Drifting into a perfect storm

Jobs are down, the dollar is up, exports are down, imports are up. The US is battening down for the bumpiest of rides, reports our US correspondent, Caren Chesler.

For years, with the US dollar weak relative to the Euro, Americans have had to watch European tourists come over by the busload to go on weekend shopping sprees while they've had to suffer abroad, paying $10 for a cup of coffee.

But the worm is finally turning. As central banks in places like Europe and Australia begin lowering their interest rates to boost liquidity, rates in the US - already extremely low - are poised to rise, experts say, and that's likely to push up the value of the US dollar relative to other currencies. US investors selling overseas stocks back into dollars is also putting upward pressure on the currency.

But while that's good news for Americans traveling abroad, it could spell lower profits for US corporations. That's because companies with exposure to foreign currencies will take a hit in revenues as they convert those currencies back into dollars. If Levi's sold blue jeans in Europe for 100 Euro last year, for instance, those Euros might have translated into $US140. As the dollar strengthens relative to the Euro, however, those same pants will only yield about $120.

"There's no doubt US exporters benefitted significantly from the weaker dollar over the last three or four years," said Hossein Kazemi, a finance professor at the Isenberg School of Management at the University of Massachusetts, Amherst. "The export sector has been responsible for the entire growth of the US economy for the last couple of quarters, and that was due to the cheap dollar, which made US products cheaper overseas and made imports more expensive. US companies were able to capture significant market share overseas."

The steel industry, the agricultural sector, technology companies like Honeywell and United Technologies, they all benefited from a weak dollar, Kazemi said. But that's about to change, and evidence of it is already being seen in the stocks of steel producers, for instance, which have seen their share prices fall by about 50% over the last few months.

"It will be a bit of a perfect storm for US corporates," said Wolfgang Koester, CEO of FiREapps, which provides companies with foreign exchange software. "For the last few years, they have been benefitting from a weaker dollar because their overseas revenues have been valued higher. Now, they've got a tougher economic environment and a stronger dollar working against them."

Koester believes American companies are going to have a tough time, or what he called "negative surprises" for the next five quarters on account of the strong dollar. The US auto industry will be hit particularly hard, he said. American car sales were already down about 25 per cent last month compared to the prior year, a 15-year low. A strong dollar will only erode revenues further.

"They were already selling fewer cars, and now, when they bring those Euros back and get less dollars for them, they're going to sail right into hard economic times," Koester said.

The credit crunch hasn't helped. Car sales have been hurt because dealers have not been able to offer competitive financing. Indeed, Bill Heard, the nation's largest Chevrolet car dealership, closed its doors on 24 September after being in business for 90 years.

The dealership blamed it on the declining automobile market, the high price of gasoline and how that affected sales in the dealership's core products, which are heavy trucks and SUVs, as well as the difficult financing conditions the automobile industry as a whole has faced because of the subprime lending industry collapse.

Some 3,200 employees lost their jobs as a result.

After seeing Wall Street's $700 billion handout, the auto industry asked for one of its own, which they received, although it's small in comparison. The federal government passed an energy bill that included $25 billion in loan guarantees for the auto industry. The guarantees enable the Big Three automakers to borrow at interest rates of around 5 per cent rather than the 15 per cent rates to which they would be subject if they hit the open market for financing. The measure was meant to enable America's Big Three automakers to remodel their factories so that they can produce more fuel-efficient cars.

For now, companies are likely to use the funds to make ends meet.

Banks pay a high price for auction rate securities

In normal times, auction-rate securities look pretty attractive. For issuers, like local governments, student-loan trusts and closed-end mutual funds, they could borrow long-term debt at lower short-term rates, given that the securities rate reset weekly or monthly by auction. For investors, the securities were billed as a safe way to get a slightly bigger bang for their buck.

But when demand at these periodic auctions began to subside late last year, dealers stepped in and bought the debt themselves to prevent auctions from failing. By February of this year, as the credit crunch worsened, dealers pulled out, the auction market failed, and this market has been frozen ever since, leaving investors unable to sell their holdings.

With the threat of state and federal investigations into their sales practices, a handful of Wall Street firms and banks reached a settlement in August with New York State Attorney General Andrew Cuomo in which they agreed to repurchase auction-rate securities held by customers. The firms, which included Merrill Lynch & Co., Goldman Sachs Group Inc., Deutsche Bank, Citigroup and UBS, agreed to buy back about $US50 billion of roughly $US60 billion in auction-rate debt estimated to be held by individual investors.

