Banking by John Hoefle

Oops! $9 Billion Turns to Dust

The vaporization of two Bear Stearns hedge funds shows that the value was never there in the first place.

In a letter recently sent to clients, the investment bank Bear Stearns admitted that two of its hedge funds, which were nominally worth some $9 billion, had essentially vaporized, suffering "significant deterioration in performance for May and June."

"The preliminary estimates show there is effectively no value left for the investors in the Enhanced Leverage Fund and very little value left for the investors in the High-Grade Fund as of June 20, 2007," the letter said.

That the two funds were revealed as worthless should have come as no surprise to anyone. The names alone—the High-Grade Structured Credit Strategies Fund and the High-Grade Structured Credit Strategies Enhanced Leverage Fund—should have been enough to give anyone pause. The funds took in money from clients, used the clients' money as the basis to borrow much more money from banks, and then spent the whole bundle on bets which were doomed to fail. It was a remarkable display of stupidity, blindness, and greed.

The real story here, however, is not merely the fate of the two funds, but what this little episode reveals about the system as a whole, where hundreds of trillions of dollars of notional value of financial assets are in the same boat as the Bear Stearns hedge funds were a few months ago, carried on the books at illusory values which can disappear in a flash.

The financial types will naturally scream at such assertions, claiming their expertise and their algorithms will save the day, but as events unfold, their bare sterns are increasingly exposed. The reality which they are so determined to ignore is that the U.S. economy has been operating below breakeven, and increasingly so, since the late 1960s.

One element which gives the game away is the composition of the workforce, where the number of manufacturing workers is now well below what it was in 1950, and in per-capita terms is slightly below what it was in 1860 (yes, 1860, nearly 150 years ago!). As a result, our balance of payments on merchandise trade (exports minus imports) has dropped through the floor, from a slight surplus in 1970 to a whopping $838 billion deficit in 2006. We have, as the purveyors of globalization intended, become dependent upon goods produced elsewhere for our survival, and increasingly dependent upon the imperial cartels to sell those goods to us at rigged "market" prices.

As we shut down our industry and took lower-paying service jobs, our society stratified into a wealthy few at the top, a declining middle class, and a growing impoverished class at the bottom. At the same time as wages have dropped in real terms for most, the prices of basics like food, housing, medical care, and transportation have soared. To cover the gap, U.S. households and businesses have borrowed huge amounts of money, in many cases funds they have no hope of being able to repay.

The result, predictably, has been an explosion of debt, with total credit market debt (as reported by the Fed) up 81% since the beginning of the 2000s. That's roughly a $5 increase in debt for every $1 increase in GDP (and GDP itself is dominated by services). Then there are the derivatives, which have grown hyperbolically; the derivatives held by U.S. commercial banks alone, as reported by the FDIC, have soared from $35 trillion to $146 trillion since the end of 1999.

How does an economy, the productive activity of which is collapsing, manage to remain, as is so often claimed, fundamentally sound? The simple answer is that it cannot. We have continued to exist by treating our ever-growing mountains of unpayable debt as assets, and then speculating heavily on those assets in order to maintain the fiction of profit.

As long as these so-called assets remain undisturbed in their virtual world, they provide the illusion of wealth—not wealth, but the perception of it, a perception the financiers have a vested interest in maintaining. As the bubble grew and asset values inflated, the illusion was protected. Now, however, the system is kicking into reverse, with some asset values, notably home prices, deflating, and the value of some of the mortgages, and more so the mortgage-backed securities and collateralized debt obligations based upon the mortgage-payment stream, are vaporizing. They are not "losing value," because they never had any value to begin with; they were an accounting fiction, a shell game designed to present an illusion of prosperity.

The U.S. economy, indeed the entire global financial system, is rotten with worthless paper. Like the assets of the Bear Stearns hedge funds, the moment you move to sell, the alleged value evaporates. As assets deflate, more gamblers will be forced to sell, triggering further vaporization in a classic self-feeding process. This is how panics are born, and nations fall.