Red Devils on the Loose

It was a sea of red again last week as stock markets across the world finished down heavily on the week. The FTSE 100 finished down 3.26%, the CAC down 4.80% and the DAX down 2.35% on the week. US markets faired slightly better thanks to an attempted rally towards the close on Friday. The S&P 500 closed down 2.14%, the Dow down 1.67% and the Nasdaq 100 down just 1.28% on the week. Irans testing of missiles caused a spike in crude oil prices, to make yet another record high above $147. Although the US and Israeli government have spoken about a diplomatic solution, speculators obviously are not convinced. Investors flocked to traditional safe havens such as Gold which closed near $960. The catalyst for much of the selling last week is the unraveling doomsday scenario of a US Government bail out, of Fannie Mae and Freddie Mac. These government sponsored enterprises (GSEs) together own, or guarantee half the $12 Trillion of outstanding US home loans. Fed member, William Poole spooked markets by stating that the two firms are now technically insolvent. The ratings agencies are maintaining the AAA ratings on the stocks, but derivatives traders are scoffing at this; valuing their debt 5 points lower. Western banks also have a stake in this because they own some of the debt associated with the two companies. Whatever form the eventual bail out takes, it has the potential to make the UK Governments handling of Northern Rock, look a trifling affair in comparison. The focus at the start of this bear market, was around the ability (or inability) of banks to raise capital, and maintain their capital adequacies. Unfortunately as the crisis has continued, the situation has only worsened. With large chunks of financial firms assets still tied to the housing market, we appear to have a self perpetuating negative cycle. As house prices collapse, banks such as Bradford and Bingley struggle to raise capital; as a consequence, they tighten their lending practices, which in turn puts further pressure on an already fragile housing market. This was evidenced by the collapse of US mortgage lender IndyMac Bancorp on Friday. Similar to Bradford and Bingley, IndyMac specialised in self cert type mortgages, which have a higher risk of default than traditional loans. US pending home sales dropped 4.75% against the expected -2.8%. Year on year, US foreclosure activity is up 53 percent from June 2007. One in every 501 U.S. households lost their home to foreclosure, received a default notice, or was warned of a pending auction. California, the home of IndyMac has been one of the hardest hit US states with one foreclosure filing for every 192 households in June. The UK market is fairing little better. Last week, the latest Halifax house price index showed than houses were on average 8.6% down on last years levels. The acceleration of this decline is already well ahead of recent housing recessions. The week ahead is full of top tier economic announcements. We start with UK PPI figures on Monday and CPI figures on Tuesday. Both these data sets will add fresh colour to the BOE inflation letter tentatively planned for the Tuesday. Tuesday also brings the UK RICS house price balance, and sees the start of a two day Bernanke testimony before congress. Thursdays US housing data will round off what is a very busy week on the economic news front. Central bankers are currently stuck between a rock and hard place with regards to interest rates. The decline in the housing market and general economy might normally lead to rate cuts, but this is currently being resisted due to soaring inflation. Movements on the currency markets usually track interest rate decisions or expectations. The GBP/ USD exchange rate has been trading in a range between $2 and $1.94 over the last quarter (April to June), perhaps as a function of the gridlock in rates policy for the Fed and MPC. However, the potential for massive liabilities for the US government with potential bank bail outs could push the GBP/ USD outside of this range in the near future. A One Touch trade predicting that the GBP/ USD will touch $2.00 at least once during the next 16 days could return 28% in BetOnMarkets.com.

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