

...AND THE WOLF EVENTUALLY COMES...

(THE FORTHCOMING COLLAPSE CORRECTION OF THE GLOBAL FINANCIAL MARKETS)

The author of this article is a coward. Moreover, he is a coward without a crystal ball. As a result, for fear of being ridiculed and ostracised, he has chosen this modest subheading, at the very last minute changing "collapse" to a less controversial "correction". However, the controversy is not really about whether and how one chooses to view or ignore the state of the financial markets. The controversy is in the general blissful complacency surrounding these markets despite massive budget deficits, the loss of jobs to Asia, the deteriorating geopolitical situation, and supercharged price growth for all commodities — from zinc to palm oil. From time to time, over the last two to three years, a lonely "bear" would raise a voice shouting "Wolf! Wolf!" but the wolf did not come, and the hapless "bear" would retreat into a deep hole followed by angry booing from the investment community.

Why has not the wolf come to huff and puff and ruin the flimsy walls of the global financial markets, despite all the recent wars, oil price spikes and global imbalances? The answer is: liquidity. The avalanche of liquidity — cash and cheap credit — has proliferated into every thinkable and unthinkable corner of the financial world. Officially, liquidity — the combination of the free cash flows generated by companies and spare cash owned by individuals — has been growing at 9% per annum, three times the growth in the world economy. This is bad enough as it is, reminding us of a textbook definition of inflation: too much money chasing too few goods. However, this definition does not take into account even greater liquidity sloshing around the financial system, outside corporate and personal coffers. All this liquidity has been created by the non-concerted efforts of several central banks, either by keeping interest rates low (ie well below the

rates of return on capital, which can be earned by the companies or even individuals), or by simply printing money (something the Japanese Central Bank has been engaged in for years). There are estimates that demonstrate that the US Federal Reserve has pumped around \$3 trillion of cheap credit and cash into the global financial system over the last three years. The amount of yen liquidity created during the last decade of the Japanese economy's weakness cannot be imagined even in our wildest dreams.

The problem is: no one really knows how much liquidity has been created by any individual country, let alone globally. In paranoid fear of a recession, the world's central banks have enthusiastically embraced the neo-monetarist theories prescribing that the money supply solves everything. Paradoxically, there is no place for actual money in these theories, as a result of which a number of countries have stopped publishing money supply indicators (completely abandoning all controls



over such supply). The new theories recognise only interest rates as a true measure of all things: interest rates are to be set by the central banks in such a manner as to avoid both recession and inflation. What happens to the monetary mass — volumes of lending, patterns of consumption, savings rates and other economic fundamentals — is a secondary consideration, if important at all. This is, of course, a simplification but the proof is in the pudding, and the pudding looks increasingly overcooked.

The conundrum is: why has all this credit and monetary accommodation not yet resulted in runaway inflation? The answer is: to an extent, it actually has. Most of the officially employed inflation indicators these days exclude house prices, the effect of fuel prices, foods and many other important goods and services. As we know, these are precisely the aspects, where inflation has been felt by the general populace. Nevertheless, there have been significant mitigating factors:

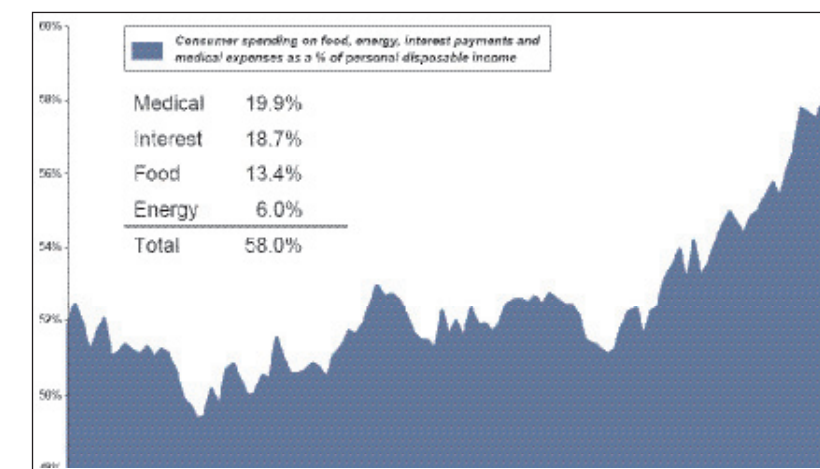
- ▲ Growth in productivity in both the main industrialised countries and the developing economies;
- ▲ The deflationary effect of China

and other Asian countries, where production costs are lower, resulting in lower prices for consumer and industrial goods;

▲ Internet — the great leveller, which has eliminated many a distributor or intermediary and brought goods and services direct to the consumer.

