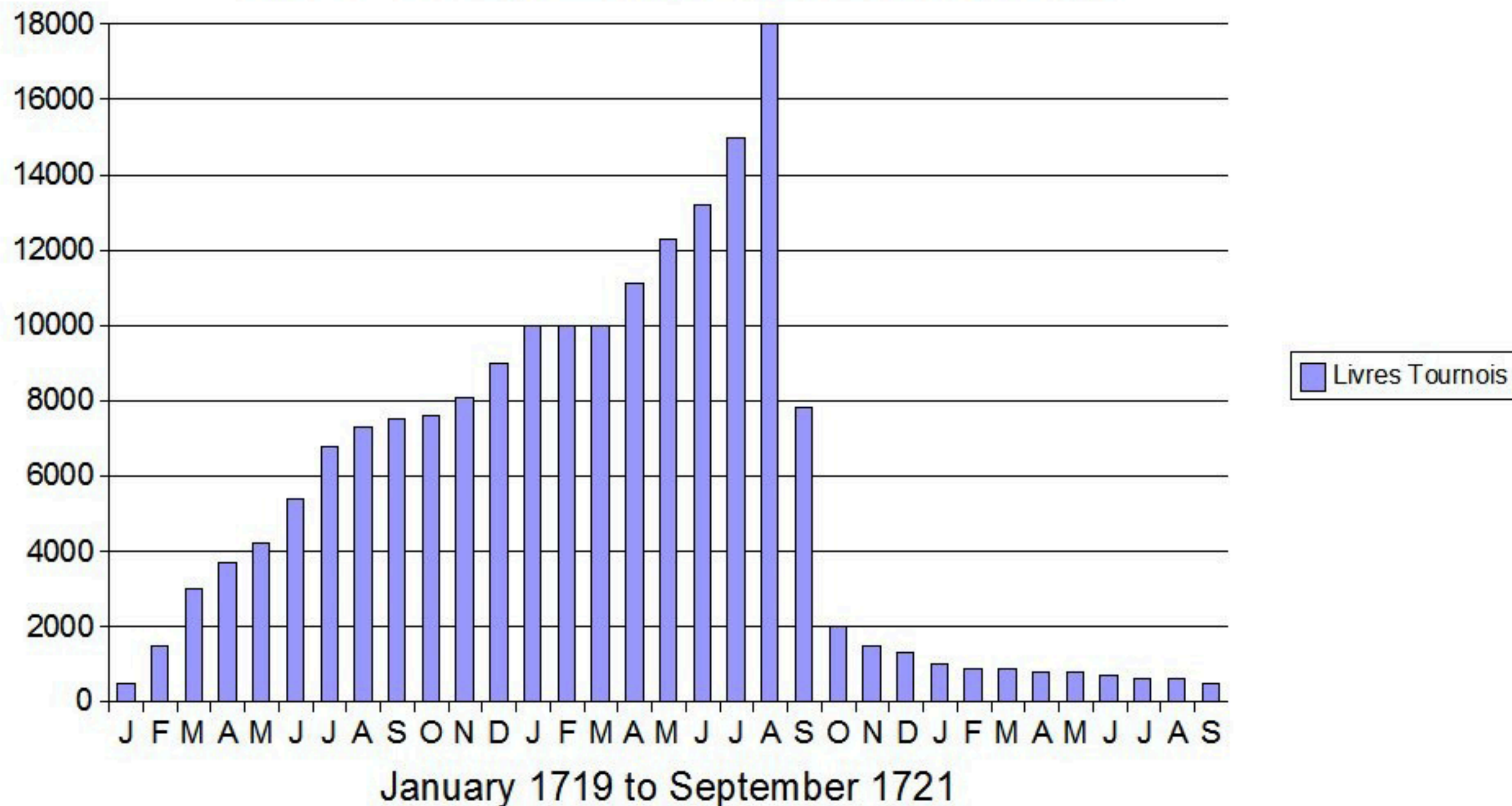
The "night singer of shares" sold stock on the streets during the South Sea Bubble. Amsterdam, 1720.

BUBBLE CARDS

The Headlong Fools Plunge into South Sea Water:
But the Sly Long-heads Wade with Caution after.
The First are Drowning but the Wise Last
Venture no Deeper than the knees or Waist.

Mississippi Company

- John Law escaped to France where he did the same thing.
- Holders of bonds could use their depreciated French bonds at face value to acquire Mississippi Co. shares.
- Mississippi Co. agreed to accept lower interest payments from the French government on the bonds they acquired.
- Everyone seemed to benefit:
  - the government was able to reduce the interest payments on the public debt
  - bondholders would receive [what seemed to be] full value for their bonds
  - The new company would presumably be able to reap large profits from future trade with the Americas
- The stock rose by a factor of ten in a buying frenzy
- The Mississippi Company went through the same type of cycle – a runaway bubble followed by a popped bubble.


Value of One Share of Mississippi Company Stock
18000
16000
14000
12000
10000
8000
6000
4000
2000
0
J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S
January 1719 to September 1721
Livres Tournois

Florida Land Boom – 1920s

- Miami had become one frenzied real-estate exchange with 2,000 real-estate offices and 25,000 agents marketing house-lots or acreage....
  - The city fathers had been forced to pass an ordinance forbidding the sale of property in the street, or even the showing of a map, to prevent inordinate traffic congestion
- By 1925 they were buying anything, anywhere, so long as it was in Florida.
  - One had only to announce a new development, be it honest or fraudulent, be it on the Atlantic Ocean or deep in the wasteland of the interior, to set people scrambling for house lots
- By the height of the 1920s land boom, **a single piece of land was changing hands as many as six times a day**.
  - "Binder Boys" sold land for a small down payment, the understanding being that the land would probably sell at a higher price before the next payment came due. There always seemed to be another buyer hoping to jump into the market, causing the prices to skyrocket further.

J.S.BLAIN'S Greatest Land Offering

Greater than Merritt's Island-Greater than St.Andrews Bay

$15 per acre

COLUMBIA ACRES gem of the SUWANNEE RIVER COUNTRY

1st $37.50 BALANCE $15 QUARTERLY

Never before have you been offered such an opportunity—perhaps never again! A bargain feast few days

10 Acres for $150

—FIRST COME-FIRST SERVED—

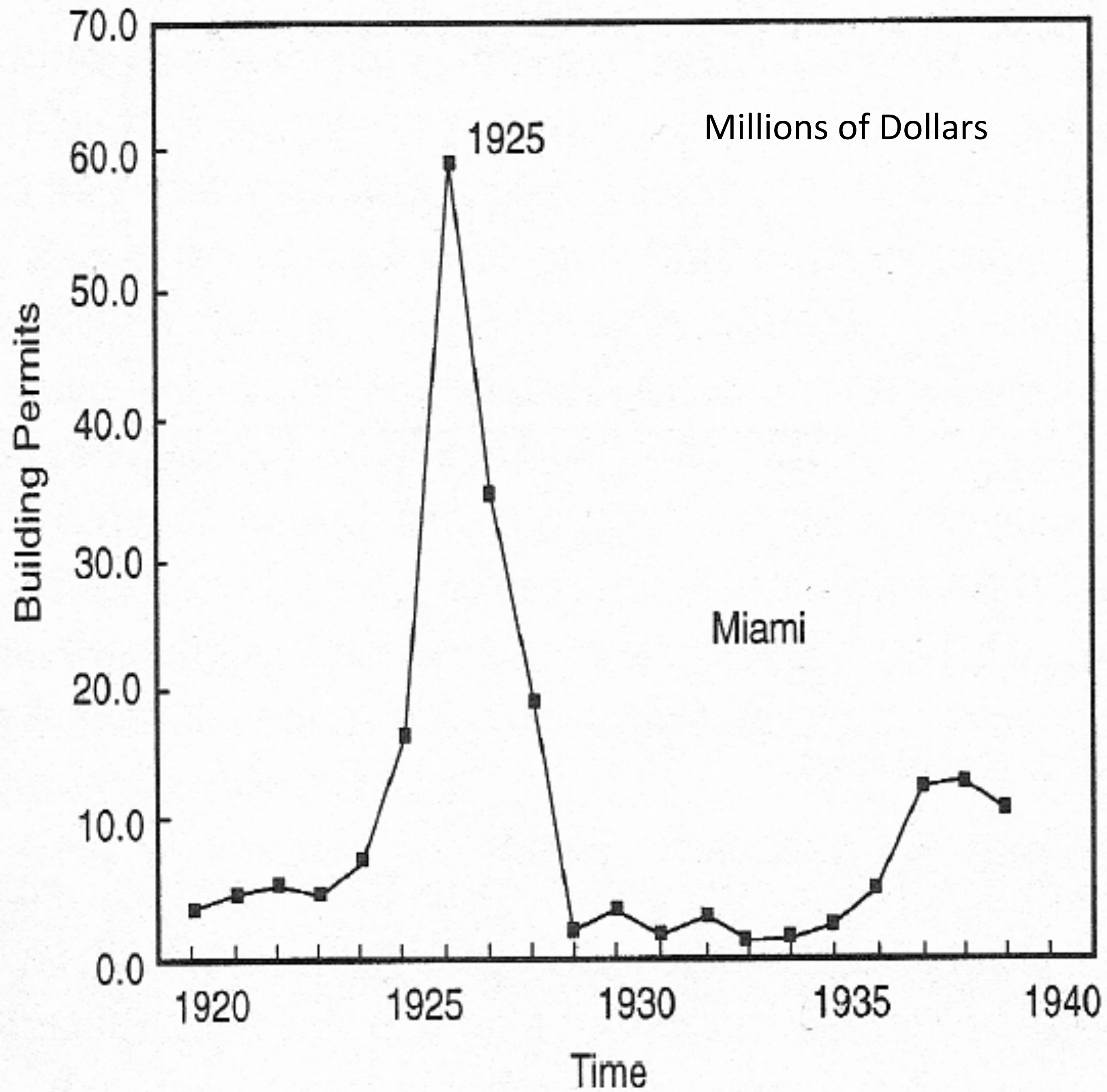
ALL-FLORIDA REALTY CO.

Brokers and Salesmen —You are invited to help us handle the sales on this

MAIL YOUR CHECK $37.50

Florida Land Boom – The Fall

- The Florida land boom began to collapse in the spring and summer of 1926.
- People who held binders were defaulting on their payments.
- Many of those with paper profits found that the properties they owned were preceded by a series of purchases and sales, all at 10% down,
  - and as many of these defaulted, the only options were to either hold onto the land at a great loss, or default.
- The land was often burdened with taxes and assessments that amounted to more than the cash received for it, and much of the land was blighted with a partly constructed development.
- As the deflation expanded, two hurricanes added the finishing touch to the bursting bubble. The hurricanes left four hundred dead, sixty-three hundred injured, and fifty thousand homeless


70.0
60.0
50.0
40.0
30.0
20.0
10.0
0.0
Building Permits
1925
Millions of Dollars
Miami
1920
1925
1930
1935
1940
Time

