

## Starbucks, the "Core," and Conventional Mortgages:

This week's announcement that Starbucks plans to close 600 stores and fire 12,000 employees is emblematic of the major restructuring that lies ahead for the deeply maladjusted U.S. Bubble Economy. Throughout the real economy, businesses that had previously luxuriated in robust profits during the Credit and asset inflation-induced boom now see earnings and cash-flows rapidly erode. During the boom, Starbucks aggressively spent on capital expenditures, while expanding its employee base, product offerings, and real estate commitments. "Money" was easy, revenues were easy, and growth was easy.

For the economy overall, the enormous expansion of mortgage (and other) Credit poured spending power throughout, especially in the "services" sectors. This purchasing power was "multiplied" by additional borrowings by the likes of Starbucks and others, as well as by the real estate developers borrowing, building and leasing space to tens of thousands of coffee shops, retailers, restaurants, hotels, casinos, nail salons, health clubs and such. It amounted to a historic borrowing and "investment" boom in building out a massive consumption/services-based infrastructure. Now, with the Credit Bubble having burst, the economic viability of broad swaths of this economic structure is in question.

Years of Credit, asset price, and consumption-based investment inflation created a deeply ill-structured real economy. Simplistically, the U.S. Bubble economy was structured for a particular variety of inflation. As long as Wall Street could inflate mortgage and other asset-based Credit, along with real estate and stock prices, additional purchasing power would be created and distributed for spending throughout the economy. Sufficient business and government cash flows ensured adequate household income growth to go along with booming – and self-reinforcing - asset price gains. As such, Household Net Worth (asset values less liabilities) swelled by about \$4.0 TN annually for the finale Bubble years 2003-2006.

And as the "world's reserve currency," our Credit system was able to generate endless new (and mostly top-rated) financial claims that so easily financed our import buying binge. Meanwhile, with business profits generated with such ease in the booming finance, consumption and asset sectors of our economy, the U.S. and global Credit booms worked deleteriously to hollow out our nation's manufacturing base. But what difference did it really make if the economy's "output" were goods or services?

For years, we've protested this combination of over-investment in consumption-based infrastructure and the hollowing of manufacturing capacity. And for the longest time, most have scoffed at our analysis and pointed to the rising stock market and generally inflating asset prices as indicators of the efficiency, productivity, and profitability of the so-called New Economy. We warned of the eventual perils of over-borrowing and the lack of household savings, while Alan Greenspan and others argued that it didn't matter because we had become so efficient at investing our limited savings. Besides, the world would

always seek the superior quality and liquidity of our securities markets.

Yet the optimists failed to recognize that only massive – and increasing – amounts of system Credit would sustain the inflated boom-time asset prices, household incomes, corporate cash flows, and government receipts that had become essential for levitating the various facets of the Bubble Economy. The deteriorating quality associated with the massive inflation of our financial claims should have been obvious. And today - as symbolized by Starbucks - the required Credit stimulus is no longer forthcoming, leaving scores of enterprises throughout the economy attempting desperate measures to cut expenses and maintain viability.

The finance, automotive and airline industries are also notable for having come to rely on a very different inflationary environment than the one we face these days. And today's unfolding retrenchment will place only further downward pressure on business profits, household incomes, asset prices, and government receipts - forcing additional spending restraint and deeper retrenchment. At the same time, this self-reinforcing retrenchment will create only greater financial strain on an already impaired Credit apparatus, ensuring even greater Credit troubles and tighter Financial Conditions, especially for the business sector.

And to attempt a response to the above question: What difference did it really make that our economy's "output" was services rather than goods? It made a huge difference. At the end of the day – at the conclusion of the Credit boom - a finance and consumption-based economy is left with enormous financial claims backed by woefully inadequate wealth creating assets. During the boom, Starbucks could earn seemingly endless profits by selling \$4 lattes. The stock price went to the moon; financial wealth was abounding. Now, with discretionary spending being sharply reduced by the confluence of sinking asset prices, tightened Credit, and inflating energy and food prices, the enterprise value of Starbucks and scores of other businesses has been greatly diminished. Worse yet, for the economy overall, there is little in the way of real economic value remaining for billions of "output" Starbucks and other services providers created over the long boom. Only the financial obligations (the original asset-based borrowings) remain, while the market is increasingly suspect of their true state of underlying quality and value.

And the harsh reality is that Starbucks is a microcosm of scores of enterprises that have come to comprise the Core of the U.S. Bubble economy. The economic viability of so many businesses – and even industries – will be in jeopardy in the unfolding Credit and financial landscape. The stock market is still in the early stage of discounting the unfolding Credit and economic bust. And I'll reiterate that we expect the unfolding economic adjustment to be of such a magnitude as to be classified as an economic depression as opposed to a more typical recession.

