June 2, 2023 Podcast transcript

Working title: Are Record Corporate Profits Caused by “Greedflation”?

Hi Everyone. Welcome back to Finance Friday on the ARC-UK Youtube network. I’m HardmoneyJim, as always interested in money creation and its consequences, speaking from Beautiful Jackson Hole, Wyoming, where both the tourists and the wildlife have returned for the summer season.

And here they are together. However, as you can see from the recent photo here, the tourists are not always rational animals. They really need to remember that these are not barnyard creatures, and they can be pretty dangerous if you get too close. So I encourage you to come to Yellowstone for a visit, but when you do, please don’t do this!

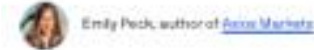
Today we’re going to talk about different a kind of irrationality, an increasingly popular myth about inflation that I see often in the financial press. I am speaking of the shopworn, recycled claim that business people cause inflation by charging exorbitant profits. We are going to slay that dragon today. After we take care of that critical chore, time permitting, I’ll comment on a couple of other newsworthy topics that I am sure you are aware of, namely the debt ceiling debate, which has dominated the mainstream news, and then the stock market hype surrounding the so-called artificial intelligence stocks, which has dominated the financial news.

So we have three parts today. Part One, the main event, is on the increasingly popular myth that price-gouging business profiteers cause inflation. Then, in Part Two, some comments on the meaning and importance of the recent debate in the US Congress over the debt ceiling. And finally, Part Three, I’ll comment on the extraordinary surge in the stock prices of companies that promise to benefit from this startling new technology, artificial intelligence, also known as machine learning.

PART ONE: DO PROFITS CAUSE INFLATION?

So let’s dive into Part One with a question. Can business decision-makers cause higher inflation simply by charging higher prices?

Once a fringe theory, "greedflation" gets its due



Emily Peck, author of Axios Markets

Once dismissed as a fringe theory, the idea that corporate thirst for profits drives up inflation, aka "greedflation," is now being taken more seriously by economists, policymakers and the business press.

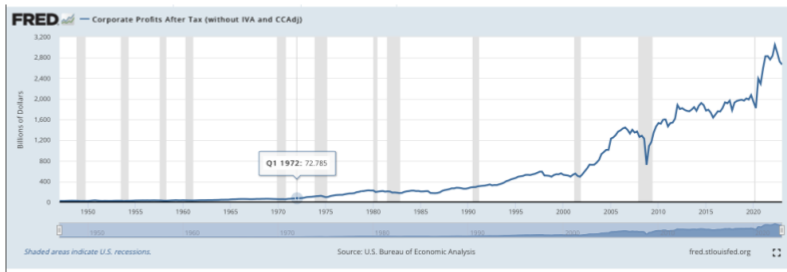
Here is a typical example of the financial news stories I am seeing today. There is a growing school of thought – it is not new, just an old idea being recycled for the current inflationary economic cycle – claiming that business people can raise prices arbitrarily and that because they can do this, our recent bout of consumer price inflation is caused at least in part by their corporate greed. The purveyors of this idea have adopted a ridiculous portmanteau – “greedflation” – to capture the concept. (You know that term? A “portmanteau” is a made-up word that is supposed to combine two meanings into one word, like “stagflation” or “Brexit.”) The proposition behind so-called “greedflation” is that businesses can take advantage of their monopolistic position to raise prices, hiding these price increases in a sea of other rising prices, and they can do this simply because they are greedy.

This recent article from Axios is a case in point. The New York Times is also behind it. (I don’t show the Times’s headline because I don’t have a subscription.)

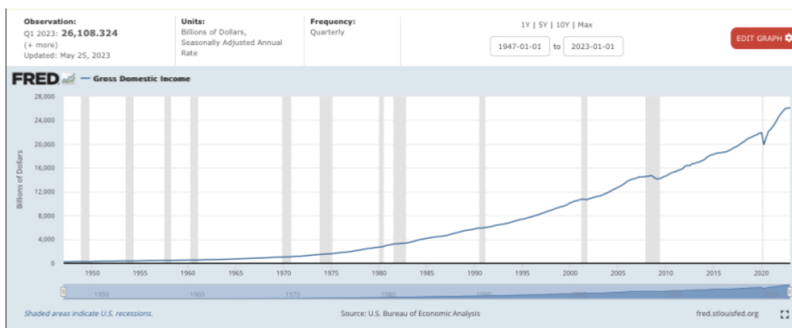
Has 'Greedflation' Caused Corporate Profits To Increase? What You Should Know

May 31, 2023 08:30 AM | **S&P 500 Index(SP500)** | By: Logan Kane

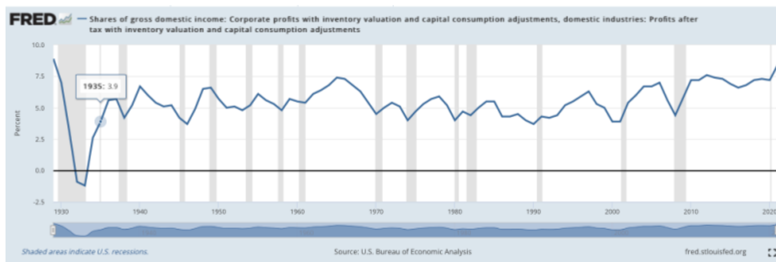
Here’s another example from a mainstream investment publication. And in a modern example of capitalists trying to commit public suicide by catering to their enemies, some Wall Street firms are even jumping on the bandwagon.



