# Stock Market Meltdown

By Mike Whitney
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*"Whatever is going to happen, will happen…just don't let it happen to you."* **Doug Casey, Casey Research**

**I**t's a Bloodbath. That's the only way to describe it.

On Friday the Dow Jones took a 280 point nosedive on fears that that losses in the subprime market will spill over into the broader economy and cut into GDP. Ever since the two Bears Sterns hedge funds folded a couple weeks ago the stock market has been writhing like a drug-addict in a detox-cell. Yesterday's sell-off added to last week's plunge that wiped out $2.1 trillion in value from global equity markets. New York investment guru, Jim Rogers said that the real market is "one of the biggest bubbles we've ever had in credit" and that the subprime rout "has a long way to go."

We are now beginning to feel the first tremors from the massive credit expansion which began 6 years ago at the Federal Reserve. The trillions of dollars which were pumped into the global economy via low interest rates and increased money supply have raised the nominal value of equities, but at great cost. Now, stocks will fall sharply and businesses will fail as volatility increases and liquidity dries up. Stagnant wages and a declining dollar have thrust the country into a deflationary cycle which has—up to this point—been concealed by Greenspan's "cheap money" policy. Those days are over. Economic fundamentals are taking hold. The market swings will get deeper and more violent as the Fed's massive credit bubble continues to unwind. Trillions of dollars of market value will vanish overnight. The stock market will go into a long-term swoon.

Ludwig von Mises summed it up like this:

"There is no means of avoiding the final collapse of a boom brought about by credit expansion. The question is only whether the crisis should come sooner as a result of a voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved." (Thanks to the Daily Reckoning)

It doesn't matter if the "underlying economy is strong". (as Henry Paulson likes to say) That's nonsense. Trillions of dollars of over-leveraged bets are quickly unraveling which has the same effect as taking a wrecking ball down Wall Street.

This week a third Bear Stearns fund shuttered its doors and stopped investors from withdrawing their money. Bear's CFO, Sam Molinaro, described the chaos in the credit market as the worst he'd seen in 22 years. At the same time, American Home Mortgage Investment Corp—the 10th-largest mortgage lender in the U.S. —said that "it can't pay its creditors, potentially becoming the first big lender outside the subprime mortgage business to go bust". (MarketWatch)

This is big news, mainly because AHM is the first major lender OUTSIDE THE SUBPRIME MORTGAGE BUSINESS to go belly-up. The contagion has now spread through the entire mortgage industry—Alt-A, piggyback, Interest Only, ARMs, Prime, 2-28, Jumbo,—the whole range of loans is now vulnerable. That means we should expect far more than the estimated 2 million foreclosures by year-end. This is bound to wreak havoc in the secondary market where $1.7 trillion in toxic CDOs have already become the scourge of Wall Street.

Some of the country's biggest banks are going to take a beating when AHM goes under. Bank of America is on the hook for $1.3 billion, Bear Stearns $2 billion and Barclay's $1 billion. All told, AHM's mortgage underwriting amounted to a whopping $9.7 billion. (Apparently, AHM could not even come up with a measly $300 million to cover existing deals on mortgages! Where'd all the money go?) This shows the downstream effects of these massive mortgage-lending meltdowns. Everybody gets hurt.

AHM's stock plunged 90% IN ONE DAY. Jittery investors are now bailing out at the first sign of a downturn. Wall Street has become a bundle of nerves and the problems in housing have only just begun. Inventory is still building, prices are falling and defaults are steadily rising; all the necessary components for a full-blown catastrophe.

AHM warned investors on Tuesday that it had stopped buying loans from a variety of originators. 2 other mortgage lenders announced they were going out of business just hours later. The lending climate has gotten worse by the day. Up to now, the banks have had no trouble bundling mortgages off to Wall Street through collateralized debt obligations (CDOs). Now everything has changed. The banks are buried under MORE THAN $300 BILLION worth of loans that no one wants. The mortgage CDO is going the way of the Dodo. Unfortunately, it has attached itself to many of the investment banks on its way to extinction.

And it's not just the banks that are in for a drubbing. The insurance companies and pension funds are loaded with trillions of dollars in "toxic waste" CDOs. That shoe hasn't even dropped yet. By the end of 2008, the economy will be on life-support and Wall Street will look like the Baghdad morgue. American biggest financials will be splayed out on a marble slab peering blankly into the ether.

Think I'm kidding?

