The Oil Drum
DISCUSSIONS ABOUT ENERGY AND OUR FUTURE

For all practical purposes the markets are closed right now

Posted by Jerome a Paris on July 30, 2007 - 10:00am
Topic: Economics/Finance
Tags: bonds, chrysler, citigroup, corporate debt, finance, loans, subprime [list all tags]

> Banks Delay Sale Of Chrysler Debt As Market Stalls
>
> Wall Street's corporate-debt machine has helped to finance the increasingly exotic takeover deals of the buyout boom and to shore up some of the nation's ailing industries with cheap loans and bonds. Now, that machine is sputtering.
>
> Yesterday, Chrysler Group became a signpost for the high-yield-debt market's strain as bankers for the ailing auto giant postponed a $12 billion sale of debt to investors as part of a buyout severing Chrysler from German parent DaimlerChrysler AG.
>
> (...)
>
> "For all practical purposes the markets are closed right now," said Chad Leat, co-head of Global Credit Markets at Citigroup.

While you've certainly heard of the big drop in the Dow Jones in the past two days, and probably heard that the housing market keeps on getting worse, the most ominous news are actually coming from a distinct part of the financial markets - leveraged debt.

That particular market, as suggests the quote I used in the title of the diary, is undergoing a dramatic change in mood as bankers, which had been bending over backwards to lend ever more money at ever more favorable conditions have suddenly decided that this was not a good idea and are brutally turning off the taps. Deals such as the huge $12 billion financing for the purchase of Chrysler by Cerberus have been canceled - or, to be more precise, the syndication of these deals has been killed, which means that the client will still get the money, but the banks that structured the deal initially and underwrote the loans (i.e. they committed to lending the money) won't be able to share that risk with others on the market and are stuck with it. For those deals already underwritten, the victims are the banks that did the deal; for deals not yet underwritten, the client won't see any money.

That market matters, as it is the one that has been feeding the private equity boom, i.e. the increasingly aggressive purchases of companies by funds which were able to bid high prices precisely because they could find cheap and easy finance. That boom had fueled the increase in stock market prices (with the price of targeted companies after jumping on such deals, and many others going up on speculation that they could be purchased) and in the price of many other assets - simply because buyers had lots of money.

It's the same kind of market that lent money to subprime lenders for them to on-lend to clients borrowing to buy overpriced houses (in the hope of flipping them quickly). As long as money was plentiful, prices kept on going up and the bet on them going up was vindicated, further fueling the boom.

Easy lending came through lower interest rates, and lower financing costs. Thus, for a while, higher acquisition prices (whether of homes or of other companies) did not translate into higher financing burdens, making such acquisitions not unreasonable proposals. But as interest rates increased (because of Fed-driven increases, out of inflation fears), these costs jumped up - at least for those borrowers on adjustable rates.

The first to feel the pain were those home owners that took out the most recent mortgages, i.e. the most aggressive and those the most unlikely to resist to any market deterioration like those called "ninja" loans: no income, no job or assets, which often included interest rate triggers after a year or two and delayed principal repayments. Many of these are in payment arrears, dragging down with them the subprime lenders that provided the money, and damaging the banks that financed these. That has been going on for a number of months, and will take many more months to fully reveal itself, as lenders are not keen to take drastic action that would reveal how bad things are: acknowledge payment defaults and you trigger covenants (obligations to inform your own lenders and the markets) and risk downgrades and increased costs, repossess and you end up with hard to sell houses in a tough market (repossess lots of houses and you cause a supply glut and a price crash), call in loans to weakened subprime lenders and you might push it to bankruptcy, and get handed a big pile of dodgy loans instead of actual money, etc... So everybody is trying to slow the day of reckoning as much as possible, and we're basically seeing a big slow motion crash, with no panic as of yet.

Everybody is tightening lending and practices (so as at least not to increase the size of the existing problem), which is a good thing per se, but is contributing to the market slowdown as buyers can no longer access aggressive financing terms and can afford to spend less on their purchases, thus bringing the market down and forcing additional tightening.

But as the tightening includes lending to many funds that dabbled into real estate, banks are reconsidering their lending practices to other sectors, starting with those where other funds are active, and that's where we get to the leverage buy-out / private equity credit crunch: banks are simply becoming more prudent and, to put it simply, have stopped throwing money at funds for big-ticket acquisitions. That does not mean that existing deals are going bad, but that it's getting harder to do new deals. But, again, we have a vicious circle starting: with fewer buyers, the price of the targets will stop going up and may go down as market speculation on take-over recedes. As prices go down, older deals look increasingly expensive, and may create (as of yet virtual) losses for those that bought at inflated prices. Should any buyer be unable to service its debts, the banks that lent the money will end up owning assets that are worth less than the money they put on the table to help buy it, and will swallow real losses (the investors lost their money first, but as they borrowed a lot, they may not have lost that much in absolute amounts).

