Credit markets: 'Don't panic', they beg

Posted by Jerome a Paris on August 10, 2007 - 9:45am
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Something is happening in the credit markets...

(*Note: this text was written Tuesday. For a more polemical take written this Thursday, taking into account the most recent developments of the day (including the unprecedented $130 bn liquidity injection by the European Central Bank) you can go read this new story on European Tribune.*)

on the front page of the Financial Times, 7 August

The above is the price of corporate loans in the secondary market - i.e. on the market where banks trade IOUs from corporations. If you have a contract that says that a company owes you 100, you can usually sell it (to other banks or financial investors) for 100 or thereabout - a bit more if the buyer thinks the interest rate on the loan is really good, or a bit less if it thinks the interest rate is not quite enough to cover the risk that the company might go bankrupt before paying its debt back.

As you can see above, the price of an IOU of 100 dropped brutally this month from 100 to 95 in the US (and to 97 in Europe). This is the lowest level ever for that market, and an unprecedented drop.

This is a credit crunch.

As **gjohnsit** chronicled in this recent diary, this means that banks no longer want to lend money to corporations. Almost no new debt was issued for the whole week. And banks that had underwitten loans (i.e. committed to lend) are now unable to sell these commitments down to other investors. Rumors puts such commitments at $300bn; at the 5% discount that such loans now carry, as per the graph above, that's a potential loss of $15bn for these banks if they want to dump that paper (they may decide to sit on it not to take any loss, as after all the borrowers have not defaulted, but that will weigh heavily on their balance sheets and at the very least will freeze a lot of capital and prevent them from doing new business).

Analysts everywhere (those that mocked the Cassandras that have said for a while that markets had gone crazy) have been forced to acknowledge that there is a brutal repricing of risk, and a new, sudden, unwilligness by banks to fuel the buy out craze - the debt-fuelled purchases of corporations by private equity funds at ever rising valuations. However, many are still calling this "healthy": a belated, but reasonable, return to normal after some excesses. (This is also what was said about the housing market before it claimed its first victims in the subprime lending sector this year). Some are even saying that all is well:

> Don't Panic About the Credit Market
> Housing and debt markets are not that big a part of the U.S. economy, or of job creation. It's more likely the economy is sturdy and will grow solidly in coming months, and perhaps years.
> Unlike the 1998 seizure in credit markets to which many are now drawing comparisons, reservoirs of global liquidity are full to overflowing, not empty as they were that year. The deep 1997-1998 Asian crisis has been replaced with an all-cylinder boom. Unemployment rates are falling all around the world, while China's equities have continued hitting new highs.
> *Mr. Malpass is chief economist at Bear Stearns.*

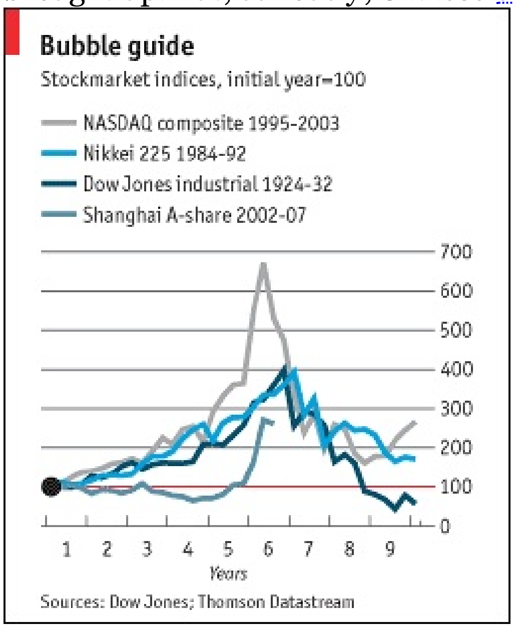
Bear Stearns? The same Bear Stearns that has lost 25% of its value after two of its mortgage funds collapsed? The same Bear Stearns that has been put on 'negative watch' by the rating agencies (i.e. they are looking into bringing its rating down)? The same Bear Stearns whose boss has been doing the rounds on Wall Street begging for other banks not to dump them?

> Jimmy Cayne, chairman and chief executive of Bear Stearns, has been calling round other Wall Street chiefs to reassure them about its financial health and to head off a crisis of confidence in the bank.
> Mr Cayne phoned Stan O'Neal, chief of Merrill Lynch, on Friday and has asked for a meeting with Chuck Prince, Citigroup's chief.

"Asked for a meeting?" The CEO of one of the biggest banks around is no longer able to talk to the CEO of Citibank? How scary is that?