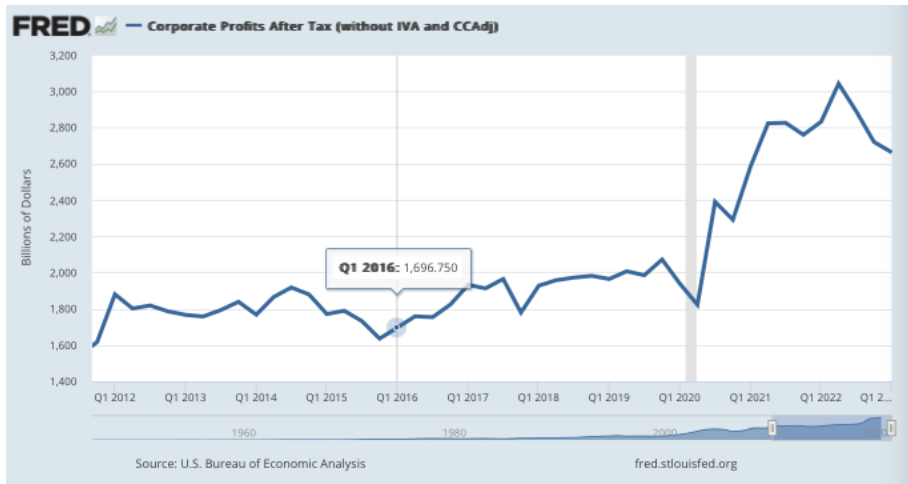
To unpack this thesis, let's start with the aggregate after-tax profit data in the USA, courtesy of the BEA and as reported by the Fed. There has been a significant upward thrust in profits, especially since 2020 (the far right bulge on the graph), coinciding with substantial consumer price increases, which came about after the great Pandemic monetary stimulus.



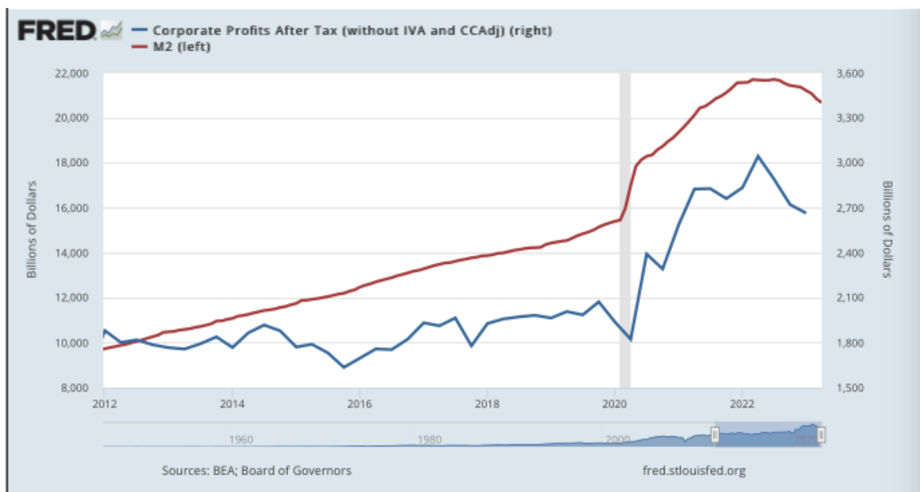
Next is a long-term chart of nominal Gross Domestic Income in the USA. Gross domestic income is equivalent to Gross Domestic Product (GDP) and is a pretty good proxy for total business sales. The direction here is also clearly upward, with only rare downturns, which are small and temporary during recessions.



Combining those two data sets, dividing profits by sales, we get profits as a percent of sales, also known as profit margin. As you can see, the after-tax profit margin oscillates, but it is stable, rarely going below 4% and sometimes reaching as high as 8%, as it did recently. Most of the time, it fluctuates around 6%. And that makes sense when you consider that businesses compete for profits, price their goods high enough to make a profit but low enough to maintain market share, and profits ebb and flow as companies invest and sell their goods.



Here's a close-up of that after-tax profits chart, going back to around 2010. To a simple-minded capitalist, this looks great for business, right? Surging profits must be good for business.



Now look at the same chart alongside a chart of broad money supply, M2. Money supply, M2, is in red on the left-hand scale. Profit after tax is in blue on the right-hand scale. Note several things:

- Profits were fairly level for years until the Pandemic, then profits surged.
- Profits surged along with the Pandemic monetary stimulus right after the short Pandemic recession shown in grey.
- Both money supply and profits had an unprecedented rate of increase in 2022. Profits skyrocketed alongside skyrocketing M2
- This is an all-time high for both profits and money supply and an all-time record increase in both profits and money supply.
- M2 and profits seem to be closely correlated: both rise and fall at about the same time
- Profits have tailed off somewhat since 2022 from about 3 trillion to 2.7 trillion. This coincided with a slowing rate of increase in M2.

These two datasets – money supply and profits – show a strong correlation, and we can reasonably suspect they are related, but how? I contend the surge in money supply (red line) is the cause for the rise in profits, and I now want to illustrate why.

So we want to know: What caused this surge in profits? Was it corporate greed or something else? Is this profit surge beneficial to business, as it appears to be?

One of the leading outcomes of inflation (which I define as an undue increase in the money supply) is rising prices. So let's now look at an individual firm and see what happens to profits, first under stable prices and then under rising prices.

