

EIRFeature

Gambling psychosis propels stock market toward implosion

by Richard Freeman

Those whom the gods would destroy, they first make mad. Over the last several years, Americans have engaged in an orgy of stock market investment, believing that each and every one will become a millionaire. Through mutual funds, pension and retirement plans, and direct investment through brokerage houses, Americans have poured more than one-quarter of a trillion dollars per year into the stock market, for each of the past few years. Like the ancient Romans who worshipped the goddess Fortuna, they have watched the stock market go up and up and up, brainwashing themselves that the market could never go down.

At the same time, they embrace the means of their own demise, championing the post-industrial society policies, the speculative stock and derivatives markets that are sucking dry the real physical economy, the economy upon which human existence and these markets depend for their survival. The U.S. stock market could not be supported at even one-third of its current level: The means of its growth includes, as one of the forms of leverage, a large dose of leveraged buy-outs (LBOs). The LBOs strip the assets from companies and slash wages to cover a part of the debt (leverage) financing.

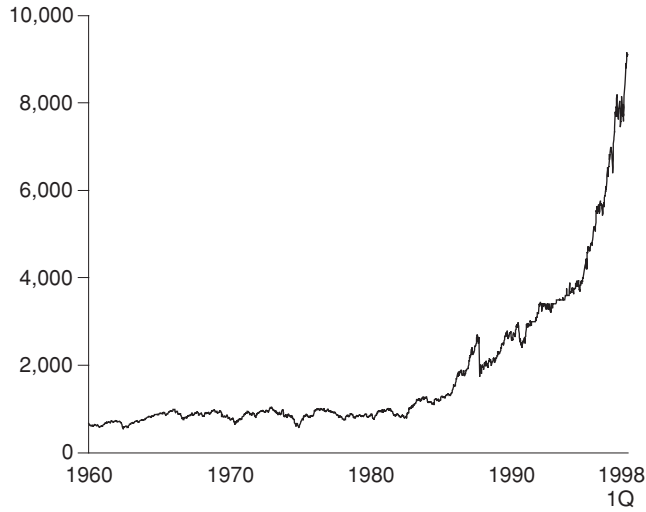
Many people delude themselves that the U.S. economy is in the midst of a “great expansion,” and that this explains why the stock market is rising. In fact, the economy is not expanding; it has been contracting at the rate of about 2% per annum since 1971, as a result of the British oligarchy’s imposition of the post-industrial society in the United States during the mid-1960s.

The stock market is not growing as a result of real economic growth, but is creating fictitious value, via the rigged appreciation of stocks, which appreciation is then capitalized and used as the basis for spending or purchases in other sectors of the economy.

By every traditional standard of stock market measurement applied for the last 30 years, the stock market is completely over-priced. It has shot way past its peak for any period in the postwar era, including the period just before the 1987 stock

FIGURE 1

Dow Jones Industrial Average weekly closings, 1960-98

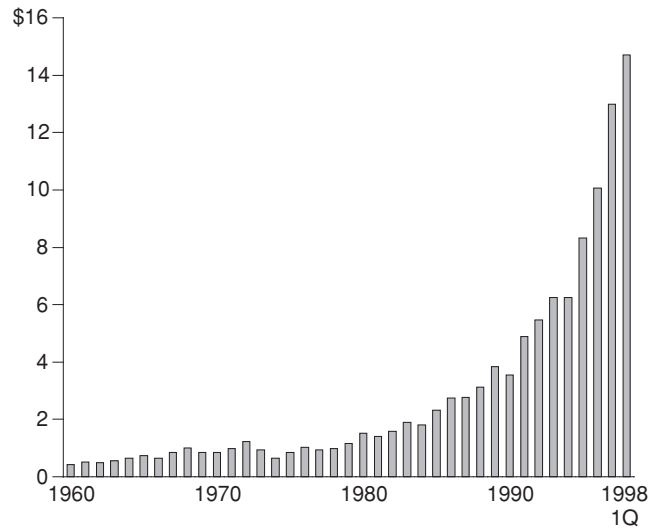


Source: Dow Jones & Company.

FIGURE 2

Capitalization value of all stocks traded on U.S. stock market, 1960-98

(trillions \$)



Sources: Board of Governors of the Federal Reserve System, "Flow of Funds Accounts;" EIR.

market crash. Compared to industrial production, the market is at least 385% overvalued. Indeed, even with limited information, it can be shown that the stock market exceeds its level of 1929, in this respect.

What is holding the market up is the greatest infusion of multiply-connected, mutually self-supporting leverage—debt at high gearing ratios—in American history. Each time the City of London-Wall Street crowd leverages the market further upward, suckers pour in tens of billions of dollars more, propelling stocks ever higher. The danger is that any adverse incident, small or large, either endemic to the stock market, or the raising of interest rates, or an economic catastrophe abroad, can set off the reverse leveraging of the market. This can result in defaults on margin loans, dumping of stocks to meet margin calls, the failure of stock derivatives contracts, and so forth.

The ensuing damage to the American economy, and about 35 million stock-holding households, will be without parallel, and would quickly become global. The U.S. stock market's collapse would either immediately be the trigger for, or have already been triggered by, the de-leveraging of the \$130 trillion worldwide derivatives market. The combined effects of these two reverse leveragings would set off the biggest financial disintegration in 650 years. The collapse would be global and systemic, not cyclical as in 1929.

A speculative bubble

To help understand the huge inflation of the market, **Fig-**

ure 1 shows the weekly closings of the Dow Jones Industrial Average, from 1960 through the end of the first quarter of 1998. **Figure 2** shows the market value or capitalization of the U.S. stock market, since 1960 (capitalization is the market value or share price of a U.S. company's stock, times the number of those shares outstanding, carried out for all the shares outstanding of all U.S. companies). Of late, the trajectory of both curves has been hyperbolic. The Dow Jones Industrial Average has risen from 884 in 1982, to roughly 9,200, a 941% increase, with much of that registered in the last seven years. The Dow Jones represents 30 highly capitalized U.S. stocks; the market capitalization represents more than 5,000 U.S. stocks. That capitalization has risen from \$1.6 trillion in 1982, to \$14.7 trillion, an increase of 825%.

At a March 18 Washington, D.C. seminar, Lyndon LaRouche characterized the stock market: "In the United States, we're pumping up a balloon, in terms of the financial markets, through what? Through hyperinflationary methods. The printing of money, to steer it into financial markets, where it is heavily financially leveraged, and thus results in an ascending balloon, in terms of the stock market prices, which creates the spectacle of a man clinging to a balloon without a carriage, and without an oxygen flask, reaching the 60,000-foot level and going higher. He's going to suffocate and die, if the balloon doesn't explode. And that's what we're doing."

The U.S. monetary aggregate, represented by M3, the broadest measure of money supply, has grown at a rapid 9.3%

clip over the past 52 weeks, to keep this mass of financial stock titles liquefied—as well as liquefy other inflated speculative assets in the United States.

Mass psychosis

But there is one vital additional element: The stock market frenzy has assumed the dimensions of a mass gambling psychosis. Americans are buying considerable stock positions on their credit cards (carrying double-digit interest rates), via home equity loans, by borrowing against their 401K retirement plans, and even with food or rent money. The May 11 issue of *Time* magazine reports that, this year, Americans may make 30% of their retail purchases of stock through the Internet.

While wealthy individuals are earning large sums, and some executives are collecting tens of millions of dollars in stock option bonuses, every stratum of the American population, especially the middle class and a portion of the lower class, has become deeply involved in the stock market. Thus, there will be an immense personal, existential crisis for tens of millions of American families, when the stock market collapses, as it must.

The intertwining of the speculative stock market bubble, and the enormous exposure Americans now have to that market, represents one of the greatest strategic vulnerabilities

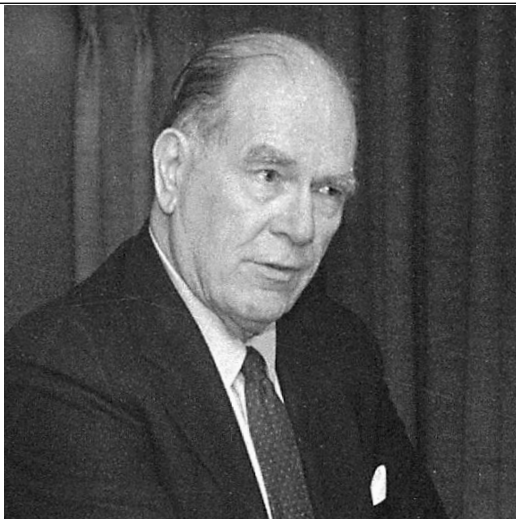
America faces.

The British oligarchy realizes that this strategic vulnerability exists, and is rubbing its hands with glee. The *Economist* magazine, mouthpiece for the City of London, made its April 18-24 issue's cover story, "America's Bubble Economy," and gloated: "The more that asset prices continue to be pumped up [in the United States] by easy money, the more inflated the bubble will become and the more painful the economic after-effects when it bursts." The British oligarchy has the means to pop the bubble; at the same time, it has been using its assets, such as independent counsel Kenneth Starr and his moneybags Richard Mellon Scaife, to escalate the attack on President Clinton, threatening to remove him from office. A step-up of the attack on the Presidency, combined with a market blowout, could cripple the United States.

But Britain could not exploit an American stock market bubble, unless it existed in the first place. For this, America has itself to blame. Rather than seeing the stock market as a development that cannot fail, Americans must free themselves from their insanity, and see it as the instrument of their doom.

