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# Healthy market correction or prelude to a perfect storm?

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## Healthy market correction or prelude to a perfect storm?

An international chorus of experts dismissed the sudden equity market quake of late February as a healthy correction, clearing the underbrush for another year of solid growth based on rising corporate earnings in an excellent economic environment. The mid-March aftershock cast fresh doubt on that happy global scenario.

The late winter correction of 2007, like the brief bull market downturn of May 2006 to which it has frequently been compared, may soon vanish like snows of yesteryear, as so many experts predict. Nevertheless, a few mavericks still wonder whether they may actually be witnessing the early onset of a perfect storm for the world's fragile financial architecture.

Hedging his bet on the outcome, Princeton University economist Paul Krugman sketched in a New York Times column March 2 how the gyrating markets could swap their "self-reinforcing cycle of complacency" for "a self-reinforcing cycle of anxiety" in just a couple of months. Defaults and bankruptcies kicked loose by the falling prices of heavily leveraged hedge-fund assets might then snowball into a global recession.

Even if the worrywarts are wrong, there are a few ugly blemishes on the otherwise attractive economic environment. And they certainly deserve closer attention than they have received. A flameout among the estimated 10,000 hedge funds, to cite just one disturbing example, could trigger a "juicy financial crisis," German Finance Minister Peter Steinbrück warned just before the February G7 meeting in Essen. He repeated his warning on March 16 in Washington, with a plea for international oversight of this speculative $1.4 trillion segment.

A list of other systemic lumps and warts would also have to include ballooning dollar liquidity, the overheated Chinese economy, cross-border interest-rate arbitrage, the outsized clout of globe-trotting investment funds, a boom in leveraged buyouts, widespread derivative hedging and the unprecedented international payments imbalance. All of these together look like reflections of the bubbly mechanics of fiat currency in the age of globalization.

The 1998 collapse and Fed-organized, offstage banking rescue of LTCM, the brain-child of two Nobel economics laureates, has already illustrated what hedge-fund speculation can mean for speculative financial markets. The new-millennium equity crash showed how the system can also overdose on "irrational exuberance" when spiced with Enron-style accounting. So, the U.S. residential property bubble is just the latest financial swelling to turn malignant.

Expert opinion split on what triggered the Feb. 27 market tremor that rippled around the world. It was either the 9% plunge of stock prices in distant Shanghai or a remark by former Federal Reserve Chairman Alan Greenspan about a possible recession in the United States, where the Dow industrials then shed 416 points – their biggest single drop since Sept. 11, 2001. An analysis by George Friedman, president of the Stratfor geopolitical think-tank of Austin, Texas, described the Chinese event as a deliberate, government "engineered drop" designed to curb runaway speculation. Greenspan, on the other hand, was belatedly acknowledging a more serious problem for a vastly larger financial market.

There was no doubt at all about what hit the markets on March 14, however. It was the apparent default of another U.S. financier of sub-prime housing mortgages, Accredited Home Lenders, recalling the spectre of the savings-and-loan banking collapse that preceded the first U.S.-Iraq war.

## U.S. mortgage bubble

The retreat of U.S. house prices underway for about a year has now snapped a notoriously weak link in a daisy chain of systemic risks built on artificially low interest rates and high liquidity. Falling prices kicked the props from under a profitable new sector of easy house financing for private buyers who lacked the income to make the cash down-payments for normal mortgages. Loan defaults multiplied when the marginal borrowers could no longer refinance with increasing homeowner equity to keep up with their rising mortgage interest payments.

These sub-prime house loans with their seemingly attractive interest now slumber malevolently in the portfolios of many institutional investment funds in the form of mortgage-backed securities packaged by investment banks. The money that had fuelled the house purchasing boom in a rising market had also been gladly loaned to the innovative mortgage firms by a blue-chip list of international banks. After all, the overnight U.S. money-market lending rate had barely matched inflation as recently as three years ago in an environment of easy credit.

U.S. house prices fell by a nominal 3% last year, which works out to a real 6% with inflation. Ten percent of those who had taken out new sub-prime adjustable-rate mortgages in the last 10 months could no longer make their payments. The inventory of unsold houses rose by one-quarter in a year as investors soured on high-risk mortgages. Falling dominoes have now rocked some traded stocks.

The international reach of the current market backlash can be read from the list of creditors of one large and troubled U.S. mortgage bank, New Century. Barclays, Credit Suisse and Deutsche Bank are reportedly in this same leaky boat with Citigroup and Bank of America. A couple of those same addresses were once tapped for the LTCM bailout, too.

