INFERENTIAL FOCUS BRIEFING

IF 2613
June 17, 2005

"LEANING ON AIR" AND "PUKING TRANCHES": LINGERING ELEVATED EXPECTATIONS MEET POST-GROWTH REALITIES

Federal Reserve Board Chairman Alan Greenspan has lately been speaking of conundrums and an economy that those around him do not fully comprehend. These confessions of confusion are arising because some leaders and experts keep working toward results typical of normal business cycles in the middle of a very atypical economy, something we have called the Post-Growth Economy.

Those clinging to concepts arising from the past era of substantial growth have been manufacturing returns through extraordinary accounting maneuvers and through instruments carrying elevated, and little understood, risks. Corporations, the bond market, hedge funds and private-equity firms have all succumbed to the lure of higher risks to realize old-style returns in the Post-Growth Economy. These tactics are increasingly "leaning on air," dependent on support that could shift quickly and substantially or completely vanish. One segment of the bond market, however, may have a better grasp on what the Post-Growth Economy portends.

Fear and Trembling

In a rare moment of unobfuscated candor, Federal Reserve Board Chairman Alan Greenspan, speaking via satellite to a conference in China in early June, admitted, "The economic and financial world is changing in ways that we still do not fully comprehend." This admission of a knowledge shortfall among the royal "we" at the Federal Reserve followed 2 weeks of rumors that several hedge funds might soon collapse and trigger a "domino effect" of financial failures all the way back to the banking industry. Analogies to Long-Term Capital Management's fiasco of seven years ago surfaced everywhere. The spreading fear of an imminent "financial crisis" came one week after Standard & Poor's downgraded Ford and General Motors bonds, which, in turn, triggered something akin to a panic-gag response among certain hedge-fund managers as they scrambled to unwind highly leveraged positions that were adversely affected by the ratings change. (*Financial Times*, 6/6/05; *The Week*, 6/3/05)

A fear of imminent financial collapse, a panic about unsurprising bond-rating changes and ominous comparisons to Long-Term Capital Management –

these types of responses suggest that the knowledge shortfall among Greenspan's "we" may encompass a lot of people, including institutional investors who are currently charting new territories of risk and leverage. In a way, this should not be surprising. A new reality has created unique responses. The realities that comprise what we have called the Post-Growth Economy – constant oversupply, hyper-competition, endemic deflationary pressures – are pushing corporations and investors to find novel ways to squeeze profits and returns from the system.

Some less creative individuals have developed "gaming" routines to circumvent or ignore rules and laws, and they are keeping several states' attorneys busy in grand jury proceedings. Those avoiding rule-bending schemes are simply developing riskier and riskier practices that are dependent on more and more financial leverage to realize the gains they feel they must produce. Because these leveraged practices are relatively new, not many really grasp how the resulting instruments or their holders will behave when an economy that Greenspan says no one fully comprehends changes in ways that no one anticipates.

"'Be careful!' All you can tell me is 'be careful'?"

Conundrums to Ponder

Part of Greenspan's knowledge shortfall no doubt arises from interest rates. While the U.S. Federal Reserve was raising short-term interest rates from 1.0 to 2.5 percent, the market was lowering the rates on 10-year Treasury notes from 4.58 to 4.1 percent. This diverging movement in debt markets, Greenspan says, "remains a conundrum," by which he no doubt means that the forces causing this contrary movement are parts of what "we still do not fully comprehend" about the economy. (*New York Times*, 5/19/05)

While we, as in the Inferential Focus "we," do not claim to comprehend the emerging economy either, we have identified enough substantive changes in its dynamics to suggest that it should be called the Post-Growth Economy, as a way to distinguish it from the economy that expanded persistently after World War II. The long period from the second world war through the end of the century was a period of massive growth, especially in the earlier half of that period. For companies, revenues grew and profits rose. For employees, salaries increased, benefits expanded, and job-security stabilized, resulting in a financial security that made them comfortable and eager consumers – thereby helping the companies that offered those benefits. Companies and the government – comfortable in the thought that profits would grow and tax revenues would increase – assumed more and more liabilities to protect workers and citizens from crises, through expanded health insurance, pension plans, Medicaid or Medicare, enhanced Social Security and increasing investments in institutions such as schools and infrastructure.