Inflation has found its way into the housing market, with the price of properties reaching exorbitant heights. More importantly and less noticeably for consumers, it has penetrated the financial markets, boosting asset values — the prices of bonds, equities, loans and their derivatives — to unsustainable levels. Whether this inflation will finally filter through to consumer markets — is unclear. The diagram below shows that the level of consumer spending by US households, as a direct result of very low (until recently) US interest rates, is the highest in more than 25 years and is clearly unsustainable. Note that it shows only interest on borrowings and not the repayment of principal. Any upward shift in interest rates and/or acceleration of principal repayments would cause a reduction in consumer spending. This would prevent an

Source: Federal Reserve Board and Bureau of Economic Analysis



inflation spill-over but, at the same time, would lead to an economic slowdown.

What is clear, though, is that this “non-consumer” inflation will eventually cause a major upheaval in the financial markets, which will probably consist of a series of corrections across different segments of financial markets and significant re-pricing of risks.

What are the main factors, which are exacerbating these imbalances and which will contribute to such “corrections” in the global financial markets? They are all rooted in liquidity and manifest themselves in the following excesses:

1. Uninhibited global currency arbitrage (“carry trades”);
2. Search for yield and the resultant mispricing of risk;
3. The derivatives’ bubble;
4. Unchecked growth in hedge funds and private equity.

GLOBALISATION OF CURRENCY FLOWS

All the above factors show, first and foremost, that the current liquidity bubble is a problem stemming from economic globalisation — its defining factor. One major consequence is what the current US Federal Reserve Chairman Ben S Bernanke called a “global savings glut”. Billions of US dollars — bought from Chinese exporters by the Chinese Central Bank at an artificially low, fixed rate (for which purpose the Bank has been printing yuans, of course), as well as billions of dollars received by Middle Eastern oil exporters — are all immediately recycled into US Government obligations, or end up invested in hedge funds and private equity firms. This constant feeding supports the

dollar, despite the avalanches of greenbacks issued by the Federal Reserve. This also permits the US Government to indulge in both tax cuts and a spending spree, resulting in the greatest budget deficit of all time. Mr Bernanke, however, is not unduly concerned about this: after all, he is known for his musings on Milton Friedman’s ideas about throwing cash from helicopters so as to inject liquidity into the economy and avoid deflation. These self-perpetuating excesses rest on two pillars: US and European consumers. For, as long as they buy consumer goods, the cycle will continue. How long will they continue, given rising interest rates and the level of household debt, specifically in the USA?

The addiction of the Japanese Central Bank to printing money as a means of fighting deflation has also gone global. As the yen has been depressed for years now, a new financial *modus vivendi* has developed, whereby speculators (mainly hedge funds) borrow yen at a negligible interest rate (NB: base rate in Japan is 0.25%), use them to buy other currencies in those countries where interest rates are higher, and invest the resultant cash in higher yielding instruments (bonds, loans, even bank deposits). This

leads to two further self-perpetuating trends: the more the yen is borrowed and immediately sold, the lower is the exchange rate of the yen against other currencies. The more cash is injected into financial instruments with higher returns, the lower such returns rapidly become, as the demand for anything bearing a coupon higher than the microscopic interest rates in Japan constantly grows. This is because for such freely tradeable financial instruments demand/supply fundamentals do hold true.

This arbitrage is called a “carry trade” and, until recently, even the mighty dollar was financing such trades. By keeping interest rates below inflation, the US Federal Reserve was effectively paying speculators to borrow dollars.

The yen is currently at its 20-year low and, as can be seen from the diagram below (yen exchange rate vs euro), has not had any meaningful corrections in the last 18 months. However as recently as 1998, unwinding of carry trades pushed the yen up by 18% in just three days. That was almost 9 years ago and has long been forgotten. Will the political pressure on the Bank of Japan to keep interest rates low delay the inevitable rise of

the yen? Inevitable, because Japan is no longer the “sick man of Asia”. It is an economy, which is coming back with a vengeance and will soon dominate the headlines again with a steady return of economic growth, consumer demand and confidence.

