More from the Front Lines of the Financial Crisis

By Stephen Lendman

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In its latest economic outlook, Merrill Lynch economists "worry about inflation, or more precisely," a lack of it. From crashing global equity markets, falling commodity prices, rising unemployment, stagnant wages, over-indebted households, declining production, the continuing housing crisis, and more. All pointing to several future quarters of negative growth. Showing that Fed chairman Bernanke will face "his greatest fear: deflation." An analysis of the coincident to lagging indicators signals "deep recession."

In his October 24, commentary, Merrill's North American economist David Rosenberg sees "economic data deteriorating in a very serious way (and says) we are witnessing unprecedented stuff happen:"

— the two-year housing recession "is still far from over" with new lows in a number of key readings;

— it's "morphed into a capex recession, industrial production" had its worst decline in 34 years;

— consumer confidence showed record declines;

— retail sales keep falling; evidence is that auto and chain store sales will show four straight down months; it's happened only four other times since 1947, so "we're living through a 1-in-200 event;"

— based on CPI data, prices are falling; at a rapid pace also seen only four other times since 1947;

— GDP will decline at 2% annual rate in Q 4; 4% in Q 1 2009 and 3.3% in Q 2.

Conclusion: "This recession is unlike any seen in the last five decades." Typically caused by inflation, inventory cycles or aggressive Fed tightening. "This is a balance sheet recession deeply rooted in asset liquidation and debt repayment, and would seem to have more in common with pre-WW I cycles."

Going back to 1855, "a typical recession lasts 18 months." It's no assurance this one won't be longer. Rosenberg thinks it started in January and believes will end "within a month of the National Bureau of Economic Research (NBER) making the call." It defines recession as "a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales." Some say that occurs when economic growth is negative for two or more consecutive quarters.

The signs are evident and growing, yet NBER is usually late making its call. It may hold off until housing shows signs of stabilizing. For some analysts, it's the core economic problem, and as long as it keeps eroding no end of recession is in sight. The latest data aren't encouraging:

— Case-Shiller's 10 and 20-city composite indexes set new record declines of 17.7% and 16.6% respectively; year-over-year dropping for 20 consecutive months; Case-Shiller predicts a peak to trough 28.6% drop in its 10-city composite index; it also sees up to 50% declines in some areas;

— nominal house prices down 20% from their 2006 peak; according to the Center for Economic Policy Research (CEPR), this implies a 27% real decline; a loss of $5 trillion in housing wealth, and 60% of the bubble deflated so more is yet to come; at least another 10 – 15% to return to trend levels; another question is "whether markets will overshoot on the downside;" a very distinct possibility;

— on October 29, CEPR reported record high ownership vacancies according to Census Bureau data at 2.8%; for rental units at 9.9%, slightly below the peak first quarter 10.1% level; CEPR predicts a fully deflated housing bubble by mid-2009 but added a caveat; "With the employment picture turning bleaker and the plunge in the stock market," housing is certain to be even more negative in coming months; "the tens of millions of workers….fearful about their future job prospects will be very reluctant to buy a new home;" compounded by trillions of lost personal wealth (from home and stock market losses) will make households "much more cautious in all their expenditures;"

— the Office of Federal Housing Enterprise Oversight (OFHEO) index fell .6% in its latest July reading and is down 5.3% on a year-over-year basis; its sharpest decline ever;

— Fitch expects home prices to fall another 10% in the next 18 months and will decline by an average 25% in real terms over the next five years; beginning from the second quarter 2008; they're now back to early 2004 levels and heading lower;

— the PMI Group predicts home price declines will double to a national average of 20% by next year with lower values in areas experiencing the sharpest increases;

— economist Paul Krugman cites his "preferred metric;" the ratio of housing prices to rental rates; it shows the former got way overvalued; will retrace and result in about a 25% home valuation decline;

— Goldman Sachs forecasts a 15% home price decline with no recession and 30% with one; and

— The Economist sees "no end in sight….to America's housing bust as prices continue to fall fast."

