

S&P: Bearish

Nasdaq: Bearish

Bonds: Bearish

Most Foreign Markets: Bearish

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Danger of Debt Collapse



Martin Weiss and Mike Larson

- Failure possible at Wachovia, Washington Mutual, HSBC, SunTrust, National City, Sovereign Bank.
- Fannie Mae, Freddie Mac, GM, Ford nearing brink of bankruptcy.
- Consumers, businesses, local governments shut out from vital access to credit.
- Deflation ultimately unavoidable.

The U.S. economy is facing the growing danger of a debt collapse, and the government's power to prevent it is diminishing by the day.

A debt collapse is not merely a decline in the availability of *new* credit, commonly called a "credit crunch."

A debt collapse is a tidal wave of defaults by millions of consumers, a rash of bank failures and a chain reaction of corporate bankruptcies that tear apart an economy's *existing* debts.

So far, in this credit crunch, the nation's mountain of debt has merely been growing at a much slower pace. But in the next phase of the crisis — the debt collapse phase — you could see that debt mountain actually shrink.

On the surface, that may sound like a good thing; and someday, after it's all over, it could be. But in a debt collapse, debt reduction doesn't happen because borrowers suddenly decide to pay off their debts. It happens because of ...

- the mass *repudiation* of debts, as borrowers and lenders alike are forced into bankruptcy, plus ...
- the *destruction* of asset values — falling home prices, sinking bond markets and plunging stocks.

In the U.S. today, this process is just beginning. And among the major debt sectors that the Fed tabulates each quarter in its *Flow of Funds* report, so far, there's only *one* sector showing a net *shrinkage* in the total debt outstanding. But the tell-tale signs of a much broader and

deeper debt destruction are everywhere:

First, we have a tidal wave of debt defaults by consumers — not just on mortgages, but also on auto loans, credit cards and student loans.

Second, so much money has already been lost in U.S. bank failures this year that the Federal Deposit Insurance Corporation (FDIC) has seen its capital ration dwindle to the lowest since 1995. This means the FDIC will either have to raise insurance premiums on banks that can ill afford them or tap additional funds from a U.S. Treasury Department that's already swamped by other bailout demands.

Third, major banks have already booked \$506 billion in credit losses, or more than triple the total lost in the great S&L crisis of the 1970s. And that \$506 billion represents just *half* of the losses predicted by the International Monetary Fund (IMF).

Fourth, some of these banks may not be able to raise the capital they need to stay afloat. Previously, in late 2007 and early 2008, they were able to buy time by selling off big chunks of their shares to U.S. and foreign investors. They even went begging for capital to the world's big "sugar daddies" — the rich sovereign wealth funds of Dubai, China, Singapore and elsewhere. But despite those efforts, the

most they could raise was \$336 billion, or only 66.4 cents for each dollar in losses.

Now, as these banks go back for second and third rounds of capital raises, they're getting the cold shoulder — and for obvious reasons: Profits across the banking industry plunged 86.5% to just \$5 billion in the second quarter, according to the FDIC. Moreover, the sovereign wealth funds and other investors have now seen their prior investments in U.S. banks sink dramatically in value. So they're increasingly reluctant to throw good money after bad.

Fifth, with mounting losses and diminishing avenues for raising capital, the failure of some of the nation's megabanks, previously considered unthinkable, has now become a real possibility ...

■ Citibank NA, with \$1.3 trillion in assets, has an oversized portfolio of shaky consumer loans and, in our view, inadequate capital to cover the risks it's taking with depositor money. It merits a borderline financial strength rating of C- from TheStreet.com. Plus, not considered in the rating is the fact that, for every dollar of capital, it's exposed to \$2.79 in credit risk related to derivatives, according to the Comptroller of the Currency (OCC).

■ Wachovia Bank, with \$666 billion in assets, is overexposed to the

deepening disaster in home equity loans, option ARMs and commercial real estate.

■ Washington Mutual, the nation's largest S&L (\$319 billion in assets), is loaded with mortgages turning sour. It currently merits a D+ rating.

■ HSBC Bank USA (\$188 billion in assets) gets a D+ rating, reflecting low capital and big risks in its loans and investments. Making matters worse, the OCC reports that, in its derivatives positions, this bank is exposed to an outrageously high \$7.21 of credit risk for each dollar of capital.

■ Other large institutions we think are in danger: SunTrust Bank (rated C-), National City Bank (D), Sovereign Bank (D+), Huntington NB (D+), E*Trade Bank (D+) and First Tennessee Bank (D+).

