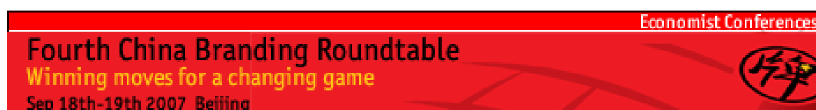

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The credit squeeze

Abandon ship

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Investors sail into a credit storm amid worries about the debt markets

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THE symbolism is almost too perfect. According to TheStreet.com, a financial website, John Devaney, a hedge-fund manager, has put his 142-foot yacht *Positive Carry* up for sale, along with his 16-bedroom mansion in Aspen, Colorado. Funds run by Mr Devaney's group, United Capital, have had to halt payouts to investors after making heavy losses on mortgage-backed bonds.

Ironically, Mr Devaney's early life pointed to the excesses that were to come. He used his student credit card to buy a house, on which he took out a second mortgage. But Mr Devaney's recklessness was not unusual in the recent global debt bonanza, where rash lending became commonplace. Bank executives will be haunted by memories of Ninja loans (to people with No Income, No Job or Assets) and Pik toggles (agreements that gave firms the right to pay interest in the form of further IOUs rather than cold, hard cash).

Hedge-fund managers, such as Mr Devaney, were happy to borrow money to buy those loans because they made the "positive carry" that he boasted about; ie, the return on their holdings was greater than the cost of financing them. What they forgot was that relying on positive carry alone comes with a risk: that the debtor will not repay the loan.

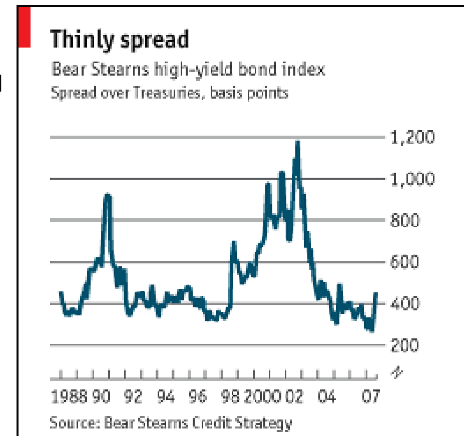
Now, at last, investors and lenders have woken up. Credit spreads, the premium that riskier borrowers must pay over government debt, have surged since June. That is a problem for companies and banks in the middle of doing deals. Financing packages for the takeovers of Alliance Boots, a British health-care chain, and Chrysler, America's third-biggest car giant, have been postponed. Merrill Lynch says some 35 bond or loan deals have been cancelled or restructured in the past five weeks. And it is not just the riskiest borrowers that have been affected. Globally, only $98 billion of investment-grade bonds (to the most creditworthy borrowers) were issued in July, the lowest since August 2004.

The stockmarket has reacted with alarm to this credit squeeze, partly because it was counting on a continuous stream of debt-financed takeovers to push share prices higher. That confidence has now gone, and with it the

market's swagger.

The change in mood was swift. On July 19th, the Dow Jones industrial average closed above 14,000 for the first time. By July 27th investors were as risk averse as at any time since September 2001, according to UBS's risk index. But for all the nervousness, there has not (yet) been a calamitous decline in share prices. In percentage terms, the 311-point fall in the Dow Jones Industrial Average on July 26th was only the 698th largest in history. The Dow has yet to fall 10%, the level that qualifies as a correction in market lore.

As for credit markets, the remarkable thing is the low level of spreads before the sell-off, rather than where they are now (see chart). Spreads would have to double to get back to the levels of the early 1990s and almost triple to be where they were after Enron and WorldCom collapsed in 2002. And thanks to lower yields on government bonds (as investors sought out safer assets), the price of debt for companies with a Baa rating from Moody's is little changed from mid-July, according to the Federal Reserve.



Many companies have no need to borrow. Corporate profits are still rising, although at a slower pace than in recent years. Jan Hatzius of Goldman Sachs points out that American companies overall have enough cashflow to cover their capital expenditure.

Nor are firms having problems paying back their existing debts. According to Jim Reid of Deutsche Bank, the global default rate is 1.38%, near the bottom of its historical range. Standard & Poor's, a ratings agency, had 621 bonds on standby for a downgrade in mid-July; that was slightly below the 12-month average.

As a result, the latest bout of investor caution might have only modest repercussions for business investment. It might even do some good. Richard Berner, an economist at Morgan Stanley, suggests that as the terms of acquisition finance become unfavourable, companies might think less about buy-outs and switch their energies to growing businesses through capital spending. If so, greater caution in the financing of leveraged buyouts (LBOs) could even boost the economy.

Yet the dire situation in America's housing market cautions against a too sanguine view of the latest credit events. There, the deadly combination of loose lending practices and higher interest rates has created a prolonged, and ever-deepening, bust.

Residential construction has plunged and house prices have fallen. Mortgage defaults have soared, particularly among the least credit-worthy subprime borrowers. Home-owners who took out mortgages at cheap introductory rates face sharply higher payments as these loans reset. There have been plenty of financial-market casualties. The latest was American Home Mortgage Investment, a largish lender which this week said it would no longer fund home loans.