On October 28, economist Nouriel Roubini was even more alarming on housing citing "The recessionary macro effect of the worst US housing bust ever." He reported the view of a "senior professional in one of the (world's) largest financial institutions" who emailed him "privately and confidentially." As early as a year ago, he predicted "the worst housing recession in US history" and described "a bust process" in four phases:

(1) "rising mortgage defaults, home prices start falling, sale volumes fall, housing starts and

permits decline;" it's been happening and we're beginning phase two;

(2) "home-builders' bankruptcies, housing starts and permits crash, substantial layoffs in construction and real estate-related fields (mortgage brokers, mortgage lenders, etc.);"

(3) "substantial price declines in major metro areas, large rise in defaults of prime but low-equity mortgages;"

(4) "large-scale government intervention to help households going bankrupt;" a political phenomenon so its timing and nature can't be reliably forecast.

He cites clear phase two evidence already:

— countless smaller builder and subcontractor bankruptcies;

— Levitt Corp. home-building unit getting loan default notices;

— national home builder Tousa with $1 billion in senior notes and subordinated debt hired law firm Akin Gump Strauss Hauer Feld as a precaution in case of bankruptcy; and

— Neumann Homes and Enterprise Construction file for bankruptcy.

Roubini agrees with his emailer "with one caveat." He believes we're past the beginning of phase two; most of its aspects have occurred, and we're heading into phase three or close to it; he cites sharply falling home prices; rising defaults in prime and near prime mortgages; also some prime and near prime lenders in trouble; we're also getting close to phase four as "over a dozen proposals to rescue 2 million plus households on the way to default and foreclosure are now being debated in Washington." Debate is one thing. Meaningful action another and likely a ways off at best. Possibly once a new president is in office for something substantial if it comes at all.

Rubini's emailer followed up with another. That consensus now "admits" what it denied last year. The reality of a severe housing downturn. In price action and foreclosures. The worst since the 1930s. But they're still behind the curve by acknowledging "only minor macro effects." He called it extraordinary that a decline this severe is being taken dismissively. "Perhaps the most astonishing aspect of this event is the refusal to recognize the possible dimensions, the impact of what is coming." It's "delusional" to believe that the "biggest housing recession in US history will not have severe macro effect. Most of the consensus (according to Bloomberg earlier)" was for 1.8% fourth quarter growth. It then predicted a Q 4 slow growth bottom with "economic growth recover(ing) in soft landing territory (2.5%)."

On what basis, he asks? "Mostly wishful thinking (because of) the economic and financial shocks leading to falling demand (and a worsening housing bust); anemic capex spending; slowdown in commercial real estate demand; sharp private consumption slowdown and weak supply (from weakening ISM – Institute of Supply Management;" falling employment; a glut of new and existing homes; weak auto sales; consumer durables; "a capacity overhang;" and excess inventory); these factors will persist well into the new year.

The latest Q 3 GDP report hints at what's coming. A minus .3% with personal consumption (PCE) dropping 3.1%. The first decline since 1991 and largest drop since falling 8.6% in 1980. Residential construction also fell at a 19.1% annual rate. Its 11th straight quarter drop. It now represents 3.3% of GDP. Its lowest level since 1982. Non-residential investment fell 1% and will likely fall further in Q 4. A quarter likely to be much weaker than Q 3 as most private activity is slowing. Only government spending remains strong.

On October 31, still another disturbing report. Bloomberg reported that the "US Chicago Purchasers Index (the Institute for Supply Management-Chicago, ISM) Falls by Most on Record." To 37.8 down from 56.7 in September, and its lowest reading since the 2001 recession. A clear indication of a deepening downturn. Readings below 50 signal contraction.

Another Shoe to Drop: Credit Cards

Even The New York Times published a rare ahead-of-the-curve October 28 admission. In an Eric Dash article headlined: "Consumers Feel the Next Crisis: Credit Cards." As they're squeezed by an "eroding economy." An "already beleaguered banking industry" is threatened as lenders are sharply curtailing credit card offers and "sky-high credit lines." Even creditworthy consumers are affected because of growing amounts of bad loan losses. An estimated $21 billion in the first half of 2008.

