Worse than 2008

2011-DEC-22

There are clear signs of a liquidity crunch in the asset markets right now, and the question I keep hearing is, *Is this 2008 all over again?*

No, it's worse. Much worse.

In 2008 there was a lot more faith and optimism upon which to draw. But both have been squandered to significant degrees by regulators and authorities who failed to properly address any of the root causes of the first crisis even as they slathered layer after layer of thin-air money over many of the symptoms.

Anyone who has paid attention knows that those "magic potions" proved to be anything but. Not only are the root causes still with us (too much debt, vast regional financial imbalances, and high energy prices), but they have actually grown worse the entire time.

As always, we have no idea exactly what is going to happen and when, but we can track the various stresses and strains, noting that more and wider fingers of instability increase the risk of a major event. Heading into 2012, there's enough data to warrant maintaining an extremely cautious stance regarding holding onto one's wealth and increasing one's preparations towards resilience.

Here's the evidence:

- Oil prices higher now than in 2009
- Derivatives up more than $100 trillion since 2009
- Government debts exploding
- Weak GDP growth
- Europe in trouble
- Small investors leaving the market
- China hitting a wall

One of the most important things we need to track is simply untrackable, and that is market perception. When faith in a faith-based money system vanishes, the game is pretty much over.

If you have been reading my work (or anyone else's) with a decent macro view, you likely lost your faith in the system a while ago and marvel that it can continue along for another moment, let alone all the years it has been creaking towards its eventual date with reality. But along it creaks, day after day, week after week, and month after month, threatening to wear down the observant and vigilant before finally letting go.

2012 promises to be an interesting year, with more than $10 trillion in funding and rollover financing required to keep the developed world floating along. But where will that funding come from? The lesson from defunct economies is "not internally!" And if China's recent slowdowns and projections of an even more lackluster 2012 come true, then we might also scratch a few external sources off the list as well.

Oil Prices

As Gregor recently penned so eloquently for us, high oil prices are like sand in the gearbox of the economy – they represent the most serious form of friction there is. Rather astutely, Jim Puplava has called oil prices "the new Fed Funds rate," meaning that the traditional role of the Federal Reserve in regulating the economy via the price of money has been usurped by oil.

As oil prices go up, the economy slows down, and vice versa.

The simple fact is that oil prices remain quite elevated by historical standards, and since the correction in 2008, they have been ratcheting steadily higher each year. They are now at their highest average rate in three years. In round dollar terms, oil is $30/bbl higher than in 2009 and $10/bbl than in 2010.

I won't rehash the data here, but the best explanation for this steady increase is that supplies of cheap oil are dwindling and flow rates of the desired blends are having a hard time keeping up with demand.

The twin deficits to the export market are falling production from existing fields and rising internal demand in the producing countries. The way all that gets balanced is in the usual fashion – through prices.

All of this would be fine, except for the idea that the world is in a far more fragile condition today than back in 2008 when it suffered the first insults levied by high oil prices.

As the Bank of England's Paul Fisher recently put it:

> **Financial markets in greater danger than 2008-BoE's Fisher**
> Dec 19, 2011
>
> Dec 19 (Reuters) - Financial markets are facing a more dangerous situation now than during the financial crisis of 2008, Bank of England policymaker Paul Fisher was quoted as saying on Monday.
>
> Fisher, who is the central bank's executive director of markets and sits on the Monetary Policy Committee, also said **governments had fewer options to deal with the current crisis** because of their stretched public finances.
>
> Fisher was quoted as saying that **in 2008, governments had more leeway and cash available to stimulate their economies and bail out banks. Today that "sovereign backstop is less clear",** Fisher said.
>
> "The policy out is going to be **more difficult than it was in 2009**, given the current position of the sovereigns."
>
> (Source)

We'll explore these ideas in greater depth below, but I think the bolded parts illuminate why high oil prices are potentially more corrosive now than in 2008. The bottom line is that economic growth is central to nearly every story of recovery, and there are appallingly few analyses coming out of the OECD countries that address how the various debt rescue plans will fare if said economic growth does not materialize. Most just note that 'it will not be good' and leave it at that.

Debt

Let's begin with debt. This crisis was rooted in too much debt. Even without the headwinds caused by

banks Chile China Comex commodities copper price debt ceiling debt crisis dollar Doug Casey Dow/Gold Ratio ECB economics ETF euro euro crisis Europe Fear Index Fed fiat currency France Friedrich Hayek GATA GDP Germany gold bars gold bullion gold coins gold investment gold price gold standard gold test gold/silver ratio Gordon Brown government bonds Greece Hong Kong IMF India inflation Iran Ireland Italy James Turk Japan Jim Rogers Jim Sinclair Keynesianism LBMA Lew Rockwell Marc Faber Mexico Middle East mining monetary history Nepal oil prices PAGE Pakistan palladium price Peru Philippines PIIGS platinum price Portugal Qatar quantitative easing rare earth minerals Ron Paul Russia SDR silver bullion silver coins silver price silver price manipulation sound money South Africa South Korea Spain stock market store gold store silver Sudan Swiss francs Swiss Goldvreneli Switzerland Thai baht Thailand UK uranium price USA Utah Venezuela Vietnam WGC