As the century moved toward its end, however, those same institutions started feeling new pressures and began finding ways to transfer liabilities, which they once gladly assumed, to employees, whom they once sought to protect. A globalized economy was bringing new forces of competition to the U.S. market, not only to companies, but to workers who had to compete with workers everywhere in the world. This competition has put a downward pressure on prices and salaries because of what we have called the New Industrial Revolution.

The New Industrial Revolution involves the transference of market leverage first from manual to machine-based production, and then from the industrial producers to the marketers and distributors, and finally from those distributors to the end users. As production became easily transferable and replicable, its value diminished because more producers caused an endemic oversupply of goods. As a result, the value of making goods declined, and the value of distributing and marketing goods to end users rose. In turn, as the ability to sell goods became more commonplace with the advent of retail sales through catalogues, the Internet, and physical stores, especially the "big box" retailers, the value of distributing and marketing goods started to decline.

At each stage of transference of market leverage, the entity with the rising power has been able to play those in the prior stage against one another for pricing advantage, creating an atmosphere of hyper-competition among those in the prior stage. Marketers played the oversupply of producers against one another to drive down prices. Similarly, as the number of marketers or distributors proliferated (physical stores, catalogues, the Internet), consumers or end users could play them against one another for leverage (see "The New Industrial Revolution & Embedded Risk, Part I," **IF 2526**, 11/4/04).

This moving power has had a circular aspect to it. When marketers started playing producers against one another, then producers launched efficiency projects (from automation and reengineering to Six Sigma), which resulted in the downsizing of the producer's employee base. When market leverage moved to consumers or end users, then the layoffs spread across the field of marketers and distributors. Thereafter, as laid-off employees found new jobs – most often for less money – their diminished discretionary income became another incentive to play one marketer against another for lower prices. The more pressure the consumers' actions put on pricing, the more pressure both marketers and producers felt to reduce their costs, soon laying off more workers and triggering another cycle of lower pay and more pressure to lower prices, and so on. From that, the New Industrial Revolution cycle plays itself out, creating an endemic deflationary environment, a key element of the Post-Growth Economy.

A curious feature of the Post-Growth Economy – and a verification of Greenspan's assessment that the economy is changing in unanticipated ways – is that it has been producing statistics that are atypical for business cycles in the past. For example, the U.S. Commerce Department reported that pretax profits of private and public companies were up 13.5 percent in the fourth quarter of 2004 compared to the third quarter. The Department adjusted those figures to account for distortions resulting from the hurricanes and noted that the real figure was close to 5.9 percent, which, annualized, meant a rate of 25.9 percent. These are the kinds of numbers that one might expect in the forty-third month of a recovery. (*Wall Street Journal*, 3/31/05)

While those numbers reflect the peak of a business cycle, other numbers do not. In the fourth quarter of 2004, salaries declined 0.9 percent, the steepest drop since 1991, which was the heart of the last recession. In 2004, workers remained unemployed an average of 19.6 weeks, the longest average stretch since the deep recession of the early 1980s. Thus, the economy in its forty-third month of recovery is generating employment numbers that compare with those generated during the last two recessions. (*Atlanta Journal-Constitution*, 6/8/05; *Financial Times*, 5/11/05)

The befuddling thing about the Post-Growth Economy is that it is generating numbers associated with peaks in past business cycles and, at the same time, generating numbers associated with troughs in past business cycles – perhaps another conundrum to ponder.

"I'm doing a lot better now that I'm back in denial."

Getting Returns in a Post-Growth Economy

The way various business institutions have reacted to the realities of the Post-Growth Economy says much about how well business leaders and investors are adjusting to the new economy. Based on our observations, corporate executives and institutional investors are acting in accordance with a reality that no longer exists, and thus, while the short-term returns their actions have generated may be fine, they are not sustainable. Leaders are retaining unrealistic expectations of returns – something they learned during the post-World War II growth economy – even as they face realities that say growth has structural impediments. A look across the field of business and investment reinforces that context.

