The Economy is in Deep, Deep Trouble…

Question for Bernanke: "Do you have the cojones to raise rates?"

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Booyah. It's morning in America. The jobless numbers are stabilizing, the stock market is sizzling, quarterly earnings came in better than expected, traders have turned bullish, housing is showing signs of life, and clunker-swaps have given Detroit a well-needed boost of adrenalin. Even Cassandra economists –like Paul Krugman and Nouriel Roubini–have been uncharacteristically optimistic. Is is true; did we avoid a Second Great Depression? Is the worst really behind us?

Maybe. But there is only one way to find out for sure. Raise rates.

Bernanke should welcome the opportunity to show everyone how he's pulled the world's biggest economy back from the brink of disaster. All he needs to do is stop giving away free money, shut down a few of his so-called lending facilities, and stop manipulating interest rates by purchasing mortgage-backed securities (MBS) from Fannie and Freddie. How hard is that? The S&P 500 has skyrocketed 48 percent since March 9. What's Bernanke waiting for; a 75 percent increase; a 100 percent increase??? How high do stocks have to go to convince Bernanke that the economy can stand on its own two feet without the torrent of cheap liquidity issuing from the Fed?

Bernanke can prove to his critics that the US economy doesn't need the Fed's monetization programs and price fixing; that it doesn't need the liquidity injections and the buying up of junk mortgages. ($80 billion last month alone) After all, as Bernanke opines, "The fundamentals of our economy are strong!"

Right. Now prove it.

All Bernanke has to do is boost rates by a point or two and demonstrate that he's willing to mop up some of the $13 trillion he's pumped into the financial markets. With just one announcement, the Fed chair could show our biggest creditor–China–that he's serious about defending the dollar and the trillion dollars of US Treasuries China purchased believing that the US was a responsible trading partner who would never write checks on an account that was overdrawn by $12 trillion. (The National Debt)

So, go ahead, Ben. Raise rates, shut down the printing presses, roll up the corporate welfare programs. Be a He-man. Make your critics eat their words. This is from Bloomberg News 8-12-09:

"The Fed's policy-setting Open Market Committee will today keep the target rate at zero to 0.25 percent and retain plans to buy as much as $1.45 trillion of housing debt by year-end to help secure a recovery, analysts said. The FOMC's statement is expected at about 2:15

p.m. in Washington."

Hmmmmmm. So all the "green shoots" happy talk is pure gibberish, right? There is no recovery. Bernanke plans to continue flooding the financial system with cheap liquidity. It's all a fraud. Things aren't better; they're worse.

Look at the facts.

There were 1.9 million foreclosures in 2009 in the first six months, and there will be another 1.5 before the end of the year. Is that better? According to Bloomberg: "A glut of unsold homes is also pushing down prices. The 3.8 million homes for sale in June would take 9.4 months to sell at the current pace of transactions, according to the National Association of Realtors. The inventory turnover rate averaged 4.5 months in the six years from 2000 to 2005…..More than 18.7 million homes, including foreclosures, residences for sale and vacation homes, stood vacant in the U.S. during the second quarter. That compared with 18.6 million a year earlier, the U.S. Census Bureau said July 24

Total home sales fell 23.7 percent in June versus a year earlier." Bloomberg)

Massive supply, falling prices, record foreclosures, flagging demand–and according to Deutsche Bank–48 percent of all mortgages will be underwater by 2011. It's all bad.

Here's another clip from Bloomberg today 8-12-09:

"Home price declines in the U.S. ACCELERATED in the second quarter, dropping by a record 15.6 percent from a year earlier, as foreclosures weighed on values.

The median price of an existing single-family home dropped to $174,100, THE MOST IN RECORDS dating to 1979, the National Association of Realtors said today.

> "I don't think we're at a bottom yet in home prices," said Scott Anderson, a senior economist at Wells Fargo & Co. in Minneapolis. "There's also a pretty big shadow supply of houses. People are kind of waiting for the bottom but there's a pent up supply out there."…Home prices are tumbling even as mortgage rates remain near all-time lows. The average U.S. rate for a 30-year fixed home loan was to 5.22 percent last week, down from 5.25 percent the prior week." (Bloomberg)

The decline in housing prices is ACCELERATING, not slowing down. The historic collapse in real estate is ongoing and it is wiping out trillions in homeowner equity making it increasingly difficult for consumers to borrow on the diminishing value of their collateral. This is why foreclosures, defaults and personal bankruptcies are soaring. (According to the American Bankruptcy Institute: consumer bankruptcy filings reached 126,434 in July, a 34.3% increase year over year, and a 8.7% increase sequentially (116,365 in June). July's number is the highest monthly total since the October 2005 bankruptcy reform aka the Bankruptcy Abuse Prevention and Consumer Protection Act.)