With layoffs increasing, analysts forecast at least another $55 billion in the next 18 months. Around 5.5% of outstanding debt now and may "surpass the 7.9% level reached after the technology bubble burst in 2001." As a result, lenders like American Express, Bank of America, MasterCard and Visa are "tightening standards (and) culling their portfolios of the riskiest customers." Credit lines are being reduced as well, and lenders are avoiding over-indebted consumers. Treading carefully in housing ravaged areas and with customers employed by troubled industries.

It's impacting already strapped households. With lower credit scores. Higher rates for those rated creditworthy. Less willingness to allow high balances. Less availability of loans with many needing them shut out. "The depth of the financial crisis has shocked a credit-hooked nation into rethinking its habits. Many families once content to buy now and pay later are eager to trim their reliance on credit cards….At the same time," lenders are retrenching with one CEO saying "If you're not fearful, you're crazy."

It's seen in mail solicitations slowing to a trickle. "Credit card issuers have realized their market is shrinking and that there is no room for extra credit cards, so they have to scale back," according to Mintel analyst Lisa Hronek. "People are completely maxed out with mortgages, home equity lines and credit card debt."

It's hitting hard on both ends. Rising losses and shrinking profits for issuers. Less credit availability for consumers already strapped and cutting back of necessity. At a time the only bull market is in bailouts. Amidst towering debt levels. Soaring defaults. Wobbly global economies. Some cratering. America teetering. Confidence shattered, and everyone wondering what's next.

First the Banks. Next "the Coming Insurance Meltdown"

According to analyst Mike Larson of Weiss Research. AIG was just the beginning. Falsely called an "anomaly (and that) the rest of the insurance industry is doing just fine." Larson and Weiss disagree and identified "46 insurers with $500 million or more in assets that are at an elevated risk of failure." It's seen in their share prices. Down 80 – 90% for some because the largest US and Bermuda-based insurers have lost $98 billion year-to-date, and they have more in unrealized losses.

A Possible Goeotterdaemmerung?

On October 28, from the Financial Times forum in a Peterson Institute for International Economics Anders Aslund article titled: “It can be worse than the Great Depression.” A possibility, not a prediction. Because of “the worst global asset bubble and financial panic” since that time. Because lessons learned then haven’t prevented new mistakes, and unlike in the 1920s, “CNBC and Bloomberg can spread worldwide panic instantly.” Old blunders may not be repeated, but “new policies (may be) even worse.”

Anders laid out a “then” and “now” comparison:

— Then: exchange rates over-zealously defended; Now: floating exchange rates could cause a trade panic;

— Then: the money supply shrank dramatically; Now: monetary expansion and budget deficits are dangerously excessive; currency collapses may result; the fundamentals don’t justify the current dollar surge;

— Then: nations didn’t go bankrupt; some may today; some major ones; Italy, for example, had over 100% of GDP in public debt before the crisis; it risks major state bankruptcies; America was unmentioned, but the rapidly mounting public debt and money supply growth alone pose immense risks, including default and future hyperinflation;

— Then: subprime loans existed at modest levels, but that era didn’t have “non-transparent collateralized debt obligations;” Now: derivatives “created the mother of all bubbles; the deeper the financial system, the harder we may fall;”

— Then: the Great Depression “largely emanated from two countries, the US and Germany; Now: “never before has the world seen such a monstrous and truly global bubble;”

— Then: financial institutions engaged in minimal overleveraging; Now: it’s mirror opposite; “never have big financial institutions been as overleveraged as Fannie Mae and Freddie Mac or the former US investment banks, not to mention the hedge funds;”

— Then: protectionism froze global trade; Now: frozen finances in countries like Iceland, Ukraine and possibly others have temporarily left them outside the world financial system;”

— Then: the dollar and gold “were unchallenged sources of value;” Now: the dollar is neither stable nor the uncontested world currency;

— Then: policymakers made mistakes but “stood for principles;” Now: “George Bush is assembling (Group 20 leaders) for a photo opportunity in Washington on November 15;” failure to come up with meaningful corrective policies “could unleash untold (global) financial panic;” and

— Then: the 1920s lacked television and the internet for fast information dissemination; Now: information and decisions move instantly; often with no transparency; the combination is potentially harmful.

