Stock Market Brushfire; Will there be a run on the banks?

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On Friday, the Dow Jones clawed its way back from a 200 point deficit to a mere 31 point loss after the Federal Reserve injected $38 billion into the banking system. The Fed had already pumped $24 billion into the system a day earlier after the Dow plummeted 387 points. That brings the Fed's total commitment to a whopping $62 billion.

By some estimates, $326.3 billion has now been added to the G-7 Nations' intra-banking system to prevent a breakdown. That amount will rise considerably in the weeks ahead as the situation continues to deteriorate. Some readers may remember that on Tuesday, August 7, the Fed announced that it was NOT planning to bail out the market.

My, how quickly things change.

So far, economic pundits and CEOs have applauded the Fed's intervention as a "constructive" way of staving off an impending credit crisis.

Are these same "experts" who always sing the praises of unregulated "free markets" while condemning any government intervention?

Yes.

The investment banks and fund mangers love "free markets" when it means eliminating the rules that prevent them to "gaming the system". But they don't like it so much when their shabby Ponzi-rackets start to unravel. Then they're the first in line to beg for a bailout.

That's what's happening right now. The Fed is keeping the stock market afloat by increasing liquidity at the banks. If it wasn't for Bernanke's billions of dollars of low interest credit—the banking system and stock market would collapse in a heap. The Fed's "not-so-invisible hand" is the only thing holding the whole dilapidated system in place.

Is that the way it's supposed to work in a free market system—with the Fed acting as the nation's Economic Central Planner intervening whenever it suits the interests of its wealthiest constituents?

Sounds more like a Financial Politburo, doesn't it?

In truth, the "free market" means nothing to the men who run the system. It's just a public relations scam designed to dupe investors into plunking their money into a system that's rigged for the carnivores at the top of the economic food-chain.

Does anyone really believe that the market-commissars would allow the system to operate according to the arbitrary swings in investor confidence and random speculation?

This is THEIR SYSTEM and they run it THEIR WAY. The only time that changes is when their twisted schemes go haywire and they need a handout from the taxpayer. In the present case, they are asking Big Brother Bernanke to bail them out on trillions of dollars of non-performing subprime garbage-loans which masquerade as securities in the secondary market. The Fed has already indicated that it is only-too-willing to help.

But what good will it do?

The banks are currently holding (roughly) $300 billion in collateralized debt obligations (CDOs) and another $225 billion in collateralized loan obligations (CLOs) More than one-half trillion dollars in debt which is essentially “illiquid” and has no clear market value. They could be worthless for all we know.

That hasn’t stopped the Fed riding to the rescue, buying up many of these toxic CDOs and increasing banking reserves so the great fractional banking con-game can continue unabated. This is what one astute observer called “alchemy finance”.

Central banks around the world have opened up the liquidity spigots to avoid a global credit meltdown. But their efforts are bound to fail. The banks are sitting on huge losses from assets that they can’t move through the pipeline and which have gobbled up their reserves. Bloomberg News summed it up like this: “The $2 trillion market for mortgages not backed by government-sponsored agencies is at a standstill”.

The same is true of the corporate bond market. As the Wall Street Journal reported last week:

“The investment grade corporate bond market HAS GROUND TO A HALT, making it difficult for companies to access capital and hard for investors to find a place to put their money to work. ….The problems in the primary market could, if they persist, throw a wrench in the workings of corporate America, making it tougher for companies to finance, among other things, investments, buyouts and equity buybacks….For July, corporate bond issuance was down 77% from June.” (“Corporate Bond Market has come to a Standstill”, Wall Street Journal)

The mighty wheels of commerce have rusted in place. Nothing is moving. Only the sense of panic continues to grow. Trillions of dollars poisonous CDOs need to unwind, but the banks cannot put them up for bid for fear that they’ll only get pennies on the dollar. This is what a slow-motion train-wreck looks like. The Fed’s cheap credit won’t help either. At best, it’ll just buy a little time before the true value of these bonds is established and trillions of dollars in market capitalization vanish into cyber-space. Banks, equities, hedge funds, insurance companies and pension funds are all in line to suffer major losses.

The irony, of course, is that the Federal Reserve created this mess by lowering interest rates to 1% and flushing trillions of dollars into the economy. That cheap money created a series of lethal equity-bubbles in housing, credit, stocks and bonds which are quickly falling to earth. Expanding the money-supply might be a short-term fix, but it’s really just throwing more gas on the fire. Why add hyper-inflation to the long-list of existing problems?

The volatility in the stock market is a red herring. We should be paying attention to the underlying problems which are just now beginning to surface. The banks have been originating loans and bundling them off to Wall Street to avoid the normal reserve requirements. Now they've been "caught short" and don't have adequate funding to cover their bets. If the Fed doesn't help out, we'll see at least one or two major bank closures.

This is a story that won't appear in the media. Bank-runs are the beginning of the end—financial Armageddon.

And there's more bad news, too. If the stock market corrects more than 10 or 15%, the massive overleveraged $1.7 trillion hedge fund industry will crash-and-burn. This may explain why the stock market has behaved so erratically recently. There have numerous late-day rallies with no good news to support the soaring equities prices. Is the market being micro-managed behind the scenes to keep it above a certain level?

Many people think so. There's been a flood of articles about the activities of the Plunge Protection Team's in the last two weeks. The Fed's desperate infusions of credit into the banking system will only reinforce growing suspicions of market manipulation.

DERIVATIVES DOWNDRAFT

Banks routinely hedge against adverse moves in the market by purchasing various types of insurance in the form of derivatives contracts. Derivatives trading has skyrocketed in the last few years and the "British Bankers Association estimated last fall that by the end of 2006, the market for all credit derivatives was $20 trillion and expected to be $33 trillion by the end of 2008."These relatively new instruments are about to be put to the test by worsening market conditions. "Hedge funds may account for as much as 30% of such credit protection" but that is little solace for the banks "because hedge funds that are losing money but also selling credit insurance may not be able to honor their commitments, rendering the protection worthless." ("Insuring against Credit Risk can carry risks of its own" Henny Sender, Wall Street Journal)

Credit insurance in the form of credit default swaps have created a false sense of security that may prove to be unfounded. In fact, the Credit insurance business has probably encouraged lenders to make shakier and shakier loans believing that they were protected from risk. But that doesn't appear to be the case. For example, Bear Stearns tried to soothe investor's fears during the collapse of its two hedge funds by pointing to its derivatives coverage.

"Bear executives repeatedly referred to their dependence on hedges, including credit derivatives, to offset their losses on subprime mortgages and loans to poorly rated companies, stating that such hedges would offset losses." (Ibid, H. Sender, Wall Street Journal)

We all know how that story ended up.

Derivatives have been celebrated as a critical part of the "new architecture of the financial markets". Now we can see that they are poor-performers under real-life conditions and liable to trigger an even greater disaster. If the stock market stumbles, we can expect a major breakdown in credit insurance-trading with trillions of dollars in derivatives disappearing overnight.

The abstruse world of derivatives trading will suddenly explode onto the headlines of newspapers across the country.

HOUSING BRUSHFIRE SWEEPS THROUGH THE ECONOMY

The contamination from the massive real estate bubble has now infected nearly every area of the broader market. The swindle which began at the Federal Reserve–with cheap, low interest credit—has spread through the entire system and is threatening to wreak financial havoc across the planet. The Fed's multi-billion dollar bailout will do nothing to contain the brushfire they started or avert the catastrophe that lies just ahead. Greenspan opened Pandora's Box and we'll all have to live with the consequences.