Corporations – Greenspan's "we" should not have to ponder the corporate-profit/salary-slide conundrum too long. The long-term effects of the New Industrial Revolution point toward slow growth, a strong contrast to the rapid growth of industrialized countries since World War II (thus, we call it the Post-Growth Economy). That has inspired some rather extreme actions among American businesses, actions that account for the anomalies in the business cycle.

✦ In all post-World War II recoveries before this one, corporate income going to profits averaged 26 percent, and never exceeded 32 percent. During the current recovery, 46 percent of that income has gone to profits. Also, in all post–World War II recoveries before this one, labor's share of corporate income growth averaged 61 percent and was never less than 55 percent. In this recovery corporations have passed along just 29 percent of their corporate income growth to workers. (*Washington Post*, 12/21/03)

✦ In the previous seven business cycles, 75 percent of the benefits arising from increased productivity went to employees. Since 2001, productivity has risen an average of 4.1 percent per year. Meanwhile, compensation growth has averaged just 1.5 percent. In fact, one assessment revealed that just 28 percent of company gains in productivity were passed on to workers. (*Financial Times*, 5/11/05)

The Post-Growth Economy suggests that the pace of growth is slowing and that the slackening pace is part of a new structural reality. Of course, that transition will be hard, and expectations of current executives and their corporate investors, which were shaped by the era of amazing growth, have yet to adjust to that reality. And so, they are struggling to make profits without growth. Apparently, one way to create the appearance of growth in the Post-Growth Economy is to extract profits from employee compensation.

"I don't object to being called a 'dependable workhorse' but do you have to keep yelling 'giddyup'?"

Bond Market – One segment of the bond market seems to be grappling with what the Post-Growth Economy portends. Players in this part of the bond market are reconciling their actions with the reality of slower growth, a unique perspective in the investment community.

✦ In March, Telecom Italia became the first corporate borrower to issue a euro-denominated bond with a **50-year** maturity. Even though the long-maturity bond offered just a 20 basis-point yield premium over the company's 30-year bond, Telecom Italia received orders equal to 1.7 billion euros, more than triple the company's 500-million-euro issue. (*Financial Times*, 5/16/05)

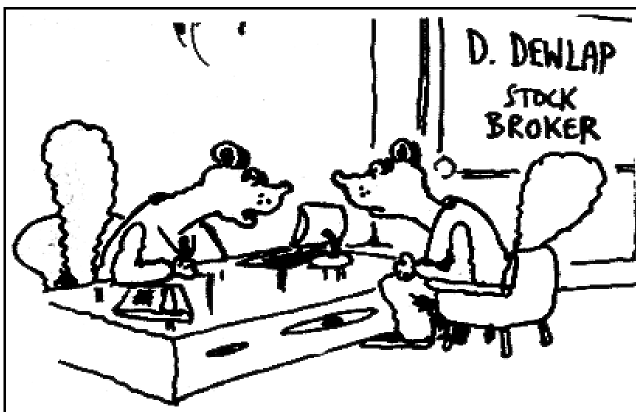
✦ In February, the French government issued a 50-year bond, and its success led England to announce in May that it, too, would issue the super-long-term bonds. Germany and Italy may follow. Meanwhile, the United States, the Netherlands and Spain have expressed interest in reviving 30-year bonds. (*New York Times*, 5/5/05; *Financial Times*, 5/16/05)

Those issuing the bonds are trying to exploit historically low interest rates, but those buying these bonds may have either of two strategies in mind. For one, they may have identified long-term needs and, through the extra-long-term bonds, locked in returns that meet those obligations, a practice the Texas state teachers retirement program started two decades ago, with the result that today it is relatively unique as a fully funded pension plan. Or second, long-term-bond buyers may see that expansion in the Post-Growth Economy will be so slight that the U.S. Federal Reserve and the European Central Bank will need to reverse course and lower rates, thereby making their purchases more marketable.

But these actions, which reconcile needs with the new post-growth reality, are atypical of the investment community. For the most part, the bond market clings to elevated expectations lingering from past eras of growth and mania.

