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“A Generalized Meltdown of Financial Institutions”

Take a Look at Professor Roubini's Crystal Ball

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Reality has finally caught up to the stock market. The American consumer is underwater, the banks are buried in debt, and the housing market is in terminal distress. The Dow is now below its 200-Day Moving Average — the first big “sell” signal. Anything below 12,500 could trigger program-trading and crash the market. The increased volatility suggests that we are watching a “real time” meltdown.

International Business editor for the UK Telegraph, Ambrose Evans Pritchard, summed up yesterday’s action in the Asian markets:

> “The global credit crisis has hit Asia with a vengeance for the first time, triggering a massive flight to safety as investors across the region pull out of risky assets. Yields on three-month deposits in China and Korea have plummeted to near 1pc in a spectacular fall over recent days, caused by panic withdrawals from money market funds and credit derivatives.
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> “‘This’ is a severe warning sign,’ said Hans Redeker, currency chief at BNP Paribas. ‘Asia ignored the credit crunch in August but now we’re seeing the poison beginning to paralyze the whole global economy.'” (Credit ‘Heart attack’ engulfs China and Korea” Ambrose Evans Pritchard,UK Telegraph,)

The credit storm that began in the United States with subprime mortgages has spread to markets across the globe. In fact, the train has already crashed. What we’re seeing now is the boxcars piling up on top of each other.

On Tuesday Chinese government officials ordered a complete halt to bank lending to slow the speculative frenzy that has created an enormous equity bubble in the stock market. According to the Wall Street Journal:

> “Chinese authorities are slamming the brakes on bank lending, in their latest attempt to curb the runaway investment threatening to overheat what is soon to be the world’s third-largest economy. In recent weeks, regulators have quietly ordered China’s commercial banks to freeze lending through the end of the year, according to bankers in several cities. The bankers say that to comply, they are canceling loans and credit lines with businesses and individuals.” (“China freezes lending to Curb Investing Frenzy” Wall Street Journal)

The move illustrates how concerned the Chinese are that a slowdown in US consumer spending will trigger a crash on the Shanghai stock market. It also shows that the Chinese are having difficulty dealing with the inflation generated by the hundreds of billions of US dollars absorbed via the trade imbalance with the US. China is awash in USDs and that surplus is causing a steady rise in food and energy costs. This could be mitigated by allowing their currency to "float" freely. But a sudden, steep increase in the Chinese yuan's value could also send the world headlong into a global recession. For now, the lending freeze and price fixing appear to be the way out.

Another sign that the markets have reached a "tipping point" appeared in a Reuters article on Wednesday; "Interbank Covered Bond Trading Halted on Volatility":

> "Renewed credit turmoil and volatility led the European Covered Bond Council (ECBC) on Wednesday to suspend inter-bank market-making in covered bonds until Monday, Nov. 26.
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> The move is a sign of the stress in the covered bond market, which is dominated by German institutions that have almost a trillion euros of covered bonds outstanding.
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> Covered bonds — backed by pools of assets that remain on the borrower's balance sheet — are usually highly liquid and typically rated triple-A by ratings agencies. The ECBC's recommendation is aimed at relieving the pressure on market makers who are forced to quote prices at a fixed bid-offer spread.
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> "In light of the current market situation and in order to avoid undue over-acceleration in the widening of spreads, the 8-to-8 Market-Makers & Issuers Committee recommends that inter-bank market-making be suspended," the ECBC said in a release."

Note: This isn't mortgage-backed junk that's being sold, but highly liquid bonds that are usually easy to cash in. The ECBC's action is a sign of pure desperation and indicates that credit paralysis has infected the entire euro banking system.

Reuters: "Due to general market conditions and the specific mechanics of the inter-dealer market making it even seems possible that inter-dealer market making will not be resumed this year."

That's bad. The mechanism for converting covered bonds into cash has broken down.

The dollar took another pasting on Wednesday, sliding to $1.49 on the euro; another new record. Gold shot up to $814 per ounce. Oil continues to flirt with the $100 per barrel mark, and the yen rose to 107 per dollar forcing a sell-off of hedge fund assets levered through the carry trade.

Jon Basile, economist at Credit Suisse, summed it up like this: "There's a heck of a lot of bad news out there." Indeed.

In California Governor Arnold Schwarzenegger has joined with four mortgage lenders to freeze adjustable interest rates (ARMs) for some of the state's highest-risk borrowers; another unprecedented move. The Governor hopes to avoid a collapse of the California real estate market which has gone into a tailspin. Home sales have plummeted more than 40 per cent for the last two months. Prices have dropped sharply—roughly 12 per cent statewide. New construction has slowed to a crawl. Layoffs are steadily rising. Jumbo loans (mortgages over $417,000) have been put on the “Endangered Species” list. Even qualified borrowers can’t get mortgages. Nothing is selling. California housing is “off the cliff”.

