

The Great Thaw

Federal regulators appear to be chipping away at the ice as shaky investors attempt to get back in the game.

By Riley McDermid, Deputy Editor

Recent moves by federal regulators to breathe new life into formerly frozen credit markets appear to have worked, at least for now, in a sign that global capital markets are beginning to stabilize amid new confidence in liquidity and valuation across the board.

"There is no question that credit markets are definitely unfreezing," Michael Jaliman, a senior adviser at Boston-based advisory firm Vantage Partners, tells Markets Media. "The risk premiums over certain funds are much lower, the corporate markets have come back, the Federal Reserve has created all these loan facilities."

All of those factors have combined to coax liquidity and movement back into markets that had been listless at best only a few months ago. That diagnosis was echoed frequently during interviews for this story over the course of late April and the first two weeks of May.

"Sure, they are nowhere near back to where they were [at their height]," says Jaliman, "but they are also nowhere near as frozen as they had been."

Fund managers worldwide agree that the outlook for credit markets now is much more optimistic than it has been in nearly a year.

"Most indications are that the credit market tide has turned the corner on the back of the massive reflation efforts orchestrated by central banks worldwide and that the credit system has started thawing," says Prieur du Plessis, a Cape Town, South Africa-based portfolio manager and chairman of Plexus Asset Management, who closely monitors credit markets. "However, although the convalescence process seems to be well on track, it still has a way to go before confidence in the world's financial system is restored and liquidity starts to move freely again."

Former regulators, too, said they are more positive about the direction that markets are moving. "I think most would agree that federal government intervention has helped to thaw the markets in recent months," Kevin Petrasic (pictured at right), a former official at the Office of Thrift Supervision tells Markets Media. Petrasic served at the OTC from 1989 to 2008 and is now an attorney at law firm Paul Hastings, Janofsky & Walker in Washington, where he is part of the firm's financial services practice group.

He says that thus far, the Fed's Term Asset-Backed Securities Loan Facility, or TALF, has been "especially effective" in freeing up credit in the markets that it has targeted, while the Federal Deposit Insurance Corporation's Temporary Liquidity Guarantee Program has been effective in restoring liquidity to the interbank lending markets, "which were really struggling at one point last fall." All of those moves, as well as widespread interest in the new presidential administration's Public-Private Investment Plan, has served to stabilize formerly shaky credit markets and restore positivity where they were frozen solid as recently as this fall.

"Overall, tighter regulation brings about a certain level of assurance and confidence in the credit markets that has benefited many areas, but not all," says Petrasic. "Regulations can help going forward, but are not going to do much to deal with some of the problems already embedded in the banking system, such as the significant commercial real estate exposure of many regional and community banks."

For now, the thaw appears to be limited but spreading, as it reaches into various specific markets, say analysts. "There are signs that the downturn is starting to abate in certain sectors," wrote Jonathan Basile, an economist at Credit Suisse Holdings, in a note the last week of April. "We'll start to see smaller minus signs" for the economy overall going forward, he added.

But there is still some work to be done by regulators, however, says Josh Galper, principal of Finadium, a financial consulting and data tracking firm. "There is some thaw, but I see the real initiative being taken by community banks looking to jump-start their local economies with effectively no returns for themselves," he says. "These banks are taking [Troubled Asset Relief Program] money and lending it out with little to no margin." Galper says that larger banks appear to be more reluctant to reenter the chilly credit space, as they attempt to rebuild their capital reserves and await any future nasty surprises.

"I do not see Citi et al lending to any substantive degree. That does not make me hopeful about a near term thaw," says Galper. Those banks could see even greater problems on the horizon, he warns. "I think that credit card debts could see a massive default, which would in turn impact credit markets and lending," he says. "If this is going to happen I think we will start to get news about it this spring."

