



Ambrose has covered world politics and economics for a quarter century, based in Europe, the US, and Latin America. He joined the Telegraph in 1991, serving as Washington correspondent and later Europe correspondent in Brussels. He is now International Business Editor in London.

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Brace yourself for the insolvency crunch

Posted by [Ambrose Evans-Pritchard](#) on 23 Aug 2007 at 17:38

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The liquidity crunch is not yet over: the insolvency crunch has hardly begun.



Repercussions will follow for the man on the street

Yes, investors are jumping back into the stock markets, hoping this is just another routine shake-out - much like February 2007, or May 2006 - before the rally resumes. The 'buy-on-dips' orthodoxy dies hard.

And yes, speculators have renewed their leveraged bets on the yen and Swiss

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franc carry trades, borrowing cheap in Tokyo and Zurich to play global assets.

The core belief is that nothing has really changed, that the world economy is still in rude good health.

Be very careful. Interest rates in Europe and Asia are that much higher now, with delayed effects starting to bite hard. Japan's economy has stalled to 0.1pc growth in Q2; the euro-zone has slowed to 0.3pc; and China's refusal to import (by currency manipulation) makes it a drain on world demand. Above all, the credit bubble that perpetuated the rally of the last eighteen months beyond its natural life has definitively burst.

Credit spreads on the iTraxx Crossover (a good barometer of corporate bonds) have ballooned 180 basis points since February. The cost of borrowing for most firms in Europe and North America has jumped from circa 6.5pc to 8.3pc, if they can get it.

Many cannot. Germany's Chamber of Industry told me yesterday that it had been flooded with distress calls from family Mittlestand firms unable to roll over credit lines. In Canada and Australia, junior mining finance has dried up almost entirely.

Global junk bond issuance has been frozen for two months. Fresh sales of collateralized debt obligations – the CDOs of [subprime](#) notoriety: a \$1 trillion sold last year - have all but stopped. Banks have yet to off-load \$300bn of debt from leveraged buy-out deals, forcing them to keep the liabilities on their books. They are all snake-bitten now.

The private equity buy-out premium – which pushed up the price/earnings ratio on the MSCI-600 of "median" stocks to a record high of 20 in May - has vanished.

The P/E ratios on the DOW 30 big stocks are much lower – because they are too

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big even for the big cat predators, KKR and Carlyle – but they are not low, given the late stage of the cycle. In reality, an earnings bubble and ultra-cheap credit have flattered profits.

So no, the world has changed, dramatically. Whether this means a protracted global downturn and a “profits recession” depends on how quickly the central banks choose to respond, and how far they are willing to go.

Ben Bernanke is looking hawkish to me, given the shock of what happened on Monday when yields on 3-month US Treasury notes plunged at the fastest pace ever recorded, a panic flight to safety that no living trader had ever seen before.

Why? Because trust had collapsed to such a degree that players with a lot of cash no longer believed it safe to leave wealth in bank accounts, or the money market funds of brokerage companies - (exposed as they are to short-term commercial paper and subprime CDOs). This did not occur after 9/11, or in the heat of the October 1987 crash. Nor did was there such a banking panic in October 1929. (it hit in August 1931). If you think this is of no importance, or that this will pass swiftly, you have a strong nerve.

“When you have a run on the money markets like this, it is bound to spill over into the real economy,” said Albert Edwards, global strategist at Dresdner Kleinwort.

“We already thought there was a 40pc chance of a US recession before all this happened, but the risks are now much higher and don’t forget that rates on adjustable mortgages will keep rising until a peak next March, so the maximum pain will be in the second and third quarters of 2008,” he said

“There will be large bankruptcies, and liquidity is not going to help because too

many people bet the farm at the top of the cycle, and they're now insolvent. A lot more bodies are going to be floating to the surface before this is over," he said.

The belief that Europe would somehow be insulated has been tested over the last two weeks. Two German banks have required bail-outs on subprime bets – Sachsen LB for Eu 17.3bn, IKB for Eu 8.1bn.

Alexander Stuhlmann, boss of WestLB, confessed that the German banking system was in a "not uncritical situation". Jochen Sanio, head of the German regulator BaFin, said a few days earlier that the country faced the worst banking crisis 1931.

Hence the continued actions of the European Central Bank, which has quietly injected 85bn euros in extra liquidity so far this week, almost as much as it did on the first day of emergency stimulus in early August.

"Banks are still thirsty for credit, and the spreads have been amazing. This is not business as usual at all," said Julian Callow, chief Eurozone economist for Barclays Capital and an expert in the arcane field of central bank operations. (He used to work for the Bank of England.)

