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"Shadow Lending" and the Financial Crisis

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What the tax package proves conclusively is that the President, the House and the Senate have absolutely no intention of getting their fiscal house in order. We will address the lurid details later. There is no change in the policies of borrowing continuously in order to sustain current consumption and to keep the economy from collapsing. As far as we are concerned the hold up in the package was to load it up with pork and stimulus. Some call it bells and whistles – we call it irresponsible. The Fed and all the players are buying time and 70% of the public knows that and they are going along with it. Very few want to face the music.

The Fed, via the "President's Working Group on Financial markets" is targeting asset prices, if possible, and the equities market. This is really the only bastion of wealth that the public recognizes. Wait until government and Wall Street go after their retirement plans, then they will get a wake-up call. Mr. Bernanke believes a strong stock market will spur spending, leading to higher income and profits. They had best have some heavy propaganda ready because 4th quarter GDP will probably come in around 2%. Inventories are building production is again stagnant, railroad traffic is off over 1% and the Baltic Index is down. Consumer credit has expanded more than $3 billion the first two-month rise in more than two years, although that number was aided by one off student loans, which accounted for all of October's gains. In reality consumer credit fell more than $32 billion, the lowest level since late 2004. If you cut away the student loans consumer credit fell about $75 billion over the past three months.

What may seem odd to you is that a federal judge's rejection of mandatory insurance, a keystone provision of the Obama Health Care Reform Package, is bullish for the stock market. The bill is enormously unpopular and the gutting of this part of the bill neuters it. It is on to the Supreme Court, where unfortunately it will be upheld, by our bought and paid for socialist activist judges. It reminds us in many ways of the Warren Court. The judges may take the case for decision by next June.

Irrespective, temporary fiscal stimulus has been just that, temporary. We ask, why would the result be any different this time? All the exercise, a very expensive exercise of $2.5 trillion annually, is doing is buying time. The result will be more inflation and unemployment and the beginning of demonstrations and violence as we have seen all over Europe for the past few years. Incidentally, both are worsening and next year will reach a level not seen since 1968 in Paris. Riots are on the way in America, just be patient, they will come in good time. This is the result of austerity from the bottom up and the rich getting richer. Washington and NYC had best re-read French history starting in 1788.

The last time we saw numbers that we see today was in mid-2007, when the stock market took a sharp plunge. A correction to 8,000 on the Dow would wring out present excess evaluation and perhaps then some. This market is way over valued.

In none of the news and research reports we read do we see any reference to the fact that insured unemployment jumped 523,000 to 4.2 million. Markets often ignore cold hard facts at their peril.

We wonder what Wall Street thought about the expose forced by court order of the distribution of bank bailouts? There was no discussion. They just ignored the preliminary report. There are different estimates, but we will stick with our original estimate of $13.8 trillion. There is no question the collateral was substandard and in defiance of Fed rules. It is understandable why the Fed wanted to hide what they had been up too. There were 4,200 different loans and securities purchases under 13 different bailout programs of $3.8 trillion, that is that we know of at this time. This was shared by a host of lenders to affect profits to lessen these lenders deplorable condition. It even included transnational conglomerates. Some $61 billion was loaned to hedge funds to assist their exit from ABS, Asset Backed Securities. Much of the money found its way to the Cayman Island accounts of these entities in order to cover up what has happening. These funds may have bailed out these hedge funds, but the funds were also used to attack the European bond market and the ECB and its policies. We still do not know how many trillions are still out there. Did they also use the IMF and World Bank to front secret transactions? None of this has been as yet disclosed. It is estimated that some 36% of collateral for the loans was stock, which is illegal, including junk bonds. This is only the beginning. When the full story is known the reign of the Fed will be history.

The final details of the tax package are not as yet available, but here are a few comments. The tax extension bill has become a boondoggle worth about $900 billion. Payroll tax cuts will work about as well as the Bush tax rebates – they didn't work. Temporary measures never work, because they do not affect long-term behavior. Most of the money will be saved or used to reduce debt. Business needs accelerated depreciation allowances and research credits like they need a hole in the head. They are sitting on almost $2 trillion in cash, or 7.4% of assets, the highest in 52 years. This is just another payoff to business for their campaign contributions.

One of the things we would like to address is the "Shadow Lenders." As you know the Fed gave support to hundreds of banks and other corporations and then would not divulge what they had done. One of the sneaky things they did was to use $140 billion, or 20% of the Fed's Commercial Paper Funding Facility, $28 billion, to secretly fund domestic and foreign corporations. Banks around the world benefited. How they did it was via vehicles known as conduits. This contributed significantly to asset bubbles in residential and commercial real estate prior to the financial crisis, which began three years ago, by obscuring risks. Spokesmen for theses facilitators, banks, won't say whether their firms borrowed money from conduits that tapped the commercial paper facility. These people are real beauties. Some transactions allowed companies to remove assets from their balance sheets and reduce capital requirements. These vehicles get quite large and were secretly hidden from regulators and Congress. This criminal enterprise functioned from September 2008 through January 2010.

The total loaned from this facility by the Fed was $738 billion. The Fed says they did not know what the conduits were doing with the money. If you believe that I have a bridge you might be interested in. These conduits were similar to SIVs, or Special Investment Vehicles, where assets, usually their losers, were held off balance sheets. In pulling this slight of hand they did not need to hold capital against these assets. Thus, Citigroup, Royal Bank of Scotland, etc. served as a vertical faucet for loans that very few knew about. As you can see, just about anyone who wanted or needed funds got them and the fed often didn't even know where the funds went.

