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G-8 Meet To 'Manage' Hedge-Fund Crisis

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The meeting of the Group of Eight industrialized nations, to be held in Scotland July 6 to 8, is reported as dealing with issues like debt forgiveness for the world's poorest nations, and global warming. But just a week before the scheduled meeting, the Bank for International Settlements (BIS) released its annual report, indicating that a very different set of topics is likely to be on the agenda: how to manage the barrage of risks that could devastate the global financial system. The BIS report summarized the discussions ongoing among governments and international banking circles about whether the world needs a new "international macro-financial stabilization framework," and said that three approaches to this question are being discussed:

1. The establishment of a single international currency;
2. Reverting to "a system more like that of Bretton Woods"; and
3. "Informal cooperative solutions," that is, crisis management.

A highly placed U.S. intelligence source has informed *EIR* that the discussions on returning to a Bretton Woods system, indeed reflect debate about Lyndon LaRouche's proposals, but, as the BIS report indicated, the bankers will be pushing hard to get a crisis-management arrangement, with structures defined by the bankers, who are desperately trying to preserve their control under conditions of impending meltdown.

Among the largest risk factors, according to the BIS report, is "the widening current account deficit of the United States," which "could eventually lead to a disorderly decline of the dollar, associated turmoil in other financial markets, and even recession. Equally of concern, and perhaps closer at hand, it could lead to a resurgence of protectionist pressure."

Another area of grave concern is the credit derivatives market. The "explosive growth" of CDS and other credit derivatives contracts belongs to "the most significant developments in finance in recent years." "The notional amount outstanding on CDS contracts globally reached $4.5 trillion at end-June 2004, up sixfold from end-June 2001."

In spite of the recent turmoil triggered by the downgrading of GM and Ford, the real stress test of the credit derivatives market is still to come, says the BIS: "It remains to be seen how the CDS and CDO markets would handle a string of credit blow-ups or a sharp turn in the credit cycle. . . . One concern is the impact of highly leveraged positions on the balance sheets of financial institutions when markets turn. Another is the nature of the systemic role played by highly leveraged institutions such as hedge funds in affecting market liquidity; two-way markets could conceivably disappear as protection sellers exit at precisely those times when default insurance is needed most." As investors were able to anticipate the downgrades of General Motors and Ford, the report states, "the events of spring 2005 might not be a true reflection of how these markets would function under stress."

To put it more plainly: The BIS says that the situation in the credit derivatives market is already precarious; however, it will get worse, and it might entirely collapse.

Hedge Funds: The Corpses Multiply

And then, there are the hedge funds, whose corpses are beginning to float to the surface. The hedge funds and derivatives trade divisions of the major banks are currently in a near panic, desperately trying to limit the shock waves of derviatives and hedge-fund losses that were apparently triggered by the collapse of General Motors. They are trying to avoid even the hint of danger for the system, but it's not working.

It's not unusual for one out of ten hedge funds to collapse in the course of a year, without fanfare. Almost always these are small or medium-sized funds. But now, suddenly, and for the first time since the LTCM drama in Fall 1998, the large hedge funds are coming onto the radar screen. Three of them have recently acknowledged their dissolution:

Bailey Coates Cromwell Fund, London. It was founded in July 2003 by Jonathan Bailey and Stephen Coates, formerly working at the London section of the U.S. securities firm Perry Capital. The fund was able to accumulate $1.3 billion in capital and another $2 billion in bank credits. Bailey Coates was exposed in particular to bets on U.S. stocks, and for the past few months, it has found itself on the wrong side of such bets. Initial losses led to large withdrawals by investors.

According to EuroHedge, a private institution that tracks the European hedge-fund "industry," the capital of Bailey Coates imploded to $635 million by early June. On June 20, the management announced the fund's immediate liquidation.

Marin Capital, California. The fund was founded in 1999 and raised $1.7 billion in capital. Marin Capital specialized in credit derivatives related to convertible bonds. Exactly these kind of bets led to extreme losses after the downgrading to junk of General Motors. In mid-June, the management decided to liquidate the fund.

Aman Capital, Singapore. The fund was set up in September 2003 by top derivatives traders at UBS (the largest bank in Europe), and Salomon Brothers, and was intended to become Singapore's "flagship" in the hedge-fund business. But by the end of March, the fund's capital already had shrunk

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to $242 million. In April, Aman Capital suffered large derivatives losses. In a statement published by London's *Financial Times* on June 20, the managers of Aman Capital acknowledged that "the fund is no longer trading," and that they will distribute whatever is left of the capital to investors.

