Trouble in Hedgistan: “Its gonna get a lot worse”

by Mike Whitney via rialator - ICH *Sunday, Jul 22 2007, 12:35am*
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> Two columns of black smoke can be seen rising over Wall Street and disappearing into the ice-blue New York sky. Terrorism? Not quite. The plumes of smoke are all that’s left of two major hedge funds which blew up just weeks ago leaving nothing behind but a few smoldering embers and a mound of black soot.

The compiled assets of the Bear Sterns High-Grade Structured Credit Strategies Fund—nearly $20 billion—have vanished into the miasma of cyber-space where they will soon be joined by $1.4 trillion of other, equally worthless, Collateralized Debt Obligations (CDO).

If you look carefully, you can almost see the mangled and bloodied bodies of the CDOs, the CSDs, the RMBS and the other shaky debt-instruments being pulled from the wreckage and tossed unceremoniously on the bonfire.

Is this how it all ends? The first whiff of trouble in the housing market and then—in a flash--all the funds in “Hedgistan” begin teetering towards earth?

“No Value”-“No Bids”

According to Bloomberg News, Bear Sterns announced last week that there’s “little value left” in one of its funds and “no value left” in the other.

Nothing, nada, zippo.

The news was like a bucket of cold water dumped on the stock market leaving slack-jawed traders shuddering in trepidation.

What does it all mean?

Does that mean that the entire hedge fund empire—which is built on a foundation of dodgy loans and quicksand---may be headed for the crapper?

No one really knows. But a pall has settled-in over downtown Manhattan where gloomy-looking men in pinstriped suits are waiting for the other shoe to drop.

Y’see, the hedge fund industry is based on the bizarre notion that one does not have to produce anything of value to make boatloads of money. You don’t even need assets any more---just a risky loan that can be transformed into an investment grade security through the magic of “securitization” a sprinkling of Wall Street snake oil.

Abrah Kadabra---presto-chango!

It’s like taking shards of bottle-glass and selling it as the Hope Diamond. Who’s gonna notice?

The only catch is that--now that these toxic CDOs are going to auction--there are no bids. That's a bad thing.

"No bids" means that $1.4 trillion of shaky investments have no discernable market-value. The CDOs were graded "mark to model" which translates into "mark to fantasy". It means that the investment bankers and hedge fund managers got together over Martinis one night and pulled a number out of a hat.

Now no one wants to buy them. They're worthless.

The skydiving hedge funds just pulled the CDO rip-chord and nothing came out but confetti.

Aaaaaaaahhhh!

And that's just half the story. There's trillions of dollars in derivatives riding on these shaky CDOs. That's enough to bring down the whole market in a heap once interest rates rise or liquidity dries up. Now it's just a matter of "when" now, not "if".

This illustrates an important point, though. It shows what it takes to be a good hedge fund manager:

Take a shabby sub-prime mortgage; chop it into "investment", "mezzanine" and "equity" tranches. Bundle it with other equally suspect mortgage backed securities (MBS). Decide (arbitrarily) what the CDOs are worth Tell your banker. Leverage at a ratio of 10 o 1. Take 2% "off the top" plus salary for your efforts. Buy a summer home in the Hampton's and a Lexus for the wife. Wait for the crash. Then repeat.

Congratulations; you are now a successful hedge fund manager!

Oh yeah; and don't forget to prepare a few soothing words for the investors who just lost their entire life savings and will now be spending their evenings squatting beneath a nearby freeway off-ramp.

"We're so very sorry, Mrs. Jones. Can we get you some cardboard-bedding to keep off the rain?"

The problems that are appearing in the stock and bond markets all started at the Federal Reserve when Fed-Chief Alan Greenspan opened the sluice-gates in 2003 and lowered interest rates to 1%. (Way below the rate of inflation) Since then, trillions of dollars have flooded into the markets creating multiple equity bubbles in real estate, stocks and credit.

Serial bubble-maker Greenspan is to finance-capitalism what Wrigley is to chewing gum. The greatest flim-flam man of all time.