Global frenzy

The stock market frenzy is not restricted to the United States; it is a disease that has gripped the Western "industrial



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world.” For the period between Jan. 1, 1997 and the end of April 1998, an interval of only 16 months, the following are the rates of increase of the principal European stock exchanges: Germany, 78%; France, 63%; the Netherlands, 80%; Belgium, 63%; Sweden, 52%; Britain, 42%; and Switzerland, 83%. In Italy, over just the past 12 months, the stock market has doubled.

The world financial crisis has spread to Japan, South Korea, Malaysia, Thailand, Indonesia, Russia, Brazil, Argentina, and other points. *EIR* has said that each crisis could turn out to be the flashpoint that could detonate a world financial collapse. But think, then, of the danger represented potentially by the collective stock, derivatives, and debt markets of the Western nations, especially the United States. The U.S. stock market has a greater market value/capitalization than the combined market value/capitalization of all of the Asian (excluding Japan), Ibero-American, Middle Eastern, and African stock markets.

In the report that follows, we will look at the stock market, without blinders on, showing why it must collapse. We concentrate on four characteristics: 1) the dimensions of the bubble; 2) the history of how it was artificially built up; 3) the multiply-connected, mutually-supporting leverage that props up the stock market; and 4) the American population’s investment and overexposure in the market.

The biggest bubble in history

The highly leveraged U.S. stock market has shattered all previous records, by conventional standards of measurement. But is there a better means by which to measure the absurdly high levels that the stock market has achieved?

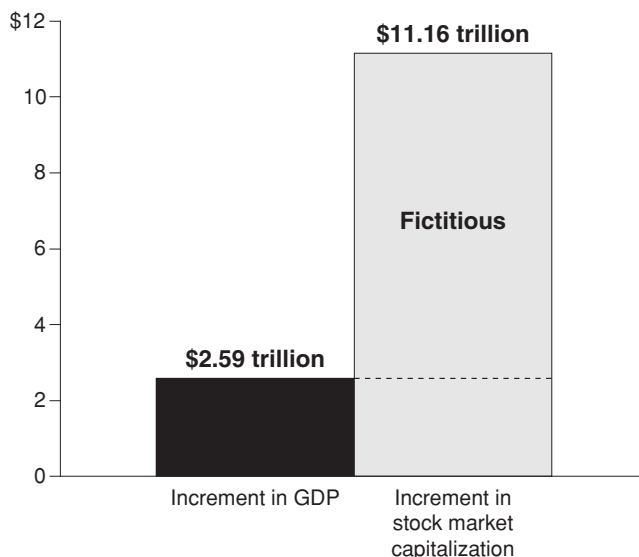
Looking back at Figures 1 and 2, notice that for both curves, there are three distinct periods. During the first, from 1960 through 1982, the curves stay within a relatively stable band; nothing excessive happens. During the second period, from 1982 through 1990, the trajectory of the two curves rises quickly, representing the first phase of the stock boom. During the third period, from 1990 to the present, the curves follow a hyperbolic trajectory. The stock market has entered a frenzied state.

For the whole of the 16-year stock market boom since 1982, the Dow Jones Industrial Average has risen by 10.41 times (941%). For the same period, the market capitalization of more than 5,000 stocks has increased by 9.25 times (825%).

To appreciate the full impact of this, we concentrate on the last and most explosive of the three periods. From 1990 to the present, the market capitalization rose from \$3.54 trillion to approximately \$14.7 trillion, or fourfold—an increment, during this period, of \$11.16 trillion. During the same period, the U.S. Gross Domestic Product rose by only \$2.59 trillion. Since 1990, the increment of market capitalization of the stock market has risen by an amount that is four and one-

FIGURE 3
1990 to present: increment in stock market capitalization is only 23% covered by increment in GDP

(trillions \$)



Sources: Department of Commerce, Bureau of Economic Analysis; Federal Reserve Board of Governors, “Flow of Funds Accounts;” *EIR*.

half times the increment by which the GDP has risen. That is an absurd development, that the run-up in value of stock should so far exceed the economy’s growth.

This raises the question: How much of the increase of capitalization of \$11.16 trillion represents economic growth, and is real, and how much represents a fictitious hypothecation of paper?

A way is presented to get at the answer. We know that \$2.59 trillion of the \$11.16 trillion increment in the stock market valuation since 1982, is covered by a growth of goods and services (as bad as GDP is as a measure of real goods and services, we will accept it for the moment, for the purpose of this experiment). This then means that \$8.7 trillion is uncovered by any growth in goods and services. This \$8.7 trillion, constituting 77% of the \$11.16 trillion, would mean that 77% of the increase of the stock market’s so-called “valuation” since 1990, is hot air. Thus, 77% of the stock market’s increase in value, or \$3 out of every \$4, is fictitious (see **Figure 3**).

Let us now compare the increment in stock market valuation to something more substantial: industrial output, as measured by the Industrial Production Index, which is published by the Federal Reserve Board of Governors. (The Fed’s Industrial Production Index [IPI] is also bad as a measure of goods production, but we will also accept it for the moment. It eliminates services, concentrating on goods.) Since the cap-

italization is denominated in dollars, and the IPI is an index, the only way to compare the growth of each, is to set the values of each for 1990, equal to 100, and then compare the growth of the indices. From 1990 to the present, the index of the capitalization of the stock market rose by 215%. The index of industrial production rose by 30%. This means that only 30% of the 215% increase of the market capitalization represents an increase of industrial output. Conversely, 185% of the 215% increase of the market capitalization was *not* covered by growth in industrial output. The 185% comprises 86% of 215%. This would signify that 86% of the stock market's increase of valuation since 1990, has been fictitious.

We can raise this to a third level of refinement. As economist Lyndon LaRouche has stated, and *EIR* has documented in other locations, since 1990, the real physical economy, inclusive of infrastructure, as measured by the energy of the system, has declined at a rate of about 2% per annum. Using this more accurate standard, the entirety of the stock market's increase of valuation since 1990, is purely fictitious.

Thus, we can calculate that between 77% and 100% of the increase of the stock market's valuation since 1990, is fictitious. Thus, of the \$11.16 trillion increment in market valuation since 1990, between \$8.7 trillion and \$11.16 trillion has been hot air.

Looked at from the standpoint of the real economy, the

stock market is a money-making machine that hypothecates paper on top of paper, with only a tiny percentage of it backed by something of real physical value.

This indicates the current danger: Just as between \$8.7 trillion and \$11.16 trillion in paper value has been cranked out since 1990, that same amount can disappear. All that needs to happen is that the multiple levels of leverage that are propping up the market, are knocked out through reverse leveraging. Then, that paper value vaporizes.

We can make a further useful experiment, this time involving the Dow Jones Industrial Average. It is widely acknowledged that Japan's Nikkei 225 stock average index is overvalued. The Nikkei is now trading in the range of 15,000, and if it falls to the level of 13,000 to 14,000, this may cause several bank and corporate bankruptcies, because these companies have large stock holdings, and in the case of banks, count it toward their core bank capital. But, we at *EIR* constructed an index, in which we set both the 1982 level of the Nikkei, when it was 7,399, and of the Dow Jones, when it was 884, equal to 100. We measured all subsequent years as a measure of the 1982 standard. **Figure 4** shows that the Nikkei peaked in 1989 and today is roughly double its 1982 level. The Dow Jones is 10 times its 1982 level. If today, the Nikkei 225 is considered dangerously inflated—and it is—think of how dangerously inflated the Dow Jones is.

What does Wall Street know?

Shouldn't Wall Street be concerned about this? *EIR* has not found any graph, prepared by any economist or analyst on Wall Street, that compares the capitalization or market value of the U.S. stock market to the growth of industrial production. The likely explanation is that were Wall Street financiers capable of thinking about something real, like industrial production, they would not want to know what the graph shows.

But Wall Street, and the broader community of citizens, does have some standard, traditional measures, to track what is going on. The problem with the measures is that they compare the market capitalization of industrial stocks, or the market price of individual stocks, against some entity which serves as the denominator, such as the cost of replacement of plant and equipment, or earnings per share, which is infected with an inflationary bias and reflects asset inflation.

This builds a limitation into the measures, which are stated as ratios. But because the ratio is consistent from year to year, it is still useful. The same standard is applied each year, and trends do clearly emerge.

Here are three of the conventional measures:

1. *The Tobin "Q-Ratio,"* devised by Nobel Prize Economics laureate Prof. James Tobin of Yale University. It compares, for non-farm, non-financial corporations, the value of their stock with the value of their plant, equipment, and inventories (the equipment and inventories are valued at their replacement cost; the plant structures at market

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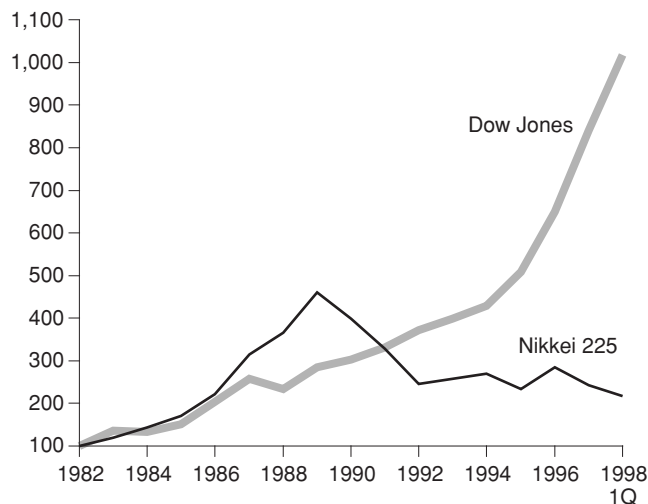
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FIGURE 4
**Dow Jones Industrial Average versus
 Nikkei 225**

(index 1982 = 100)



Sources: Dow Jones & Company; Tokyo Stock Exchange.

value). The ratio shows how the stock of a company is valued relative to the plant and equipment that the stock is supposed to represent.

