Global reverse-leverage collapse is under way

by John Hoefle

For years, Lyndon LaRouche has warned that the growth of the derivatives bubble would inevitably lead to a reverse-leverage chain-reaction disintegration of the global financial system, unless sovereign nations intervened to put the bubble, and the financial institutions which support it, into receivership. That reverse-leverage process is now under way, a process from which the current system will not survive. Trillions of dollars of what were carried on the books of individuals and institutions around the world, have simply evaporated over the past three months, and the speed of that evaporation is accelerating. The losses are piling up fast and furious, and there is only one end in sight—the total disintegration of the system—unless sovereign governments snap out of their paralysis, and turn to the one man who has the competence and the courage to oversee the creation of a new global monetary system, Lyndon LaRouche.

Most of our readers are now familiar with LaRouche's Typical Collapse Function Triple Curve, in which the rate of the rate of change of financial aggregates grows hyperbolically, triggering a similar but lesser growth in monetary aggregates to service the financial ones, while the productive output of the physical economy collapses hyperbolically. Such a system must inevitably break down, and it is that breakdown, now under way, which is driving the chaos on global financial markets.

Live by leverage; die by reverse leverage

As the speculative bubble grew, led by that specimen of clinical insanity known as the derivatives market, participants in the bubble borrowed large amounts of money, and invested that money in even larger amounts of derivatives, in a process known as leverage. As long as the bubble grew, this process was—from the standpoint of the virtual reality of the casino—immensely profitable for the big banks, investment banks, insurance companies, and hedge funds.

The case of Long-Term Capital Management (LTCM), which Federal Reserve Chairman Alan Greenspan is trying to bail out, is exemplary. LTCM used $2.2 billion in equity capital to borrow some $125 billion, then used that to enter into derivatives contracts with a notional value of $1.25 trillion (and these numbers may be understatements, according to some reports). LTCM was therefore able to leverage each dollar of equity into at least $57 in assets, and $568 in derivatives bets, winning enough to pay off its borrowings and book huge profits—until it collapsed.

Just as LTCM's profits were multiplied through leverage while it was winning, its losses were multiplied when it lost its bets, through a process known as reverse leverage: Its losses on its trillion-dollar derivatives portfolio wiped out its equity in a matter of weeks, leaving it unable to pay its debts, forcing its creditors to foreclose.

This process of reverse leverage, is now dominating the global financial markets. The trillions of dollars of notional financial values which have disappeared, have triggered substantial losses throughout the system. The system itself, has switched from expansion and inflation, to contraction and deflation; from maximizing income, to minimizing loss. The commercial banks, facing heavy losses on their own derivatives trading and on loans to other speculators, are increasing their demands for collateral to hedge funds and other lenders. The hedge funds, in turn, are having to sell assets to meet the demands of their lenders. Due to the collapse of world stock and bond markets, many of these assets are being sold at a loss, worsening the financial problems of the sellers. Since selling into a declining market tends to drive the market down even further, the entire process turns into a vicious cycle, in which selling to cover losses creates more losses, which requires more selling, and so on.

The hedge funds are taking the most visible hits at the moment. Besides LTCM, which is still hemorrhaging money, several other funds are liquidating all or part of their portfolios. The Ellington Management Group, a $1 billion fund specializing in mortgage-backed securities and related derivatives, has been forced to sell substantial amounts of securities to meet the demands of its bankers, including the new Citigroup. Ellington is run by Michael Vranos, former mortgage-bond chief at Kidder Peabody, which failed in 1994 when the mortgage-backed securities market collapsed after the Fed raised interest rates. The Eagle Global Value Fund, a $118 million hedge fund in Minneapolis, is also liquidating a portion of its holdings, at the demand of Citigroup and others.

The banks are placing demands on the hedge funds, because the banks themselves are in mortal danger. According to *American Banker,* the market capitalization of the top 100 U.S. bank holding companies dropped $242 billion (23%) in the third quarter, due to the meltdown in the value of bank stocks. BankAmerica, the new bank created by the takeover of BankAmerica by NationsBank, reported $529 million in trading losses for the quarter, and took a $372 million loss on the $1.3 billion it loaned to D.E. Shaw & Co., a New York-based securities firm and hedge fund. Merrill Lynch, which poured $300 million into LTCM last month, reported a $164 million loss for the fourth quarter, its first quarterly loss since 1989, while Paine Webber's profits for the quarter dropped 27%, Bear Stearns dropped 60%, and Donaldson Lufkin Jenrette dropped 83%. And, with some $40 trillion in derivatives holdings among U.S. banks and investment banks, the losses due to reverse leverage are just beginning.