



# MONEY MORNING

105 West Monument Street Baltimore, MD 21201

## Three Ways to Know When the Credit Crisis Hits Bottom

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“Have we seen the worst from the financial sector?”

The question – a very good one – came from an audience member following my global investing presentation at the Agora Wealth Symposium in Vancouver, British Columbia. During my entire time there, the interest in the ongoing credit crisis was intense.

I took a deep breath and launched into my three-point response. First, I’m encouraged by what I see lately but still believe there is a fair distance to travel before all the skeletons are cleaned out of the financial sector’s closet.

There is a growing body of data that suggests banks have recognized only a fraction of the overall potential losses – approximately \$50 billion to \$75 billion so far on subprime debt alone. And a variety of estimates suggest that total subprime losses may be more than \$300 billion before we’re through.

And that figure, incidentally, doesn’t include the additional losses from secondary-prime mortgage loans, auto loans, credit card balances, student loans and the other credit-related flotsam and jetsam floating around in the debt markets.

That suggests that the hundreds of billions of dollars in emergency capital infusions from the world’s central bankers we’ve seen to date may only be a fraction of what’s ultimately needed by the time fully leveraged figures are thrown into the mix.

Second, liquidity conditions now may actually be worse than when the entire credit-crisis mess began to unravel this time last year. For example, the benchmark London Interbank Offered Rate (LIBOR) remains higher than so-called “policy rates” and U.S. Treasuries of comparable maturities.

This suggests that banks still don’t trust each other and therefore are keeping so-called “Interbank” borrowing rates high in order to reflect what they perceive to be the added risk of doing

business. We've been warning investors to watch out for this **since as far back as April**, and have generally been preaching caution since the credit crisis began last year.

In other words, the fact that Libor-Treasury spreads are wider today than they were a year ago suggests that **the banks really don't know who continues to hold the toxic debt instruments the entire world has come to fear** – despite a recent earnings parade of CEOs making claims to the contrary.

The upshot: Many institutions are hoarding cash - something you'd hardly expect to see if the credit crisis were really on the mend.

Third, judging from recent reports, it's beginning to dawn on financial regulators that this crisis was never about a lack of liquidity in the first place, which is something I suggested in an open letter to U.S. Federal Reserve Chairman Ben S. Bernanke some time ago.

Instead, this crisis is about three things:

- *Too much* liquidity.
- Fundamental structural problems in the credit industry, including the almost-total lack of regulation.
- And the lack of transparency of complex financial instruments for which there is no public market, making them tough to value and nearly impossible to trade.

It is becoming clearer by the day that – partly because of these three factors – a good deal of money has been made fraudulently, if not illegally.

Granted recent changes surrounding the “mark-to-market” accounting of so-called “Level 3” assets are a step in the right direction. But what few people realize is that, in the short-term, these new requirements could involve the immediate recognition of even larger losses than we've seen to date.

The reason is that many of the firms involved – Merrill Lynch & Co. Inc. (MER) and Citigroup Inc. (C), for example – will no longer be able to hide their losses in Level 3 assets, as they have in the past.

As you might expect, there's a counterargument to this, and it's a highly popular one on Wall Street - especially inside the CEO set, whose members desperately want to stop the financial hemorrhaging their firms are enduring. They claim they're “selling” risky assets and “de-leveraging” their balance sheets.

But here's what they are not telling you.

Even though these folks are technically “selling” assets – particularly the distressed “Level 3” assets I mentioned a bit earlier – what they are really doing is assigning the upside to hedge funds, private equity firms, and sovereign wealth funds in exchange for cash.

And here's the kicker: The banks actually are **holding onto the downside liability in the event the underlying securities go bad**. That brings us back to the start of this commentary, when I said

that I expect more securities to go bad.

No matter how you look at it, these financial institutions are playing a vicious shell game, hoping all the while that they're not the loser who is taken to the cleaners when he picks up the wrong shell.

Where this goes from bad to worse is that at the same time they're playing more fancy accounting tricks, these firms continue to pony up to the Fed's private backdoor lending window for sweetheart financing. After all, they can't get the financing anywhere else.

That means that every taxpayer in this country is involuntarily being put in the bailout business.

As for whether or not we're near the end of the credit crisis as a whole, it depends on whom you ask.

When this crisis started a year ago, I was asked a similar question and answered it by saying that we would not even begin to approach the end of the line until the total losses exceeded \$1 trillion.

My audience chuckled politely.

Fast-forward 12 months, and nobody's laughing anymore – especially when I say that I'm now raising my industry loss estimate to nearly \$2 trillion.

Increasingly, other analysts are embracing a similar viewpoint. UBS AG (UBS) raised its estimate of the total cost of the credit crisis to \$600 billion, while noted hedge fund manager John Paulson suggested \$1.3 trillion is not unthinkable. Meanwhile, in a report issued last May, the International Monetary Fund (IMF) projected the bailout costs at \$1 trillion.

All of this leads us to a single conclusion: At least for now, this is a “recovery” in name only.

**[Editor's Note: R. Shah Gilani – a retired hedge fund manager and a nationally known expert on the U.S. credit crisis – has predicted five key financial crisis “aftershocks” that he says will create substantial profit opportunities for investors who know just what these aftershocks are, and how to play them. In the [Trigger Event Strategist](#), trigger events,” as gateways to massive profits. To find out all about these five financial-crisis aftershocks, and about the trigger-event profit strategy they feed into, [check out our latest report.](#)]**