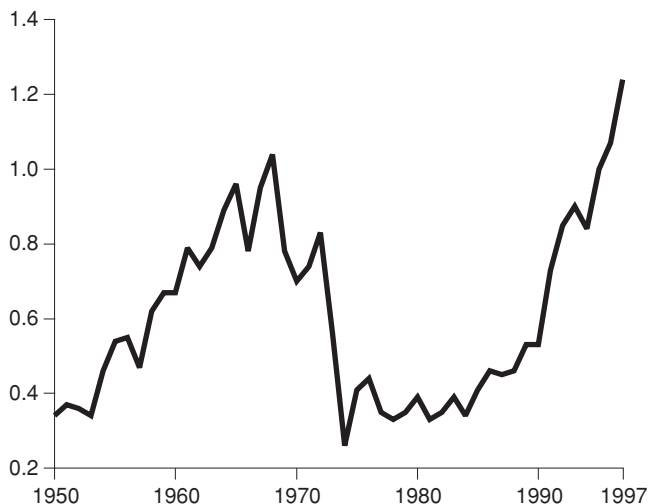
Figure 5 presents the average of the ratio from 1950 through 1997. It can be seen that, prior to the recent period, there is one period, 1960-72, when the Q-ratio rose above the level of 0.6. During most of the 1960s, there was still moderate growth in the economy. Although part of the 1960s was known as the Go-Go Years, for its mergers and acquisitions activity, there was still a fairly solid economy underlying the stock market. But notice what has happened since 1990: The ratio has shot up past 0.6, and at the end of 1997 stood at 1.24. This is the highest level it has been in 47 years.

The limitation of the Q-Ratio, is that it vastly understates the high level of the stock market by having an inflated denominator. This includes the market value of plant structure, which is pumped up because of the inflation of real estate values. Likewise, the current replacement cost of equipment is also considerably inflated. These two items are the biggest part of the denominator.

2. *The price-earnings ratio.* This is the best known of all measures. It compares the price of a share of company stock to the company's earnings per share. Let us take a hypothetical company A. If company A's stock price is \$100 per share, and its earnings (the dividends it will pay out plus the profits it will retain for internal use) are \$10 per share, then company A's price-earnings ratio is 10:1.

During the 1960s, stocks had a higher price-earnings ratio,

FIGURE 5
Q ratio



Source: Prof. James Tobin, Yale University.

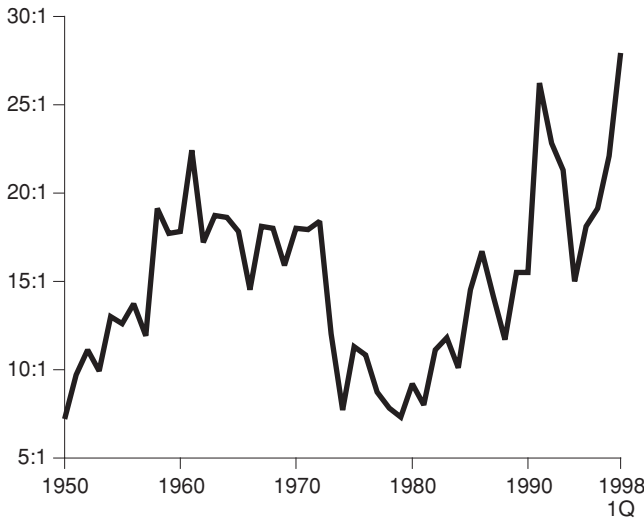
partly because of speculation; but since there was a more durable economy during the early part of the 1960s, the process did not go out of control. During the 1970s and 1980s, the price-earnings ratio averaged 12:1, which is about normal. In most cases, if the ratio gets to 18:1 or much above, there is no way that the earnings stream of the company can support such a high price.

Figure 6 presents the average of the price-earnings ratio for the 500 stocks that are included in the Standard & Poors 500 stock average (the information is supplied by Standard & Poors). By April 1998, the last point marked on the graph, the price-earnings ratio is 27:1. This is more than double the normal level, and the highest in 50 years.

The price-earnings ratio is flawed. During the 1950s and 1960s, when the economy was relatively functional, most of the reported earnings were real: They were derived from productive output in manufacturing, mining, construction, or agriculture. But today, much of what is counted as earnings is "financially engineered." A company may boost its earnings by any number of tricks: firing workers, selling off divisions, playing the derivatives markets, which many Fortune 500 companies do. Entire companies, which are considered industrial concerns, have profits which are from non-industrial, largely speculative income streams. For example, General Electric is America's fifth largest "industrial" corporation in assets, and second largest in profits. But GE earns half of its profit earnings from its NBC television subsidiary and from its giant investment company, GE Capital Corp. Thus, profits today are not what profits were 30 to 40 years ago, being much more infected with financial and outright specu-

FIGURE 6

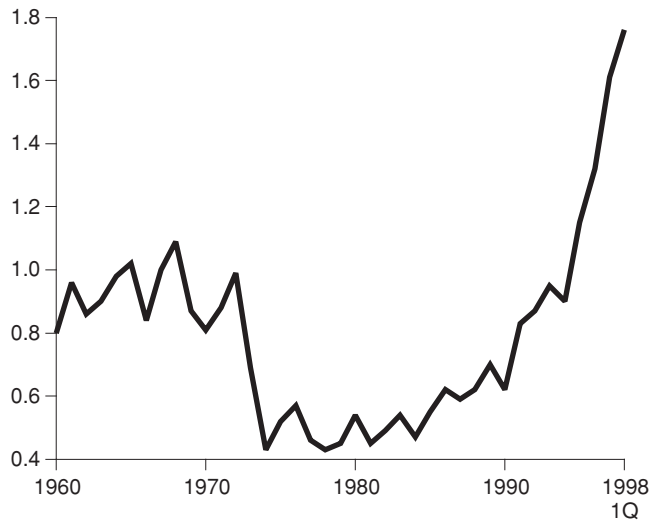
Price-to-earnings ratio



Source: Standard and Poor's Corp.

FIGURE 7

Ratio of stock market capitalization to GDP



Sources: Federal Reserve Board of Governors, "Flow of Funds Accounts;" Department of Commerce, Bureau of Economic Analysis.

lative income streams. Were those speculative earnings first eliminated from reported earnings, then the price-earnings ratio would probably be flying around 35:1 or greater.

3. *The ratio of the market value or capitalization of the U.S. stock market to the value of GDP.* We have compared, above, the increment in market capitalization, for the interval from 1990 to the present, with the increment in GDP, for the same interval. We found that since 1990, the market capitalization of the stock market has risen by an amount that is four and one-half times the amount by which the GDP rose during the comparable period. Here, we compare market capitalization to GDP on an annual basis.

Figure 7 presents the results for the period 1960 through the first quarter of 1998. There is a huge jump from the 1989-90 period, so that by the first quarter of 1998, the ratio of market capitalization to GDP is 1.76, an all-time record. Excluding values for the 1990s, previous high-points don't approach the current level. Thus, the value of the stock market is nearly twice the value of GDP.

The limitation of this ratio as a measure, is that the denominator of the equation, the value of GDP, is very inflated; the revenues of the brokerage houses are included in GDP itself, so, as the stock market swells, it swells GDP. More broadly, the problem with GDP is that two-thirds of it is services, and one-fifth of it is the revenues of the speculative "Fire, Insurance and Real Estate" sector.

Still, any broker or economist can calculate the market-capitalization-to-GDP ratio, the Q-ratio, and the price-earnings ratio. Their meaning leaves no room for misinterpretation: This is the most speculative market in 50 years. For each

measure, the level today is at least twice what it was in 1987, the year of the stock market crash.

The British rig the market

Between 1975 and 1982, the British oligarchy, and its flunkies in factions of the U.S. government and financial community, initiated four crucial policy-changes which fundamentally altered the U.S. stock market. The moves were built upon the "post-industrial society" policy that the oligarchy had initiated in the United States, following the November 1963 murder of President John F. Kennedy (see article by Jonathan Tennenbaum, in this issue, p. 34).

The stock market went from being a market that was used by companies to raise equity for expanding and improving industrial and agricultural production, and where investors bought the stock to hold over the long term, to a market where the importance was placed on how much profit could be made in capital gains in fictitious appreciation of stocks, in large volumes of trading. In 1965, the New York Stock Exchange traded, on average, 6.2 million shares per day; today, it trades more than 450 million shares per day. Instead of holding a stock for 10 or 20 years, many investors will hold a stock for a week, an hour, or a nanosecond. Stock dividends are not irrelevant, but they now take a back seat; if a stock's price can be manipulated upward, say, from \$9 to \$10 per share, and one can buy 1 million shares at the lower price, using leverage, and sell it 30 seconds later at the higher price, then that is all that matters.

The market today is one large gambling den. Leverage rules—not the physical production of the underlying company.

It is important to remember, that the stock market was not always as we see it today. During periods when American policymaking was governed, in the main, by the American System of political economy, the stock market was also relatively sane. The American System, unlike the British System of free trade, starts from the premise that the republican nation-state can intervene in the economy as a positive force for growth and development. It issues cheap and abundant credit for manufacturing, agriculture, construction, mining, transportation, and infrastructure. It also provides Classical education to the citizen, to develop the cognitive power of his or her mind.

It is the divine spark of reason in each individual, his or her ability to make revolutionary, new validated discoveries of scientific principle, that is the source of all economic wealth. These discoveries can provide an increase in the capital-intensive, power-intensive productive mode of the economy. Combined with the improved cognitive powers of labor, man's power over nature is increased. This is reflected in an increase in the rate of potential relative population density.

Over the centuries, the British oligarchy has done everything possible to destroy the American System. In the 1960s, the oligarchy imposed the post-industrial society policy to that end. The policy favored speculation, and crushed production.

