Merrill Lynch reports billions in losses amidst growing signs of US recession

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Merrill Lynch & Co., the world's largest brokerage firm, reported a net third-quarter loss of $2.4 billion Wednesday and acknowledged writing off $8.4 billion in assets from failed investments in subprime mortgage-linked securities.

The massive write-off exceeded the Wall Street giant's net earnings for all of 2006. It equals about one-eighth of the investment bank's total market capitalization.

The announcement sent shock waves through Wall Street, setting off a sharp decline on the New York Stock Exchange that was only reversed when data showing a continuing decline in the housing market persuaded traders that the Federal Reserve Board would impose a further cut in interest rates when it meets next week.

The impact of Merrill Lynch's bleak report was magnified by the fact that only two-and-a-half weeks before Chairman and CEO Stanley O'Neal had estimated that the firm's write-off resulting from the meltdown in the housing and credit markets would total $5 billion—a huge sum, but considerably less than the $8.4 billion the company reported on Wednesday.

Merrill's shares plunged 6.3 percent and all of the major rating agencies downgraded the company's credit. A spokesman for Standard and Poor's called the $2.4 billion loss "startling" and the write-off "staggering."

Merrill's disastrous financial report is only the sharpest expression of a general crisis gripping the biggest Wall Street commercial and investment banks. It is further evidence that the credit crunch which erupted over the summer is symptomatic of a deep-going crisis of the American and global financial system—one whose dimensions and consequences are only beginning to unfold.

In recent weeks, virtually all of the major Wall Street banks have reported sharp earnings declines for the third quarter, including a 32 percent drop for Bank of America and a 61 percent decline for Bear Stearns, two of whose hedge funds collapsed last August.

Billions have been written off by the biggest banks: $5.9 billion by Citigroup, $3.4 billion by USB, $2.4 billion by Morgan Stanley, $1.7 billion by Goldman Sachs, $1.6 billion by Bank of America, and $1.6 billion by JP Morgan Chase.

Merrill has suffered the biggest hit because, of all the Wall Street firms, it was the biggest underwriter of so-called collateralized debt obligations, or CDOs. These are bank loans, usually tied to subprime mortgages and other highly risky investments, that are divided up, bundled, repackaged and resold to big investors.

Annual issuance of CDOs, which was just $52 billion in 2001, hit $388 billion in 2006.

In the real estate and leveraged buyout-driven speculative boom from 2003 to early 2007, CDOs were used to inflate a credit bubble that imploded last summer, largely as a result of the sharp downturn in housing sales and prices, and the consequent surge in home mortgage defaults. All of the major banks raked in huge profits in fees and other income derived from investments in high-risk and therefore high-yield ventures—a process that could continue only so long as the credit-worthiness of these financial manipulations was not called into question.

The funneling of resources into these parasitic operations, while the productive base and infrastructure of society were starved of resources, benefited the financial elite, further expanding their already immense personal fortunes. Merrill CEO Stanley O'Neal, for example, was paid $51 million last year.

Now the financial crisis is reverberating throughout the general economy, threatening the jobs, homes and livelihoods of tens of millions of people.

On Thursday, Bank of America announced that it was downsizing its investment banking unit and eliminating 3,000 jobs, signaling the beginning of mass layoffs throughout the financial sector. Tens of thousands have already been laid off by mortgage companies crippled by the collapse of the housing market and the soaring rate of mortgage defaults and home foreclosures.

According to the *Wall Street Journal*, jobs cuts are expected at Bear Stearns, Citigroup and JP Morgan Chase.

The housing crisis shows no signs of abating. On the contrary, recent reports indicate that the worst is yet to come.

The National Association of Realtors reported Wednesday that existing home sales fell by 8 percent in September from the August level. September's annual rate of 5.04 million sales was well below Wall Street expectations of 5.25 million. The September pace was the lowest in 19 years, since the association began accounting for combined single-family and condo sales.

Median home prices continued to fall and inventories of unsold homes rose to the highest level in nearly twenty years. Existing home sales tumbled in all regions. Sales dropped 7.0 percent in the Midwest, 10.0 percent in the Northeast, 9.9 percent in the West, and 6.0 percent in the South.

The Commerce Department reported Thursday that new home sales recovered slightly in September, but simultaneously revised its figure for August to record a steeper decline than previously reported for that month.

Sales of single-family new homes increased 4.8 percent last month to a seasonally adjusted annual rate of 770,000. August new-home sales fell 7.9 percent to an annual rate of 735,000. Originally, the government had said August sales were on track to rise 795,000 for the year.

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Year over year, new-home sales were 23.3 percent lower than the level in September 2006.

