

A Market Without Parachutes

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The Long Fall

America is finished, washed up, kaput. Foreign investors and central banks around the world have lost confidence in US markets and are headed for the exits. The dollar is sinking, the country is insolvent, and its leaders are barking mad. That's bad for business. Investors are voting with their feet. They've had enough. Capital is flowing to China and the Far East in a torrent. It's "sayonara" Manhattan and "Hello" Tiananmen Square.

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The dollar fell another 2% last night, gold soared to \$840 per ounce, oil topped \$98 per barrel, General motors reported a \$39 billion loss after the market closed on Tuesday, the real estate market continued its downward slide, and the major investment banks are marching in lock-step towards bankruptcy.

The news is all bad. The nation's economic foundation is in shambles. US credibility is shot. Bush and Greenspan have put us on the road to ruin. Now their work is done. We're flat broke.

The catalogue of fiscal ailments now facing the country is too long to list. We'd need a ledger the size of a small encyclopedia. There's been a stampede away from the dollar even though it's already lost over 60% of its value since Bush took office and even though central banks around the world will lose their shirts if it collapses. They don't care. They're getting out while they can.

Cheng Siwei, the vice chairman of China's National People's Congress, announced yesterday that China would continue to diversify its \$1.4 trillion reserves away from the dollar to "stronger currencies" like the euro. "Strong currencies"; isn't that Paulson's line? Siwei's comments ignited a firestorm in the currency markets triggering a big blow-off of the greenback. The poor dollar has no place to go now but down, and it's on a greased pole to the bottom. With consumer spending paralyzed by the decline in home equity and frozen wages, and the banks "stuffed to the gills" with over a trillion dollars of mortgage-backed sludge; the prognosis for the hobbled dollar is looking grimmer by the day. The bulging trade deficits and dwindling foreign inflows haven't helped either. The greenback has suddenly become the global pariah; all it needs is a leper's rattle and a tin cup.

The news is no better in the real estate industry either, where the nation's biggest builders are reporting record losses and inventory is backed-up 11 months. Sales are off 22% in one year alone. Foreclosures are skyrocketing, jumbo loans (over \$417,000) are impossible to get regardless of one's credit history, 40% of all mortgages (subprime, Alt-A, piggyback, reverse amortization, interest-only) have been eliminated, and entire projects in Florida, Arizona, Las Vegas, and California's Central Valley have stopped building altogether. Tens of thousands of unoccupied homes across the Southwest have been reduced to ghost towns. Nothing is selling. The building boom, that began when Alan Greenspan ginned-up the Fed's printing presses in 2002, has turned into the biggest housing bust in American history.

On top of that, the banks are tightening lending standards and shunning potential buyers just when the economy needs a boost in demand. Loan originations are down and bankers are spooked by the gathering storm in the credit markets. That means that home sales will continue to be sluggish, prices will correct more quickly, and the anticipated "soft landing" will turn into a full-blown crash.

New home construction has accounted for 2 out of every 5 new jobs created in the last 5 years. Most of those workers are either delivering pizzas, cleaning bed pans or are lining up at the soup kitchen. The BLS's numbers on employment are bogus. It's just more government bunkum. They're predicated on a "birth-death" model that creates millions of fictitious jobs out of whole cloth. In truth, unemployment is soaring and the most vulnerable and impoverished among us are taking a beating from housing debacle.

According to the Mortgage Bankers Association of Washington, the total of mortgage loans outstanding in 2006 was \$10.9 trillion; \$6 trillion of which were transformed into securities. (CDOs, MBSs) About \$1.5 trillion of those securities are subprime; another \$1 trillion Alt-A (nearly as risky) and at least another \$1.5 trillion in adjustable rate mortgages (ARMs) At least 20% of these shaky liabilities/securities will default, and yet, no one really knows who is holding them on their books. All of the major financial institutions—the insurance companies, foreign banks, hedge funds, investment banks---have purchased these CDO "roadside bombs" and mixed them in with their other performing loans and hard assets. The projected explosions have already begun to take their toll on the financial giants---Citigroup and Merrill Lynch are just the latest victims; others will follow. The problem can't be fixed with Bernanke's low interest rates. The bad debts are everywhere and must accounted for and written down. That puts us on the threshold of a jarring market-downturn triggered by an unprecedented number of defaults that will rumble through the entire system. Bankruptcies will pop up everywhere at random. It is a blueprint for economic chaos. And it is unavoidable.

The global markets have never seen a financial typhoon of this magnitude before. Mortgage lenders, homeowners, banks, hedge funds, bond insurers, etc. will all either go under or feel the sting of a slumping market.

Many of the major investment banks are already broke; it's clear from their own reporting. Charles Hugh Smith sums it up like this in his recent article "Empire of Debt: The Great Unraveling":

"If their bad bets were marked to market, Citicorp and Merrill Lynch would be declared insolvent. Why? Because they are insolvent-right now. The meaning of insolvency is straightforward: their losses exceed their capital. Recall that these firms list assets of \$100 billion (or whatever) but their actual net capital is on the order of 2.5% to 5%---a mere sliver of their stated assets. In other words: a 5% loss of their stated assets wipes them out.....The game is now over, and the players shuffling losses can only last a few more days or weeks."

Up to this point, the banks have been able to place a sizeable portion of their "hard-to-value" assets in a Level 3 grab bag, which allowed company accountants to assign a value to those assets according to their own judgment. No more. The new FASB 157 regulation will force the banks to use "market prices" to determine the true value of their holdings. Some analysts believe that these new disclosure rules may result in \$200 billion write-downs on assets and require that the over-leveraged banks to increase their capital reserves. That will slow down lending and put a wrinkle in the banks' bottom line. In any event, once the law is enacted; we'll see who's "faking" the value of their assets or as Warren Buffet says, "Who's swimming with their clothes off."

Professor Nouriel Roubini summed it up like this:

"The amount of losses that financial institutions have already recognized - \$20 billion - is just the very tip of the iceberg of much larger losses that will end up in the hundreds of billions of dollars....Calling this crisis a sub-prime meltdown is ludicrous as by now the contagion has seriously spread to near prime and prime mortgages...And it is spreading to every corner of the securitized financial system that is either frozen or on the way to freeze....The reality is that most financial institutions have barely started to recognize the lower "fair value" of their impaired securities....The credit crunch is getting worse and its financial and real fallout will be severe." (Nouriel Roubini blog)

The constant drumbeat of bad news is having a numbing affect on Wall Street. Traders' are tight-lipped and downcast. Spirits are sagging. No one likes loosing money, and yet, the credit storm shows no signs of letting up anytime soon. Yesterday, the Dow Jones Industrial's took another 360-point pounding before the bell rang. Another day, another bloodbath. The subprime virus has now infected the broader markets leaving the once-brawny financial giants bruised and reeling like Joe Frazier in the Thrilla in Manila. A few more down-days like yesterday and they'll be carrying out hedge funds feet first. The stock market is looking more and more like a glass pitcher propped up on the edge of a bookshelf. One little bump, and down she goes.

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