The Oil Drum: Canada
DISCUSSIONS ABOUT ENERGY AND OUR FUTURE

The Year In Review And a Look Ahead for 2008

Posted by ilargi on January 3, 2008 - 10:57am in The Oil Drum: Canada
Topic: Economics/Finance

This is a guest post by Karl Denninger. It originally appeared on Karl's Market Ticker site, part of Denninger.net. We find it an excellent discussion piece, with a lot of valuable information on what goes on behind-the-money-scenes. Karl can be reached at karl at denninger dot net.

This year saw “subprime” become the buzzword in the mainstream media, as people crowed about how horrible it was that banks and others made loans to “poor despondent people who could never pay them back”, and harping on the “predatory” nature of 2/28s and other similar death-by-debt traps.

The market saw three major swoons, the first in February, the second in August, and the last in November. It also saw multiple “Hindenburg” crash omens, all of which (on a technical basis) confirmed with the predicted plunges (a 5% move off the first observation downward qualifies as “confirmation”.)

Finally, in November, we got a primary bear market indicator according to Dow Theory.

There are many who argue that The Bear Market, however, not only did not arrive but that we will rocket to new highs, and have a solid market in 2008.

It is my view that they are sorely mistaken, and soon are to be not only dead wrong but dead broke.

Let us first look at what led us to where we are today.

The common wisdom – and one that I, until relatively recently, accepted, was that Alan Greenspan was partly (or even entirely) to blame for this debacle as a consequence of the rate cuts put into place in 2001 after 9/11 in an attempt to stave off a recession. This view holds that “too cheap” money caused the inflation of an asset bubble in a place it had not been in the American Experience – Residential Real Estate.

The effect – that residential real estate bubble – is real.

But the cause is not so simple.

Critical investigation leads one to the inescapable conclusion that The Federal Reserve does not actually set interest rates – long or short – at all. In fact, they don’t even claim to. Their official language is that The Fed sets the “Fed funds Target rate”. Note carefully that you cannot borrow at a “target” rate....

So what does The Fed actually do?

The target is indeed a lending rate – their “intended” overnight lending rate between banks.

They “defend” this target by either injecting liquidity (cash) into the banking system, or withdrawing it from the banking system. To inject “cash” they temporarily take in various debt securities (Treasuries and others) from banks, and issue them cash – much like you’d pawn your Rolex, diamond ring or handgun. These “repos” have a relatively short term (typically from one to 30 days) and when they expire, you are required to give The Fed back the cash, with, of course, interest. These “TOMOs” (or “Temporary Open Market Operations”) are conducted daily in the normal course of operation of the banking system. If the actual “trading rate” of overnight money between banks is too low, The Fed will either refuse to “roll over” some of the expiring TOMOs (thereby reducing the amount of “sloshing”, or free cash, in the system) or, if necessary, will actually do a reverse TOMO, effectively “putting” some of its Treasuries (that it holds itself) out into the marketplace.

When the manipulations of this sort become overly burdensome to maintain the target rate, because the demand for overnight money has either fallen or risen too strongly to be defended, the target is changed.

That’s it.

There is also a second sort of operation called a “POMO”, or **Permanent Open Market Operation**. These are far more rare; they are literally outright purchases (or sales, if a reverse) of these securities. Typically The Fed will do a handful of these per year to cover the increase in the actual demand for hard currency that accrues in the system over a year. **These are very small, usually in the neighborhood of $10 or 20 billion in total in a given year, and really ARE “printing” of money, in that The Treasury is the source of the T-bills, and when they are “permanently” taken off the market and exchanged for dollars, those dollars are, effectively, “printed”. The Fed did not do the printing – Treasury did – The Fed was merely the conduit.**

Let’s be absolutely clear here folks – “Liquidity” is not “printing money”. It is not “inflationary”. In addition, the actual monetary inflation conducted by injections of real, hard, **CASH** into the system has been miniscule all through 2007 (and prior years as well.)

Liquidity is a loan!

Let’s apply it to a typical individual’s situation and it should become clear.

Let us say that you have some diamonds, a Rolex, and a couple of handguns.

Let’s also say that you have a job, and that job pays you $5,000 a month, after taxes. You spend basically all of this, having only a few hundred dollars in the bank in cash. After all, you’re a good little consumer, right?

Now let us assume that your car has no collision or comprehensive insurance. That is, you maintain only the legally-required liability insurance.

Ok, so late one night while you are sleeping Joe Thugg shows up and steals your car. You wake up in the morning and find that your car is gone! This is, of course, a disaster. You need to get to work, or you will soon not have that $5,000 a month in income.

Well now you have a problem, don’t you?

You could go to the bank, but the bank is likely to look askance at your request for a loan. After all, you don’t have a house, and they’re not all that interested in your Rolex.

So you go down the street to the local pawn shop. Here you find “liquidity.” You execute the equivalent of a personal TOMO with the pawnshop owner. He gives you cash, and you give him your Rolex, your diamonds, and all but one of your handguns (you need the last one in case Joe Thugg shows up again!)

Note that once you walk out of the Pawn Shop you are actually in a worse financial situation than you were before! Yes, you're "liquid", but you now have an interest payment monkey on your back to go along with the cash.

When The Fed "injects liquidity" they have not created money; in fact, they have made the bank's balance sheets more encumbered because the interest has to be paid too!

But of course, just like the bank, you use that $2,000 to buy yourself a car. This allows you to go to work and keep your job. A month passes, you tighten your belt, and the "TOMO" matures – you pay the Pawnshop owner back (with interest) and retrieve your Rolex, guns and diamonds.

