

Tea Leaf

...weekly since 1976

Your guide to understanding
today's economy and
financial markets

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Major Steps

Written by Jeff Thredgold, CSP, President, Thredgold Economic Associates

There is a saying in many communities around the country about rapid changes in the weather that goes something like this...

"If you don't like the weather now, just wait 10 minutes..."

...the same description could be used in reference to stock markets around the globe.

As you have heard *ad nauseum* in recent days, the American stock market had its worst week ever last week. Friday's more than 1000 point trading range during the day for the Dow average was also one for the history books. Similar carnage was found in stock markets around the world.

On the Road Again

During 18 speaking presentations across the country over the past five weeks, I have told audiences that current market challenges and governmental policy developments are the kind of "stuff" we, our children, and our grandchildren will be reading about in history books in coming decades...

...it is fascinating and enormously scary at the same time

Market emotions, at least for the moment, shifted 180 degrees on Monday with strong stock market performances around the globe. The Dow average recorded its largest one-day gain EVER.

Numerous forecasters suggest that we have seen the bottom in regard to stock prices...

...we'll see

Our *Tea Leaf* newsletter dated September 23, 2008 was entitled *The Big Guns*. It discussed the reality that the application of one band-aid after another by the Federal Reserve and the U.S. Treasury Department in prior days and weeks to deal with individual problems with enormous U.S.-based financial institutions was not working.

Terrified domestic and global financial markets needed something more all-inclusive. The \$700 billion financial stabilization package was hoped to do the trick...

...at least initially, it did not

European Moves

Many politicians and business leaders across Europe have been gloating during the past year about the "failure" of the U.S. business model. Many have been vocal in their view that unbridled American capitalism was doomed to failure, while the European approach of greater state involvement in the private sector and a more regulated financial model was indeed the way to go...

...whoops

It turns out that balance sheet problems with enormous European-based investment banks and commercial banks were every bit as challenging as those of U.S.-based firms, in some cases actually more so.

The Really Big Guns!

Stock market players on Monday responded favorably to the powerful steps taken by governments around the world to deal with the extremely serious global credit crisis:

- The British government will pump the equivalent of \$63 billion into three of the nation's largest commercial banks, taking a significant ownership interest at the same time
- Germany will provide up to \$683 billion to guarantee lending between banks and to secure the nation's financial institution deposits
- France will spend up to \$480 billion to do the same
- Austria and Italy will provide similar lending and deposit guarantees, while the other nations that use the euro currency have or will provide similar relative funding
- The U.S. announced similar today, with an impending injection of \$250 billion into select banks

Capitulation

Students of stock market performance frequently note that a point known as

The Poster Child

While much of the global media's focus regarding the freeze up of financial markets has centered on the U.S., followed by similar issues across Europe, it is Iceland that could ultimately be the poster child of financial institutions run amuck.

Within the U.S., the top three commercial banks have domestic and global assets of roughly \$6 trillion. These assets equal roughly 40% of the size of the \$14.5 trillion U.S. economy (annual output of goods and services).

Now take that 40% relationship and multiply...

...by 25!

Through extremely aggressive global lending and investment, Iceland's top three banks (which were privatized in 2001) soon had assets exceeding \$136 billion dollars...in a nation of just 302,000 people (*The Wall Street Journal*).

Such banks are now ruined, with the stock market closed in recent days. The krona has ceased functioning as a currency outside of the country. Inflation and debt payments are soaring. The country could easily default on its debts. European depositors in online Icelandic banks may never again see their money.

Fishing provided a means of survival for Icelanders for centuries. Various government officials suggested in recent days it may be time to return to the sea.

Initial intent was for the U.S. Treasury Department to buy "toxic" real estate securities from the balance sheets of commercial banks and investment banks. Such a balance sheet "cleansing" would, in theory, allow now healthier banks to attract new sources of private capital and get back into the game of lending to valid customers.

While such purchases will occur, the program is now more likely to follow the European model. Neel Kashkari, the U.S. Treasury official overseeing the \$700 billion rescue of the financial system, said government equity injections will be aimed at "healthy" firms. The govern-

ment will essentially buy stock (inject capital) into numerous U.S.-based financial institutions (www.bloomberg.com).

"We are designing a standardized program to purchase equity in a broad array of financial institutions," Kashkari said in a speech in Washington. "The equity purchase program will be voluntary and designed with attractive terms to encourage participation from healthy institutions."

Success?

As noted previously, it is the unfreezing of extremely scared credit markets that is crucial to minimizing the domestic (and possibly global) recession. A viable flow of credit among and between major financial institutions is mandatory. A viable flow of credit from financial institutions to their business customers and consumers around the country and around the globe is also mandatory. We'll see in coming days how credit markets respond...

...stay tuned



"TEA"ser

Those are my principals. If you don't like them...I have others.

—Groucho Marx



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capitulation must be reached before a stock market bottom is established. Capitulation is typically defined as that point where highly emotional sellers will dump stocks at almost any price to simply get out of the market.

Such markets involve extremely high levels of emotion (especially panic). Market technicians see such panic selling as finally eliminating many "potential" sellers from the market and thereby quickly providing very attractive buying opportunities...

...whether we reached that point of capitulation last Friday when the Dow briefly traded below 8000 is being hotly debated at this time

The Shifting \$700 Billion Program

The U.S. Government's \$700 billion Emergency Economic Stabilization Act finally made it through the Congress on Friday, October 3. It was quickly signed into law by the President. It is already changing in scope.