

CARRY TRADE, U.S. MORTGAGES

The Global Financial System Is Burning at Both Ends

by Paul Gallagher

Only two weeks after the Bank of Japan triggered an unwinding of the yen carry trade with its Feb. 21 interest rate increase, one of the largest U.S. mortgage lending companies, Century Financial, declared itself effectively bankrupt and at the mercy of its bank lenders for more credit—credit those same banks cannot afford to give. And three of those lenders—Morgan Stanley, Merrill Lynch, and Goldman Sachs—by March 3, were being rated by their own securities traders virtually as issuers of junk paper.

During the second half of February and first week of March, the shrinking yen (and Swiss franc) carry trades, and the imploding markets for U.S. mortgage-backed securities, became the hammer and anvil of a disintegrating international financial system which has been blown up by larger and larger debt bubbles ever since the October 1987 stock crash. The biggest of all those bubbles by far—U.S. real estate mortgage values as of the end of 2006, half the assets of the U.S. banking system—is now going down.

“The amount of indebtedness outstanding is greater than could ever be repaid, so the system is hopelessly bankrupt,” said leading economist Lyndon LaRouche at the opening of his March 7 webcast from Washington, D.C. Leading nations now must agree to replace that bankrupt system with the “New Bretton Woods” monetary reform LaRouche proposes, and issue new productive credits to replace the masses of collapsing debt—before a complete collapse of the dollar and monetary chaos make that impossible.

London has played a key role in triggering the carry trade reversal, and potential dollar collapse, in a possible repeat of Harold Wilson’s British government’s role in using a 1966-67 pound sterling crisis to destroy FDR’s post-war Bretton

Woods system. In the five days preceding the Bank of Japan move, Bank of England governors Mervyn King and David Blanchflower both made public statements that the British pound was overvalued and should fall—and it has fallen most rapidly against the yen. In the huge growth of central banks’ currency reserves since 2001, the British pound has benefitted most from outflows from the Japanese yen; and London is in a position to play the game of reversing that flow—and sinking the dollar with it—to gain *political control* over a global financial crash.

‘The Great Unwind Has Started’

To give an idea of what LaRouche is pointing to: Estimates of household debt in the OECD countries are at roughly 90% of total GDP, compared to just 29% in 1990; estimates of corporate debt in those nations at the end of 2006 were at approximately 80% of GDP—compared to 55% in 1995—because of the global “leveraged takeover boom” which reached nearly \$4 trillion in takeovers during 2006. The 80%-of-GDP level was 20% above that of 1988, at the collapse of the 1980s takeover boom and the 1987 stock crash.

Since 1995, the yen carry trade—borrowing money in Japanese yen at virtual-zero interest, and investing it in high-interest speculations of all kinds, all over the world—has been the largest single driver of these debt bubbles. Various economists familiar with the yen carry trade, in discussions with *EIR* since Feb. 21, have estimated its annual pumping rate at anywhere between \$300 billion and \$1 trillion. Since Feb. 21, despite universal claims at that time in the financial media that Japan’s interest-rate hike would “have no impact on the carry trade,” it has begun to unwind with a force felt

worldwide (see “Japan Interest-Rate Hike Could Collapse the System,” *EIR*, March 2).

Now, as one economist in Asia wrote March 2, “The huge outflow of yen will come to a halt,” and the dollar is likely to go down to 100-105 yen within a short time.

Perhaps the biggest receptacle of this debt speculation, the U.S. mortgage-based securities market, has been struck hard—and it was *already disintegrating* before the Bank of Japan move and the rise of the yen. As an official of Dresdner Kleinwort bank, which warned clients a month earlier that an explosion could be about to hit the hedge funds from this direction, said on March 2, “We believe ‘the great unwind’ has now started.” As several economists have noted, the uncertainty about how fast this debt will collapse, is caused only by the *terra incognita* nature of the mortgage securities market, the roughly \$30 trillion credit derivatives partly based on it, and the hedge funds which buy, sell, and bet on these debt securities and derivative contracts. These debt markets are opaque: No government, regulator, or market participant knows how concentrated this debt paper is, or who holds it.

