

ECONOMIC NEWS UPDATE

IRWIN M. STELZER

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The housing situation is deteriorating, as inventories of unsold houses rise, and prices continue to fall. Credit markets are snarled, as lenders hoard cash to pay the bill for the shoes that are still to drop. Bank earnings are down some 25%, driven by mortgage and consumer credit card defaults and late payments, which forced the banks to increase their loan loss provisions to the highest level in twenty years. Layoffs in the construction industry are picking up speed. Consumer confidence is down, partly because oil prices are so high as to be sucking purchasing power out of the economy; retailers fear that the Grinch has stolen Christmas. The dollar is sinking, driving the euro and the pound to levels that is forcing you to rethink that European vacation. The world worries that the newest American export might turn out to be a recession.

The American economy is going through a traditional credit cycle. For about fifteen years credit has been somewhere between cheap and virtually free. Result: lots of borrowing to buy houses, credit cards worn to the nub by hyperactive consumers, and deals by

private equity firms based on loans made by banks eager to get their hands on new securities to flog to investors. Now, the party is over, and it turns out that too much of the collateral for too many mortgages and too many loans is not quite as good as it was thought to be. Indeed, some of it has no market at all, which should pose a problem for auditors asked to certify a value higher than zero.

So much for a summary of the news. One of our popular radio broadcasters attracted millions of listeners with promises of “the story behind the story”. Let me try to repeat his success.

We are indeed witnessing a retreat by the banks from the business of providing credit. But banks are not the only game in town any more. Indeed, although traditional banks remain important financial institutions, there is reason to believe that their woes are less relevant to the long-run performance of the economy than they have been in the past.

Start with the commercial property market. Banks are demanding

that property developers put up 25% of their projects' finance, compared with only 10% before the troubles started this summer, and want to see current cash flow rather than projections of future income. As a result, the issuance of securities backed by commercial loans dropped from about \$30 billion per month to \$6 billion.

But the absence of traditional banks has called into the game new players, including non-US banks, such as the Bank of Ireland, insurance companies and what the Wall Street Journal describes as "smaller real-estate shops". So property developers are paying more, but they can get financing for sound deals.

Then there is the deals business. Small buy-outs, say those under \$200 million, are having no trouble getting the debt needed to complement the equity being put up by buyers. Sources in the London tell me that funding for transactions in the £200-£400 (\$400-\$600 million) range remains available. And not all big deals are being called off. Dealogic reports that companies and private-equity firms pulled off \$435 billion of acquisitions in the first three weeks of last month, a 23% increase over the same period last year. European deal volume tripled. So although the higher interest rates and increased equity being demanded by lenders, the deal business is hardly at a standstill.

Most important of all is the rise and rise of sovereign wealth funds -- massive aggregations of capital in the hands of the world's oil producers and major exporters such as China. China's \$200 billion pile of money looking for a home pales in comparison to Abu Dhabi's, variously estimated at \$650 billion-\$1 trillion (these funds are less

than transparent, so estimates of their size varies). It would be an exaggeration to say that the managing director of Abu Dhabi's sovereign wealth fund, Sheik Ahmed bin Zaayed al-Nahyan only had to dip into his petty cash drawer to come up with the \$7.5 billion needed to make his country the largest shareholder in Citigroup. But not much of an exaggeration. If estimates that the Abu Dhabi fund earns a return of about 10% annually are correct, the Citigroup investment represents something like a mere one year's earnings. Saudi Arabia's Prince Walid bin Talal, reportedly instrumental in forcing out CEO Chuck Prince, has been joined as one of Citigroup's largest shareholders.

The high 11% interest that Citigroup will pay, in addition to giving Abu Dhabi convertible stock -- the so-called equity kicker -- shows how desperate Citigroup is to get its hands on new capital, and to avoid cutting its dividend. But to leap from that to a conclusion that the credit markets are in terminal decline would be unwarranted. Citigroup was having problems long before market conditions deteriorated. It is regarded by many observers as a massive, inefficient and possibly too-big-to-manage dinosaur that should be broken up.

Besides, the banking sector as a whole is going through a long-term change that is merely compounded by current credit-market tightness. The world has changed. Wealth has moved into new hands. "We are seeing a transfer of wealth of historic dimensions. It is not just Qatar and Abu Dhabi. Investment funds are being set up in places like Kazakhstan and Equatorial Guinea," says J. Robinson West, chairman of international consulting firm PFC energy. Morgan Stanley estimates

that the world's sovereign wealth funds hold some \$2 trillion in assets, more than the global hedge fund industry. And they are adding about \$500 billion to their assets every year. One Goldman Sachs banker told me that until recently he had never been to the Middle East; now he makes several trips each month, secure in the knowledge that the Middle East oil producers have to invest \$5 billion every week from their oil revenues, according to Edward Morse, chief energy economist at Lehman Brothers.

Traditional banks, licking their wounds and trying to restore their balance sheets, are reluctantly selling off pieces of themselves to these funds. Estimates are that total purchases of bank shares by sovereign wealth funds already total \$37 billion, and they continue to shop in what they consider to be an under-priced market. So look for more such deals.

And for these funds to take equity positions in non-financial companies. It is not far-fetched to think that the equity capital from these sovereign wealth funds is in part replacing the debt capital that in the past fifteen years greased the wheels of commerce. Setting aside the security issues that might arise if foreign governments seek to buy control of strategic assets -- an issue for another day -- the result will be a healthy deleveraging of the world's business: less debt, more equity. Since equity costs more than debt, profits will drop, but so will the risk that bad times will lead to bankruptcies and defaults -- not a bad trade-off.

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