Financial Monsters

Contributed by Alice Friedemann
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We are entering the Money/Energy Transition. (The term was coined by Tom Robertson, moderator of the energyresources listserve.) This is when people will realize they can't fuel their cars with dollar bills -- that money is meaningless and all that really matters is energy. M. King Hubbert, the original peak-oil visionary, proposed an energy currency half a century ago so that people would understand how critical a role it plays in our survival. But it isn't practical to carry tanks of gas around or bits of uranium in your pocket.

So we spent our energy foolishly, plundering and poisoning the planet for a blip-in-time of pleasure, and now the "Limits to Growth" boas of peak oil, climate change, and natural resource shortages are tightening around us.

But most people don't see the world ecologically. Nearly everyone is brainwashed to see the world through economic and political filters. As we sink into depression -- both individual and economic -- brought on by increasing population, pollution, and decreasing energy and natural resources, most people will blame politicians, the Federal Reserve, and "evil" foreign governments for our woes. So we should start recognizing our personal, national and global financial monsters.

It appears the United States is succumbing to what all governments have been tempted to do over time: run the money printing presses overtime to pay for wars, debts, and corporate welfare. In anticipation of completely worthless money, we ought to at least design it in colors and shapes to make origami and something to do, since most of us will be out of work (you can start practicing at
members.cox.net/crandall11/money).

The subprime market is just the first tremblor bursting out of the ground to suck the life-blood out of your bank account and "disappear" your job.

Other Economic Monsters

Derivatives. Originally used to hedge risks, then as leverage, i.e., "swaps," derivatives allowed hedge funds to get around the leveraged limits the SEC instituted after the 1929 crash.

Warren Buffett has been warning for years that derivatives are endangering the financial system. He believes that the widespread use of swaps makes the leverage that preceded the 1929 crash "look like a Sunday school picnic." (Smith 2007). He warns that derivatives are financial weapons of mass destruction (BBC 2003):

• An explosion in derivatives contracts could create serious systemic risks; derivatives are like time bombs waiting to explode the economic system. Large amounts of risk have become concentrated in the hands of relatively few derivatives dealers.

• Outstanding derivatives contracts -- excluding those traded on exchanges such as the International Petroleum Exchange -- are worth close to $85 trillion.

• Some derivatives contracts appear to have been devised by "madmen." Buffett warns that derivatives can push companies onto a "spiral that can lead to a corporate meltdown," like the demise of the notorious hedge fund Long-Term Capital Management in 1998.

• Derivatives also pose a dangerous incentive for false accounting. The profits and losses from derivatives deals are booked straight away, even though no actual money changes hands. In many cases the real costs hit companies many years later. This can result in nasty accounting errors. Some of them spring from "honest" optimism. But others are the result of "huge-scale fraud," for example, with the US energy market, which relied for most of its deals on derivatives trading and resulted in the collapse of Enron.

Many derivatives don't trade often, making it hard to value them accurately. Institutions don't trust each other because no one knows who's got the most skeletons to hide. It's hard to make financial instruments like leveraged loans transparent if the asset has never traded, or no one's buying. Institutions tend to put as much gloss on their numbers as possible, and investors, lenders, and shareholders are very suspicious. (Davies 2007)

If hedge funds ever have to put an accurate price on what they own, the outcome could be scary -– that's why the Bear Stearns subprime debacle caused such concern, because it could start a chain reaction of other hedge funds forced to truly discover their asset values and adjust them sharply downward. Banks have about 375 billion dollars in leveraged loans. Bank, private equity, brokerages, and hedge fund failures are likely as assets continue to decline in value. Hedge funds have used derivatives to dampen volatility, and act like shock absorbers against market risk. But if the real value of derivatives has been exaggerated, then when these "shock absorbers" break down, there could be a hard landing (Patterson 2007).