To clarify: the ECB allotted an extra Eu 45bn extra through a 'weekly refi' on Tuesday; and then Eu 40bn in a 3-month offer on Wednesday to stop the short-term commercial paper market seizing up.

What we know is that 146 banks bid for loans on Wednesday, some clearly in such distress that they were willing to pay up to 5pc interest – a full 1pc above the ECB's benchmark rate.

Just like the dotcom bust: when the US sneezes, Europe catches... you know the

rest.

In a warped sense, one has to admire the cool way that Americans – who save nothing, in aggregate – tapped into the vast savings pool of thrifty Germans to finance their speculative excesses, and then left the creditors holding a chunk of the subprime losses.

Was it sharp practice, in the same way that foreigners were recruited by Lloyds of London in 1986 and 1987 – before the impending asbestos losses were known – and place like cannon fodder on “spiral syndicates” to absorb crippling losses? (Lloyds denies this occurred).

I am indebted to Randall W.Forsyth from Barron’s for this delicious quote from a hedge-fund operator, recounting with disgust what happened this time in a letter to clients.



'Real money' (U.S. insurance companies, pension funds, etc.) accounts had stopped purchasing mezzanine tranches of U.S. subprime debt in late 2003 and [Wall Street] needed a mechanism that could enable them to 'mark up' these loans, package them opaquely, and EXPORT THE NEWLY PACKAGED RISK TO UNWITTING BUYERS IN ASIA AND CENTRAL EUROPE!!!!

"These CDOs were the only way to get rid of the riskiest tranches of subprime debt. Interestingly enough, these buyers (mainland Chinese banks, the Chinese Government, Taiwanese banks, Korean banks, German banks, French banks, U.K. banks) possess the



'excess' pools of liquidity around the globe. These pools are basically derived from two sources: 1) massive trade surpluses with the U.S. in U.S. dollars, 2) petrodollar recyclers. These two pools of excess capital are U.S. dollar-denominated and have had a virtually insatiable demand for U.S. dollar-denominated debt . . . until now.



Shameless.

Posted by [Ambrose Evans-Pritchard](#) on 23 Aug 2007 at 17:38

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Shameless

[jon livesey](#) 23 Aug 2007 20:50

Yes, it is shameless, but it brings to mind the old crack about not being able to cheat an honest man.

Foreign banks have investors, and they were trying to generate returns for them, so they turned to the highest interest bearing bonds they could legally buy.

Now, are we to suppose that not one of those banks employs someone competent enough to look at the bonds in detail and see their weaknesses?

I think that what really happened is that the foreign Banks really took a bet on the Fed. They knew they were buying smelly junk, but they took the bet in the belief that the US home industry and its lenders are "too big to fail".

In other words, they looked at how the savings and loans were bailed out in the previous crisis and said "Moral hazard? Gimme another slice of that."

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It takes two to tango

[Walt OBrien](#) 24 Aug 2007 03:09

What this "crisis" looks like in the trenches (or should I say "tranches," heh, heh) makes the entire situation much easier to understand. It also explains why a bailout is not only wrong, to do so is compounding a crime of not simply lenders, but the people who bought into the scheme.

First off, anyone who uses equity in their home as a sort of automatic teller machine to cover expenses like a new deck in the yard, a new hot tub, a new Lincoln Navigator, at the same time these borrowers are eating at their parents five days a week because they can't afford groceries, are nuts. Millions of Americans for years have been borrowing money on this basis with a shrug saying, "If I can't pay it back, no problem. I'll just declare bankruptcy and keep all the trash I bought without paying for it."

You can buy books here on how to defraud a legitimate bank systematically using our bankruptcy laws with strategies described in detail which I have seen to work.

Millions have done this, Ambrose. Whole cities full of scofflaws. Everyone wants to talk about it like it was some sort of act of Nature or force majeure or a product of the alignment of the stars, but the plain facts are, like in the 1920's, but for the simple honest few, the entire middle class has been running around like a teenager with their first credit card for at least a decade. In the Twenties, it was blue sky stock flotations to rob farmers and small manufacturing investors for laughs, then off to NYC under an assumed name or to Mexico with the loot.

I am hoping that the next step is for credit cards to be returned to their status in 1969, when only Diners' Club and Carte Blanche and American Express were the only firms in this business: business use only, fully prepaid like what they call a debit card now, and jail for refusing to pay them down.

REAL inflation is at 18-20% because most middle class boneheads float most of their daily and weekly consumable expenses through their cards. Where do people get the idea inflation is at 3-4% or less? Doesn't anyone read the price stickers when they go shopping anymore from year to year? Credit cards, as well as home equity loans and sleaze-dog "let the Fed's pay for it" easy money loans need to go, too.

