Down, sure, but not out

It's been another three months of fear and loathing on Wall Street, while the battle for the White House has seen both frontrunners making vague economic promises, reports Insto's US correspondent, Caren Chesler.

Investment banks thumped

The second quarter opened in the wake of the Bear Stearns bailout debacle, and three months later, Wall Street's prospects still look grim. Financial shares have continued to their fall, with Lehman Brothers reporting a $2.8 billion loss, and Morgan Stanley suffering a sharp drop in profits. As the quarter came to a close, analysts were predicting revenues at the investment banking firms would come in 20 to 45 per cent lower than last year.

Longtime Wall Street analyst Richard Bove, of Ladenburg Thalmann, reduced his 2008 and 2009 calendar year earnings estimates for Morgan. Market observers were suggesting Merrill Lynch could soon be forced to raise equity by shedding part of its interests in either Bloomberg or Blackstone.

Firms continue to lay off employees, contributing to the 83,000 people who have lost their jobs since the credit crisis began. Most recently, Citigroup announced it would be laying off hundreds of investment bankers, including senior executives, as part of the 6,000 layoffs in investment banking that it announced earlier this year. JPMorgan has already dismissed about 25% of its workforce, after combining its own operation with that of Bear Stearns.

Even Goldman Sachs, which fared the best in the credit crunch, said it will be cutting its investment-banking staff beyond the 5 per cent reductions it typically sees after annual review time. Still, the firm was the only one to weather the storm this quarter, reporting net income that was down by only 11 per cent over the comparable period last year. Goldman apparently saw the credit woes coming long before its rivals and began selling off its mortgage-related securities more than a year ago, at a time when there was actually a market for them.

William Mills III, managing director of the Highland Good Steward Management fund, a socially-responsible fund in Birmingham, Alabama, said his fund's investment criteria – it can only invest in companies with good governance records and low leverage - kept his fund out of the banking sector, and it ended the quarter on a positive note because of it. It returned 2.1 per cent in the second quarter, returns that look pretty good when the rest of the hedge fund industry reported flat to negative returns.

"We invested in energy and commodities, too, but I really can't stress enough, it was our avoidance of overleverage, and illiquid securities that helped us," Mills said. "We avoided the write-downs to a fair degree."

The financial sector is likely to face further write-downs and credit-related losses for some time to come, analysts say, and the problem isn't just the residential housing market. Some, like Merrill, have exposure to commercial mortgages, a problem that hasn't even hit the market's radar yet. Firms may have to start taking write-downs on those loans as well, says Jack Bass, a financial services consultant in Vancouver, Canada.

"Their auditors are going to press them to take write-downs on their commercial mortgages," Bass says.

Bass said the ebullient housing market resulted in overbuilding in commercial real estate, but as the economy has slowed and businesses are struggling, some are simply walking away from their leases. "In malls across America, there are empty spaces they hadn't counted on, and this puts pressure on the mall owners, who have taken out large mortgages that they can no longer pay," he says.

With tighter regulations expected, potentially making it harder for banks to take risks, some are viewing this not so much as a correction or cyclical slump but as the beginning of a new era on Wall Street.

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When the Federal Reserve opened its credit window, giving investment banks access to the central bank's low cost capital, it confirmed that the U.S. government clearly views these banks as too big to fail. But that's likely to come at a cost in the form of tighter oversight of capital and risk management. One suggestion has been to limit the cheap overnight funding in repo markets on which investment banks have come to rely. Another has been to limit how much they can leverage. Either way, Wall Street firms may have to find other ways to earn high returns outside of borrowing and arbitrage. Profit centres during the crisis, such as foreign exchange and equities, may not look as attractive if firms are forced to reduce risk and cut leverage.

Terry Connolly, dean of the business school at Golden Gate University and a former investment banker at Salomon Brothers, says Wall Street's reliance on cheap overnight loans, to finance their trading positions, has come home to roost.