West Flagler St. after the hurricane
Miami, Fla. Sept. 18, 1926

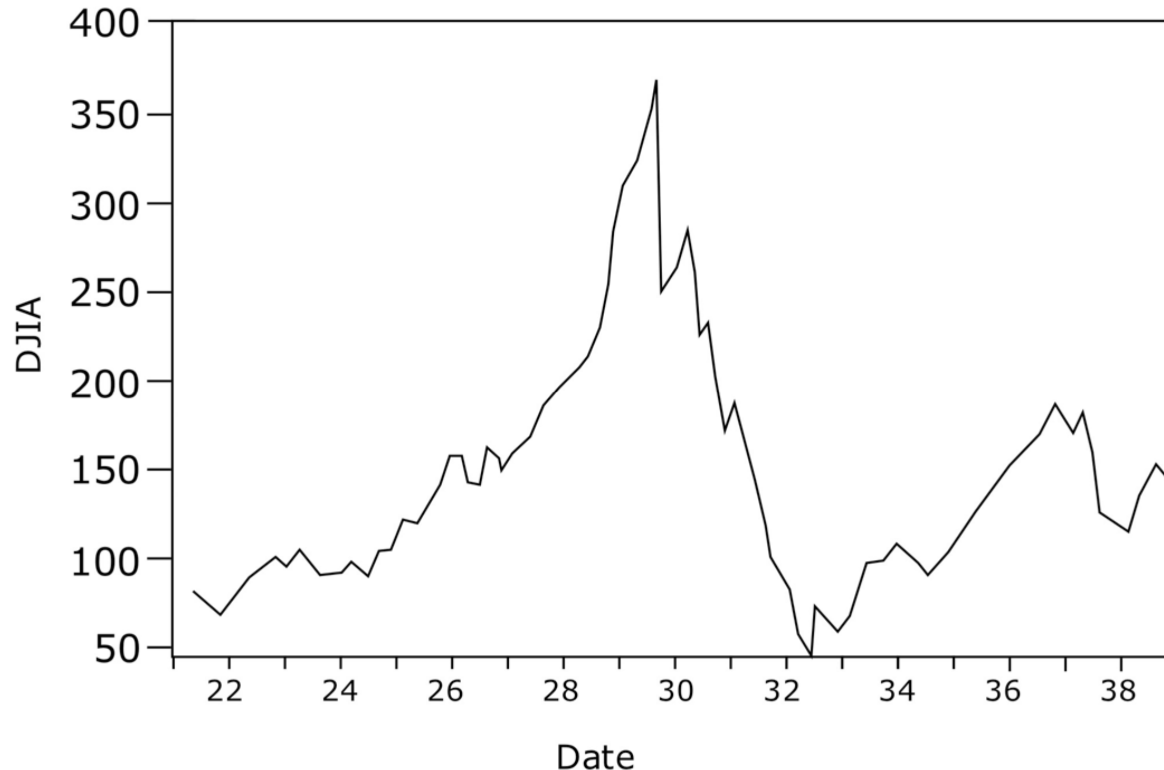
The Boom of the 1920s

- Real economic gains in the period 1925-1929:
  - Value of output rose 13% in five years
  - Increase in automobile production was 23% in 3 years
  - Industrial production increased by 64% in 7 seven years (after the down year of 1921).
  - The Federal Reserve index of industrial production rose
    - from a depressed value of 67 in the recession of 1921
    - to 100 in 1924 to 126 in mid-1929.
  - Automobile production reached 5.4 million vehicles in 1929, an increase of a million over 1926.
- Wages were not going up much but prices were stable.
- However, as in all booms, the price of assets soon rose far higher than the real increase in prosperity, producing a bubble in which stock valuations were bid up to very high levels. (not unlike 2012?)

Factors that contributed to the economic boom of the 1920s

- Gradual transition from agrarian nation toward an industrial nation
- Advent of mass production in electrically powered factories with assembly lines producing products efficiently at low prices
- Automobiles became commonplace
- Widespread electrification
- Taxes were low and businesses and individuals were able to retain much of their earnings.
  - The uppermost income tax bracket during the second half of the 1920s was 25% – the lowest it has ever been.
  - Similarly, the capital gains tax was the lowest it has ever been.
- There was an ample money supply.
- Advertising became a big business and America became a consumer society driven by the urgings of the advertisers.

Stock Market in 1920s



- "The stock market did not rise by slow, steady steps, but by great vaulting leaps. On occasion it also came down the same way, only to recover and go higher again" - JKG

WALL ST.
ONE WAY

Explanations for the Crash

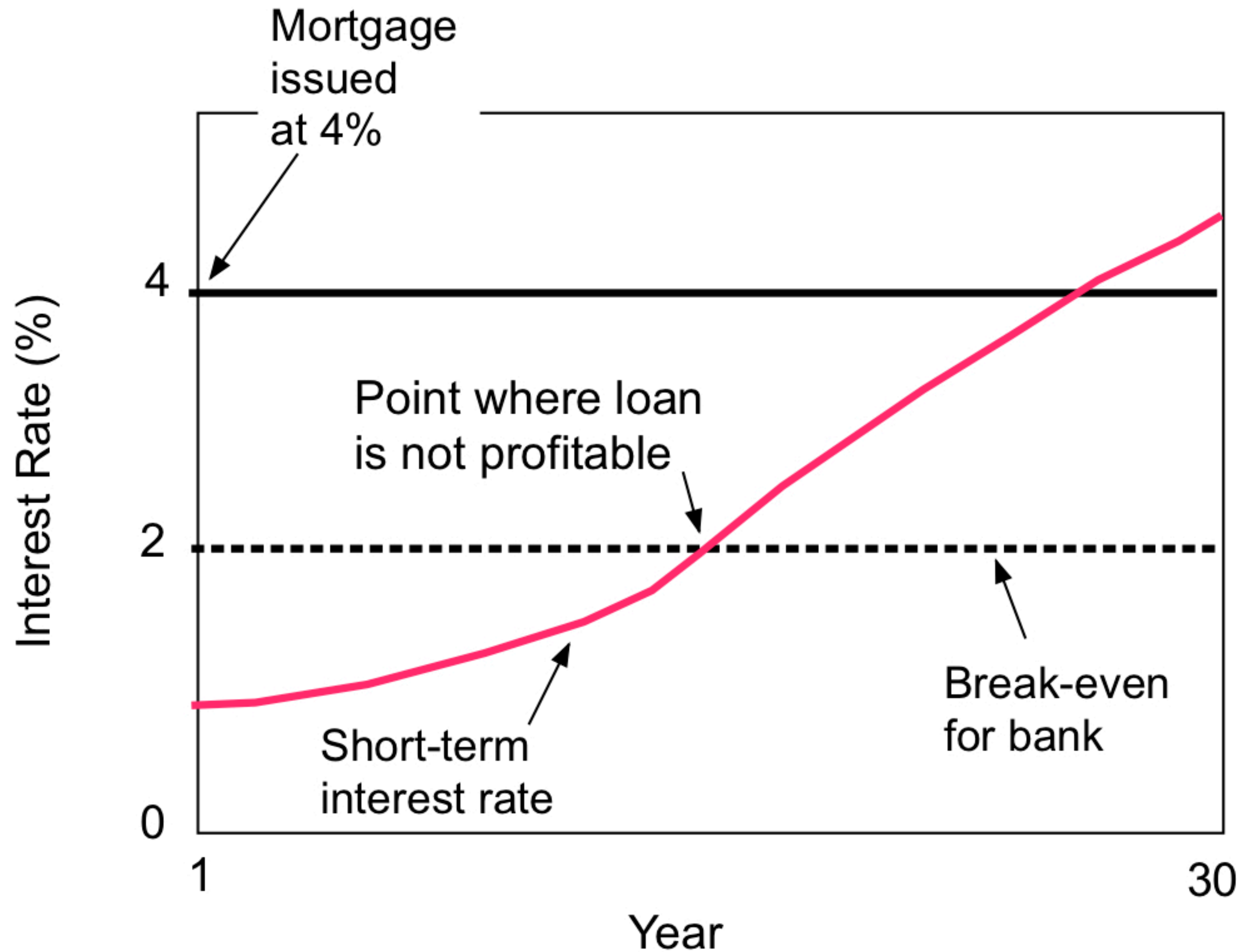
- **Many explanations have been offered**.
  - Most lean toward the view that the rise of the 1920s was not acutely abnormal, and special circumstances caused the downfall of the markets and the ensuing depression.
- **One common "explanation" is based on credit tightening**
  - JKG disagreed: The bubble mentality was so frothing that investors were happy to pay double-digit margin interest rates to plough more money back into the stock market In late 1929, investors were happy to pay margin interest rates ~20%
- The Federal Reserve System published a report in 2003 that concluded:
  - "Even at the 1929 peak, ***stocks were undervalued relative to the prediction of theory***."
  - Apparently, the Federal Reserve believed that even after the spectacular rise in stock prices of the latter half of the 1920s, stocks still remained underpriced.
  - However, JKG described the Federal Reserve in 1929 as "a body of startling incompetence" and there seems to be no reason to suggest that this has changed in the past 80 years.
- **What seems to be missing from the explanations for the crash (except for writings of JKG) is that the crash was a natural and unavoidable consequence of the speculative rise that preceded it**.

I HAD TO MAKE SOME ADJUSTMENTS SO YOUR NEW RETIREMENT DATE IS 2065
RETIREMENT PLANNING
MARKET ANALYSIS

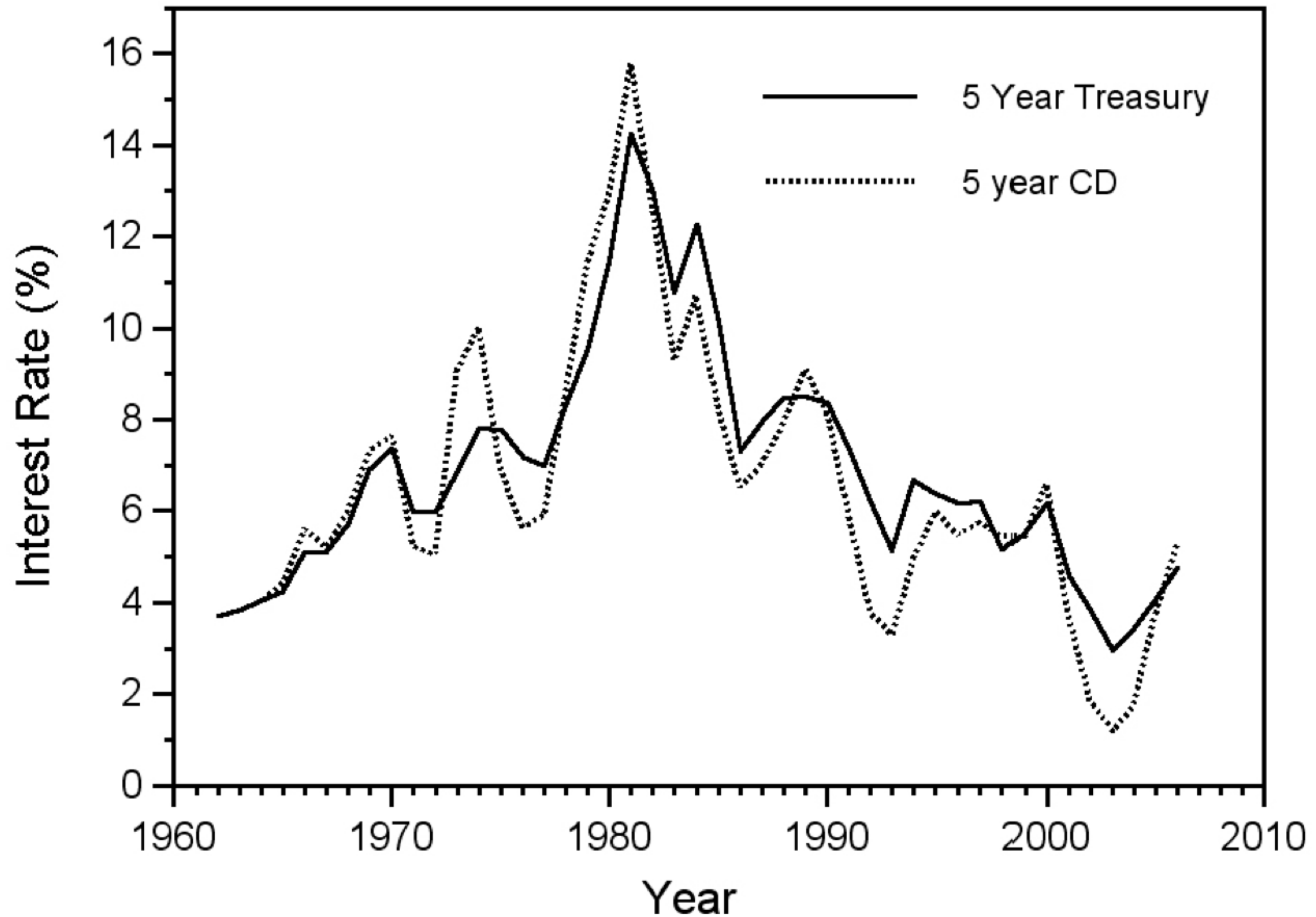
S&L prior to 1980

- The Savings and Loan (S&L) institutions of America were founded for the purpose of providing funding for residential homes.
- Prior to the late 1970s, most home mortgages were at a fixed interest rate, typically for 30 years, but occasionally for shorter terms.
- S&Ls were highly regulated and typical requirements included:
  - Fixed upper limits to the interest they were allowed to pay on deposits.
  - They were not allowed to borrow long-term.
  - Requirements for maintaining capital as a percentage of assets.
  - Business was limited to loans for residential housing. Loans were not permitted for non-residential construction, raw land investment, or other enterprises. (However, Texas approved a major liberalization of S&L powers in 1967).
- At least 400 stockholders with no single investor owning more than 25 %
- Typically, mortgagee paid down at least 20% of the value of the property