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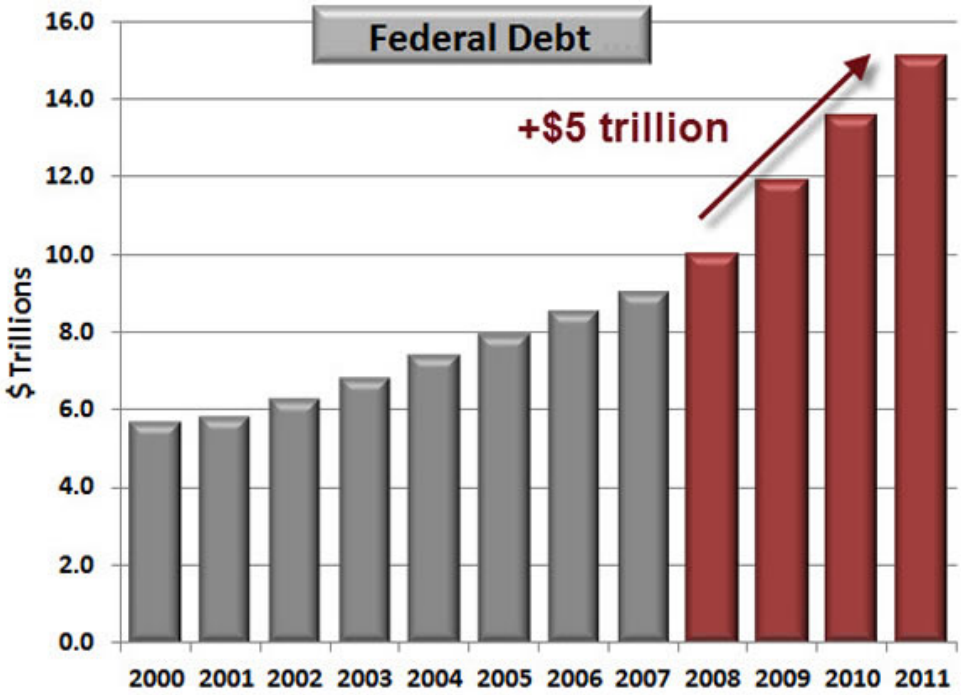
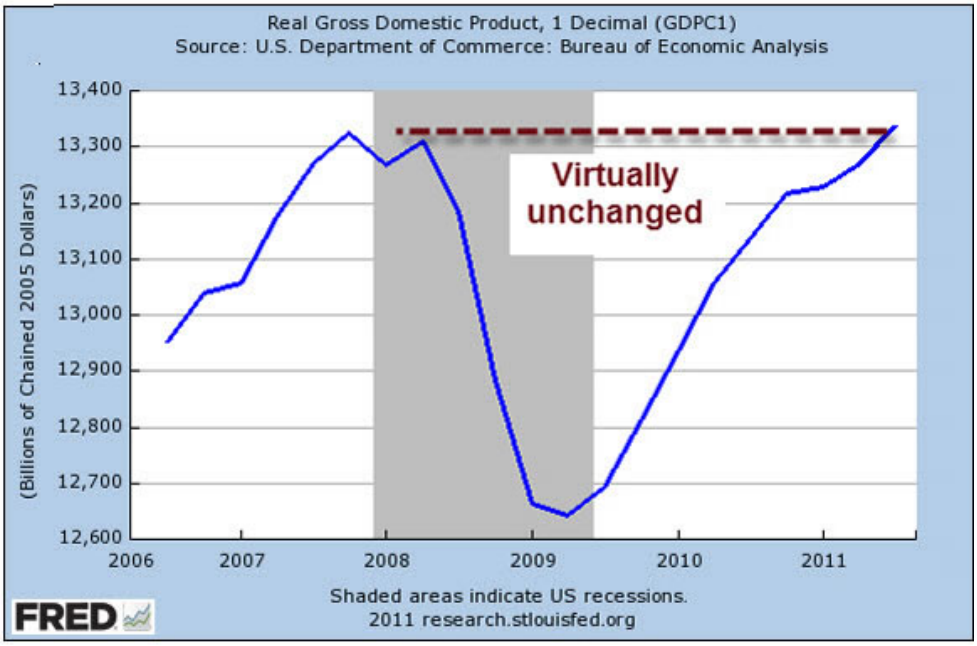
structurally rising energy prices (we'll get to those in a minute), the credit bubble was destined to someday pop all on its own. After all, there's no way for debt to continually expand faster than income, which is what was happening across the entire OECD, thanks to the ultra-accommodative policies of the world's central banks.