In 1971, President Richard Nixon, on the advice of Treasury Undersecretary for International Monetary Affairs Paul Volcker, took the disastrous step of taking the United States off the gold-reserve standard. This severed a crucial link between production and financial flows. Such a severing is manifest in the fact that, whereas in the 1960s, U.S. merchandise goods trade (exports and imports combined), accounted for 75% of U.S. foreign exchange trading, it is less than 0.5% today.

In 1975-82, as noted above, four important changes opened the door to wild gambling binges, and the stock market's being governed by the power of leverage.

1. On June 4, 1975, Senate Bill 249 was passed, officially deregulating America's brokerage houses and securities firms. Fixed rates and fixed-rate commissions were eliminated. While this was hailed as a "liberating step," it caused a violent shakeout of the brokerage industry. Many old-line firms either failed outright, or had to be merged with other companies in order to survive. In this chaotic environment, firms such as Drexel Burnham Lambert, which had access to dirty-money flows, including drug money, shot to the fore, and began to dominate with their "junk bond" financing.

2. During the week of Oct. 6-12, 1979, Federal Reserve Chairman Paul Volcker sent interest rates into the stratosphere. By February 1980, the prime lending rate was 21.5%. During the 1970s, Volcker had been one the project directors of the British-run New York Council on Foreign Relations' "Project 1980s," which advocated "controlled disintegration" of the economy, through the use of high interest rates, credit

How asset-stripping works

In 1978-79, one of the first really large leveraged buy-outs (LBOs) involved Houdaille Industries, primarily a machinery producer, which had absorbed a number of machine-tool companies, including the Burgmaster Corp. In 1965, Burgmaster had become the largest machine-tool maker west of the Mississippi, after developing a turret drill press in the late 1940s. Kohlberg Kravis Roberts, the dirty-money asset-stripper tied to the George Bush apparatus, undertook the Houdaille LBO for \$355 million, which was ten times the size of most of the LBOs up to that time.

"Wall Street recognized immediately that the rules were no longer the same. . . . There was virtually no limit on how large a buy-out could be," Max Holland writes in his 1989 book, *When the Machine Stopped*. The financiers made a killing, but Houdaille was devastated. Recounting an interview with Allan Folger, then president of Burgmaster, Holland writes, "After the buy-out, Houdaille

per se changed,' Folger recalled. 'It seemed to lose its equilibrium.' Financial expertise became the single most-valued resource, and understandably so. 'Accounting hires grew faster than manufacturing hires,' because managing for cash flow 'to service the debt became the whole end,' said Folger. Corporate headquarters now demanded so many extensive financial reports that even Folger, with his capacity for numbers, came to believe that it interfered with attempts to improve Burgmaster's product and defend its market."

By 1983, Burgmaster's backlog of orders was quite modest, only two to three months, compared to the 18 months that were common before Kohlberg Kravis Roberts arranged the LBO, when the company's machine tools were in high demand. As money was being siphoned from production to pay pyramided debt service, Burgmaster's machines were becoming less reliable, but still they were being shoved out the front door. On Oct. 1, 1985, a bankrupted and destroyed Burgmaster machine-tool company was shut down permanently.

Dow Jones rigged index, became less industrial

In March 1997, Dow Jones & Company, which owns and publishes the Dow Jones Industrial Average (and also owns the *Wall Street Journal*), made a change in its index, by dropping four stocks and adding four others. The change helped rig the DJIA upwards, while making the index more speculative.

The Dow Jones dropped Bethlehem Steel, Texaco, Westinghouse Electric, and Woolworth—all of which had been part of the Dow Jones industrial index since 1928—and replaced them with Travelers Group (insurance-financial services), Hewlett-Packard (computers), Johnson & Johnson (health care), and Wal-Mart.

The shift had two purposes. First, three of the four companies had registered huge gains in their stock price since 1991, and it was hoped that were that pattern to continue—which it did—it would drive the DJIA even higher. Three of the four companies dropped had registered stock-price losses since 1991, and thus, dropping them was also calculated to boost the Dow Jones higher (by eliminating the “losers” that pulled the market down).

Company added	Change in stock price since 1991
Travelers Group	+628%
Hewlett-Packard	+372%
Johnson & Johnson	+154%
Wal-Mart	+40%
Company dropped	
Texaco	+54%
Woolworth	-27%
Westinghouse	-32%
Bethlehem Steel	-40%

The second purpose of the change was to make the Dow more post-industrial. With the removal of Bethlehem Steel, there are no longer any steel companies listed among the Dow Industrials (U.S. Steel was replaced by Walt Disney in 1991). There are now three bank-insurance companies: the Travelers (which just merged with Citicorp), J.P. Morgan (added in 1991), and American Express (added in 1982).

Of course, many of the industrial companies listed on the Dow Jones Industrial Average report profits earned from post-industrial income streams, such as from real estate and currency speculation.

cut-offs, energy price shocks, etc. In November 1978, speaking in Leeds, England, Volcker stated, “Controlled disintegration is a legitimate objective for the 1980s.”

Volcker’s policy decimated real physical economy, sending machine-tool, steel, and auto production downward by 40-60% over the next three years. But, his policy was, eventually, very beneficial to the growth of the stock market. A businessman could not afford to borrow at 15-18% interest rates, since he could not earn enough in manufacturing or agriculture to pay the loan back. But, in the goosed-up stock market, he could earn a quick-buck return of 20-25%. Steadily, starting in 1982, savings and other investments flowed into the stock market.

3. The Kemp-Roth Tax Act of 1981 (formally called the Economic Recovery Act), which went into effect in 1982, was pushed by the British-run Mont Pelerin Society’s “supply-side economics” advocates, such as Art Laffer of the University of Chicago; Robert Mundell of Columbia University; Robert L. Bartley, the editor of the *Wall Street Journal*; and Rep. Jack Kemp (R-N.Y.). This crowd exerted tremendous influence over President Ronald Reagan.

The Steiger Act, which went into effect in 1979, had cut the top tax rate on capital gains from 49% to 28%. The Kemp-Roth Act cut the capital gains tax top rate again, this time down to 20%. Thus, within the span of four years, the top tax

rate on capital gains had been slashed from 49% to 20%, a 60% reduction in the amount of tax to be paid. This encouraged short-term trading, as one paid 60% less tax for realizing capital gains in the short-term fictitious appreciation of stocks. The name of the game became short-term capital gains, as opposed to long-term investments.

(As the giveaways of the Kemp-Roth Act to wealthy investors caused the U.S. budget deficit to soar, many of its main features were repealed or modified by the 1986 Tax Reform Act, which took effect in 1987. In 1987, the top capital gains tax rate was restored to 28%.)

4. On Oct. 12, 1982, the Depository Institutions Act, sponsored by Sen. Jake Garn (R-Utah) and Rep. Fernand St Germain (D-R.I.), was signed into law, deregulating the entire banking system, both commercial banks and savings and loan institutions. Vice President George Bush had been the head of a White House financial regulatory reform task force which studied, recommended, and oversaw the deregulation.

The act cut out the special emphasis banks and S&Ls had placed on lending to industry, agriculture, and housing. It eliminated the special privileges of the S&Ls, forcing them into the speculative real estate business instead; repealed the usury limit on the interest that a bank could charge a customer, which limit had usually been set at 10%; and so forth. In Volcker’s era of high interest rates, banks were now prodded

to make large loans to leveraged buy-out operators, feeding the merger and acquisition fever.

Thus, there was a concert of mutually supporting activities.

The outcome

There were two principal outcomes from these four changes. The first, as noted above, was to make the stock market a mere facilitator of gambling bets. A stock's price could be anything the market could make it to be.

The second outcome, is that many operatives came to the fore who were connected to the dirty-money flows of organized crime and the drug trade. One such operative was Michael Milken, of Drexel Burnham Lambert, one of the driving forces putting together mega-deals, including several hostile takeovers, and running a yearly "Predators Ball" at which many gangsters of the takeover movement gathered. During the 1990s, Milken was convicted of various manipulations, and served several years in prison. In the 1970s, Drexel came under the control of the following unsavory figures: Meyer Lansky, who for many years was the chief financial officer of the National Crime Syndicate, as well as being linked to the Anti-Defamation League; Edmond de Rothschild of Banque Privée, of Geneva; the Lambert financier family of Belgium; and the House of Morgan. Additionally, money was put into Drexel by the United Fruit Company, America's largest importer of illegal narcotics. Drexel worked with dirty-money-linked firms such as Bear Stearns of Maurice "Ace" Greenberg, as well as "white shoe" firms, such as Morgan Stanley and Crédit Suisse First Boston, to build up a huge mergers and acquisitions movement, fed by leveraged buy-outs and junk bond money. Now, any corporation in America, now matter how large, could be taken over by another corporation. If a corporation resisted, then there could be a hostile takeover. Ninety to 95% of the money for the takeover could be borrowed.

Leveraged takeovers, junk bonds, derivatives bets on stocks, risk arbitrage—these came to be the dominant activities of the stock market. An example of a leveraged buy-out, and the attendant asset-stripping of a firm in the LBO, is provided in the box on p. 23.

An additional element was introduced: A company could be stripped down, just so that its stock price could be made to rise, and its chief executive officer would earn a large stock option (see box on this page).

The national financial media now said that businessmen should be like Michael Milken. In the 1980s, the London-run *Institutional Investor* magazine ran a headline that said it all: "Milken the Magnificent." In a June 13, 1986 article, the *Wall Street Journal* wrote glowingly of Milken, "Tales of Mr. Milken's frenetic, workaholic style, immense earnings and relentless stance against interlopers have made him a Wall Street legend at age 39. Even some Drexel critics have compared him to J.P. Morgan as an innovator."