And that may be a good thing. Most of the investment banks that have failed in the last two decades ultimately suffered from an inability to obtain overnight funding. It happened to Drexel Burnham, Kidder Peabody, Salomon Brothers, and most recently, Bear Stearns. "It's a big problem when your overnight funding dries up," Connolly says.

Commercial banks like Citigroup and Bank of America have taken big hits this quarter and must now decide things like whether to cut their dividend, or issue more equity. But it's not the kind of crisis an investment bank faces when it loses its overnight funding, Connolly said.

"With an investment bank, if you have a run on them – where people want their securities back and the lending dries up – they go out of business overnight, because they no longer have overnight financing to support their trading positions," Connolly said.

The question is how far will regulators go to avoid that situation.

Oil remains pumped

Oil continued to reach record highs this quarter, driven by a falling US dollar and a global economy that is consuming more oil than it's producing --particularly with increased demand from China, India and other developing countries. And analysts say the price will continue to rise until it reaches a price at which people radically change their behavior.

And so as oil continues to rise, the stock market continued to fall, with a barrel of crude oil hitting $144 in the first week of July, and the Dow Jones Industrial Average hitting levels that were 21 per cent lower than the market's peak back in October (a trend reflected on Australian markets).

With no end in sight, the fingerpointing has began, with U.S. government officials blaming high energy prices on large institutional investors, whose speculating, they say, has driven up the price of oil and gas. A few weeks later, PepsiCo's chief executive officer, Indra Nooyi, blamed the energy crisis on Washington, saying the White House has had no energy policy to speak of. The only oil policy the US has in place, snapped one analyst, is to go cap in hand to Saudi Arabia and beg them to produce more oil.

John Branch, an oil industry consultant based in Los Angeles, estimates that only about one-third of the run-up in oil prices is due to speculation, but it's a

contributing factor that he attributes to the federal government. Branch, who worked for 16 years in risk management in the oil industry before covering the industry as an auditor, says banks are using the cheap funding they're obtaining from the Federal Reserve and turning around and lending it to hedge funds, which then invest in oil.

"They're loaning the money to hedge funds, and a hedge funds favorite trade right now is to go long commodities and short financial services," Branch said.

The number of people trading in oil and gas has tripled in the last five years, Branch says, and for that, he blames the Federal Reserve and the fact that it has kept interest rates too low and pumped too capital into the banking system. Liquidity always drives a bubble, he says.

Many, like Branch, believe prices will come down when the market experiences destruction demand, where the price gets so high that people are forced to rely less on oil, and by that time, new supplies may come online.

And when the price comes down, it will be fast. "Prices drop seven times faster than they go up," Branch says.

Hedge funds savaged

After the worst start to a year in about 20 years, hedge fund performance made a small comeback in April and May, only to have those returns wiped away as the quarter came to a close, giving the sector a -1.5 per cent return for the year to date, according to The Hedge Fund Research Inc's global hedge fund index.

But returns are only half the story. More than 100 hedge funds were either forced to close, needed cash infusions or were liquidated this year. And new hedge fund launches are at their lowest level in eight years.

The industry is getting a bit of a black eye because if nothing else, the poor performance shows the industry's biggest promise – that hedge funds can provide positive returns even when the stock market tanks – is not necessarily true.

"Most hedge fund strategies rely on a bull market, even though many advertise that they're there for uncorrelated returns," said Pierre Villeneuve, managing director at Mapleridge Capital, based in Toronto, Canada. "The traditional long/short managers, they're basically long stocks."

Villeneuve said his fund happened to go up in the last quarter – it returned more than 9 per cent -- but that's because its style of trading tends to do well when stocks go down. It thrives on volatility, and the stock market has been volatile for months, with March showing the market's highest volatility in five years.

It wasn't just returns that gave the industry a black eye this quarter. Several high profile hedge fund managers faced criminal charges, and the severity of their sentences shows regulators are beginning to play hardball with those who try to cheat investors.

