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# From the Desk of Karl Denninger

October 27, 2007

President George Bush
1600 Pennsylvania Avenue
Washington DC
By Fax: 202-456-2461
**Open Letter Posted On The Internet**

Dear Mr. President:

You have, today, received two other faxes from my "spewing fax machine" – one a "reprint" of the petition signatures being sent to Congressional Representatives and Senators on the rampant fraud in our financial markets, and the second the "backstop" data supporting the petition.

There are well over 1,000 signatures on the petition (http://www.financialpetition.org) thus far. There will be more, I'm sure.

I write to you specifically, however, on a related topic – that is, to urge you to take personal action to put a stop to some of these shenanigans, and put forward my theory on why attempting to put off the day of reckoning is likely to lead to a Republican disaster in 2008.

I'm sure you have countless hoards of political advisors who all put forward the same mantra that every President hears, and which your predecessor, Bill Clinton, believed more than anyone else – "Never take the medicine today that you can put off until tomorrow."

I spend my time writing to you here because you, standing among few other Presidents in history, have had the courage to go against that grain.  Not only in Iraq, which of course many have chided, insulted, or outright attacked you for.

But you also displayed this fortitude in your proposal for privatization of Social Security.  No, your proposal did not go far enough.  However, it was a good start – and one that you had to know was in fact akin to trying to use a garden hose to put out a raging forest fire.

That cancer – promised entitlement spending that cannot possibly be met – is a part of our fiscal crisis – and indeed, is one of the most important elements of it.  As I'm sure you are aware, there is somewhere between $50 and $75 trillion worth of "unfunded liabilities" on the United States' balance sheet via Medicare and Social Security – and our GDP is about $13 trillion.  Clearly, we are "in debt up to our eyeballs."

But the American Consumer is even more so.  I know your, and Hank Paulson's job is to "cheerlead" the American economy, but the facts are what they are.

During the late 1990s I both wrote letters and was in contact with various officials in which I opined that virtually the entire "Tech stock boom" was in fact based on nothing more than fraud.  My company, Macro Computer Solutions Inc (dba MCSNet) was conservatively operated, had no debt on its balance sheet, was closely held and profitable.  Most other firms in the space were operated by people who appeared to be high on crack cocaine in their hyperactive stock prices, were publically traded, and never made a nickel. Chief among the "fraud drivers" was the often-repeated false claim that "the Internet is doubling in size every three months."

While that was true in the very early days, it was not true for long. Yet the mantra never went away. The facts, however, were known to all of the market participants who actually had "core internet routing table" access – my firm included. There were more than 4,000 of these firms who had a partial or complete look at the table – my firm's "ASN", or "Autonomous System Number", was 3365. From that you can presume (correctly so) that there were at least 3300 before us, and ours was assigned in the mid 1990s – before the boom really got cranking.

The consequence of willful ignorance by the Clinton Administration of outright fraud in the financial markets – projections of profits that could never come, as they relied on Ponzi-scheme-like growth rates – led to the 2000 tech crash.

Like you, President Clinton, instead of taking strong action during the "IANA wars", when Ira Magaziner was personally involved, to put a boot on this fraud and bring the curtain down, apparently decided that he'd let it go – and that it would not "blow up" until his successor was in office.

In short, he decided to try to hand you a financial hand grenade with the pin out and the spoon missing.

As you're aware, it didn't work. In early 2000 the Tech Market imploded, and a few months later so did the S&P 500. The peak-to-trough losses in the S&P were 50%, with the Nasdaq losing more than 75% of its value.

While many blamed you for the economic malaise that followed and the losses in the market, that of course was nonsense – the actual crash happened before the election was held and the fraud stretched back years.

But now, on your watch, **a whole new breed of fraud** has been given root, watering, and support.

The housing bubble, caused by Alan Greenspan's inappropriately low interest rates, led to wild speculative excess in the US housing market. At the same time the "financial alchemists" came up with new ways to get "better and better" returns, since treasury bonds were yielding almost nothing.

But they did this, effectively, by committing fraud.