This transformation, documented for the period from 1975 through 1982, and then from 1982 through 1990, was radically thorough. The transformation of the stock market, which had nothing to do with the "invisible hand," laid the basis for leverage to completely dominate the stock market in the 1990s.

The leveraging and dangerous de-leveraging of the market

There are three forms of leverage, which are largely responsible for pushing up the U.S. stock market to its current dizzying heights: 1) individuals and professional investors borrowing from brokers on margin, i.e., margin loans; 2) leveraged buy-out fund borrowing of leverage; and 3) the leverage of stock and stock index derivatives. As we reported above, between 77% and 100% of the increment in stock market valuation of \$11.16 trillion, since 1990, is fictitious. It is leverage that inflated the market by that much fictitious

CEOs make a killing from stock options

Corporations are paying their top executives in large stock option packages. If the executive can get the company stock price up to a certain level, and then hold it at least at that level, the options suddenly become valuable. Under a compensation plan involving options, an executive may be promised that he can buy shares of the company stock at, say, \$10 per share, once the share price reaches and stabilizes at \$30 per share. If the executive exercises the option, and buys shares at \$10 per share, he makes \$20 per share for each share he buys.

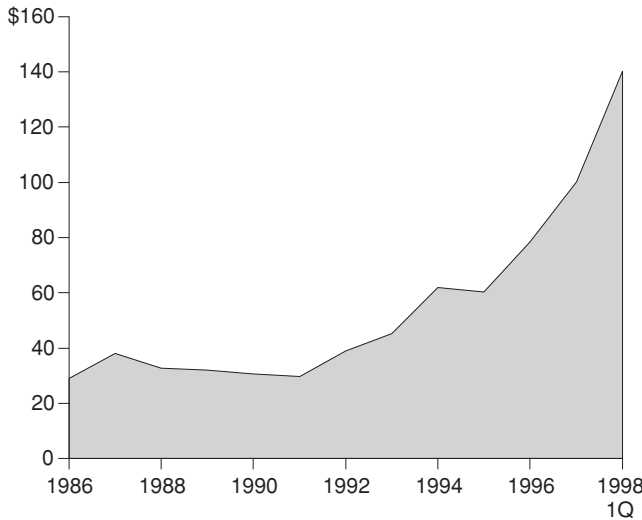
Such options often work directly against the interests of that company and its workforce.

In January 1996, Robert Allen, then chief executive officer of AT&T, announced 40,000 layoffs, the latest installment in 123,000 worker firings that his company has been in the process of carrying out since 1990. This represents 30% of AT&T's 1990 workforce. AT&T is still paying off \$7.5 billion in LBO debt connected with its 1991 takeover of NCR Corp. After AT&T announced the firings, the value of AT&T stock soared. In 1996, Allen earned an annual salary of \$3,362,000. He then made more than \$5 million from the resulting increased value of his stock and options.

FIGURE 8

Margin debt

(billions \$)



Source: New York Stock Exchange.

valuation, and it is leverage that is preventing the market from falling.

Remove that leverage, and that fictitious valuation will evaporate: \$11 trillion could disappear, almost overnight.

There is one additional degree of danger: This leverage is multiply-connected, that is, the three kinds of leverage support and feed one another. That means that the failure of any one kind of leverage will amplify and speed up the effect across the stock market.

Leverage refers to borrowing. A leveraged buy-out is a buy-out or takeover of another company, in which the purchase is financed by a large amount of borrowed money. But leverage has come to take on a broader meaning: the use of a small amount of funds to gain control over an instrument whose worth is many times the amount of funds one is putting up. This is sometimes referred to as a gear-leverage.

We look at each kind of leverage, and then their combined effect in a crash scenario.

1. Official and 'hidden' margin debt

In order to buy, say, \$100,000 worth of stock, an individual may either buy the stock with his own cash or secure a margin loan from a broker. The initial margin requirement on qualified stocks (which margin requirement is set by the Federal Reserve Board) is 50%. That means that the individual can borrow up to 50% of the value of the stock he wishes to purchase through a loan extended to him by a broker. In this case, the individual can borrow a margin loan of \$50,000

TABLE 1

Margin accounts expand

	Margin accounts (millions of accounts)
March 1991	7.3
March 1992	7.4
March 1993	9.7
March 1994	13.2
March 1995	12.7
March 1996	15.8
March 1997	22.9
March 1998	27.4

Source: New York Stock Exchange.

to buy the stock in question, and will have to pay the other \$50,000 out of his own cash. In return for the margin loan, the broker may require the investor to pledge, as collateral, an amount of stock equal in value to the margin loan.

The individual investor borrowing the margin loan, may be either an ordinary investor or a professional investor.

Thus, through the margin loan, the individual investor is buying stock on margin, i.e., by borrowing.

Individual investors have gone hog wild in their accumulation of margin debt to buy stocks. **Figure 8** shows the volume of margin debt outstanding, at the end of the first quarter, for each year, 1986 through 1998. For 1986 through 1991, margin debt remained more or less the same. At the end of the first quarter of 1991, the level of margin debt stood at \$29.7 trillion. Its increase since then has been stupendous, reaching \$60.3 billion at the end of first quarter of 1995, and \$140.3 billion at the end of first quarter of this year. In the seven years since 1991, the volume of margin debt lending increased four and three-quarters times.

Since the margin requirement on stock purchases is 50%, that means that if one is buying \$100,000 worth of IBM stock, one pays for \$50,000 worth of the purchase with a margin loan borrowed from a broker, and the other \$50,000 out of one's own cash. However, many investor/brokers recommend buying only 25% of a stock's purchase price with a margin loan. Were the \$140 billion in margin loans outstanding to represent 25% of the amount paid for the purchase of stock, then this \$140 billion in margin loans would have contributed to \$560 billion worth of stock purchases.

However, margin loans make possible many stock purchases which would not otherwise be countenanced. This therefore boosts the stock market up by a greater amount, than the immediate sums at issue would seem to indicate.

Table 1 shows that by the end of the first quarter of this year, there were 27.4 million margin debt accounts. This translates into one in six American adults possessing a margin debt account, making America a gambling society (although, because an individual may possess more than one margin

account, the actual ratios may be a little smaller). This represents a far higher percent of the population having margin accounts today, than in 1929 or 1987.

Unable to get their hands on enough margin credit to buy stocks on margin, Americans delirious with stock market fever are buying stocks with credit cards, by borrowing against home equity lines, and borrowing against 401K accounts.

Raymond DeVoe, Jr., an economist for Legg Mason Wood Walker stockbrokers, who has worked on Wall Street since 1949, estimated, in the July 1997 issue of his newsletter, the *DeVoe Report*, that “the actual level of customers’ margin debt could be at least 2 to 3 times [the officially] reported level.” DeVoe calls this the “hidden margin.”

DeVoe describes how his study of hidden margins began. He happened to be in a supermarket, and, “since I was probably the only person in the store wearing a suit, shirt and necktie,” a woman working at the store approached and asked him if he was a stockbroker. He told her no, but she pushed forward. “‘What do you think of Vendenteen Technologies?’ she asked undaunted. I said I had never heard of it. She persisted, ‘I’ve got 10,000 shares — bought it at \$0.50 [per share] and it’s 75 cents a share now. It’s going to \$10. I’m thinking of buying more.’” DeVoe asked her how she could afford that much money in one stock. “Her reply, ‘Visa and MasterCard don’t ask what you do with the money.’”

DeVoe stopped two other people in the same supermarket, and asked them if they played the market. They replied that they did: They put a good amount of each pay check into the stock market. “When the money for food runs out at end of the month — we charge it,” one person explained. DeVoe asked, “How often does this running out of food budget money occur?” “Every month,” they answered in unison. Thus, people incur double-digit interest charges on their credit cards, in the attempt to make more in the market.

Provoked by these incidents, DeVoe conducted a study, and found 17 other cases of this phenomenon over the next few months. He also found individuals taking out home equity loans to buy stocks. To see how easy it was to get the money for this purpose, he applied to a bank for a home equity loan. When he came to the application line which asked him the purpose of the loan, he told the bank’s loan officer only that he wanted the funds available in case of emergencies. The banker told him, “Put in ‘for emergencies.’” The loan was approved.

According to DeVoe, the American Bankers Association reported for the end of 1995, that there was \$276 billion outstanding in open-ended equity loans and another \$138 billion in closed-end equity loans in America, more than \$400 billion, some of which could be used for stock purchases.

Available evidence indicates that tens of thousands, and

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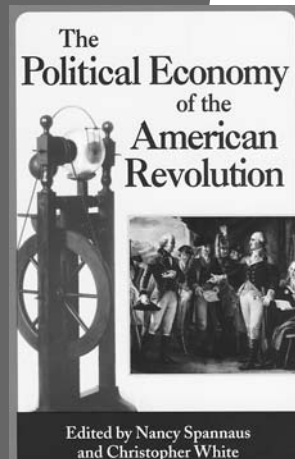
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perhaps hundreds of thousands of Americans are using some or all of the proceeds of home equity loans to play the stock market.

DeVoe reported that another option is borrowing against one's 401K retirement plans. If one borrows against the stock holdings in the plan, perhaps to pay down the borrowings on a credit card which one has used to buy stock, then this is the equivalent of borrowing on margin from a broker, but no broker loan is involved: One is borrowing against one's own individual retirement plan.

In addition, according to DeVoe, there are a good number of workers employed in high-tech companies, who are paid rather low salaries, but are offered stock options in the stock of the company they are working for. When it comes time to exercise the stock option, they may have to borrow the money. For example, let us say one has a stock option plan that after seven years allows one to buy 10,000 shares of stock at \$20 per share. The stock may be trading at \$30 per share, so the option is a bargain. But to exercise the option, one has to come up with \$200,000. This would be borrowed from a bank.