(Source)

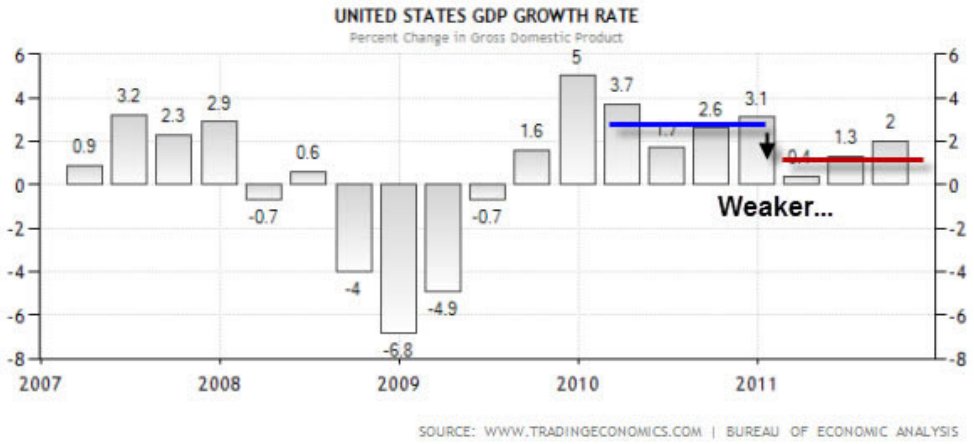
Note that GDP is virtually unchanged since 2008, meaning those $5 trillion did not buy us any incremental GDP; it only managed to bring us back to about even:



(Source)

That means we have about the same-sized economy to support an additional $5 trillion in federal debt, or roughly a third more than when the crisis started.

It is also true that GDP growth in the US is weaker this year than last year, a trend that does not bode well for the US deficit situation:



(Source)

It should be noted here that this weak growth is happening even though the US federal deficit for FY 2011 was $1.3 trillion, or more than 10% of GDP. If that's how anemic the economy is with that level of deficit spending, where would it be with less?

Europe in Trouble

The bad news out of Europe continues unabated, including debt and ratings downgrades, sliding economic growth, and exploding red ink.

Much of the hope in Europe rests upon carefully crafted bailouts that rest upon assumed rates of economic recovery and growth in order to pencil out. Without the assumed rates of growth, the plans fall apart, and more rescue funds – or outright defaults – lie in the future.

Ireland is an instructive case because it entered its difficulties earlier, and it has already received a bailout and implemented the austerity measures that were meant to balance the equation.

Ireland

Unfortunately, the plan is now in tatters with the recent revelation that the Irish economy is slumping more than expected under the twin weights of reduced lending and imposed austerity

> **Ireland's debt rating under threat as economy contracts**
> Dec 16, 2011
>
> Rating agency Fitch tonight warned it may **downgrade Ireland and five other euro zone countries** in the absence of a comprehensive solution to the region's debt crisis which it concluded may now be "technically and politically beyond reach".
>
> The agency placed the ratings of **Belgium, Spain, Slovenia, Italy, Ireland and Cyprus in credit watch "negative"**, which means a downgrade is possible within three months.
>
> The move comes on back of unexpectedly poor economic data for Ireland which showed economy weakened considerably in the third quarter, shrinking at the fastest rate in more than two years.
>
> (Source)

Here's the data:

Ireland 16 December 2011

Quarterly National Accounts
Quarter 3 2011

GDP and GNP Seasonally adjusted at constant prices

	Q3 2011	Q3 2011
	Amount €m	Quarterly % change
GDP	40,052	-1.9
GNP	32,234	-2.2

Ouch

(Source)

GNP is a better measure than GDP in this case because GNP removes repatriated corporate profits that have left the shores. Many companies use Ireland as a tax haven, so the monies that cycle briefly into and then right back out of the Irish system really should not be counted towards their economic progress.

With economic contraction, the Irish fiscal deficits will once again breach agreed-upon levels, and repaying debts also becomes that much harder. It is a negative spiral that can be quite destructive and difficult to stop.

The bottom line here, which should surprise exactly nobody, is that austerity shrinks an economy and that economic shrinkage and crushing debt loads are incompatible. Ireland has not been fixed, and it seems that the can is once again right in front of the ECB, ready for another good kick down the road.

Ireland's debt yields are instructive here. While it is true that Ireland's debt yields are down quite a lot from their maximum levels (which were over 23% for 2-year paper and 15.5% for their 9-year debt), the current yields of 7.9% and 8.6%, respectively, are utterly unsustainable for an economy that is shrinking. It is only a matter of time before those rates crush the finances of the Irish government.