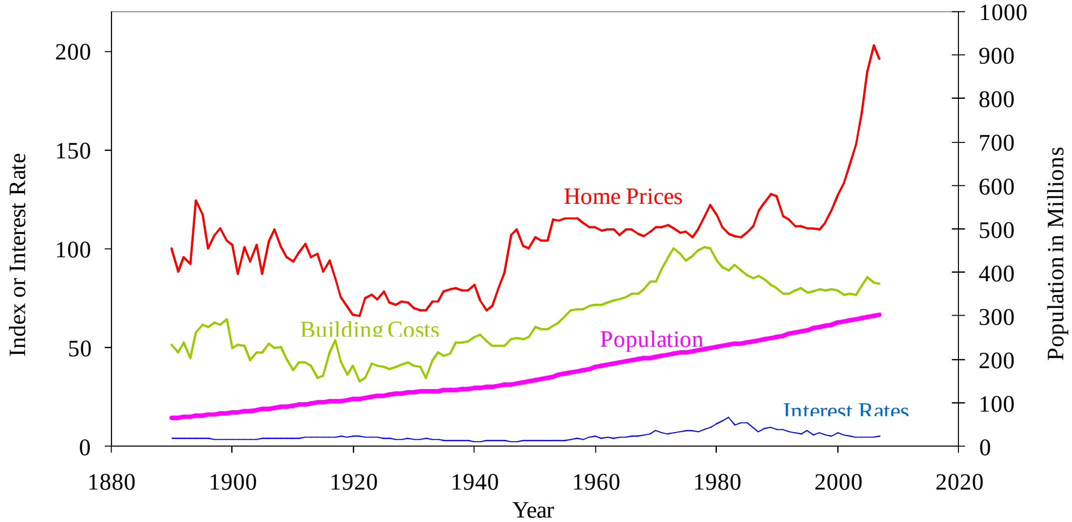
As I'm sure you're aware, there is no such thing as a free lunch. The only way you can price a bond with an **actual** higher return is if it has higher risk! Yet these people managed to get ratings agencies (who they paid, of course) to rate this debt *as if it was as safe as that of the United States Federal Government*!

This was all fine and well so long as there was a bigger sucker to buy that house at a higher price.

But now the suckers have run out of money.

Fact is that home prices cannot continually increase at a rate that exceeds wage growth. The bill must be paid, and it cannot as housing consumes an ever-higher portion of one's income. You know it, I know it, and anyone who has passed basic mathematics knows it.

*This entire cycle of fraud, down to the individual homeowner, was predicated on something that is mathematically impossible!*




As you can see, starting in roughly the year 2000, house prices took off on a tear. But going back more than 100 years, *home prices on an adjusted basis for incomes have never been sustained at more than about a 3:1 ratio!*

In short, home affordability is at all-time lows.

It does not matter what Ben Bernanke wants, what Wall Street wants, what Hank Paulson wants or what you would like to have happen. *Home prices must fall by about 50% in order to restore affordability to the top end of the historical range. They have fallen, so far, by only 3-4%.*

**There is much further to go, and it will occur whether anyone likes it or not.**

The currency markets picked up on the stupidity of this scheme a couple of years ago. The following chart should make clear what has been going on.

I frequently refer to currency traders as "the smartest guys in the room." That's simply because in the FX markets, you (even retail investors) are given 100 or even 200:1 leverage – that is, with $100 you can buy or sell $10,000 to $20,000 worth of some currency pair.

Obviously, with such leverage, even a ½% or 1% move that goes the wrong way on you will wipe you out. As such only the highly intelligent survive for more than a few days or weeks.

Note that on the above chart, from roughly the middle of 2005 the dollar has been in a relentless downward trend. This is because the currency markets deduced the scam – *house prices cannot appreciate at more than the rate of wage growth over long periods of time, and a major correction in those prices was imminent. This correction would thrash our lending system and ultimately our economy – it simply was unavoidable.*

But what the traders did not count on was the outrageous "prop up the goons with even more fraud and stupidity" – that occurred starting this summer.

When **that** became apparent the selling of the dollar **REALLY** took off, and along with it, Treasury bond *outflows* from foreign holders started to gain legs as well.

What happened in August of 2007 to provoke this?

Several things:

1. The Federal Reserve started issuing "exemption letters" to Regulation "W", allowing affiliates to hold up to 30% of a bank's regulatory capital hostage. This limit is one of the last vestiges of Glass-Steagall, banking regulation adopted in the wake of The Great Depression, and was intended to prevent affiliate bankruptcies from taking down entire banks. *The Federal Reserve continues to issue these letters like heroin to a junkie, instead of forcing these investment banks to recognize the losses that their affiliates are taking and, if it renders them insolvent, dissolving them!*