Putting together all the anecdotal and other evidence together, DeVoe stated, "I feel that the actual level of customers' margin debt could be at least 2-3 times [the] reported level." At the end of March 1998, the level of margin debt was officially \$140 billion. Two to three times that would be between \$280 and \$420 billion. That amount of margin could contribute to stock purchases, using margin, of as much as \$1.68 trillion (were margin to represent 25% of the total stock purchase price).

DeVoe's report shows to what extent Americans are willing to borrow, to buy into the market. The danger is that suffering even a 20% loss, would be enough to wipe out credit card or home equity loans, and ruin a 401K retirement fund.

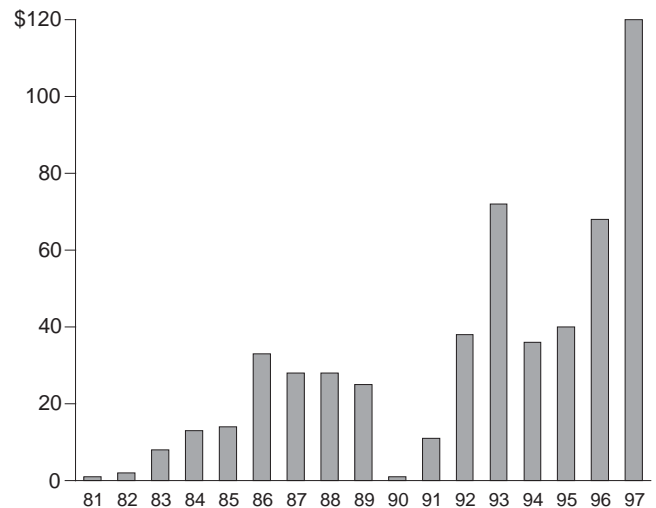
2. Leveraged buy-outs and junk bonds

The British strategic policy during 1975-82, was to break down the traditional function of the stock market, and turn it into a gambling pit. This involved the heavy use of leveraged buy-outs. The LBO frenzy got started in 1973-79, and though its activity was quite intense then, still by today's standards, it would seem like small potatoes. From 1982 through 1989-90, it assumed greater intensity. But, from 1993 to the present, the market has teemed with leveraged buy-outs.

The LBOs have led a surge of mergers and acquisitions that is unequalled in U.S. history, and dwarfs all other economic activity in the U.S. economy. Not all mergers and acquisitions (M&As) use leverage; that is, only a percentage of all M&As are leveraged buy-outs. But LBOs drive forward and consolidate the M&A process.

The leveraged buy-out is transacted with a considerable sum of leverage. For example, let us assume that a firm that specializes in LBOs wants to purchase a company for \$5 billion. It could borrow \$4 billion, and put up only \$1 billion of its own funds. This leverage is 5:1, the LBO firm is buying

FIGURE 9
Junk bonds issued in the United States
(billions \$)



Source: Securities Data Company.

something for \$5 billion, but spends only \$1 billion of its own funds. The 5:1 leverage is meant to work to its advantage. Let's say it makes \$200 million from the deal. If the LBO company had put up \$5 billion of its own money to consummate the deal, then its rate of profit would be \$200 million divided \$5 billion, or 4%. But with 5:1 leverage, the LBO firm's rate of profit would be \$200 million divided by \$1 billion—which represents the amount of its own cash that it put up—or 20% (out of this, the LBO firm must pay the interest on the \$4 billion it borrowed). In the speculative world, the higher the leverage, the greater the profit.

Today, many of the LBO firms execute their takeovers with the same asset-stripping as Michael Milken did during his hey-day of the 1980s, including firing workers, shutting down divisions, etc.

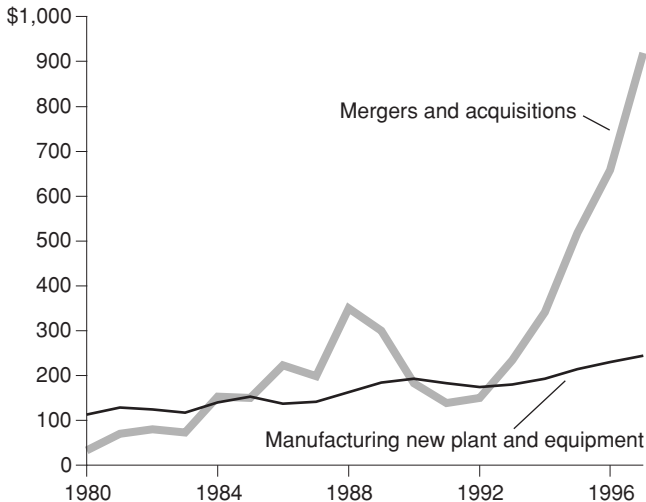
One of the chief means of financing LBOs is still junk bonds, the high-risk, high-yield bonds. Many people assumed that junk bonds died, when Drexel Burnham went bankrupt in 1991, and Milken went to jail. False: The practice is stronger than ever. **Figure 9** reveals that more junk bonds are being floated than were ever floated during Milken's day. In 1997, more than \$120 billion in junk bonds were issued. In March and April of this year, \$18.83 billion and \$18.96 billion worth of junk bonds, respectively, were issued, the highest two monthly issuances in history.

LBO leverage has spurred the merger and acquisition movement. **Figure 10** shows the dollar volume of merger and acquisition takeovers, since 1980. Notice that there is a first run-up in mergers and acquisitions between 1982 and 1988.

FIGURE 10

U.S. mergers and acquisitions versus manufacturing expenditures for new plant and equipment

(billions \$)



Sources: Securities Data Company; Bureau of Economic Analysis of Department of Commerce; EIR.

The impending collapse of Drexel caused the market to plunge. But since 1991, they have been virtually unstoppable. In 1997, there were \$919 billion worth of corporate takeovers and mergers, and for the first four months of this year, 1998 is on target to surpass \$1.2 trillion.

Every new takeover catapults stock prices higher. Each takeover not only raises the stock price of the company targeted for takeover, but also the stock prices of all the corporations in the industry group (electronics, pharmaceuticals, etc.) of the company slated for takeover. Companies are regularly paying an exorbitant three to five times book value, to take over another company. Each successive takeover binge is bigger, at a higher price.

As the stock market rises, and the world financial disintegration approaches, U.S. corporations are engaged in a dance of death. They are flinging money at each other, with Citicorp and Travelers Group in a \$72 billion merger; BankAmerica and NationsBank in a \$60 billion merger; and SBC Communications and Ameritech in a \$62 billion merger.

Further, several once-conservative institutions, managing significant sums, are pouring their money into the LBO fever. Many key leveraged buy-out firms, even though they now dub themselves "alternative investment funds," are the same LBO sharks that operated during the 1980s. The godfathers of the buy-out business mania include: Henry Kravis of Kohlberg Kravis Roberts & Co., who is a key figure in the dirty political machine of George Bush (Kravis, a personal friend

of Bush, served as co-chairman of the finance committee of the Bush for President campaign in 1992); Stephen Schwarzman of the Blackstone Group (Blackstone's chairman is former Council on Foreign Relations chairman Peter Peterson); and Leon Black of the Apollo Investment Fund (in the 1980s, Black was a star at Drexel Burnham; his father had chaired the drug-laundering United Fruit Co.).

The Oregon State Treasury Department has invested an astounding amount of more than \$2.5 billion in Kravis Kohlberg Roberts LBO funds. Manhattan's Sloan-Kettering Memorial Cancer Center, one of the world's preeminent cancer treatment and research hospitals which has a \$1.5 billion endowment, last year committed \$200 million — one-seventh of

What are corporate stock 'buy-backs'?

In a corporate stock buy-back, the company uses part of its profits, not for expansion of its production, but to purchase its own shares on the open market. This has been used to "bull" the stock market. By shrinking the number of shares of a company that are trading, its earnings are distributed against fewer shares (and shareholders); this increases the earnings per share, and, the company hopes, that will be rewarded with the share price rising even higher.

Such buy-backs are being carried out by International Business Machines (IBM), for example. For the first quarter of 1998, IBM announced a drop in earnings; but it also announced that it was buying back \$3.5 billion of its own shares. The result: Despite lowered earnings, the company's stock price rose. Since Jan. 31, 1995, IBM has repurchased \$20 billion of its shares — about one-fifth of its total shares outstanding. During this period, IBM's stock price leapt from about \$47 per share during 1995, to \$117 per share on May 1 of this year, an increase of two and one-half times. While IBM reported profits during this period, approximately half or more of the stock price increase came from its buy-back program.

IBM is one of the 30 stocks of the Dow Jones Industrial Average; its increase in share price helped push up that average. Coca-Cola, another of the 30 stocks of the Dow Jones, repurchased 1 billion of its shares between 1984 and 1996. Since 1995, twenty-four of the Dow's 30 companies — that is, 80% of them — have announced buy-back plans. Indeed, the main preoccupation of most companies these days is not production, but a rising stock price.

its endowment—to 18 different “alternative investment” funds.

Meanwhile, return to Figure 10. The dollar volume of mergers and acquisitions dwarfs the manufacturing sector’s expenditures for new plant and equipment. Paper return has become more important than physical output.

3. Stock-based options and futures

Stock-based derivatives, options, and futures, with a leverage that ranges up to 660:1, are the most potentially explosive.

These derivatives, which were practically nonexistent in the 1970s, have ballooned during the 1990s. As much as anything, they characterize the stock market of today.

In 1996-97, some 19.6 million futures contracts, taken out on the most popular stock index, the Standard & Poors 500 index, were traded through the Chicago Mercantile Exchange. In the same period, 4.5 million options contracts, taken out on the S&P 500 index, were traded through the CME. These contracts controlled an underlying notional amount of more than \$1 trillion, and shaped the performance of the New York Stock Exchange.