> The head of risk at a leading Wall Street bank said (...) it could be "a bit like a run on the bank" with the threat that clients, counterparties and lenders would pull back quickly if they lost confidence.

When top names talk about lost confidence and a bank run, all alarm bells should be ringing... So yes, you'd expect an all out attempt to shore up confidence, and all possible rosy arguments being brought up. But, seriously, *Chinese equities*?



Of course, financial players have been quick to cry for mommy and hope already for some kind of government bail out:

> US stocks rebounded [on Monday] as financial shares gained ground on hopes that Fannie Mae and Freddie Mac - the giant government-sponsored mortgage companies - would help stabilise credit markets.
> (...)
> Fannie and Freddie soared 10.4 per cent and 7.7 per cent, respectively, as investors bet that their funding advantages would help them profit from the turmoil. Because of their links to the government, Fannie and Freddie are able to raise money more cheaply than other companies that buy mortgages, either to hold as investments or to package as securities for investors.
> Investors were also reacting to **speculation that the companies would be given greater opportunity to buy mortgages by their regulator**, the Office of Federal Housing Enterprise Oversight.

A government bail out of the financiers that have stupidly bet on ever rising asset prices would be a major scandal, but pressure to do so is likely to increase as the crisis spreads. A bank run would indeed require public intervention, but major losses by banks, funds and other investors should certainly not trigger any kind of help, despite endearing pleas such as this one:

For once, wisdom is coming from the editorial pages of the WSJ, which apparently still host some consistent monetary hawks, and share my views on "Bubbles" Greenspan:

> As always amid a credit turn, the pleas for easier money are rising. We're even hearing nostalgic cries for the return of Alan Greenspan, who is remembered fondly for supplying liquidity during the credit crises of his era. But what these cries forget is that **the Greenspan Fed is one reason for the current mortgage mess**. It's tempting to blame Wall Street and other bankers for all those bad residential loans, and they are paying the price now. But they were also **lending into a housing asset bubble fed by easy monetary policy**. Risky mortgages always look better when home prices look like they'll never decline.
> Current Fed Chairman Ben Bernanke was along for the Greenspan ride, so he's hardly blameless. No doubt he'd love to play the hero role now, signaling easier money this week. However, he'd have to do so at a time when the dollar is weak, oil is at $78 a barrel, and commodity prices in general are roaring. Mr. Bernanke and the Fed might have more room to maneuver this week had they been tighter earlier. But now they can't afford to ignore global dollar weakness. The run on Bear Stearns would look like a Sunday stroll compared to a global run on the dollar.

And it seems that Bernanke has heeded such advice today, by holding Fed rates steady and maintaining their tightening bias. While acknowledging the recent economic downturn, the Fed has decided it cannot ignore the monster it unleashed earlier and needs to bringdown to size.
A couple of economists commenting on this have the right words:

> "Bernanke tied to the mast, the FOMC remains deaf to the song of sirens" -- to borrow from Homer's Odyssey. Markets are like the sirens, and Bernanke and the FOMC are Ulysses and his crew, steadfast with their policies, not giving in to cries from the marketplace; economic data and credit events to date do not warrant rate cuts or neutral bias just yet. *Zoltan Pozsar, Moody's Economy.com*
> (...)
> Unless one believes the Federal Reserve to be a collection of utter buffoons, one must now suspect Bernanke and company fully realized they created a credit monster with a 1% Federal Funds rate and that they knew they'd have to clean it up at some point. *Chip Hanlon, Delta Global Advisors*

What this means is that the inertia of big financial masses is such that the asset price inflation continues to seep through into actual goods inflation, thus preventing a lowering of the rates. The need for the USA to fund its current account deficit by foreign investors also militates against any rate cuts (as they would cause a drop in purchases of US Treasuries, and a further weakening of the dollar) Finally, of course, the need to not cause any further panic (we're close enough to that, as suggested above) also pushes against any decisions which would be seen as an acknowledgement of the gravity of the situation. Better to do as if all were fine, for now.

The most likely consequence is going to be more volatility, as investors become increasingly unsure of the "real" value of financial assets and buy or sell on the slightest whiff of danger or comfort, as the following graph, which tracks the share price of Natixis, one of the biggest French banks, shows:

01/08/2007	02/08/2007	03/08/2007	06/08/2007	07/08/2007	Date
15.41(c)	**15.26(c)**	**13.75(c)**	**14.59(c)**	**15.90(c)**	Dernier
-5.75%	-0.97%	-9.90%	+6.11%	+8.98%	Var.
6 935 870	6 653 727	10 082 936	13 890 896	6 998 223	Volume

Enjoy the ride. And don't panic!