The Global Europe Anticipation Bulletin (GEAB), LEAP/E2020’s Disturbing

Prediction

In its October 15 28th edition. About a “global systemic crisis.” An alert because its researchers believe that before summer 2009 “the US government will be insolvent (and will) default and be prevented to pay its creditors (holders of US Treasury Bonds, of Fannie May and Freddy Mac shares, etc.).” It envisions “the setting up of a new Dollar to remedy the problem of default and of induced massive drain from the US.” It gives five reasons for its prediction:

— the current US dollar surge is temporary; the result of world stock market collapses;

— the Euro has become “a credible ‘safe haven;’ ” an alternative to the dollar;

— the out-of-control US public debt;

— the collapsing US economy; and

— future “strong inflation or hyper-inflation;” by 2009.

GEAB states: “the whole planet has become aware that a global systemic crisis is unfolding, characterised by the collapse of the US financial system and its contagion to the rest of the world.” As a result, “a growing number of global players are beginning to act on their own.” In their own self-interest. Because US policies are ineffective. The crisis is very serious and “far more important, in terms of impact and outcome, than” in 1929. With the US economy weaker now than then. Because of unmanageable public debt. Reckless consumer borrowing and spending. Enormous current account and budget deficits. A hollowed out industrial base, and a highly inflated dollar.

With that in mind, it’s up to “vigilant” citizens and “clear-sighted” leaders to assure that America won’t “drive the planet into a disaster.” It will take divergent policies. What’s “good for the rest of the world will not be good for the US.” America defaulting will be partly from “this decoupling of decision-making….” A new dollar will be “imposed.” And “one morning (in) summer 2009….after a long week-end or bank holiday,” Americans will discover that their “US T-Bonds and Dollars are only worth 10 per cent of their value….”

A Jesse’s Cafe Americain commentary suggests something similar. That in 2009, “the US will be forced to selectively default and devalue its debt.” Because of its extraordinary financial needs. A $2 trillion annual deficit. It will take a terrible toll on Treasuries. Forcing a significant drop by 2011. We’re approaching “the apogee of the Treasury bubble, with the credit bubble” already broken.

Once market deleveraging subsides, “the dollar and Treasuries will drop, perhaps with momentum, as the rest of the world realizes that the US has no choice but to default.” Unless foreign sources (for a while at least) keep buying American debt despite the risk. Offer debt forgiveness. The dollar is devalued short of default. Taxes raised substantially, and debt instruments pay higher interest rates. Even then, these measures may fall short and prove ineffective.

America way exceeded its debt service ability from real cash flows. A turnaround will require a “severe devaluation and selective default.” For GEAB down to 10 cents on the dollar. Following on its March 2008 prediction that by yearend “a formidable debacle will affect pension funds (worldwide) endangering the entire system of capital-based pensions.” Their revenues collapsing "at the very moment when they should be making their first large series of payments to pensioners." A disturbing picture in the current climate that may reveal other unexpected hazards in the coming months.

On October 28, Bloomberg reported on the Treasury's "unprecedented" 2009 financing needs. To fund a growing budget deficit and raise hundreds of extra billions to contain the current financial crisis. To assure guarantees the government committed for. Almost $6 trillion alone for Fannie and Freddie debt and mortgage securities. With continued growing demands as other obligations arise. Plus over $1 trillion annually for national defense with all expenditure categories included. An impossible burden Bloomberg didn't mention. A deepening dilemma as the financial crisis grinds toward more unsettling realities.

