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Risky Business!

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What a difference a year makes. In a very short time money has gone from plentiful to scarce. The consumer, which had been resilient despite rising energy costs and falling home prices, has started to cut back. Private equity deals, which fueled much of the market upturn in the first half of 2007, have not only slowed significantly, but a number of announced deals are being canceled. Huge allocations to hedge funds, which have been rapidly expanding, are still waiting to be invested. And financial firms, having fueled much of the S&P earnings growth over the last several years, are retrenching. Although the jury is still out on whether we have actually entered a recession, it is pretty clear that the US economy is in a credit crunch.

The advent of securitization resulted in easy credit and a global liquidity boom. Before securitization, banks were limited by their reserve requirements in the amount of loans they could make. But securitization made it possible to make as many loans as they wanted, by simply packaging up the loans they made, selling them and collecting a fee. The ample liquidity led to an insatiable appetite for risk, driving up the prices of risky assets and lowering their returns.

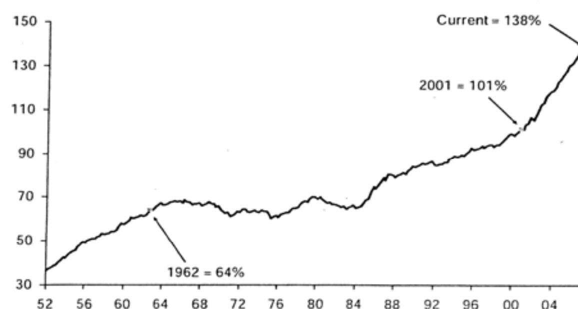
Moreover, this extensive securitization of loans, which was extremely profitable, led to a situation where the perceived risks were widely underestimated by issuers and investors. Rating agencies and the bond insurers contributed to this underestimation of risk, as did the complex pricing models, which were based on historical trends, e.g. rising home prices. Default risk was underestimated; but liquidity risk was even more underestimated. Now underlying default risk has been rising, but liquidity risk has skyrocketed.

The impacts of this reassessment of risk are rippling through the economy. According to a Federal Reserve survey conducted last month through January 17, about 80% of banks raised standards on commercial property loans, while a majority tightened terms on prime home mortgages. After about $150 billion in asset writedowns and credit losses since the beginning of 2007, banks are making it more difficult to get financing. The Fed's interest rate cuts, while helping, have not done as much as expected in alleviating the shortage of credit. Banks are using the liquidity provided by Fed interest rate cuts to repair their balance sheets rather than to make new loans. Since the first cut in the Fed Funds rate last September, spreads on risky securities have widened dramatically.

In a credit crunch, those who benefited the most when credit was plentiful are typically the ones who are hurt the most when credit becomes tight. Today, that means the homebuilders, the US consumer, and financial firms - not too different from past credit cycles. But this time the problems are more far-reaching, affecting a broad range of market participants in the securitized debt markets. With the extensive securitizations in place (over $500 trillion in global derivatives) and the globalization of today's economy, the deleveraging process will take some time.

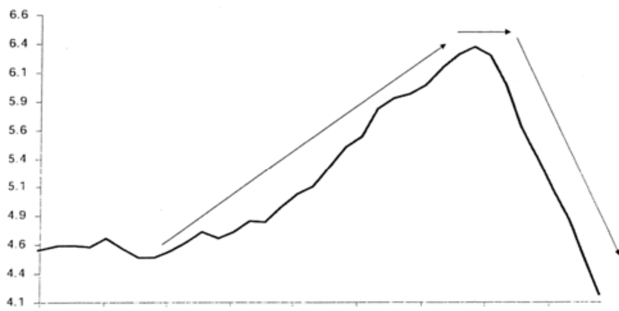
The US **Consumer** has often been referred to as "resilient". Indeed, consumer spending has been up every year since 1991, including the recession year of 2001, and now accounts for about 70% of GDP. But strong spending has been accompanied by massive increases in debt and a backdrop of rising home prices. As shown in Figure 1, the US household debt-to-income ratio currently stands at 138%, up almost 40% from 2001, and more than double that in the Sixties. With the bursting of the housing bubble (as illustrated in Figure 2) and credit drying up, it is difficult to see what will drive spending going forward.

Figure 1: Household Debt to Income Ratio



Source: Bureau of Economic Analysis, Merrill Lynch

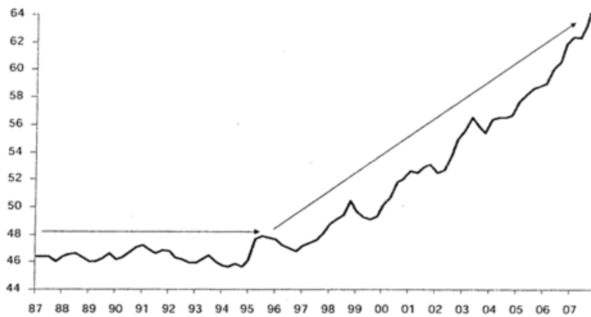
Figure 2: Residential Construction as a percent of GDP



Source: Bureau of Economic Analysis, Merrill Lynch

Financial Firms profited significantly from the abundant credit and the growth in securitization. As shown in Figure 3, they have played a large role in the economic growth we have been experiencing over the last few years. Now with the securitization market shrinking, at least for awhile, and balance sheets severely impaired by writedowns and illiquid holdings, financial firms will not be able to grow as they have in the past.

Figure 3: Bank Credit as a percent of GDP



Source: Bureau of Economic Analysis, Merrill Lynch

Private equity is also feeling the pain of the credit crunch. *Pensions & Investments* notes that in the US, 20 large buyout deals worth $84.4 billion fell through in 2007 versus 20 deals worth $46.9 billion in 2006. Globally, 83 deals worth $231 billion fell through last year, double the year before.

Moreover, the tight credit conditions that have forced private equity firms to cancel or postpone pending buyouts have now spread to completed deals. Debt issued for recent buyouts is losing value and has become more difficult to trade. Almost a third of the bonds issued for buyouts since 2002 sell at a discount. This distressed debt will dampen future dealmaking, which over the past few years has been a driver of stock prices, and will ultimately mean lower returns for private equity investors. On the other hand, companies making strategic acquisitions should benefit from any falloff in private equity deals as more rational pricing prevails.

As of the end of 2007, **hedge funds** were sitting on about $52 billion of unallocated funds, according to *Pensions and Investments*. Institutional allocations to hedge funds rose 165% last year. However, with investment banks cutting back on lending to hedge funds, leverage is getting harder to obtain, and the securitized assets that helped above average returns are no longer easily marketable.

The credit crunch has further to go. In fact, correction of an excess often results in excesses on the opposite side. The repricing of risk has only been occurring for about 6 months and could take at least another 6 months to bottom out. Even then, we are not likely to return to the easy credit times of the last few years.

With the S&P off about 13% from its October 11th high, the stock market appears to have reflected much of the bad news. In fact, our market factors are indicating the possibility of a short-term rally in stocks, with Sentiment, Monetary and Valuation factors all positive. Inflation, while rising, still appears to be manageable. However, the extent to which earnings hold up through this adjustment process will determine whether any rally will be sustainable.

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