Profit and Loss (typical presentation)		
	Sales	110
	Costs	-100
Profit before tax		10
	Tax on profit	-2
Profit after tax		8

As we all know, the profit of a business is just the difference between sales and costs. Sales minus costs during a designated period. Here is a typical presentation of a company that makes a modest profit. Imagine a simple, steady business with annual costs of 100 and annual sales of 110. The profit before tax is 10, 110 in sales minus 100 in costs. The income is taxed at 20 percent, leaving a profit after tax of 8. That is a steady-state business under stable prices.

So what do most people think happens to sales, costs, and profits under inflation? You can do some math in your head, and Intuitively you might think that if prices are rising throughout the economy, then the effect on sales and profits are the same. So, if sales go up 10% from 110 to 121, and costs go up 10% from 100 to 110, then profits before tax are 121 minus 110, or 11. And 11 in profits is 10% higher than the steady state profits of 10, so it appears sales, costs, profits, and taxes are all increasing uniformly at 10% per year.

I want to show why this intuitive thinking is not only simplistic but dead wrong, and needs to be corrected. It is wrong because of two factors: first, because of the time that elapses between when production costs are incurred and when a product is sold, and second, because of the effect of income taxes on pre-tax nominal profits.

Let's consider the time factor first. We must remember there is a time lag, sometimes a significant lag, between when most business costs are incurred (when cash is paid out for materials or labor or other investments) and when the product is sold. People often forget this, perhaps because when we look at a traditional profit and loss sheet, sales are always at the top, followed by costs or deductions against sales to compute profit. This standard presentation gives the impression that sales and costs are incurred simultaneously, but nothing could be

further from the truth. If you think of how far in advance materials and labor have to be sourced, assembled, and paid for before any product can be manufactured and marketed, you begin to see that almost all costs listed on a profit and loss statement were made long before any revenue was brought in from a sale. This is a critical function of the capitalist: to finance investment over time, to provide the capital – the materials, labor, land, and so on – to put these factors of production to work before anything is sold, resulting in a marketable product produced over time.

All economic production occurs over time. And nearly all expenses shown on a profit and loss statement are paid for in advance of sales. (The rare exceptions are expenses like royalties and commissions, which are netted out of sales and paid for at the time of sale.)

Stable prices	Year 0	Year 1	Year 2	Year 3
Cost	100	100	100	100
Sales		110	110	110
Profit before tax		10	10	10
tax on profit		2	2	2
profit after tax		8	8	8
Funds available for next year		108	108	108
replacement cost		100	100	100
Dividend to owner		8	8	8

Here is a simple financial model of a simple business. It is like a profit and loss statement, except it lists the expenditures and sales in the order they occur. So you see, the business starts at Year 0 with an outlay of cash of 100, followed in Year 1 by sales revenue of 110. Notice that I drew the little diagonal arrows from costs in a previous year to sales in a later year. This is to remind us that it is the costs paid in a *previous* period that are subtracted from sales in the *current* period to calculate profit in the current period. That is how it happens in a real-world business, and it's crucial to remember this.

This simple model assumes conditions of stable prices or no inflation. The owner lays out 100 in costs at the beginning of the year, Year 0. At the end of the year, he sells his product for 110. This leaves him a profit before tax of 10, on which he pays 20% income tax, leaving him a profit of 8. Of course, he has to repeat the process to stay in business. So, at the end of Year 1, he has cash on hand consisting of his total sales revenue, 110, minus tax of 2, leaving 108 to fund next year's business expense plus some residual for his living expenses. He can reinvest 100 into the business for next year and keep a dividend (or his net profit of 8) to feed his family and pay for his other living expenses. Under stable prices, all else equal, this can go on year after year.

10% inflation	Year 0	Year 1	Year 2	Year 3
Cost	100	110	121	133
Sales		121	133	146
profit before tax		21	23	25
tax on profit (20%)		4.2	4.6	5
profit after tax		16.8	18.4	20
funds available for next year		116.8	128.4	141
Replacement cost		110	121	133
Dividend to owner		6.8	7.4	8.0
Dividend req to compensate for inflation		8.8	9.7	10.6
loss in standard of living		23%	24%	25%

Now let's see how things look when prices rise at 10% per year. We start with the same outlay of 100 in costs. But now, between the time when costs are incurred and when the product is sold, all prices are rising. (For simplicity, we assume the prices of everything moves up at the same rate, 10% per year.)

What we see is that profits rise substantially because the cost of production was recorded before all prices started to rise. Profits after tax more than doubled, going from 8 to 16.4. Taxes more than doubled as well, going from 2 to 4.2. Both the businessman and the government made out pretty well, right? Maybe inflation is a good thing for business.

Not so fast. At the end of Year 1, look at what it costs the business owner to stay in business and continue living. Prices rose 10% during the production period, so the owner has to replace his inventory at 110, not 100. But he has only 116.8 (his total sales revenue minus taxes) to pay for the new, more expensive inventory. After investing 110 to pay for new inventory, he has only 6.8 left to live on – less than he had under stable prices! Even worse, the dividend dollars he did get to keep now buy 10% less than they used to. To maintain his standard of living, he needed a dividend 10% higher than what he was getting before inflation started. But his dividend is now much lower. Under these conditions, when profits more than double, the business owner's standard of living has declined by a whopping 23%.

This process of wealth destruction continues yearly as long as prices keep rising year after year. The businessman's profits go up nominally, and after the first year, his dividends start going up nominally. But his dividends are always well less than he needs to maintain his original, pre-inflation standard of living. He has to delve into his dividend, i.e., reduce his standard of living, to invest enough money to stay in business.