Cracks in the Ice

A spring thaw appears to have come to the secondary market for loans backed by the Small Business Administration, a sign that the credit crunch may finally be easing in some sectors, Kurt Chilcott, president and chief executive of CDC Small Business Finance, tells Markets Media. San Diego, Calif.-based CDC says it approved \$20.3 million in loans in April, a leap from only \$11.6 million in March, and Chilcott says he expects recent efforts by federal regulators to unfreeze the markets to help that trend continue. GovGex.com, a secondary-market exchange where bundled SBA-backed loans are bought and sold, also showed some positive movement this spring, with the total loans for sale on the exchange jumping to \$67.5 million from \$7.8 million from mid-March.

Chilcott says he expects that trend to continue as players begin to feel safer in formally dangerous waters. "We're already seeing movement post-stimulus bill signed by Obama in February," says Chilcott.

He adds: "[Our] SBA-504 loan approvals in California, Nevada and Arizona are up 20 percent. CDC Small Business Finance approved 37 loans in April, up from 21 in March, a 76 percent increase. We're hoping this positive movement continues."

He says that while many small businesses are naturally struggling through a deepening recession, thus far many business owners have been waiting for certain types of fee eliminations to be enacted by the organization, which could spur another spate of lending. "Many small businesses in January and February were sitting on the sidelines, waiting for the SBA fee eliminations to take effect," says Chilcott. "Since these fee eliminations [took] effect Feb. 17, many small business owners have jumped back into the game, determined to help their companies grow."

The market also continues to wait for new regulations on lending to broker-dealers in the secondary market for SBA-backed loans, which were originally supposed to be enacted by March 19 in an effort to help dealers get toxic assets off their balance sheets.

TED Spread Spurs Hope

Analysts are also closely watching the TED spread, which measures the difference between what banks and the U.S. government pay for three-month borrowing, and has recently narrowed to its most favorable level since August 2007, decreasing from 465 basis points to about 75 basis points the week of May 15. That spread is nearly 4.7 percent of LIBOR, or the London Interbank rate over T-bills for 3-month deposits – a positive sign for many market participants looking for any clues of market stabilization.

"This signals that confidence in the banking sector is returning to more normalized levels," Kathleen Shanley, a senior investment grade analyst at Gimme Credit, which provides independent corporate bond research to institutional portfolio managers, tells Markets Media. For some contextual understanding, the long term average of the TED has been 30 basis points with a maximum of 50 basis points.

"During 2007, the subprime mortgage crisis ballooned the TED spread to a region of 150-200 basis points. On Sept. 17, 2008, the TED spread exceeded 300 bps, breaking the previous record set after the Black Monday crash

of 1987," says Jaliman. "Some higher readings for the spread were due to inability to obtain accurate LIBOR rates in the absence of a liquid unsecured lending market. On Oct. 10, 2008, the TED spread reached another new high of 465 basis points."

Thus, the fact that those numbers have now begun to tighten is an unmistakable sign that some confidence has begun to seep into markets previously spooked by risk and hoarding cash in an effort to ride out uncertain times. Shanley says that broader signs of confidence have also returned to the market, as several major banks have "rushed" to issue equity and nonguaranteed debt, including a pledge by Citigroup in mid-May to issue nonguaranteed 10-year bonds.

"I don't think the market would have been receptive to this as recently as a few weeks ago. But investors appear to have been reassured by the results of the stress tests, even if there is still uncertainty about the economic outlook and the prospect for future credit losses," says Shanley. "We also saw JP Morgan sell a creditcard asset-backed security this week without the involvement of the government's TALF funding program – this was the first creditcard offering this year without government support."

Falling mortgage rates are also good news for analysts hoping for a major credit thaw heading into the summer, says Plessis, even though the markets have not yet passed those savings directly on to consumers.

"After hitting a peak of 6.51 percent in July last year, the average rate for a U.S. 30-year mortgage declined markedly. However, the rise in the yields of longer-dated government bonds over the past eight weeks – 57 basis points in the case of US 10-year Treasury Notes – resulted in mortgage rates creeping higher since the April lows," says Plessis. "Also, the lower interest rates are not being passed on to consumers, as seen from the 414 basis-point spread of the 30-year mortgage rate compared with the threemonth dollar LIBOR rate."

