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Stock and bond markets sound alarm warnings

by William Engdahl

No sooner did the world's financial centers conclude that, as one European banker put it, "Y2K was the biggest hype of the last century," than the major stock and bond markets around the world began to plummet.

The epicenter of the financial earthquakes in the first week of the new year, as might be expected, was New York City, where the combined valuation of all stocks listed publicly, topped a staggering $13.8 trillion at the end of December, according to the Wilshire Equity Index. That put the paper value of all U.S.-traded stocks at 155% of U.S. Gross Domestic Product, the highest in recorded history, and almost double the stock-to-GDP valuations at the time of the October 1929 market crash.

Empty heads on the daily blab shows immediately began debating whether the week's events point to a "major market correction" or just another hiccup in amid the feast of "prosperity." But in fact, it is neither. As economist Lyndon LaRouche details elsewhere in this issue (see p. 18), what we are seeing is the death-throes of a financial system that is doomed to extinction. Our report should therefore be read not as a sports score-card, but rather as one would read the involutions of a Classical tragedy, as the foolish characters are propelled to their inevitable end.

Of the rising U.S. stock markets, none has risen as fast in the past year, especially in the last month, as the Nasdaq over-the-counter index. Nasdaq is where most of the high-tech Internet and related stocks trade, such as AOL, Amazon.com, eBay, or Cisco Systems. The Nasdaq index rose moderately over the past decade, until 1998. At that point, in the wake of Federal Reserve Chairman Alan Greenspan's huge injections of liquidity into U.S. banks and financial markets in October 1998—in his frantic bid to forestall a global financial meltdown, following the collapse of the Long Term Capital Management (LTCM) hedge fund—the Nasdaq became the focus of feverish speculative inflows from Wall Street investment firms and banks desperate to recoup heavy losses. Nasdaq prices soared from late 1998 to December 1999.

In 1999, the Nasdaq rose 86%, to an all-time high of 4,069 points. Even this was peanuts, compared with individual Internet stocks traded on the Nasdaq. Puma Technology, which writes software for linking mobile phones to the Internet, gained 3,770%. Qualcomm was up 2,835%, while Digital Lightwave rose a mere 2,667%.

Historically, analysts have compared a company's stock price to that company's current per-share earnings, to determine if a stock is inflated in value. Traditionally, a price/earnings ratio of 10-15 has been considered healthy in this regard. That was the level of the Dow Industrials from the late 1950s through much of the 1970s. At the time of the October 1987 stock market crash, the P/E for the Dow was 26. At the end of December 1999, the P/E on the Nasdaq stocks averaged over 200!

Greenspan's bubble

Various market commentaries from London to New York to Frankfurt have compared the Internet-led Nasdaq levels with the spectacular Dutch Tulip Bubble of the 1630s.

Rare bulbs for black tulips were the focus of such frenzied speculation in the Amsterdam market, that in the month of February 1637, prices for bulbs rose 2,000%. The following month, that speculative bubble, which had managed to suck in the life savings of many ordinary Dutchmen along with the

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wealthy burghers, burst. So many people lost everything, that the economy plunged into depression. With more than 43% of American households now betting on the eternal rise of U.S. stocks via private pension investment plans such as 401-K or simple mutual fund investment of their savings, the potential for a bursting stock bubble to collapse consumer spending and, with it, the U.S. economy, should be obvious.

The latest phase of this stock bubble in U.S. markets took off in late November. Then, the Federal Reserve began pumping high volumes of liquidity into the banking system, announcing that the liquidity was intended to insure against possible depositor panic withdrawals and bank runs, should the Y2K turn on Jan. 1 result in catastrophic breakdowns in the banking system electronic transfer systems.

Over the course of 1999, with the rise in the stock markets, Fed infusions of new liquidity were rising in tandem. In the last week of December alone, the Fed added an enormous sum of $24.4 billion, bringing total Federal Reserve assets to $618.8 billion, an increase above "normal" credit in the system of approximately $107 billion. Some observers put the excess amount even higher.

