

April 2 Fake 'Recovery' Could Kill the System

by Lothar Komp

President George W. Bush's re-election strategy was based on a glorious victory in Iraq and a great economic boom at home; however, the Iraq situation is growing worse by the day; and in spite of an incredible amount of so-called stimulus to boost the economy—tax cuts by the Administration and interest rate cuts by the Federal Reserve—the recovery simply refused to materialize. Yes, some ingenious statistics experts at the U.S. Commerce Department had been able to calculate a spectacular 8% growth rate for the Gross Domestic Product in the fourth quarter of 2003. But as jobs and wages remained stagnant or shrinking, people were losing faith. At the same time, the renewed stock market bubble at Wall Street, based on the promise of an imminent economic boom, was about to go into crash mode again.

So, Bush called in his team and said: "I want my recovery now. A recovery with jobs." It took some time, but finally the President received what he was calling for: It's April Fools' Day, and the President and his economic advisors are very happy. They have just received the latest jobs report by the Labor Department and here are 308,000 new jobs in March. For more than three years, the Administration had been blamed for the loss of several million jobs in the U.S. economy. Now the world has changed. The "recovery" is here!

Unfortunately, certain things go wrong the next day. Until 8:00 a.m. New York time, nobody besides the President and his Council of Economic Advisors knows the great news—no journalist, no broker, not even the Federal Reserve. That's according to strict embargo regulations. At 8:00, a group of journalists sitting in a special room at the Labor Department, with restricted communication and tight security, are handed the jobs report, to prepare their stories to be released no earlier than 8:30. But already two minutes before that time, global financial markets go wild. Suddenly, huge volumes are being traded at U.S. and European bond markets. Some seconds later, currency markets are effected. And there is strong demand for certain economic derivatives—bets on the outcome of economic reports—offered by Deutsche Bank and Goldman Sachs. Describing the unusual developments, HSBC currency expert David Bloom said later: "Before the payrolls [report] is released, you can normally hear a pin drop, there is a hushed silence. But suddenly two minutes before the numbers, there was extraordinary activity, a crescendo, a cacophony."

Within a few hours, the U.S. dollar and stock markets worldwide are zooming up, bonds are being sold off, and the gold price dives by \$12. Those who started trading already at 8:28 could have generated profits or prevented losses in the billions. First, it's believed that "Reuters" leaked the jobs report two minutes early. But this issue required clarification: Who else could have caused the insider trading? Did one of the President's economic advisors, after the April Fools' Day champagne in the White House, call up his broker or make a euphoric remark to a golf club comrade? The Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), and the Labor Department are investigating.

Bond Markets in Panic

More important than the insider trading affair is another outcome of the jobs report: the most dramatic fall of U.S. bond markets in six years. Chances of an interest rate increase by the Federal Reserve before the November election had been assessed as very low; but suddenly, due to the new data pointing to a "recovery," the prospect of a rate increase by August, or even at the Fed's FOMC meeting on June 29, was on the radar screen. The immediate consequence was a huge sell-off on bond markets on April 2, pushing up the yield of ten-year U.S. Treasuries from 3.89% to 4.15%. That 26 basis points was the biggest one-day increase since the LTCM hedge fund bankruptcy nearly sank the global financial system in Autumn 1998. For two-year U.S. Treasuries, the yield shot up by 23 basis points from 1.62% to 1.85%. As long-term bond yields are the basis for defining mortgage interest rates, the average 30-year mortgage rate increased to 5.52% on April 2, compared to 5.40% in the week before, according to Freddie Mac, and rose further the next week. Stock prices of mortgage lenders, home builders, and home improvement retailers were plunging. Thanks to the President's "recovery," the ultimate collapse of the bond and mortgage bubbles had come a step closer.

Why is this the case? First of all, there is no "recovery." The 308,000 new jobs in March are basically a fiction created by sophisticated methods to assess developments on the job market. As an example, the Bureau of Labor Statistics (BLS) isn't able to get timely data on job creation through start-ups. So, the U.S. Census Bureau has developed a software called "X-12 ARIMA" which "imputes" such jobs based on certain assumptions. The computer model assumes that the more companies "die" in bankruptcy, the more companies at the same time will be "born." From earlier surveys, going back to the "New Economy" bubble years of the late 1990s, they have calculated a certain "jobs death/jobs birth" ratio. A parameter for the average amount of new jobs per start-up has to be put into the equation as well. In summary, as the number of bankruptcies and liquidations of small firms went up sharply in March, the "X-12 ARIMA" software produced—

assumed—153,000 new jobs for that month, and assigned those jobs to sectors of the economy where it *assumed* they had been created.

Another 20,000 of the “jobs created” were West Coast grocery workers, who had been on strike for months, going back to their existing jobs.