To figure out the importance of these stock-based derivatives, and how they work, it is useful to say a word about the functioning of derivatives.

There are four levels of economic-financial activity represented by these futures and options contracts.

On the first level is the real physical economy. Man, through the creative power of discovery, creates breakthroughs in science and technology, which are applied to the alteration of nature, through manufacturing, agriculture, etc.

On the second level are financial instruments, such as stocks, bonds, and mortgages, which in a well-functioning economy have a role to play—stocks raise funds for capital expansion, mortgages can be used to buy a house, etc. But over the last 25 years, these have become speculative instruments.

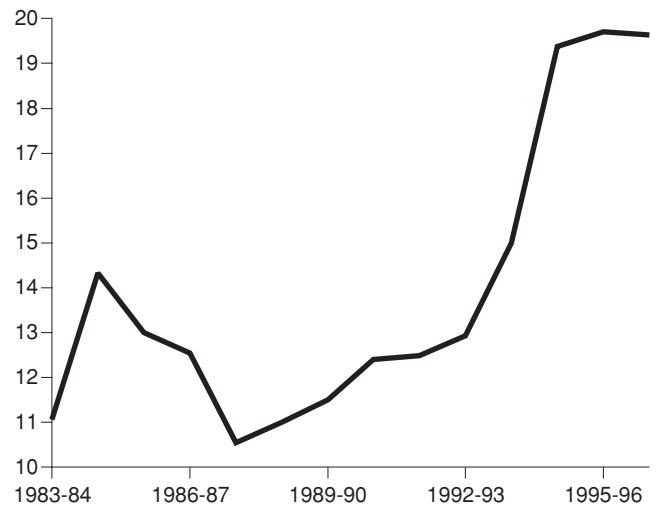
On the third level, are derivatives. These are financial instruments which are bets on instruments of level two. One such derivative is the S&P 500 index. When one buys this index, one buys the trading value of the S&P 500, a basket of 500 stocks. It has a trading price, which is the sum of the value of the S&P 500 stocks, adjusted by some factor. When one buys the S&P 500 index, one is not buying any one of the 500 stocks (although technically, a portion of each of the 500 stocks is held in a unit trust account for the purchaser); one is really buying the value of the index. One is betting that the index as a whole will go up (or down), like some baseball player’s batting average.

On the fourth level, is what we were seeking to examine, an *option to buy the S&P 500 index*, which gives one the right, but not the obligation, to buy the S&P 500 index—this is a derivative upon a derivative.

On May 18, the S&P 500 index was trading at 1,106. In

FIGURE 11

Volume of trading of S&P 500 future contracts, at Chicago Mercantile Exchange (millions of contracts)



Source: Commodity Futures Trading Commission, annual reports.

the case of the purchase of an option, one pays a premium of usually 2-3% of the value of the underlying instrument. To make this concrete, let us say that one buys an option on 1,000 units of the S&P 500 index. This has an underlying notional value of \$1,106,000 (\$1,106 times 1,000). Let us assume that the cost of buying the option—which is called the option’s premium cost—is 3% of the value of the underlying instrument. In this case, that would be 3% of \$1,106,000, or \$33,180. By buying the option, one does not yet own the 1,000 units of the S&P 500 index, but, to use the technical term, one *controls the underlying instrument*. So, putting up \$33,180 controls an underlying instrument of \$1,106,000. That is a 33:1 leverage ratio.

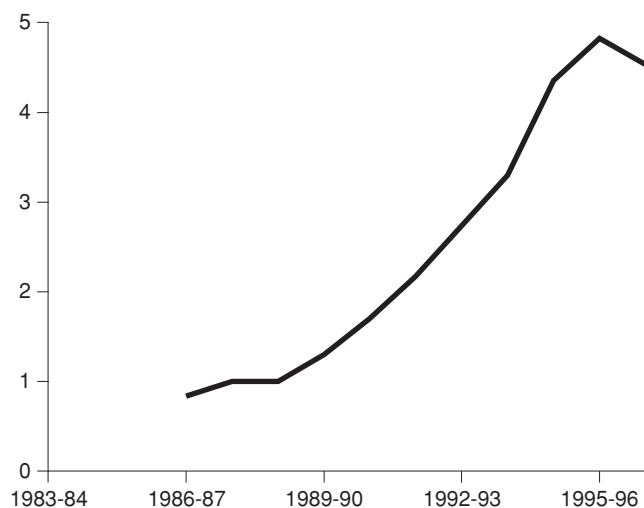
However, if you are George Soros’s Quantum Fund, you don’t even put up the \$33,180, which is the cost of the option premium. Soros could borrow 95% of the cost of the premium from a bank, and so would only put up \$1,659 of his own money. That \$1,659 would buy up an option with a premium cost of \$33,180, that’s a 20:1 leverage between what he puts up, and what the cost of the premium is. The \$33,180 premium controls an underlying instrument of \$1,106,000, which represents a 33:1 leverage. Combining the two, Soros is only putting up \$1,659 of his own money to control an underlying instrument of \$1,106,000; that’s a leverage of 660:1.

One can buy a lot of options and futures contracts on the S&P 500 index. If one buys a sufficiently large volume of them, this creates pressure to make the underlying cash market—the actual stocks traded on the New York Stock Ex-

FIGURE 12

Volume of trading of S&P 500 option contracts, at Chicago Mercantile Exchange

(millions of contracts)



Source: Commodity Futures Trading Commission, annual reports.

change—rise in price, to meet the close-out price of the options and futures. This is called “updrafting” the market. Conversely, one can force the prices on the markets downward, which is called “downdrafting.”

Finally, consider a stock market that has been updrafted. It is like a building structure that is being held up by a thin, reedy scaffolding, i.e., the derivatives contracts, which are at a 660:1 leverage. Let us say, that there is a derivatives market failure somewhere in the world. Since derivatives extend across national boundaries, and across markets, this can hit the stock market. What has risen by a 660:1 leverage scaffolding, can now come down by a 660:1 leverage. This is called reverse leverage. This process will be very swift—a matter of hours or days—and the trajectory will be straight down.

How exposed is America to this possibility? **Figures 11 and 12** show the tremendous volume of trading, respectively, of futures and options contracts taken out on the S&P 500 index, on the Chicago Mercantile Exchange. In 1997, there were 19.4 million futures contracts and 5.4 million options contracts traded on the S&P 500 index. Both indices have grown in volume over the past decade. Although the S&P 500 index is the most popular stock index in America, there are also future and option contracts on the Dow Jones stock index, etc. Plus, there are options and futures on individual stocks, such as IBM, GE, and so forth. Though a single comprehensive figure does not exist, *EIR* estimates that in 1997, about 50 million future and option contracts on stocks and stock indices were traded in America. They would have

had a minimum combined value of several trillion dollars.

This type of leverage is like dynamite, just waiting to be ignited.

But, return to the reality we stated at the beginning of this section of our report: This leverage is multiply-connected, multi-pyramided; that is, the three kinds of leverage support and feed one another. That means that the failure of any one kind of leverage will amplify and speed up the effect across the stock market.

When reverse leverage strikes, broker margin loans will be called in, or investors will have to dump stocks to meet margin calls; junk bonds will melt down, as companies that issued them will not be able to pay interest costs; and the derivatives bubble of futures and options will collapse. De-leveraging in one sphere will trigger de-leveraging in another sphere, because all the leverage of the different spheres is interconnected.

The props will come crashing out from under a market that has risen 825% since 1982.

Unprecedented American exposure

The lure of the market is making Americans crazy, distorting their grasp of economic and strategic reality. Encouraged by stories in magazines and newspapers, tips from hot-shot newsletters and “insider” investment advisers, and talk-show gossip, Americans are betting their shirts on the market. When warned to get out, they reply, “I can’t get out now, I might miss the opportunity to make a profit tomorrow.”

One is reminded of a dance in which the partners whirl around faster and faster, in a frenzied trance. Under the bright lights, they are unable to distinguish reality: Faces are blurred, voices cannot be heard. Still they go faster, hurling themselves toward oblivion.

According to the best estimates of historians, in 1929, between 8 and 15% of American households owned stock. In 1985, about 25% did; and today, approximately 35 million households do, representing 35% of all American households.

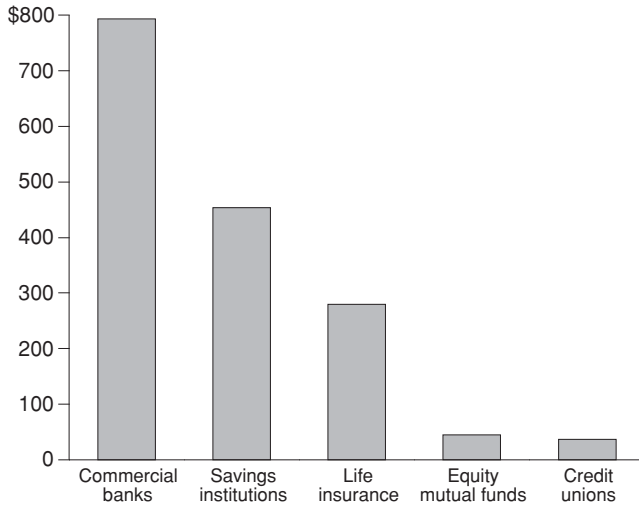
The prime vehicle for attracting American participation in the market is the equity mutual fund. This is bringing about a phenomenal shift in where Americans keep their assets. The equity mutual fund is the equity-holding portion of the mutual fund sector. Mutual funds can own a variety of assets, such as cash, U.S. Treasuries, or corporate bonds, and their total holdings have become quite sizable (in fact, today U.S. mutual funds have more assets than U.S. commercial banks). We concentrate strictly on the equity holdings of mutual funds.