When you hear that The Fed has injected "liquidity" into the system, this is what has happened. Further, what is almost always not reported in the media is that amount of maturing TOMOs on the same day or those bordering the action. So you will hear reported that "The Fed (or ECB) has injected a record amount of liquidity into the system" as if this is some "bullish" thing, but what they fail to mention is that the same – or even more, in many cases, TOMOs have matured on the same day, making the net injection zero!

Just remember folks – "liquidity" isn't hard cash. It's a loan, it carries interest, and it has to be paid back – on a short term basis.

Ok, so we've dispensed with this foolishness that "The Fed can save us."

In fact, they cannot.

They want people to believe they can, however, because from that belief derives literally **all** of their power. Should people actually come to understand the above paragraphs – the fact that "liquidity" is just really a loan much like a pawnshop gives you, and that **The Fed is powerless to impact what is going on in this fashion in the end, as loans always have to be paid back**, they would lose the only **real** weapon they have: **The power of the mouth.**

You've seen it. Some Fed Governor speaks and the market moves, often dramatically. **The public and investors believe that The Fed is omnipotent, and that results in the market moving when they talk.**

The power is, in fact, illusory, just as was The Wizard of Oz's.

Understand the above and you're ahead of 99% of all investors on Wall Street – including so-called professionals.

And oh, by the way, if questions I'm getting from a couple of college student friends of mine are any guide (who are in business-oriented majors), they're not teaching this in "higher education" either!

Ok, now, on to inflation and deflation.

Inflation is **always** a monetary phenomenon, as is deflation. **The effects** of inflation or deflation are usually found in prices for goods and services, **but they may show up in various items in different ways**.

The event, however, is simply a change in monetary base.

PERIOD!

The monetary supply, to maintain balance, must grow at a rate which approximates the growth in productive output, otherwise the money system will eventually starve itself of liquidity. An example will make this clear.

Let’s assume the world has only two people in it, you and your neighbor, and $100 in total.

You have some farmland, and some corn. You plant the corn and it grows. You now have more corn than you started with; you began with some kernels as seeds, they grew through the input of your labor, rainfall and the sun’s radiation, and now you have more corn kernels than you started with.

You and your neighbor, however, have been eating some of the corn during the year. This “essential consumption” must be subtracted out from the whole. (Clearly, if you planted no corn, eventually you would eat it all and you’d both starve to death.)

So let’s say that at the end of the year there is 10% more “stuff” in the world than there was at the beginning, where the only “stuff” that we’re counting is, in fact, corn.

If the amount of cash (money) remained at $100, you would suffer deflation. The monetary base has not grown, but the amount of “stuff” has. Each dollar buys more “stuff”, but that’s an effect – not the cause. The cause is that the monetary base has not expanded.

To maintain parity you would have to issue $10 more in money. This money was “printed”, in that you just literally fired up your printing press and made it. But because it exactly matched the increase in “stuff”, there is no inflationary or deflationary change.

Price for corn would remain stable, all other things being equal.

But let’s say you printed another $100. Now the price for corn would likely rise, because the total amount of money has increased by more than the amount of “stuff”. Therefore, the balance on prices shifts to the right, and the price-per-kernel (or bushel) for that corn rises.

This is “how money and inflation really works”, but it’s not what you are taught.

In reality, of course, there are all sorts of different kinds of “stuff”. Oil, gasoline, diesel fuel, corn, wheat, pork, beef, houses, TVs, computers, cars, haircuts, lawn mowing services, electricity and more. The system is thus very complex, but it still works the same way – in total.

So when you hear that “inflation” is rampant because oil has gotten more expensive, that’s not necessarily true. Oil is more expensive, perhaps, because oil is scarce while people who wish to buy oil are not. That is, the supply and demand component on any particular item in the economy may change while the total monetary base compared to the increase in global output may or may not.

One must look in the right place to find the truth.

The media doesn’t help you in this regard.

Ok, so how about what’s been going on since 2001?

Well, now here it gets sticky.

See, money isn’t just cash. We think of “money” as Federal Reserve Notes – or what I like to call “Dead Presidents”. In point of fact that’s true – hard money, or cash, is indeed these “FRN”s and deposits denoted in them. That is, if you have $2,000 in your bank, even though that $2,000 is just an entry in a book somewhere (electronic these days) you can show up at your bank and demand it, and they will give you $2,000 in dead presidents with which you can then walk around.

Ok.

But what about that pawn shop up above?

Ah, now we’re getting to where the problem is.

See, The Pawn Shop doesn’t start with much, other than the building the owner is sitting in.

He is, however, in fact a **debt merchant**. That is, his job is to siphon off some of your productive output and keep it for himself. He does this by giving you FRNs – cash – for things that currently aren’t cash but represent some past productive output of yours. In your case these things are diamonds, handguns and your Rolex.

But in doing this he takes some of your hard-earned future output, because when you go to redeem those items you must pay him more than he gave you.

Is he “manufacturing money” when he does this?

No.

He in fact borrowed the actual money he gave you himself! He went to his bank (or someone else) and pledged his business assets in exchange for some money. They charged him interest!

So he must charge you more than he pays; if he manages to do this, he can pocket the difference and make a profit. If not, he eventually goes bust.

But what happens if you can’t pay him?

He seizes your collateral and sells it.

Now what?

Well, if he manages to get more for the collateral than he gave you, he has turned a profit.

But what if he gets less?

Then money is effectively destroyed – and this, my friends, is deflation!

Let’s say that he gave you $1,000 for that Rolex. You spend it and can’t pay him back. He goes to sell the Rolex and discovers that either nobody will pay HIM $1,000 for it, or worse, it’s not a real Rolex! Let’s say he can get only $500 for the watch when he sells it.

What happened to the other $500? It has been destroyed, along with the interest that he paid to the bank to borrow the $1,000 in the first place when he loaned it to you!

