Those Financial 'Good News' Stories for 2005 Are Lies

by Lothar Komp

A tempestuous year has just drawn to an end on the money markets. In the spring of 2005, the downgrading of $400 trillion worth of General Motors and Ford debt to junk bond status, unleashed a systemic imbalance in bond derivatives and hedgefunds. For months, the major central banks pumped in liquidity as discreetly, but as massively as possible, in hopes of heading off a chain reaction. Throughout the year 2005, raw materials prices rose across the board, to reach peaks that have not been seen for as much as 25 years.

"Good news," some would claim: the so-called hedgefund industry, plying ever-new forms of financial derivatives, has not collapsed, nor has the huge, debt-driven property bubble in the U.S.A., Great Britain, and the European Continent burst. While the U.S. dollar, on which the entire world financial system depends, itself totally dependent on constant injections of foreign capital, seems to be holding the fort.

Here we are, though, in the year 2006. And the momentum in all the aforesaid, is a momentum headed for catastrophe. On Jan. 11, the head of the New York Federal Reserve, Timothy Geithner, more or less so acknowledged.

To date, the Federal Reserve, in the person of its Chairman Alan Greenspan, now about to step down, and his successor Ben Bernanke, has acted on the basis that a central bank need not be concerned with asset inflation. Whether it be a true bubble or not, they say, will come out in the wash; in other words, once it's burst. And even if one acknowledges that it be a bubble, it would be foolish to attempt to prevent it by jacking up interest rates. The impact on the real economy, they contend, cannot be assessed, so why bother one's head about it? Provided the so-called basic inflation rate remains low—and that's what creative inflation statistics are about, eh?—everything comes up roses.

In his Jan. 11 speech to the New York Association of Business Economics, Geithner stated that in the future, the Federal Reserve will pay greater attention to fluctuations in the price of assets such as shares, bonds, and real property. Under certain circumstances, there may arise risks, that the Fed must deal with by changes in monetary policy. What Geithner did not say, is that the Federal Reserve has long since lost all control over asset inflation. As there already exists a gigantic bubble, raising the indicative interest rate significantly is out of the question.

Indebtedness of the World Economy

Over the last five years alone, the price for dwellings in the world's main industrial economies has shot up by over $40 trillion, more than total worldwide GDP! Such "growth," if that is the word, not only in absolute figures, but relative to GDP, is well beyond the stock market bubble which burst in 1929 and 2000. Worse still: unlike the stock market bubble, the real property bubble is entirely debt-financed. U.S. private households, by the end of the third quarter of 2005, were in debt to the tune of $8,209 billion. Fresh mortgage indebtedness in the U.S.A., that was roughly $200 billion throughout the 1980s and 1990s, crossed the threshhold of $1 trillion for the first time in 2005, and by the third quarter of 2005, had already reached a yearly rate of roughly $1,107 billion.

By comparison, fresh debt incurred in Germany, a debt that the Liberals are wont to refer to as the grim albatross auguring the End of the World, seems almost negligible. U.S. private households and firms, that are not part of the financial sector, now run up $2 trillion of fresh debt per annum, twice as much as during the Boom Days of the so-called New Economy. If one factors in the finance and public sector, U.S.

domestic indebtedness is growing at a rate of $3 trillion annually.

These debts are the lever, used to maneuver both the finance-bubble, and the U.S. economy itself. A lever of scarce use, as ever-more fresh debt is run up, simply to produce the same effect. The long-term rates have, in the meantime, risen constantly. Which is why the U.S. Bond Market Association expects a 20% drop in issuance of mortgage-backed bonds. These are amongst the financial assets that the mortgage banks Fannie Mae and Freddie Mac have disposed of worldwide, to refinance the buyout of private U.S. households' mortgages.

The Hong Kong Shanghai Bank has just published a study, predicting a short sharp end to the U.S. property boom. In somes areas, notably California and Washington D.C., houses are already 50% over-valued. Stagnation in property prices could have a very adverse effect on the U.S. economy.

