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Investment Outlook

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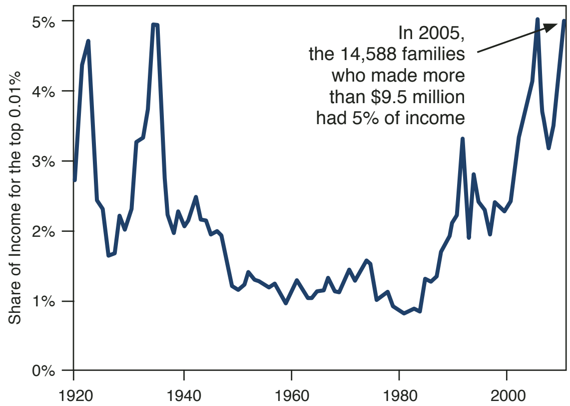
Enough is Enough

"The rich are different from you and me," wrote Fitzgerald and I suppose they are, but the differences – they wax and wane with the economic tides. Gilded ages come, go, and are reborn on the monsoon cloudbursts of seemingly intangible forces such as globalisation, innovation, and favourable tax policy. For the rich to be truly rich and multiply their numbers, they need help. Adept surfers they may be, but like all riders, the wealthy need a seventh wave that allows them to preen their skills and declare themselves masters of their own universe, if only for a moment in time. That the golden glazed surfboards of the 21st century seem unique with their decals of "private equity" and "hedge finance" is mostly a mirage. Wealth has always gravitated towards those that take risk with other people's money but especially so when taxes are low. The rich are different – but they are not necessarily society's paragons. It is in fact society's wind and its current willingness to nurture the rich that fills their sails.

What farce, then, to give credence to current debate as to whether private equity and hedge fund managers will be properly incented if Congress moves to raise their taxes up to levels paid by the majority of America's middle class. What pretense to assert, as did Kenneth Griffin, recipient last year of more than $1 billion in compensation as manager of the Citadel Investment Group, that "the (current) income distribution has to stand. If the tax became too high, as a matter of principle I would not be working this hard." Right. In the same breath he tells, Louis Uchitelle of *The New York Times* that the get-rich crowd "soon discover that wealth is not a particularly satisfying outcome." The team at Citadel, he claims, "loves the problems they work on and the challenges inherent to their business." Oh what a delicate/tangled web we weave sir. Far better to admit, as has Warren Buffett, that the tax rates of the wealthiest Americans average nearly 15% while those of their salaried and therefore less incented assistants just outside their offices are nearly twice that. Far better to recognise, as does Chart 1, that only twice before during the last century has such a high percentage of national income (5%) gone to the top .01% of American families. Far better to understand, to quote Buffett, that "society should place an initial emphasis on abundance but then should continuously strive to redistribute the abundance more equitably."

Rich Getting Richer



Source: Thomas Piketty and Emmanuel Saez. The New York Times

Chart 1

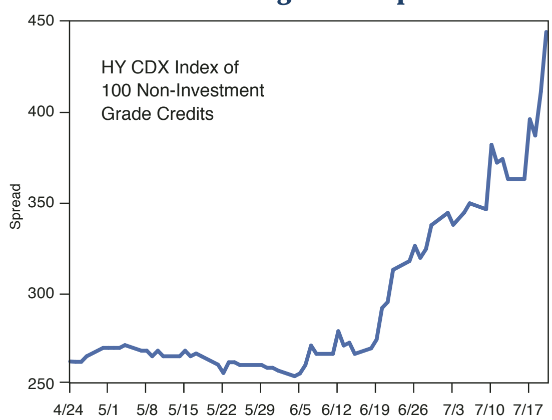
Buffett's comments basically frame the debate: when is enough, enough? Granted, American style capitalism has fostered and encouraged innovation and globalisation which are the fundamental building blocks of wealth. That is the abundance that Buffett speaks to – the creation of enough. But when the fruits of society's labour become maldistributed, when the rich get richer and the middle and lower classes struggle to keep their heads above water as is clearly the case today, then the system ultimately breaks down; boats do not rise equally with the tide; the centre cannot hold.

Of course the wealthy fire back in cloying self-justification, stressing their charitable and philanthropic pursuits, suggesting that they can more efficiently redistribute wealth than can the society that provided the basis for their riches in the first place. Perhaps. But with exceptions (and plaudits) for the Gates and Buffetts of the mega-rich, the inefficiencies of wealth redistribution by the Forbes 400 mega-rich and their wannabes are perhaps as egregious and wasteful as any government agency, if not more. Trust funds for the kids, inheritances for the grandkids, multiple vacation homes, private planes, multi-million dollar birthday bashes and ego-rich donations to local art museums and concert halls are but a few of the ways that rich people waste money – and I must admit, I am guilty of at least one of these on this admittedly short list of sins. I have, however, avoided the last one. When millions of people are dying from AIDS and malaria in Africa, it is hard to justify the umpteenth society gala held for the benefit of a performing arts centre or an art museum. A thirty million dollar gift for a concert hall is not philanthropy, it is a Napoleonic coronation.

So when is enough, enough? Now is the time, long overdue in fact, to admit that for the rich, for the mega-rich of this country, that enough is never enough, and it is therefore incumbent upon government to rectify today's imbalances. "The way our society equalises incomes" argues ex-American Airlines CEO Bob Crandall, "is through much higher taxes than we have today. There is no other way." Well said, Bob. Enough said, Bob. Because enough, when it comes to the gilded 21st century rich, has clearly become too much.