So what is this business owner supposed to do? If he can successfully anticipate his cost increases, and if his customers will bear the increased costs, he could raise his prices by more than 10%. I did a quick calculation, and in this case, the owner could maintain a "real" dividend – meaning a premium high enough to make up for inflation – if he increased his prices by 12% while his costs went up 10%.

But of course, he does not and cannot know in advance how much costs will rise, and he cannot even know if his customers will pay the increased sales price he needs to charge. Remember, we are looking at these business results after the increase in prices has occurred. But no one – not the Fed, not the business owner, not his accountant, and not the customer – can know what these increases will be in advance. Everyone is flying blind, guessing, and taking risks of miscalculation under conditions they have never faced before.

This is why a significant effect of an undue increase in the money supply (my preferred definition of inflation) is the difficulty (a near impossibility) of making reasonable economic calculations. This difficulty in planning applies equally to producers as well as consumers. All market participants are confused, and virtually everyone is surprised by the outcome. This uncertainty leads to major economic behavior changes in businesses and their customers. These changes in behavior then add further uncertainty to business conditions.

With my made-up numbers, looking backward, it seems easy to see how the businessman is being screwed, but these price changes are not easy to identify in real life. For example, the businessman might not realize that he must raise prices substantially to keep his business going, even though this lack of knowledge might be lethal to his business. Under inflation, neither the business owner nor the customer can know in advance how much to charge or how much to pay.

The example also illustrates the effects of financial repression. Notice how taxes almost double the first year, then continue rising at 10%. This is a significant increase in actual revenue for the government, even as the business owner's real profit is declining. Note, and this is important, that under inflation, the business owner is losing more real wealth to the government than ever before.

Please recall our discussions of financial repression. One essential element of repression is that the government needs to inflate prices to collect more taxes, as shown by this example. In collecting these taxes, the government leaves the business owner poorer than before the inflation began. So this is a concrete example of how financial repression robs the real wealth of business people and savers and transfers it to the government so they can increase spending or pay down their debts with inflated money. I hope you see here how heavy-spending government benefits at the expense of its citizens under inflation. It is the classic way to raise taxes and confiscate real wealth without the people realizing it. This is the mechanism by which governments inflate their way out of debt.

One lesson here is that inflation (i.e., money creation) may have effects that look good on the surface, like increased profits. But don't confuse increased profits with an increase in actual wealth or with real economic progress. On the contrary, this example explains how the surge in corporate profits was caused by the Pandemic-related surge in money supply, which is the most blatant act of inflation by the government in my lifetime.

ECONOMIC REVIEW

How Much Have Record Corporate Profits Contributed to Recent Inflation?

Firms raised markups during 2021 in anticipation of future cost pressures, contributing substantially to inflation.

January 12, 2023 | Economic Review | Inflation | Macroeconomics | Inflation Research

OK, back to "greedflation." There is no lack of anti-business pundits and economists ready to reverse cause and effect and blame the business people for inflation. A recent Kansas City Federal Reserve Bank study concluded that corporate profits "account for" a large percentage of the increase in CPI. So I can imagine that in the eyes of the PhDs at the Kansas City Fed, the business owner in our example is guilty of price-gouging his way to inflated profits, even as his standard of living declines by 23%

Their twisted reasoning assumes that businesses can arbitrarily raise prices, thus raising their profits, and that this is the cause of inflation. But their claim is exactly the opposite of reality. The actual mechanism is that money creation inflates demand, thereby inflating prices and nominal profits. So higher profits are a result of inflation, not the cause of inflation.

Business decision-makers set prices based on perceived market conditions, over which they have little control. Despite what Elizabeth Warren and Joe Biden say, they are not in a position to jack up prices at will.

MARKETS | HEARD ON THE STREET

'Greedflation' Is Real—and Probably Good for the Economy

Companies have used inflation as excuse for big price increases, first-quarter earnings suggest

By Jon Sindreu Follow

Updated May 25, 2023 12:10 pm ET

And I am sorry to say that at least one alleged defender of capitalism, *The Wall Street Journal*, is not getting it right. Here is an appalling article from May 25th, reminiscent of the Gordon Gekko "Greed is Good" speech from the movie *Wall Street*. In the author's view, raising prices is an inherently bad thing, but it's a necessary thing that can be "excused," that is, morally justified. And the self-contradictory justification seems to be that despite the inherent immorality of price gouging, profits serve a positive social function, so they should be permitted. The implicit assumptions are not only that business people are in a position to raise prices at will but that under normal conditions, they should minimize their profits for the good of the rest of us,

except when the greater good justifies higher profits. Of course, as our example shows, nothing could be further from the truth.

Higher Corporate Profit Margins Aren't Causing Inflation

TAGS Booms and Busts, Economic Policy, Inflation

05/30/2023 • Reza Eghbali

It is hard to ignore the headlines about US corporate profit margins stabilizing at their highest level in decades. This information has provided plenty of ammunition for populist commentators and politicians who blame corporate greed for the sharp increase in

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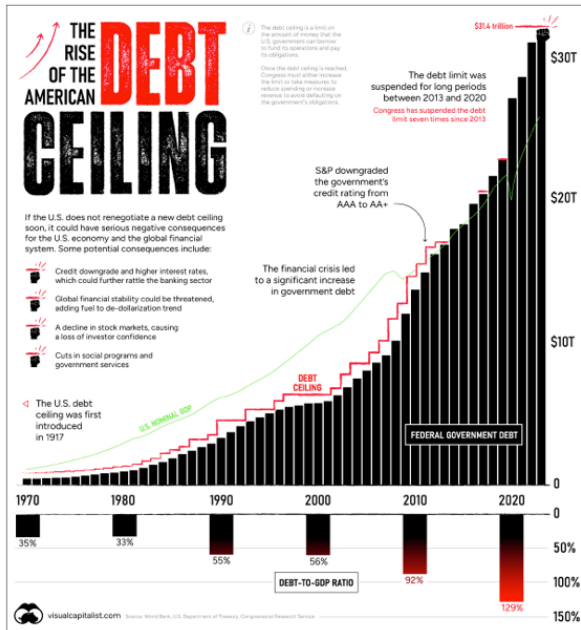
postcovid consumer prices and ignore the elephant in the room, which is a more than 40 percent increase in broad money supply after March of 2020 mostly due to central bank balance sheet expansion and the monetization of massive budget deficits.