The normal response of financial institutions to rising risk would be to tighten credit terms. And the typical response of the central bank to past market upheavals has been to slash its leading interest rate while flooding the system with the soothing balm of liquidity. But that option is now fraught with dangers for the Federal Reserve because of what it might do to the capital inflows needed to finance the U.S. current account deficit.

## Japanese arbitrageurs

If shrinking interest-rate differentials weaken the dollar, interest-rate arbitrage would backfire. So-called carry trades that cross currency borders to take advantage of the difference between low borrowing interest in such currencies as yen and Swiss franc and high investment yields in dollars are already dissolving. The foreign exchange risk of holding dollar investments apparently outweighs the dollar yield advantage for some carry trades. As a result, both yen and Swiss franc have appreciated against the dollar recently.

IMF boss Rodrigo Rata recently voiced alarm about a reversal of capital flows, should Japanese arbitrageurs fear an incipient worldwide recession with falling U.S. interest and dollar exchange rates. Chinese, Arab and European investors could be swept along. For the dollar sphere, this implies a capital outflow which affects the stock and bond markets. At a New York conference March 7, Greenspan expressed concern about both the U.S. real-estate recession and the Japanese carry trades, which he said could not last. Foreign-exchange specialists have been predicting a lower dollar against euro as well.

Thanks to abiding confidence in the dollar, the United States regularly engorges huge gulps of foreign savings needed to defray the chronic trade deficits associated with its conspicuous

domestic consumption. This steady demand sustains the surplus industrial output of China, Japan, Germany and other exporting countries that produce more than they consume. But this great engine of global prosperity may now be running rough.

A U.S. Treasury tally showed net capital inflow to the United States fell last December to $15.6 billion, the lowest monthly value in nearly five years, wrote Stephen Roach, chief economist of Morgan Stanley, in a syndicated column. One reason he offered for this development was that the United States "has done nothing to curtail negative savings." Indeed, the national debt has now past the $8.8 trillion level with no tax increases in sight.

## Both guns and butter

President Bush recently proposed a 2008 fiscal budget that would raise outlays for just the Pentagon to at least $583 billion, 6% more than estimated military spending for 2007, following actual Pentagon outlays of $499.4 billion in 2006. And this gigantic fiscal line item excludes military-related programs, such as atomic weapons development, that are nested in other agency budgets. In the absence of any sign of domestic fiscal belt-tightening, a militarized foreign policy may have become the primary bulwark of the dollar system. Robert Higgs, senior fellow in political economy of the libertarian Independent Institute, filled in the blanks in his own military budget analysis. "The conclusion seems inescapable: The government is currently spending at the rate of approximately $1 trillion per year for all defense-related purposes," he wrote.

Given signs of slowing U.S. economic growth, it is increasingly difficult to understand how the expensive military surge in the world's main oil region along with other government spending, most notably social entitlements, can continue to expand as though there were no limit to deficits. Like the red-lining current account, the internal fiscal deficits are now also partly financed by foreigners.

One such creditor is China, which is sitting on a huge pile of dollar reserves and low-yielding U.S. Treasury IOUs. Occasionally described as a U.S. strategic competitor, China has just announced that it is forming a new fund that will actively seek more attractive yields and diversification for its vast currency reserves.

Iran has already bailed out of the petrodollar recycling system, partly under pressure from an extraterritorial U.S. banking boycott. Other Near Eastern oil producers as well as Asian countries have at least signalled their desire to diversify currency holdings, too. Although suitable dollar alternatives are scarce, Roach detected signs that the rest of the world is finding some with higher yield as surplus countries with high savings struggle to invigorate their neglected domestic economies. The birth of the euro in 1999 offered what some observers hoped would be a serious international competitor for the dollar. Although Euroland's current account surplus has stood in the way of the euro's ambitions, this new currency has gradually strengthened.

## Globe-trotting liquidity

The euro gained another notch on the dollar last autumn. Capital seems to be flowing in. The stock markets of Spain and Germany outperformed all other major markets last year. The 22% performance gain for Germany's 30 DAX blue-chip stocks compared with 14% for the Dow Jones industrials and zero for Japan's Nikkei, Commerzbank calculated. There is little doubt about who is bidding up German share prices. Foreign professional investors, especially big Anglo-American funds, now hold a bigger stake in the DAX than Germans, said domestic equity investors' lobby DSW. Despite levitating share prices and corporate dividends, the

number of domestic stockholders shrank by 13.3% last year, said German equity capital lobby, Deutsches Aktieninstitut (DAI). That left only 10.3 million Germans who still own stocks directly or through mutual funds, fewer than at any time since pre-crash 1999.