Both Europe, the UK and the US are on life support. Why else would they need such massive injections of money and credit? Now and during the coming year there will be about 2% growth, half of which will be supplied by quantitative easy of one form or another. These estimates come from official statistics, which unfortunately are incorrect: all three general economies in reality are in the minus column.

In order to maintain this level far more money and credit will be needed than has been admitted or anticipated. By June there is a good possibility that Greece, Ireland, Portugal and Spain will have defaulted. Already Moody's has 10 Portuguese banks under review for possible downgrade.

Europe waited too long to pour money and credit into the system and as a result is showing distinct signs of deflation. Strains will be great during the first quarter of the year due to heavy refinancing demands. The euro zone has to refinance $750 billion. This event could push Spain and Portugal into the same position that Greece and Ireland are now in. This means for those who have to be in currencies the US dollar and the Swiss franc will be the obvious gainers. You might call them, for this period, the best of the worst. This is not as yet being reflected in the currencies or their bond markets. Higher US rates are the result presently of US fiscal fears that will abate as we cross into the first quarter of 2011.

It won't take long for Rep. Ron Paul and Senator Bernard Sanders to go gunning after the Fed, which has to expose what they have been up too and what they have done, which has been illegal under their charter. That should calm dollar strength and add fuel to the fires that are driving gold, silver and commodity prices higher.

The "Build America Bond" program will be dead and the states will be strangled for lack of funds and as a result muni yields will have to climb further, which means lower muni prices and more layoffs in a sector that makes up 1/7th of the economy.

Housing will have another bad year that will stretch to 2013, and see 20% lower prices, many more foreclosures and a staggering inventory that could hit a 4 to 5 year supply, when normal is 4 to 5 months.

It looks like the administration and Congress with the assistance of the Fed will attempt to make $2.5 to $3 trillion in stimulus in a combination QE2-QE3, stretch out over two years. We are afraid they will find that is not going to work.

As we mentioned the first quarter should be good for the dollar, but as massive money has to be raised other borrowers will be crowded out of the market and yields will tend to rise again. The Fed could end up buying almost all the Treasury and Agency bonds, new and existing. This will continue to strangle credit to small and medium sized businesses that create 70% of new jobs. That means little improvement in employment. That also means the Chinese and Japanese could leave the Treasury-Agency markets and spend their dollars elsewhere, such as they have been in commodities, gold and silver. We have seen two years where loans to small and medium sized businesses have fallen by 25%. That is going to worsen.

Long-term debt will be overwhelming not only in the US and UK, but in Europe as well. If you can believe it banks have again been borrowing short, lending long a proven recipe for disaster. The 3% spread isn't worth the effort.

On top of such a poor choice they have leveraged themselves as well. Many banks will bankrupt themselves in this process as they did in the early 1980s. The taxpayers simply cannot bail every bank out, especially if they get hit simultaneously. At the same time these banks have bad real estate loans on their books.

Unemployment should improve only slightly, up to June, due to adjustments and financial turmoil in the US, UK and Europe. The following year could improve by 1% to 2% on a U6 basis. That could take real unemployment over two years from 22 5/8% to close to 20%, which will neutralize recovery again.

We could see 0.4% ten-year T-notes and perhaps even higher over the next two years as deliberately created inflation takes its toll on purchasing power.

Most of you have observed rioting in London, Athens and Rome this past week, as Europeans become more militant in retaliating against austerity, higher taxes and growing unemployment. The bitterness, resignation and militancy is reminiscent of the late 1960's demonstrations in Paris. Now we have seen this not only in Paris over the last three years, but now over Europe as well. The entire Continent is in contagion.

The established parties in every country represent the financial interests and on the edges we see the parties of protest. If an establishment politician steps out of line their money is cut off and they are isolated. No new direction is allowed. Wages must be lowered; the cost of business must fall, as well as corporate taxation. All the gains from higher productivity and lower wages must fatten the bottom line to increase salaries and options for the leadership. They cannot have constituents getting anything whether it is in Europe, the UK or the US. The elitists want all the wealth and world government to go along with it. The bureaucrats and the technocrats make the decisions and pass their orders on to the countries leadership.

In Europe the media is largely government controlled, which means it is controlled by the people behind the scenes that control government. It is more or less the same in the UK and US, but the elitists have direct control. That is why talk radio and the Internet, that emanates from the US, is so important. Their existence breaks the monopoly censorship. This process of sterilization then becomes broken and decent rises. The discontent you see in Europe is being fueled by the truth that is being dispersed by alternative media.

In Europe, education is in the hands of government, as well as research. As a result there is no cause and effect. This, of course, leads to mediocrity, an absence of original thinking and conformity, and a mold that youth is trying to break away from among other issues. Freedom in Europe has been extinguished by socialism. Socialism was the compromise lost in the 1930s between National Socialism and communism. It was a third way that began after World War II as a political and social solution. It avoided war but otherwise has been a failure. Unfortunately in every one of these isms, including what is called capitalism; freedom has been asphyxiated by the state. The question is do we opt for anarchy? What we did find out like others before us is that there is no ideal society. In the next issue we will cover more on the dilemma of civilization in Europe, the US and England, and where we believe the powers behind societies are leading us.

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