And there is almost certainly worse to come. With demand weak and the stock of homes for sale close to its highest level for 15 years, prices are likely to fall further. Tighter lending standards will reduce the supply of new homebuyers, putting further downward pressure on prices. This squeeze (along with higher petrol prices) has already dampened consumer spending—and is likely to continue doing so.

Small wonder that financial markets have decided that monetary policy may soon be loosened. Few expect the Federal Reserve to cut short-term interest rates, which are currently at 5.25%, at its next meeting on August 7th. But judging by the prices of federal funds futures, a rate cut this year—barely considered a possibility at the beginning of July—is now priced in as a virtual certainty.

In fact, markets may be too optimistic about the odds of a cut. Americans' domestic spending may be weak, but the strength of the global economy has boosted exports. With unemployment low and oil prices high, the central bankers are still worried about inflation. Provided it does not unduly disrupt financial markets, the Fed probably welcomes the repricing of credit risk.

That is a big change from 1998, when the fallout from the Asian financial crisis and Russia's debt default reached a critical level, prompting the central bankers to cut rates quickly. At that time, much of the developing

world was in recession and the American economy was the mainstay of global growth. The Fed could rely on the deflationary impulse from abroad to contain price pressures. Today the world economy is growing strongly, despite the weakness in America.

This point was underlined by the IMF's most recent forecasts, released on July 27th. The Fund cut its projections for America's GDP growth this year from 2.2% to 2%, but raised its forecast for global growth from 4.9% to 5.2%. Even if financial markets are in thrall to events in America, the world is less dependent on its economy.

The moderation

For all that, financial markets could still create even nastier economic problems. That is mainly because of the large, and ill-understood, debt piles they have generated. Ironically, the greater stability of the world economy may be to blame. The absence of severe recessions or abrupt shifts in monetary policy has made investors more confident, and thus more willing to borrow. Greater confidence has driven down yields as investors needed less compensation for risk. As a result, hedge funds that promise high returns (especially after deducting their substantial fees) need to take outsized bets to deliver.

Ever-innovative financiers have given hedge funds new tools to double up their bets. Credit derivatives have made it easier to separate the credit risk (the danger of default) of bonds from the interest rate risk. They have also allowed investors to make big bets, despite putting little money down. And they have widened the range of investors who can get involved in risky asset classes, such as subprime mortgages and junk bonds.

Traditionally, many stodgy investors, such as pension funds, steered clear of such things because they lacked an investment-grade rating. But banks can now bundle together risky assets into collateralised-debt obligations or CDOs. The CDOs slice and dice these debts to suit potential investors. The riskiest tranche, known as equity, earns the highest return but takes the first hit from any defaults in the underlying portfolio. By adding other tranches on top, each taking progressively less risk, it is possible to create a security that the rating agencies place in the coveted triple A class from a pile of junk bonds.

Fine in theory, but only now are these new instruments being tested. And some are flunking. Defaults in the 2006 vintage of subprime loans have been much higher than expected. The riskiest mortgage-backed securities trade at around 40 cents on the dollar. This has rippled through to the CDO market, prompting the near-wipeout of two Bear Stearns hedge funds.

The problems at Bear Stearns triggered the current market decline. Investors were surprised by the scale of the losses and the time it took for them to emerge. And attempts by Merrill Lynch, one of the prime brokers to the Bear Stearns funds, to sell some of their assets showed how illiquid the market for such securities had become. The security in credit derivatives, it seems, is not so certain after all

Then there are the banks themselves. In theory, the derivatives markets have strengthened the financial system, by allowing risk to be dispersed away from the banks. But banks still have two vulnerable points. The first is the period between their agreement to launch a deal and its subsequent sale to investors. The fees for arranging deals, particularly the LBOs beloved by private-equity firms, are highly attractive. So banks have used their capital to underwrite such deals (see article). Suddenly, they have found they do bear the risk after all.

Then there is the link to hedge funds. Ever since the demise of Long-Term Capital Management in 1998, regulators have worried that banks might lend too much to individual funds. But the Bear Stearns debacle shows that banks may also have to stump up capital to rescue hedge funds within their own stable. Bear had to promise an additional $1.6 billion of collateral to the funds' prime brokers.

All this puts banks in a dilemma. Prime brokers, the arm of investment banks that deals directly with the hedge-fund sector, are imposing tougher lending terms to protect themselves against the risk of collapse. But the bond-syndication arms of those same banks need hedge funds to buy the debt they issue on behalf of their corporate clients. Tighter lending standards may, in effect, be cutting off their noses to spite their faces.

At the moment, most banks' balance sheets look pretty secure. The latest figures from the *Banker* magazine show that among the world's top 1,000 banks, Tier 1 capital—the most reliable liquid sort—rose by 18.3% last year. And Kevin Gardiner, of HSBC, says that profits forecasts for banks are still being revised higher.

But things could easily get nastier. And it is already clear that the titans of Wall Street and London will face a tricky summer. Holidays in the Hamptons and Tuscany will be cancelled. And more yachts will be put up for sale.

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