Dangerous Unintended Consequences

by Martin D. Weiss, Ph.D. 03-23-09

I've just returned from Washington, DC, where I held a press conference at the National Press Club and a round-robin series of meetings with members of Congress … with more to come this week.

Let me first tell you what I told them. Then, I'll explain what I think you should do about it …

Why Banking Bailouts, Buyouts, and Nationalizations
Can Only Prolong America's Second Great Depression
And Weaken Any Subsequent Recovery

(Edited Transcript of Press Conference Presentation)

The Fed Chairman, the Treasury Secretary and Congress have now done more to bail out financial institutions and pump up financial markets than any of their counterparts in history.

But it's not nearly enough — and, at the same time, it's already far too much.

Two years ago, when major banks announced multibillion-dollar losses in subprime mortgages, the world's central banks injected unprecedented amounts of cash into the financial markets.

But that was not enough.

Six months later, when Lehman Brothers and AIG fell, the U.S. Congress rushed to pass the TARP, the greatest bank bailout legislation of all time.

But as it turned out, that wasn't sufficient either.

Subsequently, in addition to the original goal of TARP, the U.S. government has loaned, invested, or committed $400 billion to nationalize the world's two largest mortgage companies … $42 billion for the Big Three auto manufacturers … $29 billion for Bear Stearns, $185 billion for AIG, and $350 billion for Citigroup … $300 billion for the Federal Housing Administration Rescue Bill … $87 billion to pay back JPMorgan Chase for bad Lehman Brothers' trades … $200 billion in loans to banks under the Federal Reserve's Term Auction Facility (TAF) … $50 billion to support short-term corporate IOUs held by money market mutual funds … $500 billion to rescue various credit markets … $620 billion in currency swaps for industrial nations … $120 billion in swaps for emerging markets … trillions to cover the FDIC's new, expanded bank deposit insurance, plus trillions more for other sweeping guarantees.

And it STILL wasn't enough.

If it *had* been enough, the Fed would not have felt compelled this week to announce its plan to buy $300 billion in long-term Treasury bonds, an *additional* $750 billion in agency mortgage backed securities, plus $100 billion *more* in Fannie Mae and Freddie Mac paper.

Total tally of government funds committed to date: Closing in on $13 trillion, or $1.15 trillion more than the tally just hours ago, when the body of this white paper was printed.

And yet, even that astronomical sum is still not enough!

Why not? Because of a series of very powerful reasons:

First, most of the money is being poured into a virtually bottomless pit. Even while Uncle Sam spends or lends hundreds of billions, the wealth destruction taking place at the household level in America is occurring in the trillions — $12.9 trillion vaporized in real estate, stocks, and other assets since the onset of the crisis, according to the Fed's latest *Flow of Funds*.

Second, most of the money from the government is still a promise, and even much of the disbursed funds have yet to reach their destination. Meanwhile, all of the wealth lost has *already* hit home — literally, in the household.

Third, the government has been, and is, greatly underestimating the *magnitude* of this debt crisis. Specifically,

The FDIC's "Problem List" of troubled banks includes only 252 institutions with assets of $159 billion. However, based on our analysis, a total of 1,568 banks and thrifts are at risk of failure with assets of $2.32 trillion due to weak capital, asset quality, earnings, and other factors. (The details are in Part I of our white paper, and the institutions are named in Appendix A.)

When Treasury officials first planned to provide TARP funds to Citigroup, they assumed it was among the strong institutions and that the funds would go primarily toward stabilizing the markets or the economy. But even before the check could be cut, they learned that the money would have to be for a very different purpose: an emergency injection of capital to prevent Citigroup's collapse. Based on our analysis, however, Citigroup is not alone. We could witness a similar outcome for JPMorgan Chase and other major banks. (See Part II of our white paper.)

AIG is big. *But it, too, is not alone.* Yes, in a February 26 memorandum, AIG made the case that its $2 trillion in credit default swaps (CDS) would have been *the* big event that could have caused a global collapse. And indeed, its counterparties alone have $36 trillion in assets. But AIG's CDS portfolio is just one of many: Citibank's portfolio has $2.9 trillion, almost a trillion more than AIG's at its peak. JPMorgan Chase has $9.2 trillion, or almost five times more than AIG. And globally, the Bank of International Settlements reports a total of $57.3 trillion in credit default swaps, more than 28 times larger than AIG's CDS portfolio.

Clearly, the money available to the U.S. government is too small for a crisis of these dimensions.

External Sponsorship

Definition of Financial INSANITY:
Following the SAME Wall Street advice and expecting DIFFERENT results ...

» Citigroup has PLUNGED -97% ...
» General Electric SANK -79% ...
» Fidelity Magellan Fund ... DOWN -49%.

WHY do so many Wall Street "experts" make the same investment mistakes? They put your hard-earned money in the same stocks, bonds and funds that are *STILL* crashing in value.