The inevitable unwinding of carry trades, which involves hundreds of billions of US dollar equivalents, will cause rapidly increasing losses for those who owe yen. This will also lead to spikes in the yields on various financial instruments: the same people, who owe yen, will have to sell non-yen denominated investments, which will depress their prices and the credit and market risks will no longer be mispriced.

MISPRICING OF RISK

How can the risks be mispriced? Liquidity is again the answer. Money needs to find investments. Too much demand for investments increases their price and drives down returns. In a frantic search for better returns, older and more experienced credit analysts have been pushed aside by the yield-hungry banks and asset managers. At the same time, the new generation of credit analysts, who were not operating through the real recessions of the 1980s and early 1990s, or even during the light corrections of 1997-1998 or 2001-2002, have been blissfully optimistic. And so they should be, as not only have borrowers been able to repay cheap or even negatively priced (in real terms) loans, but even struggling borrowers can now easily refinance their debts at lower cost, thus pushing the problem into the future. In the search for yield, lending standards have been continuously lowered, with highly indebted companies enjoying unprecedented access

to credit. In 2006 the default rate (percentage of companies unable to repay debt) by the riskiest borrowers (sub-investment grade rated companies) was only 1.7%. Will this rate go up if investors are forced to sell bonds and loans to exit carry trades and will lenders continue to provide abundant cheap credit? Suffice to say that in 1990-1991, only 2% of risky issues had the rating of CCC (signifying a 27% probability of default within one year from receiving such a rating). The overall default rate in the sub-investment grade markets in 1991 rocketed to 13%. Note that, in 2006, CCC issues currently amount to 20% of the risky debt spectrum.

Another example: bonds issued by less developed countries currently have the lowest returns in history. Many of them are issued by countries who, in the past, had no qualms about defaulting “on a whim”, let alone when dictated by economic circumstances. This includes Latin American countries, who have recently chosen populist and socialist minded leaders not necessarily holding much respect for international investors. The world is currently nervously awaiting the consequences of a default by Ecuador. However, it is unlikely that its inability to pay will cause any major shocks, as the amount of bonds issued by that country is relatively small. The world needs a series of smaller defaults or one large one to re-assess the emerging markets risk.

And what about the solid, safe, “investment grade” companies? These have also benefited from the search for yield and the hunt for alternative investments. Some have issued bonds with a 50 year tenure: for example, Telecom Italia issued a bond maturing in 2055 and paying a “staggering”

coupon of 5.25%, which yields as little as 1.69% over the base rate. Investing in such, almost perpetual, bonds is a test in itself: some countries, let alone companies or entire industries, ceased to exist over a period of the last 50 years. But why stop there? Some companies actually did issue perpetual bonds with no maturity. And some companies issued hybrid bonds, which allow them to pay interest if they want, or capitalise it if they do not.

And why stop at solid, large corporates? The above mentioned CCC-rated borrowers have also been issuing non-paying bonds or loans, the holders of which are promised a fixed, capitalised amount on maturity — in about 10 years, after all other debt has been repaid (so called Payment-in-Kind bonds or loans). The European sub-investment grade borrowers alone issued as much as €6.7 billion in such PIK instruments in 2006, with the month of January 2007 already seeing close to €1 billion more in issuance.

Credit analysis has been irrelevant for the last four years because anything could be refinanced, repackaged or collateralised. The dinosaurs of the financial markets think that nothing can replace fundamental credit analysis and painstaking review of the borrowers’ market position, growth plans, competitive outlook and financial performance. The new argument rules that something can. This something is called “derivatives”.

THE DERIVATIVES BUBBLE

The author is far from demonising derivatives as “weapons of financial mass destruction” — the phrase famously coined by Warren Buffett. Derivatives can be very complex but they serve only two simple



Source: Bloomberg

purposes: they either 1) represent an insurance contract allowing the original lender to share some of the default or price movement (volatility) risk with other lenders (eg credit default swap); or 2) represent a form of contract, which allows investors to participate in financial instruments usually eligible only for dedicated or specialised institutions (eg collateralised loan obligations permitting non-banks to buy into traditional bank loans). Thus, derivatives either transfer/syndicate the risk or provide an alternative investment exposure for investors keen to diversify their portfolios.

