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Profits mask coming storm

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Contrary to surface appearances such as the recent stock market rally and "glowing" first quarter profitability statements from certain Wall Street banks, multipronged risks for renewed, considerable turmoil in the US financial sector are mounting.

The recent six-week rally on Wall Street, led mostly by banking and other financial shares, isn't based on any concrete turnaround in the deeply worrying fundamentals of the financial sector.

Instead, it is based largely on the fact that the new administration has trotted out into public view multiple and very large government programs aimed at cleansing the banks' balance sheets of huge sums of toxic assets, unlocking the persistently seized credit markets, stemming the swiftly mounting foreclosure rate, creating jobs, and otherwise stimulating an early economic revival.

None of these aims and goals has been accomplished yet, not even in part, but investors were heartened by the raft of government programs that has been announced, and they have responded by bidding up banking and other shares on Wall Street, hoping that the bottom of the crisis in the financial sector has already been reached.

However, that bottom hasn't been reached, and is still nowhere in sight, despite the recent quarterly profit reports by a few of the largest US banks. It should come as no surprise that Wall Street financial institutions that have been in receipt of massive sums of bailout money and have been targeted by varied "liquidity" operations from the government are suddenly able to report a "profit".

Additionally, much of the "profit" reported for the first quarter resulted from one-off events that have little or no chance of seeing a repeat. In these most recent quarterly statements, the accounting and reporting methods have been altered so as to put a better face on their operations and fiscal position. Their already notoriously "fuzzy" math, which permitted banks to arbitrarily designate which assets are included in their profit statements and which ones are not, now also conveniently permits them to arbitrarily decide which losses are "temporary" and can be excluded from the statement altogether. Consequently, "fuzzy" has now gotten even fuzzier. Why? And, why now?

Wall Street financial institutions have suffered a gross loss of investor confidence in this crisis and have seen their share values ravaged as a result. Hence, there is a concerted and vigorous effort underway on their part to bolster that collapsed confidence, with the aim of driving the value of their shares back up.

Remember, these big institutions all participated in one way or another in the grossly deceptive schemes and practices that created and artificially inflated fundamentally risky investment assets, grossly overstated their creditworthiness, and sold them on to unsuspecting investors – the massive swindle that brought us into this crisis in the first place, a crisis that emerged right on Wall Street itself.

Hence, it is nothing for such firms and their accounting and credit rating accomplices to engage once again in spin, deceptively cooking the numbers to make their position look much better than it really is, so as to attract investors and drive up share prices. Sovereign wealth funds around the globe, having suffered huge losses on their investments in US banks, can be described by the adage "once bitten, twice shy". Many have decided to largely divest themselves of their holdings in US financial shares. Why? They no longer trust the banks to disclose their true financial position fully, accurately and honestly. The savvy investor will keep such facts very close in mind.

Now, with the May 4 deadline for releasing the government stress test results bearing down on us, Wall Street institutions have much greater reason and motive for spinning their financial position (propagandizing investors) – none of Wall Street's big banks wants to take a renewed hit as a result of being portrayed by the stress tests as being in a less-than-desirable financial condition.

Therefore, the Wall Street spin machines are operating at full speed, striving to portray the 19 banks involved in the stress tests as profitable, stable, healthy and vibrant. They are doing everything they can to maintain, and bolster, the fundamentally frail investor confidence they have regained in the past six weeks, and they are trying to position themselves to massively capitalize on the release of the stress test results if they can, or at least to minimize their potential ill effects.

The entire idea of the stress tests has come under fire as a bone-headed scheme that was aimed at restoring confidence but will almost certainly accomplish the exact opposite. If the results paint a rosy picture for all 19 banks, then investors will pan the stress tests as having no credibility, and their suspicions and fears that the banks and the government are lying about their true condition will probably skyrocket. If any of the 19 banks get less than flying colors in the stress test results, then those banks will likely see their shares take a renewed pounding as investor confidence collapses again.

There may well be depositor runs on such banks, depleting their capital and bringing on a renewed crisis. If the government and/or the banks themselves do not release meaningful data on May 4, then investors will conclude that the results were too grim, and a new crisis of confidence will result. But if too much information is released, then the same thing could likely be the result because a number of respected experts warn that the US banking system is fundamentally insolvent.

The government and the banks do not want investors at large to see hard data that only bolsters that dismal assessment. The Barack Obama administration has thus painted itself into a potentially very grim corner with the stress tests. Almost no matter what is done on May 4, the risks of a new crisis of confidence in the US financial sector are significantly rising.

Why such a bleak assessment here of the current fiscal position of the US financial sector?