Fed Chairman Ben Bernanke said on May 5 that "mortgage credit is still relatively tight," which Plessis says "raises the possibility that the Fed will boost its purchases of Treasuries to keep the cost of consumer borrowing from rising further."

"The Fed has so far bought \$95.7 billion of Treasury securities from \$300 billion earmarked for this purpose," Plessis adds. "Similarly, purchases of agency debt of \$71.5, out of \$200 billion, and mortgage-backed securities of \$365.8 billion, out of \$1.25 trillion, have taken place."

"Another indicator worth monitoring is the Barron's Confidence Index. This index is calculated by dividing the average yield on high-grade bonds by the average yield on intermediate-grade bonds," says Plessis. "The discrepancy between the yields is indicative of investor confidence. There has been a solid improvement in the ratio since its all-time low in December, showing that bond investors are growing more confident and have started opting for more speculative bonds over high-grade bonds."

Still, Shanley cautioned that although credit spreads have "improved materially" from December 2008, when levels reached all time wises, the market is still only in the early stages of a potential credit thaw, as the international economy continues to skid. That could mean that the while the optimism of market participants is growing, it is largely a question of the psychology of how the market feels after massive intervention by federal regulators.

"Considering that the economy remains weak, and that defaults are likely to keep climbing, especially in the high yield sector, I would attribute this improvement to an improvement in sentiment rather than to any improvement in economic fundamentals," says Shanley.

Slowing Redemptions

A significant reduction in redemptions from hedge funds is also another sign that markets have begun to reach equilibrium, as investors begin to see hedge fund performance "pick up" and decide to wait things out a big longer in a bid to capitalize on any turnaround.

"There are likely a lot of investors who have made decisions to stay in the game for the long haul after having stayed with it up until now," says Petrasic. "You don't want to be the last one out the door right before things start to turn around." Dan Cook, senior market analyst at IG Markets, says that while for now redemptions may be "perceived" as easing, "it is still a story of net-outflows." IG Markets specializes in financial derivatives and a dealer in margined Foreign Exchange for brokers, fund managers and trading companies plus.

"Similar to the broader economy where we have seen some slowing of the declines, they are still declines and not improvements," says Cook. "There is still a vast gap between slowing deterioration and actual recovery."

That gap will probably remain wide for at least the short-term, because even thawing credit markets do not necessarily soothe investors who continue to grapple with questions of valuation and risk across all asset classes.

"In the banking and financial services context, I would say that most hedge funds have stayed on the sidelines waiting for opportunities to enter the markets. Generally, these groups have been cautious, but remain able to move quickly to capitalize on particular market improvements," says Petrasic. "I would expect that you will continue to see these same characteristics portrayed in the months ahead, with fund managers taking carefully calculated risks to capitalize on market opportunities in the banking and financial services as they arise."

But Petrasic warns that while there remains a "certain phenomenon" that hedge fund players will "watch and wait to make sure a move produces a certain return," investors continue to be cognizant that "the potential reward has to be there to justify the risk, particularly in a market like we are in right now."

Navigating the Thaw

Jaliman says that for the time being, he is seeing a greatly increased interest in commodity, macro and market neutral strategies, which have become "much more popular" as investors begin to switch toward buying things they see to have "intrinsic worth." "They are seeing that macro strategies are doing well, and people like that you can predict them on that sort of backing,"

"There are likely a lot of investors before things start to turn around," says Jaliman. "Market neutral strategies, too, make a great deal of sense if you are a conservative investor looking to increase your yield" something which had previously kept some market players out of the deep freeze of many credit markets.

Other market players still seem to share those concerns, making it unlikely that the credit thaw could turn into a widespread defrosting anytime soon. One of the nation's largest pension funds, the California Public Employees' Retirement System, says that for now it was waiting to see if still-locked up credit markets loosen anytime soon, adding it was "reluctant to telegraph our tactical plans in this still competitive world." However, a similarly sized pension fund says privately that "there's considerable interest in the TALF, which I understand is offering promising risk protection for big investors like us who may take on toxic debt."