The problem with derivatives is that, like anything investable and tradeable, they have become an end in themselves, far removed from the

two original *raison-d'être*. No longer do the majority of them represent noble asset allocation or risk transfer. Overall volumes are now seen at \$700 trillion — several times the value of the aggregated global domestic product! Whilst hair-raising in itself, when put into context, it is even more chilling: according to some estimates, the volume of default protection — a form of insurance — exceeds \$28 trillion, ten times the value of underlying debt; whilst the repackaging of already repackaged debt, ie the derivative of the derivative product — synthetic collateralised obligations (the proverbial “toxic waste”) — more than doubled in 2006 to \$1.5 trillion. Why buy derivatives? For certain types of investors, again mainly hedge funds,

this is the cleanest way of earning a return from the carry trade: you do not actually need to invest in the original stocks, bonds or loans, or even indexes of such. One can buy and sell derivatives on anything through standardised contracts without involving stock exchanges, registrars, custodians, clearing systems etc etc. It is increasingly a form of “virtual” trading, driven more by supply and demand for the speculative spread, rather than credit or economic fundamentals. If carry trades unwind and hedge funds lose money on their investments, which would include derivatives to a great extent, this is only the tip of an iceberg. Such a fall-out will badly scathe the entire financial infrastructure, including its pillars — the banks.



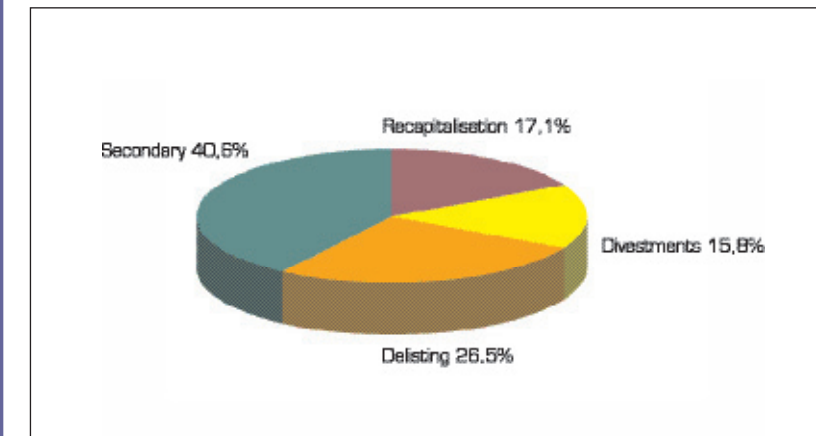
HEDGE FUNDS

The usual proclamation is that derivatives allow banks to move risks to the rest of the market and spread them around a greater universe of investors. The problem is that the banks also lend money to such investors — predominantly hedge funds — so that they can buy these risks in the first place. Based on a report from one high profile hedge fund, for each dollar of risk shifted via default or volatility insurance to this hedge fund, the banking community lent it another 11.5 dollars to fund its ability to buy more risk from themselves. In the case of defaults or event triggers on such derivative contracts, the clever banks will get back their one dollar. But they may easily lose another 11.5 dollars as the counterparty may go into default itself, ie significantly multiply the loss they would have incurred without lending to hedge funds in order to buy protection from them.

It was already mentioned above that credit default swaps exceed by ten times the volume of debt subject to such contracts. This means that these contracts are purely speculative, not really needed to cover a genuine risk. Overleveraged sellers of protection or buy-and-sell spread arbitrageurs lose sight of the actual underlying credit (why worry? credit analysis is irrelevant!). Most of them are unregulated hedge funds without minimum capital requirements (imposed on banks and traditional, regulated asset managers). If a credit event or flight to risk occurs, hedge funds may be found unable to deliver the insured amount. Nor would they be able to sell these swaps onwards. They may need to liquidate other trades (at an ever decreasing price due to an ever increasing sup-

ply) or just nurse losses if buyers are not found, following which they may quickly run out of cash and investors' capital. Furthermore, often the insured debt is repaid in full well before the expiry of the derivatives. Such insurance contracts become “orphaned”, not linked to any specific debt or borrower. However, the

larger hedge fund collapses — Refco, Amaranth, Archeus, Mother-Rock. Some have been caused by massive but wrong gambles (\$6 billion of losses by Amaranth) or inaccurate accounting records (Archeus apparently lost \$2.3 billion because the fund's records had not been appropriately reconciled).



Categories of European buy-outs in 2006

Source: S&P LCD

buyers of insurance have to continue paying the premiums, which can no longer be financed from the insured debt returns. The buyers will have to dip into their capital or borrow to continue servicing the protection. Finally, the delay between striking the trades and finalising documentation (often not just confirmation but the entire framework agreements) is several months. As a result, nobody knows the true volume and value of such derivative contracts issued and entered into.