Already the big investment banks are taking on water. Merrill Lynch has fallen 22% since the start of the year. Citigroup is down 16% and Lehman Bros Holdings has dropped 22%. According to Bloomberg News: "The highest level of defaults in 10 years on subprime mortgages and a $33 billion pileup of unsold bonds and loans for funding acquisitions are driving investors away from debt of the New York-based securities firms. Concerns about credit quality may get worse because banks promised to provide $300 billion in debt for leveraged buyouts announced this year……Bear Stearns Cos., Lehman Brothers Holdings Inc., Merrill Lynch & Co. and Goldman Sachs Group Inc., are as good as junk."

That's right—"junk".

We've never seen an economic tsunami like this before. The dollar is falling, employment and manufacturing are weakening, new car sales are off for the seventh straight month, consumer spending is down to a paltry 1.3%, and oil is hitting new highs every day as it marches inexorably towards a $100 per barrel.

So, where's the silver lining?

Apart from the 2 million-plus foreclosures, and the 80 or so mortgage lenders who have filed for bankruptcy; a growing number of investment firms are feeling the pinch from the turmoil in real estate. Bear Stearns; Basis Capital Funds Management, Absolute Capital, IKB Deutsche Industrial Bank AG, Commerzbank AG, Sowood Capital Management, C-Bass, UBS-AG, Caliber Global Investment and Nomura Holdings Inc.—are all either going under or have taken a major hit from the troubles in subprime. The list will only grow as the weeks go by. (Check out these graphs to understand what's really going on in the housing market. http://www.recharts.com/reports/CSHB031207/CSHB031207.html?ref=patrick.net

The problems in real estate are not limited to residential housing either. The credit crunch is now affecting deals in commercial real estate, too. Low-cost, low-documentation, "covenant lite" loans are a thing of the past. Banks are finally stiffening their lending requirements even though the horse has already left the barn. Commercial mortgage-backed securities are now nearly as tainted as their evil-twin, residential mortgage-backed securities (RMBS). There's no market for these turkeys. The banks are returning to traditional lending standards and simply don't want to take the risk anymore.

Bataan Death March?

Leveraged Buy Outs (LBOs) have been a dependable source of market liquidity. But, not any more. In the last quarter, there was $57 billion in LBOs. In the first month of this quarter that amount dropped to less than $2 billion. That's quite a tumble. The Wall Street Journal's Dennis Berman summed it up like this: "the Street is scrambling to finance some $220 billion of leveraged buy out deals" (but) the "mood has gone from Nantucket holiday to Bataan Death March".

Berman nailed it. The investment banks took great pleasure in their profligate lending; raking in the lavish fees for joining mega-corporations together in conjugal bliss. Then someone took the punch bowl. Now the banking giants are scratching their heads–wondering how they can unload $220B of toxic-debt onto wary investors. It won't be easy.

"The banks and brokers are in the bull's eye," said Kevin Murphy. "There's article after article not only on subprime, but also banks sitting on leveraged buy out loans." (WSJ) Credit protection on bank debt is soaring just as investor confidence is on the wane. In fact, the VIX index (The "fear gauge") which measures market volatility— has surged 60% in the last week alone. The increased volatility means that more and more investors will probably ditch the stock market altogether and head for the safety of US Treasuries.

But, that just presents a different set of problems. After all, what good are US Treasuries if the dollar continues to plummet? No one will put up with 5% or 6% return on their investment if the dollar keeps sliding 10% to 15% per year. It would be wiser to one's move money into foreign investments where the currency is stable.

And, that is (presumably) why Treasury Secretary Paulson is in China today—to sweet talk our Communist bankers into buying more USTs to prop up the flaccid greenback. (Note: The Chinese are currently holding $103 billion in toxic US-CDOs—and are not at all happy about their decline in value.) If the Chinese don't purchase more US debt, then panicky US investors will start moving their dollars into gold, foreign currencies and German state bonds as a hedge against inflation. This will further accelerate the flight of foreign capital from American markets and trigger a massive blow-off in the stock and bond markets. In fact, this process is already underway. (although it has been largely concealed in the business media) In truth, the big money has been fleeing the US for the last 3 years. What passes as "trading" on Wall Street today is just the endless expansion of credit via newer and more opaque debt-instruments. It's all a sham. America 's hard assets are being sold off to at an unprecedented pace.

Credit Crunch: Whose ox gets gored?

