Outlook 2008

In my view, the crisis precipitated by sub prime mortgages and the structured products into which they were packaged is merely symptomatic of a broader, simpler theme: over-leveraged consumers, themselves, symptomatic of an even simpler theme: conflicted central banks operating confused policy.

The existence of central banks is an admission of the inefficiency of money markets. By unilaterally setting short term interest rates, a central bank removes the information that a market rate of interest would provide to the market. When central banks use interest rates to 'manage' the economy, they also create moral hazard. Each period of rate cutting has been in response a crisis, each crisis born of a prior period of excess precipitated by an earlier rescue. The reflationary efforts of the US Fed in the current equity market downturn is a risky strategy. The USD is weak and the US faces commodity price inflation. Cutting rates to bail out home owners and financial institutions creates further inflationary pressures through a depressed exchange rate and increased liquidity.

Securitization technology provided the opportunity for adverse selection. If loans can be arranged and the risks transferred, then the motivation for lenders is subverted in that credit underwriting standards become subordinated to volume and scale. The structured credit invention, in itself neither good nor bad, provided the vehicles for leverage to be applied by providing funding to the securitized assets.

Therefore, I do not believe that CDOs are to blame, or that banks are to blame or that regulators are to blame. Sadly, it is investors who are to blame. Principal agent theory points to the misalignment of interests in loan origination arising from debt securitization and should have counselled scrutiny of the underlying debt much more carefully. ABS and CDOs introduce great complexity and opacity making it difficult to understand the risks in such securities. The solution is not to eschew the technology completely but to embrace it with more scrutiny. Securitization and structured credit are useful technologies if properly implemented and understood.

If the underlying problem is one of over-leverage, the solution must be a bout of de-leveraging. The process unfortunately implies decreased consumption and investment leading to slower economic growth if not recession. For the under-levered balance sheet, however, there is the opportunity for profitable expansion. For more levered balance sheets, there will not be the opportunity to double down. What is clear is that there will be significant distress in debt markets of the developed economies. Already, large amounts of capital are lining up in preparation for this opportunity in the US which may actually slow the price discover process and lower returns. In Europe, the opportunity for distressed investing may be higher due to the higher economic leverage created by unions and inflexible employment policies. Covenant light loans and weaker credit standards also pose their own particular problems leading to a more protracted downturn and companies entering restructuring or bankruptcy in much weaker shape.

In the short to medium term, M&A deal flow will slow as domestic deal flow dries up. Leveraged deals, in particular those involving private equity buyouts will be at risk. Current pipeline is already showing increased risk of deal breaks. The likelihood is that those with committed financing will renegotiate but endeavour to close and those with weaker agreements will simply break. The motivation for acquirers to renege on current deals is high but war chests remain full and activity should rebound. GPs suggest that the environment will not normalize till as far as 2009. Of late, banks have been reneging on contractual obligations to fund agreed deals. This is disturbing in cases where the litigation risks of failure to perform exceed the mark to market losses that would occur if they simply do the deals. It signals that banks may be as unable as they are unwilling to lend. There is, however, a silver lining albeit a bit of a wildcard. A protracted commodity boom has enriched the developing world under whose feet are found metals, oil, fertile soil. Their sovereign wealth funds find themselves bursting with capital with which to invest. The opacity of their objective functions, corporate governance standards and accountability maintain a level of uncertainty over their value as rational commercial investors. As with all investors, not all are of the same quality.

The commodity boom has also benefited emerging market companies who find their debt and equity valuations inflated by the influx of capital in search of returns. At the same time, the robust growth of the economies of BRICs and their less well known cousins from Latin America to Sub Saharan Africa, have similarly attracted investors leading to the same inflation of valuations. These companies not only have strong balance sheets but have high equity valuations representing attractive acquisition currency. Cross border M&A is expected to increase. The path will not be smooth as a shrinking pie precipitates nationalistic, protectionist and mercantilist policy responses. I can only hope that commercial rationality triumphs.

I believe that there has been a significant decoupling between developed and developing economies. The deleveraging of the developed economies of US and Europe will have significant impact on the emerging markets. The impact will be most felt in public markets which are most susceptible to correlation. Private markets will be impacted as well, although the exact winners and losers may be unexpected. In any case, private transactions are sheltered from the full extent of the over valuation and the subsequent downside volatility in emerging economies’ public markets.

Globally, banks will be deleveraging. Two elements are required for banks to resume normal expansionary credit: the willingness and ability to lend. The ability to lend is currently highly impaired. A recapitalization of the banking system is a prerequisite and it is something that is beginning to happen. The willingness to lend is less clear. With weak covenants in loans originated in the last two years, companies in stress or distress may not trigger covenants for some time and may have ample opportunity to deteriorate. Banks are unlikely to be willing to extend new credit until current loan obligations are restructured. The subsequent dearth of credit will provide interesting opportunities in direct lending and alternative finance. A potential arbitrage exists in emerging markets where economic growth is robust, corporate earnings growth is healthy, balance sheets are strong but local banks are undercapitalized and international banks are delevering. Structuring a bank funded as a hedge fund may provide an efficient means of gaining exposure to this theme.