✦ Between 2000 and 2003, new bond issues rated B or below accounted for roughly 20 percent of the overall high-yield (or "junk") bond market. So far this year, that especially risky subcategory of junk bonds has accounted for nearly 50 percent of the new issues, up from 40 percent last year. Last year, junk-bond issuance surpassed $140 billion for the first time. (*Financial Times*, 12/21/04 and 4/22/05)

✦ In March of this year, foreign central banks were net sellers of low-yield U.S. Treasury bonds and notes, dumping a net $15 billion back on the market. (*Economist*, 5/21/05)

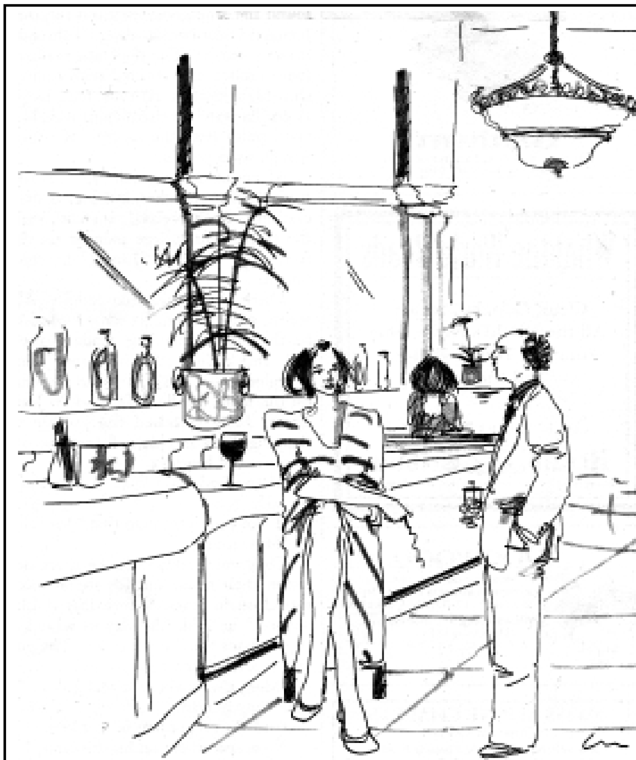


"I would take what you can stuff in your cheeks and bail out."

Hedge Funds – As foreign central banks were dumping Treasuries, the U.S. bonds sold handsomely to offshore hedge funds, which upped their purchases of the government notes by one third, to $42.9 billion. But of course such "hot" money could dump those notes as quickly as they bought them, bringing unwanted volatility to the Treasury market. As one business publication noted, "…if Treasuries are relying on hedge funds for support, they may find themselves leaning on air before they know it." (*Economist*, 5/21/05)

Hedge funds exploiting the small discrepancies in the Treasury market suggest that they feel constrained by the Post-Growth Economy as well. Created three decades ago to do what their name implies – supply a "hedge" against market volatility – hedge funds in the 1990s and especially after the collapse of the dot-com mania came to be the place investors put money to get higher returns, especially when measured against stock and bond returns between 2000 and 2004. In the meandering stock market of this period of transition from the growth era to the post-growth era, investors have come to see hedge funds as an investment that can generate high returns independent of the rise and fall of equity markets, due to their ability to sell short and use various derivatives. Because of this role shift from "hedge" instrument to vehicle for elevated returns, hedge funds have grown from roughly 600 funds with a total value of $76 billion fifteen years ago to roughly 7,000 funds valued at more than $1 trillion today, a growth not always based on complete understanding of the risks involved. Between 1998 and 2004, pension funds upped their investment in hedge funds five-fold, to roughly $72 billion. Yet one study revealed that 56 percent of pension-fund managers who had placed money with hedge funds did not understand the risks involved. (*New York Times Magazine*, 6/5/05; *Details*, 4/05; *Time*, 10/4/04)

Yet even hedge funds, with their independent strategies, are losing momentum to the powerful downdraft of the Post-Growth Economy. During the first quarter of this year, total returns in this investment sector fell to less than 1 percent. According to some estimates, hedge funds actually lost money in April, and after the downgrading of bond ratings for GM and Ford, they may have taken another tumble, as many had to unwind unwanted auto bond positions. If early estimates prove correct, the industry could finish the first half of 2005 with negative returns, which follow a relatively lackluster 8.72 average return in 2004. That has left some investors disgruntled. In the first quarter of 2005, investors put a net $25 billion into hedge funds, down from a net $38 billion in the same quarter in 2003. (*Financial Times*, 5/25/05)



"I thought I had the flu last weekend, but it was my hedge fund."