There *MUST* be a better way! Attend Weiss Capital Management's briefing on **Wednesday, March 25**, and learn how you can defend your wealth and perhaps profit, even in bear markets.

Click here now for more information ...

Fourth, but at the same time, the massive sums being committed by the U.S. government are also too much:

In the U.S. banking industry, shotgun mergers, buyouts, and bailouts are accomplishing little more than shifting their toxic assets like DDT up the food chain.

And the government's promises to buy up the toxic paper have done little more than encourage banks to hold on, piling up even bigger losses.

But the money spent or committed by the government so far is also *too much* for another, relatively less-known reason: Hidden in an obscure corner of the derivatives market is a unique credit default swap that virtually no one is talking about — contracts on the default of United States Treasury bonds. Quietly and without fanfare, a small but growing number of investors are not only thinking the unthinkable, they're actually spending money on it, bidding up the premiums on

Treasury bond credit default swaps to 14 times their 2007 level. This is an early warning of the next big shoe to drop in the debt crisis — serious potential damage to the credit, credibility, and borrowing power of the United States Treasury.

This trend packs a powerful message — that there's no free lunch; that it's unreasonable to believe the U.S. government can bail out every failing giant with no consequences; and that, contrary to popular belief, even Uncle Sam must face his day of reckoning with creditors.

We view this as a positive force. We are optimistic that, thanks to the power of investors, creditors, and the people of the United States, we will ultimately guide, nudge, and push ourselves to make prudent and courageous choices:

1. We will back off from the tactical debates about how to bail out institutions or markets, and rethink our overarching goals. Until now, the oft-stated goal has been to prevent a national banking crisis and avoid an economic depression. However, we will soon realize that the true costs of that enterprise — the 13-digit dollar figures and damage to our nation's credit — are far too high.

2. We will replace the irrational, unachievable goal of jury-rigging the economic cycle with the reasoned, achievable goal of rebuilding the economy's foundation in preparation for an eventual recovery.

Right now, the public knows intuitively that a key factor which got us into trouble was too much debt. Yet the solution being offered is to encourage banks to lend more and people to borrow more.

Economists almost universally agree that one of the grave weaknesses of our economy is the lack of savings needed for healthy capital formation, investment in better technology, infrastructure, and education. Yet the solution being offered is to spend more and, by extension, to save less.

These disconnects will not persist. Policymakers will soon realize they have to change course.

3. When we change our goals, it naturally follows that we will also change our priorities — from the battles we can't win to the war we can't afford to lose. Right now, for example, despite obviously choppy seas, the prevailing theory seems to be that "the ship is unsinkable" or that "the government can keep it afloat no matter how bad the storm may be."

With that theory, they might ask: "Why have lifeboats for every passenger? Why do much more for hospitals which are laying off ER staff, for countless charities that are going broke, or for the one in fifty American children who are now homeless? Why prepare for the financial Katrinas that could strike nearly every city?"

The correct answer will be: Because we have no other choice; because that's a war we can and *will* win. It will not be very expensive. We have the infrastructure. And we'll have plenty of volunteers.

4. Right now, our long-term strategies and short-term tactics are in conflict. We try to squelch each crisis and kick it down the road. Then, we do it again with each *new* crisis. Meanwhile, fiscal reforms are talked up in debates, but pushed out in time. Regulatory changes are mapped out in detail, but undermined in practice. Soon, however, with more reasonable, achievable goals, theory and practice will fall into synch.

5. Instead of trying to plug our fingers in the dike, we're going to guide and manage the natural flow of a deflation cycle to reap its silver-lining benefits — a reduction in burdensome debts, a stronger dollar, a lower cost of living, a healthier work ethic, a better ability to compete globally.

6. We're going to buffer the population from the most harmful social side-effects of a worst-case scenario. Then, we're going to step up, bite the bullet, pay the penalty for our past mistakes, and make hard sacrifices *today* that build a firm foundation for an eventual economic recovery. We will not demand instant gratification. We will sacrifice our lifestyle today to assume responsibility for our

future and the future of our children.

7. We will cease the doubletalk and return to some basic axioms, namely that:

The price is the price. Once it is established that our overarching goal is to manage — not block — natural economic cycles, it will naturally follow that regulators can guide, rather than hinder, a market-driven cleansing of bad debts. The market price will not frighten us. We can use it more universally to value assets.

A loss is a loss. Whether an institution holds an asset or sells an asset, whether it decides to sell now or sell later, if the asset is worth less than what it was purchased for, it's a loss.

Capital is capital. It is not goodwill or other intangible assets that are unlikely to ever be sold. It is not tax advantages that may never be reaped.

A failure is a failure. If market prices mean that institutions have big losses, and if the big losses mean that capital is gone, then the institution has failed.

