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The Credit Cycle: Getting Closer to a Minsky Moment?

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The Credit Cycle: Getting Closer to a Minsky Moment?

For the second time this year, credit markets are going through a nasty bout of indigestion. The focus has been on a handful of highly publicised developments involving originators and investors in the sub-prime, CDO and leveraged loan sectors. The manifestations have been seen in wider swap spreads, some re-pricing of risk premiums, and steadily growing (but not yet spectacular) pressure to address the mis-pricing and questionable ratings of some of the high-volume asset and debt structures that – to many of us and to much of the regulatory community – remain opaque.

Whereas earlier this year, for a few short weeks, markets and media zoomed in on just sub-prime lenders, borrowers and securities, now they're focused on a wider range of participants and issues in credit markets. There's a lot of comment around, including some insightful work from UBS credit strategists and in some of our sales commentaries, about the mechanics and real-time developments in markets known only by acronyms and in specific deals and instruments. An economic view can't add anything complementary to this material, but it can drill down to the over-riding single issue: namely, whether the credit cycle is starting to close and, from there, what the economic implications might be. Put another way, is a Minsky Moment getting closer? This is a brief update and reboot of *The Credit Cycle and Liquidity: Have We Arrived at a Minsky Moment?*, Economic Insights By George, March 2007.

Once again, defining a Minsky moment

Recall that a Minsky Moment is basically about the highest stage of leverage and its relationship with and to the price of money and asset prices. It's less of a moment, as such, and more about a sequence of events in credit markets, triggered by anything that causes asset prices to falter and risk premiums to rise sharply. First, credit supply begins to dry up as lenders tighten lending standards; the terms and the cost of credit and, nowadays credit insurance, increases. Subsequently, this can result in a more serious withdrawal of liquidity as lenders reduce or shut down lines of credit and call in loans, and borrowers may have to sell liquid assets in order to raise cash or comply. The final 'moment' is where the prospect (or fact) of a deflationary credit contraction forces the monetary authorities to relax monetary conditions and lower interest rates in order to ensure the integrity and functioning of 'good' lenders and borrowers and avert, if possible, the likelihood of contagion into income, spending and hiring and firing decisions in the real economy.

The February/March 2007 wobble in credit markets was never going to be an isolated event, even though most people lost interest in it when nothing of great significance happened immediately. This latest bout of instability should be viewed as part of a continuing sequence of events at the top of a credit cycle, any one of which might cause a more dramatic shake-out in credit markets, but of which none, taken alone, can be assumed necessarily to be 'The' event. In fact the current bout, considered this way, seems unlikely to qualify. The financial sector, as a whole, still continues to register relatively sound performance and looks capable of absorbing the immediate threats to stability.

This stand-off, then, raises a vital question for investors – as well as for lenders and borrowers, of course. The media and blogs are again dominated by doomsters looking for immediate credit cycle closure (in both senses of the word). The stand-off doesn't mean they don't have a fundamentally valid case, but the closure isn't happening, and risk premiums don't reflect a crisis as such. Something must be keeping the ship afloat. What is it? This then begs the subsidiary question of how long 'it' might last.

Widening from sub-prime to leveraged loans

We'll come to that in a second. Sub-prime has been analysed a lot in the last few quarters, and clearly it has been the catalyst for credit market instability earlier this year and again now. In the March Minsky paper, we suggested that in and of itself it wasn't likely to mark the actual end of the credit cycle, but that was not to say it wasn't and isn't important. However, there is no need to pore over developments in the housing sector that are now widely known, and it is worth noting the widening of credit market problems because risk spreads have started to widen in markets that don't really have much, if anything, to do with housing.

Leveraged loans, for example, have now captured broader attention in a way that was absent earlier this year. The sub-prime and leveraged loan markets have a few things in common: inadequate or no disclosure or transparency; insufficient or poor information about both lenders and borrowers, especially in the non-quoted sector; the use of off-balance-sheet financing; intense competition; a recent history of loosening or weak underwriting standards; and last, but not least, products for which demand and supply exploded out of the search for yield and the low cost of capital.

