

# A Threat to Global Financial Stability: The Fed's Taper Sends Global Shares and Emerging Markets Tumbling

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*The selloff that began in May 2013, when the Fed announced its plan to scale back its asset purchases, resumed with a vengeance on Monday as global shares were slammed in heavy trading sending the Dow Jones for a 326 point-loss on the day.*

The proximate cause of the rout was a worse-than-expected manufacturing report and sluggish construction spending, but the underlying source of the trouble was the Fed's decision to wind down QE which, according to Bloomberg news, "helped drive the S and P 500 up 157 percent from a 12-year low in 2009." The Fed's tightening has reversed the dynamic that pushed equities into the stratosphere and generated an unprecedented boom in the emerging markets. Now capital is fleeing the EMs to the safety of US Treasuries while jittery investors ditch stocks and wait to see if the storm passes or gradually gains strength.

The mood on Wall Street has turned bearish overnight as markets in Europe and Asia continue to hemorrhage led by another bloodletting on Japan's Nikkei which has slumped by a full 14 percent since its Dec. 30 peak. Societe Generale's emerging market strategist, Benoit Anne, summed up the mood in a terse note to her clients saying, "There is no point spending too much time trying to pick and choose when faced with a severe market crisis like the one we are witnessing in front of our screens. Right now, sell everything."

Markets have entered a new phase in the ongoing financial crisis, a crisis which originated on Wall Street where trillions of dollars of fraudulently-manufactured "toxic" assets were produced by a criminal bank cartel and sold to unsuspecting investors around the world. Rather than write down the losses and restructure the banking system, policymakers at the Central Bank and US Treasury opted to conceal the damage with massive bailouts, financial repression, zero rates and regular infusions of liquidity, all of which helped to hide the rot at the heart of the system. The Fed's plan to taper has removed the veil and exposed the weakness of an undercapitalized system that has been made more unstable by 5 years of misguided policy. This is real source of the problem.

Just as the Fed's uber-accommodationist policy lifted stocks to record highs in the months preceding its taper announcement, so too, the withdrawal of central bank support is likely to increase the pace of the decline. That is why we expect the taper to be implemented in a stutter-step manner, stopping and starting sporadically depending on conditions in the market. Naturally, this will undermine the Fed's attempts to send investors a clear message about the direction of policy. It also means that new Fed chairman Janet Yellen is going to

spend less time trying to maintain the Fed's mandate of "price stability and full employment" then simply putting out fires. Here's a clip from Naked capitalism with some background on the turmoil:

"Since Bernanke started talking about "tapering off" Quantitative Easing, the bond markets have freaked out. This is a very logical reaction....Bernanke and other Federal Reserve economists appear bewildered by this phenomenon. The impression one gets from their follow-up comments is that they wished they could ask bond speculators "did you read the damn speech?" The answer, of course, is no and for good reason.

All investors need to know is the conditions under which QE ... will be pursued has changed. Now the substantive change may actually be relatively minor, but that's irrelevant to speculators. The reason is very simple: those holding assets with longer maturities will take huge capital losses with relatively small changes in interest rates .....It is better to exit now when those future changes are uncertain than take even more massive losses." ("Market rout continues, proving abject failure of Fed's forecasts and policies", Naked Capitalism)

This is the logic of selling early even though the reduction of asset purchases is still in its opening phase. There's no sense in waiting until the last minute and taking a chance of getting trampled in the stampede to the exits. Just cash in and relax.

The Fed's trillion cash injections have created a fantasy world of ever-rising stock prices that's gradually giving way to the emerging reality of dismal earnings, chronic-high unemployment, droopy incomes, stagnant wages, swollen P/E ratios and a bloated financial sector that requires a larger and larger share of the nation's wealth to avoid another devastating collapse. This is the situation we find ourselves in today, a situation that is papered over with propaganda about meaningless data points that fail to identify the real source of the problem, which is the gigantic capital hole created by the toxic assets that have not yet been written down, but are still sucking the life out of the bedraggled economy via debt servicing, rate and liquidity subsidies, and the reshaping of economic policy to preserve zombie institutions which need to be euthanized.

The problem is not hard to grasp, in fact, most people will understand what's going on by just reading this two-paragraph excerpt from an article which appeared in Forbes magazine back in February, 2009. Here's a clip from the piece titled "Zombie Firms and Zombie Banks":

"Beginning in 1991, Japan experienced a financial crisis that has been documented and studied by many. Japan's crisis was triggered by a real estate and equity price bubble followed by a collapse of equity and real estate prices. But unlike the examples I cited above, Japanese policymakers met the crisis with prolonged denial and then, when conditions forced recognition of the severity of the problem, very halting steps to address it. Banks were not forced to recognize the condition of their balance sheets and were encouraged to continue lending to firms that were themselves unprofitable. Anil Kashyap labels these "zombie firms."

Zombie banks continued to direct capital to zombie firms. This charade continued for more than a decade, with the result that the once-powerful Japanese economy was completely stagnant for that period. The government's main response was to dramatically increase spending on infrastructure and

frantically try to get Japanese households to save less and consume more. The resulting “lost decade” of economic growth cost Japan more than 20% of GDP.” (“Zombie Firms And Zombie Banks”, Thomas F. Cooley, Forbes)

Sound familiar? This same phenom is playing out in the US today. The Fed has spared no expense to perpetuate the illusion that the zombie banking system is solvent and that the trillions of dollars in losses from worthless assets has somehow vanished into thin air. But they haven’t vanished. They are either hidden-away via accounting trickery, passed off to gullible, yield-crazed investors, or transferred onto the Fed’s bulging balance sheet. In any event, the debts are real, they’re impeding the recovery, they’re sucking the life’s blood out of the economy, and they’re clear and present danger to financial stability.

The red ink has to be purged, just as the rickety, Potemkin banking system has to be put out of its misery. We need a fresh start.

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