June 27 – Bloomberg (Simon Kennedy): "U.S. and European central bankers are intensifying pressure on counterparts in emerging-market countries to step up the fight against inflation. Federal Reserve Vice Chairman Donald Kohn yesterday urged countries where 'rapid' economic growth is elevating prices to respond. Hours earlier, Bank of England Governor Mervyn King said

global monetary policy looks 'a little lax.' Bank of France Governor Christian Noyer said the day before that 'coordinated, resolute action' is needed to encourage more exchange-rate flexibility as a way of tackling inflation. The comments reflect concern among central banks in major industrialized economies that their own campaigns against inflation will be undermined by a failure of others to combat price pressures. Demand in emerging markets is already propelling the cost of commodities such as oil, tin and corn to records. 'The bulk of inflation is coming from emerging markets,' said Stuart Green, a global economist at HSBC... 'The concern in developed economies is that inflation is rising because of pressures outside of their remit and that monetary policy overseas is too loose.'

"The reasons for the trajectory and persistence of increases in prices of food and energy this year, as global growth has moderated, are not entirely clear. The upward trend in prices of food and energy over the past several years, however, importantly reflects the pressures posed by rapidly growing demand in developing economies against relatively inelastic global supplies of commodities." Fed Vice Chairman Donald Kohn, June 26, 2008.

"We are living through the unthinkable... The list of casualties is very different. What has suffered most is the credibility of the most sophisticated financial systems in the world." Mohamed El-Erian, Pimco Co-CEO, June 25, 2008

Now that inflation manifestations have shifted from asset prices to energy, food and general consumer prices, the finger pointing has begun. I am compelled to return to my old "Core" versus "Periphery" analysis. As Mr. El-Erian is suggesting, the "Core" of the global Credit system is in the process of being Discredited. To be sure, the world is increasingly loath to accumulate additional "Core" risk assets. Especially in the case of dollar financial claims, this major devaluation and, increasingly, revulsion is tantamount to a major inflation in the pricing of energy, metals, food, and myriad resources that are in increasingly global short supply.

This supply shortage is related to at least two now powerful dynamics. First, there are the booming emerging economies at the "Periphery" – booms largely fueled by unfettered Credit systems and acute inflationary forces unleashed initially by runaway Credit excess at the "Core." And, second, there is today's acute speculative excess in almost anything energy and resource related. This is also a consequence of Dysfunction at the Core, namely the massive U.S. Current Account Deficits and resulting Rapidly Expanding Global Pool of Speculative Finance coupled with the Discrediting of Wall Street Finance. There is today much too much global liquidity (running away from sophisticated financial instruments while) chasing too few global resources whose supply is not easily expanded ("inelastic").

I find it rather incredible that U.S. and European policymakers are increasingly pointing blame and calling upon their emerging economy cohorts to aggressively combat inflation. With the U.S. today stuck with intractable \$700bn Current Account Deficits and European Credit systems still churning out double-digit Credit growth, the Periphery is not the root cause of today's escalating global inflationary pressures. The global Credit system has run amuck, a process that

evolved from years of Credit and speculative excess generated by, and tolerated at, the Core. It is today unreasonable to expect the Chinese or Asians generally to bring their booming economies to their respective knees to fight global inflation anymore than we can expect the Fed to tighten the economic screws to the point of balancing our Current Account and punishing the destabilizing speculators.

Today's inflationary dynamics have been developing for decades. Only discipline and stability at the Core of the global financial system would have stemmed the strong inflationary bias of contemporary electronic fiat "money" and Credit. But the Core was instead egregiously undisciplined and unstable, setting the stage for the type of runaway inflation we are now experiencing. The Core came to love and rationalize asset inflation and consumption. The Periphery was forced along for the ride and happy to oblige.

And now we find ourselves in the midst of another leg down with regard to the credibility of U.S. (and, increasingly, British) financial assets and economic structures overall. And while recent market tumult has not had the intensity of March's acute de-leveraging, the ramifications of recent developments are more problematic. For one, the markets are now coming to grips with the reality that much of the massive apparatus of various types of Credit insurance is insolvent and has little chance of recovery. While the nature of these companies' obligations may not require bankruptcy filings in the near-term, the market nonetheless recognizes that much of the future protection guaranteed by these companies/financial players has become worthless.

The "monoline" insurers do not have the resources to fulfill their huge future obligations. The players behind the Credit default swap (CDS) marketplace do not have the wherewithal to fulfill their unfolding obligations. And the mortgage insurers do not have the resources to pay their share of the rapidly escalating costs of a historic real estate bust. And if the mortgage insurers are indeed bust, the GSEs have a major dilemma. Not only do they have very large exposures to these firms, the entire "conventional" mortgage market is at great risk to any insurance-related dislocation. If much of the "private mortgage insurance" industry loses its capacity to write new policies – or if this insurance is no longer trusted by the agencies or the marketplace – this would be tantamount to a major tightening in the thus far bullet-proof "conventional" mortgage market. Or, said differently, if significant down payments come to be required for GSE-related mortgages the effects will be felt immediately in neighborhoods all across the country – not to mention the acutely vulnerable consumption-based U.S. Bubble economy.

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