The once famous hedge fund run by the Nobel Prize laureates — Long Term Capital Management — collapsed and had to be bailed out in September 1998 by the banking community for fear of a systemic crisis in the financial markets. The bail-out cost \$3.6 billion. It would be a modestly sized collapse today. We have recently seen several

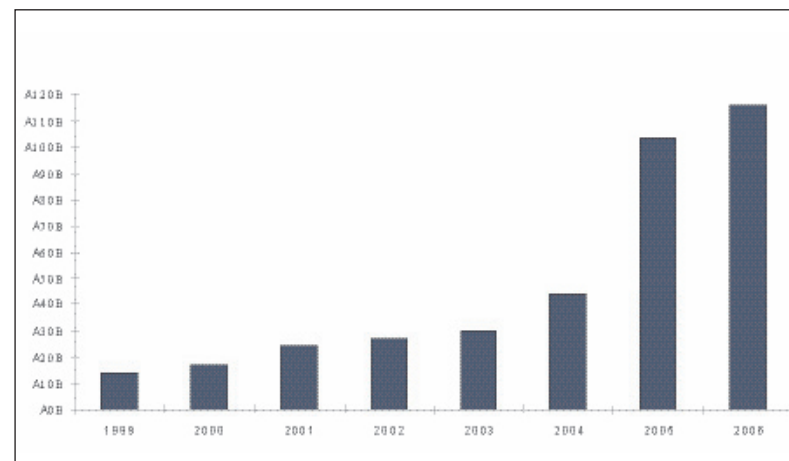
However, all of them went almost unnoticed. A couple of billion dollars of losses meant a lot in 1998. However, in 2006, three trillion dollars, uncounted trillions of yen, euros, Icelandic kronas and Australian dollars later, it will take dozens of Refcos and Amaranths to collapse for the markets to take notice. Can that many collapse in a short period of time? In 1998, we had only several hundred hedge funds. Today, we have around 9,000 of them (HedgeFund.net alone has as many as 7,000 registered), more than the number of companies listed on the New York Stock Exchange. Most of these funds are playing the same game — carry trade, equity arbitrage, long bond/loan trades... they are all riding the same liquidity curve, following the same strategies. For credit analysis is a thing of the past, and the

next 15 minutes of marginal gains matter more than years of decent returns. Such decent, consistent returns have been produced in both booming and depressed markets by the titans of finance, the financial geniuses, the fathers of the hedge funds — Soros, Rogers, Leitchner, Tudor Jones. But who needs consistency and stability, when the next 15 minutes of carry trade can provide an instant gratification, and who cares about the performance in a downturn because the downturn will never happen?

The old adage goes: when a taxi driver starts giving you stock tips, it is time to get out of stocks. In a digital age, this adage takes on a new form: last week, a hedge fund for sale appeared on eBay.

PRIVATE EQUITY

Another link in the liquidity chain is private equity. Private equity is one of the most noble and necessary segments of the financial markets. The historic (and often market defining) objective of private equity houses is to acquire underperforming companies or their divisions and to restructure them into efficient, profitable, lean-and-mean organisations. This may be followed by a stock exchange listing to give members of the public access to the shares in the revitalised company or concluded by a sale to another successful company wishing to expand (such closures are called "exit"). Private equity firms make money from the better price charged for the companies they have nurtured to health and glory, which profit is further improved by using more debt and less own capital to buy such companies (so called "leverage"), as this is the more efficient way to finance such deals. Clearly, with a



Growth in the European leveraged loan volumes
Source: S&P LCD

lot of debt, such a company cannot operate in the long term as it would not have spare funds for investment in growth, technology, ideas and people. This is why it needs a new owner and an injection of unencumbered capital within 3 to 5 years after a buyout.

However, over the last couple of years, specifically in 2006, as the above diagram shows, that noble cause has been sidelined in favour of continuous trading in companies between the private equity houses themselves, so called secondary, tertiary and even quaternary buyouts. Private equity firms have been increasingly unable to achieve the price necessary to produce a satisfactory return for their investors, who have cash burning their pockets, as the public markets and corporate buyers cannot justify the expected price tags for strategic or commercial reasons.

Such chain buyouts are not real exits as the companies stay continuously indebted and are squeezed for cash until a natural decay in the overall business proposition accelerates. This is really a game of musi-

cal chairs. Trouble is — the music eventually stops and somebody will be left without a chair.

