The 'Financial Locusts' Are on the Defensive

by Paul Gallagher and Richard Freeman

The threat of a global blowup of major hedge-fund losses in the mortgage-based credit derivatives market, was brought to light on Feb. 13-14 in both public reports and private bank advisories. "The Great Unwind" was the ominous forecast of one bank report on the hedge-fund sector, and London's *Financial Times* reported Feb. 14 that the market for derivatives contracts based on sub-prime mortgages in the United States, had "exploded," even as the number of U.S. sub-prime mortgage lenders going bankrupt or suspending their loans went over 20.

While this explosion in the hedge funds' globalized speculative markets was beginning, a fight against hedge-fund looting intensified in several European countries, where governments or popular movements are trying to stop the "leveraged takeovers" of industry, services, and housing authorities. Laws were introduced by the government in Denmark and drafted by the German government, to stop these takeovers and outsourcing, by prohibiting the huge corporate tax evasions which result from them. The *Financial Times* on Feb. 14 attacked the German critics of hedge funds as "anti-Semitic," citing Wall Street fund managers branding such as Vice Chancellor Franz Müntefering as anti-Semites. But the next day, Müntefering answered back in an interview, insisting that his term, "financial locusts," was on the mark. A British parliamentary movement involving 100 members of the House of Commons has sprung up against "the asset strippers," as they call the hedge funds and private equity funds.

In fact, the wealthiest individuals and institutions have been pulling investments *out* of hedge funds in the past two months—while those funds have started launching initial public offerings (IPOs) to draw in the little investors as suckers to replace the big ones. This is the characteristic of the last stage of a financial bubble about to burst.

In the context of the broader strategic/economic policy shift under way in major nations, the moment may have arrived to stop the hedge funds' and equity funds' looting, or to see them collapse.

The Great Unwind of Hedge Funds

The ominous "Great Unwind" report was written by Stefan-Michael Stalman and Susanne Knips at Dresdner Kleinwort Wasserstein bank for Dresdner Kleinwort's private banking clients; leaked sections of the report were covered in *Barron's* on Feb. 12. The report's assessment is stark: that the highly leveraged $1.3 trillion-in-assets hedge-fund sector, and its bank creditors, by following the practices of the deceased Long-Term Capital Management (LTCM) hedge fund, are headed toward a swift unwinding of its leveraged positions, which will result in a financial crash.

The report says that while the hedge funds control only 1-2% of all global assets under their management, they have contracted two-thirds of all worldwide margin debt (borrowing of funds for stock investment).

The authors warn that while it is made to appear "that hedge fund strategies across the industry [are] diversified, there is actually a high degree of correlation," that is, most hedge funds are betting using the same strategy. Further, during periods of high market volatility, the hedge funds had exploited the volatility to make quick, big speculative killings. Various forces have greatly lowered the volatility. Instead, "a clear majority of hedge funds . . . employ long-short strategies—removing market risk with what are essentially spread or arbitrage bets with a relatively low return." This means that these hedge funds will realize a low return for each bet; therefore, in order to compensate, they bet large amounts of money—most of it borrowed (leveraged); i.e., if the yield on a bet is less than 0.5%, but one bets hundreds of millions of dollars on it, one can earn a million dollars.

Many of the bets, which thousands of hedge funds are synchronously following, is to bet on the spread (the difference in interest rates) between a high-yield instrument, such as a junk bond, and a low-yield instrument, such as a normal corporate bond or U.S. Treasury bond. The hedge funds often employ mathematical models that determine what the historical spread between these particular instruments are. In an insane, linear fashion, the hedge funds bet that the spread will return to the historical norm—they exclude those real world crises that diverge from and disrupt the norm.

This is exactly what LTCM did in 1998: It blew up. However, this time, the hedge funds have and are investing nearly 1,000 times the assets/money that LTCM had.

Imploding Sub-Prime Credit Derivatives

The emerging trigger for this "Great Unwind" is the horrific crisis in the market of credit derivatives, which have been built upon sub-prime mortgages. This is not a big market, but its failure has the power to bring down not only hedge funds, but the financial system.