2. Ben Bernanke and The Fed cut the discount rate *on options expiration Friday* in August, a move timed to *intentionally* burn "short sellers" of the market. There was no reason to do it then – when those who were exposed were unable to hedge off their risk, as they were "pinned" by the way index options expire. Waiting just eight hours, until the market **closed** on Friday, would have had the same impact on the banking system. *Ben's clear intention was to send a message – if you short the market, I will screw you.* The previous afternoon a number of very questionable trades were put on that indicated that certain "favored parties" were told **in advance** that this action was about to take place. This sort of **blatant** manipulation of the financial markets is unlawful for private citizens to engage in; obviously, The Fed and the "favored" appear to be immune from the law, as there has been **no** investigation of those questionable trades. *Currency traders and international investors are deeply worried about markets that are not honest, as they don't want to hold assets that can be stolen from them by corrupt officials! Do you remember Hillary Clinton's "fortunate" trade in cattle futures? <u>May I politely ask why the cops are all eating donuts instead of arresting the bad guys</u>?*

3. In September, accelerating the trend, Ben cut both fed funds and the discount rate by 50 basis points, immediately following a **bad print** of job data that gave him cover to do so. That this was "bad data" was revealed the following month when the "negative" claimed jobs number was revised away. The claim behind that cut is that "inflation expectations remain well-anchored." Tell that to anyone who buys food, energy, medical care or education. *My food bill has more than doubled in the last seven years along with my energy bill. This is <u>real inflation</u> and it is running at a rate more like 10% - not the "official 2%".* Again, currency traders are reacting to the fact that The Fed is cutting interest rates into a commodity price **boom** and real inflation that is in the double digits. *The last time this was done we got stagflation that persisted until Paul*

*Volkler raised interest rates to the high double digits.* It will happen again **unless** this reckless cycle of bailing out Wall Street's "bad bets" is stopped – and soon.

4. "SIVs" and "Conduits" are nothing more than raw attempts to game the financial system. These balance-sheet games are a big part of what brought down **<u>Enron</u>**, and now we have **your Treasury Secretary** attempting to prevent a market correction that forces these bad debts back onto the balance sheets of their guarantors. Remember, **<u>Enron</u>**'s "key people" were convicted of **<u>felonies</u>**. Why is your Treasury Secretary encouraging the same sort of "off-balance sheet" games that resulted in felony charges for executives of a company that exploded just a few years ago and resulted in strong calls to **BAN** the practice of off-balance sheet investment vehicles? *The currency markets are not stupid – any such attempt will ultimately end with a Federal monetization of these bad debts and they know it.*

5. We have successfully exported our inflation to China and the Middle East oil exporters for nearly a decade. *They are now starting to push back, being unable to continue to absorb inflationary pressures that <u>we</u> should be eating.* China *WILL* break the peg to the dollar – it is now only about *when*, not if, it will happen. The Middle East exporters *will* break their pegs; some already have, others will follow if we do not act to curtail our monetary policy foolishness – and soon!

Today the stock market is effectively a junkie that needs another shot of heroin, and is pounding on the door of The Fed to give it to them.

On Halloween we find out if the shot will be administered.

"Trick or Treat"?

The problem Mr. President is that should this "cycle of rate cutting" and "hiding of liabilities" continue not only will it not solve the problem but it will destroy the middle class and ultimately our economy. Already inflation has become structural in the food and energy complex – there is a *five year trend* in both that shows no sign of reversing. Oil continues to hit new highs, while we refuse to drill for our own resources off the coast of Florida and recover shale out west on federal land. Gasoline prices have remained muted only because the "crack spread" has contracted well beyond historical norms over the last few months – this will revert to the mean in the coming months, driving gasoline prices up to $4/gallon – or more.

As is sometimes said, "The gig is up" on running this scam, and now the bill has come due.

Mr. President, it is time to force these entities to take their medicine.

Yes, we will have a recession. It is unavoidable. Your ability to prevent one ended in 2003 when housing took off on its "rocket ride" into the stratosphere, insuring that a bust would come and when it did, that the economy would be dragged down with it.

**There has never, in the history of the United States, been a housing correction that has not caused a recession.** This is a 100% reliable indicator – your administration will not avoid the lessons of history.

The question now is one of timing and collateral damage.

If you do not put a stop to this nonsense now the full weight and fury of the credit unwinding will happen *next spring and continue into the fall, when the elections are held.*

*<u>There is no chance you will be able to put this off until after the election</u>.*

There will be no chance to show the nation that a turnaround is in process.

*Republicans will lose even more seats in the House and Senate, and Hillary Clinton, despite having the highest "negatives" among the nation as a whole, <u>will become President of the United States</u>.*

The end result of this will be a total unwinding of our favorable tax policy – policies that you helped put in place. Health care will become fully nationalized. The dollar will be utterly debased and destroyed, oil will be priced in Euros, the stock market will plunge to well below its 2003 lows, and our economy will be decimated. Bills are *already* being filed, as you know, to implement some of these tax increases, and the election hasn't even been held yet!

