The Stock Market Bubble is Back in Full Stride **(Whoops…!)**

We've done it again…! The Wilshire 5000, which is a Dow Jones Index average representing all U.S. based stocks on any U.S. trading exchange, just blew by its old nominal total market capitalization record seven weeks ago on Jan 19th reaching a level of approx. $17.9 trillion [(1)] (surpassing the old mark from March 24, 2000). Why no flag waving and parades for the Wilshire 5000 record? Because the venerable blue chip "flag bearing" Dow Jones 30 Industrial Index (DJI) reached its record earlier (Oct 2006) and always gets the headlines. The Wilshire 5000 Index nominal record market cap achieved in March 2000 was $17.870 trillion [(1)]. Even with the market drubbing this week (through Thursday, March 1st) we are still @ approx. $17.7 trillion or about even with the prior record peak in 2000. Yes, we've done it again…!

The big news of the Dow Jones 30 Industrials setting a new record last October was heralded by most of the media as an historic event. Those who know better understand the inflation-adjusted record (approx. 13,600) is still yet to occur. Also, since the "record" was set in 2000 the Dow Jones Industrials Index has changed 3 companies and one has merged. So, for a legitimate apples-to-apples comparison one would want to compare the same group of companies rather than an upgraded group relative to the old group. Further, the Dow has a distorted basis of measurement, which compiles the index weighting on stock *prices* rather than *market capitalization*. For example, if the smallest Dow company in terms of market cap doubled in price say from $100 to $200 per share, and the 20 largest Dow market cap companies were trading at $10 per share and lost 50% of their value to $5 per share, the DJIA index would not change, but the total valuation of all 30 Industrials would have dropped by nearly half. That is why very few of the Dow companies are at record highs while the index is breaking records every other day (except this week, of course).

Aside from the noted DJI distortions, the more enlightening news to me is that although the Dow Jones Industrial, the Wilshire 5000, and Wilshire small cap 2000 have recently hit new records, the public believes the "stock market" has not really recovered back to the levels of early 2000 before the 3-year semi-bust (2000-2002), because the other major indexes are still below their prior heights. i.e. the S&P record of 1527 vs current 1403 and the NASDAQ record of 5046 vs current 2404. Yes, the public mindset is that we still have some catching up to reach the old nominal market records, let alone inflation adjusted records. It's as though the 2000 levels were legitimate and fundamentally justified, and there is still plenty of upside to go and reach yet higher inflation and growth adjusted levels after the past 6.5 years to new highs ahead!

What does this Wilshire 5000 record mean? Most analysts agree that the stock market peak in 2000 was the "mother of all bubbles" by nearly any measure. Speculators and Ponzi schemes were rampant pushing any stock up to insane nosebleed heights far above fundamental legitimate values, especially in "tech stocks". Utilizing my fundamental calculation methodology the legitimate level of the market at that time was approx. $5.6 trillion [(2)]. Thus the actual $17.7 trillion market valuation represented a ***$12.1 trillion illusion of wealth***. That was approx. 6.5 years ago. If GDP (nominal) output percentage increases were applied to my calculated "legitimate" valuation 6.5 years ago, today's "legitimate" valuation might be $7.7 trillion vs the $17.7 actual or only ***about 230% overvalued*** today! See my "U.S. Economic Health Graphs" for a graphic look here… http://www.austrianenginomics.com/id10.html Look for the "Total Equity Valuation…" graph (the second graph).

How is it possible? Austrian Enginomics recognizes **there is a complete disconnect between the Real Economy and the Financial Economy**. If the Real economic growth is driven by

employment hours increase (close correlation to population increases) and productivity increases, then ideally all stocks and "paper" wealth (cash, debt securities, etc., which are simply claims on a future stream of goods and services produced), should climb at about the same rate. If stocks (or "paper" wealth) doubled for example and the population plus productivity grew @ 3%, and inflation grew by 2%, there might be a justification for the stocks and "paper" assets to grow 5% in nominal value. The other 95% is likely a bubble representing an illusion of wealth.