The most high profile case involved Samuel Israel, the former manager of a hedge fund run by Bayou Management. Israel pleaded guilty to conspiracy and fraud, and just as he was supposed to begin serving a 20-year sentence, he disappeared. Police found his SUV at the edge of a 150-foot-high bridge over the Hudson River, after etching the words “Suicide is Painless” in the dust on the hood. But when authorities couldn’t find a body, they arrested his girlfriend and began questioning her. Israel turned himself in to police several days later, after speaking with his mother on the telephone. Aside from a 20-year prison term, he must pay $300 million in restitution.

Also this quarter, two former hedge fund managers from Bear Stearns were taken from their homes in handcuffs after being indicted on securities fraud and conspiracy charges. The two men, Ralph Cioffi and Matthew Tannin, are accused of touting the financial health of their hedge fund, despite knowing the fund was in dire financial condition. The fund wound up collapsing shortly thereafter.

Investigators are now looking into whether two men misled their own banks and trading partners. The banks reportedly involved in the probe are Bank of America, Barclays, Dresdner Bank and Merrill Lynch & Co. The pair have already been charged with lying to Dresdner Bank about the number of investors planning to pull their money out of the two Bear Stearns hedge funds.

The Securities and Exchange Commission has also filed a civil suit filed against the two men, alleging they persuaded Barclays to put another $100 million into one of their funds in February 2007. They gave the bank false performance figures about the fund’s health, authorities allege.

Election running on empty

With Hillary Clinton out of the race, the battle for the White House has picked up, with Democratic candidate Barack Obama and Republican candidate John McCain exchanging jabs over who is better suited to resurrect the country’s languishing economy. Not surprisingly, the Democrat’s plan is to redistribute the wealth to the middle class while the Republican plan calls for tax cuts.

Saying McCain would just follow the same policies as President Bush, Obama says he would raise the top income tax rate from 35 to 39.6 per cent and take the capital gains tax rate from 15 to 25 per cent. He’s also said he wants to increase the tax burden on corporations and revisit major trade pacts such as the North America Free Trade Agreement.

Indeed, McCain’s proposals call for keeping much of President Bush’s tax reductions intact, while lowering the top corporate income tax rate by 10 percentage points and scaling back the Alternative Minimum Tax (the so-called “tax for the wealthy" that is now hitting many in the middle class thanks to inflation). Responding to critics who question how he can finance the budget with lower revenues, McCain says he can do it through spending cuts, and he has promised to veto every bill that contains pork spending by lawmakers. McCain has also called for a petrol tax holiday, while Obama considers it a gimmick.

Polls already show Obama edging out his opponent on the economic front, with more Americans believing Obama can cure the economy’s ills than McCain.

And yet critics say neither is being very specific about how they’d actually address the country’s biggest problems, like rising foreclosure rate, falling property values, and skyrocketing oil price As Sen McCain tours the country, he has repeated his call to build at least 45 new nuclear plants, which he said "will create over 700,000 good jobs to construct and operate them.” Obama has called for a $50 billion "second stimulus package" that includes energy rebate checks for many families, and a fund for families in foreclosure, but critics question how he can pay for it.

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“The key issues that are having a huge impact on the US economy are not being addressed,” said John Caslione, president and CEO of GCS Business Capital LLC, a cross border M&A advisory firm. “They don’t make for good soundbites.”

Caslione says neither candidate is addressing runaway fuel costs, or the extremely weak US dollar, which would lead to hyperinflation. Nor are they addressing the fact that Americans don’t save. The U.S. savings rate is close to zero, compared to Europe, where that figure ranges from 8 per cent to 20 per cent., or China, where it stands at about 40 per cent. Much of the focus has been on the Iraq war, which the country simply can’t afford, he says.

“Pro-war or anti-war is not the issue. The issue is, how do we fund it?” Caslione says.