The Great Unwind: Leveraged Debt. Not since the Great Depression has there been so much leverage in the stock market. Hedge funds, private equity firms, and Wall Street have found ways to work around the legal limits of leverage via derivatives and other complex financial instruments. Part of the reason we got into this mess was that banks, which are regulated and supposed to be transparent, don't control credit or money anymore.

Hedge funds and private equity firms are not regulated. If there's a serious market downturn, leverage can create a snowball effect, as stocks are dumped to raise cash, spiraling prices ever downwards. Wall Street analysts call this "The Great Unwind." The Wall Street Journal summarized this risk by saying, "No one is sure what will happen with this complex web of borrowing and derivatives in the event of a serious market downturn."

Larry Fink of BlackRock, says that lenders to highly indebted companies are making the same mistake as the subprime mortgage market, and will become "tomorrow's problem" as leveraged buy-out and junk-rated lending grows. The Bank of England also warned that cheap corporate lending with loose credit standards "has increased the vulnerability of the global financial system", and cautioned against weak standards of risk assessment for repackaged bank loans that are sold to the rest of the financial system (Beales 2007).

In the Economist magazine (June 21, 2007), Daniel Arbess, of Xerion Capital Partners, said that "perhaps the most worrying thing for financial institutions holding mortgage-backed paper is not the subprime market, but the unnerving parallels with an even bigger one to which they are also exposed: leveraged loans to companies". Subprime might well be "a dress rehearsal for something bigger and scarier."

Private Equity & Hedge Funds. These financial devices and firms are not subject to regulation, so the risk they're adding to the financial system is unknown. Worse yet, they’re given special tax rates of less than 10% (which amounts to a public subsidy), and that, combined with investor money, is used for leveraged buyouts. Then, these companies are stripped of assets and the employees outsourced and offshored. Jobs are lost and established companies destroyed. The big winners are the managers who engineer the buyouts, and who can earn billions in just one year (Monks 2007).

The time horizon of asset-stripping is short –- just 3 to 4 years -– and ignores the long-term interests of investors, employees, customers, and suppliers. The Chairman of Germany's Social Democratic party in 2005, Franz Munterfering, described private equity groups as "swarms of locusts" (Gordon 2007).

After asset stripping and outsourcing, these companies are laden with debt, which will become a serious problem when borrowing costs rise and an economic downturn occurs.

Distribution of Wealth. The gap between rich and poor has never been as great as it is now. The top 1% of households in the USA received 8% of national income in 1980 and 16% in 2004. During that period, the tax burden on the top 1% decreased from 44.4% to 30.4%, increasing their income even further. Wealthy individuals and corporations know how to hide their wealth offshore, or put money in questionable tax shelters, so the gap is even wider than what Piketty has been able to glean from tax records (Piketty 2007).

The Pew and Brookings Institutions have done research which shows that men in their 30s earn 12% less than their fathers did in 1974 adjusting for inflation (Guha 2007).

Such huge and fundamental unfairness often leads to social chaos, civil war, or revolution.

Federal Debt. The long-term economic health of the United States is threatened by $53 trillion in government debts and liabilities that start to come due when baby boomers begin to retire. Many leading economists say that even the world's most prosperous economy cannot fulfill these promises without a crushing increase in taxes -- and perhaps not even then -- as each household has an obligation of about $475,000 (Cauchon 2004).

Public Debt. The average American household in 2004 was $85,000 in debt from the $9.5 trillion owed on mortgages, cars, credit cards and other personal debt. The average American has negative savings.

Energy Costs. McMansions and sprawling suburbia will force families to dedicate dollars to heating their homes and driving that they would have rather spent eating out, and on vacations, electronic toys, and so on.

Job Loss: Offshoring. Check out the U.S. Department of Labor "Occupational Outlook Handbook" at

bls.gov/search/ooh.asp?ct=OOH
which lists job categories and statistics in America. A large percent of these have been or can be outsourced overseas to the billions willing to work for less money than Americans in clerical, administrative, accounting, actuaries, analysts, bookkeeping, etc. Up to 40 million jobs are potentially offshorable (Wessel 2007). Work that must be done here often goes to immigrants who don't have legal papers.