There is a variation on the theme: if a company has improved profits, it can borrow more. So, the company is recapitalised, ie more debt is taken on to pay dividends to the private equity owner. They take some or all of the expected returns, whilst the company is becoming increasingly orphaned and financed entirely by debt.

Another activity shown on the diagram is delisting of public companies, ie taking them private by purchasing them from a stock exchange. This is all about the "inefficiencies" of their balance sheets — for which read: "not enough debt". When listed, these companies are subject to detailed public and regulatory scrutiny because many of them are of public importance: employers of thousands of people, who use numerous suppliers, have large customer bases, subcontract to other businesses. A "public-to-private" deal takes them into the quieter, unregulated domain, where they can be run by private equity

firms — not monitored by the authorities responsible for the public interest. Today, this often leads to 1) an increase in payments to management and owners, by distributing reserves previously not permitted for distribution (as a margin of protection for investors); and 2) a massive increase in debt on the balance sheet in an atmosphere of rising interest rates. This frequently made sense in the past, when such companies could be undervalued (eg traditional economy companies in the days of a "dot-com" boom). The curious thing is that these companies are not undervalued in the current markets. They are not the overlooked, "ugly ducklings" of the past. Nor are they bought on the cheap: premium-to-share-price is often as high as 30%. Indeed, it is a potential private equity bid expectation that keeps many a share price in the realms of "irrational exuberance". Current speculation circling around Sainsbury's, one of the UK supermarkets, values the chain at 50 times its historic earnings based on last year's numbers. One needs a lot of debt to finance such a multiple!

(Un)Fortunately, for the money is plentiful, — debt is not a problem. Blackstone has just won the bid for the US listed company — Equity Office Properties Trust — paying around \$39 billion for the privilege. Blackstone went into the deal alone, which is an interesting contrast to the (until recently) largest ever leveraged buyout of HCA (US private hospital business) for \$33 billion by three private equity houses (plus the founder and management). The

1988 \$25 billion acquisition of RJR Nabisco by HHR, one of the first private equity houses, immortalised in the famous book "Barbarians at the Gate", has been trampled in both nominal and real terms. Barbarians are no longer at the gates. The Romans are. Not charging, but meekly waiting for a comeback.

As a result, the traditional deals — acquisitions of corporate investments — constitute less than 16% of the total buyout volume in Europe. The problem with this is that more and more companies move into the risky, highly leveraged, sub-investment grade category. We recalled above that their default rate in 1991 rose to 13%.

...AND THE CREDITS AT THE END...

One hasty conclusion from the above would be that it is banks, hedge funds, private equity houses, and their appetite for deals and derivatives, that are to blame for the numerous bubbles swelling all around the financial markets. Not true. Equally, it is false to blame investors for throwing money the way of hedge funds and private equity firms: money is burning their pockets and needs to generate returns. It is the Central Banks and academia that are the culprits, for it is their un-coordinated efforts and their unwavering faith in the new idols of monetarism that have created the most unbalanced global financial situation in economic history. However, neo-monetarism or not, part of the blame also lies with

the global leadership. As the world's political elite failed to create new global political mechanisms after the end of the Cold War to prevent the "clash of civilisations", equally, the global "powers that be" failed to create a new financial mechanism, which could regulate financial regimes and currency flows in the globalised world. Lack of cross-border regulation, and of controls and systems of checks and balances, result in local issues (eg low interest rates in Japan) becoming global ills. The absence of centralised capital requirements (eg for hedge funds) fails to ensure transparency and accountability from the new and massive financial sector. The danger to the global financial system must not be underestimated or ignored. But it currently is, as the recent G7 summit demonstrated by not addressing the yen issue. As the dollar debacle in 1985 resolved by the Plaza Accord or earlier monetary agreements (eg 1944 Bretton Woods) showed, the resolution of the next global crisis requires a concerted international effort. Unilateral support for the defunct system (Bretton Woods II) cannot maintain it alive forever. This is not a rallying call as only with the benefit of hindsight shall we be able to understand what could have been done to prevent the crisis. Nor is it an attempt to cry "Wolf!" yet again. However, as aptly noted by David Rosenberg, Chief Economist of Merrill Lynch in the USA, "the wolf in that story eventually arrived..." The tragedy is that the world is not prepared for the arrival of the wolf.

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