

# Financial Meltdown: Haircut Time for Bondholders

By [Mike Whitney](#)

Global Research, March 12, 2009

12 March 2009

Region: [USA](#)

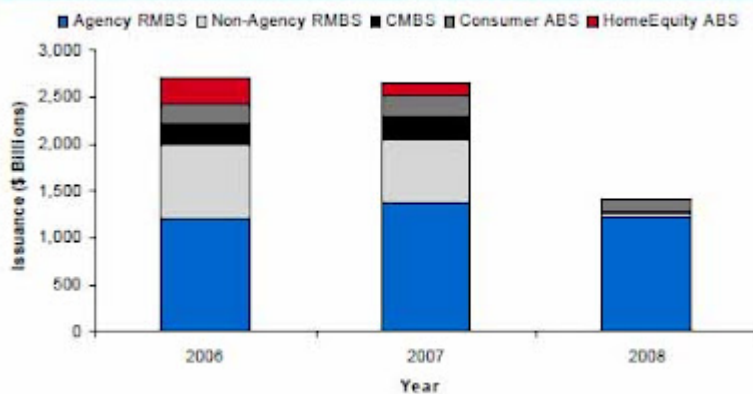
Theme: [Global Economy](#)

“The only function of economic forecasting is to make astrology look respectable.” John Kenneth Galbraith

When George Soros recently said that the financial system had “effectively disintegrated”, it caused quite a flap. But Soros was not exaggerating. The financial system has disintegrated. What we are experiencing now is just the fallout from that event. This is easier to understand by using an analogy. Imagine watching the demolition of a hundred-story skyscraper. After the explosives detonate and the building implodes, the chunks of debris and the shattered glass begin to fall to the ground below. That’s where we are right now. The financial super-structure has already been blown to bits, but a thick shower of fragments keeps raining down on earth. Rising unemployment, falling consumer confidence, severe contraction of the economy, growing pessimism; these are all the knock-on effects of a full-blown system collapse.

Take a look at this chart and you’ll see what I mean. The chart explains in simple, graphic terms everything that one needs to know about the financial crisis.

**Consumer and Real Estate Securitization Volumes Declined \$1.3T Since 2006.**



Source: Bloomberg, SIFMA, Banc of America Securities – Merrill Lynch.

As you can see, the upper part of the graph disappears in 2008, as though it was surgically removed. That is because in 2008, the source of funding for residential mortgage-backed securities (RMBS), commercial mortgage-backed securities (CMBS), consumer asset-backed securities (which include everything from student loans, credit cards, and auto loans) and home equity loans has almost completely dried up. In fact, all that’s left of the previously vibrant credit markets, is the agency mortgage-backed securities sold through Fannie Mae and Freddie Mac which rely exclusively on government funding. Apart from government sponsored GSEs, there is no mortgage credit.

What does it all mean? It means that Wall Street’s credit-generating mechanism has

disintegrated cutting off 40 percent of the blood-flow to the economy. This is why the drop in spending has been so sudden and precipitous. No economy, however strong, can reduce credit by 40 percent without sliding into a depression. Every area of industry, trade, investment, commerce and consumption has been battered. No sector has been spared. Look closely at the chart and you will see why housing will continue to plummet, because the primary funding mechanism for selling mortgages no longer exists; all the applications are now shoveled over to Fannie and Freddie. Wall Street has gone A.W.O.L.

The often repeated mantra “the banks aren’t lending” is a myth. The banks are lending; it is the wholesale funding apparatus that’s broken. That’s why the Fed’s low interest rates have had little effect, because they don’t increase sales in the secondary market where MBS and other complex investments are sold. Those markets are frozen due to investor angst. People are scared out of their wits. Toxic subprime mortgages poisoned the well and now investors have boycotted the entire market for structured debt-instruments. Until there is some resolution on the true value of the underlying assets, the market will remain paralyzed. Investors want price discovery, something that is basic to every market. Here’s what Bank of America’s CEO Ken Lewis said in the Wall Street Journal on Monday:

“The banks aren’t lending. This claim is simply not true. Yes, banks have tightened lending standards after a period in which standards were too lax. But, according to Federal Reserve data, bank credit has actually increased over the course of this recession, and business lending is trending up modestly so far in 2009. Also, mortgage finance volume is booming as a result of low interest rates. What’s gone from the system is the easy credit that got us into this mess, as unregulated nonbank lenders have disappeared, and the market for many asset-backed securities has all but dried up. Most banks are making as many loans as we responsibly can, given the recessionary environment.”