When money gets tight; anyone who is "over-extended" is apt to get hurt. That means that the maxed-out hedge fund industry will continue to get clobbered. At current debt-to-investment ratios, the stock market only has to fall about 10% for the average hedge fund to take a 50% scalping. That's more than enough to put most funds underwater for good. The carnage in Hedgistan will likely persist into the foreseeable future.

That might not bother the robber-baron fund-managers who've already extracted their 2% "pound of flesh" on the front end. But it's a rotten deal for the working stiff who could lose his entire retirement in a matter of hours. He didn't realize that his investment portfolio was a crap-shoot. He probably thought there were laws to protect him from Wall Street scam-artists and flim-flam men.

It'll be even worse for the banks than the hedge funds. In fact, the banks are more exposed than anytime in history. Consider this: the banks are presently holding a half trillion dollars in debt (LBOs and CDOs) FOR WHICH THERE IS NO MARKET. Most of this debt will be dramatically downgraded since the CDOs have no true "mark to market" value. It's clear now that the rating agencies were in bed with the investment banks. In fact, Joshua Rosner admitted as much in a recent New York Times editorial:

"The original models used to rate collateralized debt obligations were created in close cooperation with the investment banks that designed the securities"….(The agencies) "actively advise issuers of these securities on how to achieve their desired ratings" (Joshua Rosner "Stopping the Subprime Crisis" NY Times)

Pretty cozy deal, eh? Just tell the agency the rating you want and they tell you how to get it.

Now we know why $1.7 trillion in CDOs are headed for the landfill.

The downgrading of CDOs has just begun and Wall Street is already in a frenzy over what the effects will be. Once the ratings fall, the banks will be required to increase their reserves to cover the additional risk. For example, "As a recent issue of Grant's explains, global commercial banks are only required to set aside 56 cents ($0.56) for every $100 worth of triple-A rated securities they hold. That's roughly 178 to 1 ratio. Drop that down to double-B minus, and the requirement skyrockets to $52 per $100 worth of securities held—a margin increase of more than 9,000%".

"56 cents ($0.56) for every $100 worth of triple-A rated securities"?!? Are you kidding me?

As Mugambo Guru says, "That is 1/18th of the 10% stock margin equity required in 1929"!!
(Mugambo Guru; kitco.com)

The high-risk game the banks have been playing—of "securitizing" the loans of applicants with shaky credit—is falling apart fast. There's no market for chopped up loans from over-extended homeowners with bad credit. The banks don't have the reserves to cover the loans they have on the books and the CDOs have no fixed market value. End of story. The music has stopped and the banks can't find a chair.

The public doesn't know anything about this looming disaster yet. How will people react when they drive up to their local bank and see plywood sheeting covering the windows?

This will happen. There will be bank failures.

The derivatives market is another area of concern. The notional value of these relatively untested instruments has risen to $286 trillion in 2006—up from a meager $63 trillion in 2000. No one has any idea of how these new "swaps and options" will hold up in a slumping market or under the stress of increased volatility. Could they bring down the whole market?

That depends on whether they're backed-up by sufficient collateral to meet their obligations. But that seems unlikely. We've seen over and over again that nothing in this new deregulated market is "as it seems". It's all stardust mixed with snake oil. What the Wall Street hucksters call the "new financial architecture of investment" is really nothing more than one overleveraged debt-bomb stacked atop another. Ironically, many of these same swindles were used in the run-up to the Great Depression. Now they've resurfaced to do even more damage. When the crooks and con-men write the laws (deregulation) and run the system; the results are usually the same. The little guy always gets screwed. That much is certain.

At present, the stock market is running on fumes. Another 4 to 6 months of wild gyrations and it'll be over. The NASDAQ plunged 75% after the dot.com bust. How low will it go this time?

Keep an eye on the yen. The ongoing troubles in subprime and hedge funds are pushing the yen upwards which will unwind trillions of dollars of low interest, short term loans which are fueling the rise in stock prices. If the yen strengthens, traders will be forced to sell their positions and the market will tank. It's just that simple. The Dow Jones will be a Dead Duck.

So far, Japan 's monetary manipulations have been a real boon for Wall Street–enriching the investment bankers, the big-time traders and the hedge fund managers. They're the one's who can take advantage of the interest rate spread and then maximize their leverage in the stock market. It works like a charm in an up-market, but things can unravel quickly when the market retreats or starts to zigzag erratically. The recent rumblings suggest that the volatility will continue which will push the yen upwards and cut off the flow of cheap credit to the stock market. When that happens, the end is nigh.

