If Stock Markets Jump Up or Down, Does Real Wealth Change?

Not even close! There has never a more emphatic **disconnect** between the Financial Wealth driven by the extraordinary floods and purges of liquidity (money and credit), and the Real Wealth within the economy.

Imagine the aggregate stock exchanges rocketing up say 10% in one "super" day. The perception of 98% of all economists and 99.9% of all financially adept minds today is that, in fact, wealth has increased 10%. They have been conditioned to believe stock markets are generally efficient and the day-to-day prices reflect the real values (hence "real wealth") of the traded businesses, which are made up of capital stock, inventories, good will, etc. Wall Street would ding their little bell, applaud themselves at the end of the trading session, then go home and sleep soundly believing they have actually created extraordinary wealth that day. How heroic!

Austrian Enginomics views the financial world in an entirely different context. It requires a paradigm metamorphosis to grasp the "Real Wealth" concepts.

What is "Real Wealth"?

"Real Wealth" is ultimately that which all humans seek from an economic context, NOT MONEY! All fiat currency and debt securities are at best contracts to ***acquire*** Real Wealth. Real Wealth is exclusively Goods, Delivered services, Infrastructure, natural resources, and Human Capital. Recognizing natural resources as a given within any sovereign country, incremental Real Wealth can ***only*** be created from work [(1)] (labor). ***One cannot WILL Real Wealth into existence!***

Businesses are a subset of the aggregate **Real Wealth** on earth, and are made up of **Goods** (including raw, work-in-process, and finished goods inventory), **Capital stock** (including the supporting utilities and building infrastructure, tools, equipment, and etc.), and the most important component **Human Capital**.

Business Real Wealth in aggregate cannot increase without work [(1)] (labor). Even Human Capital must receive training and education to increase Real Wealth for any business. Hence, when the total stock market rockets up (or down) by more than a snails' pace, there is likely a complete disconnect between business Real Wealth and the stock pricing that the financial and political worlds would like you to believe reflects Real Wealth.

What is a Realistic Rate of Real Wealth Increase?

The answer to this question should be a very high correlation with a long-term legitimate stock market price level.

Since only work creates real wealth, then the amount of labor and its efficiency are the sole drivers of aggregate wealth creation and enhancement. In the past 50 years U.S. population and employment hours have increased approx. 1.0% per year. Further, in the past 50 years the efficiency of U.S. labor (productivity) has increased an average of 2.0% per year. Hence, the sum of the two drivers noted (3.0%) is the legitimate amount that our aggregate stock markets should raise in REAL terms each year over the long haul. Add in our Central Bank's inflation target of 2.0% you now total 5.0% in nominal terms for a realistic aggregate stock market increase per year. That calculates to a 0.02% increase per day! That is ***two-hundredths of one percent per day!*** (i.e. less than 3 points on the DJIA!!). I would assert that is a "snails pace" in real growth each day.

Not to be disappointed in the snail pace numbers a 2.0% annual productivity improvement will yield a DOUBLING of our real buying power per capita in a short 36 years. That is very powerful and achievable for an industrialized country. The rates of 8-10% in China and 6-8% in India may be realistic for underdeveloped countries trying to catch up.

Is There a Disconnect Between the Financial Markets and the Real Economy?

We have become conditioned to expect a 1-2% daily volatile move in the market. We're jubilant when the market goes up and depressed when it goes down. That 1-2% "Financial" change per day is not even on the same planet as the "Real" 0.02% per day. What's concerning is the expectation of the average investor to see their Real Wealth nest egg increase 10-15% per year. Those expectations inevitably pressure government, our central bank, and the financial cartel including major investment banks, commercial banks, hedge funds, private equity companies, agencies, etc., to supply ample liquidity (money and credit) that enable the popular market advances into bubble-insanity. ***LIQUIDY Injections ARE NOT and DO NOT CREATE REAL WEALTH!!!*** They create an ***illusion of wealth***. Austrian [(2)] Economic theory teaches us that government injections of money and associated credit temporarily boost select segments of the economy, which must later contract because they were propped up artificially (read the housing market bubble). Austrians describe this as malinvestment and a misallocation of resources.

Because of the relentless liquidity injections severely outweighing any contractions since 1971 [(3)] and especially in the past 15 years, all financial markets are in bubble altitude. See my last missive to grasp the magnitude of these extraordinary bubbles here…
http://austrianenginomics.com/AndNowTheGreatestBustinUSHistoryA.pdf

What if We Were on a Gold Standard?

A TRANSFER of gold from one to another does not create real wealth; it is simply a transfer of Real Wealth. Humans cannot manipulate the aggregate quantity of gold on earth. They cannot will it into or out of existence. They can certainly manipulate its transfer of ownership and pursue unproductive hoarding. If accompany "A" stock is bid up in price one day because of an exciting new development, even if gold (as money) was transferred from some source to company "A" shareholders, real wealth has only been transferred; NOT created. That stock move up may be justified, if the entrepreneur is able to fulfill the future profit expectations due to the new development. Real wealth has not been created or enhanced UNTIL the improvements are realized, which will take months or years.

Value is always relative. If an investor values stock "A" more than stock "B" that he owns, he may bid on stock "A" forcing the price up, but stock "B" MUST come down when he sells it, otherwise the aggregate stock valuation (read price and market cap) becomes out of line with the real wealth make-up of the companies (capital stock, human capital, inventories, etc.). Certainly limited short-term market volatility is in order for the mechanics of the trading process to function. However, without the systemic central liquidity manipulation, the total market cap valuation increases would stay in line with the "snail's pace" Real Wealth creation. Lot's of assumptions here, but hopefully you get the idea.

Bottom line…. The stock market would only move up an average of 0.012% per day (1% population increase and 2% productivity increase divided by 250 days) assuming all businesses including gold-mining companies increase productivity at a 2% annual rate. Volatility would be massively reduced because humans controlling the expansion of credit would be on a very tight leash, since they would no longer have the power to create rampant liquidity illusions that find their way into our equity markets. Just imagine…. If we ditch our unfair and manipulated fiat currency charade, we might find those who capitalize upon the daily financial market volatility and the puffed-up financial world actually shift into industries that produce consumable, durable, or capital goods. Many of America's greatest minds would leave the liquidity manipulation world and enter the industrial world to enable our long-term global competitiveness.

Conclusion

Sudden market increases do not reflect an increase in Real Wealth; nor do sudden stock market decreases reduce Real Wealth. By converting to a fiat-money system in 1971 [(3)] we have gradually enabled a complete disconnect between the Financial economy and the Real Economy. Anytime a politician or our central bank feels compelled to "do something" about the economy, the go-to course of action is to goose it with more liquidity. That process only exacerbates the imbalances and illusions that exist, and makes the inevitable return to stability that much more abrupt and painful. I expect the illusory assets to become exposed when Boomers all over the world begin leaving the work force in mass beginning 2008-2010. The Boomers then tasking (cashing in) the financial assets will force a re-pricing we have never experienced in the history of the Republic.

References:

(1) An important point; work is NOT necessarily proportional to Real Wealth! More labor does not necessarily yield more value, or real wealth. If I take twice as long to paint a room, the delivered service of painting the room is no more valuable. The work element is simply always a condition required to produce Real Wealth.
(2) See the www.mises.org web site for more details on the Austrian Economic Theory.
(3) President Richard Nixon abandoned the Bretton Woods quasi-gold backed currency standard agreement in 1971. Ref: http://en.wikipedia.org/wiki/Bretton_Woods_system

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