What Euro Pacific Capital's Peter Schiff writes about in his 2007 book "Crash Proof: How to Profit from the Coming Economic Collapse." What he adds to in commentaries on his web site: europac.net. His latest on October 31 titled "The Tales Get Taller." Debunking mainstream explanations for recent dollar strength. A currency he's very bearish on. Because of our extreme profligacy. Decades of borrowing trillions we can't repay. How we blew it on consumption and by letting our industrial base erode.

Our problems are now too big to contain. A possible bankruptcy is ahead. "The main lesson our creditors will learn from this crisis is not to lend American consumers any more money. Once the lending stops, our 'cart before the horse' borrow to spend economy will crumble. While the rest of the world absorbs their losses and moves on, we will be digging our way out of the rubble for years to come. Earthquakes are caused by the fundamental shifts of tectonic plates beneath the Earth's surface. A similar move is underway in the global economy."

America's salad days are over, he believes. We've gone from a nation of savers, investors and producers to one of borrowers, consumers and gamblers. Official government statistics lie. They conceal hidden truths. America's house of cards is crumbling. It won't be pretty when it collapses. His advice is get out of the dollar. Get your money out of the country while you can, and gold is one of his recommendations.

Gold is on Paul Amery's mind as well in his Prudent Bear.com October 31 commentary titled "The Credit Crisis Endgame." He sees it likely becoming "a bloody standoff between investors and governments (on a) market for government bonds" battlefield.

He reviewed the unfolding credit crunch stages:

— its beginning with liquidity drying up in "esoteric, structured-finance securities, linked to riskier types of mortgages;"

— it then spread "to more mainstream mortgage bonds, structured finance in general, and other types of debt;"

— by early summer 2008, it hit many non-financial companies having trouble refinancing loans;

— by late summer, it affected sovereign states; mostly ones with high current account deficits like Iceland, Hungary and Ukraine;

— it points globally to a spreading ailment affecting major economies and their bond markets.

The US for example. While nominal Treasury bond yields declined (10 year T-bonds at 4% October 31), their credit risk component has been increasing since last year. Credit specialists CMA DataVision shows the 10 year credit default swap (CDS) spread rose steadily. From 1.6 basis points in July 2007; to 16 basis points in March 2008; to 30 basis points in September; and to over 40 basis points on October 27. In other words, insuring against a US government bond default rose 25-fold in the past 15 months. The same is true for Britain and Germany.

Some observers find this astonishing. How could America or other major states default on their debt? It would be “the equivalent of a (financial market) nuclear explosion” smashing global economies with it.

Further, the dollar is the world’s reserve currency. The Fed can create unlimited amounts of them, so any default would likely be through inflation and devaluation, some argue.

Maybe not, according to University of Maryland’s Carmen Reinhart and Harvard’s Kenneth Rogoff in their April 2008 paper: “The Forgotten History of Domestic Debt.” They explained that throughout history debt defaults have been more common than realized. They’re the rule, not the exception, in times of severe economic stress.

Again America for example. Budget and national debt levels have exploded. Bailout amounts will increase them and cause enormous strains. Morgan Stanley forecasts a sharply rising 2009 fiscal deficit. Besides the escalating national debt, to more than double the previous 1983 record. As a percent of GDP, it’s expected to be around 70% in 2009. The tip of the iceberg, some say, compared to the private debt to GDP ratio. At an unprecedented 300%, according to University of Western Sydney economist Steve Keen.

He saw the storm coming before most others. He’s also very skeptical about the rescue plan and compares it to King Canute’s effort against the tide. Given the enormity of the problem, he sees the possibility of the debt pyramid crashing from a violent and uncontrollable chain of defaults, taking the government bond market down with it.

Strains in the US Treasury market are already evident in spite of their historically low yields. Recent auctions have had poor bid-to-cover ratios and long “tails” indicate weak demand. Secondary market delivery failures are also at record levels. Another sign of poor liquidity. If the worst of all possible worlds happens – a US debt default – the consequences will be “cataclysmic for the financial economy.” The entire system will be bankrupt.