The American People: "We're not a dumb as you think"

It's always refreshing to find out that the majority of Americans seem to have a grasp of what is really going on behind the fake headlines. For example, The Wall Street Journal/NBC conducted a poll this week which shows that two-thirds of Americans believe that "the economy is either in a recession now or will be in the next year." That matches up pretty well with the 71% of Americans who now feel the Iraq War "was a mistake". Americans are clearly downbeat in their outlook on the economy and haven't been taken in by the daily infusions of happy talk about “low inflation” and “sustained growth” from toothy TV pundits. In fact, the mood of the country regarding the economy is downright gloomy. “Only 19% of Americans say things in the nation are headed in the right direction, while 67% say the country is off on the wrong track”. Iraq , of course, is the number one reason for the pessimism, but the dissatisfaction runs much deeper than just that.

“Only 16% expressed substantial confidence in the financial industry”—“18% in the energy or pharmaceutical industries”—“17% in large corporations and 11% in health-insurance companies”. Only 18% of the people have confidence in the corporate media and only 16% in the federal government.

These are encouraging numbers. They show that the vast majority of people have lost confidence in the system and its institutions. They also illustrate the limits of propaganda. People are not as easily indoctrinated as many believe. Eventually the “bewildered herd” catches on and sees through the lies and deception.

The American people know intuitively that something is fundamentally wrong with the economy. They just don’t know the details or the extent of the damage. Decades of neoliberal policies have inflated the currency, broadened the wealth gap, and destroyed manufacturing. Workers can no longer buy the things they produce because wages have stagnated through a stealth campaign of inflation which originated at the Federal Reserve. When wages shrink, prices eventually fall from overcapacity and the economy slips into a deflationary cycle. This downward spiral ultimately ends in depression. So far, that’s been avoided because of the Fed’s massive expansion of cheap credit. But that won’t last.

Economic policy is not “accidental”. The Fed’s policies were designed to create a crisis, and that crisis was intended to coincide with the activation of a nation-wide police-state. It is foolish to think that Greenspan or his fellows did not grasp the implications of the system they put in place. These are very smart men and very shrewd economists. They knew exactly what they were doing. They all understand the effects of low interest rates and expanded money supply. And, they’re also all familiar with Ludwig von Mises, who said:

“There is no means of avoiding the final collapse of a boom brought about by credit expansion.”

A crash is unavoidable because the policies were designed to create a crash. It’s that simple.

The Federal Reserve is a central player in a carefully considered plan to shift the nation’s wealth from one class to another. And they have succeeded. Nearly 4 million American jobs have been sent overseas, the country has increased the national debt by $3 trillion dollars, and foreign investors own $4.5 trillion in US dollar-backed assets. While the Fed has been carrying out its economic strategy; the Bush administration has deployed the military around the world to conduct a global resource war. These are two wheels on the same axel. The goal is to maintain control of the global economic system by seizing the remaining energy resources in Eurasia and the Middle East and by integrating potential rivals into the American-led economic model under the direction of the Central Bank. All of the leading candidates—Democrat and Republican—belong to secretive organizations which ascribe to the same basic principles of global rule (new world order) and permanent US hegemony. There’s no quantifiable difference between any of them.

The impending economic crisis is part of a much broader scheme to remake the political system from the ground-up so it better meets the needs of ruling elite. After the crash, public assets will be sold at firesale prices to the highest bidder. Public lands will be auctioned off. Basic services will be privatized. Democracy will be shelved.

The unsupervised expansion of credit through interest rate manipulation is the fast-track to tyranny. Thomas Jefferson fully understood this. He said:

"If the American people ever allow private banks to control the issue of our currency, first by inflation, then by deflation, the banks and the corporations that will grow up will deprive the people of all property until their children wake up homeless on the continent their fathers conquered."

We are now in the first phase of Greenspan's Depression. The stock market is headed for the doldrums and the economy will quickly follow. Many more mortgage lenders, hedge funds and investment banks will be carried out feet first.

As the disaster unfolds, we should try to focus on where the troubles began and keep in mind Jefferson 's injunction:

"The issuing of power should be taken from the banks and restored to the people to whom it properly belongs."

Rep. Ron Paul is the only presidential candidate who supports abolishing the Federal Reserve.