Merrill Lynch, for instance, said that beginning 1 October, it would repurchase at par $US12 billion in auction-rate securities from some 30,000 clients who hold municipal, closed-end funds and student loan auction rate securities. The firm also agreed to pay fines of $US125 million. The firm also settled with the Massachusetts Secretary of the Commonwealth William Galvin, who charged Merrill Lynch with fraud in pushing the sale of auction-rate securities while "misstating the stability of the auction market itself." Among other things, the complaint alleged Merrill co-opted its research department to help sell the securities. Massachusetts also reached settlements with UBS, Morgan Stanley, Wachovia, Citi, Bank of America and Fidelity Investments.

Michael Weiss, founder of Frontier Financial Advisors in New York, said brokerage firms used to sell the product largely to individuals, but when demand there began to wane, they turned to high net worth individuals, some of which were his clients. But they were told the product was a lot safer than it turned out to be, he said.

"I have been an advocate for the individual investor for a long time, and I think what's going on is disgusting," Weiss said.

But it wasn't just individual investors who got caught up. Weiss has a client who owns his own business and had about $7 million of his operating capital in auction rate securities when the market froze.

"You can imagine the alarm and concern," Weiss said.

"I'm not surprised the banking industry is consolidating. It's the speed with which it's happening: two weeks."
Dr Mary Harris,
Cabrini College,
Radnor, Pennsylvania.

Weiss said some of the brokerages began allowing clients to borrow against their own money. But to add insult to injury, the firms were charging people interest.

Bailout too late for some

When the US House of Representatives failed to pass legislation on 29 September aimed at rescuing the financial markets, panic ensued and the stock market plunged. Later that week, a $US700 billion bailout bill was passed. The market's response: it plummeted. This week, as the Federal Reserve and European governments stepped up efforts to address the deepening financial crisis, international investors sold stocks in nearly every corner of the globe. The Dow Jones Industrial Average dropped below the 10,000, a sign that regulators may not be able to stop the bleeding.

Under the US rescue package, the federal government will purchase distressed mortgage and other asset-backed securities from banks with the hope that by freeing up their balance sheets, they can begin lending again. It was already too late for some. In one month, the markets saw the demise of Lehman Brothers, the acquisition of Merrill Lynch by Bank of America, a federal bailout of insurance giant AIG Group, a federal seizure of Washington Mutual, and a rescue of Wachovia - though at press time it was unclear whether the bank would be bought by Citigroup or Wells Fargo.

"I'm not surprised the banking industry is consolidating. It's the speed with which it's happening: two weeks!" said Dr Mary Harris, business department chairman at Cabrini College in Radnor, Pennsylvania.

Photo: courtesy of Joachim Clasohm, under the Creative Commons Attribution License.

The consolidation in September, which also included the conversion of investment banks Goldman Sachs and Morgan Stanley into bank holding companies, fundamentally changed the landscape of Wall Street.

"We're basically saying the Wall Street model is gone, and we're looking at it more from a commercial banking oversight mode," Harris said, noting that much of the regulations in the financial markets have come out of crisis like the Great Depression and the Savings and Loan crisis. "I'm hoping that what comes out of this is long-term regulations for things like swaps and derivatives, because there really hasn't been a lot of oversight of those products."

While the turmoil in the financial markets is said to be the worst since the Great Depression, Harris is confident things will turn out better this time.

"They understand macro-economics now; they know what needs to be done to start fixing this problem. Back in the Depression, they had no idea," Harris said.

Back then, regulators used pro-cyclical policies, which meant when the economy was already contracting, banking officials employed contractionary rather than expansionary policies. Today, the Fed uses counter-cyclical policies, such as employing expansionary policies during recessions.

But what ails the markets right now is a little trickier to address as it involves perceptions rather than money supply, experts say. Investors are fearing the worst and selling, whether it's justified or not. Consumers smell bankruptcy and yank their money, even if their bank wasn't failing. Lenders don't want to extend credit for fear they won't be repaid.

"The fundamental problem is, people cannot tell who are the bad financial institutions and who are the stable or secure ones," said Anthony Page, associate professor of law at Indiana University of Law.

Two weeks ago, the CEO of Wachovia said he was looking forward to the bank's opportunities as a standalone entity, and days later, it is selling itself for $1-a-share. Washington Mutual looked like a viable entity 14 days ago, and they wind up getting wiped out, Page said.

"Parties can't tell who will be solvent, and who won't, so they don't want to business with anybody," Page said. "The markets depend upon trust, and if you can't trust the other side anymore, the markets freeze up."