

## Banking by EIR Staff

### Foreign creditors get squeamish

*The Fed can lower interest rates, but it can no longer convince European and Japanese investors to join in the fun.*

Salomon Brothers released two research reports March 27 which reflect a turning-point in America's capacity to finance a \$150 billion per annum payments deficit. The first, by analyst Richard Segal, took note of the sudden, recent emergence of a nearly 1% spread between the interest rates for U.S. government securities, and comparable-maturity Eurobonds (U.S. corporate bonds issued abroad). The second, by Vilas Gadkari, recommended that Japanese investors switch to non-dollar paper.

In plain language, the Fed and Treasury have shoveled money into the banking system, while instructing the banks to postpone reckoning with bad loans, in order to keep the banking system afloat, while, at the same time, persuading foreign investors to consume \$150 billion a year in U.S. dollar paper. America's foreign creditors are getting squeamish. When they begin to cut their losses, interest rates will trace a "J" on the graphs.

Historically, American corporate Eurobonds bore slightly lower interest rates than Treasury securities, despite the greater safety of the latter, for a simple reason: Foreign buyers may purchase corporate paper anonymously. Eurobonds are "bearer bonds," payable to whatever Swiss trust account holds them. The Treasury registers the names of purchasers.

Since the bulk of real, investible cash in the international markets derives from roughly \$500 billion a year in flight capital, narcotics revenues, and similar illicit or semi-licit funds,

Eurobonds bore a premium for simple anonymity.

However, as analyst Segal noted, "The yield differential between high-quality Eurodollar bonds and U.S. Treasuries is at its widest level in three years, as a result of a strong rally in the Treasury market, the continued weakness of the U.S. dollar, and heavy new-issue volume in the Eurodollar market.

"Spreads of U.S. corporate Eurodollar issues to Treasuries are especially wide, reflecting uncertainties about the stability of credit ratings. In the case of some corporations, these uncertainties stem partly from increases in debt leverage due to takeover and leveraged buyout activity, plus concern about the effect of falling oil prices on energy company profitability."

Three years ago, Continental Illinois was on the ropes, Brazil was still in confrontation with the International Monetary Fund, and money rushed into Treasury securities as a refuge against the expectation of a banking crisis. As Segal points out, comparable conditions have re-emerged for the first time since then.

The Fed can stage a Treasury bond rally by depressing short-term interest rates, and the federal funds (overnight interbank lending) rate has fallen from about 7.4% in the week ended April 2, to between 6 and 6¾%. However, it cannot convince European and Japanese money to join the fun.

The Japanese have been investing \$50 billion per annum of their trade

surplus in the United States, becoming the largest single funder of the American payments deficit. But now, another Salomon report warned, "Japanese investors currently face a dilemma: In seeking high current income, they have concentrated their foreign security purchases in U.S. dollar-denominated assets, which represented 86% of Japanese net purchase of foreign currency bonds in 1985. However, the . . . sharp drop in the value of the U.S. dollar has resulted in a large decline in the yen value of these securities.

stances, Japanese investors should now reassess their portfolio strategy to consider the high-yield opportunities that exist in non-U.S. dollar markets."

Squeamishness about U.S. corporate paper reflects the accumulating horror abroad after a three-year binge of mergers, acquisitions, and other forms of bidding-up existing corporate assets. Two months before the unfavorable "spread" between Eurobonds and Treasuries appeared, *Euro money* magazine warned, "If denunciations could have put a stop to leveraged buyouts, there would be none today. In the summer of 1984, the LBO was a target for virulent criticism by Paul Volcker, chairman of the Fed, and [others]. . . . The gist of all the denunciations was that top-heavy reversed pyramids of debt were being created; and they would soon come crashing down, destroying assets and jobs. . . .

"But the growth of public deals has been astonishing. . . . According to data provided by Merrill Lynch Capital Markets, in the eleven and a half months to mid-December 1985, a record \$31.5 billion of LBOs were completed: double the volume of a year earlier and three times that of 1983."

The only surprise is that it has taken this long for America's foreign creditors to grow leery.