Mortgage and Interest Rates



Interest Rates circa 1980



S&L in the 1980s

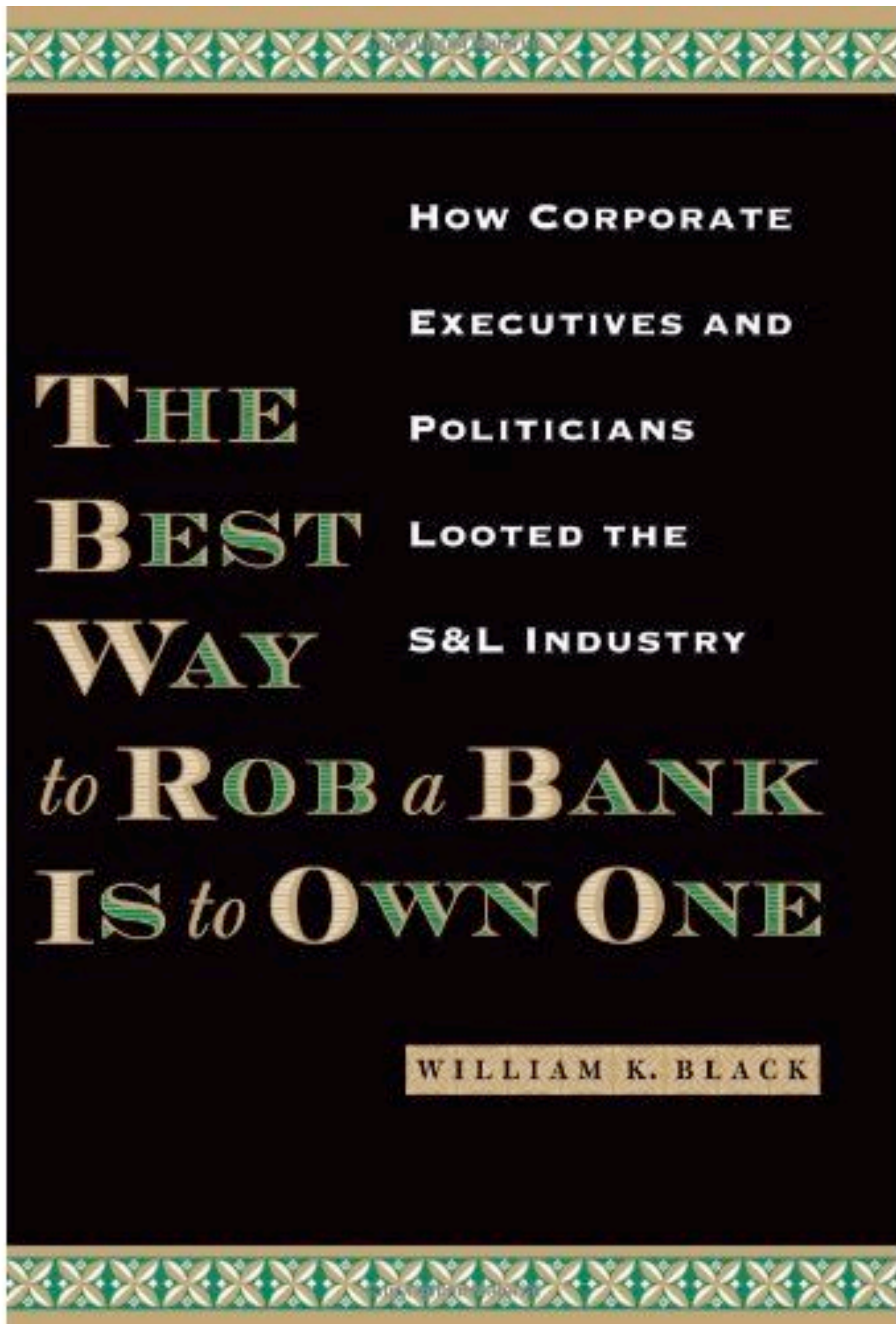
Year	No. of S&Ls	Total Assets (TA)	Net Income	Tangible Capital (TC)	TC/TA (%)	No. Insolvent S&Ls	Assets in Insolvent S&Ls	FSLIC Res-erves
1980	3,993	604	0.8	32	5.3	43	0.4	6.5
1981	3,751	640	-4.6	25	4.0	112	28.5	6.2
1982	3,287	686	-4.1	4	0.5	415	220.0	6.3
1983	3,146	814	1.9	4	0.4	515	284.6	6.4
1984	3,136	976	1.0	3	0.3	695	360.2	5.6
1985	3,246	1,068	3.7	8	0.8	705	358.3	4.6
1986	3,220	1,162	0.1	14	1.2	672	343.1	-6.3
1987	3,147	1,249	-7.8	9	0.7	672	353.8	-13.7
1988	2,949	1,349	-13.4	22	1.6	508	297.3	-75.0
1989	2,878	1,252	-17.6	10	0.8	516	290.8	NA

Deregulation

- In the late 1970s, deregulation as a generic policy was in the air.
  - The trucking and airline industries had already been deregulated.
  - It seemed obvious that regulations on S&Ls should be relaxed
- Reagan was elected in 1980 and he made a bad situation much worse – via a variety of "shenanigans"
  - Swept state rules and regulations aside
  - Eliminated L-T-V requirements (allowed ~ zero down payment loans)
  - Originators of new S&Ls were allowed to start (capitalize) their S&L with land or other non-cash assets rather than money
  - S&L were allowed to make all sorts of non-mortgage loans, loans on vacant land, and loans far from their region
  - Allowed a single stockholder to own a S&L
  - Changed the definition of net worth so fewer S&Ls would have to be declared insolvent
- Meanwhile, Reagan decimated the staff of the FSLIC

Deregulated S&Ls

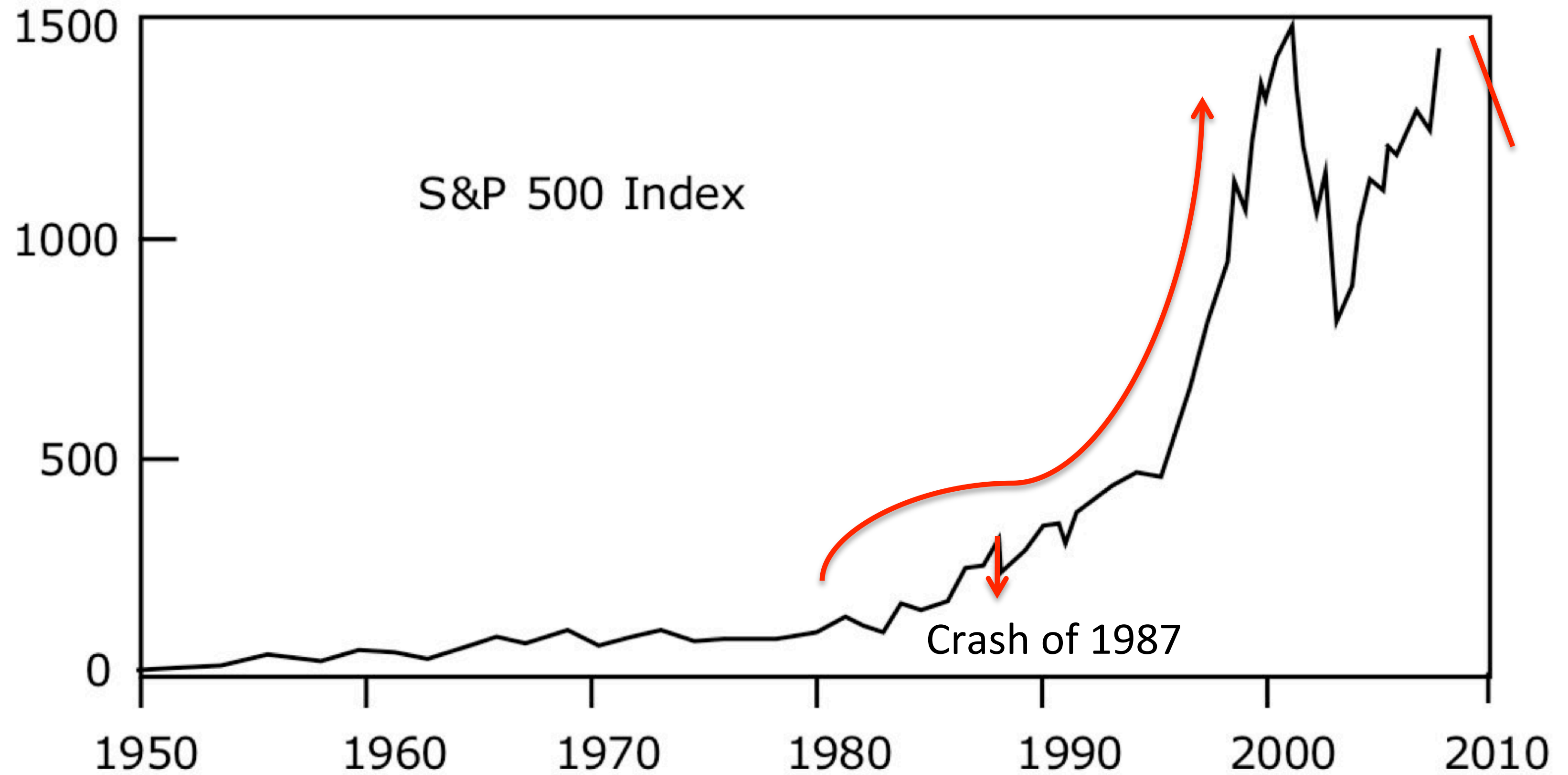
- **The only way out seemed to be to rapidly acquire huge volumes of new loans to dilute the overhang from past loans, and repair the balance sheet.**
- After 1982, S&Ls were deregulated allowing them to pay very high interest rates
  - The period from 1982 to 1985 was characterized by extremely rapid growth fueled by an influx of deposits into institutions willing to pay above-market interest rates.
  - With money flowing so plentifully, risk takers gravitated toward the S&L industry, altering ownership characteristics.
  - S&L invested heavily in construction loans for condominiums, office buildings, shopping centers and hotels, casinos to fast-food franchises, ski resorts, and windmill farms, junk bonds, arbitrage schemes, derivative instruments, etc.
  - As the FDIC Report said:
  - "***Although more than a few of these new owners engaged in highly publicized cases of fraudulent activity, many others were just greedy.”***


HOW CORPORATE
EXECUTIVES AND
POLITICIANS
LOOTED THE
S&L INDUSTRY
THE
BEST
WAY
to ROB a BANK
IS to OWN ONE
WILLIAM K. BLACK

