# *Financial Markets Highlights May 2007*[*]

## I. Desynchronised growth, liquidity and 'Goldilocks' continues

***Markets have recouped their losses following the February correction***

There was a sizeable correction in financial markets in February. However, since then all of the reflation trades have returned: equities have recouped their losses to the end of April; bonds yields have fallen and spreads have resumed their narrowing pattern; commodities have rallied along with commodity currencies; and the US dollar is weaker.

**The recent market rally was helped by**: *(a)* the Fed's decision to go on hold for now; *(b)* the fact that there is no current sign of inflation excluding energy prices; and *(c)* the emerging desynchronised pattern of growth, which is a comfort factor that this can continue into the future – 'Goldilocks' is still here after all.

***Lending standards are beginning to tighten***

**There are some minor negatives in the overall global economic situation**, which are mostly concentrated in the United States – the housing slump and the likelihood of a slowdown in profit growth from currently very high margin levels are the main concerns in this regard. The US financial system is well capitalised and flexible enough to absorb the credit losses from the sub-prime fallout, so the real question is whether this event leads to a more general tightening of credit standards. Such a pullback in risk taking is beginning to happen, particularly for mortgages

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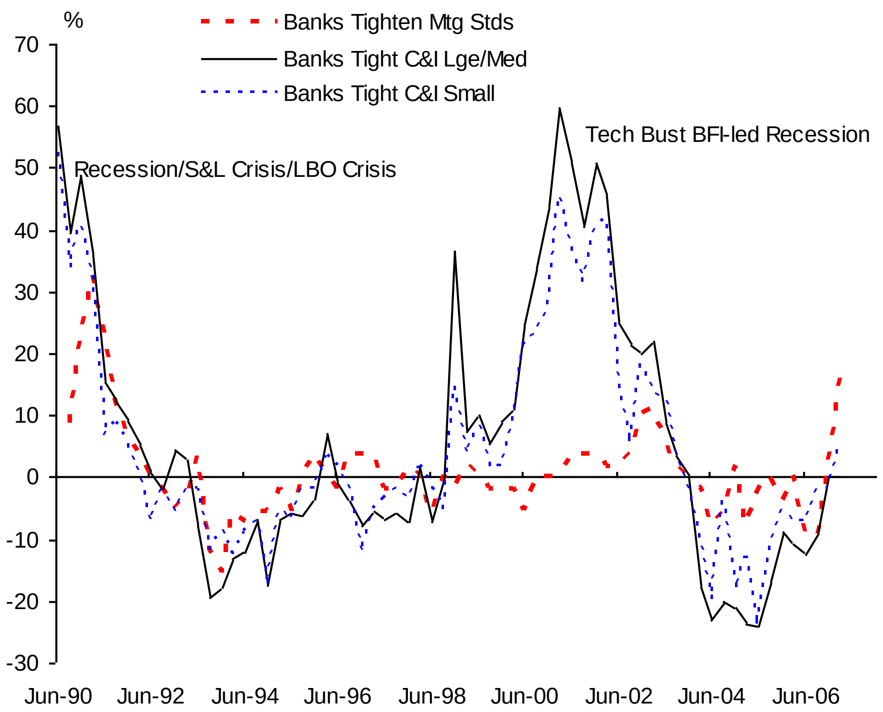
(see Figure 1), and is healthy from a financial stability perspective. But this does imply tighter monetary conditions for a given level of the Fed Funds rate, and it could prolong the period of slower growth.

**Figure 1. US banks tightening lending standards: mortgages & C&I loans**

Net percentage of banks tightening




*Source:* Federal Reserve, Senior Loan Officer Opinion Survey on Bank Lending Practices; Thomson Financial Datastream.