The alternative path is for you, personally, to put your foot down on the necks of those in your administration and elsewhere that are causing this to happen.

Specifically, you can act in the following ways in the coming days and weeks, and gain the advantage for our nation and the Republican Party:

1. You can direct Hank Paulson, along with the SEC, to force all financial entities to consolidate on their balance sheets *all outstanding liabilities, including SIVs and Conduits.*

2. You can strongly "suggest" that Ben Bernanke and the Fed Governors *revoke all of the outstanding 23A exemption letters.*

3. You can take a *public* stand against market manipulation and fraud, and insist, from your bully pulpit, that the SEC investigate and prosecute those who have leaked inside information related to the financial markets (e.g. the discount and fed funds cuts), *and those who profited from the information, no matter which firm(s) they may be.*

4. You can point out that home affordability simply must return to historical levels, and that until it does the market pain will continue.

5. You can strongly suggest, in public, *that The Fed stop talking about "inflation expectations" and act instead on actual inflation as is in their legal mandate, recognizing that middle class Americans have been and continue to be squeezed.* This would make any further rate cuts not only inappropriate, but strongly suggest that in fact what we need are rate **increases.**

In short, you can help force the markets to face reality, atone for the ills of the past, many of which stretch back to before you took office, *and vow to sin no more.*

**You can help restore confidence in America's markets and economy.**

Should you embark on this course of action I would expect all of the following:

1. Equity markets will correct by 30% over the coming six months, trough in the summer, and start to rise into the election.

2. Mortgage issuers, insurers, and financial institutions that wrote these bad loans without regard to ability to pay or the true underlying value of the properties will be forced into reorganization. The FDIC will, as they have in the past, forcibly reorganize those banks that become insolvent. Other firms, including a significant number of builders and mortgage insurers, will fail outright.

3. Housing prices will contract by 30-50% over the next 12-24 months. There will be a tsunami of foreclosures and ruined credit among those who bought during "the bubble." *However, those who are foreclosed upon will be able to buy their house back at half of its "current" price; in the long run this results in <u>stable</u> home ownership gains, although at the price of a quick, sharp housing dislocation.*

4. The US economy will undergo a sharp but short recession. The recovery will be apparent as we head into the 2008 elections, as sustainable home ownership begins to take hold.

5. Your administration and Republicans in general will get credit for rooting out the fraud in the system and returning the markets to a rational foundation. *Since there are far greater numbers of middle and lower income Americans than "fat cats", this is the path to electoral success.*

In short, the choice is yours Mr. President.

You can choose to stand on the side of Americans who have been cheated, lied to, manipulated and turned into debt zombies over the last decade through a policy of inappropriately low interest rates, conniving mortgage brokers and Wall Street financiers.

You can be The Common American's hero.

Or you can side with "The Pigmen" of Wall Street. Yes, they make big campaign contributions. Yes, they hire lobbyists who incessantly pound on the door of your administration, along with Congress. Yes, they want the party to continue forever – for them.

Unfortunately, neither you or they can control what foreign interests do.

That second choice leads to an economic dislocation that, if we're lucky, will be limited to 1970s style stagflation and stunted economic growth *for a decade or more*, and then an accelerating decline for America as we become increasingly unable to pay the bills that the retiring Baby Boomers submit. At the very time The Boomers cannot afford it, our equity markets will crater. Congress will be sorely tempted to impose punitive taxes on 401ks and IRAs which were "promised" tax-free appreciation.

But if we get unlucky, the market will force our nation's hand in ways we cannot imagine, and much sooner than we would expect. Should the cycle of "rate cuts" continue and force the dollar lower, at some point China and petroleum exporters could decide to dump their $2 trillion worth of US Treasuries, forcing real interest rates up to 20% and destroying our currency, turning us into an instant banana republic and driving the price of gasoline north of $6. That would in turn precipitate a full-on economic collapse, with credit becoming unavailable to essentially everyone. Massive job loss and a replay of The Depression could result, or a protracted economic malaise even worse than that of Japan, which has been trying for more than a decade to escape from their deflationary spiral – without success.

In short, President Bush, I hope you will choose to take the side of the common man, and do the right thing.

I voted for you twice Mr. President, because I believed in America, I believed in an ethical White House, and I believed in what you promised – sound economic policies, sound geopolitical policies, and transparency in our government.

I would like to be able to vote for your successor – a Republican – but cannot do so unless *this* Republican administration delivers in the coming days, weeks and months.

Sincerely,

Karl Denninger