On a brighter note, a few better writers are tackling this subject. In this article from last Wednesday, the Mises Institute got it partly right, but even they did not identify the crucial point that production occurs over time. The report also neglected the tax issue. So two cheers, or maybe one and a half cheers, for Mises.org in this case.

So to wrap up this first section, my final message on this topic is: As you read popular economic journalism, read it carefully and critically, no matter the source. Stick to facts and logic; you will often come up with a different answer than the sources you thought were sympathetic to free markets. And if you have a personal interest, you will be doing yourself and others an excellent service by studying sound economics, becoming an economist or a financial journalist, and reporting the facts fairly.

[pause for questions or comments]

PART TWO: THE DEBT CEILING (The Hogwash Fables)



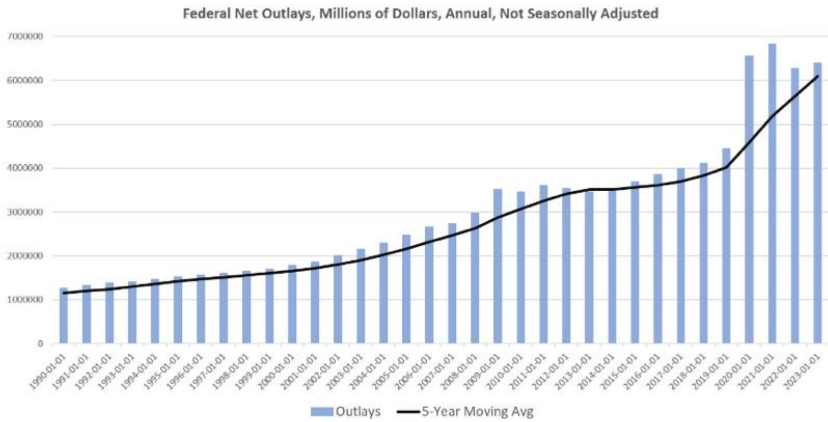
OK, so now, onto part two, the debt ceiling debate. In this golden age of misinformation, we find ourselves in, the fables surrounding the recent debate on the US debt ceiling are the epitome of a false narrative.

Politicians are spreading at least three giant falsehoods through the mainstream news. I call them the Hogwash Fables. Let's discuss each in turn. Some of the following information is compiled from the Mises Institute, and some are from me.

Hogwash Fable number one: The Republicans want to control spending

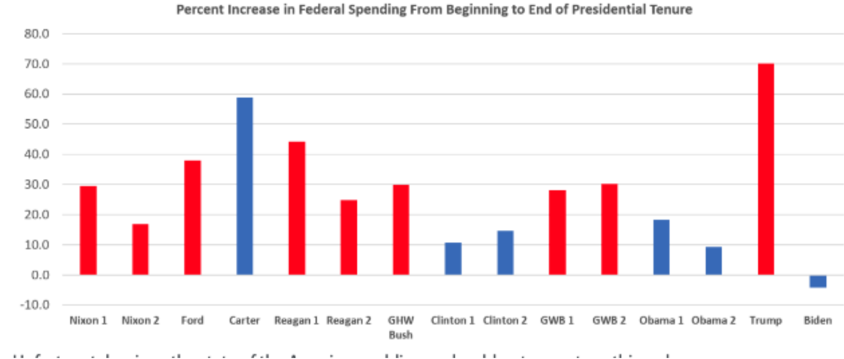
When politicians talk about spending cuts, they are really talking about *small reductions in the rate of increase* in spending. For example, if defense spending has been increasing at 2 percent per year, then an increase next year of 1.5 percent will be identified by some politicians as a "cut." In reality, it's not a cut at all, of course. It is an actual increase, just less than someone else projected. It is equivalent to saying: I might have gained 20 pounds this year, but instead, I gained 10 pounds. The result was that I lost 10 pounds.

In the current debate, the Republicans said they wanted "less spending than last year" for the 2023 fiscal year and a "cap" on spending at 1 percent increases each year for the next ten years. But under the bill passed yesterday by the Republican-led House, spending will continue to grow rapidly. But still, in the minds of most Washington politicians, any slowdown in the flow of free money is branded a "cut."