To keep this sort of thing from getting out of control the banking regulators are supposed to enforce reserve requirements, and the markets are supposed to enforce margin requirements. This is done because although there are deflationary pressures in any market, if they ever get out of control asset prices will fall and quite rapidly this becomes a self-fulfilling spiral.

See, if you wish to buy a car (or house), but see that the prices for cars are going **down** rather than up or remaining stable, assuming you do not immediately need the car (your old one still runs) and you have the cash you are well ahead of the game to wait! After all, if cars will be cheaper in six months, why buy now? **This destroys demand, which in turn means that**

the guy who makes cars can't pay his suppliers because he hasn't sold his stock of vehicles. That results in more defaults on debt which further deflates the money supply. This, in turn, causes prices to fall further, and on it goes!

So why are house prices deflating?

Well, the short version is "because they overly inflated in the first place."

The long version is a bit more complicated.

After 9/11 Greenspan not only followed the demand for credit down but he also "winked and nodded" at banks and others, especially those on Wall Street, who were in effect cheating the system.

Let's say that you have 1,000 mortgages that you've written to all sorts of people. Their actual risk if defaulting on their mortgages is reasonably low, especially when you look at all 1,000 of them as a pool, instead of each individual mortgage. Let's say for the sake of argument that the actual "risk premium" – that is, the reasonable cost of the money compared to a "risk free" investment such as US Treasury bonds, is 200 basis points – that is, a 2% higher interest rate "fairly" compensates for the risk you won't pay.

Ok.

So I have a pool of mortgages that was made when the 10 year Treasury bond was yielding 5%, and the "fair" return on that pool is 7%. All is good.

Or is it?

Well, no. See, everyone who touches that pool wants a piece of the action. If I'm an investment bank I can't possibly do this work for free, so I want 25 basis points of that 200 for my profit in "putting all these together and managing them."

Then there is the company that services the loans. They take the payments from each homeowner and make sure that they're correctly accounted for. This requires staff, phones, computers, etc. They too want to be paid – let's call that another 25 basis points.

So now we have 150 basis points left of "margin" over the 10 year Treasury rate. If we sold "slices" of this debt off, at best we could "allow" a coupon that reflected that 150 basis points.

Unfortunately greed got into the equation.

The banks figured out that they could structure these 1,000 mortgages into different "tranches" with different characteristics. If you take all the money coming in and look at this as one big pool, that gives everyone only one thing to buy. But if we take that pool and split it up into a bunch of different levels of risk, we can now offer slices that have different levels of return.

For instance, we could draft some documents that say that if the total amount of money due isn't paid (by everyone) that the first risk of people not paying would fall on a certain class of the buyers. These buyers would get a much higher coupon payment, but they'd take much higher risk, because no matter which "Joe" doesn't pay their mortgage, these people would eat it preferentially, while those above them with a "lower" grade of risk would keep getting their payments.

This is the essence of the "Mortgage-backed security", or MBS.

But remember – no matter how you slice this whole deal up only 200 basis points of profit is in there over treasuries to make. You can change who eats the losses and how much the various "fingers in the pie" get to siphon off, but you can't change the total amount of profit available.

OR CAN YOU?

Wall Street figured out that **YOU CAN IF YOU ARE WILLING TO CHEAT.**

All you have to do is find someone who will run your "deal" through a computer program and "grade" the quality of its debt. If you can find someone who will claim that the total risk of the deal is **lower** than it actually is, you make out like a bandit, **because instead of 200 basis points of actual profit you suddenly "find" another 50 or 100!**

The problem is that the real risk **DID NOT CHANGE**.

So how do you go about trying to "massage" the deal?

One of the ways is that you find someone who will write you what is called a "Credit Default Swap." In its simplest form this is an insurance policy; you pay someone a small amount of money and they issue a contract that says that if the bond defaults you give them the bond and they give you the face value. They then have the defaulted bond and can try to recover whatever is still there (remember that the house that was pledged didn't go to zero – it has some value, so the "defaulted" mortgage money is not entirely lost.) Now, with this "CDS", the ratings agency "sees" that your risk of actually losing money has gone down, and they issue you a better grade – after all, if the bond does default, the swap-writer will pay you.

Didn't we just find a free lunch?

NO – We found a scam!

Why?

Because nobody gives money away; everyone always expects to make a profit.

If the CDS writer has charged you an amount of money necessary to actually cover the risk of a default, plus their profit, the total amount of money available off that 200 basis points decreases. That is, the total profit available in the deal must decrease for each component that is added to the complexity of the transaction and for each person who has some "finger in the pie."

The common law of business balance prohibits it from being otherwise in fact, no matter what you are told.

THERE IS NEVER A FREE LUNCH!

But by intimating that there is, **which can be as simple as finding someone who will "misprice" risk, either out of their own stupidity (in other words, greed) or outright intentional deception**, we make money "cheap", and suddenly, people can buy houses they could otherwise not afford.

Why?

Because the person who writes that swap at a lower-than-actual-risk premium has effectively "created" money. They have made a promise to pay they cannot keep at the actual price of risk; in effect, they have "grown" the monetary base via cheating!

A person who is a hairdresser and makes $8/hour ($16,000 a year @ 2,000 hours annually) cannot possibly afford a $500,000 house. **But a lot of $8/hour hairdressers bought**

$500,000 houses! If those loans were properly priced to reflect the odds of default the interest rates on those loans would have been astronomical. **But they were not, and in fact they were priced in many cases with "teaser" and "negative amortization" rates that were as low as 1 or 2%, with the rest of the interest and principal being "capitalized" – or put back into the loan balance!**

This was all justified by the belief that house prices would never go down and so if the Hairdresser could not pay, the bondholder would not really take any loss. Yes, they'd default, but the recovery would be near perfect, since the house would be worth more than the mortgage outstanding.