"We're taking a much bigger cash position these days than we did before the recession in order to maintain enough liquidity to meet our capital calls, mainly private equity and real estate, and to be flexible to take advantage of good deals in the market," said the fund that declined to be identified, citing privacy on strategy issues. "Obtaining credit isn't the problem for us that it is for smaller investors."

In the meantime, many hedge funds that outperformed the market have been adapting "pretty well" during the first part of the year, says Cook, as they struggle to adapt to a brave new world that for now has kept them relatively unregulated – a boon for flexible investment strategies. "Last year was horrific overall and the successful funds have found a way to make even adverse markets work for them," says Cook. "Without the regulations that are put on mutual funds, a hedge fund can really take advantage of any circumstance provided they can adapt quick enough."

Mixed Feelings

For their own part, many of the key regulators who helmed these sweeping regulations appeared to be conflicted on how well they are working or whether they are targeting the right chunks of the market. Even Treasury Secretary Timothy Geithner told Congress on May 5 that for now, "to date, frankly, the evidence is mixed" that the federal intervention has unlocked markets.

"Ultimately though we have to look at two things," said Geithner in testimony before the Congressional Oversight Panel, which is tasked with keeping an eye on how regulators administer the massive \$700 billion financial bailout. "One is, do the institutions themselves have enough capital to be able to lend? And does the system as a whole, is it working for the American people for recovery?" said Geithner. "And that's the standard we're going to look at."

Geithner's efforts spurred scathing criticism from Neil M. Barofsky, the special inspector general in charge of monitoring the bailout program, in his second report to Congress at the beginning of May. Calling the \$700 billion

TARP program an ambitious effort of “unprecedented scope, scale and complexity,” Barofsky continued to press the Treasury on exactly how it is keeping track of how financial firms spend the money and criticized the lack of oversight of the program.

“The American people have a right to know how their tax dollars are being used,” wrote Barofsky, who noted the plan could have “significant fraud risks,” because of the massive systemic problems associated with many subprime or nonprime loans now being considered “toxic” assets by federal regulators. He also took aim at the more recently debuted TALF, because it may rely too heavily on the credit ratings of agencies that previously rated many of those toxic assets much higher than was merited – in which case, the government may be falling into the same sticky credit market trap as banks and market players did earlier during the financial crisis.

“Credit ratings, cited as one of the primary credit protections in TALF as currently configured, have been proven to be of questionable value,” Barofsky’s report says. “The wholesale failure of the credit rating agencies to rate adequately such securities is at the heart of the securitization market collapse, if not the primary cause of the current credit crisis.”

Jaliman adds that while any short-term thaw may seem small in comparison to the heady days of debt buying only a few years ago, it is still a sign that the market has been saved, at least for now, from sliding into a “very severe” depression.

“Is it working enough to sustain actual economic growth as opposed to just saving us from an accelerated crash in GDP? That we can’t know quite yet,” he says. “But the Fed and the government deserve credit for what they did to accelerate a decrease in GDP and preventing a much worse recession. They have accomplished that and that has restored a sense of credibility.”

Hanging Out a Shingle

Several market watchers says that although there has been an exodus of talent from large Wall Street banks to smaller boutique operations, thus far they have seen little in the way of start-ups from former fund stars in the finance industry.

“The hedge fund industry was never meant to survive a world in which the fund managers were this far away from their high water marks,” says Randy Cass, a Canadian hedge fund manager and former institutional portfolio manager, and founder of financial data firm First Coverage. “Management fees keep the lights on but performance fees, which can only be obtained once those high water marks are passed again, pay for the lifestyle. If capital was easier to access I think you’d see a much greater exodus of talent into new ventures, new funds, with clean histories.”

