

Waiting to turn trash into treasure



Mingling with the locals for the next great trade

“THIS is going to be the next great trade,” one American hedge-fund executive effused early this year. For more than two years funds have been salivating over the slew of assets that Europe’s banks will have to sell. Many have been opening offices in London and hiring to prepare for this “tidal wave” of opportunities.

Up for grabs will be distressed corporate loans, property debt and non-core businesses as European banks shrink their balance-sheets to meet stricter capital requirements. Huw Van Steenis of Morgan Stanley estimates that banks will have to downsize their balance-sheets by €1.5 trillion-2.5 trillion (\$2 trillion-3.4 trillion) over the next 18 months. Funds have only about \$150 billion to spend on distressed debt in Europe, he reckons, which means they should have their pick of assets.

For now the “next great trade” is not looking that good, mainly because there have been no fire sales. Most banks that are selling assets have priced them close to face value, providing little to entice buyers.

Even where sales are agreed, financing is scarce. In July Blackstone, a large alternative-asset manager, agreed to buy a £1.4 billion (\$2.2 billion) real-estate loan portfolio from Royal Bank of Scotland, but has yet to raise an estimated £600m to pay for it. Worse still, many banks may not be able to sell assets cheaply even if they wanted to, because it

would force them to take losses that would erode scarce capital.

“We’ve been lying in wait for this opportunity since 2008. But it will come piecemeal. It will take years and years and years,” says Joe Baratta, head of European private equity at Blackstone. Some predict that Europe could go the way of Japan’s glacial deleveraging and take a decade or more to clean up its banks. Politics play a role too. European politicians, no hedge-fund lovers, won’t want to see them buying up assets at truly distressed prices and profiting from Europe’s gloom. It may even be “politically impossible” for banks that got a government bail-out to write down assets significantly, says Jonathan Berger, the president of Stone Tower, a \$20 billion alternative-asset firm.

What could turn things around? Some fund managers hope a plan to recapitalise Europe’s banks to the tune of €106 billion by next June will at last force disposals at banks. So too may the introduction of Basel 3 rules that will require banks to hold more high-quality capital. Marc Lasry, the boss of Avenue Capital, a distressed-debt hedge fund, wants to buy from these “forced sellers”, because they will offer lower prices.

Banks aren’t the only prey that funds are hunting. A wave of refinancing that will hit private-equity-owned firms over the next few years may prove profitable for distressed-debt funds. And plans by some European governments to privatise infrastructure assets may also be enticing.

In the meantime, inventive fund managers are figuring out other ways to do deals. Some, such as Highbridge, a large American hedge fund that is owned by JPMorgan, and KKR are scaling up their lending operations as banks cut back. They are able to charge high interest rates, because companies are desperate for cash.

Banks are being inventive too. Unable to sell assets, they have come up with a compromise of sorts, and have started agreeing to “synthetic risk transfer” arrangements with hedge funds. For example, BlueMountain Capital, an American hedge fund, has agreed to take on some risks on a credit-default swap portfolio from Crédit Agricole, a French bank. Another hedge fund, Cheyne Capital, has reached an arrangement with two big banks in Europe to take the first 4% or so of losses from a securitised portfolio of loans, in exchange for a very healthy return.

Funds’ investors may need convincing, given that “synthetic” became a dirty word after 2008. The deals can also be risky, says Galia Velimukhametova of GLG Partners, a European hedge fund. “You could lose 80-90% of your capital if things go very wrong, but

make 10-15% if everything goes right," she says.

Robert Koenigsberger of Gramercy, an emerging-market hedge fund focused on distressed investing, insists it is best to look elsewhere. "The best distressed opportunities created by Europe are now outside of Europe," he says. He believes opportunities are particularly bright in emerging markets. Many of them are undervalued because investors are selling everywhere as a result of worries about the stability of the euro zone.

For those hedge funds set on playing Europe, the main dilemma they face is how long to wait before buying. Steve Schwarzman, the boss of Blackstone, insists that it is important to stay put. "It's like dating someone," he says. "You can say let's wait two years. But she probably won't be around then."

ANGELA MERKEL, the German chancellor, spoke for many Europeans when she said last year that "We must re-establish the primacy of politics over the markets." The Europeans created the euro to prevent the crises caused by currency speculators, only to find themselves pushed around by bond investors.

Politicians have often cursed the markets. Harold Wilson, a British prime minister, used to fulminate against the "gnomes of Zurich" who speculated against the pound. In the mythology of the British Labour Party, a "bankers' ramp" pushed the party out of office in 1931. James Carville, a political adviser to Bill Clinton, wanted to be reincarnated as the bond market so he could "intimidate everybody".



In theory, there is an easy answer. If you don't want to be bothered about the bond markets, don't borrow from them. The finance ministers of Norway and Saudi Arabia have no cause to worry about their borrowing costs because they are net creditors.

Not all nations can be creditors, of course. But John Maynard Keynes's plans for the post-1945 monetary system were aimed at limiting the imbalances that arose in the inter-war system, and have popped up again in the past 20 years. Since this involved restricting the rights of surplus nations, his plans were circumscribed by Washington, a nice

irony now that America is a debtor nation.

After the Bretton Woods system collapsed in 1971, trade imbalances ceased to be much of a constraint on the developed world. Financial markets seemed happy to provide the money to allow countries to run deficits on both the fiscal and trade accounts. This may have led to a fatal complacency on the part of governments, which assumed that their credit was limitless. But rather like Northern Rock, the British bank that became too dependent on the wholesale markets for funding and collapsed in 2007, countries such as Greece and Italy have discovered that investors can suddenly withdraw their favours.

Is the latest run the action of speculators, as Silvio Berlusconi mused in his farewell statement? On the contrary, the sell-off is probably down to caution. The Greek debt deal required private-sector investors to take a 50% hit, while official investors would be repaid in full. This made private-sector investors worry about potential losses elsewhere. They have shifted their assets into the perceived safety of Germany and Britain. In addition, it seems that banks are selling off bonds in an attempt to shrink their balance-sheets and meet new rules designed to make them safer.

Countries can escape from the tyranny of the markets by turning to official lenders: other countries, the International Monetary Fund or the European Financial Stability Facility. But such creditors are just as keen on extracting their pound of flesh (in terms of economic reform) as the private sector.

Vague plans for a fiscal union seem to depend on a bargain in which Germany agrees to transfer money to debtor countries but the debtors agree to limits on their ability to run a deficit. This implies that someone in Brussels (or Frankfurt) will have a veto over a debtor country's budget.

In short, having lost their ability to control their monetary policy, voters may have to lose control over their fiscal policies as well. National politics will be reduced to dealing with social issues, such as smoking bans.

Perhaps this is inevitable. Just as voters cannot repeal the laws of gravity, they cannot insist that foreign creditors lend them money. Domestic wealth, alternatively, can be taxed or confiscated, although this is a strategy that is likely to be successful only in the short term or during national emergencies such as the second world war. Capital controls worked under the Bretton Woods system but it is not clear whether they can be enforced in an age where money can be transferred through the click of a mouse.

The prospect of financial ruin was one reason why many people feared the introduction of democracy. “The ignorant majority, when unrestrained by a superior class, always sought to tamper with sound money,” said Thomas Hutchinson, a lieutenant governor of Massachusetts in 1753. Alexander Hamilton described the progressive accumulation of debt as “perhaps the natural disease of all governments.” Over the centuries, countries have tried various rules—the gold standard, balanced-budget requirements, independent central banks—in an attempt to limit government profligacy. But when those rules fail, the markets assert their own grim discipline.

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