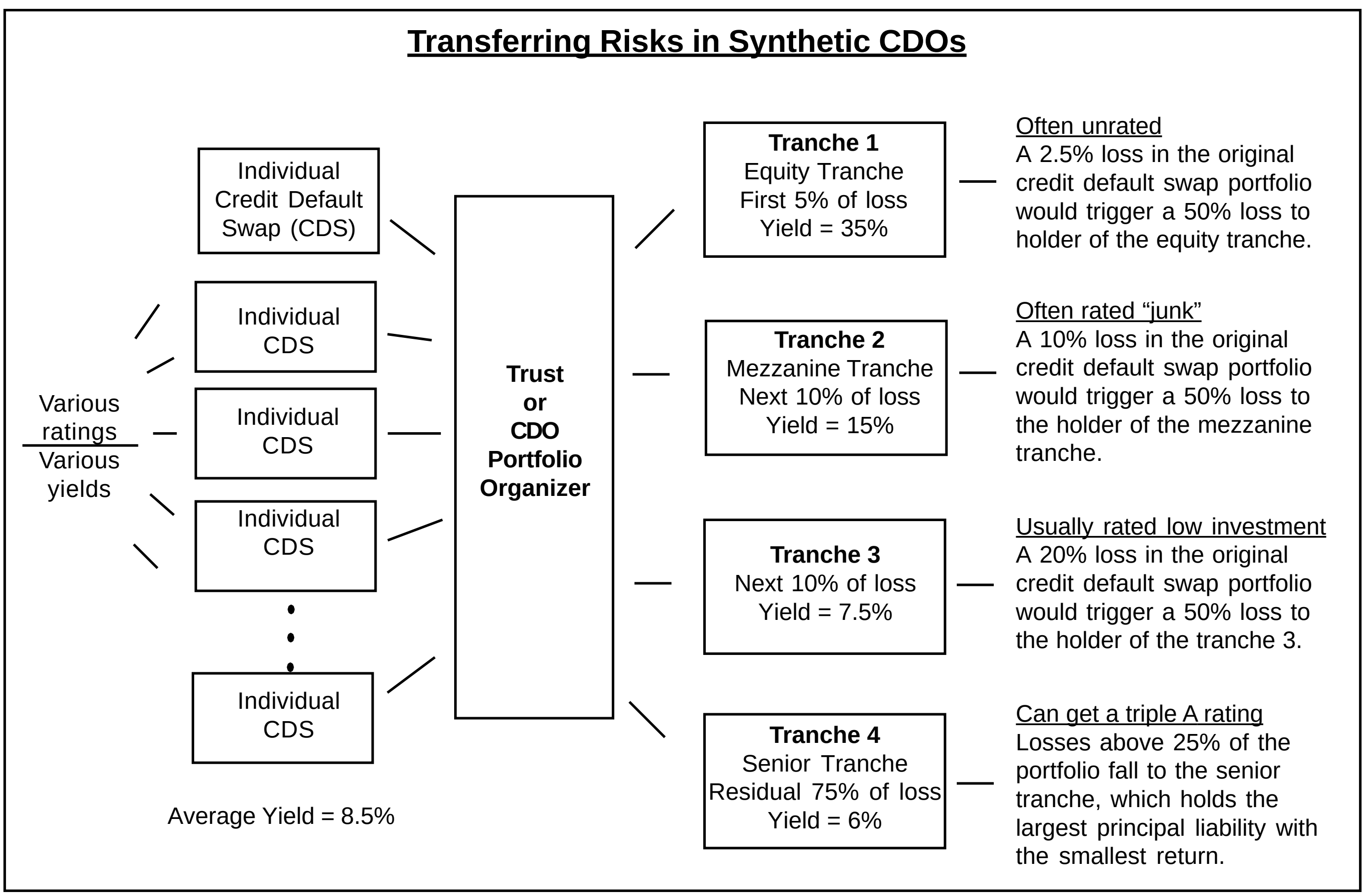
In a Post-Growth Economy, producing the kinds of returns that investors think hedge funds should provide has pushed the funds and other institutional investors to apply greater amounts of leverage to their investment strategies. Nothing highlights this added leverage more than the rapid rise of synthetic collateralized debt obligations (CDOs).