This is why households and consumers can no longer spend as much as they had before the crisis. Credit lines are being pared back; personal savings are rising, and GDP (excluding fiscal stimulus) is shrinking. Every one of the 3.5 million foreclosures represents hundreds of thousands of dollars the banks will never recoup. NEVER. That's why the rate of bank failures will be much greater than current estimates. The banks are facing a triple-whammy;

soaring foreclosures, plummeting asset prices, and a meltdown in commercial real estate. The combo has created a gigantic capital-hole which is forcing the banks to slow lending even to applicants with flawless credit. The Fed has built up excess bank reserves by $800 billion, but it hasn't made a bit of difference. They banks are still not able to lend.

The uptick in housing last month reflects seasonal changes and a shifting of pain from the low end of the market to higher priced homes; nothing more. Homes that are priced over $1 million are now sitting on the market for 20 months; a lifetime in real estate parlance. High-end neighborhoods have turned into leper colonies. Zero interest; zero traffic. Expect a crash this year.

Now take a look at this from CNBC's Diana Olick:

"The number of homes listed officially on the market, while still at historically high levels, might be only the tip of the iceberg," said Stan Humphries, chief economist at real estate website Zillow.com in Seattle, Washington. According to Zillow's latest Homeowner Confidence Survey, 12 percent of homeowners said they would be "very likely" to put their home on the market in the next 12 months if they saw signs of a real estate market turnaround, 8 percent said "likely," while 12 percent said "somewhat likely." Survey results could translate into around 20 million homeowners trying to sell their homes, a startling number given that the Census bureau indicates there are 93 million U.S. houses, condos and co-ops, Humphries said.

According to the National Association of Realtors, the market is currently on track to sell 4.89 million homes annually.

> "At this pace, it would take about four years to run through this amount of backlogged inventory," he said. "Shadow inventory has the potential to give us another leg down on home prices during the second half of the year," said Steven Wood, chief economist at Insight Economics in Danville, California. (Diana Olick, "Shadow inventory lurks over US housing recovery" CNBC)

The banks are using all types of accounting tricks to hide the real losses or the true value of downgraded assets. The only difference between a common crook and a commercial banker is a well-paid accountant. The banking system is broken and its only going to get worse as the hammer comes down on the commercial real estate market. The Fed and Treasury are already working out the details for another stealth bailout that they'll initiate without Congress's approval. It's all very "hush-hush". The plan will involve more mega-leveraging of government liabilities. Bernanke has appointed himself the de facto Czar of Hedge Fund Nation, Clunkerville USA.

An article in this week's Financial Times further illustrates how the Fed has transformed the economy into a riverboat casino:

> "The Federal Reserve Bank of New York is aggressively hiring traders as its seeks to manage its burgeoning securities holdings, making the central bank one of Wall Street's most active recruiters of financial talent.
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> The New York Fed – the arm of the US central bank that implements its monetary policy – plans to increase the staff in its markets group to 400 by the end of the year – up from 240 at the end of 2007.

> The Fed, which says that most of its new recruits come from private sector financial firms, is hiring employees as many banks, rating agencies, hedge funds and private equity groups shed staff. New York city officials recently estimated that the sector's woes would lead to a loss of up to 140,000 jobs.
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> The Fed's need for more traders is a direct consequence of the central bank's efforts to keep credit flowing through the US economy. The Fed has been buying fixed-income securities at such a rate that its assets have more than doubled to $2,000bn in the past year, leading the central bank to conclude that it needs more people to monitor the markets and to manage its credit risks." (Financial Times, "NY Fed in hiring spree as assets soar", Aline van Duyn)

Nice, eh? So now the Fed needs to enlist a gaggle of professional speculators just to keep all the balls in the air. What a joke. This isn't a rebound; it's just more hype. Here's Warren Buffett summing it up on CNBC:

"I get figures on 70-odd businesses, a lot of them daily. Everything that I see about the economy is that we've had no bounce. The financial system was really where the crisis was last September and October, and that's been surmounted and that's enormously important. But in terms of the economy coming back, it takes a while…. I said the economy would be in a shambles this year and probably well beyond. I'm afraid that's true." "The economy is in a shambles". That's from the horse's mouth. Inventories are down 11 percent year-over-year, durable goods are down 10.4 percent y-o-y, industrial capacity is at record lows, manufacturing is still contracting, housing is in the tank, shipping and rail freight are scraping the bottom, retail is in a long-term funk, and–according to Krugman–the slight dip in unemployment was a statistical anomaly. Here's Bob Herbert's great summary of the unemployment data:

"Some 247,000 jobs were lost in July, a number that under ordinary circumstances would send a shudder through the country. It was the smallest monthly loss of jobs since last summer. And for that reason, it was seen as a hopeful sign. The official monthly unemployment rate ticked down from 9.5 percent to 9.4 percent….The country has lost a crippling 6.7 million jobs since the Great Recession began in December 2007…

The percentage of young American men who are actually working is the lowest it has been in the 61 years of record-keeping, according to the Center for Labor Market Studies at Northeastern University in Boston. Only 65 of every 100 men aged 20 through 24 years old were working on any given day in the first six months of this year. In the age group 25 through 34 years old, traditionally a prime age range for getting married and starting a family, just 81 of 100 men were employed…. The numbers are beyond scary; they're catastrophic.

This should be the biggest story in the United States. When joblessness reaches these kinds of extremes, it doesn't just damage individual families; it corrodes entire communities, fosters a sense of hopelessness and leads to disorder….

A truer picture of the employment crisis emerges when you combine the number of people who are officially counted as jobless with those who are working part time because they can't find full-time work and those in the so-called labor market reserve — people who are not actively looking for work (because they have become discouraged, for example) but would take a job if one became available.

The tally from those three categories is a mind-boggling 30 million Americans — 19 percent of the overall work force.

This is, by far, the nation's biggest problem and should be its No. 1 priority.("A Scary Reality" Bob Herbert, New York Times)

Sorry, Bob, the media has no time for unemployment news. It tends to undermine the positive vibes from green shoots stories.

The stock market rally has made it harder for people to see the truth. But the facts haven't changed. Deflation is setting in across all sectors and the economy has reset at a lower rate of economic activity. Housing prices are falling, consumer spending is slowing, layoffs are rising, and demand is getting weaker. That means growth will be sub-par for the foreseeable future. Here's an excerpt from a speech given by San Francisco Fed Janet Yellen drawing the same conclusion:

"I don't like taking the wind out of the sails of our economic expansion, but a few cautionary points should be considered… a massive shift in consumer behavior is under way.. American households entered this recession stretched to the limit with mortgage and other debt. The personal saving rate fell from around 8 percent of disposable income two decades ago to almost zero. Households financed their lifestyles by drawing on increasing stock market and housing wealth, and taking on higher levels of debt. But falling house and stock prices have destroyed trillions of dollars in wealth, cutting off those ready sources of cash. What's more, the stark realities of this recession have scared many households straight, convincing them that they need to save larger fractions of their incomes…. a rediscovery of thrift means fewer sales at the mall, and fewer jobs on assembly lines and store counters….

This very weak economy is, if anything, putting downward pressure on wages and prices. We have already seen a noticeable slowdown in wage growth and reports of wage cuts have become increasingly prevalent—a sign of the sacrifices that some workers are making to keep their employers afloat and preserve their jobs. Businesses are also cutting prices and profit margins to boost sales….. With unemployment already substantial and likely to rise further, the downward pressure on wages and prices should continue and could intensify….

If the economy fails to recover soon, it is conceivable that this very low inflation could turn into outright deflation. Worse still, if deflation were to intensify, we could find ourselves in a devastating spiral in which prices fall at an ever-faster pace and economic activity sinks more and more."

"Falling prices." "Deflation." "Devastating spiral." That's not the kind of honesty that one expects from a Fed chief. Yellen must not be drinking the lemonade.

