VIEWPOINT

It's A Small (Flat) World After All

By Jonathan Friedland and Geoffrey Richards

One of a series of opinion columns by bankruptcy professionals

The American consumer, some domestic lending institutions and the U.S. dollar are struggling. Sovereign wealth funds could be the capital source that provides the necessary ballast to the U.S. economy. These sources of foreign capital could greatly aid the ability of the U.S. economy to maintain its buoyancy in the near term.

The American consumer's seemingly insatiable appetite has long driven the U.S. economy. Indeed, where the American consumer goes, so too goes the American economy. Domestic consumers gobbled up $9.7 trillion of goods in 2007, more than the aggregate gross domestic product of India and Japan. Financial institutions have devised innovative products to try to satisfy this demand. Some would suggest that if the credit was not there for the taking, consumers would not have incurred the debt. This is like the idea that fast food restaurants cause obesity. But that is a topic for another article. Second mortgages, home equity loans, home equity lines of credit, credit cards, convenience checks, auto loans - these products and more contributed to the abundance of easy money.

Securitizing loans, mortgages and receivables into interest-bearing securities dates back to the late 1970s. These products exploded in popularity in the early 1990's as banks explored ways to revive the moribund real estate financing market in the wake of the S&L crisis. Residential mortgage backed securities (RMBSs) enabled lenders to shift risk from their balance sheets to third parties and provide buyers with the liquidity to fund real estate transactions. Another product, the collateralized debt obligation, or CDO, bundled diversified RMBS pools, repackaged them and then sold them to investors. CDOs were attractive to institutional investors because they offered higher returns in a low interest rate environment. Like bonds, various CDO tranches were assigned credit ratings by ratings agencies with the tranches least likely to default (i.e., senior tranches) often receiving triple-A ratings, the same rating as U.S. Treasury securities.

After riding the RMBS and CDO wave for several profitable years, it became increasingly clear that this wave had crested by the early summer of 2007. Interest rates on mortgages rose; the housing market slowed; the pace of delinquencies and foreclosures on recently originated loans increased. The negative feedback loop had begun. Tighter liquidity conditions, reduced asset values, constrained capital resources, curtailed credit availability, and decelerating demand all began to feed back on one another. A precursor to more significant events to come, two hedge funds managed by Bear Stearns collapsed in July 2007, and several of the Australian-based Basis Funds imploded in August. The debt markets were rattled and served as an abrupt wake-up call to investors.

That stumble prompted downgrades from rating agencies and set in motion a downward spiral as investors scrambled to liquidate investments in sub-prime mortgage backed securities. Several other prominent hedge funds and investment vehicles (with impressive track records) are unwinding or have been forced to liquidate: Peloton Partners, Focus Capital, Sentinel Management Group, DB Zwirn, Carlyle Capital, Deephaven Event Fund, and Sowood Capital Management to name a few. They were on the wrong side of the trade, and excessive leverage - in some instances approaching 30:1 - came home to roost.

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As the credit markets continue to contract, concern about the health of the American consumer is growing, and with good reason. Slumping home values, tighter lending standards, higher levels of household debt, and rising food and fuel costs are poised to make 2008 a difficult year for the U.S. consumer. Homeowners, confronted with declining home prices and tightening lending standards, are losing their homes at an escalating pace not seen since the Mortgage Bankers Association started tracking the data in 1979. As of December 2007, 2.2 million homes were in foreclosure according to Realtytrac.As a percentage of all home loans outstanding, the number of loans in foreclosure has doubled in two years to 2.5%. And, of all foreclosures in the fourth quarter of 2007, 42% were related to subprime adjustable rate mortgages. With nearly $600 billion of adjustable rate mortgages resetting in 2008, more foreclosures are certain to follow.

Homeowners' ability to borrow against the equity in their homes is constrained by declining home values in most parts of the country, causing many consumers to increasingly rely on other forms of credit including credit cards. This shift to plastic caused credit card debt to rise 7% in 2007 to more than $900 billion, the largest year-over-year percentage increase since a 10% increase in 2001. As balances have increased, so too have credit card delinquency rates, rising to 4.6%, the highest level since the first quarter of 2003, and 40 basis points shy of the 5.0% peak reached this decade in the third quarter of 2001.

Consumer weakness has spread beyond homes and credit cards as default rates on auto loans hit a 10-year high in January 2008. As the debt burden builds, consumers in many instances are faced with the decision to pay the mortgage, put food on the table, or make the car payment. For families with a primary and secondary vehicle, the secondary vehicle may be sacrificed. For families and individuals with only one vehicle, default on the primary means of getting to and from a job may be the last straw. And while a $600 rebate from the government is found money, and may help those in the greatest need, it likely will only postpone the day of reckoning for many consumers in greatest distress.

Certain parts of Wall Street have not fared much better than the consumer. A number of financial institutions have taken a hit, with $140 billion in asset write-downs to date. The market capitalizations of eleven U.S.-based investment banks and lending institutions have similarly suffered, falling $375 billion since the spring of 2007.

As banks incur losses and as the assets that serve as collateral to their loans decline in value, the risk increases that these institutions become risk averse, tighten their underwriting and lending standards and reduce market liquidity. The list of busted deals since the spring of 2007 is growing longer with over $100 billion of announced M&A transactions cancelled to date, including the previously announced acquisitions of SLM Corp., Affiliated Computer Services, Harman International, BEA Systems and United Rentals.

Although the U.S. consumer is continuing to struggle, very recent data suggests that the Federal Reserve's multi-pronged and tireless strategy to stabilize the markets and the economy is having an impact. And just as the Fed is devising new methods of shoring up the economy, there is a flood of off-shore money looking to be deployed in the U.S. in a variety of asset classes.

Enter the sovereign wealth fund. Previously, foreign sovereign wealth mostly found its way into U.S. Treasury bonds, historically the safest place to deploy capital. Today, this money is finding its way into U.S. companies. With an estimated $2.5

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trillion, these funds have invested over $40 billion since 2007 in U.S. financial institutions alone. Abu Dhabi invested $7.5 billion in Citigroup in November 2007 while the governments of Singapore, Kuwait and South Korea were the primary capital sources behind a nearly $20 billion investment in Citigroup and Merrill Lynch in January of this year. China Investment Corp and Abu Dhabi invested $3 billion and $1.35 billion in private equity firms Blackstone and the Carlyle Group, respectively.

There are a number of reasons for this interest in U.S. assets. Diversification against commodity prices is one: think about the rise in the price of oil, the resulting flow of petrodollars to be invested, and the opportunity to avoid the consequences of the boom and bust of the last sustained spike in oil prices.

Current account surpluses are another reason sovereign wealth funds are focusing more on the U.S. Whether countries in the Persian Gulf region are looking to deploy their significant surge in oil export revenue or countries like China that have amassed a large build-up in foreign exchange reserves, these countries are less concerned with defending against economic shocks and more concerned with generating returns. With more than enough money to manage their exchange rates, these countries are seeking to deploy capital across a wide range of risk profiles and asset classes.

And let's not forget about the weak dollar. As the U.S. dollar declines, U.S. assets become increasingly attractive to foreign funds that are playing with their houses' money. The activity and influence of the sovereign wealth funds will likely continue to grow in 2008 and beyond.

There are a few raised eyebrows in Washington over sovereign wealth funds and their purchase of and investments in U.S. companies. Arching them any higher in the direction of these deep-pocketed investors should be carefully balanced against the consequences of economic protectionism and the resulting difficulty of trying to go it alone in a global economy.

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