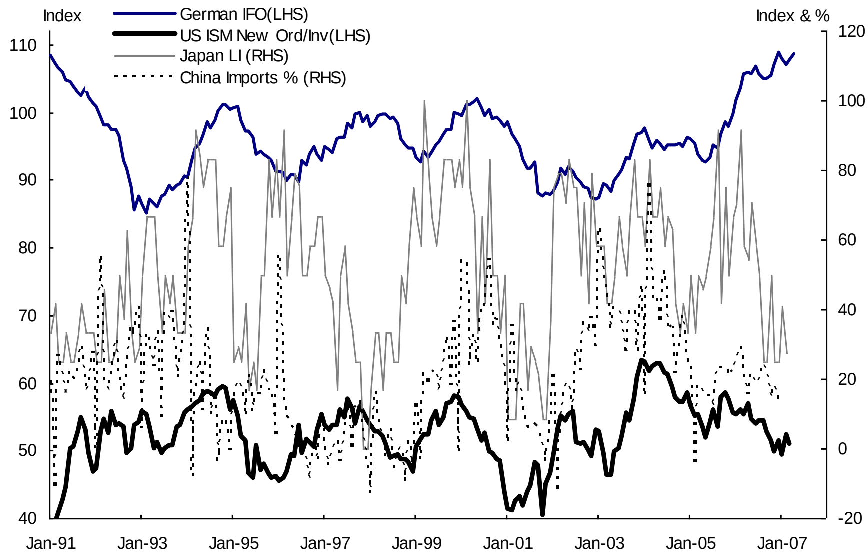
***Desynchronised growth reinforces the perceptions of low inflation risk in financial markets***

**The world economy is quite desynchronised at present**. The US slowing is being offset by stronger momentum in Europe and very strong growth in emerging markets, led by China and India. Even in Japan, which continues to lag, the news is not all bad. Figure 2 shows a selection of regional lead indicators – the IFO in Germany is particularly strong as the US weakens. This is a healthy backdrop for financial markets. As a consequence, equity markets, underpinned by ample global liquidity, have continued to rally quite strongly.

***Sound fundamentals* vs. *excessive liquidity***

However**, there are two schools of thought on the financial situation from here**: *(i)* that policy has done such a good job in causing economic volatility to be low, that there are no major excesses, and none of the cycles in asset prices seen to date reflect unmanageable bubble patterns – so while the markets climbed the 'wall of worry' in February the outlook justifies some exuberance; or *(ii)* that the excess liquidity is moving around from one market to the next: first real estate prices and now equities. Eventually the cost of capital will adjust up, via higher spreads, and once this finally happens, asset prices will move down. Some levered players will be at risk in such a scenario.

**Figure 2. Lead indicators: healthy desynchronised growth pattern emerging**




*Source:* Thomson Financial Datastream.



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The equity rally, following so closely on the heels of the housing boom-bust in the USA, is being driven in part by **the ready availability of liquidity**: the boom in private equity and the role of hedge funds in propagating narrowing spreads through carry trades (keeping the cost of capital down) is adequate testimony to this. When leverage plays a role in strong market developments, policy makers need to take notice – history teaches that these episodes often do end badly.

## II. The sub-prime and related issues

***No adverse contagion from sub-prime mortgage at this stage***

There has been a lot written on the sub-prime issue of late, and **the general consensus seems to be that there are not going to be broad adverse contagion effects at this stage**. In contrast to the S&L crisis of the late 1980s and early 1990s, a lot of the balance-sheet risks were shifted from banks via credit risk transfer mechanisms and the securitisation process. Even if the exact identity of the final holders of the securities is less well known, this shifting of risk away from financial intermediaries reduces systemic risk – in fact 40% of the mortgage-backed securities are distributed outside of the United States.

***This impact on banks affects revenue but is not a major credit event***

**This view suggests that the sub-prime issue is not a major credit issue for banks**. Rather it is one of revenue loss for exposed institutions – this conclusion is supported by recent US bank results, where only a few reported a material hit to revenues via write-downs on loan books in the sub-prime area. Some of the bank losses were related to *(a)* poor underwriting; *(b)* mortgage originators having some of the ABS products put back to them (due to the use of hitherto unnoticed covenants in their contracts with the originators); and *(c)* holding more inventory on their books than they wanted (*e.g.* because they could not get appropriate credit ratings).

**Both demand- and supply-side factors are at work** in slowing mortgage lending and, consistently, this has now spread to commercial real estate loans (median growth of the 14 largest providers slowed to 1.3% per quarter in 2007Q1, from an average of around 1.9% in 2006).