Sixth, other major U.S. industries are now in a death spiral. Ford, General Motors and Chrysler are sinking so fast, they are now lobbying Washington for a \$25 billion federal bailout of their own. They want \$25 billion in loans. Airlines, real estate, travel and leisure are also getting hurt badly.

Seventh, and perhaps least understood by most analysts, is the fact that we do have one major debt sector where *the debt collapse is already happening* — in the commercial paper market, where corporations issue short-term IOUs to raise quick cash.

Many years ago, the average Fortune 500 company kept its own cash hoard to cover its needs. Today, many have let their own cash dwindle, relying more heavily on their ability to raise the money from investors by issuing these

short-term IOUs.

So this market is critical. If it shuts down, even companies that are supposedly rich in other assets could wind up in a sudden cash squeeze, shocking the world with unexpected bankruptcy filings.

The primary disaster area: Commercial paper that's backed by auto loans, credit cards and mortgages — called asset-backed commercial paper.

The problem: Fundamentally speaking, auto loans, credit cards and mortgages are not really assets. They're debts! So this entire industry is a flaky construction of debt piled onto more debt.

The undeniable facts: *Asset-backed commercial paper outstanding plunged from a peak of \$1.22 trillion last August to around \$750 billion at end the end of the first quarter*, according to the Fed. That means that new issuance *fell 100%*. Plus, it means there was an *additional decline of 39%* — a net *destruction* of the debt outstanding. That's the essence of a debt collapse. And we believe it's a giant condor in the coal mine, warning of more debt destruction ahead.

Eighth, already the debt destruction is threatening to spread beyond the commercial paper market to a much broader range of credit markets ...

■ In the first eight months of this year, the issuance of securities backed by commercial mortgages plunged by 82% compared to the same period last year. This implies a near total breakdown in the process whereby commercial mortgages are repackaged and sold as bonds. The immediate consequence: In the sec-

ond quarter, lenders slashed their new commercial mortgages by a shocking 63% from year-earlier levels, according to the Mortgage Bankers Association.

■ New securities backed by home equity loans are vanishing even more quickly. In 2006, there were \$286 billion. In 2007, they dropped by more than half, to \$132 billion — and analysts thought *that* was shocking. Now, so far this year, they're down to a tiny \$100 million. Even allowing for another \$50 million in issuance between now and year-end, that's a **99.9% decline** from last year's level. An entire industry has shut down!

■ The shutdown is also spreading to the issuance of new junk bonds, which has plunged 47% year-over-year, according to Standard & Poor's.

■ The growth in residential mortgages has slowed to a snail's pace — 3% in the first quarter, down from around 8% a year earlier and as much as 15.7% in 2003, according to the Federal Reserve's latest *Flow of Funds* report. This is *the slowest rate of growth since 1970*.

Fed's Response Is Too Little, Too Late

Fed Chairman Bernanke's response to this credit and debt debacle has been predictable: He's tried to pump the system full of money.

He slashed the federal funds rate from 5.25% to 2%. He gave banks safe Treasury securities in exchange for securities backed by sinking commercial mortgages, defaulting student loans and other bad assets. He offered similar deals to large brokerage firms, a supposedly

“temporary” measure that he just extended to January 2009.

Meanwhile, Congress and Treasury Secretary Paulson are — or soon will be — bombarded with a whole series of more permanent and more *expensive* bailout demands: Fannie Mae and Freddie Mac. Ford, GM and Chrysler. A half dozen airlines. Local and state governments. The FDIC.

But there are three fundamental problems with all of the government bailouts:

Problem #1. They're too little, too late for most industries in trouble. Even the largest bailouts contemplated by the federal government would cover only a fraction of the losses suffered in the housing market, the mortgage market, the banks, the auto industry, the airlines and elsewhere.

Problem #2. The bailouts are too much, too soon for the federal budget. Even without them, the White House expects next year's deficit to balloon to \$500 billion or more, forcing the Treasury itself to borrow heavily, shoving aside other borrowers and making the credit crunch that much worse.

Problem #3. While you can lead a horse to water, you can't make it drink. Similarly, the Fed can flood banks with money, but if the banks don't make new loans, the credit crunch will worsen and the debt collapse will spread. Indeed, that's precisely the situation we see unfolding today. According to the Fed's Senior Loan Officer Opinion Survey on Bank Lending Practices ...

■ A net of roughly two-thirds of the banks surveyed said they were

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