Synthetic CDOs are organized ways to disperse – or more precisely, to reorder – risks associated with debts, by aggregating credit swaps into a portfolio and then segmenting them into tranches, which are essentially packets of debt, each one assuming a different level of risk for the original debts. Rather than hold one debt from one debtor, the buyer owns a level of liability and a portion of the overall risk for all debts in the portfolio. The first tranche, misleadingly named the equity tranche (no "equity" is involved), assumes all risk for, say, the first 5 percent of the portfolio's overall debt obligations – that is, should anything go wrong with any portion of the original debt swaps, the holder of the equity tranche would be liable for the first 5 percent of losses to the principal. For that, the equity tranche may receive 3,000 basis points per annum. Next, the so-called mezzanine tranche assumes liability for principal risks between 5 and 15 percent and may receive a risk premium in the area of 1,000 basis points. By the time the tranches reach the fourth level, the so-called senior tranche, even though that level may hold responsibility for a large chunk of the principal – say, the final 75 percent – its protection from liability by the other tranches actually results in this level receiving an investment grade rating. In this way, segments of debts with questionable ratings at the outset get "laundered" through CDOs to receive investment-grade ratings.

When a portfolio organizer aggregates numerous CDOs into a meta-CDO, these debts become even more dispersed – and harder for either the buyer or debt-rating agencies to assess or follow. Holders of these "CDO squareds" essentially do not know what they hold. "CDO cubes" – CDOs of CDOs of CDOs – add another layer of opacity to the process. One derivatives analyst explained, "It creates a kind of shell game – you don't know where the credit risk is anymore."

Grasping the size of the CDO market can be difficult, but a glance at the default swap market, the starting point for CDOs, does offer some insight into the pace at which this market has been growing. CDOs involve credit default swaps, and that market has ballooned from roughly $1 trillion in 2001 to $8 trillion last year, adding $6 trillion in the past 18 months alone. Those watching these markets surmise that roughly two-thirds of the swaps go into synthetic CDOs, the most leveraged of the CDO instruments. More skeptical observers have put the total market at about $2 trillion. Either way, financial exposure in these markets is substantial and has recently grown at a quickening pace as more hedge funds have gotten into the game. (*Investment Dealers' Digest*, 5/16/05)

These instruments have become popular because they offer a wide array of ways to speculate on credit spreads – between debt markets, debt of different issuers, different classes of debt and single-company balance sheets. At its most basic level, premiums paid for debt swaps fund the coupons paid to the holders of the tranches. When buyers borrow to purchase these leveraged instruments, however, unwinding the investment becomes both cumbersome and difficult. (*Journal of Derivatives*, 9/04)



How aggregators price their CDOs may be an indicator of how little buyers and sellers understand the risks buried in synthetic CDOs. Evidently, putting a price tag on the credit-swap premium is close to putting a price tag on a used car: Make an offer. One would-be buyer of a senior tranche (that is, a low-risk tranche, in this instance, with a triple-A rating) thought the price she was offered was not appropriate. "I said, 'This wouldn't merit a triple-A by Moody's,' and the salesman said, 'Well, if you want more spread, you can have it.'" She said she wanted a spread associated with a double-A, and the salesman responded, "You can give me a bid at a double-A level." In another pricing example, a "quant jock" was more direct. He told a professor studying credit debt swaps, upon which synthetic CDOs are based, "We can't accurately price them, although we're confident that we're getting a good price on them." (*Investment Dealers' Digest*, 5/16/05)

To this lack of clarity as to the value and risk in the synthetic CDO market, hedge funds have added more leverage. For instance, even though returns on investment in an equity tranche can reach 35 percent (with an equally leveraged downside risk should any part of the overall portfolio change rating status), hedge-fund investors have pushed that return potential by adding another layer of risk. The so-called "correlation trade" involves buying the riskiest piece of the CDO, or the equity tranche, and then selling short the mezzanine tranche. This creates a "positive carry" – that is, the holder receives a profit while holding those positions.