Do you know why the generally agreed-upon limit for persistent government deficits is 3%? That's because it's the basic rate of GDP growth that history has shown to be sustainable. As long as deficits are growing at the same rate as the economy, then the debt-to-GDP ratio stays constant and everybody is happy. If (or *when,* I should say) the economy grows more slowly than the rate of interest that is demanded from a government, it is a mathematical certainty that either the deficits will swell or austerity and/or tax hikes must be imposed. There is no other way to balance the books.

On this basis, Ireland is still mired in a math problem.

Spain

One theme of the financial crisis is governments loading up on debt in order to get by for a little longer, with the plan seeming to be to face the music later and/or keep one's fingers crossed that the economy will have somehow sorted itself out by then.

Spain, suffering from a truly crushing housing bust that is still playing out (and will for a long time), very high unemployment, and a stalled economy, has also compounded the issues by piling up an astounding amount of new debt over the past year:

> **Spain regional debt up 22 percent to $176 billion**
> Dec 16, 2011
>
> MADRID (AP) -- **Debt levels** for Spain's cash-strapped 17 semiautonomous regions have **soared 22 percent over the past year**, the country's central bank said Friday.
>
> A near two-year recession after **a real estate bubble collapse has left Spain with swollen regional and national deficits, a stalled economy and 21.5 percent unemployment.**
>
> Many regions are facing **severe cash-flow problems** and are having to **delay payments to suppliers.**
>
> An example of the cutbacks came Thursday, when Spain's Woman's Institute said nearly 100 centers for the victims of domestic violence face closure next year in the central Castilla-la-Mancha region. Centers for drug addicts in Madrid are facing a similar fate.
>
> (Source)

The good news out of Spain is that its bond yields have fallen considerably since the end of October, when

they breached the 6% barrier and seemed ready to launch into truly dangerous, irrecoverable territory.

Most recently, Spain's 10-year bond yields were 5.13%, down from 6.7% on October 31 but still about 1.5% higher than pre-crisis levels. It's important to note that the current yield may not be indicative of the true market perception of Spanish risk because the ECB has been heavily involved in buying Spanish debt. The true yield should undoubtedly be a lot higher given the grim state of finances there.

Still, Spain's yield levels are in the best shape out of all the PIIGS. Speaking of which...

Portugal

Portugal is still in trouble, and the government has, quite worryingly for the precedent it sets, raided private pension funds to help balance the books.

> **Portugal deficit falls, helped by one-off measure**
> Dec 16, 2011
>
> LISBON, Portugal (AP) -- Portugal's finance minister says his debt-stressed country's budget deficit will likely fall to below 5 percent this year from 9.8 percent in 2010.
>
> But Vitor Gaspar says the sharp drop is largely due to the transfer to the Treasury of euro6 billion ($7.8 billion) in private banks' pension funds.
>
> (Source)

I am not sure of all the back story and intrigue that must accompany this move, but it seems loaded with implications ranging from the door it opens to other governments seeking relief, to the fact that we know that Portugal is being leaned on heavily by the international banking community and has decided to raid the pensions of...wait for it...four of the largest private banks in Portugal. Maybe there's a bit of spite built into that move?

Portuguese bond yields are down from their crisis highs of 20.4% (2-year) and 14.1% (10-year), but again not enough to count, as they are sitting at 15.6% (2-year) and 13.1% (10-year), levels well above the current rate of GDP growth.

Greece

Our poster child for the entire Eurozone mess is, of course, Greece. And quite understandably, a trickle of bank withdrawals has turned into a flood:

> **Greeks fearing collapse of eurozone bailout pulled record sums from bank**
> Dec 16, 2011
>
> An unprecedented exodus of capital from Greece – peaking in a record number of withdrawals from banks in recent months – has exacerbated the liquidity crisis now wracking the recession-hit country.
>
> The latest figures released by the Bank of Greece reveal that in September and October alone investors pulled €12.3bn (£10.3bn) from domestic banks, spurred by fears of political uncertainty and economic collapse.
>
> Overall, outflows have reached a record 25% since September 2009 – when household and corporate deposits stood at a peak of €237.5bn, the data showed.
>
> Theodore Pelagidis, an economics professor at the University of Piraeus, said: "This is part of the death spiral of the recession as a result of austerity measures. People realize that contagion has come to banks and they are very afraid of losing their deposits. On average around €4bn-€5bn in capital flees the banking system every month."
>
> The extraordinary figures back up anecdotal evidence that it is not just the super-rich behind the flight of funds.
>
> (Source)

This data, released by the Bank of Greece, is over a month old, and we'd be especially interested to see what November and December add to the story. At any rate, it is now "game over" for Greece. The market is still pricing in a nearly 100% chance of default even as the bankers and Eurocrats squabble over the prospect of raising the haircut on Greek debt from 20% to 50%.

Where the Greek crisis highs for debt yields were 151.9% (2-year) and 35.1% (10-year), they are now sitting at 146.6% (2-year) and 34.6% (10-year), which are essentially unchanged.