Abundant Liquidity is the Bane of our Financial Asset Distortion.
Governments and central banks love to expand liquidity if they can escape asset illusion discovery during the time their particular regime is in power. Liquidity is defined [3] as the value of financial instruments used to transport wealth across time. From an "Enginomics" context I recognize liquidity as any "paper" financial asset that represents a contract to acquire Real Wealth in the future (cash, savings, CD's, time deposits, debt securities, etc.); they are themselves NOT Real Wealth! Most economists agree that an instant doubling of our fiat money supply would not increase Real Wealth; it might simply double the cost of all goods and services (100% inflation). In contrast, many economists believe that an instant doubling of debt securities (e.g. Treasury Bonds) would in fact increase Financial Asset Values in aggregate, which they regard as a legitimate claim on Real Wealth at some point in time. Given enough time the doubled quantity of bonds could be fully redeemed. Further, they may be traded instantly for Real Wealth, thus are regarded as equivalent to Real Wealth. "Enginomics" disputes this logic. Bonds are simply another form of "paper" wealth. The economic engine comprised of capital equipment, facilities, infrastructure, and human capital (skill sets), which produces Real Wealth, would not change a bit if any form of "paper" wealth was instantly doubled. Thus, any "paper" contract enlisted to claim Real Wealth in the future could instantly double or reduce in half and it would make no difference upon the future stream of goods and services (Real Wealth) produced by said economic engine. Similarly, if stock valuations instantly doubled due to a liquidity expansion, the new illusory market value in excess of the legitimate market value would add no Real Wealth to the economy.
Note: The stocks (certificates) themselves in fact do represent Real Wealth to the extent they are not overvalued, as they are title to a business much the same as title to an auto or home.

The Magic of Creating Bubbles….
If a government and central bank in concert with major financial institutions increase liquidity via gross debt issuance and sales followed by repeated leverage of credit expansion, that country could increase liquidity (paper wealth) with no increase in Real Wealth output. Further, an especially crafty and mischievous government and central bank tandem could expand liquidity and witness massive valuation increases in stock, bond, and real estate far in excess of the countries' output increases on the one hand, and at the same time with the other hand selectively calculate the official inflation declaring it benign and "under control", then you would have the conditions that will ensure massive bubble creation. Mix the left and right hand of one government with efforts from trading-partner governments that intervene in currency markets to keep their currencies artificially undervalued, you have yet another major driver to pump up bubbles in the first country via incremental direct investment in its stock, bond, and real estate markets. This double-barrel liquidity boost into the U.S. markets occurred in earnest from 1995 until this week. The outcome enabled the greatest illusory asset-creation party on earth.

Why will the Bubbles Bust?
Imagine a mystical power suddenly dropped hundreds of trillions of Treasury bonds from the heavens onto all humans on earth; we would all experience instant euphoria. In fact, we could all retire and enjoy lives of leisure! Whoops… Who would operate, maintain, and grow the economic engine that provides all of the Real Wealth that we look forward to consuming in our

leisurely retirement? The reason bubbles burst is the Real Economy catches up with the Financial Economy. As soon as labor begins to exit the work force and cash in on their Treasury bonds, they will quickly realize the value of these "paper assets" are near nothing. The gift from heaven simply diluted all outstanding Credit Market Debt. The valuation of the new "heavenly" bonds along with all other "paper" wealth would drop dramatically to diluted market valuations or below due to momentum and herd dynamics.

What is the Legitimate Level of Paper Valuation?
Enginomics is dedicated to analyze the magnitude of the bubbles in stocks, bonds, and real estate from a historical perspective. The greater the magnitude (%'tage overvaluation) of illusory wealth, the more significant and painful will be the correction once the illusion is discovered. Click here for the latest illustration… http://www.austrianenginomics.com/id10.html

Conclusion:
We are currently experiencing the greatest bubble than any time in the history of our Republic. I anticipate the discovery of this extraordinary illusion of paper wealth to be discovered when the Boomers begin to retire in mass all over the world (2008-2010) or sooner! When they begin to cash in these illusory assets at the same time they are exiting the work force, the valuations will fall in a spectacular manner. BUT, please do not tell anyone in Washington D.C. as they have worked very hard to create the bubbles and would have no interest in taking the unpopular medicine of responsible monetary policy. They might lose their jobs and tarnish their legacies…!

By Russell Randall 3-2-2007
Home Page: www.austrianenginomics.com

References:
1 Dow Jones Indexes; www.djindexes.com/wilshire/us/size/index 3-1-2007
2 Calculation by Russ Randall using 1985 as a baseline, then applying BEA & BLS inflation, population, and productivity input. See graphic illustration here… http://www.austrianenginomics.com/id10.html
3 Holmstrom and Tirole (2001) footnote 1: …the value of financial instruments used to transport wealth across time…