Currently, default rates are at record lows, so there is no emergency yet. But part of that was made possible because companies that were in trouble (you know, in their actual economic activity, not in the financial engineering layer on top of it that hides the real business) could simply borrow more to go past their difficulties - which were usually of the debt servicing kind. They borrowed to pay old debts they would otherwise had trouble paying. But if borrowing more is suddenly no longer an option, then paying debt, especially if large new piles have been added on top of everything, is going to become, again, an issue. Thus default rates are likely to increase again simply because there is no longer any easy money to help hide the problems. And with record numbers of companies burdened with record level of debt following the private equity binge, defaults can only go up, especially as the economy slows down.

Financial markets make bets on the future income of the actual underlying economic activity of companies. Often, simply, financial deals effectively allow one side to "sell" (or "lock in") the future profits of a company, i.e; make these profits appear today. The other side, which puts up (borrowed) money today, expects to be repaid over the long term and usually will lowball somewhat the expectation of future streams in order to be sure to be repaid. What happened in the past couple of years is that these expectations became increasingly optimistic, and those that lent the money need the underlying economic performance to continue to do well.
Thus, the pressures that have driven profits up (and wages down, or sideways) in recent years are not going to abate, quite the opposite; in fact, they will become even more violent as the economy slows down: in order to continue to squeeze profits out of increasingly tough, or stagnant, markets, you can expect the time-tested restructurings, downsizings, rightsizings and wage restrictions to continue with ever more viciousness.

As we know, US consumers have barely seen their incomes increase in recent years. Consumption has been propped up by ever increasing levels of debt, and by buoyant house prices (whch made possible to raise home equity, i.e. to pile in again more debt). Such levels of debt are no longer going to be available, both as banks tighten standards, and as house prices stagnate or worse. And as incomes are unlikely to go anywhere in the context described above, consumption is likely to struggle, leading to lower growth, creating more economic hardship and tightening the noose over weak, over-indebted borrowers, whether households or companies, and putting their lenders in the position of having to take over assets (houses, businesses, or financial assets underpinned by the same) and holding them or trying to sell them in a hostile market. Selling makes the cost visible, but at least ends the problem. The problem is that if everybody tries to do the same, the markets will crash, as there won't be enough buyers on the other side - or not at the prices needed by the sellers.

Banks have lots of reserves, built up in the good days, and ways to hold on to assets (essentially by refinancing them, or restructuring their payment obligations) in the hope that they will survive and be worth more after things get better, and they will absorb a lot of the crisis (that process has started a while ago already in the real estate market). But at some point, there may be a bigger credit accident than the market can swallow (say, a bankruptcy by Ford or GM or by a medium-sized bank) and then all bets are off.

And of course, markets are all interlocked and all of this may have an impact on - or may be impacted by - the dollar exchange rate (a further weakening of the dollar would probably push interest rates up in order to incentivize foreigners to keep on buying the dollars needed to cover the current account deficit, which would worsen the woes of the weakest borrowers), the commodity markets and others.

What's happening today is that some alerts are ringing, and the overall financial system is highly vulnerable. Any shock could destabilise it. Some will say it will inevitably happen; some will say that the markets will manage to absorb the risks and spread them around. But we simply don't know. And the banks are clearly saying that some markets are vulnerable, and they are getting in a much different behavior than until recently, suddenly preferring prudence to doing what it takes to get the next deal.

:: ::

Politically, we need to say loudly that the current boom was the cause of much of the increasing inequality in recent years, and has been the source of many extravagant fortunes. As the bubble unwinds (or pops), it is essential to make it clear that it should not be workers, or taxpayers, that end up paying for the recklessness of the financiers, and that those that gorged on the good times should bear the pain of the new, leaner times. The dismantling of all the barriers between commercial banking and investment banking unsurprisingly took place near the beginning of the great Greenspan Bubble, it might be necessary to reconsider it. Taxes on capital gains, and on income on capital, have been lowered in the past; maybe it's time to change that again. The crushing of labor, and the erosion of labor rights, has made ever-increasing profits a reality and has fuelled the ever-more optimistic expectations of the financial markets. That should also be reconsidered. The focus on financial profits over industrial ones, unable to provide the same instant returns, has skewed the economy ever more towards financial services rather than other "real" activities (except the finance fuelled construction sector). That may not prove to have been the most sustainable policy.

Altogether, the politics of individual greed over those of a collective future need to be blamed.

PG here, and I think this brings up a couple of questions about interruptions in the trends of consolidation in the oil industry as well. Will those deals dry up too? I doubt it.