The collapse of securitization (the bundling of pools of loans into securities sold at market) has sucked more than \$1.2 trillion from the credit markets and forced a cycle of deleveraging throughout the financial system. The idea that securities-based lending was viable was predicated on the Radian belief that self-interested speculators could sustain the flow of credit to the system. That notion turned out to be catastrophically wrong. Not only did financial institutions increase their risk exposure by loading up on long-term illiquid assets, (MBS, CDOs, CDSs) they also borrowed heavily on those dodgy assets so they could skim the cream off the top and add to their 7-digit incomes and lavish bonuses. For the better part of a decade, the only things that worried the Wall Street oligarchs was whether the larder at the vacation bungalow on the French Riviera needed restocking or if their were any early morning tee times available at St Andrews. PIMCO’s Bill Gross gave an apt summary of shadow banking system in a newsletter to his investors last year:

“Our modern shadow banking system craftily dodges the reserve requirements of traditional institutions and promotes a chain letter, pyramid scheme of leverage, based in many cases on no reserve cushion whatsoever. Financial derivatives of all descriptions are involved but credit default swaps (CDS) are perhaps the most egregious offenders. While margin does flow periodically to balance both party’s accounts, the conduits that hold CDS contracts are in effect non-regulated banks, much like their hedge fund brethren, with no requirements to hold reserves against a significant “black swan” run that might break them. Jimmy Stewart—they hardly knew ye! According to the Bank for International Settlements (BIS), CDS totaling \$43 trillion were outstanding at year end 2007, more than half the size of the entire asset base of the global banking system. Total derivatives amount to over \$500 trillion, many of them finding their way onto the balance sheets of SIVs, CDOs and other

conduits of their ilk comprising the Frankensteinian levered body of shadow banks.

Pyramid schemes and chain letters collapse because there is no more credit to feed them. As the system of modern day levered shadow finance slows to a crawl, or even contracts at the edges, its ability to systemically fertilize economic growth must be called into question.”

The problem is not simply that securitization has blown up, but that Geithner and pal Bernanke are determined to sift through the rubble to see if they can fit the pieces together again. It's Humpty Dumpty redux. This is what Bernanke's Term Asset-Backed Securities Loan Facility (TALF) is really all about; another pointless attempt to fire-up Wall Street's failed credit assembly-line, securitization. TALF is set to begin in the middle of March and will ultimately get up to \$1 trillion of Fed funding for securitized loans made on credit cards, car loans and student loans. But the plan ignores the fact that the wholesale credit markets already conked out after their first big stress-test and that consumers are no longer in a position to increase their debt-load. Consumer debt is already at 100 percent of GDP, and that's before the recession slashed home equity values by 30 percent and 401ks by 40 percent. That is why personal savings have gone from negative territory in 2006 to positive 5 percent in just 2 quarters. Attitudes towards consumption have done an about-face almost overnight. Bernanke's TALF isn't necessary; what's needed is debt relief and a smaller financial system that meets the new reality.

Besides, what's the point of moving toxic assets from one balance sheet to another or providing another handout to the scamsters and flim flam men at the hedge funds and private equity firms? They're the ones who drove the system into the ditch in the first place. Peter Eavis of the Wall Street Journal explains:

“The Fed needs to lure investors back into the market for these asset-backed securities, or ABS, where new issuance has almost disappeared This has led to a contraction in lending to consumers, deepening the recession. In the fourth quarter of 2008, there wasn't any issuance of U.S. credit-card ABS, compared with \$23 billion a year before, according to Dealogic...

The TALF ladles out that leverage, and it may well work in kick-starting the moribund market. For instance, investors can borrow \$92 million to buy \$100 million of bonds backed with prime auto loans. An investment firm would have levered its equity over 12 times, which could provide annual returns of over 20% on prime-auto ABS assuming no credit impairment.” (Wall Street Journal, The Fed goes for brokerage)

Sound familiar? What's even worse than providing the leverage for the hedge fund sharpies, is the fact that the Fed will not require that investors to post collateral (like a bank) and—if the assets fall in value— investors can just “walk away” leaving taxpayers to eat the losses. Such a deal! It's another shameless \$1 trillion corporate welfare boondoggle disguised as a financial rescue plan. This shows that the reprobate Fed and its accomplices at Treasury are still committed to keeping the credit monopoly in private hands whether it destroys the country or not. The best remedy would be abandon the securitization model altogether (if only for the time being) so resources could be devoted to more pressing issues like jobs programs and debt relief. These would have an immediate stimulative effect on economy by revving up consumer spending and restoring faith in government. Otherwise, we're just dumping more money into a dysfunctional system.