The overall increase in new home sales was entirely due to a 37.7 percent rise in the West. All other regions registered declines, from 0.5 percent in the South to 6.6 percent in the Northeast and 19.5 percent in the Midwest.

The collapse of home sales has been the sharpest in those regions which saw the biggest real estate boom. Home sales in the Orlando, Florida area, for example, declined 55 percent in September from a year ago. Sales in six southern California counties—Los Angeles, Riverside, San Diego, Ventura, San Bernardino and Orange—in September were down 49 percent from a year ago and the lowest for at least 20 years.

At the same time, commercial construction, which had remained relatively strong while the residential sector was plunging, showed signs of slowing in September. The McGraw-Hill Construction report forecast that spending on commercial and manufacturing buildings, such as offices, warehouses and hotels, will decline 7 percent next year, in dollar volume, and 10 percent in the number of square feet of space built.

Since March of 2006, the housing business has shed 383,000 jobs. But that figure is set to rise sharply. Jan Hatzius, chief United States economist at Goldman Sachs, said, "You still have a million jobs that aren't really needed anymore due to the downturn in housing."

The combined crises of the housing and credit markets are generating a downward spiral that leads inevitably to recession—possibly a very deep and protracted one. Mortgage defaults and home foreclosures are soaring, undermining the credit markets and driving down home prices. As a result, home owners are no longer able to use the equity in their homes as a source of credit, and in many cases the market value of their homes has dipped below their outstanding mortgage debt.

Banks and mortgage companies have responded by tightening their loan policies, further restricting home purchases, driving up unsold home inventories, and further depressing home prices. Most economists predict that US housing prices will fall about 7 percent this year and a similar amount in 2008, but some estimate the decline could be 20 percent or higher.

At some point, the decline in home values will sharply impact consumer spending, which over previous years was bolstered by the rise in home prices.

New national data from Equifax Inc. and Moody's Economy.com show that the mortgage delinquency rate jumped to 3.4 percent in the third quarter from 2.4 percent a year earlier.

A report issued Thursday by the Joint Economic Committee of Congress predicted about 2 million foreclosures by the end of next year on homes purchased with subprime mortgages—four times the rate predicted by the Bush administration in September.

According to some estimates, there is $1.3 trillion in outstanding subprime mortgages, of which 14 percent are expected to default. This computes to a loss of $182 billion. But subprime mortgages account for only a tenth of the value of all outstanding mortgages, and the crisis is by no means limited to the subprime sector. In the next 18 months, interest rates on more than 2 million home loans will reset to higher adjustable rates, suggesting that the rate of defaults and foreclosures will rise.

The *New York Times* on Thursday provided an indication of the staggering levels of wealth that stand to be wiped out by the housing and mortgage crisis. The newspaper wrote:

"At this juncture, economists say the troubles in the mortgage market could, all told, cost financial firms and investors up to $400 billion. That is far more than the roughly $240 billion cost, adjusted for inflation, of the savings and loans crisis of the early 1990s.

"The loss in total real estate wealth is expected to range from $2 trillion to $4 trillion, depending on how far home prices fall... Experts caution that these estimates are preliminary and the total costs could get bigger still. They also note that the loss of real estate wealth could prove more damaging for the general public than falling stock values [after the stock market crash of 2000-2001] because many more American families own homes than own stock."

One result of the crisis, the *Times* pointed out, is close to a billion dollars in lost property tax revenues to state and local governments.

The crisis, moreover, poses a threat to the pensions and retirement savings of millions of working Americans. The *Wall Street Journal* reported last week that the attorneys general of Alaska and Idaho are looking into possible legal action against State Street Corp., the Boston-based financial services giant, whose State Street Global Advisers unit handles $1.9 trillion in assets.

The state retirement funds of Alaska and Idaho posted losses over the summer from investments in two "enhanced index" bond funds run by State Street. Billed as low-risk vehicles, the funds made aggressive bets on mortgage-backed securities, derivatives and other exotic, high-risk securities.

And earlier this month, a unit of insurer Prudential Financial Inc. sued State Street over $80 million in losses that 165 retirement plans it manages suffered in State Street fixed-income funds. Prudential charges that State Street didn't disclose that its money was in "highly leveraged" investments.

The *Journal* reported: "The states' and Prudential's losses show that individual investors may be facing hidden risks from the subprime and credit mess in their retirement accounts, and also highlight the proliferation and potential pitfalls of the unregistered and often opaque investment vehicles in some employee plans."

In what is, if anything, a serious understatement of the potential impact of such financial swindles on working families, Alaska's attorney general said the retirement fund losses resulting from State Street's failed investments "may delay retirement for some people."

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