From Day One everyone who plays this game has presumed the Feds will bail everyone out for being spendthrift grasshoppers. It's almost winter for these grinning grabbers, and I don't see any green Treasury cheques yet. If we stop telling people it's okay to be a thief, and they'll stop thieving, if there are consequences involved.

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So what does the smart investor do now?

[jayson](#) 24 Aug 2007 06:59

I agree with the above analysis. The sub-prime and derivatives mess has been predictable. The question is: where to go now for safety or even profit?

Will the central banks continue to inflate? If so, will the markets eventually catch-on and sell the currencies and buy gold and hard assets?

Or will debt continue to collapse and cause deflation, in which case we should have cash under the mattress?

or will it be both. First a deflating crash followed by a inflationary Fed response.

Thoughts?

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My biggest finance lesson

[Mike Newland](#) 24 Aug 2007 08:44

It was a sunny day in 1973 at the height of the first property boom and I sat in a cafe with several property dealers and estate agents.

They told me that property prices could not fall because the government could not afford to let it happen.

All those round the table went bankrupt in the subsequent property crash.

The lesson I was taught was simple - the business being invested in was TOO BIG TO FAIL!

The real lesson was similar to that offered by Long Term Capital Management. Yes there is money to be made but only if you are sufficiently capitalised to survive the runs of extremely bad luck which will occur. Don't assume no such run will happen in your lifetime.

Just like a casino in fact.....

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My biggest finance lesson

[Mike Newland](#) 24 Aug 2007 09:58

One point I omitted.

I was merely a cautious onlooker reluctant to be sucked in by the sirens of a guaranteed profit telling me to leverage and invest - I did not go bust myself.

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kondratieff

[Dr M A Rose](#) 24 Aug 2007 10:38

I once photocopied a one page article from the Economist, in 1987, on kondratieff curves. In it was a graph of world economic activity which purported to show the next big depression around 2010. The explanation for the fall from ca. 2000 to 2010 endpoint was squeezing excessive debt out of the system.

It would interesting to get the Economist to dig it out again. I lost my copy in the endless moves with jobs etc.

My personal view is that things will really go bad after the Beijing Olympics in 2008



A really stunning novel was written about the London property crash

Walt OBrien 24 Aug 2007 13:17

"The Ice Age," by Dame Margaret Drabble. Showed the human side of it in depth. It's a pity it wasn't made a film, as it would be the perfect fit for this point in history.

Come to think of it, odd that none of her books have been filmed, nor any by her sister, Dame A.S. Byatt.

During major economic downturns, industries that blossom are the film industry, literary publishers, music publishers, and such nostrums as candies, liquor, and fast food (the last Depression is what created roadside restaurants, serving jobseekers and migrant labour of all categories---everyone was a migrant labourer then, senior, even Los Angeles :>)

The finance mechanisms for industry are totally untouched by this kerfuffle. Factors and other shipping lenders, specialty heavy industrial merchant bankers, and "bridge" loan providers and capital equipment leasing firms providing working capital to purchase order-driven B2B enterprises are doing and will continue to do well.

Asian Development Bank, IBRD, and the rest of the development banks are also chugging along great guns, as they are basically pre-capitalized or put out for competitive bid for the international infrastructure project financing, in many instances.

It's odd how so many investors miss the fact that there are several totally

independent streams to the overall economy which never impact each other, like large fish passing each other in the depths. Wish I had a pocketful of Rolls Royce plc shares at this moment in time: they cannot deliver aircraft engines fast enough.

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kondratieff

[sold to rent](#) 24 Aug 2007 16:49

Dr M A Rose,

kondratieff studied prices. Modern longwave theory puts the cycle around the build-up and destruction of debt. See the www.thelongwaveanalyst.ca

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2billionaday

[webber1](#) 24 Aug 2007 17:32

Excellent article.

I was wondering why there was an endless stream of credit card applications showing up in my mailbox for the past 5 years. And Zero percent financing, various other exotic consumer credit offerings on a wide range of consumer goods, ("Start paying one year from now!"), easy mortgages and car loans, etc... Create debt by any means you can, only to repackage it as a financial instrument.

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Bubble Trouble



Mansfield Moron 24 Aug 2007 20:44

This depending disaster could so easily have been prevented by linking base rates to money supply. Curbing personal and government spending now is far too late. The toothpaste is already out of the tube.

Decreasing asset prices and the drying up of credit will lead to a recession.

Whether we get 8 years of stagflation or a thirties style bust I'm still yet to work out. It's not just the US that's dined out on debt, there's plenty of it in the Club Med, Ireland, Eastern Europe etc. eg 50% of global GDP. China with 4% isn't even capable of picking up a matchstick rather than any baton.