Whether the Obama administration fixes the credit markets or not, it will still have to recapitalize the banking system. The most efficient way would be to take over insolvent institutions, separate the bad assets, protect the depositors and give management the “pink slip”. The problem with removing the bad assets, however, is the sheer magnitude of the losses. There’s enough red ink here to stretch from sea to shining sea. Here’s David Smick in the Washington Post:

“Here’s the problem: Today’s true market value of the U.S. banks’ toxic assets (that ugly stuff that needs to be removed from bank balance sheets before the economy can recover) amounts to between 5 and 30 cents on the dollar. To remain solvent, however, the banks say they need a valuation of 50 to 60 cents on the dollar. Translation: as much as another \$2 trillion taxpayer bailout.

That kind of expensive solution could send the president’s approval rating into a nose dive. Consider: \$2 trillion is about two-thirds of the tax revenue the federal government collects each year.” (Tim Geithner’s Black Hole, David Smick Washington Post)

And, it’s not just the expense that keeps Geithner from taking swift action either. It’s also the prospect of systemic failure from unregulated counterparty contracts, mainly credit default swaps, which have tied all the major banks together in an lethal net of highly-leveraged bets. If one of the financial giants sheds its mortal coil and keels over, the others will follow like lemmings. This is why the government took over AIG and has provided a \$160 billion bailout, to stop the dominoes from tumbling through the global system. Geithner has decided that its wiser to make excuses and try to run out the clock, than stumble blindly through the derivatives minefield. Unfortunately, the clock is ticking and the problems can’t wait.. The loss of wealth is already so huge that it has blown a gaping capital-hole in the financial system triggering an unprecedented slowdown similar to the 1930s. According to Bloomberg:

“The value of global financial assets including stocks, bonds and currencies probably fell by more than \$50 trillion in 2008, equivalent to a year of world gross domestic product, according to an Asian Development Bank report.”...Blackstone’s CEO Stephen Schwarzman said on Tuesday that “Between 40 and 45 percent of the world’s wealth has been destroyed in little less than a year and a half. This is absolutely unprecedented in our lifetime.”

As capital is destroyed and credit tightens, consumers have gotten more defensive, inventories are bulging, unemployment is rising, retail and housing have continued to nosedive, asset values are shrinking, profits are dwindling and the economy has succumbed to the slow strangulation of a credit-python. Deflation has spread across all sectors; strengthening the dollar and pushing oil and commodities downward. Equities are in a deep slump that will only get worse. The S&P has already dropped 56 percent from its peak and is quickly somersaulting downward. Deflation is everywhere.

David Rosenberg, Economist at Merrill Lynch summed it up like this in “Depression-Style Jobs Report”:

“In addition to credit contraction, asset deflation, profit compression and employment destruction, we are also in a vicious inventory reduction phase in the manufacturing sector. If our forecast is correct, this would then suggest that the capacity utilization rate in manufacturing will make a new all-time low of 66.6% from 68% in January. The employment data also tell us that there is a very high probability that wages and salaries deflated -0.3%

in February as well. How we end up getting any sustained inflation pressure, or backup in bond yields for that matter, as the economy moves further and further away from any semblance of “full employment” in either the labor or product market, is totally beyond us.

The Fed’s balance sheet and the balance sheet of the federal government are expanding at record rates. But these reflationary efforts should be seen as a partial antidote, not a panacea, to the deflationary effects brought on from the unprecedented contraction in the largest balance sheet on the planet: The \$55 trillion US household balance sheet. Based on what house prices and equity valuation have been doing this quarter, we are likely in for a total loss of household net worth approximating \$7 trillion this quarter alone, which would bring the cumulative decline in consumer wealth to \$20 trillion. This wealth loss exceeds the combined expansion of the Fed’s and government balance sheet by a factor of ten. That should put the reflation-deflation debate into perspective.” (David Rosenberg, Economist at Merrill Lynch summed it up like this in “Depression-Style Jobs Report”: Mish’s Global Economic Trend Analysis)

Clearly, the capital hole in the center of the US economy is too humongous to be filled with Obama’s paltry \$787 billion stimulus. (Most of the stimulus is back-loaded anyway. Only \$200 billion will be spent creating jobs in 2009) When businesses and consumers stop spending; the government has to pick up the slack or the economy gets hammered. Obama’s job is to “go big and go long” and ignore the braying of the liquidationists and crybaby Republican’s in the Congress. This is not the time for cold feet. Cinch up the jockstrap, and do what’s needed. Dazzle the naysayers with footwork. If Obama does not meet the challenge and accept the unavoidably huge deficits, thousands of businesses will default, unemployment will skyrocket, and world trade will grind to a halt. Consider this warning from economics professor Barry Eichengreen in the San Francisco Chronicle: “We must keep Trade from falling off a cliff”

“Americans may not realize it, but the biggest threat to economic stability is not falling home prices and retail spending but collapsing world trade. The value of global merchandise exports was down fully 45 percent in November 2008 from 12 months before. This is a terrifying number.

