

Domestic Credit by David Goldman

Shades of 1929!

The light at the end of the tunnel is, unfortunately, the approaching express train.

The stock market's wild runup to slightly above 1200 on the Dow-Jones average may, for all we know, run above this year's previous high of 1286 before it blows off, perhaps even before this edition of *EIR* reaches the hands of its readers.

One winces at the prospect of President Reagan bragging of the market rally before the Republican convention, only to watch the whole thing collapse before the election.

Here is the logic behind the institutional rush into stocks:

Having beaten inflation, the Federal Reserve now has room to stabilize or even lower interest rates. The market rise was preceded by an even bigger rally in long-term government bonds, and a pronounced narrowing of the "yield curve" (the difference between short-term and longer debt maturities).

Second, the slowing of the economy, i.e., the drop in durable goods and factory orders, and the rise in unemployment, shows that the economy is settling down to "sustainable growth."

Since the value of American equity at the 1086 level of the Dow-Jones is substantially under listed book value, and the stock market was nearing the equivalent of liquidation values, the institutions said, first, "Why not?" and then, "Whoopie!" On an historical basis, stock prices are so low that a 300-point swing in the Dow-Jones represents wild speculation between auction-block prices for corporate assets, and a minimal level of earnings. There is no more basis to predict the

short-term behavior of the stock market than, for example, the prices of Czarist bonds.

The presumptions are dead wrong, though reality has never had much to do with short-term behavior of stock prices.

The Federal Reserve is, indeed, loosening credit, as measured by the sharp rate of increase of bank reserves; the most significant credit-loosening measure it took was to make permanent the bailout of the Continental Illinois Bank. But it is doing so under duress, out of fear for the safety of the banking system. There are three good reasons for the Fed to worry:

1) Although posted bank Certificate of Deposit rates, and especially Eurodollar deposit rates, have come down sharply, the posted rates no longer have much to do with the reality. In the last issue of *EIR*, we warned that the nation's largest thrift institution, the \$32 billion Financial Corporation of America, was involved in a desperate effort to raise institutional funds. FCA announced on Aug. 2 that it had lost institutional deposits during July, although it is willing to pay an effective 13.65% for 3-month money, or 2¼% above the rate for some commercial banks of the same size. FCA is huge, but there are many others in just as bad shape in the thrift industry.

2) The drop in oil prices threatens a new wave of failures in the oil patch, the weak spot that brought down Continental Illinois. As we warned on May 7, "American banks lent \$40 billion in March alone to finance speculative purchases of oil in the ground. This

was the single biggest boost to U.S. liquidity during the first quarter. What happens to the economy if the oil price drops? As Janeway notes, American banks 'are sitting on sky-high reserves valued for collateral purposes at up to \$35 per barrel—outer-space in current oil-market terms. If ever there was a classic case history of long-term market direction crowding out immediate considerations of market price, the over-borrowed, undermargined condition of the domestic oil-credit pyramid provides it. A markdown of a mere 25¢ per barrel is guaranteed to swing negative leverage against the domestic oil-patch banks—if only because it will end the winking by examiners at the loan-to-capital ratios of banks overloaded with sticky oil loans.' "

3) The Ibero-American debt crisis will likely explode again at the September meeting of debtor governments at Buenos Aires.

The Fed's willingness to print money has the above motivations; ominous is the fact that despite the Fed's monetary largesse, short-term rates, i.e., the key Federal funds rate, have not fallen. This overnight rate is still pushing toward 12%.

Significant in this context is that the Swiss, the ultimate professional pessimists, have treated the market rally with contempt, e.g., the *Neue Zürcher Zeitung* of July 30:

"Prices have been driven strongly higher on the New York bond market by the soothing words of Federal Reserve Chairman Volcker before the Senate Banking Committee, and by the fact that the latest economic data have caused no great concern. . . . Careful investors, however, are asking the question if this isn't just a brush fire burning off, and if the over-hasty rise in interest rates during the spring is not matched by an over-hasty reduction in the interest rate level. . . ."