Sub-prime mortgages are the most usurious mortgages. These are mortgages that banks make to individuals and households, that are classified as having poor credit: people who have previously defaulted on home mortgages, credit card debt, etc.; they also, generally, have lower income levels. Such mortgage loans are made at high interest rates. Various sources estimate that, at the end of 2006, the outstanding volume of sub-prime mortgages had swelled to between $650 billion and $1 trillion.

There is a market of sub-prime mortgage bonds. Either the bonds are issued by lending institutions that issue sub-prime mortgages, or the bonds are issued against Mortgage Backed Securities (MBS), which the banks themselves have issued against sub-prime mortgages. In turn, as an element of the process of pyramiding, credit derivatives have been issued against sub-prime mortgage bonds. These credit derivatives reflect the cost of buying insurance against default on sub-prime mortgages. The ABX Index, which is an index tracking credit risk on sub-prime mortgage bonds, traded on Feb. 13 at 960 basis points (bp), up from 650 bp a week earlier, and about 250 bp last Autumn. The 960 basis points means that the cost would be 9.6 percentage points above a comparable U.S. Treasury bond. The cost is directly affected by the collapse, left and right, of sub-prime mortgage lenders during the past seven weeks, and its spillover effect on sub-prime mortgage bonds.

A *Financial Times* article Feb. 14, titled, "Loans Warning Raises Concerns Over Sub-Prime Market," states, "The financial institutions' warning of difficulties with their portfolios of loans to American [mortgage] borrowers has sent credit derivative investors running for cover. And while the market for credit derivatives on sub-prime mortgages might be small, the extent of the sell-off has raised concerns about the vulnerability of the broader structured finance world." A Deutsche Bank analyst reported Feb. 14, that the crisis is so severe, that the instruments in the ABX index are illiquid.

The failure of the sub-prime mortgage credit derivatives market has the ability to bring down both the hedge funds and the $500 trillion derivatives market.

When Is Anti-Speculation Anti-Semitism?

In April 2005, as noted above, German Vice Chancellor Franz Müntefering attacked the hedge funds as "locusts." Then, German Finance Minister Peter Steinbrück proposed this year that the G-8 nations at their June economic summit, apply international regulation to the hedge funds, including registration; under City of London-Wall Street pressure, Steinbrück has since scaled back to a call for voluntary pledges by funds to provide information to national regulators.

On Feb. 14, the German edition of the *Financial Times,* the financier oligarchy's mouthpiece, smeared Germany's critics: "On Wall Street, . . . Müntefering's remarks [are] read as pure anti-Semitism, because many of the private equity firms on Müntefering's hit list had Jewish names." On Feb. 13, the self-described "Wall Street tabloid" called *The Dealbreaker* ran a nasty attack on Müntefering, which "joked" that he had "recommended a law forcing hedge fund managers to wear yellow, locust-shaped patches on their suit jackets."

In the Feb. 15 *Financial Times,* Müntefering hit back at the ludicrous charges, upholding that "financial locusts" was precisely the right description of hedge funds: "locusts that move into a field, eat it to the ground, and move on to the next without looking back. I think it was quite apt. . . . I was never prejudiced. Money in itself is not bad. But there is a finance industry out there, acting worldwide, which has little to do with classical entrepreneurship. We need rules . . . to insure that this industry . . . respects the requirements of the social market economy."

Yet, the hedge funds slime mold is continuing to advance, moving over the U.S. auto-supply sector, which they did so much to destroy. Ira Rennert's Renco Group is buying Delphi's interiors division, and Renco is hooking up with the predatory Cerberus hedge-fund group buying Delphi, to also buy up parts of the assets of parts supplier Collins & Aikman, which is in liquidation, and also some of parts supplier Dana Corp.'s assets. Meanwhile, mega-speculator Carl Icahn's private equity fund, which already owns Federal Mogul, another auto supplier, is moving to buy Lear Corp. The machine-tool capacity of these companies represents some of the most valuable in the United States; GM estimates that hedge fund owns 20% of its parts suppliers.

On Feb. 9, the Fortress hedge fund issued an IPO—the first time a hedge fund has ever issued public stock. The IPO was oversubscribed, giving Fortress a market valuation of $12.5 billion, 60 times its net profit. This is not a measure of the company's worth, but rather, of how far America has veered from reality.