Where to hide if it happens? Amery suggests a few safe havens. The “ultimate” one being in precious metals. Think gold. Understand also that the $725/ounce October 31 spot price reflects market manipulation (over the short term) to drive it down from its March 2008 high above $1000. As one analyst puts it: I’ll “give you three good reasons why gold is (underperforming). First: manipulation. Second: rampant manipulation. Third: incessant, nonstop, unabated, fiendish manipulation.”

He also believes the process is only temporary and won’t stop the metal’s eventual rise. Given the current crisis and its likely duration, it won’t surprise experts to see its price above $1000 again before it ends.

A Final Comment

In spite of trillions of asset losses. American and global households hardest hit. Wobbly world economies getting weaker. The virtual certainty of a deep and protracted recession, and the likelihood of no robust recovery when it ends.

Despite all this and Wall Street's worst year in decades, it's celebrating like it always does. With big bonuses. In the many billions of dollars. According to Bloomberg, Merrill Lynch plans $6.7 billion. Goldman Sachs about $6.85 billion and Morgan Stanley about $6.44 billion.

Bloomberg noted that Goldman, Morgan Stanley, Merrill, Lehman Bros. and Bear Stearns paid their employees "a cumulative $145 billion in bonuses from 2003 through 2007," or more than the Philippines' GDP. In 2007, the firms paid out a record $39 billion. In a year when three of them posted their worst quarterly losses ever and their shareholders lost over $80 billion. Two of them no longer exist. Another went into forced liquidation. Their combined 2008 losses should way exceed last year when they're reported.

Yet there's plenty of money for bonuses. Courtesy of ESSA/TARP. For executive pay and dividends as well. At a time all these companies are insolvent. Their survival dependent on federal handouts. US taxpayers are on the hook for them as their consumption declines. According to the Commerce Department at the fastest rate in 28 years. Because they don't get big bonuses. Are maxed out on credit and haven't the money to spend.

But the Fed and US Treasury do and plan to dispense more of it. To other takers lining up. Sovereign nations. Insurance companies. GM and Chrysler perhaps for their reported merger. Dependent on government cash to complete it. Any other company as well deemed worth saving. Big campaign contributors with friends in high places. What beleaguered homeowners don't have.

Floated proposals to help them appear meager at best. For a fraction of the millions in trouble with inadequate suggested funding amounts. A suggested $40 billion for 20 million or more homeowners facing foreclosure. With more at issue as well, according to The New York Times. Giving qualified borrowers a few grace years. Perhaps three. For lower mortgage payments that won't reduce their principal balance. It would only provide temporary relief and delay today's problem for a later time. When households may be no better off than now, yet face higher ARM reset obligations.

What's needed, but not proposed, is a 1930s type Home Owners' Loan Corporation (HOLC) plan that refinanced homes at affordable rates and prevented foreclosures. One on a grand scale as part of an enlightened New Deal agenda.

In lieu of "trickle down" to fraudsters, "trickle up" for beleaguered households. An idea so far with no traction for a new administration to consider. The one now in charge has no "imminent" plan, according to White House spokesperson, Dana Perino. On October 30, she added only that "If we find one that we think strikes the right notes….then we would move forward and announce it." Ones so far advanced are for Wall Street. Main street apparently can wait.

Stephen Lendman is a Research Associate of the Centre for Research on Globalization. He lives in Chicago and can be reached at lendmanstephen@sbcglobal.net.

Also visit his blog site at sjlendman.blogspot.com and listen to The Global Research News

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Articles by: **Stephen Lendman**

About the author:

Stephen Lendman lives in Chicago. He can be reached at lendmanstephen@sbcglobal.net. His new book as editor and contributor is titled "Flashpoint in Ukraine: US Drive for Hegemony Risks WW III." http://www.claritypress.com/LendmanIII.html Visit his blog site at sjlendman.blogspot.com. Listen to cutting-edge discussions with distinguished guests on the Progressive Radio News Hour on the Progressive Radio Network. It airs three times weekly: live on Sundays at 1PM Central time plus two prerecorded archived programs.