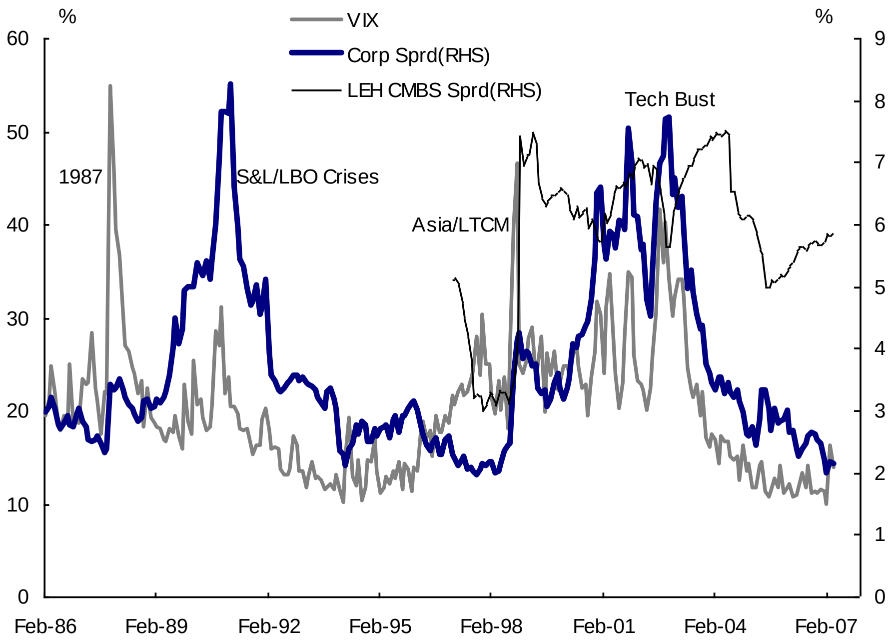
***Markets***

The market has been behaving as it should, *i.e.*

***discriminating between balance sheet risk sectors***

discriminating between the real estate market and other sectors where balance sheets are stronger. In Figure 3, the rally in corporate spreads since 2003 has not been matched in the mortgage market.

**Figure 3. High-yield corporate *vs.* high-yield mortgage spreads and VIX**




*Source:* Thomson Financial Datastream.

***Further rationalisation in the mortgage organisation industry likely***

The sub-prime crisis will likely result in further rationalisation of the industry. The reason for this is the significant excess capacity built up in the mortgage industry in recent years. Stronger players win market share and others exit from the industry. Inevitably this has led to some closures, and any further insolvencies will depend on the capitalisation of the firms concerned. Table 1 shows sub-prime and total originations from the main groups as at the end of 2006. Some of the weaker players with high sub-prime shares will undoubtedly exit. This is the normal streamlining and rationalisation that is required – it will include some moving away from exotic instruments and fragmented suppliers that have characterised the market in



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recent years, as *(a)* regulatory reform and better official guidelines crack down on weak and misleading practices; and *(b)* higher spreads act to reduce demand in relation to excess supply.

These adjustments may happen smoothly from this point, but volatility cannot be ruled out: closures of sub-prime originators could be disruptive; and defaults may spread to other adjustable rate 'Alt-A' loans (where lower or no documentation makes it difficult to assess creditworthiness).