In late December, this point was stressed by Paul McCully, managing director of the California-based PIMCO, one of the world's largest bond-trading firms. Referring to prospects for 2006, McCully referred to the now-common practice of Mortgage Equity Withdrawal (MEW), "which is Americans taking equity out of their homes by putting more debt on them." This, he said, was "turning the house into an ATM" [automated teller machine]. But, he said, the collapse of MEWs would occur, as the huge increase in property prices now comes to an end, "sufficient incomes to support the debt necessary to pay asking prices, particularly when mortgage interest rates rise." California has been especialy hard hit, where, said McCully, over 80% of new mortgages over the last year have been exotic creatures—interest only, pay option, and negative amortization concoctions. And he continued: "When the American property market comes off the boil, maybe turning tepid, the world will feel the impact, not just American homeowners."

'Swarm of Locusts'

Insofar as hedgefunds and their locust-like relatives, the Private Equity Funds (PEF), are concerned, a new "threat" looms. The worldwide campaign by the essentially U.S.-based Private Equity Funds, that have taken to gobbling up every small-and-medium German business they can, looting it to the bone, and then disposing of it again, has itself become a threat to the world financial system. What these PEFs do, is run up debt with the major banks, to finance their take-over bid. This debt, as one might expect, has become simply gigantic in the last couple of years alone.

According to the research agency Dealogic, private equity funds borrowed $128.4 billion last year to fund European acquisitions, twice the volume of the year before. The word is out and about that many of these funds are so indebted, that they may shortly be facing payment difficulties, and bring the banks they have borrowed from down with them. London's *Financial Times* made a survey among top private equity fund managers in December, where 95% of the managers agreed that the amount of debt used to finance leveraged buyouts had reached "dangerous and unsustainable levels." Jon Moulton, founder of the private equity fund Alchemy Partners, was quoted saying, "If there is any kind of a downward turn in the economy we will see a spectacular level of failure. The debt levels are without precedent." In Germany, Private Equity Funds have now invested into 5,500 firms, that employ over 638,000 persons.

Concerning derivatives and the hedge fund sector, yet another kind of speculative game was launched during 2005: so-called "Principal Protected Notes" (PPN). These PPN are derivatives contracts tracking the performance of groups of hedge funds. The idea is to allow "small investors" to participate in the alleged boom of the hedge fund "industry," as direct investments into hedge funds are restricted to super-wealthy or institutional investors. PPN contracts are a kind of "derivative derivatives," as the hedge funds themselves are massively involved in derivatives schemes.

On the finance markets, there is a feverish attempt to attract capital from small investors into the hedge funds and financial derivatives. To that purpose, new financial instruments have been introduced. While only the super-rich and institutional investors may directly play the hedge funds, where the bottom-line investment will generally be $5 million, every Joe Blow can use what is now called Principal Protected Notes (PPN) and play the so-called hedge fund boom. PPNs are derivatives contracts, that involve betting on the success—or otherwise—of entire groups of hedge funds, while the latter bet on the success—or otherwise—of other financial assets. One could thus see PPNs as "derivative derivatives."

But even that will not suffice. In Great Britain, something else has popped up, so-called Funds of funds (FOF). The FOFs invest in hedge funds, and one need only have $50,000 in hand to join the fray.

In Germany, where hedge funds were only legalized in 2004, one need invest but 124 Euros for starters, thanks to kind intercession by the Deutsche Bank's DWS Group, that has just set up two hedge funds to that very purpose. The only hitch, is that Deutsche Bank's own dealers may not be overly aware of what the funds might be up to.

In December 2005, Deutsche Bank made headlines, owing to the Ackermann trial and the property fund scandal. A brief month later, this January in London, a wet-behind-the-ears Deutsche Bank dealer may have unleashed bond derivatives losses in the area of 50 million Euros. Although the dealer himself has been fired, his superiors appear to have let him run wild. As it happens, bond derivatives involve such complex bets on bundles of outstanding debt that even the top brass scarcely understand how the thing works, nor can they possibly ascertain what the consequences might be at the end of the line. In terms of the world-wide game of Russian roulette with derivatives, bond derivatives are, so to speak, the big "growth area."