While the Fed issued the emergency new money to banks with "strict" instructions that it was to be "used only in case of fire," the explosive growth of the markets, especially the supercharged Internet stocks of the Nasdaq in December, suggest that, as City of London economist Stephen Lewis put it to *EIR,* "Banks have simply skirted the Fed rules and the money found its way into the stock market to fuel the large year-end gains." Annual bonuses for Wall Street bankers and fund managers are typically pegged to the performance of their investments that year.

However, it was not only Greenspan's Fed which had pumped in money. The European Central Bank (ECB), the Bank of England, and most spectacularly, the Bank of Japan, at year end, all joined in the rush, supposedly to prevent Y2K panic, by throwing cheap money at their banks.

Not surprisingly, the stock markets in all these places, and many more, soared as a result of all the liquidity. The London FTSE, Frankfurt DAX, and Paris CAC all hit record highs by the end of December. Tokyo's Nikkei index, which had been in danger of plunging below 12,000 early last year, ended the year at a two-year high of just under 19,000. By some estimates, at year end, total capitalization of all world stock market values combined, some $30 trillion, exceeded total world GDP for the first time.

As the first trading day of the new millennium opened, more and more bankers and stock traders realized that no major glitch from Y2K was so far to be seen. Rather than heaving a sigh of relief, they broke out into a cold sweat, as the realization dawned that the huge liquidity from the Fed, ECB, and other central banks, would now have to be dried up.

Nowhere is the market so dependent on continuing new funds as in the United States. In the event of a serious fall in U.S. markets, a huge pyramid of debt implodes, along with the stock prices. Official levels of "margin debt," that is, money borrowed by clients or private households to buy stocks on "margin," stood at an historic high in December. Margin buying of stocks involves paying, up front, only 50% of the stock price, in the hope that the stock will rise and allow the borrower to repay his loan plus interest, and still pocket a nice profit when the stock is sold in some months. With Internet stocks rising 86%, or even more than 1,000% in less than a year, the Nasdaq had managed to become the center of margin debt holders playing the market.

Official New York Stock Exchange data show a total of stock margin debt outstanding at end November of a record $206 billion. At beginning 1997, it stood at $97 billion. In November 1999 alone, margin debt exploded by $24 billion. Figures for December are believed to be even larger. Yet, according to the estimate of Raymond DeVoe of stockbrokers Legg, Mason, Wood, Walker, if we include in the calculation of the amount of stocks bought on margin, i.e., paying only 50% of the full price, from households which have taken out credit card loans at 19% interest to cash in on the stock casino bonanza over the Internet, or persons who took out loans against home equity to buy stocks on margin, the total of margin debt in the U.S. stock market easily could exceed $600 billion.

In such a situation, as in a chain letter scam, all is well, so long as new suckers play the game in greater and greater numbers. When that ends, the entire edifice implodes. As stock prices fall instead of rise, banks demand a "margin call," i.e., hard cash to cover their margin loans as the stock collateral value falls. For most borrowers of margin debt, however, their only source of fast cash is to sell their stocks. That pattern magnified many-fold, as everyone rushes to be "first out the door," fuels a panic selloff, which, in turn, forces the market even lower. That forces even more distress dumping of stocks at any price, and so on. In such a dynamic, known as "reverse leverage" on Wall Street, a mild market "correction" becomes a self-feeding, non-linear meltdown.

Central banks 'take the punch bowl away'

On Jan. 4, all hell broke loose on world markets. The Dow Index of 30 so-called Industrials slid 360 points, its worst loss since the LTCM crisis erupted in September 1998. The same day, the Nasdaq fell 229 points, a loss of 5.6%, the largest in the 29-year history of the market. By Jan. 5, the Nasdaq was down over 8%, with no bottom in sight. By Jan. 5, the German DAX lost over 9% from its Jan. 3 peak. Markets from Hong Kong to Mexico City to Tokyo fell along with the U.S. and European markets.

Official explanations by Wall Street market traders, with a desperate vested interest in calming the selloff, were that this was merely a "correction" of over-valued stocks, to take account that the Fed would probably raise rates again another one-quarter of a percentage point at the Feb. 1 Federal Open Market Committee (FOMC) meeting. The argument is that

that rate rise will dampen the brisk U.S. economic growth and thus dampen corporate profits in the coming year, hurting stock earnings performance.