**Table 1. Mortgage originators and sub-prime share (2006)**

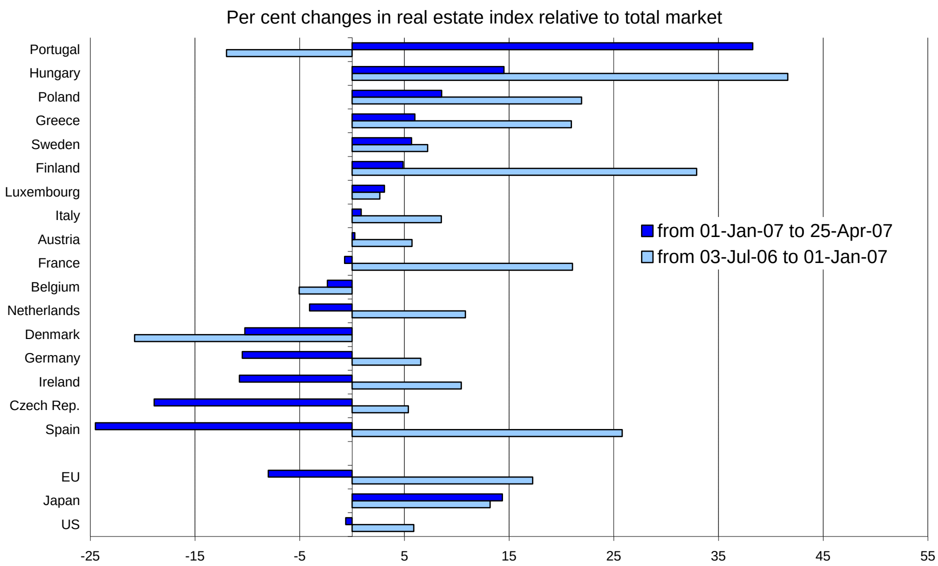
| | Institution | Sub-prime $bn | Market Share % | Total Mtg Orig. $bn | Sub-prime Share % |
|---|---|---|---|---|---|
| 1 | **HSBC** | 52.8 | 8.8 | 52.8 | 100.0 |
| 2 | **New Century** | 51.6 | 8.6 | 59.8 | 86.3 |
| 3 | **Countrywide** | 40.6 | 6.8 | 461.4 | 8.8 |
| 4 | **Citimortgage** | 38 | 6.3 | 183.8 | 20.7 |
| 5 | **Fremont Invest & Loan** | 32.3 | 5.4 | 32.5 | 99.4 |
| 6 | **Ameriquest** | 29.5 | 4.9 | 29.5 | 100.0 |
| 7 | **Option 1** | 28.8 | 4.8 | 35 | 82.3 |
| 8 | **Wells Fargo** | 27.9 | 4.7 | 396.1 | 7.0 |
| 9 | **First Franaklin** | 27.7 | 4.6 | 27.7 | 100.0 |
| 10 | **Washington Mutual** | 26.6 | 4.4 | 195.6 | 13.6 |
| 11 | **Residential Capital** | 21.2 | 3.5 | 94.6 | 22.4 |
| 12 | **Aegis Mortgage** | 17 | 2.8 | 17 | 100.0 |
| 13 | **Accredited Home Lenders** | 15.8 | 2.6 | 15.8 | 100.0 |
| 14 | **BNC Mortgage** | 13.7 | 2.3 | 13.7 | 100.0 |
| 15 | **Chase Home Finance** | 11.6 | 1.9 | 172.4 | 6.7 |
| 16 | **American General Finance** | 11.5 | 1.9 | 11.5 | 100.0 |
| 17 | **WMC Mortgage** | 11.3 | 1.9 | 33.2 | 34.0 |
| 18 | **Equifirst** | 10.8 | 1.8 | 10.8 | 100.0 |
| 19 | **Novastar Financial** | 10.2 | 1.7 | 11.2 | 91.1 |
| 20 | **Ownit Mortgage Solutions** | 9.5 | 1.6 | 9.5 | 100.0 |
| | **Top 10** | 355.8 | 59.3 | 1476.1 | 24.1 |
| | **Top 20** | 488.3 | 81.4 | 1865.8 | 26.2 |
| | **Total** | 600 | 100.0 | 2980 | 20.1 |

*Source:* Citi.

In recent weeks share prices in the US real estate sector have recovered somewhat suggesting that the crisis is moving towards an end (see Figure 4). Even HSBC with all of its sub-prime worries has staged a rally. There have already been strong bids for sub-prime assets by financial buyers (private equity, hedge funds, etc.) reflecting the lack of distressed asset opportunities, as well as by strategic buyers (banks and brokerage firms).

Bust situations arise when debt expands too quickly and excess capacity builds up on the supply side. Problems emerge when interest rates subsequently rise, reducing demand. How this unfolds in the event of any higher rates in the EU needs to be monitored.

**Figure 4. Real estate equity sector *vs.* the overall market**




*Source:* Thomson Financial Datastream.

***Are there latent excess issues in housing within Europe?***

Residential mortgage debt has risen fast in some other countries as well, notably in Europe. Examples include the United Kingdom, Ireland and Spain. With the opening up of the property market to foreign investors and the benefit from lower Euro-area interest rates, Spanish house prices have been strong (7% in the year to 2007Q1, down a little from 9.1% to 2006Q4). Housing debt is rising and competition among banks has driven them into the riskier



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segments of the mortgage market.