The Fed has tried to conceal the massive increase to the money supply, but the evidence is everywhere. (Many analysts now calculate that inflation is running at roughly 13%) Food and energy have skyrocketed. Housing prices have soared. Everything has gone up except the cheapo imports which the Fed uses to manipulate the inflation stats.

The gigantic housing bubble is mostly Greenspan's doing. After printing-up mountains of cash and creating artificial demand through low interest rates; he promoted his product-line with the typical huckster sales-pitch. "Maestro" advised us that the extension of credit to all-God's creatures, worthy or not, is a good thing.

Here's a clip of Alan praising subprime lending in a speech on April 8, 2005:

"With these advances in technology, lenders have taken advantage of credit-scoring models and other techniques for efficiently extending credit to a broader spectrum of consumers. . . . As we reflect on the evolution of consumer credit in the United States, we must conclude that innovation and structural change in the financial services industry have been critical in providing expanded access to credit for the vast majority of consumers, including those of limited means. . . . This fact underscores the importance of our roles as policymakers, researchers, bankers and consumer advocates in fostering constructive innovation that is both responsive to market demand and beneficial to consumers."

Yes, of course, with all these "advances in technology" and new-fangled "credit-scoring models" why would we need to verify a loan-applicant's income or require that he scrape together a measly $5,000 for a $450,000 mortgage?

That's all so 20th Century!

Now that foreclosures are mushrooming at an unprecedented pace, the Fed is trying to distance itself from the problem by blaming the banks for their shoddy underwriting practices. But the guilt lies with the Central Bank. Its all part of their whacko plan to crush the dollar and create a police state.

It may sound trite, but "inflation is theft". Unfortunately, inflation is also part of the ruling class' strategy to rob the poor, fuel the stock market with cheap credit, and move jobs overseas. It is the autocrat's method of "social engineering"---shifting wealth from one class to another by simply printing more money and pumping it through the system via low interest rates. Remember, bankers know that people will ALWAYS borrow money if lending standards are relaxed and the money is cheap enough. At 1%, the Fed was basically losing money on every transaction, but persisted with their plan anyway.

Anyone who cares to go back and trace interest rates moves for the last 7 years will see that the Fed is really a political organization that decides monetary policy entirely on the basis an elite agenda that supports endless war, outsourcing of American jobs, and domestic repression.

Are you surprised?

Now, a bad situation is about to get a whole lot worse. Consumer credit rose last month by a whopping 12.9%---credit card debt by 9.8%! Since housing prices have flattened out, homeowners can no longer borrow on their dwindling equity (Mortgage Equity Withdrawal; MEWs) which is forcing the maxed-out American consumer to use plastic even though rates are averaging from 18% to 27% monthly.

Automobile repos have also hit historic highs. But the real damage is showing up in the subprime market where the percentage of defaults continues to rise unabated.

In itself, a correction in real estate is not enough to bring down the whole economy. Unfortunately, the contagion from the subprime meltdown has spread to the stock market, the insurance industry, banking and pensions. Not even Secretary of the Treasury, Henry Paulson or Fed-master Ben Bernanke are claiming that the subprime problems are "contained" anymore. Just this week, the scholarly looking Bernanke said to Senators on the Hill that the housing market has "deteriorated significantly".

It’s about time. If anyone still has any doubts about the magnitude of fiasco, I recommend they look over these eye-popping charts which tell the whole story. The housing blowdown will spread the carnage from “sea to shining sea”.
http://www.itulip.com/forums/showthread.php?p=12232#post12232

The faltering housing market has drawn attention to an even more colossal credit bubble that is limping towards earth as loan requirements tighten and liquidity dries up.

The prevailing fear on Wall Street is that we may be seeing the beginning of a global credit crunch.

The danger is not just the subprime loans or even the mortgage companies that made the loans, but the overall risk to the secondary market where these loans have been sold as CDOs to the tune of $1.8 trillion.

In this new deregulated environment, the banks don’t have to rely on savings anymore to make the loans. They simply originate the loans, take their commission, and sell the debt as CDOs. They’re even allowed to sell the risk of default through credit default swaps (CDS) which are a form of insurance that minimizes the banks exposure. These weird innovations have spawned riskier and riskier loans and increased the likelihood of damage to the broader market.