The problem is that house prices cannot increase forever at a rate which exceeds the rate of productive output increase in the economy as a whole! Eventually you run out of suckers - and the scheme collapses.

So why did the banks do this if they knew that eventually they'd run out of suckers?

Primarily because their biggest source of income was the fees from making all these deals! That is, that 25 or 50 basis points that they extracted from passing the money through their hands.

Clearly, the original intent was not to keep any of this risk on their own books – they intended to pass it off to others just like the pumpers did in the 90s with the hundreds of Internet Companies who never had a prayer in Hell of turning a profit.

Unfortunately in their zeal they started to **eat their own cooking**, and kept some of these deals on their own balance sheets! Some of them got even more clever and set up "off balance sheet" conduits and "Special Investment Vehicles" to buy this paper, which allegedly were not "responsibilities" of the bank. But the "wink-wink-nod-nod" reality was that they were, because without that responsibility the ratings agencies would never give them the credit rating they **NEEDED** to be able to sell it.

Let's take just one example of "eating your own cooking" – Washington Mutual (WaMu).

Back in April I noted that their first quarter 10Q showed that they had less cash income than their dividend payout. That is, they had less than their 50 cents/share dividend in actual cash earnings. The rest of their "earnings" were in fact "capitalized interest." That is, these negative amortization loans which are increasing in outstanding balance were actually being booked as profit as the face values went up! The two obvious problems with this (although its legal under US accounting rules) are that (1) you can't spend "capitalized interest" as it is not cash you have received and (2) if the "increased balance" is not paid because it results in a default you wind up taking a monstrous write-down and restatement in the future. And oh, by the way, this trend has continued in both the 2nd and 3rd quarters for WaMu.

The stock market thought this was great in the first, second and third quarters, and their stock price hovered around $30, making people like me who had bought PUTs very unhappy.

But eventually, "Mr. Market" figured it out, and now they trade at under $20 – a more than 30% "haircut" – as people have come to realize that you can't spend negative amortization "income" and that collecting it might be doubtful as well!

What about the monoline insurers? **They are at ground zero of this mess** because they wrote "swaps" for which there is no prayer in hell of being able to actually pay.

All of this "credit" was in fact **extremely** inflationary. The monetary basis did not grow much in terms of actual cash, but the rub here is that cash, credit and debt are called "fungible" – that is, you can exchange one for the other, almost without limit. *You can spend credit as if it was cash, essentially without limit!*

When you go into a store and swipe your credit card you are in fact taking on debt. When you pay it off at the end of the month you swap cash for debt. If you pay it off at the end of the money there is no “discount” charged to you – that is, from your perspective, credit, debt and money (actual cash) are all the same thing. Of course the truth is that there was a discount charge – the merchant ate it in his “discount rate” for credit card purchases – but its invisible to you as a consumer to maintain the illusion that cash = credit = debt.

In reality they are not, because credit and debt have interest (either owed or paid) while cash does not, **but in the economy they are essentially the same thing from a standpoint of purchasing power and the impact on prices that come with it.**

Remember that bit above about “deflation” when you can’t pay the pawnbroker?

Well now we are seeing it on a global scale as people can’t pay their mortgages!

As this debt defaults, the money that it represents is **destroyed.**

As money is destroyed it becomes scarce while goods and services (especially the goods that were being bought with defaulted debt like houses) get much less expensive, because there are too many of them compared to the dollars available. **This is the effect of deflation – prices on those items tend to go down.**

How much money is going to be destroyed, in total?

It is not possible to know exactly how far down the rabbit hole this goes, but we do have some information to base a reasonable guess upon.

One of these facts is that about $6.5 trillion has been “withdrawn” from home equity over the last four years and spent. Most of that was spent not on home improvements (which at least have some residual value) but on things like computers, plasma TVs, cars and exotic vacations (directly or indirectly by paying off credit card debt accumulated purchasing those things.)

Of this $6.5 trillion perhaps one third of it is now “underwater”, in that it is represented by “Home Equity” loans (HELOCS) on houses that are now worth less than the total of the mortgage and HELOC outstanding. **This debt will almost certainly eventually default in large part if not in total.**

This is somewhere between $1 and $2 **trillion** dollars.

Nor is this stupidity limited to mortgages.

It reaches through essentially all of consumer finance; auto loans and credit cards are the other two biggies.

In auto finance dealers have, for years, allowed you to drive up in your “old” car which has a note on it, and roll the remaining balance of the loan (less the radically-depreciated “trade in” value) into the new car loan. This results in you being instantaneously “upside down” by thousands of dollars – plus the instant 10-20% hit on a new car when driven off the lot! This has been a tremendously profitable business for dealers, but remains one only until you can’t make the payments. Oh, and car loans have been securitized just like mortgages.

In the credit card space the flood of “0% balance transfer” deals has allowed consumers to stay just ahead of default by rolling balances from one company to another. The problem with all of these is that the fine print says that as soon as you charge $1 on that new card your payment goes first against your “0% transfer”, and the $1 charge accrues interest until the entirety of the transfer is paid off. Almost nobody sticks the card in the drawer, and this is how the card companies make money on you, the sheep. When the payments start to get tight you do it again.

Unfortunately there is a limit to this, and it happens when your creditworthiness is exceeded by the balance outstanding or worse, you lose your job. This is now occurring and the default rate is spiking north. Credit card deals have also been “syndicated” like mortgages and car loans; there are “asset-backed securities” for them as well, and even CDOs!

