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A Nation on borrowed time

By Mike Whitney

11/12/07 "**ICH**" -- -- On Monday, Asian stock markets took another drubbing on fears that the credit squeeze which began in the United States would continue to worsen in the months ahead. Every index from Tokyo to Sidney fell sharply continuing the “self-reinforcing” vicious cycle of losses started last week on Wall Street. The Nikkei 225 average fell 3.3%, India’s Sensex dropped 2.9%, Taiwan tumbled 3.5%, and Hong Kong’s Hang Seng slumped a whopping 4.5%. The subprime tsunami is presently headed towards downtown Manhattan, where nervous traders are already hunkered-down in the trenches---ashen and wide-eyed--awaiting the opening bell. Local supermarkets reported an unexpected early--morning run on Valium and Tylenol. Good thinking.

Amid the deluge of bad news over the weekend; one story towers above all the others. The yen gained 1.5% against the dollar. (9% year-over-year) That means that Wall Street’s biggest swindle, the carry trade, is finally unwinding. The over-levered hedge funds will now be forced to sell their positions quickly before the interest-rate window slams shut and they’re stuck with humongous bets they cannot cover. The faltering yen is the grease that lubricates the guillotine. \$1 trillion in low interest loans--which keeps the trading whirring along in US markets--is about to get a haircut. Cheap Japanese credit is the hidden flywheel in Hedgistan’s main-cylinder. Once it is removed, the industry will seize-up and clank to a halt. Fund managers can forget about the vacation rental in the Hamptons. It’ll be sloppy Joes and Schlitz Malt-liquor on Coney Island from here on out.

It’s easy to feel self-righteous when things turn out the way we anticipate. The markets deliver a type of impartial justice that we no longer expect from the courts or the government. When fundamentals are breached for too long, the market’s “terrible swift sword” quickly descends leaving the offending party in a pool of his own blood. Then, progressively, market-balance is restored.

Over the weekend Deutsche Bank announced that losses from “securitized”

subprime mortgages were likely to reach \$400 billion. The news sparked a sell-off in the Asian markets where investors have become increasingly eager to pare down their holdings of US equities and dollar-backed assets. Overnight, the greenback has become the leper at the birthday party; everyone is steering clear for fear of contagion. Foreign central banks are looking for any opportunity to dump their stockpiles of dollars in a manner that doesn't disrupt their economies or the global financial system. Their intentions may be prudent—even honorable—but it won't forestall the inevitable blow-off of USDs that is likely to commence as soon as the financial giants reveal the real size of their losses. New regulations have been put in place that will require the banks to provide “market prices” for their assets. This will expose the degree to which they are under-capitalized. When word gets out that the banking system is underwater; there'll be a run on the dollar.

On Sunday, the AFP reported that the Group of Seven richest nations (G7) is considering direct “intervention” in the dollar's decline to prevent a “disorderly correction”.

“It is not too early contemplating the risk of coordinated interventions by the G7,” said Stephen Jen and Charles St-Arnaud of investment bank Morgan Stanley. “History shows that multilateral, coordinated interventions have been key in establishing turning points in multi-year trends in major currencies in the past three decades.”

So now, the ailing greenback is being offered crutches just to keep it from tipping over? How pathetic is that?

On Thursday, Treasury Secretary Hank Paulson reiterated the same tired mantra, “A strong dollar is in our nation's interest and should be based on economic fundamentals.”

Paulson needs to retire. He's simply not up to the task. The problems facing the markets, the dollar and global economy will take more than his bland fabrications to resolve.

According to Bloomberg News: “More than \$350 billion of collateralized debt obligations comprising asset-backed securities may become ‘distressed’ because of credit rating downgrades.”

What's clear is that the situation is getting worse, not better. Honesty must at least

be considered as one of many options, although the Treasury Dept avoids that choice like the plague. Eventually, the public will have to be told about what is going on or there could be social turmoil. Is that what Bush and Paulson want; more mayhem?

Last week, the Financial Times reported: “In recent days, investors have been presented with a stream of high-profile signs that sentiment in the financial world is deteriorating. However, deep in one esoteric corner of finance, another, little-known set of numbers is provoking growing concern. So-called correlation - a concept that shows how slices of complex pools of credit derivatives trade relative to each other - has been moving in unusual ways... ‘What we are seeing in the synthetic [derivative] markets is that there is a serious fear of systemic risk,’ says Michael Hampden-Turner, credit strategist at Citigroup. ‘This is not just about price correlation within the collateralized debt obligation market, but about a potential rise in default correlation and asset correlation.’ ...Until recently, traders often tended to assume that there was relatively little correlation between different chunks of debt, because they thought that the biggest risk to the world was idiosyncratic in nature - meaning that while one company, say, might suddenly default, it was unlikely that numerous companies would default at the same time. However, some regulators have been warning for some time that in times of stress correlation does not always behave as traders might expect.”

The multi-trillion dollar derivatives industry—which has never been tested in down-market conditions---is now moving sideways. No one really knows what this means except that the most-opaque and volatile debt-instruments are now threatening to unravel triggering a cascade of unanticipated defaults and a colossal loss of market capitalization. Credit default swaps (CDS) are rarely thrashed out in market commentary. They are counterparty options which provide hedging against the prospect of default. They are, in fact, a financial Sirocco which is steadily gathering strength as foreclosures mount and mortgage-backed bonds continue to implode. As the Financial Times suggests, the gale-force gusts from this monster should be sweeping through the Wall Street trading pits in the very near future knocking down everything in its path.

There’re also new developments on the sale of “marked to model” CDOs—the red-haired stepchild of the new structured finance paradigm. “The trustee of a \$1.5 billion collateralized debt obligation managed by State Street Global Advisors has started selling assets, apparently starting a process of liquidation,” Standard and Poor’s said. The sale is a red flag for the other holders of \$1.5 trillion of CDOs who’ve been waiting for market conditions to change before they try to sell their mortgage-backed bonds. The liquidation will assign a “market price” to these complex structured investment vehicles. If the price at auction is mere pennies on the dollar, then the banks, pension funds, and insurance companies will have write

down their losses of add to their reserves to cover their weakening assets. Simply put, the State Street sale could turn out to be doomsday for a number of under-capitalized investment banks. Their revenues are already down; this would be the last wooden stake to the heart.

Finally, Greg Noland, at Prudent Bear.com reports on the “looming disaster” at Fannie Mae where, the best-known Government Sponsored Entity (GSE) has entered into the current housing slump with a “Book of Business of mortgages, MBS and other credit guarantees of \$2.7 trillion” which is backed by a measly “\$39.9 billion of Shareholder’s Equity”.

That’s all?!?

As Noland opines, “A devastating housing bust will bankrupt the mortgage insurers, while the solvency of their derivatives counterparties going forward will be in doubt in any number of scenarios. The GSEs are now integrally linked to what I expect to be Credit insurance’s and "structured finance's" astonishing downfall.”

Amen.

For now, the stock market may slip the noose, but tomorrow could be different. The subprime orgy of endless credit expansion, speculative frenzy and murky accounting wizardry has generated a system-wide crisis. The financial apparatus has thrown a rod and is in dire need of repair. At the same time, the big-hand continues to edge ever-closer to midnight. We’re on borrowed time. The dollar is flagging, the banks are floundering, the consumer is upside-down, and Greenspan’s trillion-dollar “easy-credit” dirigible is crashing to earth.

The only thing looking up is oil futures. And they’ll be denominated in euros soon enough.

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