The Toxic Cycle of Debt?

Economics correspondent, Stephen Long, explains it like this:

“The problem that arises from the subprime mortgage collapse is that it creates a toxic cycle of debt. Banks originate loans or bundle up loans that mortgage companies have made and sell the risk on to the hedge funds. Then the hedge funds say, ‘Hey, we’ve got this product that has an investment grade rating so we’ll borrow against it from the banks.’ (oftentimes leveraged at a ratio of 10 to 1) Now the hedge funds are trying to buy the original loans to stop them from going into default.”(The hedge funds are forced to slow the rate of foreclosures so they won’t go bankrupt.)

So, what happens when these shaky bonds (CDOs) are “down-graded”?

Will the hedge funds fall like dominos just like the subprime mortgage-lenders? Will we see liquidity evaporate in the broader market triggering a plunge in the stocks and a massive sell-off in the bond market?

CDOs were conjured up with the idea that vast amounts of money could be made on very meager assets through a complex expansion of leverage. They were promoted as “limiting risk” by spreading it to a greater number of investors and providing extra protection through derivatives. Mortgage Backed Securities were sliced and diced into “more risky” and “less risky” tranches depending on investor appetite. Only now—to everyone’s surprise---“collateralized debt obligations with stellar Triple-A ratings have been getting hit by the subprime market’s woes.” (Wall Street Journal, “Bernanke revises subprime outlook”) On top of that, the ABX derivative index “has started showing pronounced weakness at the top of its ratings structure.” (ibid WSJ, 7-19-07)

Get it? In other words, even the VERY BEST of these multi-trillion dollar investments are beginning to falter. The contagion is spreading through the entire market. The CDOs are worthless. No one wants them. In fact, the whole new regime of exotic debt-instruments which emerged from 2000-on, is barely hanging on by a thread. One minor downturn in the stock market and the hedge funds will go freefalling through open space.

A speech by Robert Rodriguez of First Pacific Advisors (CFA) gives us a good idea of the enormity of the money involved. In his “Absence of Fear” address in Chicago on June 28, 2007 he states:

“Since 2000 hedge funds have more than doubled in number, while their assets have tripled. They too are using elevated levels of leverage, as are PE (Private Equity) firms and investors in highly leveraged fixed income securities. These funds are heavy users of derivatives. The Global derivatives market grew nearly 40% in 2006--the fastest pace in the last nine years--to $415 trillion, per the Bank of International Settlements. The amount of contracts based on bonds more than doubled to $29 trillion. The actual money at risk through credit derivatives increased 93% to $470 billion, while that amount for the entire derivatives market was $9.7 trillion. The International Monetary Fund, in its April 2006 Global Financial Stability Report, estimated that credit-oriented hedge fund assets grew to more than $300 billion in 2005, a six-fold increase in five years. When levered at 5-6x, this represents $1.5 to $1.8 trillion deployed into the credit markets. Fitch, in their June 5, 2007 special report, “Hedge Funds: The Credit Market’s New Paradigm,” says that despite the upward trend in maximum allowable leverage, “notably, no prime broker reported raising margin requirements in response to historically tight credit spreads and growing concerns about the general level of risk-complacency in the credit markets.”

If Rodriguez’s “eye-popping” numbers are accurate and the market slumps a mere 5%, “the value of a hedge fund’s assets could lead to a forced sale of as much as 25% of its assets”. If the market falls just 10%, the fund would get a 50% haircut!

Yikes! That just shows how over-exposed the industry really is.

As the requirements on mortgages gets tougher and the subprime market continues to languish; bankers will naturally become more hesitant to loan zillions of dollars to hedge funds and private equity firms. When credit gets tighter, the hedge funds will begin to nosedive which will send the stock market in a long-term swoon. That’s what happens when a market is this over-leveraged. It’s unavoidable.

The markets are now perfectly poised for a full-system breakdown. FDIC Chairman Sheila Bair expects a CDO time bomb. She summed it up like this:

"Its going to get worse before it gets better. How much worse, I don't know."

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