As the debt defaults deflationary pressure will build precipitously. **We have seen only $100 billion or so thus far in actual write-downs by banks and other institutions worldwide. This is 10% or less of the actual damage that has been already suffered, and we haven’t even gotten to the knock-on effects that come from people waiting for cheaper prices – that is, the effect of deflation instead of the cause!**

What’s worse is that I haven’t even begun to examine if, or to what degree, this has impacted lenders and the economies of other nations – like, for example, Spain, which is known to have a huge property bubble, or England, which has also seen insane residential price appreciation. Have the same games been played there? *I would not take a bet that they haven’t!*

Why has only $100 billion been recognized and written down when far more than that has already blown up?

Simple – these banks and others are keeping their “marks”, or present value, of their holdings at artificially high levels because they hold these CDS “insurance policies” which claim to insulate them from the effects of the damage.

But as noted above, there is no chance that these companies can actually **PAY** the face values of these polices.

These firms typically have 0.1% or less of the “face” value of these written policies in available cash to pay claims.

In short the CDS policies are **WORTHLESS TOILET PAPER**.

The proof of this is found in the balance sheets of **ANY** of these “monoline” companies. Look at them yourself. Look at their cash position and then the total amount of underwritten business (the “face value” of the bonds they have written policies on.) Now tell me how these firms can possibly pay more than a tiny fraction of one percent in claims against these notes.

They cannot.

Yet the “ratings agencies” have, for the most part, maintained these firms’ “AAA” ratings! It was **just in the last week** that ACA, which had been delisted from the NY Stock Exchange, was cut to “junk” status! **The deterioration in the credit markets, including the CDOs and mortgage-backed paper, has been known since February, yet the ratings agencies SAT ON ACA’S RATING UNTIL THEY WERE DELISTED BY THE NYSE**!

While the others have been threatened with downgrades, **at this point those downgrades have not been made, even though these other firms are said by these agencies to be in violation of the capital requirements for their ratings!**

This entire charade is one of regulatory failure after regulatory failure. The Federal Reserve, the SEC, prosecutors everywhere (both State and Federal) and the bank regulators, including the OTS and OCC, **should have been all over this back in the first quarter of this year when it became apparent that the credit qualify claimed for these instruments was**

blatantly inflated.

WHEN (not if), in the fullness of time, this becomes apparent there will be massive restatements of earnings by the financials in the S&P 500 and beyond. **We will find that the S&P didn't have 10% profit growth over the last two years; they in fact had flat to negative profit growth. We will find that the S&P is not trading at "14 times trailing earnings" it is trading at 30 and has been!** We will find that many of these firms are well below regulatory capital minimums and some may be outright bankrupt.

This damage has already reached into investment pools run by the states such as Florida and California. **It will in fact be found to have polluted pension funds and other supposedly "safe" investments all over the world.**

This is arguably the worst financial scandal of all time. It has reached into the American Household in ways that no scandal has before it. During the Tech Boom the pumpers were out there with their conflicts of interest telling you to buy tech stocks, ignoring the fact that the claimed "30% monthly expansion in the Internet" was a total fraud. Those who were actually **in that space** and could see the internals of the network – thousands of us – knew. A few (myself included) wrote about it. This does not mean that there were no viable businesses in the space – there most certainly were. But those who depended on "never-ending exponential growth" were doomed to failure, and fail they did, taking trillions of investor's money with them.

This time it is far worse because these debt instruments were sold almost literally to every corner of the market. The underlying "assets" are American homes which have been inflated to twice their "true value". As these values contract back to reality the damage this collapse will spawn will spare nobody who is exposed to this toxic waste, and our economy will contract to meet the new reality of actual earnings power, production, and shrinkage of the homeowner's "house" line on his balance sheet by an average of 30-50% from 2005 values.

Now let's add the 2007 Christmas Season to the mix. The "money quote" is right here:

> "Total U.S. retail sales, excluding automobile sales, rose 3.6% for the holiday season spanning the day after Thanksgiving to midnight Monday, according to MasterCard SpendingPulse, a unit of MasterCard Advisors. That result landed on the low end of the retail-industry's forecasts for a gain of 3.5% to 4.5%. However, without skyrocketing gas prices, which have risen by more than 30% since last year's holiday season, the retail-sales increase amounted to a far more paltry 2.4% gain." (Ref: Wall Street Journal, December 25th)

Here's the problem. 2.4% is below the rate of headline inflation and damn close to "core" on a 12-month weighted basis. In other words, spending is actually DOWN when measured in constant dollars.

ICSC reported on the 26th that Holiday Spending was down 2.5% for November and December. This is well below expectations, and looks like the holiday season was, in fact, a bust.

S&P's "Case-Schiller" housing numbers for October (released on December 26th) showed a record 6.7% year-over-year decline in price, with a 1.4% decline on the month. **Those who tell you that the housing crisis is "bottoming", or that the market is "now turning", are simply wrong**. There is absolutely nothing, given the history of these market cycles, to suggest that we will see the "bottom" before 2009/2010 at the earliest. The impact of declining home prices, given that consumers are typically "levered" at least 5:1 (assuming they put down 20% at purchase), is immediate, severe and extreme. Since the "average" homeowner moves every 6-7 years, this means that *more than half of all homeowners will be forced to sell into this market decline, taking huge capital losses*. **This is the bug-a-boo that is being roundly ignored**

by nearly all of the media, and it WILL impact consumer spending behavior.

Durable goods are repeatedly coming in weaker than forecast, with the latest numbers (on the 27th) a whopper – forecasts were for up 2%, we got up 0.1%, ex-transportation they were down 0.7%. Unemployment claims continue to deteriorate, with negative revisions to previous weeks.

