

"FINANCIAL PARTY" ON WALL STREET, LIKE IT'S 1929¹

Mike Whitney©

On Tuesday, the Fed announced that it will reinvest the proceeds from maturing mortgage-backed securities (MBS) into US Treasuries. The process is called Quantitative Easing. In theory, Q.E. increases inflation expectations so that consumers spend more and rev up the economy. That's the theory. But adding to bank reserves when the banks are already loaded to the gills, achieves nothing. It doesn't put money in the hands of people who will spend it, generate more economic activity or increase growth. It's a big zero. Oddly enough, the Fed even admits this. According to an article in Bloomberg News, "The Central Bank posted a paper co-written by Seth Carpenter, associate director of the Fed's monetary-affairs division, finding that the "quantity of reserve balances itself is not likely to trigger a rapid increase in lending." No "increase in lending" means no credit expansion and no rebound. Thus, QE will have no real impact.

From the FOMC Statement:

"Information received since the Federal Open Market Committee met in June indicates that the pace of recovery in output and employment has slowed in recent months. Household spending is increasing gradually, but remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit. Business spending on equipment and software is rising; however, investment in nonresidential structures continues to be weak and employers remain reluctant to add to payrolls. Housing starts remain at a depressed level. Bank lending has continued to contract. Nonetheless, the Committee anticipates a gradual return to higher levels of resource utilization in a context of price stability, although the pace of economic recovery is likely to be more modest in the near term than had been anticipated...."

The Committee will continue to monitor the economic outlook and financial developments and will employ its policy tools as necessary to promote economic recovery and price stability."

There's not a glimmer of light in the Fed's statement, and yet, "the Committee anticipates a gradual return to higher levels of resource utilization." But how? And on what is the Fed basing its prediction? Certainly not the data. Maybe tea leaves? The truth is the economy is in very bad shape and getting worse. This is from Wednesday's New York Times:

"The government's preliminary estimate for economic growth in the second quarter is likely to be revised substantially lower...."Combining the bigger-than-expected trade deficit with other weak data suggests that Q2 growth was only 1.2 percent rather than the 2.4 percent originally estimated, placing the economy on even shakier ground than it seemed," wrote Nigel Gault, chief United States economist at IHS Global Insight." (New York Times)

The Fed has dramatically revised its growth forecast downward since its last meeting. The fiscal stimulus is petering out and inventory restocking is nearly over. Now the economy will have to

¹ Global Research, August 13, 2010. URL of this article: www.globalresearch.ca/index.php?context=va&aid=20608

stand on its own without the support of fiscal and monetary aid. But is it strong enough? Households are still patching their balance sheets, credit is tight, and businesses have no incentive to invest due to flagging demand. So where's the growth going to come from? If the government does not provide more stimulus, asset prices will tumble, unemployment will rise, and the economy will contract.

This is from Wednesday's Wall Street Journal:

"A Wall Street Journal survey found that by a two-to-one margin Wall Street economists see deflation as a bigger threat to the U.S. economy over the next three years than inflation.

"Deflation is dangerously close," said David Resler of Nomura Securities, one of 53 economists surveyed by the Wall Street Journal. Among economists who answered the question, nearly two-thirds said that deflation poses the bigger risk to the economy over the next three years; the remainder said inflation is the bigger threat. That compares to an April survey, when the economists were split 50/50 over whether inflation or disinflation posed the bigger risk over the next year." ("WSJ Survey: Risks of Deflation on the Rise, Fed on Hold Longer", Phil Izzo, Wall Street Journal)

The looming risk of deflation is what makes the future so "unusually uncertain". (Bernanke words) But investors don't like uncertainty, which is why they pulling their money out of equities and moving it into bonds. That's also why the flight to safety has continued for more than 2 years since the crisis began. No one knows what the policy is or what the rules are. It's catch-as-catch-can. At the same time, falling bond yields are a referendum on Bernanke's performance. Historic low yields on Treasuries indicate that the Fed has been unable to restore confidence or allay investor fears. Recent surveys of small business owners (National Federation of Independent Business) and CEO's show that confidence continues to plunge. Consumer confidence is in the dumps, too. Bottom line: No one has faith in the Fed's approach.