The US Office of the Comptroller of the Currency (OCC), in its 2006 Survey of Credit Underwriting Practices (October 2006), reported that competitive pressures had led to an easing of credit underwriting standards for both commercial and retail credit products for the third successive year. In the leveraged loan sector, the OCC found that over 60% of lenders had eased standards in 2006, the highest percentage since 1999. With regard to leveraged loans in particular, the OCC said that demand for bank loans from non-bank investors had influenced underwriting terms and pushed credit spreads lower while, at the same time, extending similar developments into other types of commercial credit (presumably in the high-yield and asset-backed sectors, among others). The IMF said in its 2007 Global Financial Stability Report that the strength of demand for leveraged loans from investors had led to a shift in power from lenders to borrowers, often resulting in negotiated loan covenants, diminishing the conventional advantage of loans over bonds as a financing medium. These so-called covenant-lite loans (which draw out the credit cycle by allowing weak or failing borrowers greater latitude) amounted to USD105 bn in the first half of 2007, according to Standard and Poor's, three times more than for the whole period from 1997-2006. The largest issuers of such loans are private equity firms. The OCC's overall conclusion – in the autumn of 2006 – was that while current loan performance and overall loan quality remained sound, credit risk was increasing due to the continued weakening of underwriting standards. By June 2007, the OCC would presumably be nodding sagely with an 'I told you so' look.

The just published BIS Annual Report (2007) noted that supervisory authorities have repeatedly urged a tightening of credit terms generally, but – as the tone of the report suggests – with no major effect as yet. Like other financial stability reports, the BIS noted the involvement of hedge funds in financing high-risk company transactions via CLOs, leveraged loans and high-risk derivative products, as well as the prominent role of private equity groups in M&A. But these observations are more characteristics than causes of anything in particular. Reading the entrails of the report, one comment that lingered related to a question that many investors have asked or queried. With banks dis-intermediating risk and packaging up loans into securities and selling them into a secondary market, many investors have wondered whether this does or doesn't make the financial system more stable, more capable of absorbing shocks and moving on without generating economic instability. The answer is probably 'it does', up to a point – and probably while generally benign macroeconomic conditions prevail. But the complexity of the product and market structures, whether in sub-prime, leveraged loans or elsewhere, makes it exceedingly hard to judge how risks are being allocated, who has them, how big they are, the degree to which they really can be hedged, what their market value really is at any given point (unless you auction them!), and what might happen when the credit cycle turns down.

But the BIS makes an interesting point when it says that the business model underlying this risk transfer and risk diffusion through the use of securitisation and derivatives gives rise to a major principal-agent problem. Specifically, the report asks what the implications are when originators no longer feel the need to undertake full due diligence on credit because they sell the risk on (or face strong competitive pressures to collect fee income and offer underwriting inducements to purchasers) and ultimate buyers don't have the skills or the information required to manage the risks inherent in the complex securities they are buying.

As we know, much of the boom in leveraged loan financing is related to the prominence of private equity transactions, which in turn have been a key contributor to the record volumes of M&A both last year (almost \$4 trillion) and, as things stand, this year again (announced transactions up to May up 50% on last year). So, it might seem a long way from sub-prime housing to mega-deals in M&A, but – from an economic standpoint – they have simply represented different ways of leveraging cheap money. The IMF reckons the ratio of debt to EBITDA among European LBOs reached a high for the cycle at 5.5 at the end of 2006, while in the US, a similar cyclical high of 5.1 was reached at that time. By contrast, in this credit cycle, equity-financed deals, according to the BIS, accounted for 12% of total announced deals in 2006, compared with 19% in 2004 and 26% in 2002. While the debt to equity ratio for all companies is rising, it's still well short of the highs reached in the 1980s. That said, however, it's clear that for some highly leveraged firms (and lenders, therefore), and given the rising proportion of below investment grade borrowers, even small economic shocks could be significant (default risk and/or sector stress), with knock-on effects across the financial community.

So, what is the 'it' that's keeping the doom brigade at bay – and for how long?

So, finally, we can address the question of what is keeping the credit cycle going and what might aggravate the current situation. There are of course numerous factors that could account for an elongated cycle that isn't misbehaving in a more pronounced, let alone systemic, way. But as you'll see, none of them is without caveat.