If gluttony describes the acquisitive reach of the mega-rich, then the same gastronomical metaphor applies to today's state of the credit markets. Stuffed! Both borrowers and lenders may have bitten off more than they can chew, and even those that swallow their hot dogs whole – Nathan's Famous Coney Island style – are having a serious bout of indigestion. Several hundred billion dollars of bank loans and high yield debt wait in the wings to take out the private equity and leveraged buyout deals that have helped propel stocks to Dow 14,000. And lenders… mmmmm, how do we say this…don't seem

Non-Contagious Subprimes?



Source: Bloomberg

Chart 2

to have much of an appetite anymore. Six weeks ago the high yield debt market was humming the Campbell's soup theme and now, it's begging for a truckload of Rolaids. Yields have risen by 100 to 150 basis points in response as shown in Chart 2.

Some wonder what squelched the hunger of potential lenders so abruptly, while in the same breath suggesting that the subprime crisis is "isolated" and not contagious to other markets or even the overall economy. Not so, and the sudden liquidity crisis in the high yield debt market is just the latest sign that there is a connection, a chain that links all markets and ultimately their prices and yields to the fate of the U.S. economy. The fact is that several weeks ago, Moody's and Standard & Poor's finally got it into gear, downgrading hundreds of subprime issues and threatening more to come. "Isolationists" would wonder what that has to do with the corporate debt market. Housing is faring badly but corporate profits are in their prime and at record levels as a percentage of GDP. Lenders to corporations should not be affected by defaults in subprime housing space, they claim. Unfortunately that does not appear to be the case.

As Tim Bond of Barclays Capital put it so well a few weeks ago, "it is the excess leverage of the lenders not the borrowers which is the source of systemic problems." Low policy rates in many countries and narrow credit spreads have encouraged levered structures bought in the hundreds of millions by lenders, in an effort to maximise returns with what they thought were relatively riskless loans. Those were the ABS CDOs, CLOs, and levered CDO structures that the rating services assigned investment grade ratings to, which then were sold with enticing LIBOR + 100, 200, 300 or more types of yields. The bloom came off the rose and the worm started to turn, however, when institutional investors – many of them foreign – began to see the ratings downgrades in ABS subprime space. Could the same thing happen to levered structures with pure corporate credit backing? **To be blunt, they seem to be thinking that if Moody's and Standard & Poor's have done such a lousy job of rating subprime structures, how can the market have confidence that they're not repeating the same structural, formulaic, mistake with CLOs and CDOs?** That growing lack of confidence – more so than the defaults of two Bear Stearns hedge funds and the threat of more to come – has frozen future lending and backed up the market for high yield new issues such that it resembles a constipated owl: absolutely nothing is moving.

Bond managers should applaud. It is they, after all, who have resembled passive owls for years if not decades. If, as I pointed out in my opening paragraph, wealth has always wound up in the hands of those that take risk with other people's money, then private equity and hedge fund managers have led the charge in recent years. Of course they have been aided and abetted by those monsoon forces of globalisation and innovation, producing worldwide growth that led to escalating profits and equity prices, often at the expense of labour. But the Blackstones, the KKRs, and the hedge funds of recent years also climbed to the top of the pile on the willing backs of fixed income lenders too meek and too passive to ask for a part of the action. Covenant-lite deals and low yields were accepted by money managers as if they were prisoners in an isolation ward looking forward to their daily gruel passed unemotionally three times a day through the cellblock window. "Here, take this" their investment banker jailers seemed to say, "and be glad that you've got at least something to eat!"

Well the caloric content of the gruel in recent years has been barely life supporting and unhealthy to boot – sprinkled with calls and PIKS and options that allowed borrowers to lever and transfer assets at will. As for the calories, high yield spreads dropped to the point of Treasuries + 250 basis points or LIBOR + 200. Readers can sense the severity of the diet relative to risk by simply researching historical annual high yield default rates (5%), multiplying that by loss of principal in bankruptcy (60%), and coming up with an expected loss of 3% over the life of future loans. At LIBOR + 250 in other words, high yield lenders were giving away money!

Over the past few weeks much of that has changed. The mistrust of rating service ratings, the constipation of the new issue market and the liquidity to hedge the obvious in CDX markets has led to current high yield CDX spreads of 400 basis points or more and bank loan spreads of nearly 300. The market in the U.S. seems to be looking towards this week's large and significant placing/pricing of the Chrysler Finance and Chrysler auto deals to determine what the new level for debt should be. In the UK, a similarly large deal for BOOTS promises to be the bell cow for European buyers. But the tide appears to be going out for levered equity financiers and in for the passive owl money managers of the debt market. And because it has been a Nova Scotia tide, rising in increments of ten in a matter of hours, it promises to have severe ramifications for those caught in its wake. No longer will double-digit LBO returns be supported by cheap financing and shameless covenants. No longer therefore will stocks be supported so effortlessly by the double-barrelled impact of LBOs and company buybacks. **The U.S. economy in turn will not benefit from this tidal shift and increasing cost of financing. The Fed tightens credit by raising short-term rates but rarely, if ever, have they raised yields by 150 basis points in a month and a half's time as has occurred in the high yield market.** Those that assert that this is merely an isolated subprime crisis should observe very closely the price and terms that lenders are willing to accept with Chrysler finance this week. That more than anything else may wake them, shake them, and tell them that their world has suddenly changed. High yield lenders, perhaps if only in their frozen, frightened passivity, are signifying that the wealth must be redistributed, that the onerous oppressive tax in the form of low yields must change, and that finally enough is enough!

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