"The real reason for this heavy selloff," insists London's Lewis, "is the attempt of the various central banks to drain the huge liquidity from the markets as soon as possible." An old Wall Street adage states that the "job of a central banker is to take away the punch bowl just when the party gets really going." The Fed, having soused the banks late last month, seems to have decided to do just that to the banks. Over just two days, as of Jan. 5, the Fed had drained out of the banking system some $50 billion of the $100 billion-plus emergency liquidity it had pumped in late last year. A similarly large liquidity drain by the European Central Bank is blamed for the sharp market plunges there as well.

"The severe collapse in the U.S. stock market on Jan. 4 was the direct consequence," Lewis says, "of the Fed draining some $35 billion that day." Banks caught short had to demand margin calls from their clients who had borrowed to buy stocks on margin. The result was the hair-raising selloff in Nasdaq and other U.S. markets. "By evening on Jan. 4, the Fed began to chicken out," Lewis explains. They began to add funds back in, even if slightly. That led to the widely hailed "recovery" on the Dow the following day.

"The problem is, the worst is still to come," he adds. "This pause is only temporary. The Fed, I estimate, has to drain another $90 billion, and that will cause at least another 1,000 point drop in the Dow. They are trying to do it in stages, to limit the collateral damage, such as brokers going under."

Here is the deadly dilemma faced by Greenspan and the other central bankers. If they hesitate too long in removing the liquidity, Lewis adds, bond markets will panic and force the market rates on bonds far higher than the already alarming levels of today, on the bet that Fed laxness will guarantee that all the excess money will create huge inflation problems in the next few months.

Sharply higher interest rates would endanger the record levels of corporate bonded debt created over the past five "boom years" in the United States, likely triggering a chain-reaction of bankruptcy defaults by many fledgling high-tech and other companies, in turn spreading a deep economic recession or worse.

At that point, a bond market crisis could easily spill over into a full-blown U.S. dollar crisis, as the record number of foreign holders of U.S. stocks and bonds head for the exit.

On Dec. 28, a week before the market bubble began to deflate, Lyndon LaRouche issued a statement in which he declared, "Some in print, and many more bankers, economists, and statesmen privately, are warning that the world is faced with something far more serious than a stock market crash. The world's financial system, is doomed to a systemic collapse, from which only a radical return to earlier pro-nation-state policies could rescue humanity."

'Experts' ignore role thousands die from

by Linda Everett

One of the leading causes of death and injury in America is medical error, according to a report entitled "To Err Is Human: Building a Safer Health System" (National Academy Press), released on Dec. 1 by the Institute of Medicine (IOM). The report, by the IOM's Committee on Quality Health Care in America, based on a year-long review of hundreds of studies, determined that between 44,000 and 98,000 people die in hospitals every year due to preventable medical errors by doctors, pharmacists, and other health professionals—far more than the number of Americans dying from breast cancer, highway accidents, or AIDS.

As stunning as these figures are, the committee says that these known fatalities are a modest estimate of the magnitude of the problem, which costs the nation as much as $29 billion a year. Practices resulting in preventable deaths, permanent injuries, and unnecessary suffering are also rampant in nursing homes, day-surgery and out-patient clinics, and retail pharmacies.

The report lays out a comprehensive strategy to reverse the crisis, and calls upon Congress to create a new patient safety center to address the basic flaws in the system. Within days of the report's release, President Clinton launched three initiatives to address the problem on several Federal fronts; a Senate Committee held hearings on the crisis, with more planned for the coming year; and Sen. Edward Kennedy (D-Mass.) proposed legislation to require mandatory reporting of medical errors, as the committee also proposed.

There are legitimate medical safety issues raised by the committee that warrant immediate action on state and Federal levels. According to "Incidence of Adverse Drug Reactions in Hospitalized Patients," in the April 15, 1998 issue of the *Journal of the American Medical Association,* fatal medication errors *alone* ranked among the fourth- to sixth-leading cause of death in the United States in 1994. Adverse drug effects are not always preventable, such as when a specific antibiotic is administered to a patient whose allergy has not been previously identified. But, basic flaws in how the health system is organized, and how these flaws lead to preventable deadly mistakes, are well known.

In testimony presented on Dec. 13 to a Senate subcommit-