Such leverage on top of leverage, however, works only if the broad range of debt covered in the CDO moves in concert. When two different covered debts do not move together, the leveraged bet unravels. That is what happened when GM and Ford received their downgrades, while other debt issuers maintained their same ratings. Given the lack of transparency as to who owns which liabilities in the CDOs, a kind of panicked rush to the door overtook the market, and holders were, in the colorful language of credit-market traders, "puking CDO tranches." (*Financial Times*, 5/12/05)

"How's everything?"

Given that those operating in the synthetic CDO market have no historical experience by which to anticipate how these instruments and their holders will function in stressful situations – or, worse, how they will act should a real financial "tsunami" hit – managing a crisis is itself a risky proposition. Uneven debt movements in April – prior to the GM and Ford downgrades – prompted some interesting investment moves:

✦ The credit derivatives market turned into a rampaging market in April, with a surge in activity not pushed by technical factors. According to one assessment of this area, the volume of trading jumped to anywhere from two to four times its regular volume. (*Financial Times*, 4/22/05)

✦ In April, the number of options contracts traded in the U.S. hit an all-time daily record (11 million trades) and an all-time monthly record (124 million trades). Roughly 91 percent of those contracts were equity options based on stocks or stock indices, as buyers bought options against their own holdings. (*Business Week Online*, 5/25/05)

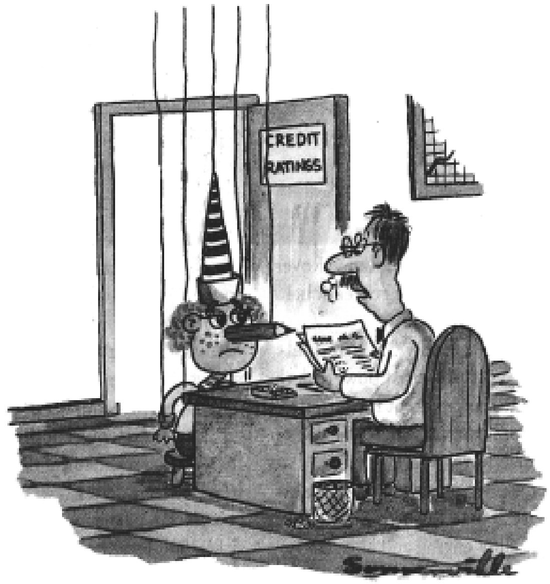
The drive to meet elevated expectations lingering in the midst of the Post-Growth Economy is pushing leverage to new heights, creating instruments that those involved do not fully understand and generating risks that trigger panicked unwinding. As a result, hedge funds are leaking cash, as more and more investors look elsewhere for returns.

Much of the new money into private-equity funds may be chasing returns. In the past two years, average returns among private-equity portfolio funds have been 22 percent, considerably above the industry's 10-year running average of 14 percent. Already this year, such funds have put $48 billion to work, and that figure does not include the $5.1 billion paid for Neiman Marcus or the $11.3 billion paid for SunGard Data – the largest leveraged buyout since the RJR Nabisco deal in 1989. (*Investor's Business Daily*, 5/16/05)

While this all seems appealing, the private-equity funds are turning to some extreme investment tactics themselves to meet their elevated expectations. Private-equity firms, including Thomas H. Lee Partners, the Blackstone Group, and Kohlberg Kravis Roberts & Co., have been taking advantage of investors' quest for higher returns and issuing junk bonds from the companies they own. These cash-out deals, called dividend recapitalizations, layer additional debts on the company but generate cash that the firm can use to pay a dividend to the private-equity firm, often covering all the equity originally invested. In 2002, firms tried just 9 such dividend recapitalizations to extract $2 billion from their companies, and they upped that number of recapitalizations to 26 the following year, pulling $6 billion from their companies' equity. In 2004, however, equity firms applied that tactic 77 times to the tune of $13.5 billion. Demand for high-yield bonds has made this equity-for-debt trade easy, but it has had its consequences. In the fourth quarter of 2004, Moody's dropped the ratings on 17 companies because of the leveraged payouts. According to John Lonski of Moody's, that is the highest number of

"And then I thought, What better hedge than a uranium centrifuge?"