That has so far failed to happen, even as credit markets begin to slowly unlock, he says, because capital still remains a scarce resource in a risk-averse climate. “As it is, we aren’t seeing a lot of new fund start-ups but I believe that’s only because the capital is very difficult to raise and if that frees up, we will see more people leave to hang out their own shingle,” says Cass.

Petrasic agrees, adding that while many former Wall Streeters may have fled for the safety and anonymity of traditionally staid, conservative boutiques, there still appear to be many major players sitting on the sidelines when it comes to acquiring struggling firms.

“While there certainly has been significant investor interest in exploring acquisitions of troubled banks, no one is seriously pursuing bank start-ups right now,” says Petrasic. “This is due, in part, to the opportunities that appear to be surfacing with the availability of attractive franchises at existing institutions, including significant interest from private equity firms in this space, as well as very strong signals from the federal banking agencies that de novo charters will have an uphill struggle to get approved.”

‘A Good Night’s Sleep’

There can be no doubt that the last two years have fundamentally changed the landscape of global capital markets, most expert say, after months of both tanking valuations and widespread scandals forced investors to question even the most basic of due diligence done during the boom times earlier this decade. Fund of funds and hedge

funds appear to have suffered the most from this suspicion in the wake of billion dollar Ponzi schemes and tanking pension funds losses.

"The myth of [fund of funds] being better able to withstand fat-tail events and being your 'eyes and ears' was obliterated in the fourth quarter of 2008," says Cass. "Between massive drawdowns, fat-tail correlations and Madoff-like scandals, they will never be able to claim that mantle again. That being said, the same tarnish has rubbed off on to the quants and the market-neutral strategies as well. The bad news continued to roll in even after the credit markets began a tentative rally right before Christmas, further spooking investors.

"No one was really able to come out of this with their reputation as 'uncorrelated' intact so I agree that fund of funds are being bypassed but I'm not sure the money is heading into the active single managers like some think," Cass adds. "Before investors used to come to market-neutral quants and fund of funds for the 'peace of mind' and a good night's sleep. That's not going to happen anymore."

Jaliman says that he agreed with that, because a year of crushing losses has many people wondering "why they are paying so much money" in fees for funds that neither met their return targets this year nor avoided multiple scandals resulting in billions in losses.

"Some fund of funds use complicated math strategies, and in that case, if it is verifiably a better strategy, it may be worth the money," says Jaliman.

"But," Jaliman adds, "some people got very wary after the scandals showed that some fund of funds weren't doing the due diligence, and that makes them reluctant to pay more."

That sort of reluctance will ultimately lead to many funds charging much lower fees, as they try to woo back big players with stressed bottom lines and an aversion to risk. "This isn't just likely, but inevitable," says Cass. "The funds have their hands tied right now. Either they agree to redeem their investors or they agree to bite the bullet on the fees that they are being asked to by some of their largest investors."

"There will still be the odd exception who is able to charge above market for a premium product, but there is no way that this hedge fund industry reverts back to the days of 2 and 20 for institutional investors," he says. "It was a misalignment of goals and compensation that ended with sophisticated institutional investors paying performance fees on returns that were obliterated. They won't line up to do that again anytime soon."

In the end, even if a bull market returns, investors are much less likely now to go in for more exotic products and vehicles, says Cook, because the old adage of "once bitten, twice shy" will apply for some time to come. "I think that people have a better level of trust, or at least a lesser level of mistrust when dealing with a single entity. Obviously the impact of the recent fund scandals, Madoff, et al, has created a lot of uncertainty," says Cook.

"One of the problems this has created is that people cannot feel comfortable if they find out that a diversified fund of fund is simply placing money in other funds and therefore has less control over investments and less accountability," he points out. "Also, I think we will see people providing the diversification between multiple funds themselves, rather than relying on someone else to do it for them."

"While regulation can be a nasty term, I feel that the funds have to embrace this aspect. The reason being is that people are scared, they want transparency," says Cook. "Until investors can feel somewhat comfortable with the risk they are taking, they will continue to stay on the sidelines or self-manage."

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