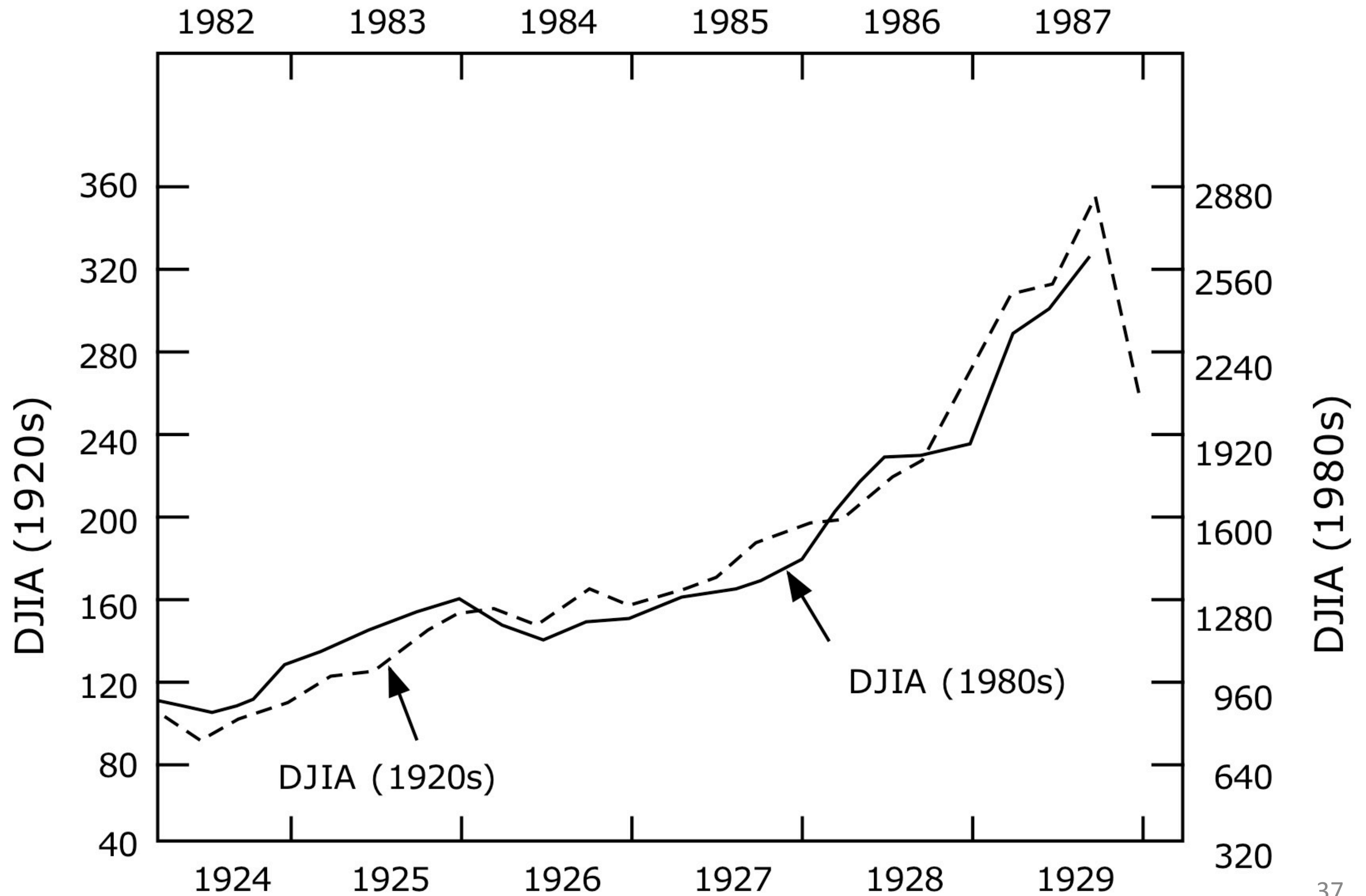
The Aftermath

- The final cost of the S&L debacle was $160 billion of which $132 billion was borne by taxpayers
- The person most responsible for the depth and extent of the Savings and Loan Scandal of the 1980s was President Ronald Reagan.
- S&Ls were allowed (perhaps even encouraged) to run wild with investment schemes backed by the FSLIC that would have been considered unimaginable in prior years
- A large portion of the funds eventually paid out by the federal government to bail out failed S&Ls could have been avoided by timely and effective action before the problem escalated out of hand.
- The government guarantee of insured deposits exposed US taxpayers to the risk of loss – while the profits made possible by deregulation and forbearance would accrue to the owners and managers of the savings and loans.
- In 1987, after auditors said that at least $50 billion was needed, some Congressmen reluctantly proposed to raise the $5 billion budget to $15 billion. It was voted down 258-153.
- Lowy in reviewing the policy of "keeping zombie S&Ls open" put it very succinctly: "the delay cost a whole lot.”

The Bull Market of 1982-1999

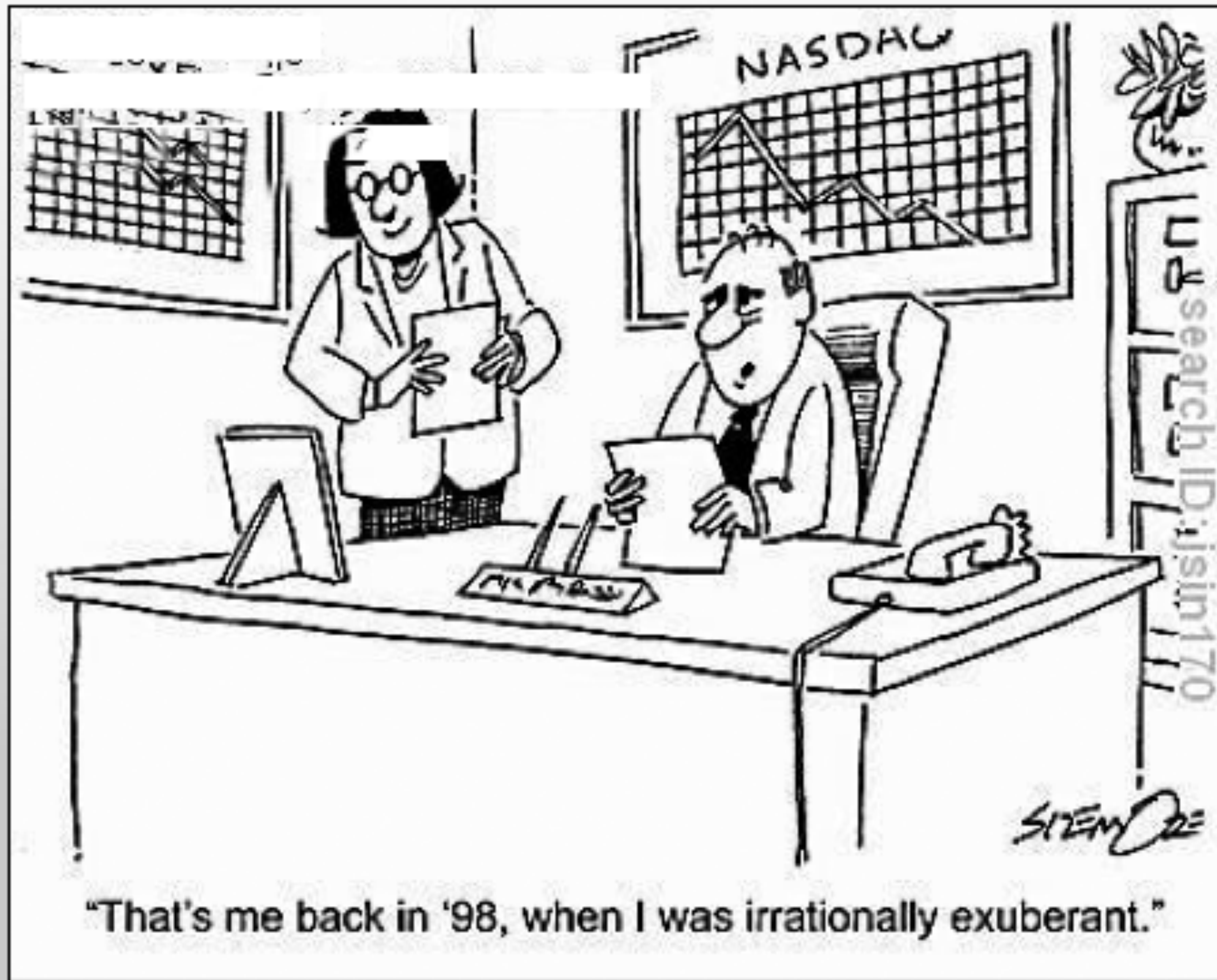


History Repeats Itself?



The Bull Market of 1982-1999

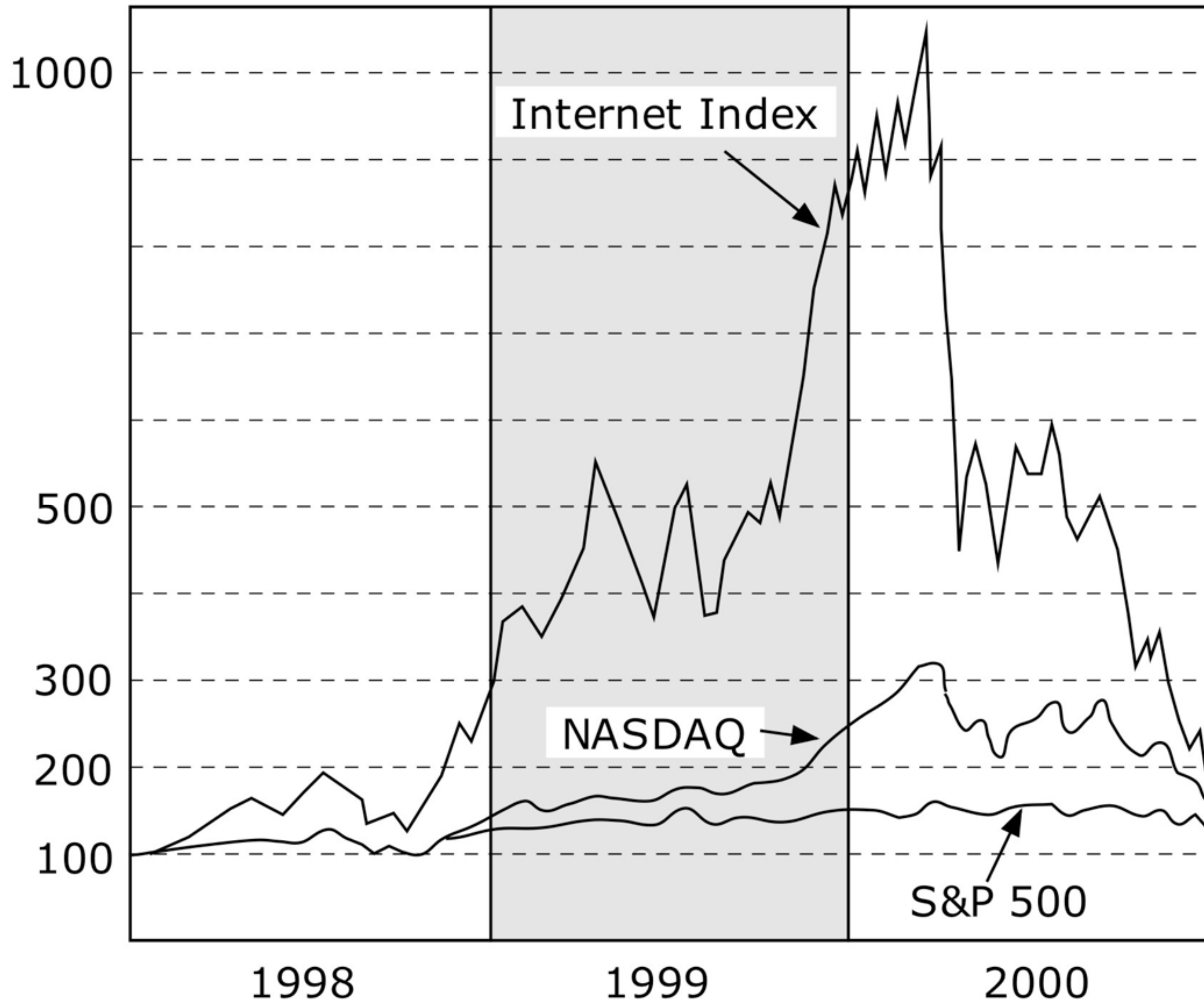
- The stock market took off in August 1982, and began a spectacular 17-year rise to 1999,
  - with a few hiccups along the way (including the crash of 1987)
- Income taxes and capital gains taxes were sharply reduced during this era, while government deficits soared
- The advent of 401(k)-retirement plans poured billions into the stock market.
- There was a widespread and pervasive belief that stocks were proven to be the best long-term investment, and there was a concomitant belief that there would quickly be a recovery from any temporary downturn.
- Mergers and acquisitions, and stock buyback programs reduced the number of shares available.
- Big gains were possible from corporate takeovers, and the advent of junk bonds for this purpose expanded the opportunities.
- The advent of the dot.com revolution poured fuel on a raging fire, driving the flames to unprecedented heights. Initial public offerings were greeted with wild enthusiasm.
- Viewpoints on how and why to value stocks became much more subjective and all the old standards were discarded.
- The tax code provided a very generous treatment of interest payments on debt. Interest payments on debt were fully deductible. Buying assets with borrowed funds meant shifting much of the cost to the federal government.