UBS is believed to have lost several hundred million dollars which the bank had invested in Aman Capital. Temasek, Singapore's government investment agency, reportedly also lost money at Aman Capital.

London in the Lead

More hedge funds, with capital in the range of billions, may find themselves in a declining situation and could face liquidation soon. Among these are 2 of the 16 hedge funds of GLG Partners in London, one of the largest hedge-fund groups in the world. The GLG Credit Fund, from January to the end of May, had already lost 14.5% of its capital, in the range of $1 billion; the Neutral Fund of GLG lost about 17.2%, or $2.5 billion. The latter fund had worked with the same contracts as Marin Capital. Recently, nervous investors took out about $1 billion from the Credit Fund and the Neutral, after being informed of the new situation at the end of May.

The GLG Group was established in 1995 by three partners of Lehman Brothers. A fifth of the start-up capital came directly from Lehman Brothers. The invested capital of GLG today stands at around $14 billion and exceeds that of LTCM many-fold. One could put it this way: What Argentina was for the loans of sovereign debtors, and General Motors was for investment loans, so was GLG Partners for the European hedge-fund sector.

At the beginning of June, GLG held the designation of the "most respected" hedge fund in London. The now-collapsed Bailey Coates Cromwell Fund was also winning prizes. Two of the four funds of another leading hedge-fund group in Europe, Vega Capital, also must have suffered serious losses this year.

At the same time, the leading investment banks have achieved their worst quarterly results in years. On June 18, Goldman Sachs announced a collapse in profits of 20%. On Wall Street, this has been combined with ongoing turbulence among the hedge funds and credit derivatives. Goldman Sachs's Financial Officer David Viniar tried hard to deny the situation: One can "not always be on the winning side," he said, and "rumors that the firm must have put up with quarterly losses due to bets on GM and Ford Motor, are exaggerated."

On May 22, Morgan Stanley announced a collapse of quarterly profits by 24%. Chief Executive Philip Purcell was forced out only nine days later.

Interest Rates and Loans

These events are directly linked to the so-called Greenspan "conundrum." In his address to a June 6 banking conference in Beijing, Federal Reserve chief Alan Greenspan again picked up the issue of the alleged "mystery" of the contrary movement of short-term and long-term interest rates. Although central banks, in particular the Federal Reserve and the Bank of England, had recently pushed up short-term interest rates, the yields on medium- or long-term government bonds are still falling—in some cases even below short-term rates. In a statement on June 20, Lyndon LaRouche noted that there isn't any "mystery." The discrepancy is "exactly what should have been expected as a result prompted by the way in which the General Motors crash has exposed the unstoppable character of the collapse of the marketable credibility of the already 'lame duck' George W. Bush Presidency," LaRouche said.

Obviously, the European Union, particularly in its current precarious state, cannot "provide even a relatively short-term refuge from a collapsing U.S. financial system," LaRouche said. This means that "everywhere, in the real universe, there is no longer any security for the present world monetary-financial system, even during the short term." Under such circumstances, government bonds, regardless of their yields, are now appearing as the only form of financial paper that offers any long-term value. LaRouche emphasized: "In short, it is the survival of the principal, not the rate of the premium on the relevant paper, which determines its perceptible value to any moderately sane investor."

In line with this assessment, the rush into government bonds reached dramatic dimensions in the trading week ending June 24. This panic-buying again pushed up the prices and drove down the yields of government bonds. Further contributing to this dynamic is the expectation that central banks will soon be forced to cut short-term rates in reaction to economic and financial emergencies. The Swedish Riksbank cut its prime rate from 2.0% to 1.5% on June 21, and there is speculation that the Bank of England and the European Central Bank might soon follow. On June 22, U.S. Treasury prices had their largest gain in seven months, pushing down the yield on ten-year Treasuries below the 4% mark, to 3.93%. Japan the following week saw the biggest decline of government bond yields, down to just 1.205%, since October of last year. In Britain, yields on two-year government bonds fell to 4.17%, the lowest since January 2004.

Perhaps the wildest action took place in the Euro-zone. In Germany, the yield on ten-year government bonds fell to 3.10% on June 24, the lowest since the Bundesbank records began in 1973. Since mid-March, ten-year yields have plunged by 70 basis points. According to reports, German government bond yields are now actually the lowest since the times of Bismarck in the 1890s. Since June 22, investors buying two-year German government bonds are being promised a yield of less than 2%, that is, less than the short-term interest rate set by the European Central Bank. But investors buy nevertheless. In the two days of June 21-22, Euro-zone government bond yields experienced their biggest drop since Sept. 10, 1998; that is, exactly the time between the Russian GKO default and the collapse of LTCM.