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False signs of the end
By Ronald Solberg

The big news in July was the taxpayer bailout of Fannie and Freddie. This is meant to help the US housing market since, in the past several months, these two institutions have essentially single-handedly kept any semblance of a normal mortgage origination market operating. In and of itself, this is a good thing. However, it remains debatable whether these institutions perform an ongoing useful purpose in a normal market, not to mention the moral issue of privatizing gains and nationalizing losses.

While this bailout has stemmed the horrible prospect of their imminent illiquidity and default, they remain technically insolvent and will need to be re-capitalized. Will this too be the taxpayer or the hapless foreign investor; the two chronic bag holders? Treasury Secretary Henry Paulsen claims only US$25 billion of taxpayer money may be needed, if that, but the ultimate bill is likely to exceed four or more times that amount [1].

Ultimately, were the US federal government forced to explicitly guarantee their debt (as a matter of foreign policy since a huge portion is owned by foreign governments and banks), the United States ratio of debt to GDP would virtually double overnight, likely putting pressure on the spreads of US credit default swaps and perhaps even lowering the country's sovereign AAA rating.

Even if this worst-case scenario for Fannie and Freddie is avoided, this bailout means ever more US dollars awash in the global financial system that increasingly investors are loath to hold (setting up prospects for further US dollar weakness) and commodity price inflation.

The bailout of these now essentially public institutions helped ignite a rally in US equities that now has held these gains through month end. Optimism waxes eternal. Of course, other events have helped to buoy the market, including the extension of the expiry date of the special Fed credit window through January 2009, the Securities and Exchange Commission's prohibition of naked short selling of major financial institutions, and the $20 per barrel decline in oil prices.

Outperforming sectors included financials, airlines, consumer discretionary, IT and health care. Taking this price action at face value would suggest investors believe the worst is over and that the economy (and stocks) are re-establishing their foundation. But do not believe it. Here's why.

Merrill Lynch recently announced a second-quarter loss of nearly $5 billion, involving an asset write-down of nearly twice that, with the chief executive stating on July 17, "Right now we believe we are in a very comfortable spot in terms of our capital". Although senior management claimed they had aggressively marked down assets, reserved against bad loans and taken sufficient write-offs in the second quarter, this shocking earnings report was followed a mere two weeks later with the news that Merrill will be taking another huge write-down -US$5.7 billion for the third quarter as it unloads huge amounts of risky debt, and will also raise $8.5 billion by selling new stock. Can the CEO's statements hold any credibility?

Globally, banks have written off somewhere between $450 billion and $500 billion in bad assets over the past year or so. The ultimate problem could be twice that size, if not more. Moreover, bank capital will need to be replenished over and over again. Which investors repeatedly will step up to do this? Singapore's Temasek replenished Merrill Lynch in January only to see their investment halve in value.

They stumped up again for the banks this month on the provision that Merrill made good on the first loss. There is unlikely to be unlimited goodwill from global investors to re-capitalize global banking without more transparency of asset quality.

Moreover, the current situation is not static. There are three aspects to this evolving scenario, each involving feedback loops (harmonic frequencies) of varying levels of intensity and time frames: financial stress; economic consequences to the real economy, including the potential for policy errors; and the erosion of business contracts amongst private stakeholders and even more gravely to the undermining of the Social Contract.

US mortgage asset quality continues to deteriorate not least of which due to monthly mortgage interest rate resets continuing to accelerate through year-end 2008. They are scheduled to continue to increase into 2009 but, by then, at a decelerating pace. US housing prices on average have fallen nearly 16% year on year and show no sign of abating. The Fannie/Freddie bailout is unlikely to keep house price deflation at bay.

The dire condition of the banks suggests that their willingness and ability to lend will constrict further, putting even greater pressure on the economy. As the economy slows and consumers increasingly retrench on spending due to the imminent need to save, asset quality problems for banks will spread to other products, including credit card delinquencies, auto loans, home equity loans, student loans and commercial real estate.

It is also likely that there will be a substantial up-tick in delinquencies on corporate, municipal and state bonds as companies, cities and states alike find that large and growing deficits cannot be solved merely by expenditure reduction and tax hikes. We are in the midst of a profound, secular debt de-leveraging cycle for which cyclical policy adjustments will struggle to reverse.

Paulsen and Federal Reserve chairman Ben Bernanke have clearly shown their hand: they will throw as much money as needed to support any major financial institution (or perhaps even markets themselves). However, their balance sheets are not limitless either and debt monetization may ultimately occur. This policy response would have enormous consequences, ranging from huge moral hazard risks, incipient inflation, increasing regulation, misallocation of resources and higher taxation.

The woeful American middle-class will have a steep price to pay for these largely unquestioned and autonomously imposed policies that bailout the fallout from Wall Street's greed, avarice and the gross regulatory mis-management by the Federal Reserve over the past two decades. A secular decline in the standard of living of the American middle class is a very likely prospect resulting from increased taxation, inflation and perhaps even the loss of seniorage from the diminished prospects for the US dollar as the world's reserve currency. Will anyone be held accountable? Not if circus, obfuscation and deflection continue to prevail.

Of course, it remains plausible that policymakers could be bailed out by a resurgence of animal spirits. Benchmark securities such as ABX and CDX indices may be oversold, and to the extent all level-3 (or mark to model) assets are based off of these, there exists the possibility of a sharp short-covering (sustainable) rally with risky assets experiencing explosive appreciation. This dynamic would be further supported if cash on the sidelines (such as sovereign wealth funds) gets involved. In this scenario, those investors with access to high return to expertise (those organizations that can identify "real value") will profit handsomely. Newly launched funds with no legacy problems would be best positioned for success.

Nevertheless, it seems more probable, likely sooner rather than later, that US bonds, equity and currency markets will react badly to this indiscriminate use of liquidity to bail out the past excesses of Wall Street and the Fed's prior neglect of mortgage fraud and loan pushing. The US Treasury curve is likely to steepen much more than the current 140 basis point spread between two-year and 10-year US Treasuries.

As investors balk at the copious new supply of long-term US Treasury notes and bonds, the 10-year yield is likely to approach double digits. Despite higher rates, it remains plausible that the US dollar would continue to decline under the weight of falling US asset markets, foreign-investor portfolios sated with US-denominated assets and the final capitulation of foreign governments on their exchange-rate regimes as they abandon their US dollar pegs to ease imported inflation.

All of this suggests a long and painful US recession that we are only just beginning. Of course, America will survive this and ultimately begin another expansion several years out. However, she will likely do so as a smaller economy with a reduced role in the global financial and commercial markets.

Note 1. Thanks to John P Hussman, president, Hussman Investment Trust for this analysis. Please refer to Bagehot's Rule and the Cost of Being "Technically Insolvent" on his website http://www.hussmanfunds.com/ for more details.

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