Private Equity – The Blackstone Group announced plans to put together the largest buyout fund ever created. The intended $11 billion Blackstone fund breaks the record for the largest such fund set by Goldman Sachs just **one month earlier** ($8.5 billion). At the peak of dot-com mania, private-equity funds raised a whopping $250 billion in one year. This year, during the onset of the Post-Growth Economy – the mirror opposite of maniacal valuations – private-equity funds are on schedule to raise more than $200 billion. At the same time, the California Public Employees' Retirement System (CalPERS) said its Alternative Investment Management Program, which focuses on private-equity investments, showed a 17.8 percent return in 2004. (*Financial Times*, 5/26/05) downgrades for the junk-bond issuance he has seen in his 20 years of work for the ratings company. (*Business Week*, 1/31/05)



"I'm sorry, Mr. Squiggle, but you've been rated 3B soft."

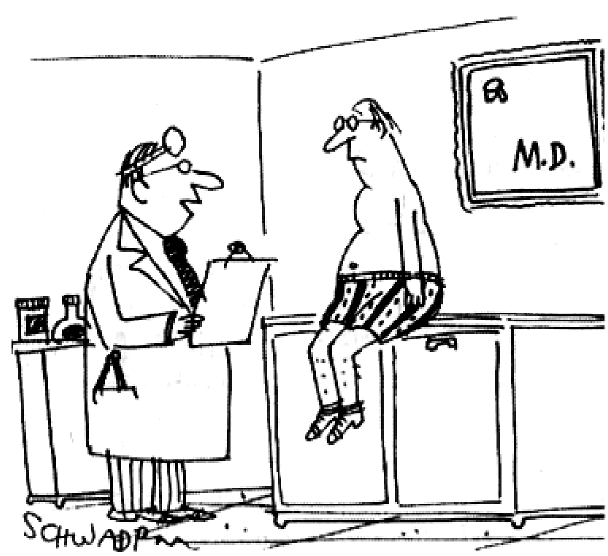
Reactions to the advent of a post-growth environment, while perhaps predictable, have not been reassuring. Reaching elevated expectations during a stumbling economy has encouraged executives and institutional investors to bolster profits from their employees' compensation, extract investment gains from their companies' equity and hide risks in non-transparent investment instruments. The economy that Greenspan says "we" do not understand is inspiring new risk instruments that many do not understand.

Get 'Em While They're Hot

Debt swaps inside synthetic CDOs have some "debt event" that ends their existence. That event may be a point in time when the "insurance" simply lapses, or it may be triggered by an event related to the insurance's purpose, something like a default on the debt or, as in the case of GM and Ford, a change in the debt's rating status. The whole search for higher returns through ever-rising risks no doubt has some "economic event" that will trigger the unwinding of new leveraged instruments and the unraveling of risk obligations. Unlike the "debt event," however, no one really knows what that "economic event" might be. Oddly enough, the investment community has acknowledged that it does not fully comprehend the risks surrounding these new instruments. Further, these new leveraged instruments are surfacing in an emerging economy that those charged with guiding it do not fully comprehend. The whole enterprise, like the Treasuries and the hedge funds, seems to be leaning on air. Such an "economic event" could come from anywhere, at anytime. We wonder if the CDO market "puking tranches" could be a signal.

The anomaly in the current period's rage for returns is the successful issuance of extremely long-term bonds. The oversubscription of these 50-year debt obligations flies in the face of the rapid turnaround, elevated returns sought by those in most other markets. Those involved in this sector of the bond market seem to grasp the significant turning point that industrial economies have reached – from the past era of substantial growth to an open-ended era of slower growth.

From this perspective, we can now see that Greenspan's conundrum – rising short-term rates with declining long-term rates – is actually the clash of two perspectives on the economy – one of lingering elevated expectations, and one of a slow-growth economy. In this instance, the extra-long-term bond market has a better grasp of reality.



"There's no evidence that the use of steroids by fund managers will improve performance."