"That's me back in '98, when I was irrationally exuberant."

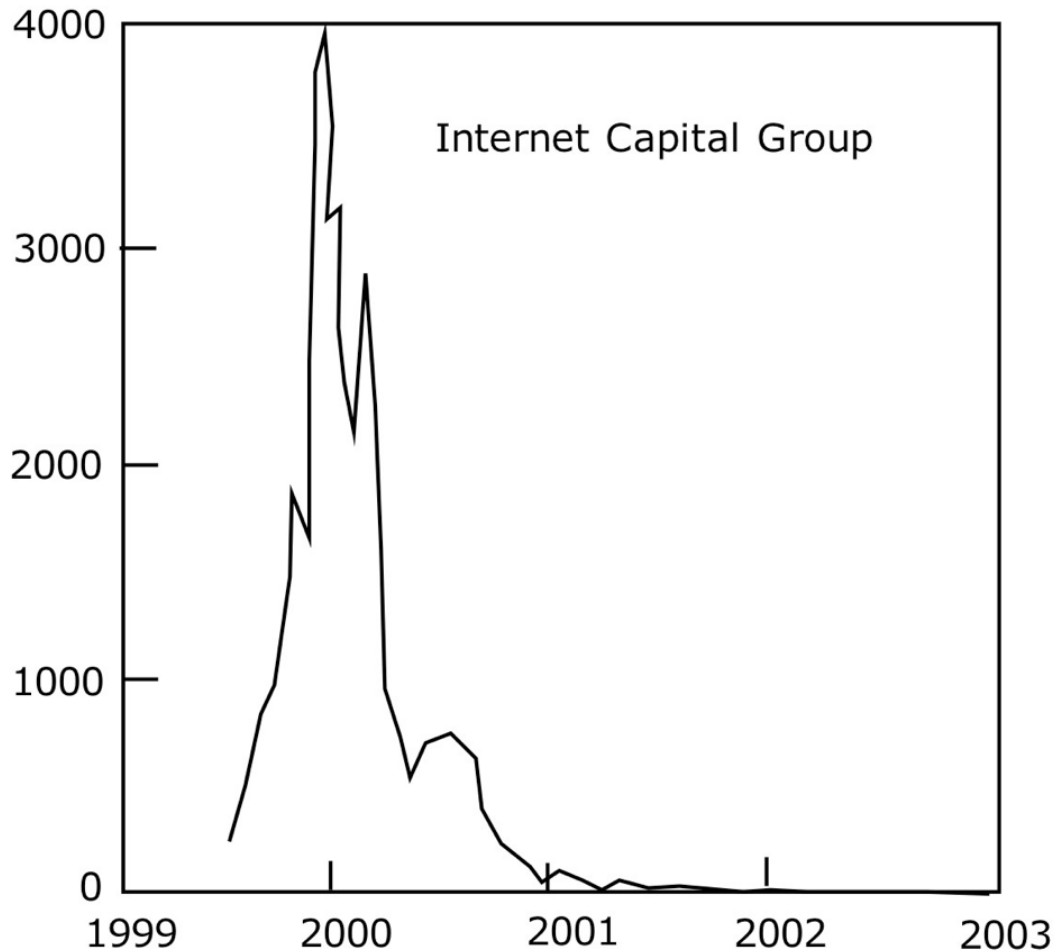
"We'd like to make a bid for a management buy-out - if you'll lend us the money."

The dot.com bubble



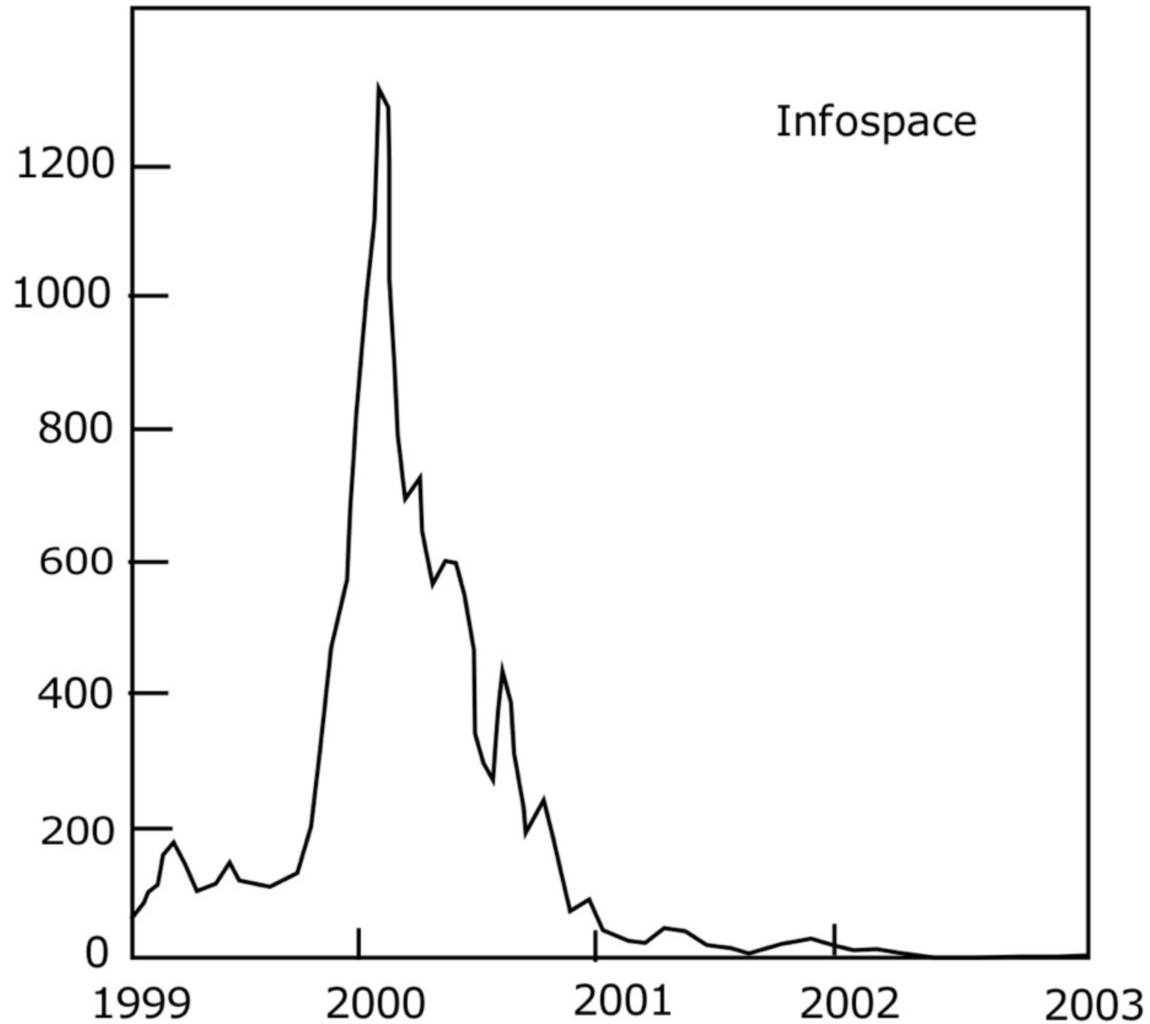
Look on the bright side; you got out of that stock before it became…unstable.

Dot.com Example



Today, you can buy a facsimile stock certificate (suitable for framing) for $69.95

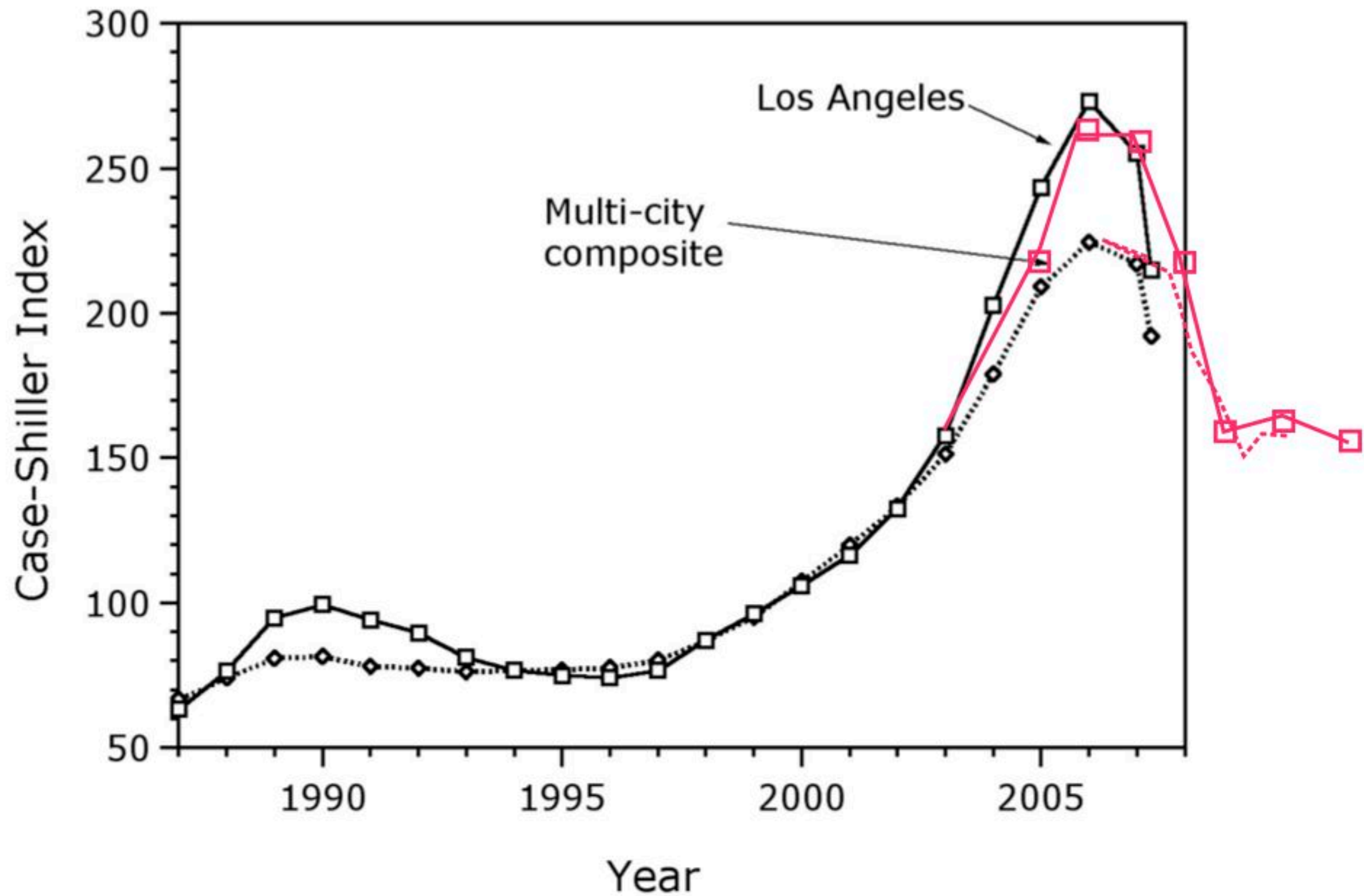
Dot.com Example



The Greenspan Magic Show
BUBBLES
Dad says he can turn everything into bubbles... even houses.
© CARTOOSH