First, as noted above, the US financial sector is not providing a clear and true picture of its fiscal position. Instead, it is seeking to paper over its fundamental insolvency with quarterly reports that are long on spin and short on hard, uncooked data. Why? The answer is quite simple. Full disclosure of its true position would not be in the interests of reviving America's fundamentally flawed model of "securitization", which has experienced a massive collapse and to this day has not been revived. Can it be revived? At what cost?

Remember that there are two fundamental camps with respect to the answer to the question of what lies at the root of the present crisis. One camp holds that America's new generation of financial assets that resulted from the recently invented financial process known as "securitization" are fundamentally sound in value, and that an over-reaction on the part of investors to the subprime crisis has resulted in a panic-induced collapse in their valuations.

This camp believes that the securitization model can and should be revived, and that when investor confidence is restored in financial assets now seen as "toxic", then all will be well again, almost magically, as toxic assets become valuable and attractive once again. All that need be done, it is believed, is for the government to work with Wall Street to jump-start securitization, a model this camp vehemently denies has failed, even though many trillions of dollars both spent and committed already have so far failed to get securitization's heartbeat going again.

The other camp believes that the toxicity is inherent in the very nature of the newly developed financial assets themselves, and that once investors recognized this fact, then that is why their values collapsed. This camp sees the securitization model as fundamentally flawed, based as it is upon artificial inflation of assets, the shortsighted growth of serial asset bubbles created by an unholy de facto alliance of government, big Wall Street banks and credit-rating agencies whose credibility and integrity were profoundly compromised, and unsustainable negative real interest rates (the creation of a massive credit excess), without which the securitization model simply won't run.

This camp sees no future for assets that have gone toxic. It sees the collapse that began in late July 2007 with the emergence of the subprime crisis as one that massively discredits the model itself. This camp believes that a revival of securitization will come at the cost of a dollar crisis only a moderate distance down the road, and that even if the model is revived, it won't be able to avoid a second, massive crash.

The US government and Wall Street are laboring feverishly to get securitization's heart beating again. That is fundamentally what is behind all their efforts. Crucial to this task, they believe, is restoring investor confidence in the model itself and in the innovative financial markets and modern financial assets it has created. Much like producers and sellers of tainted wine who've been found out and who've watched their product prices collapse as buyers shun the wine for its toxic risks, they're in cooperation again, minimizing the taint and trying to sell the sparkle as they did before this crisis broke. It is unlikely to succeed in attracting investors on the scale needed to revive securitization. But even if it does, the currency is being set up for a massive collapse when the proverbial bill soon comes due.

Therefore, essentially, on the level of the model itself, the US financial sector is headed for a more massive collapse than we've seen already, even if revival efforts were to somehow succeed in breathing life into the sector temporarily.

The second reason that this assessment here of the current fiscal position of the US financial sector is so bleak is because real events on the ground, occurring as we speak, demand such realism.

Many times I have drawn attention to the simple concept of the self-reinforcing downward spiral that has come to life within this ongoing crisis, a downward spiral that encompasses both the financial and economic sectors. Turmoil in the financial sector creates both a seizure of credit and higher costs for credit of all kinds, which feeds directly and indirectly down the line into the economic sector, translating into losses for business and individuals.

Those losses result in rising business failures, job losses, foreclosures and bankruptcies, and collapsing spending, investment and asset prices. These developments feed back, in turn, into the financial sector as banks and other institutions suffer greater losses and as the list of their toxic assets grows by leaps and bounds.

This, in turn, causes the credit seizure to persist and to tighten, which feeds directly down the line into the economic sector again, and the downward spiral continues and gains momentum. Though simple in nature, this downward spiral has been profoundly resistant to all the trillions of dollars thrown at it so far in an effort to break its grip. Additionally, its dramatic influence over where we're headed is too often minimized or forgotten altogether, until unfolding events bring a painful reminder.

In this respect, the first-quarter results of the Bank of America, announced on Monday, April 20, contain such a reminder – despite showing a "profit", credit losses are swiftly mounting as the quality of credit continues to deteriorate rapidly, without any reprieve. The Dow lost nearly 300 points that day, led by a fall in financial shares.

Just ahead, there exist strong indications of the real possibility of renewed, much deeper turmoil in the financial sector, in addition to what we're already seeing. The upcoming release of the stress test results may well provide a trigger for such renewed turmoil, which will feed once again down the line into the real economy, the economic sector, and only strengthen the downward spiral that exists between those two sectors.

We may see Wall Street rallies like the one that began six weeks ago, but they won't resolve the fundamentally grim picture for the US, which is firmly in the grip of forces that it unleashed upon itself. The US government and its Wall Street accomplices lack the insight, power, ability and integrity to break the downward spiral anytime soon. Thus, it will run its own course, just as it has been doing for many months already.

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