Job Loss: Real Estate. Nationally, real-estate-related industries accounted for 74 percent of new jobs over the past five years (Irwin 2005). In 2004, there were 460,000 real estate brokers, 1 million construction laborers, plus millions of other jobs dependent on real estate in furnishings, lumber, and other industries.

As the subprime meltdown expands, millions will earn less or lose their jobs. David Richards, in Barron's, estimates that the housing industry accounts for 6% of the US economy. Others, using wider boundaries, estimate it's more like 10% of the US economy. This many people spending less will affect everyone else in the economy; it's already happening in Florida and other hard hit states

The last time the housing market nose-dived was in the early '90s when Americans had half as much debt as they do now.

Job Loss: Automobile Industry. The Aug. 2, 2007 issue of the L.A. Times article "Imports now lead car sales in the U.S." reports that for the first time, Americans bought more imported cars than those made here. That will reverberate through the economy as well, since the supply chain for autos represents such a large part of the economy, at one time, one out of every six jobs.

Medicare/Social Security. Medicare is running out of money, may be in worse shape than SSN (Alonso-Zaldivar).

Underfunded Pension Funds (Schwanhausser 2002). For pensions that are not based on defined benefits plans, bad investments in pension funds will unwind, and as auto companies and other large companies decline or fail, their pension insurance is vastly under funded by hundreds of billions of dollars –- most people aren't going to collect what was promised.

Sudden drop in value of the dollar. What if foreigners decide to stop buying our treasury bills? As the Fed keeps printing more and more money, foreigners won’t want to be inflationary dupes. Currently, foreigners own $3 trillion of our assets -- equal to about a third of U.S. GDP. Middle East countries have been plowing their winnings into treasury bills, but they may prefer to get more of a return on their money in China and India to buy off their increasingly angry citizens. China and India will spend their increasingly valuable currency on importing food, energy, and other resources, so Americans are going to continually be experiencing a lower standard of living. It will be hard to cut back because there is such a sprawling infrastructure, petrochemical-agriculture, and minimal rail and mass transit.

Hidden Inflation. Economist John Williams has worked out that using Consumer Price Index (CPI) calculations in effect during Clinton's presidency, the CPI would be about 6% now, more than double the current CPI, which has had drastic changes made to how it's calculated (i.e. food, energy, etc aren't taken into account). So a bond paying 5% will actually lose you money, given a more realistic 6% inflation rate. If you use the government CPI figures, then the dollar has lost about 20% of its value since 2000, meanwhile gold went up 150% over the same period.

The Federal Reserve stopped reporting the M3 value, the U.S. money supply, in 2006. Adrian van Eck, however, guesses that it is increasing at about a 10% rate (and others by 12%). He figures that $1 trillion of additional 'money' will be put into the financial system in 2007 alone, 4 times faster than GDP growth. This means that your CD paying 5% is really losing 5-7% a year because currency is devalued when that much is printed or electronically made available. Consumer price inflation typically follows.

Wars are always inflationary. To keep the oil flowing, we are likely to bleed our finances to death until the oil runs out in the Middle East, Columbia, Nigeria, etc. This will be a huge drain on the economy.

Ecological Inflation. Food. Food prices are going to rise dramatically as we continue to lose cropland to pavement and development, topsoil losses, extreme weather from climate change, increasing population, and aquifer depletion. As the energy used to fertilize, plant, douse with petroleum insecticides, harvest, process, distribute, and cook food grows more expensive, food prices will rise even further. Grain will be exported to the highest bidder, countries like China with huge cash surpluses. Food is now 11% of the average household budget. In 1900 it was 40%, at a time when over a quarter of Americans still lived on farms and had much larger yards to grow some of their own food. Growing crops to make ethanol and transporting ethanol by truck and train from the Midwest to the coasts will increase food costs as well.