The Pattern

I keep mentioning that the ECB is interfering heavily in the bond markets of various countries in their attempts to keep things going. Apparently they've tossed in the towel on Greece, as evidenced by the Greek yields above.

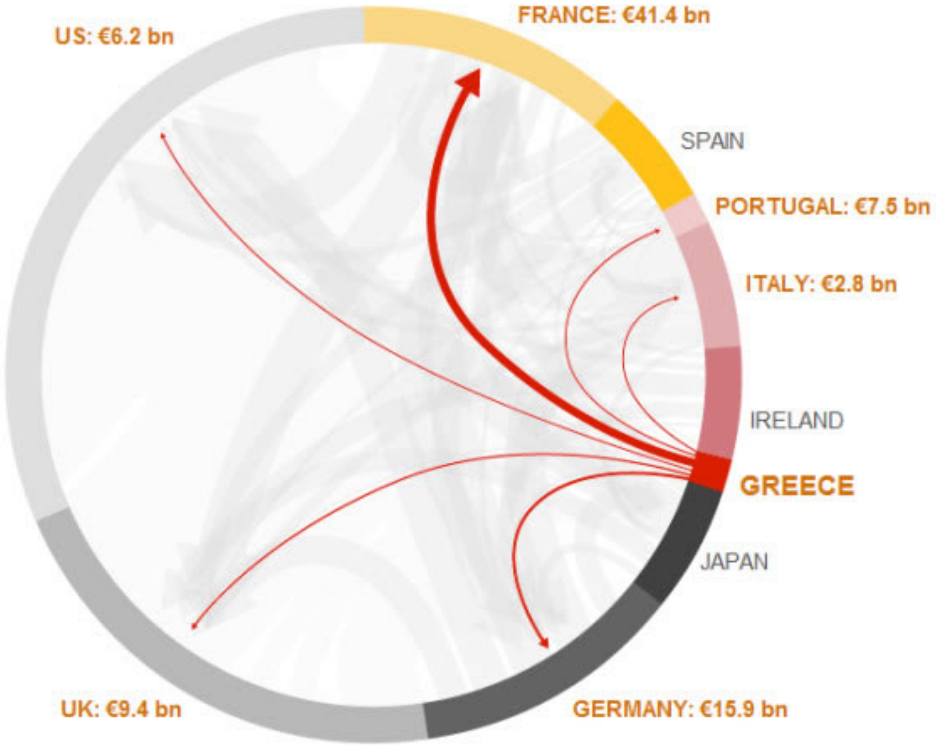
However, when we note the ways in which the Spanish, Irish, and Italian debts have come down off their

highs, can we make sense of why the ECB focused their efforts there? Sure, that's easy, and the BBC has put together an extraordinarily helpful interactive chart to make it all crystal clear.

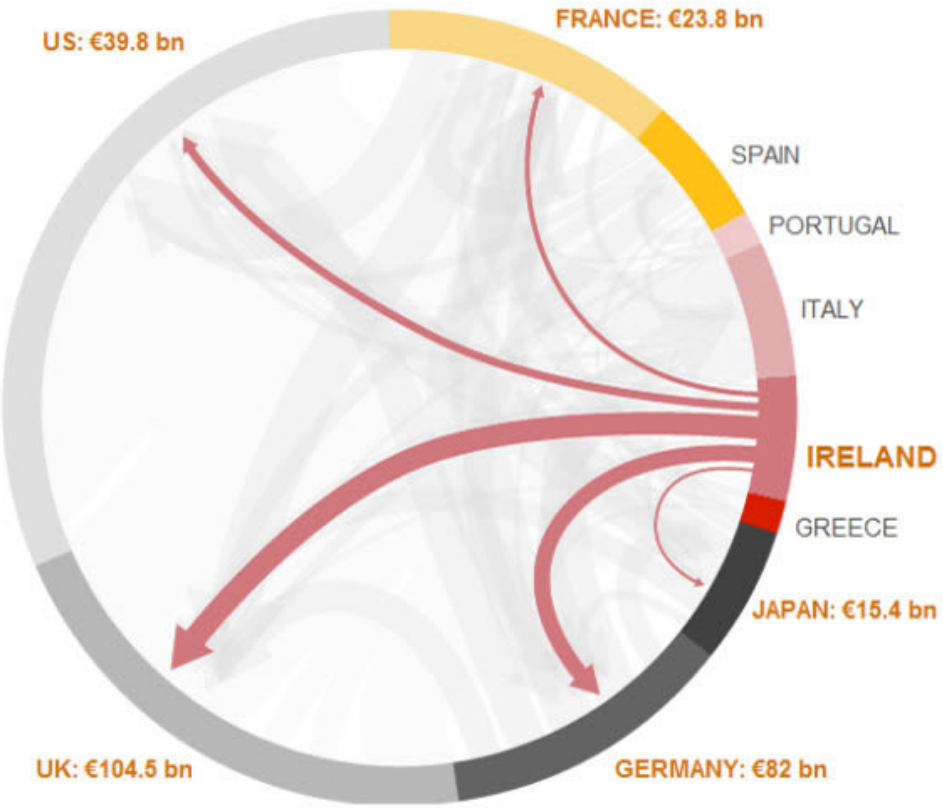
The interactive chart can be found here, but I've taken a number of screen shots so that you can more easily follow the story.