Bernanke hoped that restarting his bond purchasing program would convince Wall Street that he was prepared to provide as much liquidity as needed. But traders saw through the ruse. The bond market cast its ballot immediately, driving yields into the ground. Investor pessimism pushed the 10-year below 3% while 2 year Treasuries slumped to historic lows. Investors are betting that the economy is headed into another vicious cycle of debt-liquidation and depression. They don't believe the Fed can stop the freefall, so they are shifting into risk-free liquid assets.

It took the stock market a bit longer to grasp what was going on, but 24 hours later, the rout on Wall Street began. Shares plunged throughout the session pushing down the Dow Jones 265 points by the end of the day. The other indexes were battered as well. The dollar strengthened on fears of deflation while bond yields on short-term notes fell sharply. Bernanke thinks the economy can muddle through on its own, but Wall Street isn't buying it. They want more monetary stimulus, and they want it now.

This is from David Rosenberg's "Breakfast with Dave":

"I know this sounds a bit dire, but little has changed from where we were a year ago.....we had a huge bounce off the lows, but we had a similar bounce off the lows in 1930. The equity market was up something like 50% in the opening months of 1930, and while I am sure there was euphoria at the time that the worst of the recession and the

contraction in credit was over, it's interesting to see today that nobody talks about the great run-up of 1930 even though it must have hurt not to have participated in that wonderful rally. Instead, when we talk about 1930 today, the images that are conjured up are hardly very joyous. I'm not saying that we are into something that is entirely like the 1930s. But at the same time, we're not in Kansas any more." ("Not in Kansas Anymore", David Rosenberg, Gluskin Scheff)

The economy is on the rocks and another round of quantitative easing won't help. The Obama administration will have to toughen up and push through another fiscal stimulus program. It's the only way. QE, low interest loans, zero rates, consumer subsidies, tax cuts or more bank reserves will not do the trick. Private sector deleveraging is beginning to accelerate, which means that economic contraction is unavoidable unless government spending increases substantially for an extended period of time. The budget deficits are going to balloon. Get used to it. That's what it will take to get back on track. Obama's stimulus was never big enough. Experts like Paul Krugman, Joseph Stiglitz and Obama's-own Christiana Romer figured it would take roughly \$1.4 trillion to suck up the excess capacity in the system and really put a dent in unemployment. \$787 billion is a pittance compared to the \$6 trillion in home equity and \$4 trillion in retirement funds that were lost in the housing bubble flameout. When that much money vanishes from the system, it takes time to regroup. It blows a hole in personal balance sheets and forces people to cut back on spending. That's why the personal savings rate has skyrocketed to 6.4% in a matter of months. People are strapped and trying to pull themselves of the red. It's government's job to give them a hand.

Here's an excerpt from a report by Goldman Sachs:

"The economic landscape has changed significantly during the last two months. The macroeconomic data that seemed to indicate improvement in April and May deteriorated sharply in June and early July. Cutting our 2011 EPS estimate to \$89 represents a reversal for us and reflects the more challenging economic environment we now face compared with the backdrop just a few months ago."

Bernanke maintains the recovery is on track and that the economy is slowly improving, but as economist Dean Baker points out, demand has been weak throughout the crisis and is showing no signs of a rebound. Here's Baker:

"Growth has been boosted over the last 4 quarters by an inventory cycle as firms went from depleting to building their inventories. This cycle has now ended. Inventory growth is unlikely to accelerate further in the quarters ahead. This means that GDP growth will be close to final demand growth. Final demand growth has averaged 1.2 percent in the last four quarters and was 1.3 percent in the most recent quarter. There is no obvious reason to expect that the rate will increase in the near future." (Dean Baker, CEPR)

Bernanke's no-jobs, no-growth recovery has run out of gas. Now we need a real solution, a fiscal solution; a solution that will lower unemployment, put the country back to work and restore public confidence in government. And there's not much time to act either. As pessimism spreads and economic atrophy sets in, the prospect of a general fall in the price level becomes more likely. That will lead to more layoffs, more excess capacity, more plummeting asset prices, more debt-liquidation, more defaults and more bankruptcies. Obama and Co. need to get this thing right before the underlying downward trend reasserts itself and we find ourselves back in the soup.