California grows a third of the nation's food, but as global warming shortens the growing season by depriving farms of much-needed snowmelt water in the summer, and the cost of energy to electrically pump water for irrigation (25% of on-farm energy), everyone in America will feel California’s pain in their pocketbooks.

Corporate Fraud & Ecological Destruction. As Bakan points out in "The Corporation: The Pathological Pursuit of Profit and Power", corporate charters state that the corporation must do whatever will benefit the stockholder. So even if the CEO wants to save the environment, he can't do it if it will cost the shareholders more money than destruction. Unless we can enact the reforms Bakan recommends, we can’t make the necessary U-turn back to sustainability, and corporations will continue to strip-mine the earth at an exponential rate to the point that many scientists believe will drive us extinct (if it isn’t too late already).

Massive Illegal Trade. Moises Naim, former editor of "Foreign Policy", makes the case in "Illicit" that illegal trade may comprise 10% of the world economy now. It’s gotten so sophisticated that small groups don’t specialize – they’ll run drugs, people, weapons – whatever pays best. This trade isn't taxed, leads to immense corruption, and makes it much easier for terrorists to potentially smuggle nuclear weapons.

Your Money Market Fund may lose money. Money funds hold subprime too (Richardson 2007). Worse yet, according to Catherine Austin Fitts, former Assistant Secretary of Housing-Federal Housing Commissioner in the first Bush Administration, Fannie Mae and Freddie Mac are not in good shape (Fitts 2004), and these federal agencies are NOT insured. Most money market funds own bonds in Fannie Mae & Freddie Mac.

Glass-Steagall Act no longer in effect. After the 1929 market crash, the Glass-Steagall Act was enacted to keep banks doing the business of banks, and not getting into the stock market or insurance business. This act has slowly been eroded to the point where it's non-existent. Now you have banks doing everything, including gambling with energy derivatives.

Deflation, Inflation, or Both? Because of oil shocks, runaway debt, massive amounts of money "printed" by the Feds and other governments, and other liquidity in the market, there's been a debate for at least 5 years about whether there'll be deflation, inflation, hyper-inflation, or a mix of all three when the financial system crashes. Bill Bonner (Bonner 2007) argues for deflation. He thinks the Fed is wrong about the risk of inflation, and here's how he sees the crisis evolving: Liquidity dries up, and then lenders don't want to lend and spenders don’t want to spend, they want to hang onto what they have. And it's a downward spiral, the more prices fall, the more consumers are reluctant to spend because they might get a better deal if they wait. Basically, they turn Japanese and hoard money. Takeovers and leveraged buyouts came to a stop.

Bonner asks "What can the Feds do?" Sure they can print more money, but how are they going to get it into the hands of people who will spread it around? Once deflation kicks in, people won't borrow because they're not sure they can pay it back. Prices fall, so money paid back on a loan is more valuable than the borrowed money.

Bonner quotes Ben Bernacke, who is fully aware of the dangers but says the Feds can get around it with "a technology…called a printing press…", and if need be can drop dollars from helicopters to get money into circulation (if you start subscribing to thedailyreckoning.com, that’s why he’s called "Helicopter" Ben). Of course Bonner says, Ben was being fanciful, the Fed won't actually do this or the dollar would inflate faster than in Zimbabwe, where inflation is over 5,000% a year.

Basically, the Fed would prefer inflation -– they're already printing too much money. But they won’t be able to inflate their way out of the economic crisis, because the Feds won't be able to get the money into the hands of the people who need it most, so we'll eventually end up with deflation.

When Japan's real estate and stock bubbles popped, everyone had a lot of savings, the country had a huge trade surplus, and there was no subprime lending problem. But in America the average person is in debt. Bonner asks "Can America afford a liquidity crunch...a credit contraction...a deflation? We don’t know...but if we were Ben Bernanke, we might want to make sure the printing presses and helicopters were in good running order."