To begin with, what the chart is showing by the width of the arrows is how much money is owed to banks of other countries -- the wider the arrow, the greater the amount.

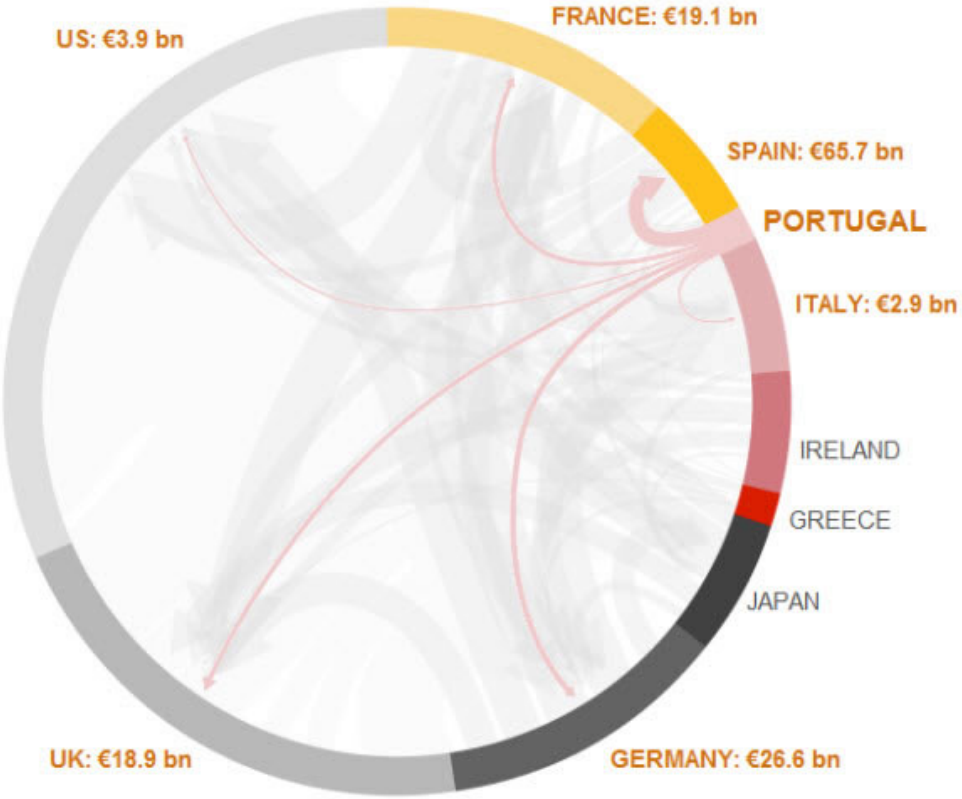
Here's the country that was let go:



Now let's compare that to Ireland, which was rescued (for now):