8. We will pro-actively shut down the weakest institutions no matter how large they may be; provide opportunities for borderline institutions to rehabilitate themselves under a slim diet of low-risk lending; and give the surviving, well-capitalized institutions better opportunities to gain market share.

Kansas City Federal Reserve President Thomas Hoenig recommends that "public authorities would be directed to declare any financial institution insolvent whenever its capital level falls too low to supports its ongoing operations and the claims against it, or whenever the market loses confidence in the firm and refuses to provide funding and capital. This directive should be clearly stated and consistently adhered to for all financial institutions that are part of the intermediation process or payments system." We agree.

9. We will build confidence in the banks, but in a very different way. Right now, banking authorities are their own worst enemy. They paint the entire banking industry with a single broad brush — "safe." But when consumers see big banks on the brink of bankruptcy, their response is to paint the entire industry with another broad brush — "unsafe." To prevent that outcome, we will challenge the authorities to release their confidential "CAMELS ratings" on each bank in the country. And we will ask them to reverse the expansion of FDIC coverage limits, restoring the $100,000 cap for individuals and businesses.

Although these steps may hurt individual banks in the short run, it will not harm banks in the long run. Quite the contrary, when consumers can discriminate rationally between safe and unsafe institutions, and when they have a motive to shift their funds freely to stronger hands, they will *strengthen* the nation's banking system.

I am making these recommendations because I am optimistic we can get through this crisis. Our social and physical infrastructure, our knowledge base, our democratic form of government are strong enough to do so. As a nation, we've been through worse before, and we survived then. With all our wealth and knowledge, we can certainly do it again today.

But my optimism comes with no guarantees. Ultimately, we're going to have to make a choice: The right choice is to make shared sacrifices, let deflation do its work, and start regenerating the economic forces that have made the United States such a great country. The wrong choice is to take the easy way out, try to save most big corporations, print money without bounds, debase our dollar, and ultimately allow *inflation* to destroy our society.

This white paper is my small and humble way of encouraging you, with data and reason, to make the right choice starting right now.

What You Must Do Now
There followed a vigorous debate and some of the most unique questions I've had the honor to answer in many years. (I'll share them with you when I have the transcript.)
In the meantime, here's what I recommend you do:
Step 1. As soon as you have a chance, take a look at our white paper on the banking crisis.
Step 2. In Part II (where I list a few big banks) and in the appendix, where I have all the rest of the banks and thrifts we believe are at risk of failure, make sure ***yours*** is not on it.
Step 3. If it is, I recommend shifting to a stronger institution, regardless of the size of the bank or the size of your account.
Step 4. For our list of the strongest banks in the U.S., plus instructions on where to find even safer havens for your money, see our free report available to all *Money and Markets* members.
Step 5. Most important, stand by for my appeal for help! I can't do this alone. I will need your support, and I'll explain exactly how soon.
Good luck and God bless!
Martin

About *Money and Markets*
For more information and archived issues, visit http://www.moneyandmarkets.com
Money and Markets (MaM) is published by Weiss Research, Inc. and written by Martin D. Weiss along with Tony Sagami, Nilus Mattive, Sean Brodrick, Larry Edelson, Michael Larson and Jack Crooks. To avoid conflicts of interest, Weiss Research and its staff do not hold positions in companies recommended in *MaM*, nor do we accept any compensation for such recommendations. The comments, graphs, forecasts, and indices published in *MaM* are based upon data whose accuracy is deemed reliable but not guaranteed. Performance returns cited are derived from our best estimates but must be considered hypothetical in as much as we do not track the actual prices investors pay or receive. Regular contributors and staff include Kristen Adams, Andrea Baumwald, John Burke, Amber Dakar, Dinesh Kalera, Red Morgan, Maryellen Murphy, Jennifer Newman-Amos, Adam Shafer, Julie Trudeau, Jill Umiker, Leslie Underwood and Michelle Zausnig.
Attention editors and publishers! *Money and Markets* issues can be republished. Republished issues MUST include attribution of the author(s) and the following short paragraph:

This investment news is brought to you by *Money and Markets*. *Money and Markets* is a free daily investment newsletter from Martin D. Weiss and Weiss Research analysts offering the latest investing news and financial insights for the stock market, including tips and advice on investing in gold, energy and oil. Dr. Weiss is a leader in the fields of investing, interest rates, financial safety and economic forecasting. To view archives or subscribe, visit http://www.moneyandmarkets.com.
From time to time, *Money and Markets* may have information from select third-party advertisers known as “external sponsorships.” We cannot guarantee the accuracy of these ads. In addition, these ads do not necessarily express the viewpoints of *Money and Markets* or its editors. For more information, see our terms and conditions.
© 2009 by Weiss Research, Inc. All rights reserved. *15430 Endeavour Drive, Jupiter, FL 33478*