These indicators tend to lead what happens in the "consumer" economy, and trouble arrives when input price increase cannot be offset by productivity gains. This inevitably results in pass-through to the consumer in the form of increased prices yet at the same time applies increasing downward pressure on wages as companies struggle to remain profitable. This, of course, feeds into consumer sentiment.

Labor is weakening significantly. The issue is not the "headline" layoff number but continuing claims, which gives you a good handle on not just how many people are being laid off *but how hard it is for them to find replacement jobs. This number is awfully close to "recession" territory, and what is particularly troubling about labor market indicators is that they lag the economic situation, so by the time you get a clean "recession" indication from this series you're already in one!*

In short, consumer spending is tracking consumer sentiment and the housing market, which is in the ditch. In addition the deterioration in the business environment has arrived quite sharply and markedly. Simply put, high energy and food prices, along with a shrinking consumer balance sheet as a consequence of the housing market downturn, are forcing people to stop spending beyond their means, while at the same time input price pressure from expanding demand in developing nations exerts fundamental pressures into the manufacturing space that tend to push affordability of finished products the wrong way.

Historically-speaking there is a very strong correlation with consumer sentiment and consumer behavior and, when both decline like this, recession.

During recessions equities typically lose 30% of their value.

On the Geopolitical front we got a "Post-Christmas Surprise" of the nasty sort on the 27th with the assassination of Pakistani opposition candidate Bhutto. While the threats against her had been the stuff of legend, the fact that she was actually hit and killed throws yet more uncertainty into the mix.

For those who are unaware, Pakistan is a nuclear nation, and has a significant number of nuclear weapons in a 'standoff" sort of pair-trade if you will with India. Serious political instability there is for obvious reasons bad news, as one or more of those that falls into "unofficial" hands could lead to an inappropriate mushroom sighting. Oh, and Al-Qaida has claimed responsibility for the killing. You don't think they might be interested in one of those "devices", do you? *The risk of a serious nuclear incident has now risen precipitously, and until some sort of clear indication on stability – or lack thereof – emerges, one must assume that "risk premium" will be added across the board in the markets.*

None of this sounds good, does it? Worthless derivatives, pumped valuations very similar to what was done during the tech bubble years, and now, a collapsing consumer balance sheet along with businesses responding to all of these pressures by cutting back – all of this is visible to anyone who looks with a critical eye.

So why are we trading 5% off all-time highs in the indices?

Because the media is not reporting the truth and you are not hearing it from your "trusted sources."

None of this is hidden nor does it require any grand conspiracy.

You can (and should) verify ALL OF IT FOR YOURSELF from public data sources such as filed 10K and 10Q reports.

What would be amusing (if it wasn't so sad) is that you can tune into CNBS **every single day** and hear them tell you that "The Market is saying we're not going into recession" (because the stock market is sitting right near all-time highs.)

Are we not putting the cart and horse in the wrong order? Are the markets near all-time highs because the economy is good, or are the markets near all-time highs **because the media is in fact lying and therefore retail investors, including those entrusting their retirement assets to the financial markets, are not allocating their funds in a way that takes down risk?**

Are some people "in the know" and preparing for this?

You bet your bottom dollar.

Chief among them are **banks and The Federal Reserve itself.** If you look at the Fed's most recent balance sheet and the Fed's most recent bank report you will find that **The Fed has been de-leveraging its own balance sheet, and banks are hoarding "vault cash" (that is, actual MONEY!) while their regulatory reserve are below minimums.**

Why?

THEY KNOW WHAT IS COMING.

Why has Goldman Sachs been shorting the very mortgage securities that another part of their firm packages and sells?

THEY KNOW WHAT IS COMING.

Why aren't the folks on CNBS telling **YOU** what is coming, and giving you an honest appraisal of the effects of several trillion dollars worth of direct impact to the financial markets **in the United States alone,** along with the deflationary pressure that **cannot be avoided or overcome?**

That's a damn good question.

Remember that back in 1999 and the first months of 2000, **the news was overwhelmingly bullish, and people were buying stocks with both fists, in no small part because the "financial media" said that there would be no recession, there was no economic problem and stocks were "reasonably priced."**

In fact stocks were, as we found out in the coming months, horribly overvalued, there was a recession, and those who listened to these "analysts" were crushed, with many investors losing EVERYTHING.

Does anyone remember Jim Cramer's **infamous rant** on February 29th of 2000, in which he listed 10 stocks "you must buy today for his 'New World'"? They were SNVX, ARBA, ISLD, EXDS, INSP, INKT, MERQ, SNRA, VRSN and VRTS.

Of those SNVX, ISLD, EXDS, INKT, SNRA and VRTS no longer are listed under their original ticker symbols. Some were outright business failures, others bought or merged in the collapse that followed.

Of the "survivors", ARBA traded for $800 back then. It now trades for $11. INSP traded for $1150. It now trades for $18.90. MERQ traded for about $90; it now is $51 (and has the ignobility of being the "best of the bad" on a total return basis!) VRSN traded for $238; it now sells for $37.88.

If you listened to Jim on 2/29/2000, you lost more than 90% of your money.

NINETY PERCENT!

Nor was he alone in his "less-than-correct" calls. In fact, the list of people who **were** calling for a meaningful decline in the markets in the major media **could be counted on your fingers.**

Yet almost without exception these people went unpunished for the hundreds of billions of dollars of investor losses that resulted **DIRECTLY FROM THEIR SLANTED, BIASED, WILLFULLY-BLIND AND JUST PLAIN WRONG "ANALYSIS"!**

Such it will be again, I'm sure.

Are these shows, newspapers, and others **reporters** on the financial markets, **entertainers**, or worse, **puppets of those who know and who need someone – anyone – to unload their shares to before the markets take a huge plunge, lest they get stuck with them?**

Now there's something to think about.