Further massaging came from the BLS’s new “concurrent seasonal adjustment” method, adopted late last year. While being tested over 18 months in 2001-02, before its adoption, this method calculated some 300,000 jobs *more* than the old seasonal adjustment then in use, according to BLS reports. No wonder it recommended itself as—and what has now become—the BLS’s exclusive method of seasonal adjustment.

Another strange element of the job “recovery” story is that a separate survey of households showed a rise of U.S. *unemployment* in March by 182,000.

In a real recovery, incomes of private households and profits of corporations go up, and the typical increase of interest rates in such periods can be handled. A fake recovery, however, which boosts interest rates only, will force households and corporations into bankruptcy. This time it’s even worse. The U.S. economy as well as world financial markets have plunged into a systemic crisis. Trying to postpone the ultimate disintegration of the world financial system, central bankers have spent recent years printing money at ever higher rates and channelling the new liquidity into the various financial markets. The liquidity not only produced the biggest financial asset bubbles in history—first on stock markets, later on bond and housing markets—but at the same time the biggest credit expansion in history.

In the United States, the credit generation not only in absolute terms, but also relative to the size of the economy, is now bigger than in the years immediately preceding the Great Depression in the 1930s. Every year, more than \$2 trillion of new debt is being added in the form of government and corporate bonds, credit card debt, other consumer debt, and most of all, mortgage debt of private households. This giant pile of debt—\$35 trillion in the United States alone—would have collapsed long ago, had interest rates not been pushed down to historic lows. But exactly that is now going to change. Long-term interest rates have already started to pick up dramatically since April 2.

‘Anything But Treasuries’

Some bond market arithmetic might help to explain these shock effects. A bond issued by a government or a larger corporation promises a fixed income stream over a prolonged period. Let’s say an investor buys a ten-year bond with a nominal volume of \$10,000 and a fixed interest rate of 4%. The investor knows that if he holds the bond until maturity (and the bond issuer doesn’t go under in the meantime), he will receive \$400 in each of the next ten years and finally the \$10,000 principal. But what is \$400 worth several years from now? What does it mean, in terms of present dollars, to receive

\$10,000 in ten years?

To assess these questions, funds investing in bonds make the following calculation. First, they estimate the average interest rate on markets over that period. This gives the “natural growth rate” of money. The fund managers assume, that any capital will inflate according to this average interest rate. If, for example, the average interest rate over the next ten years is 6%, any dollar now means \$1.79 in ten years. Looking at it another way, it would be stupid to pay more than \$5,590 now for the promise of a \$10,000 payment in ten years. A similar calculation is made for all the future \$400 interest rate payments. In total, this method defines the present “net worth” of the \$10,000 bond. It’s obvious that any change in the assessment of future interest rates immediately requires a recalculation of the “net worth” of any existing bond contract. Once it is believed future rates will be higher than previously thought, the prices of circulating bonds, which investors trade hundreds of times before maturity, go down. On April 2, they plunged dramatically. Now anyone who tries to issue a new bond, will obviously have to promise a higher yield or fail to find enough bidders. So bond yields are driven higher. And mortgage interest rates are set according to the yields of bonds with similar maturities, and are shooting up as well.

Indicative of the mood on bond markets following April 2 is the latest investment outlook by Bill Gross, head of the world’s largest bond-trading fund, PIMCO. He noted that bondholders have been placed “in the worst of all worlds.” Bond prices are set to fall further. He explicitly advised investors to sell U.S. Treasuries and to buy bonds of such regions where there certainly will be no recovery in the short-term future, such as the Euro zone. Gross concluded: “Anything but Treasuries, and hand those Old Maid Treasury bonds to the Japanese and the Chinese.” The U.S. Treasury bond auctions on April 7 already saw the smallest bidding ratio in several years. The investor sentiment index for the government bond market, reported monthly by Ried, Thunberg & Co, on April 5 fell to the lowest level in 14 years.

The fake “recovery,” commissioned and welcomed by the White House, has unleashed another escalation of the global financial disintegration. Any “good news” on the economy could now trigger the collapse of the giant bond and mortgage markets, thereby detonating as well the derivatives portfolios of Fannie Mae and Freddie Mac. Any “bad news” has the potential to drive stock market investors, long waiting for their promised economic boom, into a final sell-off. This, in an environment of over-indebted households and corporations, and 15-digit volumes of derivatives, could sink the system.

It’s a “Scylla and Charybdis”-type confrontation. There is no way it can be maneuvered around. And, unfortunately, the system this time is not a ship, but a huge balloon which just doesn’t fit between the two rocks. It’s filled with a certain liquidity provided by the Fed, so it can’t fly. Whether Scylla or Charybdis will destroy it first, is hard to tell. But, unless a systemic policy change is introduced, it will go.