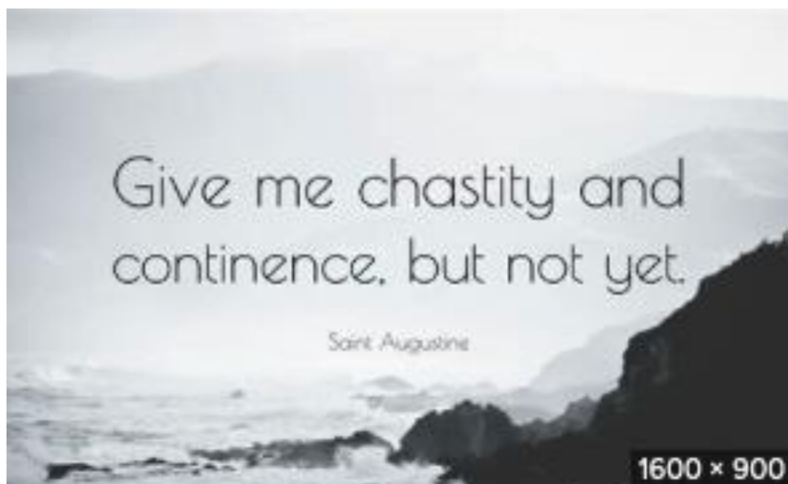
But before anyone claims this is some meaningful "cut," let's look at the federal outlays over the past twenty years (the 2023 FY total is CBO's forecast).

Do you see any trend toward moderating spending here? I see the opposite.



And here is a record of percent increases in spending under Republican and Democrat administrations. Three of the top four increases are under Republicans (Trump, Reagan, and Ford). Jimmy Carter is in the number two spot.

Both sides want to keep spending. The squabbles between left and right are only over non-essential symbolic issues. For example, Republicans wanted to install some token work requirements as a condition for receiving certain welfare payments. Neither side will even touch social security or Medicare, even though these programs will obviously have to be reformed someday.



Someday, but not today. Some of these Republicans remind me of St. Augustine, the famous church father of the early 5th Century, who wrote about his struggle to control his illicit desires. Augustine longed to do the right thing in the Church's eyes, but not just now, he said, not today. Similarly, these virtue-signaling politicians hope to enjoy the fruits of their spending sins a little longer before they repent. "Let me bask in the pleasures of my fiscal sins a little while longer before I submit to the reality of fiscal responsibility."

So that is hogwash fable number one: despite what they say, with rare exceptions, our politicians, especially most Republicans, are not serious about controlling spending.

Hogwash fable number two: The US Has Never Defaulted, so we cannot default now

A mainstay of the debt-ceiling and budget debate is the claim that they had to reach an agreement immediately because the Treasury is running out of money, and the USA cannot fail to pay any of its obligations. After all, they say, the US has never missed a payment.

But this is not true. The US has defaulted on its debt on at least three occasions. The first was after the American Revolution when the US defaulted on domestic loans. After the new constitution was adopted in 1790, the federal government renegotiated past debt at less favorable terms for the investors. That was default number one.

Then there was the Greenback default of 1862. The original greenbacks were $60 million in demand notes, redeemable in gold or silver. Less than five months later, in January of 1862, the US Treasury defaulted on these notes by failing to redeem them on demand. That's default number two.

The most blatant default was the Liberty Bond default of 1934. The US was contractually obligated to pay back its debts on these war bonds in gold. Franklin Roosevelt defaulted by refusing to redeem them in gold to Americans and further devaluing the dollar by 40 percent against foreign exchange. That's default number three.

Then there was the short default of 1979. As the late financial analyst Jason Zweig noted in 2011:

In April and May 1979, amid computer malfunctions, heavy demand from small investors, and in the wake of Congressional debate over raising the debt ceiling, the U.S. failed to make timely payments on some $122 million in Treasury bills. The Treasury characterized the problem as a delay rather than as a default. But the U.S. was promptly sued by bondholders for breach of contract. So that was probably default number four.

Then there is the ongoing soft default of inflation that pays back government debt in debased dollars. So, when you hear Joe Biden, Janet Yellen, or any other politician insist the US has never defaulted, you know better. You might even say the US government is already in perpetual default.

Hogwash Fable Number Three: Failure to reach a debt ceiling agreement will result in default.

This argument claims that failure to raise the debt limit will result in default because the federal debt clause of the 14th Amendment means all government bills must be paid in full and on time. There is no ability to prioritize or delay some payments over others. In other words, this argument claims Treasury is not permitted by law to prioritize payments using available funds.

But we know that If there was no deal at all, the Treasury could and would prioritize its payments using available funds. We know this based on the words of the paymaster herself, Treasury Secretary Janet Yellen.

> *"We take the debt ceiling seriously as a constraint on our ability to pay bills that are coming due. And my assumption is that if the debt ceiling isn't raised, there will be hard choices to make about what bills go unpaid."*
>
> *"We have to pay interest and principal on outstanding debt. We also have obligations to seniors who count on Social Security, our military that expects pay, contractors who've provided services to the federal government, and some bills have to go unpaid,"… I would say we're focused on raising the debt ceiling. And there will be hard choices if that doesn't occur.*
>
> ▪ **Janet Yellen on *Meet the Press*, May 21, 2023**

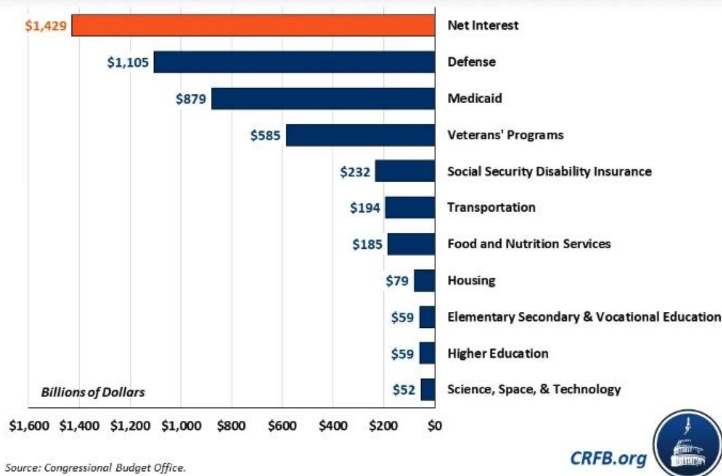
And by the way, there was always enough revenue to pay interest on the debt plus Social Security and Medicare. So even if there were no deal at all, the Treasury would prioritize payments to keep the government going. In her own words, Secretary Yellen would have started to make the "hard choices," paying some bills but not others.