## III. The liquidity issue and asset inflation risk

***Global liquidity appears to be in plentiful supply***

While the 'air' appears to have been taken out of the housing bubble for now, the strong rally in other asset markets suggests that global liquidity remains strong, and that real interest rates are perhaps too low. This encourages leverage, and private pools of capital have taken full advantage. As discussed in the other articles in this issue on private equity and on hedge funds and structured products, these pools of capital use leverage, both directly and implicitly through derivatives, to take advantage of opportunities presented by mis-priced assets. In this respect they play an important and positive role. It is important to distinguish these positive roles from the broader risks to which leverage may give rise if the global cost of capital is mis-priced as a consequence of excess liquidity. Market participants respond rationally to the signals they are given.

***Attempts to fix financial prices always cause problems for liquidity availability***

While policy has tightened in many countries, global liquidity remains plentiful as a consequence of attempts by some countries to fix the price of money; it is a basic economic principle that if one fixes the price of something (too low), one cannot control the quantity (too high). Tensions arise where policy needed for domestic purposes causes spillovers into global markets where innovative participants make use of it to move asset prices.

For example, in the 12 months to January 2007, China accumulated a further USD 259 billion in reserves by intervening to fix its exchange rate, and the stock of reserves stood at over USD 1.1 trillion. The recycling of these reserves into US bonds is a major factor keeping US rates low. At the same time the fixed exchange rate to the USD and the HKD affords all the usual mechanisms for avoiding capital controls (such as the failure to repatriate foreign currency receipts replaced by domestic loans). Within the Asian region, the ability fully to subscribe start-up investment vehicles quickly at present is well known.

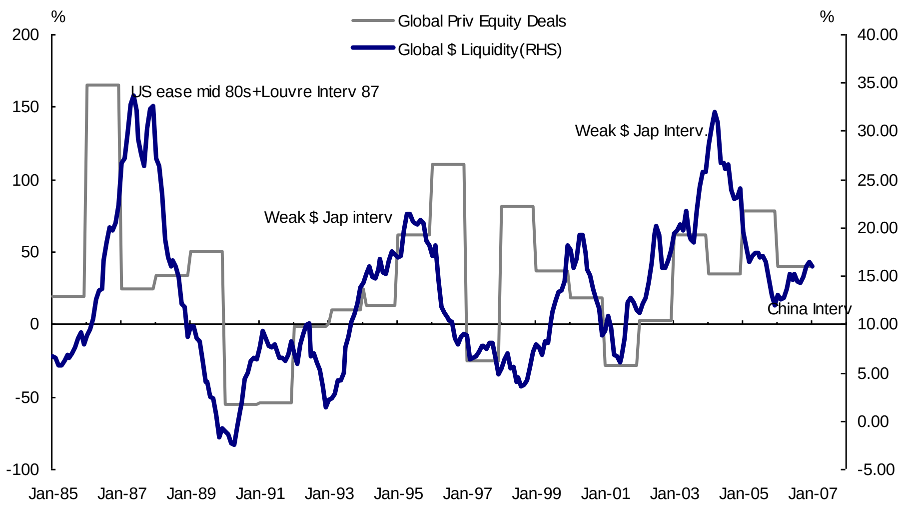
***Global liquidity cycles and private equity***

Figure 5 shows a simple concept of high-powered global liquidity measured in US dollars (the main financial

***deal making have always been linked***

transaction currency). This is equal to US base money, plus the foreign exchange reserves of the authorities in China, Japan, Asia, the UK and the euro area – *i.e.* high powered money for the credit multiplier in the US plus international reserve accumulation outside the US which creates domestic liquidity. The US dollar assets are recycled into global (particularly US) debt instruments. **The correlation of global policy driven liquidity with the relative change in private equity deals is quite striking, and is frequently related to attempts to resist exchange rate pressure in some regions**. Debt accommodation is a fungible process and financing techniques are innovative: transactions can run quite independently of the domestic monetary policy of the country where the transaction is taking place.

**Figure 5. Global liquidity and private equity LBO cycles**




*Source:* OECD and Thomson Financial.

