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Market turmoil

A good time for a squeeze

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Tighter credit conditions are just what the markets need

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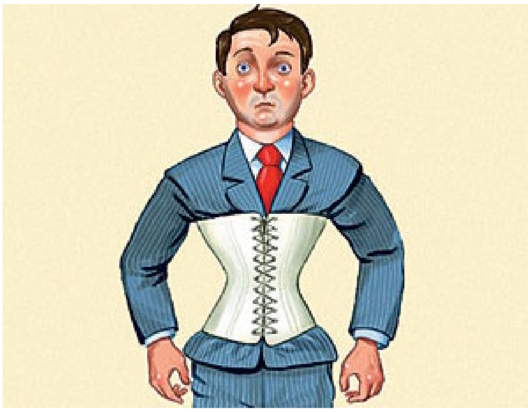

BANKERS and investors might not agree, but the recent sell-off in financial markets is good news. It may, at last, have brought people to their senses. For the past few years, too much money has been lent too cheaply and too easily to too many people, whether it was speculators trying to make a fast buck in Miami condominiums or private-equity groups financing their latest multi-billion-dollar takeover. This wake-up call came too late to save the American housing market from frenzy and subsequent bust. But it may have arrived in time to stop the takeover boom getting out of control—and when the world economy is strong enough to cope with the consequences.

Watch out for the American consumer

The big question now is how serious those consequences are likely to be. The impact on debt markets themselves will be big (see article). As standards are tightened, many of the reckless practices that have become the norm in corporate lending will be abandoned. We will now hear a lot less about firms getting "covenant lite" loans, under which lenders give up their rights to monitor the behaviour of borrowers; or "payment-in-kind notes", which allow borrowers to substitute more IOUs for interest payments. As investors steer clear of riskier debt, the takeover bids that have pumped this year's stockmarket froth will be curtailed and the most debt-laden borrowers may find it impossible to raise funds.

But most companies will be able to shrug off the credit squeeze. That is partly because creditworthy borrowers still have access to debt (albeit at a higher price), and partly because many firms don't have to borrow. Across the rich world, firms are flush with cash. Their profits have been fat for the past five years and, on average, companies have been funding their capital spending from their own resources. Credit wobbles by themselves, therefore, need not prompt an investment slump.

Other potential victims also seem well-prepared. Emerging-market bonds and shares, for instance, may jitter further. That could spell trouble for a few countries, such as Turkey, which have large current-account deficits (see article). But most emerging markets are in far better shape than they were during the financial crises of the late 1990s. They have restructured their borrowing and often built up vast coffers of foreign-exchange reserves.

The biggest risk to the global economy probably lies with debt-laden American consumers. They have been battered by falling house prices and expensive petrol, and their spending growth has already slowed sharply. A credit squeeze will aggravate the housing bust and falling house prices could drag spending down further. But the rest of the world is growing strongly and unemployment in America remains low, so a recession there is by no means inevitable. What's more, if the economy were to head downhill fast, the Fed, despite its public worries about inflation, has plenty of scope for cutting interest rates.

All told, the credit wobbles so far are likely to have only modest economic consequences. But what if they prompt a broader market meltdown? After all, many of the newfangled instruments that dominate today's debt markets have never been tested in a serious panic. Credit derivatives have probably improved the stability of the global economy by dispersing risk, but it is no longer clear where that risk is being held. And many of the new risk-dispersing instruments are so illiquid that trouble may not emerge for some time. It was several months after the subprime mortgage market turned sour before the scale of the losses at two Bear Stearns hedge funds became clear.

Investors are right to worry about more hedge-fund failures. Yet although these highly leveraged creatures seem to have made credit tremors more sudden and more frequent, these episodes have not been more calamitous. The past 18 months have seen two other credit wobbles, albeit on a smaller scale: one in May 2006 when investors worried about inflation; another in February this year, when fears about subprime mortgages first surfaced. In each case, the most exposed hedge funds had to cut their positions quickly. But thanks to the size and diversity of the hedge-fund industry, others moved in to buy the assets cheaply. The same dynamic seems to be playing out this time too (see article).

For all the hand-wringing about hedge funds and complicated derivatives, the real worry comes from a well-known source—the banks. They will face trouble on several fronts and it is they who could turn a healthy credit squeeze into a nasty crunch. Many banks have already agreed to underwrite deals and are finding that they cannot sell the debt on to investors. One estimate suggests that more than $300 billion of debt is already in the pipeline. Big losses could follow.

Banks will also suffer from their exposure to failed hedge funds, just as some have already been hit by their exposure to the subprime mortgage market. Some banks may have as-yet-undisclosed losses on their own accounts: trading in financial markets has become an increasingly important source of their profits in recent years. If banks' profits collapsed, they would become more reluctant to lend. A bank failure (or the fear thereof) could create a systemic panic.

A plump cushion

Yet although banks are the biggest worry, their balance sheets look fairly solid. America's commercial banks bought back $58 billion-worth of their shares in the year to March, suggesting they have capital to spare. And although banks' shares have tumbled over the past few weeks, analysts are still forecasting higher profits for the year ahead. If the solidity of bank finances is to be tested, the markets have chosen a good time to do so.

Credit cycles are unpredictable creatures. Things could still go badly wrong. So far, though, the financial wobbles, however unnerving, look like a healthy repricing of risk. Markets, much like people, sometimes need a good squeeze.