This entire debt ceiling debate was a farce. The closest analog to it is Kabuki Theater. Kabuki, as you know, is a highly symbolic, heavily stylized Japanese art form. Here are the main characteristics of Kabuki theater, which I looked up on a popular website on the subject

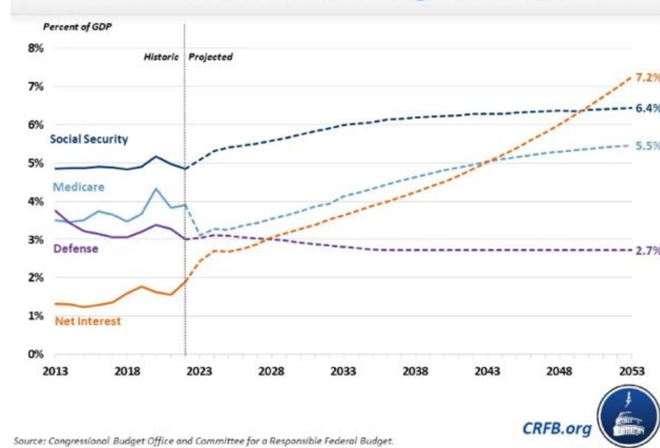
- “Kabuki” means the “art of song and dance” incorporating mime, elaborate costumes, and extravagant backdrops.
- Kabuki is a “grandiose visual spectacle” focusing more on looks than story.
- Kabuki dramas depict tales derived from historical myths. (Like the myth of the balanced budget, maybe?)
- Facts, reality, and consistency take a backseat to fantasy, elaborate costumes, and supernatural transformations.
- A related Japanese verb**, “***Kabuku,” means “to behave oddly.”*

Please let me know if you can think of a better analogy to the current debt farce. The kabuki theater of the debt limit debate is a way for politicians to pretend they really do want to pay down their unpayable debt. It is a way to pretend they are responsible stewards of government spending. But it is all theater. To me, this latest debt ceiling performance confirms that we are on a long road of inflation that will have to be addressed by financial repression, which means high consumer price inflation and suppressed real interest rates.

Before we leave this topic, here are a couple of charts to remind you of the extent of the federal debt problem.



The breaking point will be the amount of interest expense the Treasury has to pay as it continues to borrow. This year, interest expense is closing in on $1 Trillion per year, already surpassing the defense budget. Here is the projection of the non-partisan Congressional Budget Office, which historically always underestimates the debt burden in its forecasts. So by their rosy scenario, in ten years, interest costs of $1.4 Trillion will exceed every other key spending program.



In the next 25 years, interest costs as a percentage of GDP will exceed 7% and 33% as a percentage of total government spending. That's equivalent to you or me spending $33,000 in annual interest expenses on a yearly salary of $100,000. That would mean you had total debt of five or six times your 100,000 salary, all on your signature only, with no collateral posted. No responsible bank or any other honest lender would lend you that amount. If the government pulls it off, it will be because they control the interest rate.

Simply put, the superficial debate over the debt limit masks the real problem: Our debt is unpayable in current dollars. The problem must be resolved eventually, but there is no appetite to do it now because these reckless spending programs are popular, and the people elect the politicians who keep increasing the deficits.

However, I can only partially blame the masses for clinging to these spending programs. After all, if you force-feed a goose for its entire life, can you expect it to turn down the next meal? No, he becomes dependent on the force-feeding, so he's unlikely to give up his barnyard complacency.

My urgent advice to you is: Plan your financial affairs so you are not like this barnyard goose and are not dependent on a master who force-feeds you into submission with inflated dollars.

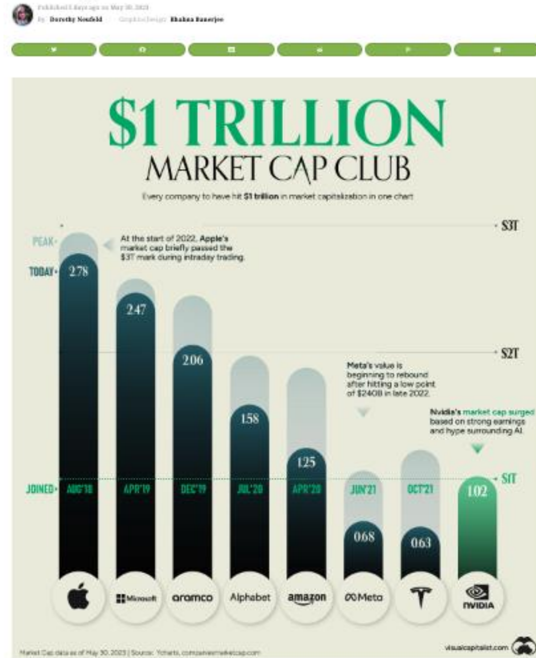
[comments, questions]

PART THREE: NVDA (the semiconductor company) JOINS THE TRILLION DOLLAR CLUB

Charlie Bilello @charliebilello · May 27
2023 Returns
NVIDIA $NVDA: +167%
Facebook $META: +118%
AMD $AMD: +96%
Tesla $TSLA: +57%
Amazon $AMZN: +43%
Google $GOOGL: +41%
Microsoft $MSFT: +39%
Apple $AAPL: +35%
Nasdaq 100 $QQQ: +31%
S&P 500 $SPY: +10%
Dow $DIA: +1%
S&P 500 Equal Weight $RSP: +.3%
Regional Banks $KRE: -31%

Finally, I'd like to share a few comments about the extraordinary price action of the last few weeks in artificial intelligence stocks. These stocks are Facebook, Amazon, Apple, Netflix,

Google, Microsoft MD Micro Devices, Netflix, Microsoft, Nvidia, and Tesla., also knowns as "FAANG + MNT." They are led by NVDA, which is up 167% in 2023, most of that in the last few weeks.