And don't forget the banking system is still broken. Not a dime from the $700 billion TARP bailout was used to purchase toxic assets. The banks are still drowning in red ink. . Bernanke has known since last September when Lehman Bros. defaulted, that the bad assets would have to be removed before the economy could recover. An underwater banking system is a constant drain on public resources and a drag on growth. Bernanke knows this, but rather than remove the assets by nationalizing the banks or restructuring their debt (as he should have done) he expanded the Fed's balance sheet by $1.2 trillion which provided the liquidity that financial institutions pumped into the stock market. "Bernanke's Rally" has generated the capital the banks needed to keep them from writingdown their debts or filing for Chapter 11, but the problems still persist right below the surface. Just this week, Elizabeth Warren's Congressional Oversight Panel released a damning report which stressed the need to address the issue of toxic assets. According to the COP's report:

> "Financial stability remains at risk if the underlying problem of toxic assets remains unresolved….
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> If the economy worsens, especially if unemployment remains elevated or if the commercial real estate market collapses, then defaults will rise and the troubled assets will continue to deteriorate in value. Banks will incur further losses on their troubled assets. The financial system will remain vulnerable to the crisis conditions that TARP was meant to fix….
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> Changing accounting standards helped the banks temporarily by allowing them greater leeway in describing their assets, but it did not change the underlying problem. In order to advance a full recovery in the economy, there must be greater transparency, accountability, and clarity, from both the government and banks, about the scope of the troubled asset problem.
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> The problem of troubled assets is especially serious for the balance sheets of small banks. Small banks' troubled assets are generally whole loans, but Treasury's main program for removing troubled assets from banks' balance sheets, the PPIP will at present address only troubled mortgage securities and not whole loans.
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> Given the ongoing uncertainty, vigilance is essential. If conditions exceed those in the worst case scenario of the recent stress tests, then stress-testing of the nation's largest banks should be repeated to evaluate what would happen if troubled assets suffered additional losses."

To sum up: There will be NO real recovery until the toxic assets problem is resolved. Unfortunately, the Treasury and Fed have shown that they intend to sweep this issue under the rug for as long as possible.

Toxic assets, falling home prices, widespread malaise in the credit markets are just part of the problem. The deeper issue is the dismal condition of the US consumer who has seen his home equity dissipate, his retirement funds sawed in half,his access to credit curtailed, and his job put at risk. Ordinary working class Americans now face what David Rosenberg calls, "the era of consumer frugality—new paradigm of savings, asset liquidation and debt repayment ." Life styles will have to be toned-down and living standards lowered to meet the new deflationary reality. More and more people will be forced to jettison their credit cards and live within their means.

It's not the end of the world, but it does foreshadow a protracted period of negative growth, social unrest and persistent high unemployment. Here's how the Wall Street journal sums it up: "A surprisingly large number of money managers and economists are warning that, despite the hopeful signs, the economy is still deep in the woods, not strong enough to support a long-running stock and bond recovery….Even after the recession ends, economists expect the gradual reduction of the nation's massive consumer debt to take years.

The debt data are striking. According to the Federal Reserve, total household indebtedness peaked at the end of 2007 at 132% of disposable income. That was by far the highest level since at least the end of World War II, nearly quadruple the 36% of 1952. By the end of March, with families boosting savings, repaying debt and defaulting, the ratio had fallen to 124%, a tad lower but still miles from the level of, say, 69% in the middle of 1985. Consumer spending today accounts for two-thirds or more of economic output. But as they boost savings and cut borrowing, consumers can't be the drivers of economic growth that they were at the end of other recent recessions.

Consumer borrowing fell in June for the fifth consecutive month….

"Consumers are under significant financial pressure," Goldman notes in its report. "The weakness in household income — partly resulting from the sharp slowdown in hourly wage growth — will make it harder to raise saving without significant constraints on consumption."

As for home building and capital spending, two other possible growth motors, "we do not expect a 'traditional' rebound in these sectors, largely because the overhang of unused capacity in both the housing and business sectors remains enormous," Goldman said." ("Debt Burden to Weigh on Stocks", E.S. Browning and Annelena Lobb, Wall Street Journal)

Stock market euphoria can last a long time, but the laws of gravity still apply. The economy is in deep, deep trouble and Bernanke knows it or he'd be raising rates right now. The patient is haemorrhaging my friends, and no amount of happy talk is going to stop the bleeding.