The Fed is sacrificing people to save the junk

by John Hoefle

Even as the line goes out to the suckers that the financial crisis has abated, the bankers are engaged in a desperate fight to head off billions of dollars of "unrealized losses" on their derivatives, junk-bonds, asset-backed securities, and related financial instruments. The band may still be playing on the upper deck, but down below, the water is pouring in.

The financial markets operate according to what some call the "greater fool" theory, under which an investor can safely buy even the riskiest piece of junk, under the assumption that it can always be sold to some bigger fool, should it begin to turn sour. In this world of the greater fool, companies with poor credit ratings can sell billions of dollars worth of junk bonds, and bankers can make billions of dollars of loans to companies and individuals who are deemed poor credit risks. Hundreds of billions of dollars of these junk bonds and junk loans have been issued over the past few years, feeding the insatiable demand of the securities markets for additional income streams to loot. As long as the bubble was growing, the junk, with its higher vigorish, was lucrative—and if the market turned, well, there was always the proverbial greater fool.

But what happens when the bubble stops growing? When panic sets in and the "investors" begin to focus not on how much money they can make by playing the markets, but instead become obsessed with trying to save as much of their virtual money as possible, when the market turns? When the sinking feeling hits them, that they might turn out to be the greater fool?

Bond hemorrhage

When Long-Term Capital Management (LTCM) failed in September, the Federal Reserve and the banks rushed to rescue its financial paper, not because they wanted to help LTCM, but to save themselves from the chain-reaction of derivatives losses which would have resulted from defaults on LTCM's hundreds of billions of dollars of loans, and its trillion-dollar-plus derivatives portfolio. LTCM specialized in what is called bond arbitrage, betting that the yields on government-backed and corporate bonds would converge over time, upon their historical values. Given that a high percentage of corporate bonds issued in recent years were junk bonds, Long-Term Capital Management was betting, in effect, that the junk bond market would grow increasingly stable, and that the spread between what governments paid to borrow, and what junk-issuers paid to borrow, would narrow.

That game blew apart on Aug. 17, when Russia defaulted on its sovereign debt and devalued the ruble. This definitive proof that Russia couldn't pay its debts sent shock waves throughout the financial world—everyone knew the losses to the Western speculators were huge, but few knew how much of the bubble had just evaporated. The result was panic, with the focus turning inward, to self-preservation. Suddenly, "risk" became a pariah, and money fled out of junk and into the perceived safe havens of government-guaranteed paper.

This flight to safety caused the spread between government and corporate bonds to widen—exactly the opposite of what the bond "arbs" had bet—causing huge losses, not only for LTCM, but for other speculators, including hedge funds, investment banks, commercial banks, and insurance companies, who were playing the game.

Save the bubble!

The carnage in the bond markets left many of these institutions with substantial unrealized losses in their portfolios, on derivatives contracts which were nearing settlement, on junk bonds and other securities they were holding for resale or for their own portfolios, and on loans to borrowers who had suddenly become unable to pay their debts. At least several of these institutions were probably insolvent, even by the see-no-evil standards of modern accounting.

Fearing that the failure of one or more of the big derivatives banks would set off a chain-reaction of precisely the sort of which Lyndon LaRouche has warned, the Western central banks initiated a series of interest rate cuts to pump liquidity into the markets. The Federal Reserve, which took a deliberately high-profile role in the LTCM crisis, cut interest rates twice in rapid succession, signalling to all that it would stand firmly behind the banks and the derivatives bubble, no matter what the cost.

But the Fed is also engaged in a desperate attempt to manipulate the markets, to convince investors that the crisis is over, to lure then out of Treasuries and back into the corporate bond markets, and into junk bonds in particular. If the bond spreads can be narrowed fast enough and far enough, the thinking goes, much of the unrealized losses on the banks' books will disappear. For this plan to work, the greater fools have to be lured back into the market, to be sacrificed by the Fed for the greater glory of Wall Street. So, the Dow is pumped back up, and the carnival barkers are deployed to lure the suckers and their money back into the game, like lambs to the slaughter.

Junking the system

Way back in pre-history—say, as far back as the 1960s—the money raised on Wall Street was used mainly to fund more or less real economic activity; speculation existed, but in limited form. The dog had fleas, but they were somewhat under control. Today, the fleas have taken over, viewing the real economy merely as a vehicle for their speculative activity.

Take the rise of the junk bond market. In 1986, at the peak of Drexel Burnham Lambert's and Michael Milken's power, a record $33 billion in junk bonds were issued, bringing the total issued since 1980 to about $70 billion. During the 1980s, a total of roughly $150 billion in such bonds were issued. So far in the 1990s, nearly $500 billion in junk has been issued, including $119 billion in 1997 alone. According to Securities Data Corp., 1998 was on a pace to smash that record, with $117 billion in junk bonds issued during the first seven months of the year—an average of $16.7 billion a month—until August, when the market for junk abruptly dried up. In September, just $2.7 billion in junk bonds were issued, and only $464 million were issued during the first three weeks of October. There are about $430 billion in junk bonds outstanding today, with at least $30 billion sitting in the vaults of Wall Street firms, gathering dust until—and if—they can be sold, according to the *Wall Street Journal*.

Even larger is the market for asset-backed securities. There are some $2.5 trillion in such securities outstanding today, of which nearly $2 trillion are mortgage-backed securities (MBS) issued by Fannie Mae, Freddie Mac, or Ginnie Mae. Mortgage-backed securities are a form of derivative, created by pooling residential mortgages, then issuing a variety of securities backed by the income from the mortgages in the pool. Nominally done for the benefit of home-buyers, the mortgage-backed securities market has become a vehicle for pumping trillions of dollars of implicitly government-backed securities into the financial markets.

Markets backed by consumer debt

Smaller than the residential MBS market, but growing rapidly—until August—are the markets for securities backed by consumer debt, and securities based on commercial real estate. Issuing securities based upon credit card receivables has become a big business for U.S. banks; as of June 30, U.S. banks had sold $239 billion in credit card securities, while carrying only $217 billion in credit card debt on their balance sheets, according to the Federal Deposit Insurance Corp. (FDIC). The $200 billion commercial mortgage-backed securities market suffered a major hit on Oct. 5, with the bankruptcy filing of Criimi Mae, which bought nearly half of the CMBS bonds issued in recent years.

Then there's the subprime lending market, in which people whose credit ratings prevent them from getting regular loans, can get loans at exorbitant rates of interest. The subprime market has exploded—double entendre intended—in recent years, with some $250 billion in such loans outstanding today. According to the FDIC, subprime loans secured by residences, both home equity and mortgage loans, amounted to between $100 billion and $150 billion in 1996, compared to the estimated $800 billion in originations of conventional mortgages; while an estimated $75-100 billion in subprime auto loans were issued, or about 20% of total auto loans outstanding.

The subprime lenders themselves are basically throwaways, created by the banks for the purpose of generating loans which can then be securitized, and as a mechanism of reaching into the pockets of people whose economic status precludes them from participating in the more traditional looting mechanisms.

A related lending practice is the high-loan-to-value home mortgage, in which the homeowner is typically loaned 25% more than the value of the mortgage. Much of the extra cash is used to consolidate existing credit-card and related debt.

The result is a system in which virtually any income stream which can be found, is seized and turned into securities, which can then be speculated upon in the financial markets. Securities backed by bankrupt companies and households, sold by bankrupt banks to bankrupt investors, piled high into a mountain of some $150 trillion of worthless, unpayable claims, upon an economy which is rapidly being destroyed. All the Fed's horses and all the Fed's men, won't be able to put this bubble back together again.