Is This the Start of the Big One?

Monday, August 17, 2009

I don't believe in market calls, and trying to time turns is a perilous game. But most savvy people I know have been skeptical of this rally, beyond the initial strong bounce off the bottom. It has not had the characteristics of a bull market. Volumes have been underwhelming, no new leadership group has emerged, and as greybeards like to point out, comparatively short, large amplitude rallies are a bear market speciality.

In addition, this one has had some troubling features. Most notable has been the almost insistent media cheerleading, particularly from atypical venues for that sort of thing, like Bloomberg. Investors who are not at all the conspiracy-minded sort wonder if there has been an official hand in the "almost nary a bad word will be said" news posture. Tyler Durden has regularly claimed that major trading desks have been actively squeezing shorts. There have been far too many days with suspicious end of session rallies.

The fall in the markets overnight, particularly the 5.8% drop in Shanghai, seems significant in combination with other factors:

More bank woes. We may be two thirds of the way through the losses, but it could also be as little as half. And despite the stress test baloney, the banking system is undercapitalized by a large margin. Even if the remaining writedowns are smaller in absolute terms than what is, past, they dig deeper into depleted equity bases. Colonial Bank, a $25 billion bank taken out last Friday, was deemed well capitalized until recently. We noted its much bigger neighbor, $140 billion Regions Bank, similarly deemed to be well capitalized, has effectively said it is insolvent How many other banks are broke save thanks to overly permissive accounting? And as we have noted before, the IMF in a study of 124 banking crises, found that regulatory forbearance, which is econ speak for letting the halt and lame limp along rather than taking them out, is far more costly, both in terms of lost growth and size of the ultimate bank recapitalization, than earlier action.

Consumers tapped out. The lousy retail sales report was a reminder of a rather central fact most have chosen to forget.

Foreclosures set to rise. We are not having a housing bounce. Some markets may be close to a bottom, but foreclosures grind on. Even if some local markets are at their nadir, there is so much overhang, between continuing mortgage stress and pent up sales, that much appreciation near term is unlikely. The record of past severe financial crises is that real estate takes over five years to bottom.

Fed in a box. Some e-mail chat pointed out a key fact: the term structure of US funding has gotten very short term. We have become in some ways like a massive bank, borrowing short and lending long. This means the idea of allowing rates to rise on the short end, which has to happen unless we stay in Japanese ZIRP land indefinitely, will be more disruptive than the Fed seems to appreciate.

More AIG losses, I am told more AIG losses are in the offing. There is still unused money out of the total alloted to the rescue, so any eruptions here may not require further official action, but it would have a bad impact on the collective mood, and further taint any efforts to shore up the financial system.

Lack of political leadership. The health care fiasco is going to be a defining event for Obama, in a negative way. His inability to respond effectively to simply absurd distortions of his plan and of the record of public supported programs overseas (including that many are government funded but still privately run, for instance) may dispel the illusion that he is or can be an effective leader. His banking policy, which is vital to recovery, became hostage to Geithner and Summer's deep loyalty to the industry, and his lack or interest in rocking any boats. All Team Obama has done on the banking front is write a lot of blank checks, hold some bogus "stress tests" in lieu of doing the real thing, and raise a stink on a few symbolic issues to try to paper over the failure to embark on real and badly needed reforms.

Ed Harrison has called him a black Herbert Hoover. If the economy takes another down leg, it will further confirm his inability to do anything other than compromise and try to spin it as success. The confidence game worked when he was a new President, but nice talk and not much action is already wearing thin. We could use someone at the helm who is willing to plot a course and stick with it, and instead what we have is someone long on charisma and short on resolve.

http://www.nakedcapitalism.com/2009/08/is-this-start-of-big-one.html