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I remain a 'Dunno'

Mikea 24 Aug 2007 22:12

The answer is we just do not know whether this is the end, the beginning of the end or the end of the beginning !

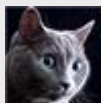
Remember when 120 or so 'eminent' economists wrote and told Geoffrey Howe he had got everything wrong ? How wrong were they ?

Remember the forecast that property prices were fine in 1989 - how wrong were the forecasters - to the detriment of those who found out about negative equity. The sub prime slime could spread over here of course.

I loathe the vulture capitalists who load companies with debt and walk away rich - whilst the workers lose everything. Boots and Debenhams could be victims of that as could Man U. It is certainly not the kind of capitalism that I feel content with. If some of these people get scorched - whoopee !

Having read all the forecasts I can only spread my money between equities, cash and property. I remain a 'Dunno' !

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End of the beginning

[jon livesey](#) 25 Aug 2007 01:56

"The answer is we just do not know whether this is the end, the beginning of the end or the end of the beginning !"

My guess is the end of the beginning. While everyone is gazing with awe at the sub-prime mortgage meltdown, the next shoe is already dropping in what's called "commercial paper" which is a form of debt higher yielding than government bonds.

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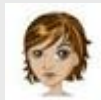
What about Japan?

[Mike Newland](#) 25 Aug 2007 12:04

A current line in newspapers says that central bankers and economists understand much better than in the past how to prevent serious problems.

But what of Japan in the 1990s which did not respond too well. Paul Krugman writes about this in his usual lucid style in 'The Return of Depression Economics'.

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Not Surprising

[systemBuilder](#) 25 Aug 2007 18:36

Well, Europe (through VAT) has rigged its markets to depress local markets and

create an unfair export-over-import economy. Asia (through artificially low currencies) has rigged its markets to obtain an unfair export advantage.

When you play games with economic fire, you deserve to get burned ...

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US Recession ahead

[oldasiahand](#) 27 Aug 2007 16:58

A lot of good commentary here. But we are a long way from the point of maximum pain in the mortgage interest readjustment game. The real tsunami is about to mushroom and hit and peak in the April-June period next year. This will cause foreclosures, already high, to go off the charts and a cutback in consumer expenditure and a probable recession next year in the US.

Something else is different this time that most people have not picked up on. Under a law passed in 2005 and pushed by the US banking lobby, bankruptcy will no longer expunge credit card debts. Unless an energised Democrat Congress changes that, consumer expenditures will suffer far more than in past slowdowns. So hunker down and avoid leverage at all costs. This could get really nasty.

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The die is cast

[debtfree](#) 28 Aug 2007 10:45

It seems to me and to some that I know in the relevant financial markets that what is going to happen is going to happen, the first domino has already fallen and the only questions that arise are when the full crunch comes and whether

the national governments and central banks can create enough and big enough breaks in the chain of dominoes.

It seems from reports today that the ECB has come under pressure, particularly from Sarkozy, to tone down their ambitions and rhetoric on interest rates and if true no doubt Sarkozy is not alone but the mere fact of such pressure will cause the problem to worsen of itself and perhaps hasten the crunch as the big financial institutions have got used to non interference by politicians and will get nervous.

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So what does the smart investor do now?

Newstar007 28 Aug 2007 18:14

Reply to Jayson.

You have it right on my friend. This will be a case of immense deflation, coupled with immediate hyperinflation.

The first (deflation - collapse) will be based upon the crunch of credit. Housing prices will collapse, and the contagion will spread across the world. This coupled with stock market crashes will evoke the Federal Reserves across the world to lower funds rates in combat, but this will prove futile, as the fiat currencies will start to crack. Immediately panick shall kick in and a run into hard goods like precious metals, to prevent debasement of fiat currencies.

The trick here is to purchase hard goods just after the crash, when everyone is scrambling to prevent the fallout...do not trust the markets to be open to accomodate paper trades or honor commodity substitutes or derivative plays.

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So what does the smart investor do now?

DAVID VINTER 29 Aug 2007 20:36

World grain stocks are at the lowest levels for years, the world population keeps growing at one and a half million every week. The US is making over 30% of it's corn crop into Ethanol. John Deere make good tractors!

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Get a life

debtfree 04 Sep 2007 16:04

Answer: If you have enough money, enjoy it. If you don't, no investment will make any difference.

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2005

Christopher in California 08 Sep 2007 00:24

In 2005 many knew that the real estate bubble was not tenable. The only big surprise is that it took this long for things to begin falling apart.

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Learn to trade Forex

pt49 21 Sep 2007 08:30

Learn to trade Forex and it matters not where the currencies of the world go.

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