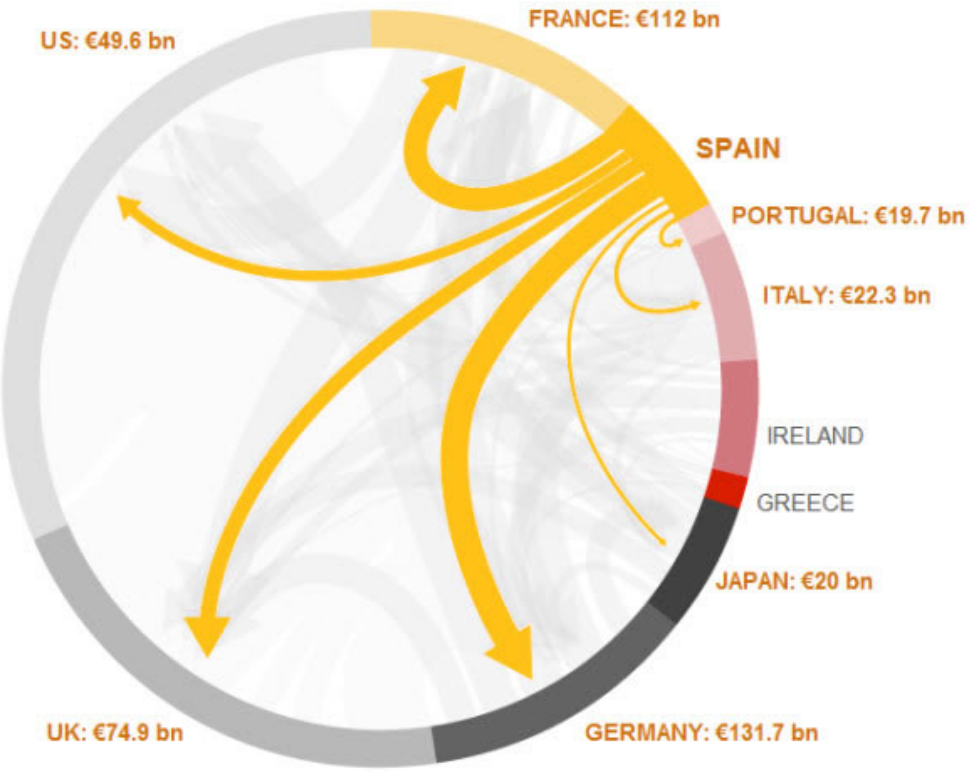


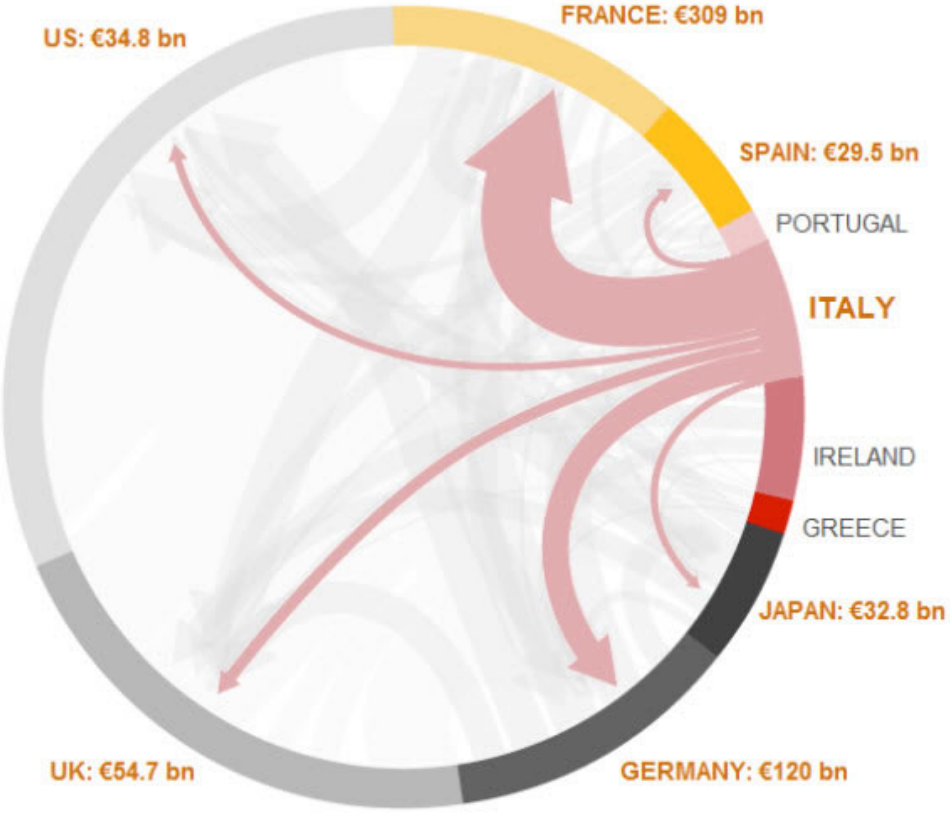
And here's Portugal, which is apparently in the process of being tossed under the bus, at least judging by how its interest rates are still punishingly (and ruinously) high:



See the pattern? Now let's look at Spain and Italy, both of which have recently enjoyed a nice decline in their