The euphoria has continued this last week, and Nvidia joined the big four (Apple/Microsoft/Google/Amazon) in the $1 trillion market cap club. (The other stocks on the chart previously surpassed $1 Trillion, but not currently.) notably, this is all due to lofty future expectations, as Nvidia presently has only $26 billion in sales versus $208-525 billion for the other big 4.

Here's a chart showing these expensive companies' last 12 months' revenues. All of them trade on very high expectations of rapidly growing future earnings.

Just how high are these expectations? Nvidia now trades at over 38x sales and over 200x earnings. We've never seen a price-to-sales ratio that high for a company of its size. To repeat, a company with 26 billion in sales is valued at over a trillion dollars in the stock market.

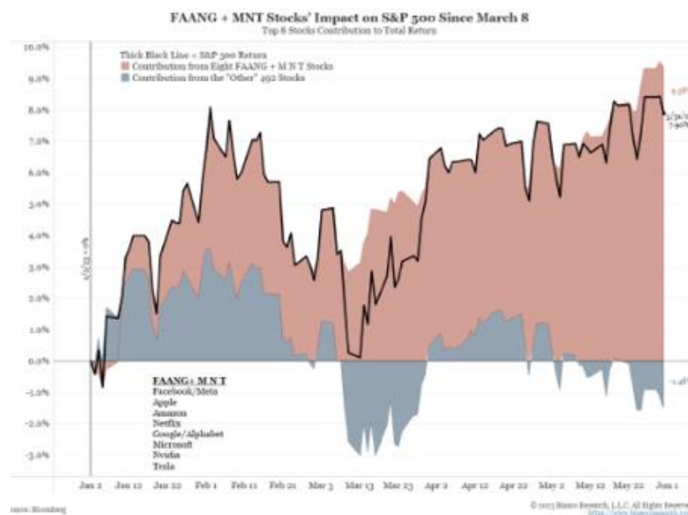
The closest comparison that comes to mind is Tesla, which traded at nearly 30x sales when it hit the $1 trillion mark in 2021. What happened after that? It would go on to decline over 70%, with its price-to-sales ratio falling to 5x.

But valuations, we are told, no longer matter in the age of AI – it's all about growth. Where have we heard that before? In every mania of the past, AI is just the latest example. NVDA represents a paradigm shift in productivity. Tesla represented a paradigm shift in technology as a solution to the problem, or so-called problem, of climate change. It is clear to me that both stock prices are a product of hope and hype.

I'm old enough to remember Amazon in 1999. Amazon, too, was a game-changing company. As part of the tech stock crash of the early 2000s, the price of AMZN declined by 95%. Of course, it

eventually became one of the most outstanding companies in history and has rewarded shareholders well over the long term. But no one knew that for sure in 1999.

I also remember that in the early 2000s, the tech stock rally became very concentrated, just like this one. I knew people who had their entire 401K plans piled into the “Four Horsemen” – Microsoft, Intel, Cisco, and Dell. As the broader market faded, these stocks rallied strongly until they crashed in 2002 and lost 90 percent of their value. All four survived as companies, some became great companies, and some became also-rans. The point is, you didn’t know until well after the fact. Today's hype and the mania around the AI stocks are very reminiscent of this. It’s very speculative, to say the least.



This chart from Bianco Research illustrates how the return in the broad market (the SP500) is concentrated in just a few stocks. These eight AI stocks, which together are 28% of the market cap of the S&P 500, account for more than 100% of the S&P 500 performance. This means that if you are invested in the index, you are heavily invested in eight AI stocks.

Jim Bianco puts it this way (paraphrasing): The stock market can currently be broken down into two broad categories. On one side are the AI/ChatGPT stocks highlighted by the eight mega-tech (FAANG+ M N T) stocks. They are soaring.

Beyond that, the rest of the stock mkt stopped cold when the banks started failing on March 8. The economy needs healthy banks. But maybe the AI stocks don’t need the banks. So what is the message of the market? Tech is booming as it ushers in a paradigm shift in the economy. The rest of the economy is “stuck in the mud” since the banks struggled.

To be clear, AI is a paradigm shift that will change the world. I use ChatGPT, and I am not exactly an early adopter of technology. It’s an immense productivity tool. And I urge you all to try out ChatGPT or another emerging app. Just treat it like it’s your personal assistant. It is not always right, but it helps you think of alternatives you have not considered.

So while NVDA (and the other AI stocks) represent a game-changing technology, its runaway stock price is most likely an all too common tale of excessive hype. So my closing message is, be careful out there, and if you are in the stock market, understand what you are invested in.

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Coming in July 2023:

A six-session course on "Modern Money Creation And Its Consequences.," offered exclusively on the ARC-UK YouTube Network.