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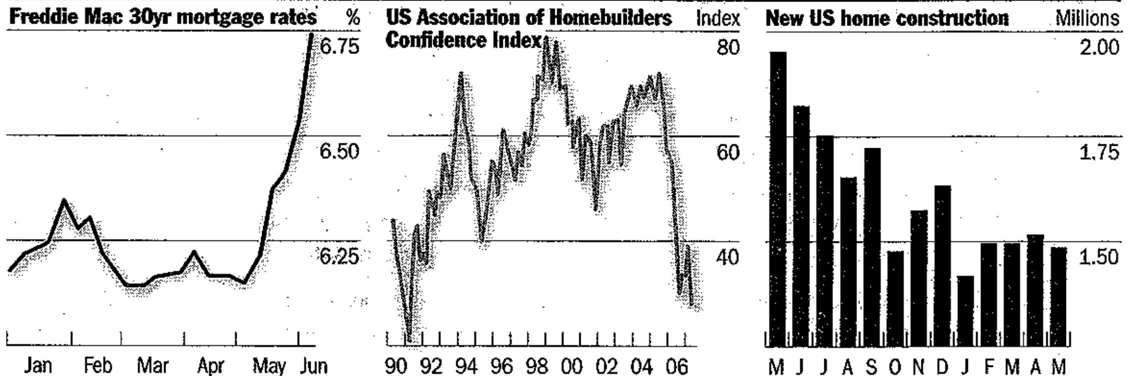
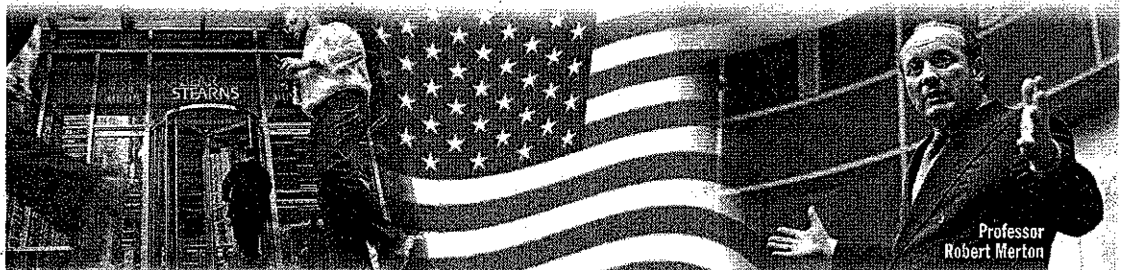
Wall Street worries as money dries up

Hedge funds are bracing for losses that will reverberate through the markets, writes **Robert Guy** in New York.





Professor Robert Merton

Source: Bloomberg

After delivering a keynote speech at a New York investor conference a couple of months ago, Robert Merton had some cautionary words for those in the hedge fund industry. Who better than the winner of the Nobel prize for economics to opine on the use of leverage in hedge funds, given the painful lessons learnt from his involvement with the high-profile collapse of Long-Term Capital Management?

That hedge fund's substantial use of leverage prompted the Federal Reserve Bank of New York and several Wall Street banks to arrange a $US3.6 billion rescue in 1998 to prevent a major market melt-down.

While the problems at LTCM were an extreme event – the fund had $US4.7 billion of equity underpinning off balance sheet derivative positions of $US1.25 trillion – the sudden evaporation of liquidity that inflicted the losses is again being seen on Wall Street. There are consequences, not only for two Bear Stearns hedge funds, but also the US economy.

"LTCM was very big with big positions," said Professor Merton. "The people with the money knew that and it was financed that way. The message is you try your best and you learn and you just have to have people prepared to deal with the unknown."

The "unknown" that Wall Street is dealing with now is the size of the losses at the two Bear Stearns hedge funds that had their portfolios packed with complex securities (known as collateralised debt obligations) backed by the low credit quality sub-prime residential mortgages. The funds attempted to juice up the returns through the hearty use of leverage, or debt.

US investment markets have been abuzz not only with speculation over the past two days about the size of the fund's losses, but also likely losses at its rivals as they too are forced to write down the value of their sub-prime mortgage exposures.

Bear Stearns has promised $US3.2 billion ($3.7 billion) of capital for one fund as part of a rescue package aimed at fending off creditors who had tried to seize assets.

The issues at the two funds have heightened volatility in US markets in which investors have become more jittery over recent weeks amid the rise in bond yields. That nervousness was on display on Monday, when the Dow Jones Industrial Average reversed a 100-plus point gain to end the session 8 points lower.

The troubles come as a US Senate report into last year's collapse of Amaranth Advisors cited "excessive speculation" as the cause of its losses, which amounted to about $US6 billion in one week. The Securities and Exchange Commission has sought information from Bear Stearns about the two funds.

But the problems at the Bear Stearns funds amount to more than a handful of banks losing money, with the ramifications slowly reverberating through the economy.

Economists are fretting about the potential impact on the US housing market and the risks, real and perceived, to the financial system.

"Renewed stress in sub-prime mortgages augurs a further tightening of standards for housing lending, menacing growth and potentially financial stability," Morgan Stanley economist Richard Berner said yesterday.

As if Federal Reserve chairman Ben Bernanke didn't have enough problems. Dr Bernanke heads into this week's two-day meeting confronted with rising interest rates on mortgages and a tightening of lending standards during the savage downturn in the housing market.

"The problems at the funds amount to more than a handful of banks losing money."

The sub-prime issues and the rise in bond yields over the past month have raised the cost of mortgages, adding further strain to the housing sector. According to mortgage finance company Freddie Mac, a 30-year mortgage was attracting an interest rate of 6.69 per cent last week compared to 6.15 per cent on May 10. A five-year adjustable rate mortgage was averaging an interest rate of 6.31 per cent last week, well up from 5.87 per cent on May 3.

The problems at the two funds have crunched the prices of sub-prime mortgage products, with an index measuring the value of sub-prime issues falling to new lows, and yields have moved higher.

Investors are concerned that defaults and foreclosures on sub-prime mortgages could surpass the 13.7 per cent and 2.4 per cent levels recorded in the first quarter, especially as those borrowers with poor credit quality either struggle or fail to secure new financing as their honeymoon loans "reset" over the remainder of this year and next.

There is also the worry that if these sub-prime instruments are downgraded by the credit ratings agencies, that will force some fund managers and investors to sell their positions, thereby exacerbating conditions in the market.

There are also concerns that deals to place $US250 billion of longer-term bond funding required for recent private equity leveraged buyout activity may struggle if credit markets become more difficult.

Private equity-backed takeover activity has been one of the primary drivers of the record-breaking run on US sharemarkets. Any lessening of the industry's ability to access debt, or higher costs of debt, may dampen appetite for big ticket acquisitions.

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