Schwarzenegger’s plan to keep over-extended subprime mortgage-holders in their homes faces an uncertain future. What incentive is there for homeowners to continue paying exorbitant monthly rates when their payments are not applied to the principle? The homeowners would be better off bailing out, accepting foreclosure, and starting over with a clean slate.

It’s unrealistic to thinks that Schwarzenegger can stop the tidal wave of foreclosures that are sweeping across the state. An estimated 3 million homeowners will lose their homes nationwide.

If you want to blame someone; blame Alan Greenspan. He’s the one who created this mess. According to the economist Mike Shedlock:

> “The Fed caused the credit crunch by slashing interest rates to 1 per cent to bail out its banking buddies in the wake of a dotcom bubble collapse. All the Fed did was create a bigger bubble. This bubble is so big in fact that it cannot even be bailed out. It’s the end of the line for a serially bubble blowing Fed.
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> “So not only was this the biggest credit bubble in history, this was also the biggest transfer of wealth from the poor and middle class to the already enormously wealthy. That is the real travesty of justice regardless of whether or not the price tag is $1 trillion, $2 trillion, or $10 trillion.” (Mike Shedlock, “Mish’s Global Economic Trend Analysis”)

The problem has gotten so serious that even Secretary of the Treasury, Henry Paulson, is putting up red flags. Last week, Paulson ignited a sell-off on Wall Street when he made this statement:

> “The nature of the problem will be significantly bigger next year because 2006 [mortgages] had lower underwriting standards, no amortization, and no down payments….We’re never going to be able to process the number of workouts and modifications (to mortgages) that are going to be necessary doing it just sort of one-off. I’ve talked to enough people now to know that there’s no way that’s going to work.”

The desperation is palpable. Like Schwarzenegger, Paulson is trying to get mortgage-lenders to provide a safety net for struggling borrowers who are defaulting on their loans.

Paulson is calling for emergency legislation that will allow the Federal Housing Administration to play a greater role in the relief effort. The FHA has already expanded its traditional role by taking on hundreds of billions in extra debt just to keep a few “private” mortgage lenders and banks from going bankrupt. Of course, when Paulson’s plan goes kaput and the debts pile up; it’ll be the taxpayer that foots the bill.

> “Paulson also called the Senate’s failure to pass legislation overhauling mortgage giants Fannie Mae and Freddie Mac frustrating,” saying that the two government-sponsored entities need to be playing a bigger role in the housing market.

> "If we ever need them it's during times like today, and they're most valuable when there is distress in the mortgage market," he said. "I'd like to see them playing an even bigger role."(Wall Street Journal)

Fannie and Freddie, have already posted enormous quarterly losses and don't have the capital reserves to put millions of subprime mortgage-holders under their "government-sponsored" umbrella. Paulson is just grabbing at straws.

Similar troubles are brewing in the broader market where late-payments and defaults have spread to credit card debt and new car loans. Every area of "securitized" debt has suddenly veered off the road and into the ditch. Last week the Fed injected more credit into the teetering banking system than anytime since 9-11.

No one has predicted the downward-spiral in the market more accurately than Nouriel Roubini. Roubini is a Professor at the Stern School of Business at New York University. His analysis appears regularly on his blogsite, Global EconoMonitor. Last week's prediction was particularly dire and is worth reprinting here:

> "It is increasingly clear by now that a severe U.S. recession is inevitable in next few months…I now see the risk of a severe and worsening liquidity and credit crunch leading to a generalized meltdown of the financial system of a severity and magnitude like we have never observed before. In this extreme scenario whose likelihood is increasing we could see a generalized run on some banks; and runs on a couple of weaker (non-bank) broker dealers that may go bankrupt with severe and systemic ripple effects on a mass of highly leveraged derivative instruments that will lead to a seizure of the derivatives markets… massive losses on money market funds with a run on both those sponsored by banks and those not sponsored by banks; ..ever growing defaults and losses ($500 billion plus) in subprime, near prime and prime mortgages with severe knock-on effect on the RMBS and CDOs market; massive losses in consumer credit (auto loans, credit cards); severe problems and losses in commercial real estate…; the drying up of liquidity and credit in a variety of asset backed securities putting the entire model of securitization at risk; runs on hedge funds and other financial institutions that do not have access to the Fed's lender of last resort support; a sharp increase in corporate defaults and credit spreads; and a massive process of re-intermediation into the banking system of activities that were until now altogether securitized." (Nouriel Roubini's Global EconoMonitor)

"A generalized meltdown of the financial system".

Looks like Chicken Little might have gotten it right this time; "The sky IS falling."

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