yields

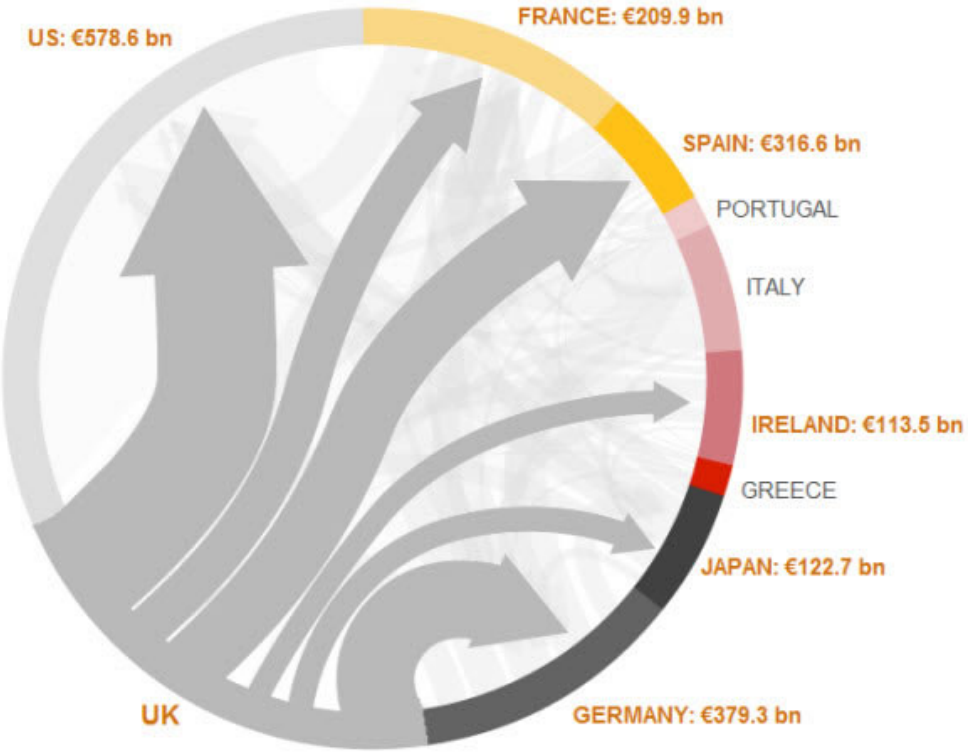


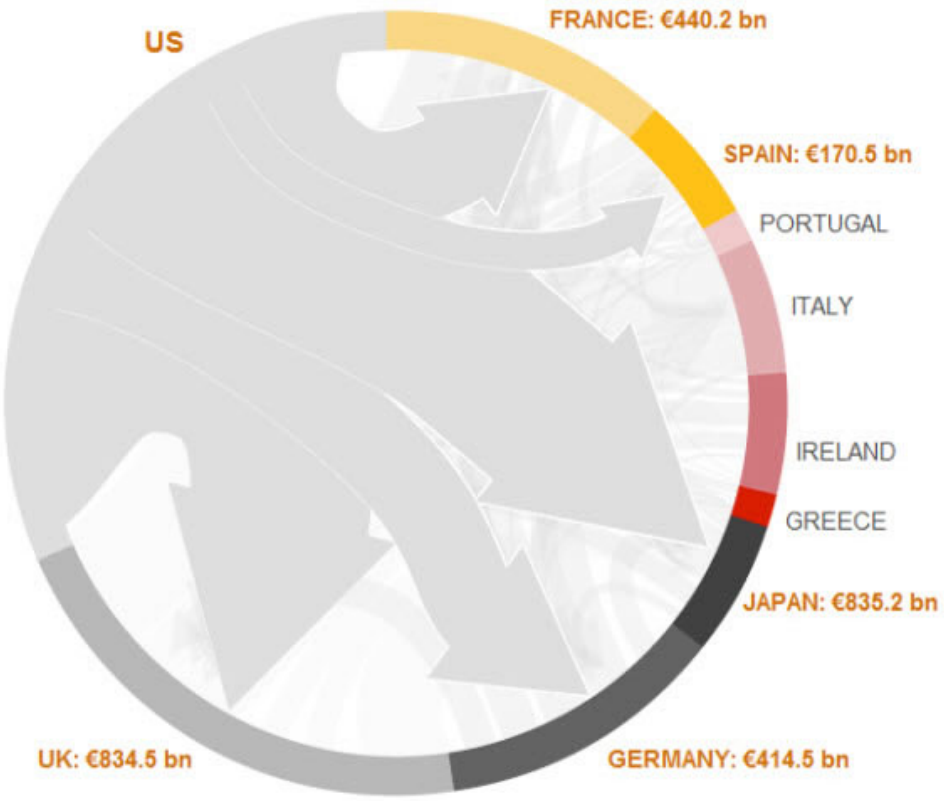


Now are the actions and focus of the ECB coming clear? It's not a surprising insight, but these charts help bring things into focus for me, and inform us that falling bond yields are probably more indicative of ECB

actions than an improving debt crisis.

Just for kicks, and to complete the story, here are the charts for the UK and the US, which hopefully make clear why these two countries could never be allowed to fail, for surely the whole world would fail to spin on its axis





The other takeaway from these charts is that everybody owes everybody, a point I've made before, but not

as nicely as these charts manage to do. Kudos to whomever thought these up.

Where Things Are Headed

In Part II: Get Ready for Worldwide Currency Devaluation, we detail the remaining risks posed by the massive amount of outstanding derivatives, small investors fleeing the markets, and China's increasingly visible slowdown. At this point, it's quite clear that there simply won't be enough economic growth to rescue the global economy from the hole it's in. So, how does this end?

It will most likely end in a concerted devaluation of the world's currencies, in an attempt to inflate away the worst of our debt burden. And if that happens, there's one asset in particular that you will want to be holding.

Click here to access Part II of this report *(free executive summary, enrollment required for full access)*.

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Tags: central banks, debt crisis, Europe, inflation, oil prices, PIIGS

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