Ok, so there's the background, but I promised "A Look Ahead" too.

Here's my view on what you can expect in 2008:

- The US will enter a recession, if it has not already done so. It will be consumer spending driven, with its genesis found in the Housing market. The slowdown will become evident once the "real" holiday sales data is posted, and accelerate into the first quarter.
- Unemployment will increase significantly, rising to north of 5% by the middle of next year. This will of course cascade back into consumer default rates (mortgages, credit cards, auto loans, etc) and cause yet more layoffs. The "virtuous cycle" will turn vicious.
- Housing **will not turn in 2008**. The total damage to prices will exceed a cumulative 15% from 2005-2008, and it will not be over. At least one, and probably several, national home builders will be cut to the single digits on their stock price or go bankrupt and be reorganized. Residential Real Estate will **NOT** be a buy in 2008; you're still at least one and probably two years too early.
- The story in the housing space in '08 will be the defaults on "prime" mortgages – which in reality were nothing of the kind (e.g. "Option ARMs"), and on the piggyback seconds and HELOCs behind them. "Jingle Mail" will become common as homeowners that are deeply – 20% or more – underwater simply mail in the keys and say "screw the credit rating." *This will result in a near-total overhaul of the "FICO" system in the next couple of years, as these people will have defaulted on mortgages but nothing else, essentially forcing risk premiums higher for consumer credit and decoupling FICO from actual consumer credit (other than mortgage) behavior. I expect there will emerge a "shadow" FICO system which ignores mortgages but rates everything else.*
- The stupidity in the rest of the consumer lending space (rollovers in auto loans and 0% balance transfer hell for plastic, primarily) will come crashing down on these companies *and bring a crushing wave of defaults there as well, along with yet more downgrades in the asset-backed paper market.*
- Recreational sectors (e.g. boats, RVs, etc) will get smashed. If you're in the market for high-dollar recreational assets and have cash, late '08 and into '09 will present some incredible buying opportunities.

- Government will, as is usual, try to meddle in the market's adjustment of risk and price. *The depth of this meddling will be the determinant on whether this is a deep but sharp and reasonably-short recession or whether it morphs into something far more serious. With 08 being an election year the temptation to engage in SEVERE tampering will be significant, and if they do, the risks rise materially.* ***There is a serious risk of an all-out deflationary depression, and if we get one, it will almost certainly be the government's fault.*** *Whoever wins the Presidency may wish they had lost come '09 and '10.*
- Buffett just announced he is setting up a Municipal Bond insurance company. *This will put a stake into the Monolines' hearts, taking all their business away that is profitable, and leaving them with structured finance which has huge embedded – and unrecognized – losses.* The announcement, which showed up on the 28th, didn't send shockwaves through the market – but it should have. Effectively, Warren threw a grenade (minus pin) into the magazine of structured finance. **This is the death knell for the few trillion in CDSs that are out there can't be paid; there is no longer any reason to believe that the companies writing these things will be able to be recapitalized off "profitable" sides of their business!** This is how fortunes are made (for Warren) and lost (for everyone who did imprudent things.) **The "big story" in the financial markets for 2008, and the likely trigger for major turmoil, will be the implosion of the CDS marketplace and how Buffett profited from it.** This will **stabilize the municipal bond marketplace** which has been positively hammered.
- Equity prices will be choppy in the first couple of months *and will experience a peak to trough swing of at least 20% during the year in total.* I expect the S&P 500 to at least touch 1220 in 2008 and **my current downside target is 1070**. Note that should we get a "parabolic" sort of move in the first quarter, which is possible, the potential for an even louder "boom" (collapse) goes up dramatically; in that case I would not be surprised to see a three-digit handle on the S&P 500 sometime during the 2008-2010 time period.
- **Return OF capital will be far more important in 2008 than return ON capital.**
- I do not expect the central banks to "hyperinflate" anything. *Metals, in a protracted, serious deflationary selloff will get smashed.* (If you're a "Gold Bug", read below for why I think you're nutty to hold metals - there's a better play if you believe in hyperinflation.)
- Debt will be paid down when possible and when not, defaulted. This, of course, prevents deploying capital towards consumption and production. *Expect this to show up in the first quarter in ways that cannot be refuted, and for the market to "get it" some time before the end of the second quarter.*
- Commercial Real Estate will collapse. The leverage in these deals has actually **exceeded** that in residential, if you can believe it. **This will prove to have been totally insane and the losses taken there will be immense.** It will also put a fork into the "this is contained" thesis, and validate the fact that generally, commercial R/E lags residential by 12-18 months. Guess what – time's up!
- Business CapEx will slow precipitously and may go negative. This will be "spun" for the first quarter or so, but by the middle of the second quarter it won't be able to be spun any more, and the truth will have to be faced. That "truth time" will likely mark the start of the second big leg down in the equity markets.
- The Dollar will bounce all over before starting to take off when it becomes apparently that *the rest of the world is going to get it worse than we will.*
- The "market callers" who are (almost to a man!) calling for big moves northward in 2008 will be coming to the public "hat in hand" as we get into the latter part of the year. *These people will be roundly discredited and yet another wave of so-called "analysts" will disappear from the scene, along with all the money the chumps who listened to them lost.*

So what CAN you do to make "Return **OF** Capital" your goal?

For 95% of long-term investors, ***this is a time to be in cash or close to it.***

There is nothing wrong with **insured** CDs. Nothing at all. In fact, you can find them yielding close to 5% or even a little above. Six month CDs, ***with no more than $100,000 in any one bank***, are not a bad idea.