Real Estate Bubble. The sub-prime debacle has only just begun and is likely to widen to other sectors of the economy. Until the 1990s, homeowners owned about 70% of their homes, free of debt. Now their equity has dropped to 52%.

Japan's equivalent of our baby boom generation began retiring and selling their homes in the late 1980's, which burst their real estate bubble. By 1989 Japanese real estate and the stock market had gone down by 60%. Our baby boomers begin turning 65 in three years.

Renters are now becoming victims of the subprime mess. When landlords foreclose, tenants in some states are given only 3 to 30 days to get out. Just a few states protect tenants from foreclosures. Many of these apartments were bought by speculators who intended to flip them before rates rose. Fewer places to rent will drive rental prices higher (Evans 2007).

Nationally, real-estate-related industries accounted for 74 percent of new jobs over the past five years (Irwin 2005). In 2004, there were 460,000 real estate brokers, one million construction laborers, plus millions of other jobs dependent on real estate in furnishings, lumber, and other industries.

Alan Greenspan pointed out the market has a lot further to fall, due to a very large inventory of unsold, shoddy new homes that are deteriorating rapidly, which puts pressure on builders to sell them quickly, which could lead to far bigger price declines (Greenspan).

Other Bubbles the past 35 years:

In the 1970s: sugar went up 45 times, oil stocks on Wall Street 30 times, and gold and silver went up 24 times

1980s: NIKKEI went up eight times

1980s - 1990s: NASDAQ went up 50 times, the DOW went up 14 times

(Saxena 2006)

Black Swans. Taleb, in his book "The Black Swan", warns that the world is not the nice, predictable place we see it as. Rather, it's full of awful and wonderful surprises that are likely to hit us over the head from out of nowhere.   So to protect yourself against a financial Black Swan, you should invest 90% of it very conservatively, so you don't lose it all.   Some of the Black Swans on the horizon are World War III over the remaining energy resources, a sudden decline in the value of the dollar, energy shocks, terrorists blowing up supertankers in the straits of Hormuz (which would prevent nearly half the world's oil supplies from being delivered), a large earthquake in Tokyo or San Francisco, hurricanes knocking down refineries and oil platforms in the Gulf, any sort of major disruption in global trade since we're so dependent on "just-in-time" delivery, a revolution in an oil state (i.e. Saudia Arabia, Nigeria), the collapse of Mexico (see theoildrum.com, "Mexico: A nation-state dissolves?" by Jeff Vail), a major nuclear disaster, etc.

In addition, China is in a massive speculation bubble, growing exponentially at rates of over 9% per year that can't possibly be sustained.   China's history is one of cataclysmic paroxysms, so when, not if, they explode, let's hope it's inward and not outward.

Dailyreckoning.com has been writing about these issues in highly entertaining and intelligent prose for over a decade -– they foresaw the dot.com and housing bubble busts, and explain derivatives, CDO's and other lurking financial monsters far better than I do. If you want to weather the coming storms financially, then subscribe to their email newsletter, and read anything Bill Bonner has ever written, especially "Financial Reckoning Day" and "Empire of Debt".

Only recently have the mainstream papers begun to sound the alarm –- the Wall Street Journal started to warn their readers about a year ago that "benign conditions will one day come undone. But for now, nobody can see how or why" (Sender 2007), "Eventually this confidence game will end" (Murry 2007), and "The longer the credit cycle lasts, the worse it will be when it ends" (Conway 2007).

Wall Street has always been Win-Lose, with the rich raking the chips in at the end of the game at the expense of the middle class suckers, who play with stocks for years, lulled by steady gains in the DOW. They stop paying attention, too distracted by TV, working overtime, and are brainwashed by conventional financial propaganda spouted by the few remaining news conglomerates.   Then, Bam! Wall Street swoops in on 401K and pension nest-eggs, smashing them apart.

The Bottom Line: Any investments outside of commodities will vaporize, any job that can be offshored will be, and the culture is about to change –- like it or not!

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