Global Economy: Could This be "The Big One"?

By Mike Whitney
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Everyone take a deep breath. This isn't 2007 again. The banks aren't loaded with $10 trillion in "toxic" mortgage-backed securities, the housing market hasn't fallen off a cliff wiping out $8 trillion in home equity, and the world is not on the brink of another excruciating financial meltdown. The reason the markets have been gyrating so furiously for the last couple weeks is because stocks are vastly overpriced, corporate earnings are shrinking, and the Fed is threatening to take away the punch bowl. And to top it all off, a sizable number of investors have more skin in the game than they can afford, so they had to dump shares pronto to rebalance their portfolios.

What does that mean?

It means that a lot of investors are in debt up to their eyeballs, so when the market tumbles they have to sell whatever they can to stay in the game. It's called a "margin call" and on Wednesday we saw a real doozy. Investors dumped everything but the kitchen sink in a frenzied firesale that sent the Dow Jones bunge-jumping 565-points before clawing its way back to a 249-point loss. The reason we know it was a margin call as opposed to a panic selloff is because there was no noticeable rotation into US Treasuries. Typically, when investors think the world is coming to an end, they ditch their stocks and make the so called "flight to safety" into US debt. That didn't happen this time. Benchmark 10-year Treasuries barely budged during the trading day, although they did stay under 2 percent which suggests that bondholders think the US economy is going to remain in the toilet for the foreseeable future. But that's another story altogether. The fact is, investors aren't "rotating", they're "liquidating" because they've hawked everything but the family farm and they need to sell something fast to cover their bets. Now if they thought that stocks were going to rebound sometime soon, then they'd try to hang on a bit longer. But the fact that the Fed has stayed on the sidelines not uttering a peep of encouragement has everyone pretty nervous, which is why they're getting out now while they still can.

Capisce?

Here's how CNBC's Rick Santelli summed it up on Wednesday afternoon:

> "We basically have a global rolling margin call that's been going on since the 3rd Quarter of last year. It's gotten a bit more intense since the Fed announced it was 'normalizing' because, in essence, a quarter point (rate hike) doesn't mean anything, but the mentality that we are about to turn the corner on the 'Grand Experiment' means a lot." (Closing Bell Exchange, CNBC)

In other words, investors are starting to believe the Fed will continue its rate-hike cycle which will put more downward pressure on stocks, so they're calling it quits now.

Santelli makes a good point about "normalization" too, which means the Fed is going to attempt to lift rates to their normal range of 4 percent. No one expects that to happen mainly because the wailing and gnashing of teeth on Wall Street would be too much to bear. Besides, the Fed just spent the last seven years inflating stock prices with its zero rates and QE. It's certainly not going to burst that bubble now by raising rates and sending equities into freefall. Even so, many investors think the Fed could continue to jack-up rates incrementally to 1 percent or higher. And while that's still below the current rate of inflation, the shifting perception of "easy money" to "tightening" makes a huge difference in investors expectations. And as every economist knows, expectations shape investment decisions. No one is going to load up on stocks if they think things are going to get worse. That's the long-and-short of it.

So is the recent extreme volatility a precursor to "The Big One"?

Probably not, but that doesn't mean that stocks won't drift lower. They probably will, after all, conditions have changed dramatically. We had been in an environment where hefty profits, low rates and ample liquidity were more-or-less guaranteed. That's not the case anymore. Stocks are no longer priced for perfection, in fact, valuations are gradually dipping to a point where they reflect underlying fundamentals. Also, for whatever reason, the Fed seems eager to convince people that the hikes are going to persist. So here's the question: If you take away the punch bowl at the same time that earnings are start to tank, what happens?

Stocks fall, that's what. The only question is "how far"? And since the S&P has more than tripled since it hit its lowest level in March 2009, the bottom could be a long way off, which is why investors are taking more chips off the table.

It's also worth noting that one of the main drivers of stock prices has been AWOL lately. We're talking about stock buybacks, that is, when corporate bosses repurchase their own company's shares to reward shareholders while boosting their "windfall" executive compensation. Here's the scoop from FT Alphaville:

> "China is slowing, the oil price is getting hammered, the Fed hiked too soon: all reasons for the ignominious start to the year for the world's stock markets. Here's another bit of meat for the pot, courtesy of Goldman Sachs chief US equity strategist David Kostin: share buybacks.
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> "One reason for the recent poor market performance is that corporate buybacks are precluded during the month before earnings are released. Any destabilizing macro news that occurs during the blackout window amplifies volatility because the largest source of demand for shares is absent."
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> Share buybacks in the US are on pace for their biggest year since 2007, he adds, estimating $561bn for full-year 2015 (net of share issuance) and a decline to $400bn in full-year 2016."
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> "Share buybacks, the markets miss you", FT Alphaville

By some estimates, buybacks represent 20 percent of all share purchases, so obviously the current drought has contributed to the recent equities-plunge. All the same, G-Sax Kostin expects a robust rebound in 2016 to $400 billion. As long as cash is priced below the rate of inflation, corporations will continue to borrow as much as they can to ramp their own stock

prices and rake in more dough. Greed trumps prudent investment decision-making every time.

As for the trouble in China: While it's true that China's woes could have been the trigger for the current ructions on Wall Street, it's certainly not the cause which is the Fed's failed monetary policy. Besides, the whole China thing is vastly overdone. As Ed Lazear toldCNBC on Wednesday:

> "A major recession in China that lasted ten years would cost would costs the US 2 % points in GDP. So you're not going to get a market fall like we're observing right now based on that."

Economist Dean Baker basically agrees with Lazear and says:

> "Even a sharp downturn in China would not send the U.S. economy plummeting, our total exports to China are only about 0.7 percent of GDP. China's weakness will have a major impact on other trading partners, especially those heavily dependent on commodity exports. But even in a worst case scenario we are looking at a major drag on the U.S. economy, not the sort of falloff in demand that puts the economy into a recession."
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> ("Wall Street Rocks!", Dean Baker, Smirking Chimp)

As for the plunging oil prices, there's not much there either. Yes, quite a few high-paying oil sector jobs have been lost, capital investment has completely dried up, and many of the domestic suppliers are probably going to default on their debts sometime in the next six months or so. But are these defaults a significant risk to Wall Street in the same way that trillions of dollars in worthless Mortgage-Backed Securities (MBS) and CDOs were in 2007-2008?

Heck, no. Not even close. There's going to be a fair amount of blood on the street by the time this all shakes out, but the financial system will muddle through without collapsing, that's for sure. The real danger is that falling oil prices signal a buildup of deflationary pressures in the economy that isn't being countered with additional fiscal stimulus. That's the real problem because it means slower growth, fewer jobs, flatter wages, falling incomes, more strain on social services and a more generalized stagnant, crappy economy. But as we've said before, Obama and the Republican-led Congress have done everything in their power to keep things just the way they are by slashing government spending to make sure the economy stays weak as possible, so inflation is suppressed, the Fed isn't forced to raise rates, and the cheap money continues to flow to Wall Street. That's the whole scam in a nutshell: Starve the workersbees while providing more welfare to the slobs at the big investment banks and brokerage houses. It's a system that policymakers have nearly perfected as a new Oxfam report shows. According to Oxfam: "the 62 richest billionaires now own as much wealth as the poorer half of the world's population." (Guardian)

Wealth like that, "ain't no accident", brother. It's the policy.

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