...RELAX, MY BROKER SAYS THE ECONOMY WILL BOUNCE BACK...
...I AM YOUR BROKER!..
WALL ST
WORK FOR FOOD

The sub-prime mortgage bubble

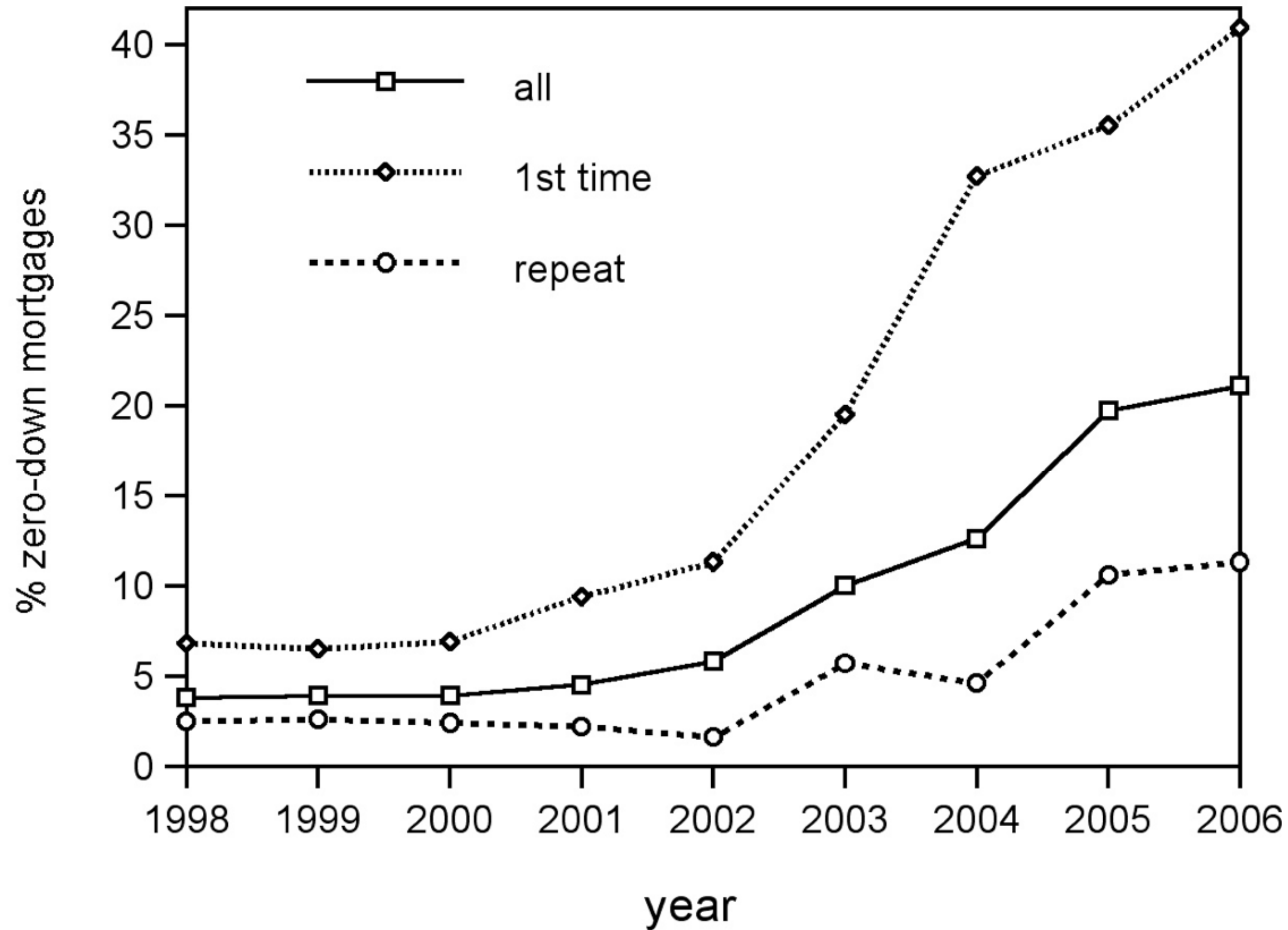


The Real Estate Boom

- When the dot.com stock market bubble deflated in the spring of 2000, the Federal Reserve rushed in to try to preserve the stock market bubble, or at least mitigate the depth of the ensuing debacle.
- It seems likely that the Federal Reserve System has a primary goal to prop up ballooning stock markets, and was alarmed at the steep drop in the stock indices, particularly the NASDAQ in 2000-2001.
- The Federal Reserve believed that it had to act. The federal funds rate, which had wavered between 5% and 6% from 1994 to March 2001, was successively reduced to 4% in May 2001, to 3% in September 2001, to 2% in November 2001, and as low as 1.25% and even 1.0% in 2002 and 2003.
- Millions of households refinanced their mortgages during this period. Many increased the amount of principal, often using ARMs with their "teaser" rates
- Others sold and traded up to higher priced homes at lower interest rates
- House prices rose as demand increased due to lower payments
- Somewhere around 2003-4, the character of this rising market changed. Speculators moved in and began replacing those who buy homes to live in as their principal residences.
- Speculators bought homes with the intention of turning them over to a later-arriving speculator perhaps within a year or two. With low or even zero down payments, they had little to lose.

THE FED
FREE MONEY
TAKE SOME
NO, VIRGINIA, THAT'S JUST BEN BERNANKE
garyvarvel.com

No Money Down

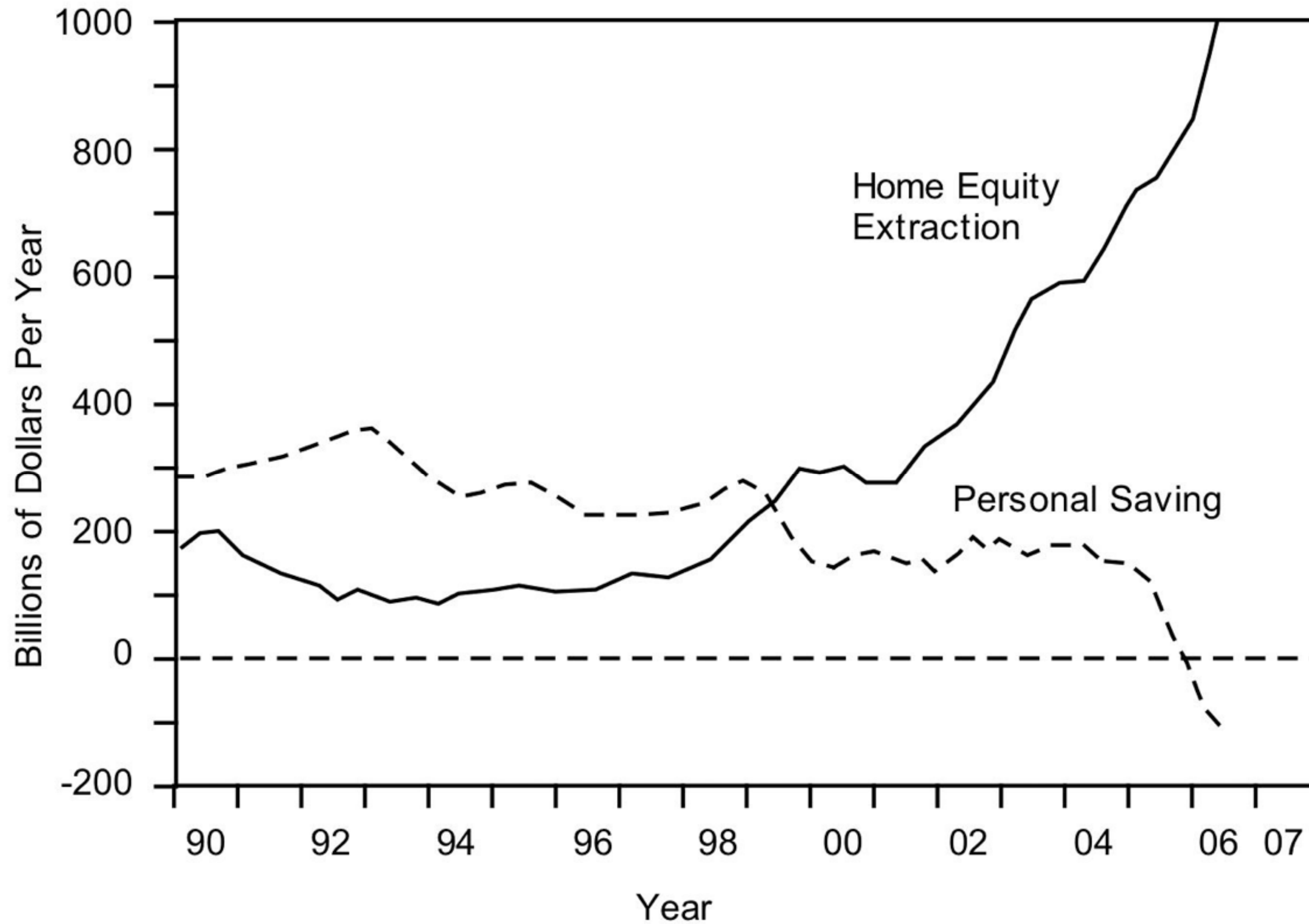


search ID: dpin321
Apparently, just because we took out a mortgage, the bank now expects us to make some sort of monthly payment.

Residences as ATMs

- As house prices inflated, households withdrew cash from their houses in three ways:
- (1) by selling their houses at inflated prices,
- (2) by refinancing their mortgages at higher levels of principal,
- (3) by acquiring "line of credit" loans in addition to their mortgage(s) using their houses as collateral.
- The cash that they took out of refinancing spent on vehicles, other consumer goods, vacations, education, and medical services – and also to pay off other forms of debt that had non-tax deductible interest.
- Example of couple in Corona

Extraction of funds from homes



If Time Permits

Money Supply and Interest Rates

- Investment public's faith in the effectiveness of monetary policy by central banks
- Each hint, innuendo or implication in Federal Reserve is given great weight and has an immediate short-term effect on the stock markets
- Typically, central banks lower interest rates when they fear stagnation in the economy
- However, as this stimulus generates a boom, central banks are loath to stifle the boom by raising interest rates because of potential negative political consequences
- They don't want to be the rain that falls on the investors' picnic

Initiation of Booms

- Kindleberger and Aliber (K&A), following Minsky:
  - an upward boom can be initiated by "an exogenous outside shock to the macroeconomic system ... if sufficiently large and pervasive.”
- New technology
  - See next slide
- Domino effect
  - After one bubble collapses, remaining funds pop up in a new related bubble
- Money supply and interest rates
  - See following slides
- Develop new geographic areas
  - Americas in 1700s, Florida in 1920s
- Financial innovation
  - Holding companies in 1920s, Mutual funds, 401Ks in 1980s to 2000s

Role of Central Banks

- K&A concluded that central bankers "have been exceedingly reluctant to attempt to deal with asset price bubbles or even to recognize that they exist or could have existed"
- The answer seems to be that they don't want to be the Grinch who stole Christmas
- Central banks would rather allow a bubble to expand than be accused of opposing prosperity
- The Fed has been unable to detect existence of a bubble in any previous episode

The Roaring 1920s

- If you query "Google" on the Internet, you find a huge number of articles and websites that address the stock market crash of 1929 and the ensuing depression of the 1930s,
- But there are relatively few sites that deal with the actual boom of the 1920s, which was clearly a proximate cause of the crash and the ensuing economic depression.
- The reason for this seems to be that we have a deep and pervasive belief in our society that it is only right and natural that stocks should go up, even by huge percentages, and such increases in asset prices are neither unreasonable nor demanding of explanation.
- However, when stocks go down, that is considered to be remarkable and deserving of study and examination. When stocks crash, it is a national calamity requiring investigations, allegations and accusations.