The European boom in private equity is a related phenomenon that is being driven especially by aggressive U.S. and British investment funds. Private equity funds, famous for leveraged buyouts of companies, collected €90 billion of equity capital in Europe last year, said EVCA, their European lobby. That was triple the amount of 2004. In a study on private equity in Europe, consultant A.T. Kearney said institutional investors gave the funds €194 billion in the most recent five-year period and that they invested €165 billion of it. The trend points sharply upward, it said.

BVK, the German association of private equity and venture capital funds, said funds domiciled in Germany invested €3.6 billion of their investors' equity alone to buy into 970 companies in 2006. But that is only part of the picture because some of the active foreign funds are not covered in this statistic, nor is the money borrowed by funds for leveraged buyouts, which were up 40% in Germany last year. EVCA said that three-fifths of the private equity landing in Germany comes from foreign funds.

Eighty percent of a leveraged buyout may involve borrowed money. The corporate raiders typically hold the companies they purchase for two to five years before selling at a profit. What happens to the workforce while the company is the maw of what critics call locusts – Heuschrecken in German – is hotly debated in several countries. Kearney has said that private equity creates jobs. But there are notorious cases of the opposite.

Real-estate purchases and property trading form another segment in which foreign funds and foreign investors are particularly active in continental Europe. And cross-border acquisitions of one company by another in the same industry can also influence international payments. Such big U.S. funds as Fortress Investment loom especially large in this once sleepy market. New legislation allowing untaxed, exchange-traded real estate investment trusts (REITs) in Germany and Britain may convert vast private and public domestic property holdings into a new asset class that can be traded internationally. And hedge funds are expected to become large investors in this new equity segment, with potential capitalization in the three-digit billions.

## Underlying assets of $370 trillion?

The financial innovation that stirs the greatest concern is the derivative, roughly analogous to re-insurance in its function. U.S. Treasury Department and Federal Reserve officials argue that these swaps, options and futures strengthen and stabilize the financial system by distributing risk, namely hedging. Others are not so sure. Billionaire U.S. investor Warren Buffet has described derivatives as financial "weapons of mass destruction." Derivatives are typically employed by hedge funds in their pursuit of the highest possible yields for their investors. Since the average yield is limited by the rate of economic expansion, it would be good to know what happens to the rest of the economy if such financial instruments do consistently managed to beat the average.

Some derivatives are traded on securities exchanges. But the lion's share, called over-the-counter (OTC) derivatives, are contracted directly between two counterparties. Bank for International Settlements said the notional value of outstanding OTC derivative contracts in mid-2006 came to $370 trillion. Of that amount, derivatives based on interest rates alone topped $262 trillion. There are also derivatives on foreign exchange rates, commodity prices, credit defaults, equity-linked derivatives and others that are harder to classify. The underlying

assets suggested by these notional amounts outstanding are staggeringly large. The annual U.S. gross domestic product, which captures the value of all the goods and services changing hands in the economy, comes to just $12 trillion.

Lenders and investors tend to feel more secure if their market exposure is hedged with derivatives. An example would be derivatives contracts written to hedge the asset-backed securities now called into question by defaults on high-risk U.S. house loans. Although widespread derivative hedging dampens the volatility of financial markets, a trend toward multiple layers of hedging of risky assets “has resulted in a practically boundless expansion of money and credit in the hands of hedge funds and private equity,” observed economist Ann Berg in a March 15 Internet article on systemic risk in the financial system.

Critical attention focused on this phenomenon in Germany a couple of years ago when a few Anglo-American hedge and investment funds wrested control of Deutsche Börse from the entrenched management of this profitable national stock exchange operator. Recently, though, stockholding hedge funds and private equity funds actually prevented an Australian bank’s takeover of a company called Techem in Germany and blocked NASDAQ’s attempt to swallow the London Stock Exchange for a price they found unacceptable.

Jochen Sanio, Germany’s chief federal regulator for banks, insurers and financial markets, has described the unregulated hedge funds as a “great black hole” of the international financial market and a “considerable danger to the stability of the financial system.” U.S. counterparts vigorously disagree. An onset of international market volatility aggravated by the U.S. mortgage crisis may soon show who is right. In view of the strong integration of the world’s financial markets, however, a collapse in just one sector of the world’s largest national economy can quickly become a global concern. In the inflated dollar system, it could be like tapping the bottom of a house of cards.

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