Chinese fixing of the RMB, while at the same time subsidising the price of energy within China, helps keep inflation low (as sterilisation policies via reserve requirement increases struggle to keep up). Cheap exported goods also help to keep global inflation low, enabling real rates globally to stay below normal. **Within Asia, real**



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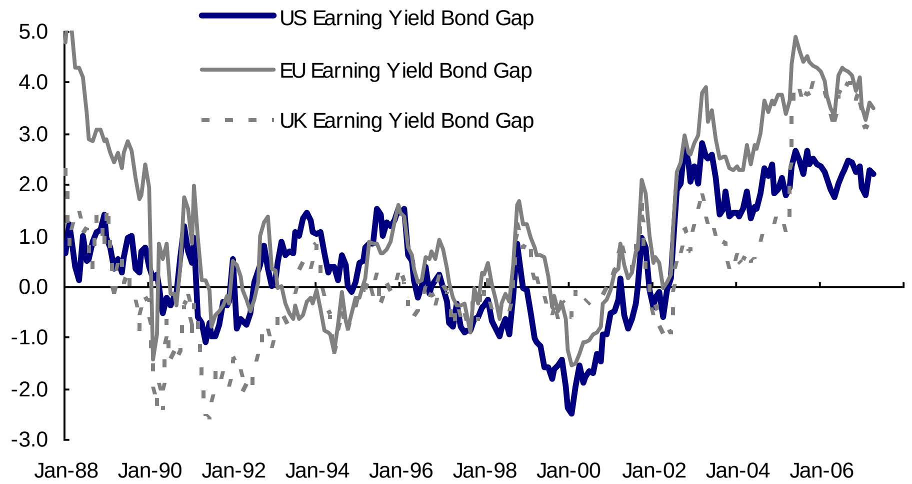
**rates significantly below GDP growth represent a significant 'subsidy' to growth.**

While Japan has intervened less since the US dollar troughed in 2002, zero rates, necessary to counter domestic deflation concerns, continue to contribute to the global liquidity and spread trades via derivatives that are difficult to measure through standard bank balance sheet flows.

**Figure 6. Equity arbitrage opportunity**




*Source:* Thomson Financial Datastream.

***Liquidity opens up arbitrage opportunities that financial markets will take advantage of***

The combined effect of such policies creates **a massive arbitrage opportunity: to borrow at low rates and buy higher yielding assets.** Carry trade activities by hedge funds reinforce the downward pressure on yields. Equity LBOs are a part of the same arbitrage process.

**This is potentially an inherently de-stabilising issue**, because equity prices have to be driven to the point where yields are equalised. If the cost of capital globally is too low, then equity prices will rise too far. Figure 6 shows the arbitrage opportunity as it pertains to the booming equity markets. The equity yield-bond yield gap is historically as wide as it has been.

In short, markets will take advantage of excess liquidity until inflation breaks out in one form or another (in commodity prices or equity markets in the first instance).

## IV. The February correction seen in this light

*"Think of a ruler held up vertically on your finger: this very unstable position will lead eventually to its collapse, as a result of a small (or absence of adequate) motion of your hand or due to any tiny whiff of air. The collapse is fundamentally due to the unstable position; the instantaneous cause of the collapse is secondary."*

(Didier Sornette, *Why Stock Markets Crash*)

***Markets are likely to remain 'jittery'***

As the quote suggests, the February correction was nothing more than a shake-out of the excesses that have been building up in an extremely overbought market (*i.e.* normalisation of risk aversion). The sell-off was attributed by some to fears of the introduction of government measures to cool down the A-share market in China. This is a market largely closed to outside investors and tends to trade irrespective of other markets (and vice versa). So the 'contagion' of jitters in the A-share market to the Asian and global markets would be a historic first. The sub-prime crisis in the US was also alluded to as a cause. Both the A-share market collapse and sub-prime issue were mainly excuses for overbought global markets to take profits, and for risk aversion to attempt some normalisation.

The rise in volatility shown in Figure 3 is not even back to historic norms. Spread and carry trades have resumed, and the equity markets have now made up all of their losses.

***How inherently unstable in the longer run are the liquidity and leverage trends?***

The extent of the next setback in the markets and its immediate triggers will not be as important as the fact that the present situation has elements of instability in excess liquidity that is difficult to control and leverage that is taking advantage of it. Further sub-prime issues; a major LBO or hedge fund credit event; defaults of the securitised CDOs that pension/insurance funds and hedge funds have happily bought; signs of actual inflation; or a strengthening of the yen (driven by a rally in domestic assets) causing the



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yen carry trade to unwind, could all be potential triggers for the next bout of volatility.

***Are the capitalisation and credit assessment practices strong enough?***

If the sources of global liquidity creation cannot easily be controlled, it is all the more important that financial institutions and levered market participants remain aware of the risk. Adequate capitalisation is important, and strong credit assessment practices need further encouragement.