Next up would be the **short end** of the US Treasury curve. **Emphasis again - SHORT END!** What's "short"? 2 years or less. You can buy these through Treasury Direct. Yield is lower, but they're even **safer** in that the US Federal Government would have to go under for them to be worthless. For an ETF that holds these, look at "SHY".

Finally, **quality** municipals look interesting here. Note that municipal bond income is federal tax exempt and in many cases AMT-exempt as well (doesn't count towards AMT income.) ***Be careful with municipals however as if this really gets bad defaults in the municipal sector are likely.***

What do you stay away from?

- Equities, **and especially momentum stocks!** This means nothing in the tech space of any sort. No banks, no broker-dealers, no consumer discretionary. At all. ***If you must buy equities for some reason, utilities might be reasonably safe, but even there the losses may be significant.***
- **UNSECURED or UNSUBORDINATED debt of** **ANY KIND.** Especially dangerous are "demand notes" from various institutions. **These have been pushed hard to many seniors and others; don't be a sucker!** They have no insurance and if the company defaults, you just plain eat it.
- **Any sort of corporate debt is dangerous, and the junkier it is, the more dangerous it is.** *EXCEPTION: If you're really good at picking through the fundamentals of the issuuing company, you can make some great buys in this space. For nearly everyone, however, you're playing Roulette here. DON'T!*
- **Any bank account that has more than $100,000 in it.** Don't do it. Just don't. Yes, I know there are exceptions (you can have $200k in a joint account.) If you're absolutely certain you can keep an eye on this to the degree required to insure you're covered by the exceptions, have at it. Just don't cry if you're wrong.
- **Any money market which holds any sort of asset-backed commercial paper or SIV assets of any sort.** These funds are extremely dangerous if there is a blowup in that your **principal** is potentially at risk.

There will be many who say "oh, that's way, way too conservative."

To which I answer - "so what?" If there is no meltdown and no sign of one in six months, what have you missed out on? 5, maybe 10% appreciation?

But what if this really is as bad as it appears to me, and you miss out on 40% of decline instead?

There are also a number of people who believe, **despite all the evidence above**, that the government (or "The Fed") will "hyperinflate" to "save the economy" (or at least try.) Typically these people **also believe that the rest of the world will fare better than we will**, and will come in to snap up assets in America that are "dirt cheap" as our dollar is debased.

This is the central thesis of the "Gold Bug" paradigm; these folks all believe Gold is going to go to $1500 (or more) in the next year, and they urge you to buy some as a result.

The problem is that if their thesis is correct they're total idiots to buy Gold!

Here's why.

Let's say that the dollar is debased by 50% from here and Gold doubles in price (in dollars.) You make 100%, right? Wrong - you are subject to a 28% collectables tax on the appreciation, **so you in fact lose compared to inflation. Congratulations - you lost real purchasing power!**

That isn't so good.

Well, what **could** you do if you believe that the government will "hyperinflate" that would stay ahead of it?

In a hyperinflation paradigm where the rest of the world "does better than we do" **stock markets will do a moonshot as foreign money comes in to buy all the "cheap" assets.** The Dow will likely double if the dollar gets cut in half. But let's say it doesn't double - it only goes up by 30%, to 20,000 by the end of the year in 2008.

Why would you not buy Index CALLs instead of Gold?

A LEAP January 2009 DIA $160 CALL was selling for $2.00 Friday (Bid x Ask at $1.94/$2.10).

Let's say you buy 100 of those contracts for $20,000 (each contract is 100 shares, so 100 x 100 x $2.00 = $20,000, plus commission of course)

If the Dow goes to 20,000 by the end of next year, your CALLs are worth $40 each! **That is a 20x profit on your original investment; that $20,000 turns into $400,000!**

Further, if the DOW **DID** double (ala China's Shanghai Market) **your little $20,000 wager would turn into a staggering $1,400,000 in one year's time!**

So tell me again - if you believe in "hyperinflation" - why do you want to buy the clear **LOSER** of an asset that metals represent, when you can buy index CALLs and, if your thesis is correct, **you will make an absolute stinking FORTUNE!**

(Of course if you're wrong and the DOW is under 16,000 by the end of the year, that $20,000 is totally flushed. That's the price of poker - but again - **just how sure are you** that "The Fed" is going to "hyperinflate"? And by the way, no, I don't think they are - in fact, I don't think they **CAN**.)

To those who go even further and are in "*It's the end of the world as we know it*" camp, I will humbly suggest that you remove the tin from your hat. It not only isn't now but also won't be tomorrow.

America has faced Depressions in the past, and our nation has survived. Yes, I used the plural form of the word. Most think the 1930s was "Our Time". Wrong. There is a long cycle in credit (typically 50-80 years) that is well-understood among those who study this stuff called the "Kondratiev Wave." This economic theory posits that credit moves in long cycles, with the evils of "overexpansion" being repeated once the previous generation that experienced its effects are all (or mostly all) dead. America has gone through **three** of these cycles previously, and we are likely in "winter" of the fourth now.

The "winter" periods tend to be deflationary credit collapses.

Alan Greenspan is rumored to have been aware of the impending implosion of the current cycle in the 2000/01 timeframe, and he allegedly knew that what he was doing at the time with his "willful blindness" was an attempt to stave it off by looking the other way – that is, change a long-cycle behavior that had played out three times previously in American history.

The problem with tampering with things like this, of course, is that the odds of success are not high, and the damage if you fail tends to be quite severe.

Nonetheless, we, along with the rest of the world, will get through this. There will be opportunity for those who are prudent and not leveraged in their personal and corporate life.

And for those who are over-leveraged?

They will get their comeuppance.

It’s about time.

SOME RIGHTS RESERVED This work is licensed under a Creative Commons Attribution-Share Alike 3.0 United States License.