Nothing remotely comparable has ever happened before - not even in the Great Depression of the 1930s.

This is a body blow to an already staggering U.S. economy. U.S. exports in the fourth quarter of last year fell by more than 25 percent in constant dollars. California is being hit especially hard: outbound container traffic from the Ports of Long Beach and Los Angeles was down 30 percent in December 2008 from a year earlier.

It’s not surprising that when global growth slows, trade growth slows. But this trade implosion is unprecedented even for a major recession.( Barry Eichengreen San Francisco Chronicle: “We must keep Trade from falling off a cliff”)

Trade credit has dried up and reversed capital flows; another casualty of the credit market crackup. Globalization has returned to the realm of (corporate) wishful thinking; look for it in the “fiction” section of the library. No sandal-clad, fist-waving anarchist put the torch to global trade (regrettably) it was crushed by a poorly-designed financial system that split into matchwood at the first strong breeze. So, how in the world are Bernanke and Geithner going to recapitalize the banks and “keep them in private hands” in the most hostile

economic environment in memory?

The only hope is to do the unthinkable; dispatch the FDIC storm troopers to the teetering banks on Friday night and shut down the biggest offenders pronto. Don't wait another minute. The real reason Geithner is stalling is because he's afraid that foreign bondholders will cut him off at the knees and stop purchasing US debt. That's a threat that has to be taken seriously, but it shouldn't stop him from doing his job. John Hussman explains it all in his weekly comment "Buckle Up":

"The misguided policy response from Washington has focused almost exclusively on squandering public money and burdening our children with indebtedness in order to defend the bondholders of mismanaged financial institutions....

Make no mistake. Buying up "troubled assets" will not materially ease this crisis, nor will it even improve the capital position of financial institutions. Homeowners will continue to default because their payment obligations have not been restructured to any meaningful extent. We are simply protecting the bondholders of mismanaged financial institutions, even though that bondholder capital is more than sufficient to cover the losses without harm to customers. Institutions that cannot survive without continual provision of public funds should be taken into receivership, their assets should be restructured to better ensure repayment, their stockholders should be wiped out, bondholders should take a major haircut, customer assets should (and will) be fully protected, and these institutions should be re-issued to the markets when the economy stabilizes." (John P. Hussman Ph.D., Hussman Funds, Buckle Up, [www.hussmanfunds.com](http://www.hussmanfunds.com))

Bondholders own everything and they shouldn't be trifled with. They represent foreign banks, governments, sovereign wealth funds, and industry giants. They can afford the losses better than the taxpayer, but they won't be happy about it. There's bound to be retaliation and gnashing of teeth. It will require a carefully executed strategy to avoid a bloodbath; a surprise incision with a razor-sharp scalpel followed by an Obama-led public relations campaign to placate the enraged bondholders. It won't be easy, but it has to be done, and fast. Unfortunately, we are no where near the point where anyone at Treasury or the Fed will set aside the corporate agenda long enough to do the people's work. That's why Geithner will have to go. Bernanke, too.

The original source of this article is Global Research  
Copyright © [Mike Whitney](#), Global Research, 2009

---

[Comment on Global Research Articles on our Facebook page](#)

[Become a Member of Global Research](#)

Articles by: [Mike Whitney](#)

**Disclaimer:** The contents of this article are of sole responsibility of the author(s). The Centre for Research on Globalization will not be responsible for any inaccurate or incorrect statement in this article. The Centre of Research on Globalization grants permission to cross-post Global Research articles on community internet sites as long the source and copyright are

acknowledged together with a hyperlink to the original Global Research article. For publication of Global Research articles in print or other forms including commercial internet sites, contact: [publications@globalresearch.ca](mailto:publications@globalresearch.ca)  
[www.globalresearch.ca](http://www.globalresearch.ca) contains copyrighted material the use of which has not always been specifically authorized by the copyright owner. We are making such material available to our readers under the provisions of "fair use" in an effort to advance a better understanding of political, economic and social issues. The material on this site is distributed without profit to those who have expressed a prior interest in receiving it for research and educational purposes. If you wish to use copyrighted material for purposes other than "fair use" you must request permission from the copyright owner.

For media inquiries: [publications@globalresearch.ca](mailto:publications@globalresearch.ca)