Figures 13, 14, and 15 show the holdings of assets by the principal financial institutions: commercial banks, insurance companies, savings and loan associations, credit unions, and

FIGURE 13

Total deposits and assets of the largest U.S. financial institutions, in 1975

(billions \$)

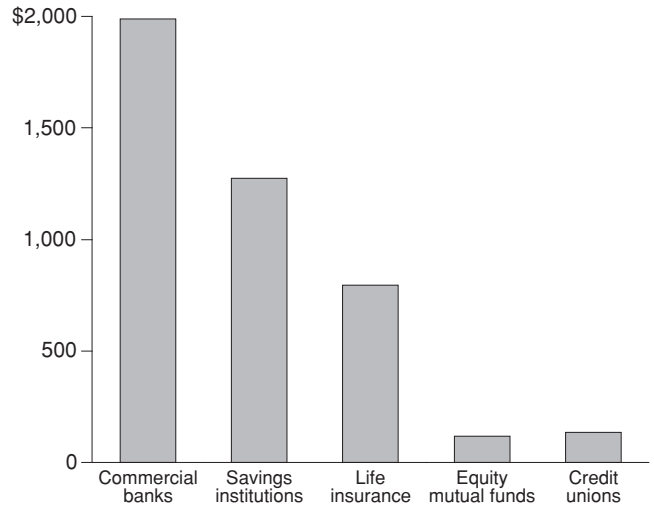


Sources: Federal Reserve Board of Governors, "Flow of Funds Accounts;" Investment Company Institute.

FIGURE 14

Total deposits and assets of the largest U.S. financial institutions, in 1985

(billions \$)

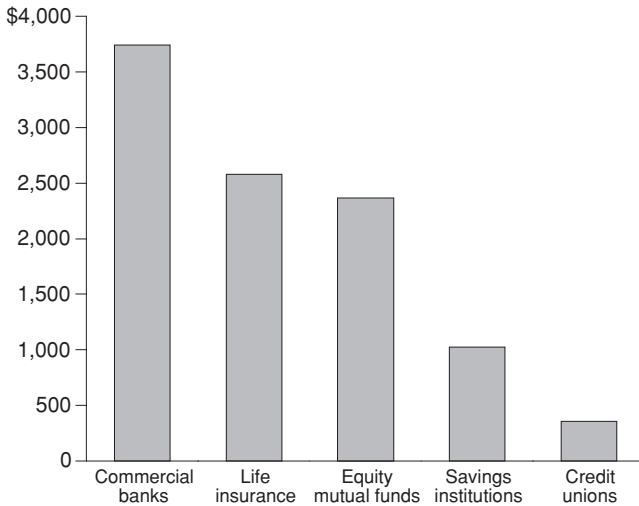


Sources: Federal Reserve Board of Governors, "Flow of Funds Accounts;" Investment Company Institute.

FIGURE 15

Total deposits and assets of the largest U.S. financial institutions, in 1997 fourth quarter

(billions \$)

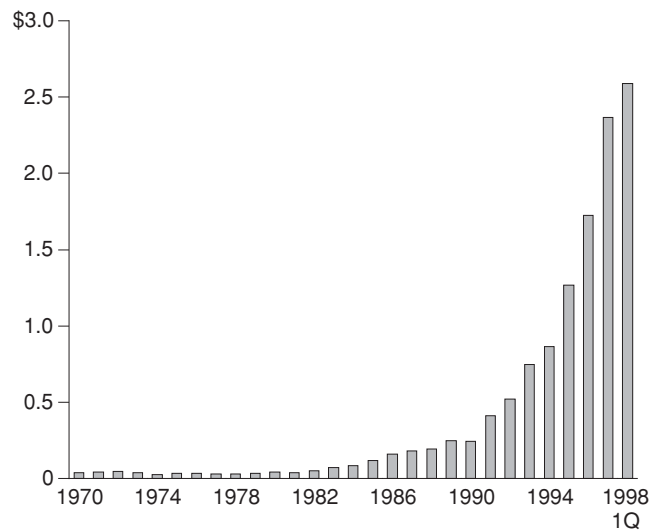


Sources: Federal Reserve Board of Governors, "Flow of Funds Accounts;" Investment Company Institute.

FIGURE 16

Equity mutual fund assets rise, 1970-98

(trillions \$)



Source: Investment Company Institute.

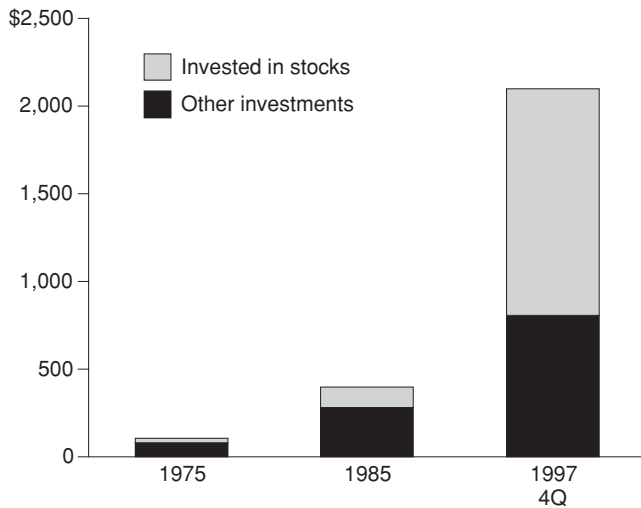
equity mutual funds. We compare the assets for the years 1975, 1985, and the fourth quarter of 1997. In 1975, mutual equity fund assets were merely a blip, at \$37.5 billion. In

1985, mutual equity fund assets were relatively small at \$116.9 billion. Today, mutual equity fund assets have surged to \$2.4 trillion, 20 times greater than their 1985 level. They

FIGURE 17

State and local retirement fund assets, showing portion invested in stocks

(billions \$)

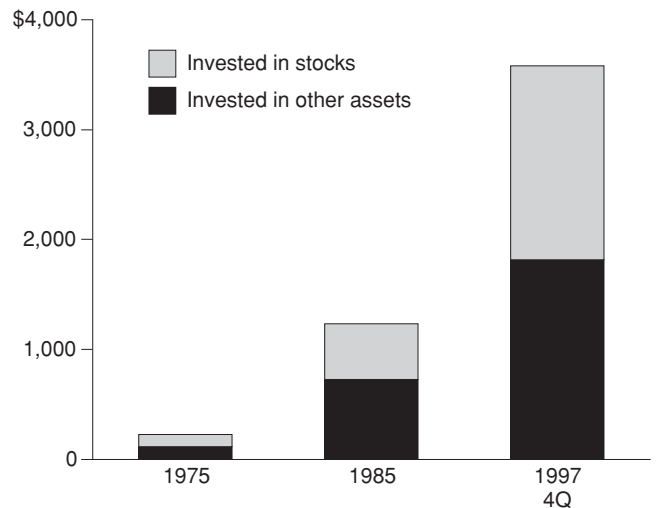


Source: Federal Reserve Board of Governors, "Flow of Funds Accounts."

FIGURE 18

Private pension fund assets, showing portion invested in stocks

(billions \$)



Source: Federal Reserve Board of Governors, "Flow of Funds Accounts."

are two-thirds the size of the U.S. commercial banking system, and trail its asset level by \$1.2 trillion. **Figure 16** shows the historical growth of equity mutual funds.

Some of the increased holdings of the equity mutual funds represent the result of appreciation of the stocks that these funds already held. But in 1997, Americans entered as new funds \$227 billion into equity mutual funds, and they are on a faster pace for this year.

But this is not the full extent of the household's exposure to the stock market. **Figure 17** shows the state and local government retirement fund accounts, and the amount invested in stocks. In 1975, state and local retirement funds had very little invested in stocks. But as of the end of the fourth quarter of 1997, state and local retirement funds had \$1.30 trillion of their assets invested in stocks, out of total assets of \$2.1 trillion. Stocks represented 62% of their total assets.

Figure 18 shows the private pension fund accounts. As of the end of the fourth quarter of 1997, private pension fund accounts had \$1.77 trillion of their assets invested in stocks, out of total assets of \$3.58 trillion. Stocks represented 49% of their total assets.

There is overlap, of course, as state and local government retirement funds and private pension funds employed equity mutual funds to invest some of their money.

Those who are looking forward to their retirement, thinking that their retirement fund will take care of them, had better think again.

Finally, many households also have direct stock owner-

ship, purchased from a stockbroker.

But normal methods of stock investing were not sufficient to satisfy insatiable appetites. Margin loans from brokers for buying stocks on leverage, increased from \$60 billion at the end of the first quarter of 1995, to \$140 billion at the end of first quarter of this year. Americans borrowed money on credit cards, against home equity, against stock-holding individual retirement accounts, and even threw their food and rent money into the upswirling market. An unprecedented level of holdings, means an unprecedented level of exposure.

Whether the nonpostponable collapse of the stock market comes from a miscalculation, or is the deliberate pricking of the bubble by the British oligarchy, the effect will be greater misery than ever before experienced in America. The after-shocks, involving a convulsion of the world derivatives market, will be global.

Lyndon LaRouche's policies offer the way out: the establishment of a New Bretton Woods monetary system, with fixed exchange rates, combined with a global infrastructure development program within the framework of the Eurasian Land-Bridge project.

Worsening objective economic conditions are never, by themselves, sufficient to bring about an historic change. There must be a subjective change, throwing off the unworkable axioms that are leading the nation to doom. Now is the moment for Americans to make such a subjective change, with respect to their thinking about the stock market. Holding onto illusions, past their expiration date, can be deadly.