The Crash

- During the month of October, 1929, jumps of as much as 10% in one day occurred, and the NYTI, which had peaked at 449, oscillated between 292 and 415, ending the month at 344 (down 22% from the August peak).
- On Tuesday, October 29, 1929, an unprecedented 16,410,030 shares were traded and the market suffered a loss of about 13%.
- During the week the market lost 30% of its value.
- By November 13, the NYTI dropped to 235, a 48% drop from the peak.
- The stock market continued to drop precipitously into 1932, when it actually finished below the low point of 1922.

Banks and Mortgages

- The whole concept of banking institutions providing mortgages depends on:
  - (1) **short-term interest rates paid by banks on deposits and CDs to acquire funds**
  - **(2) long-term interest rates on mortgages that produce income for the banks**.
- This process for funding residential housing is dependent on the stability of interest rates, and constraints on inflation.
- Typically, a S&L need a spread between mortgage interest and depositors' interest of ~2% to break even.
- If short-term interest rates rise, the spread between mortgage interest and depositors' interest may shrink, and banks start to lose money on loans.
  - When short-term interest rates rise, competitive interest rates from other sources (money market accounts, government notes, ...) tend to siphon off funds from the S&L if the rates are higher than the S&Ls are allowed to pay depositors.
- Thus the entire structure of the banking system for residential mortgages is fundamentally unstable because a future rise in short-term interest rates can make the income from long-term mortgages inadequate to cover bank expenses, and the bank will operate at a deficit.
  - This became a major problem at the end of the 1970s and into the 1980s as short-term interest rates soared.
  - Today (2012) we have a time bomb if short-term rates rise to say 2 to 3%

The S&L Crisis

- Mutual savings banks and S&Ls were losing money because of upwardly spiraling interest rates and asset/liability mismatch.
- Net S&L income, which totaled $781 million in 1980, fell to negative $4.6 billion and negative $4.1 billion in 1981 and 1982
- Tangible net worth for the entire S&L industry was virtually zero, having fallen from 5.3 percent of assets in 1980 to only 0.5 percent of assets in 1982

Fraud and Misconduct

- Pizzo, Fricker and Muolo described the "looting of America's S&Ls" in 500 pages: “an enormous record of bad management, deceit, and criminality”
- Example: Centennial Savings and Loan in a small town (Guerneville, population 1,700) in Northern California that began with an investment of $2 million in 1977
  - hired a "go-go" man as its president
  - acquired large amounts of money from brokered deposits at above-market interest rates
  - went into the construction business by paying an exorbitant sum for a local construction company.
  - purchased a stretch limousine in the president's name
  - bought 25 luxury cars for management use
  - leased a twin-engine turboprop airplane
  - bought and remodeled an office building for itself at a cost of $7 million
  - bought a property from the president for 10 times what he paid for it
  - hired a European chef full-time
  - paid for lavish trips, furniture and remodeling of property owned by the president.
  - The president and the chairman of the board declared $800,000 bonuses for themselves in 1983 – totaling 2/3 of the reported income of Centennial.
  - But in 1985, regulators finally closed down Centennial as insolvent.
  - At that time, Centennial had swelled to $404 million in assets (compared to about $2 million three years prior).
  - Eighty percent of the $435 million in deposits were high-cost brokered CDs (it is normal that this should be less than 20%).
  - Thirty-six percent ($140 million) of Centennial's loans were tied up in high-risk ventures owned by cronies or subsidiaries of Centennial.
  - Finally, 26 charges were filed by the FBI against the former president of Centennial, but he died not long after - some say by suicide.
  - The final bill to the public was $165 million.

Real Estate Boom

- The number of real estate licenses in California grew from 305,000 in early 2002 to 526,000 in early 2007. By 2007, one out of every 50 adults in California had a real estate license!
- A frenzy seems to have gripped the banking industry to market the greatest number of mortgages regardless of the generosity of the terms or the ability of the borrower to make future payments.
- As more and more of those with good credit had already purchased or refinanced, the banking and mortgage industry and builders turned to those with lesser credit ratings.
- While these mortgages were being marketed, profits to banks soared. Almost all attention was on short-term profits from up-front loan fees, while longer-term liabilities were ignored.
- There was a huge expansion in mortgage-backed securities that were purchased by many leading banks and investment institutions.
- Homebuilders responded to increased house prices by significantly increasing the number of homes built per year. Many of these new homes were concentrated in "hot" areas where the rate of home building were much greater than for the national average.
- "Flipping" became the modus operandi for buying houses. It is estimated that 20% of house purchases in California from 2002 to 2007 were by people who didn't live in the houses, and this percentage increased significantly from 2005 to 2007.

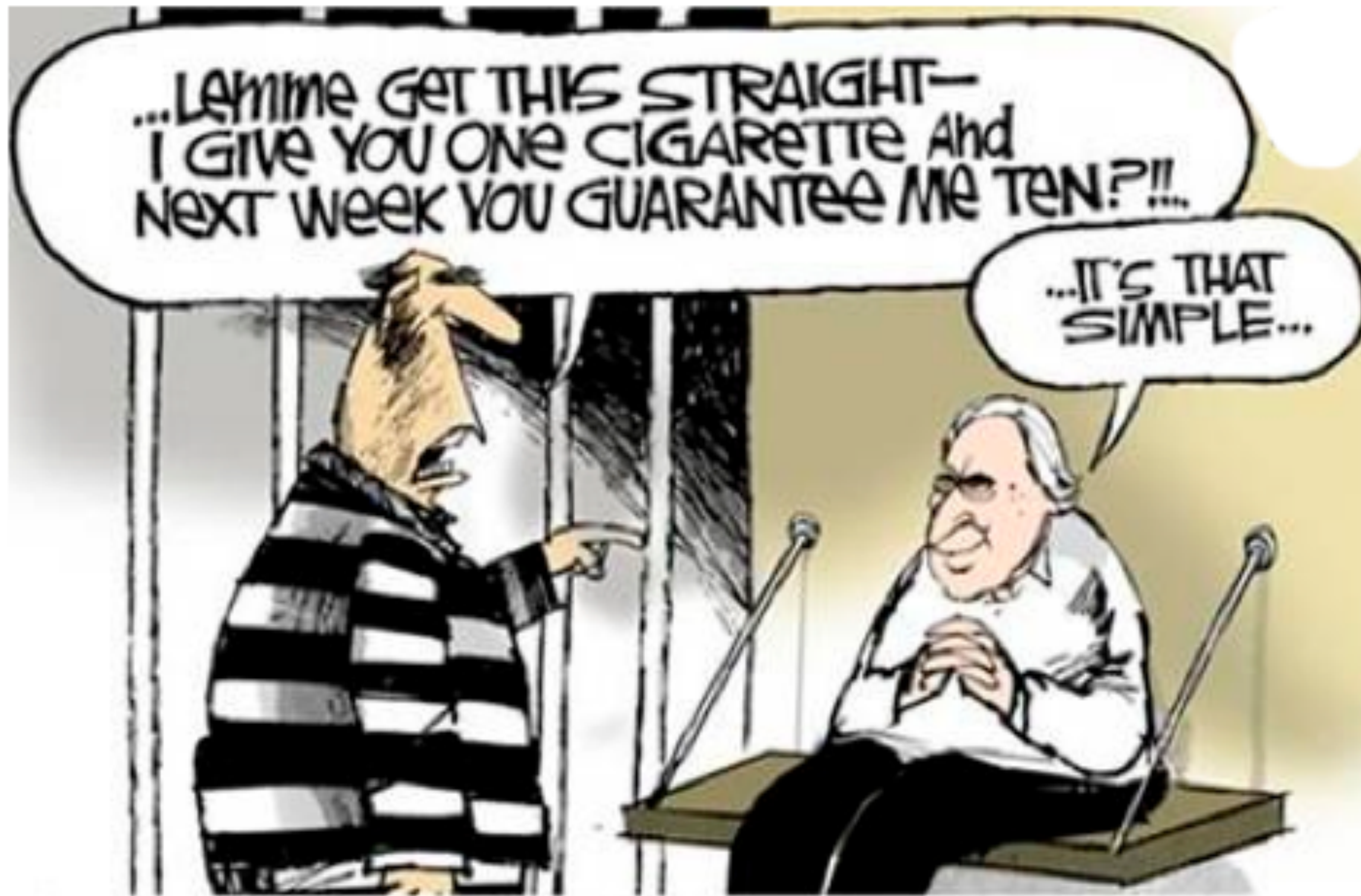
Real Estate Boom

- Many people bought several houses on little or no money down and sat back to await capital gains.
- Even more stretched their finances beyond the breaking point, knowing that they could not meet monthly payments for too long, with the expectation that a 10 to 20% per year price increase would bail them out
- Note: The 10-20% profit is on the house price. For an investor who puts 5% down on the house, the profit *on his investment* is 200-400%. For an investor who puts no money down, the profit margin is infinite

Bubbles Invite Charlatans

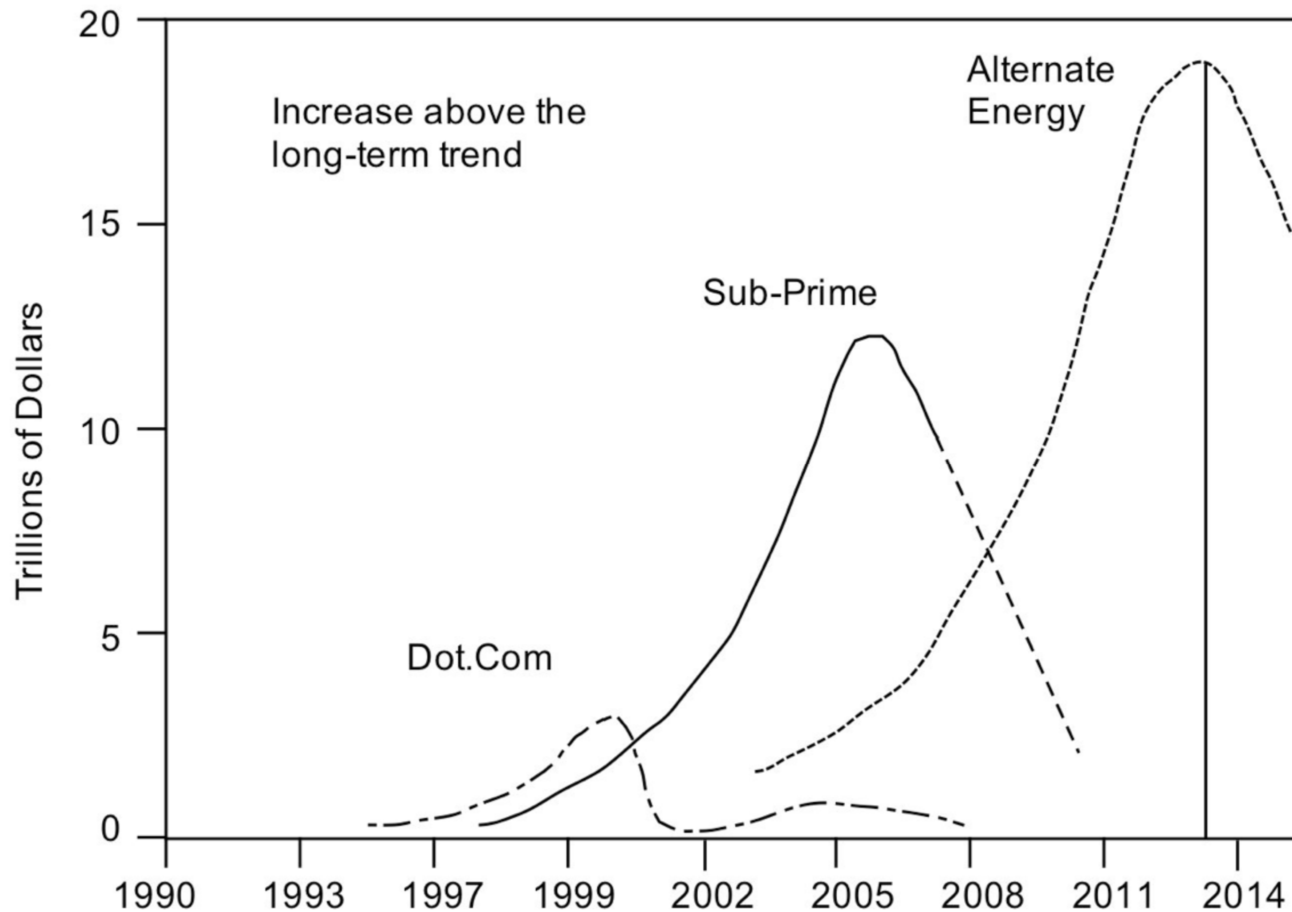
The story so far...