On March 2, it became clear that California-based New Century Financial Corp, the second-largest lender of subprime mortgages and one of the biggest mortgage firms overall, was poised to go under, with \$40-70 billion in subprime mortgages alone. Its stock had fallen by 93%, and its filing that day said that a failure to obtain waivers from lenders or find new funding sources could cause “substantial doubt” over its ability to remain in business. Since November 2006, some 25 mortgage lenders have failed, but this is by far the biggest. On March 5, Bloomberg reported, “The fate of New Century Financial Corp. may rest with securities firms including Morgan Stanley and UBS that once staked the U.S. mortgage company to more than \$17 billion and bought its loans by the thousands.” But that same day, traders at Morgan, Merrill, and Goldman were rating their own banks’ mortgage securities and credit derivatives at five or six levels below the banks’ “official” credit ratings—almost as junk paper.

At the same time, the Crown’s Hongkong and Shanghai Banking Corp. (HSBC) confirmed March 5, that it took a \$10.6 billion impairment charge, that is, loss, on its bad mortgage loans for 2006.

In fact, the whole subprime mortgage-backed securities market was turning illiquid, freezing up, with interest rates quoted at a radioactive 15% above U.S. Treasury bond rates. The issuance of Residential Mortgage Backed Securities (RMBS) against subprime mortgages, plunged nearly 60% from January to February. In March, even Fannie Mae, Freddie Mac, and the biggest bank purchasers of these mortgages were becoming unable to re-issue them as securities—which made the Federal Reserve’s panic issuance of new, restrictive guidelines for them on March 5, appear ludicrous.

By March 7, the contagion of rapidly rising “risk premiums” on debt based on subprime mortgages, had already begun spreading into other debt markets: securities and deriva-

tives based on “mid-prime” mortgages, on European corporate bonds, and then on U.S. *commercial* mortgages.

This contagion is the “disintegration” of the financial system LaRouche speaks of, as increasing categories of unpayable debt can’t be rolled over into new debt securities—and it is not stoppable except by a thoroughgoing bankruptcy reorganization, carried out by leading governments.

This meltdown is blasting hard at the real U.S. economy lying underneath. On March 8, Moodys.com estimated, for example, that the housing market, which has been laying off U.S. workers at 25,000-plus/month, is going to escalate its job losses to 75,000/month in the second and third quarters of 2007. Moodys’ economist Mark Zandi forecast that “Most lenders . . . are not going to fool around; they’re going to put the foreclosed properties up for sale fast, at a discount, to move the properties.” This will rapidly depress prices and sales, which are already falling. The auto industry is already shrinking at a 10,000 jobs/month pace, and other manufacturing industry is losing 15,000 jobs monthly.

Hedge Funds’ Losses

As the opaque, \$30 trillion credit derivatives market shakes, the hedge funds and banks that dominate this market are getting hit with widespread losses, by all reports. Trading volume on credit default swaps indexes in European markets was estimated at “three times the average weekly volume,” by Deutsche Bank and Dresdner Kleinwort. Volumes on U.S. collateralized debt obligation (CDO) markets were thought to be even larger. “Both [Wall] Street and clients have been caught long. . . . Some peoples’ year was wiped out on Tuesday [Feb. 27],” reported Martin Schüler of Dresdner.

Reports filed on March 6 by three big Europe-based hedge funds (all in the range of \$3-8 billion in capital under management) gave a window into the big hedge funds’ losses in February and early March, as the carry trades started unwinding and “financial disintegration” accelerated. Man Group’s AHL Diversified Futures Ltd. fund dropped 8.2% in first week of March, and has lost 7.2% for the year to date; Winton Capital’s Futures Fund lost 5.9% in February, and Trans-trend’s Enhanced Risk fund fell 4.1% in February, and has lost 5.7% for the year to date.

At the point the Bank of Japan raised rates on Feb. 21, the yen carry trade—or, the “yen short position” in currency markets—was at 97% of its highest volume in history. Last time the yen carry trade reached record levels and then was punctured and quickly “unwound,” was in 1998, with the Russian GKO bond default and subsequent meltdown of the large LTCM hedge fund, later admitted by both International Monetary Fund and Federal Reserve officials to have nearly collapsed the international financial system. In that 1998 “unwinding,” through early 1999, the dollar fell by more than 20%. Lyndon LaRouche has warned repeatedly that London, and some stupid U.S. economic interests—are threatening to trigger a *further* 20% dollar plunge, and international monetary and financial chaos.