ODDS AND ENDS
DON'S BLOG 2017.09.11

This is absolutely the best example of why one has to worry about what the Federal Reserve is doing to our economy. Please read the following taken from a recent CNBC interview of the N.Y. Fed's President William Dudley:

> Hurricanes Harvey and Irma actually will lead to increased economic activity over the long run, New York Fed President William Dudley said in an interview.
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> Speaking just as Irma is about to start battering Florida as a Category 4 storm, Dudley said the initial impact in both human and economic costs will be harmful. But in the long run, economies tend to snap back from such major events.
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> "Those effects tend to be pretty transitory," Dudley said in a live interview with CNBC. "The long-run effect of these disasters unfortunately is it actually lifts economic activity because you have to rebuild all the things that have been damaged by the storms."

You can't make this stuff up. "Hurricanes will boost economic activity in the long run." Are you kidding me? How does a some $250 billion disaster add to economic gain? Please refer to last week's blog. To add insult to injury, the following is another statement from William Dudley:

Adapted from mishtalk.com

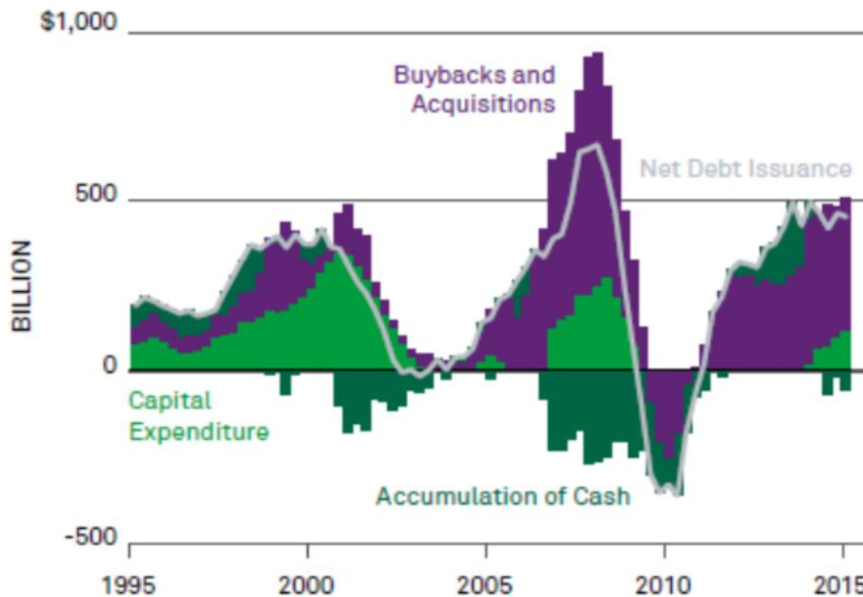
Does borrowing by the average American on his biggest asset add to the well-being? Does it really add to the country's economy? Please remember: borrowing by a consumer—as we all are—only allows them to move forward spending, unless it's for a productive capital item. And of course, the worst of all policies of the world's central bankers is quantitative easing. I have written about that many times. If you would like to see a paper on that subject please email me within the next week or so and I will try to dig it up. I could go one and on about other "swamp" activities of our esteemed policy makers, but I'm afraid it would put me on a ledge somewhere and I'm not ready for that.

Now to some activity of the private sector. As you may recall in previous blogs I have written about the corporate policy of taking out loans and buying back its own stock. It distorts earnings per share in the short-run (making executive stock options valuable), however it materially weakens the balance sheet. It's really equity in bond's clothing. Note the enclosed article taken below from the Felder Report.

Now a final comment concerning debt. Note the following chart and verbiage taken from Zero Hedge:

US Corporate debt was not used productively

U.S. Nonfinancial Firms Use of Debt, 1995-2015



Sources: BlackRock Investment Institute, Federal Reserve and IMF

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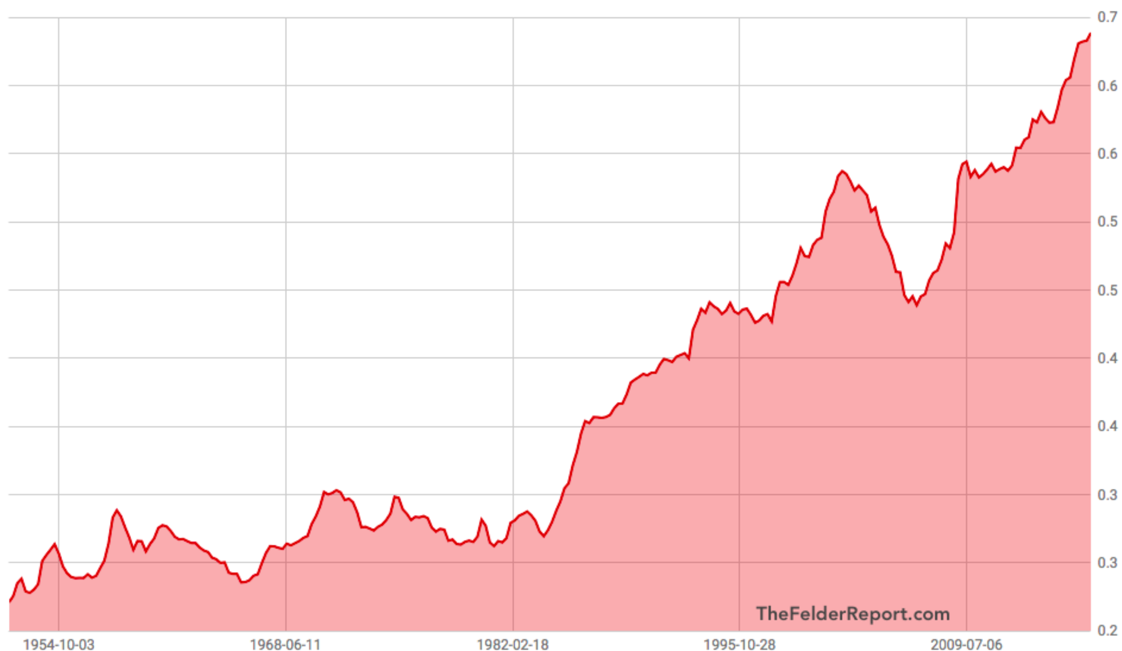
> "And if this wasn't disturbing enough, take a look at the use of that debt in this cycle. While the debt in the 1990's financed the construction of the internet, **most of the debt today has been used for financial engineering, not productive investments**. This is very clear in this slide. The purple in the graph represents buybacks and M/A vs. the green which represents capital expenditure. Notice how the green dominates in the 1990's and is totally dominated by the purple in the current cycle. Think about this. Last year, buybacks and M&A were $2T. All R&D and office equipment spending was $1.8T. And the reckless behavior has grown in a non-linear fashion after 8 years of free money. In 2012, buybacks and M&A were $1.25T while all R&D and office equipment spending was $1.55T. As valuations rose since then, R&D and office equipment grew by only $250b, but financial engineering grew $750b, or 3x this! You can only live on your seed corn so long. Despite no increase in their interest costs while growing their net borrowing by $1.7T, the profit share of the corporate sector peaked in 2012. **The corporate sector today is stuck in a vicious cycle of earnings management, questionable allocation of capital, low productivity, declining margins, and growing indebtedness. And we are paying 18X for the asset class.**"

Note, it's only from 1995 to 2015. It has gotten much worse since then. You really didn't believe I would write something without bringing up debt, did you?

Other than the above odds and ends, everything looks rosy.

Excerpt from: The Great Equity-For-Debt Swap by Jesse Felder

At the same time that $5.5 trillion in equity was being removed from the markets a nearly commensurate amount of corporate debt was being issued. Essentially, what we have seen then is a massive swap of equity liabilities for debt liabilities leaving corporations much more highly leveraged than they have ever been in the past.



It may be true that this trend towards "de-equitization" is largely responsible for the massive rise in share prices over the better part of the past decade. However, while it may help to explain the phenomenon it's important to note that it doesn't justify higher equity valuations. In fact, it should be just the opposite.

Imagine two identical companies. The only difference between them is one is financed entirely with equity; it has no debt. The other is financed partly with equity but also with a large heaping of debt. Should the equity of both enterprises be valued equally? Or should the leveraged company's equity valuation be reduced by the amount of net debt on its books?

I believe the latter is the correct answer. And if you think of equity valuations as a potential acquirer of a business does this is the only approach that makes sense. Because when you buy a company in its entirety, you must assume the net debt on that company's balance sheet as a sort of premium to the price you pay for its equity. This is essentially just the concept of "enterprise value."

When we look at the broad stock market this way, it's instantly clear that its current "enterprise value" relative to its "gross value added" is the highest on record. In other words, corporate valuations have never been higher or balance sheets more highly leveraged than they are today.