$7.3 bil phony accounting
WorldCom
$1.5 mil pension for life
Bernie Ebbers CEO
$400 mil loan
Invoke 5th Amendment
Market manipulation strategies
Auditor
$ billions $
California electricity crisis
Ricochet, Get Shorty, Fat Boy, Load Shift, Death Star
document shredding
Texas
On board of directors and audit committee
Opposed reform legislation
Associates
Wendy Gramm
Sen. Phil Gramm
Ph.D. Economics
Jeff Skilling
Andy Fastow
Ken Lay
$100's of millions
$744 mil
144 senior Enron execs
Congressional investigations
$200 mil CSFB
$80 mil Lehman Bros.
$80 mil Bear Stearns
$80 mil UBS
© 2002 wallstreetfollies.com
Auditor til April 2002
Peregrine Systems
Delisted
Restate 3 yrs of financial results
Martha Stewart Omni-media
Auditor til May 2002
Arthur Andersen
Round-trip trades
Enron
Auditor
Guilty
wire fraud
3 British bankers
Nigerian barges
Disguise loans as trades
Invested in Enron's LJM partnerships
Names of deals
$32 mil severance
Mahonia
Yosemite
Delta
Channel Isles
Cayman Isles
On board of directors
NYSE
Resigned
Wrote preface to his cookbook
Michael Milken
On BoD
Dr. John Mendelsohn
On BoD
Offshore company
Established
Merrill Lynch
Schuyler Tilney director
Fired
$80 mil J.P.Morgan
Citigroup
K-Mart
Martha Stewart CEO
daughter
Phone call Dec 27
Peter Bacanovic broker
Invoke 5th
Thomas Davis Vice Chair
5 firms $8 mil
Discarded e-mails
$400 mil Salomon Smith Barney
Jack Grubman analyst
$15 mil
Resigned
Phone call Dec 27
FDA rejects drug
Alert issued Dec 27 re: "speculation" of FDA rejection
Suspended
Fired
Douglas Faneuil assistant
David Komansky CEO
$200 mil
Martha's friend
Sold Dec 27
Learned Dec 26
Announced Dec 28
Deutsche Bank
NASD investigation
$80 mil
Sold Dec 28 before FDA announce
Eric Hecht biotech analyst
Henry Blodget Internet analyst
fines
Goldman Sachs
Abby Cohen
ImClone
Tried selling Dec 27
Sam Waksal CEO
Other Internet analysts
Eliot Spitzer NYAG
$110 mil
Morgan Stanley
Mary Meeker
$125 mil
Auditor
Chapter 11
$10 mil worth sold Dec 27
Invoke 5th Amendment
Buy & Accumulate ratings
INSP $114 → 37¢
ICGE $200 → 24¢
TFSM $69 → 9¢
ATHM chap11
Dot-Com Fiasco
Golf course
Jack Waksal father
Aliza Waksal daughter
Elana Waksal daughter
Husband
Congressional Investigation
223 times
Civil lawsuit
Privately skeptical
Resigned
The Rigases
Off-the-books borrowing
Adelphia
Power Industry
Mirant, Dynegy, Reliant, Duke Energy, CMS Energy
Dad
Grandad
$10 mil bail
Merck
Overstate $12.4 bil revenues / 3 yrs
AOL Time Warner
Insiders
$500 mil
Improperly account for $1.6 bil sales / 3 yrs
3 Arrested
Arrested
Qwest
23,000 sq ft mansion
Chairman Harvey Pitt
Lawyer for
Ivan Boesky
$10 mil bail
evaded sales tax
Renoir
Computer Assoc.
Rite Aid
Lucent
document shredding
Gary Winnick CEO
Global Crossing
S.E.C. investigations
Dennis Kozlowski CEO
TYCO
Monet
Haliburton
PurchasePro
Bristol-Myers
Cigna
Xerox
Overstate $6.4 bil revenues / 5 yrs
$10 million fine


...LEMME GET THIS STRAIGHT—
I GIVE YOU ONE CIGARETTE AND
NEXT WEEK YOU GUARANTEE ME TEN?!!...
...IT'S THAT SIMPLE...
MADOFF BEHIND BARS... DAY ONE

ALL RIGHT, MADOFF! WHERE DID YOU GET THE IDEA OF PAYING EARLY INVESTORS WITH MONEY FROM LATE INVESTORS?
FROM THE SOCIAL SECURITY SYSTEM

The Next Bubble?



ECONOMY

Bennett Chattanooga Times Free Press

- Michael Moore in his film: “Capitalism: An American Love Story”
  - Points out that the words “union” and “welfare” appear in the constitution
  - but “free enterprise” and “capitalism” do not

"I guess I'd better drop out now - I've just won the lottery..."

The way we are now

- Job Loss
- Redistribution of Wealth
- Free Trade
- Reliance on Paper Assets (vs. wages)
- Debt, Debt and more Debt
- Temporary or Permanent?

Job Loss

- Job elimination from automation, Internet sales and non-human communications have finally surpassed gains in productivity
- Corporations don't need as many employees as they used to
- These cutbacks in employment are not temporary; they are permanent.
- The main weapon against job loss by Obama is to cut interest rates. However, dropping interest rates to zero will not restore former jobs.
- We are now have a lot more people of working age than we need to conduct the commerce of our nation.
- Thus, we will divide into three classes: the rich, the workers, and the out-of-workers.
- The rich and the workers will go on as usual and that part of the economy will not change; it will just be a decreasing percentage of the total

Redistribution of Wealth

- Since Reagan was elected in 1980, the Republican Party in the U.S. (with acquiescence of the Democrats) has enacted tax policies that greatly favor the rich
- This has led to an upward redistribution of assets in America
- An unprecedented number of very wealthy people sucked up the wealth of America
  - leaving the middle classes struggling to get by,
  - And removing funds from the marketplace into sequestered paper investments.
- This money is like a tide pool, surging in and out of asset markets, but it is insulated from consumer purchases, which are the backbone of our economy.
- Since 1980, tax rates on the upper brackets have been the lowest in history except for the roaring 20s.
- It is interesting that taxes on capital gains (where the rich make most of their income) has always been much lower than earned income from wages.
- While the Republicans complain that the Democrats want to "redistribute wealth" by taxing the rich, the Republicans have done all the redistribution of the past three decades, and that redistribution was upward, not downward.

Free Trade

- The policy of free trade has allowed transfer of many manufacturing facilities from the U. S. to overseas, particularly China,
  - allowing them to produce cheaper goods with cheaper labor,
  - which is a boon to those in America with jobs who can purchase cheap products made in China,
  - but at the same time causes a shrinkage of job availability in America.
- As a result, a growing fraction of the population cannot afford the cheaper goods from China.
- Related problems occur in the problem of balance between the poorer and richer countries within the European Common Market.
- American corporations are now making greater profits overseas than they are domestically, and they have huge reservoirs of cash overseas sitting fallow because they would be taxed in brought back to the U. S.

Reliance on Paper Assets

- Starting with the great stock bull market of 1982 to 1999,
  - proceeding through the dot.com balloon,
  - and thence to the housing bubble of 2002-2007,
  - and finally the stock bull market of 2009-2011,
- we have become too reliant on paper assets (rather than wages from work) as a source of wealth.
- We keep bidding up paper assets to outrageous levels thinking that is a real source of wealth – until they collapse of their own weight.
- This saw tooth pattern of overbuying and overselling leads to excessive spending during boom times and reluctance to pull back during slack times, further exacerbating the debt problem.
- The growth of stock prices has hugely outpaced the growth of productivity and production

Debt, Debt and More Debt

- At the international, federal, state, county, municipal and personal levels, people, organizations, institutions and governments have spent beyond their means for decades
- Until finally, there is a growing realization that this is no longer viable.
- So, we find that at all levels, we are overspent with phantom money that exists only as loan balances on paper that will never, ever be paid back.
- At all these levels, we have become used to a higher level of spending and resist strongly any proposed cutbacks in spending or increases in taxes to cover these excessive spending habits.
- Eventually, the world will realize that the U. S. Government debt is a Ponzi scheme.
- In a Ponzi scheme, you provide unsustainable returns to investors, using new money coming in to pay the old investors. As long as many of the old investors reinvest their paper earnings, and don't withdraw from the fund, it can keep going a long time.
- Holders of U. S. bonds are the investors in the U. S. Government. The U. S. Government spends more than it takes in in taxes. To cover this shortfall, they borrow new money. With that new money, they pay interest on the old loans. The total deficit keeps growing. As long as new money keeps coming in, this process seems to be sustainable. However, no Ponzi scheme has ever lasted forever.

Temporary or Permanent?

- From the Democrats' point of view, we are just in a temporary economic cyclic downturn, and if we can put enough band aids on the wound, we can cure the patient and go back to prosperity.
- The Democrats see borrowing and raising the debt limit as a temporary evil, necessary to combat this temporary disease of the economy.
- The Republicans think we can cut the deficit by reducing taxes
- However, there seems to be a permanent restructuring of the economy that is neither curable nor reversible.
- When the Government adds more workers, that just adds to our debt burden.
- Corporations have found a way to do well with fewer employees. That's the bottom line.

Role of the Federal Reserve

- "Plunge Protection Team" to prevent destabilizing stock market declines by active intervention.
- Long Term Capital Management crisis in 1998
- After September 11 terrorist attacks, the Federal Reserve and large Wall Street firms supported the main stock markets by buying shares as panic selling ensued.
- Before the 2003 Iraq invasion, the US and Japan reached an agreement to intervene in stock markets if a financial crisis occurred during the war.
- **The stability of domestic stock markets is considered by the US government to be a matter of national security. Interventions are justified on grounds that health of the US financial markets is integral to American preeminence and world stability.**
- Government regulators asked market participants to buy stocks in October 1989 to prevent another plunge. When this proved ineffective, large brokerage firms intervened in the futures market. The recovery was remarkably similar to the miraculous turnaround in equities the day following the 1987 crash.
- The Fed will attempt to stabilize plunging stock markets by purchasing stock index futures contracts. There are implications that the government supported the stock market in 1987, 1989 and 1992.