Long housing cycle. In housing, for example, the cycle from notice of default to repossession, higher inventory of unsold homes and lower home prices probably takes many months, if not quarters. And homebuilders, financial institutions and regulators have had a long time to see the current denouement coming, so they may be better able to manage the risks as they unfold. This doesn't mean we will be spared a sharper drop in house prices (UBS US economists are expecting a fall of 10%, which is anything but small beer for the US) – merely that it hasn't happened yet. US home inventories are already at their highest level in 17 years (just before the 1990-91 recession), and with the bulk of the now widely estimated mortgage resets falling due over the next 18 months at rates often 200-300 basis points (or more) higher, the chances of a deepening delinquency-default cycle are high.

Low corporate leverage. In the corporate world, of course, aggregate measures of leverage and the growth in financial liabilities have remained quite restrained, as global economist Andy Cates points out regularly in the Global Economics publications set, and default rates are still quite low. This constituted one of the two items of 'good news' in the first Minsky paper in March. And in general, the lack of market price transparency or valuation in many financing structures may be a source of relative stability, but only because participants don't yet need, or haven't the ability, to recognise mis-pricing. Again, that doesn't mean they won't – and possibly all at the same time – but for the time being the lack of transparency is what they call in football 'an assist'.

On the other hand, this lack of transparency and the inability to properly judge value against the background of perhaps more uncertain financial and economic conditions could easily threaten the pipeline of deals that are waiting to be done, with perhaps adverse consequences. UBS credit strategist, George Bory, for example, says that the number one, credit-specific risk facing the market is the supply pipeline in the US involving leveraged loans and high yield issuance, which he estimates at around USD200 billion to be placed over the summer and early autumn (*Credit Strategy: Daily Pulse*, 27th June 2007). And the IMF makes the point that if some deals fail to live up to expectations and get pulled, or lenders back away from deals during syndication, then there could be more serious risks to financial stability as investors and lenders reappraise risk across this and probably a wider range of financial products and assets, in effect restricting access to credit. Developments in credit markets in the week of 25th-29th June, in which a number of deals were pulled or postponed, bear testament to this danger.

Global liquidity. A further explanation, cited as the other bit of good news in the March research report, is the ever-present atomic cloud of liquidity, represented by the stock of and continuing growth in the foreign exchange assets deployed by central banks and, of course, now also Sovereign Wealth Funds (SWF). Conventional FX assets may now be as high as USD5.5 trillion, with SWF assets possibly accounting for a further USD2.0-2.5 trillion. If they only grow at 10% per year, that's close to a fresh USD800 billion per year. By my calculations, though, the asset base is growing at nearer to 15-16% per year. UBS head of Central Bank Services, Terrence Keeley, quoted BIS numbers in a recent *Financial Times* Op-Ed (June 29th 2007) to state that the total reserve accumulation by sovereign investors in 2007 could exceed by 100% the combined net new issuance of the US Treasury, Fannie Mae and Freddie Mac, all euro-area federal issuance, all UK government issuance and all EIB and KfW issuance. Although a modest amount of these assets (from SWFs) is now being allocated towards private equity funds and the majority of SWF funds are probably invested in equities, that still leaves a lot of cash looking for a home in investment grade credit structures and in assets where they tend to depress the level of long-term interest rates, aka the price of money.

This is well understood, and we should not underestimate the power of sovereign or official asset deployment in generating on-going demand for securities and in creating yield curve 'distortions'. However, it is a bit of a stretch to imagine that even these investors can or do control or any of the levels along the coupon curve in the face of either changing monetary policy or inflation expectations.

But while the above explanations can account for the characteristics of the credit cycle, they can't really explain on their own its behaviour. So what is it that's keeping the credit ship afloat? In the words of the cliché, 'It's the economy, stupid!' Or as the *Wall Street Journal* put it (28th June, 2007), referring to credit market instability, 'Even if it's an earthquake in US, economic resilience may prevail'. Is that just cheerleading, an interesting but academic backward-looking observation, or a prescient view of the future?

Favourable economic background. The deterioration in credit markets we have witnessed so far has occurred against a background of continued robust global growth, low real interest rates, high corporate profitability and cash flows, low volatility and the absence of an obvious inflation flashpoint. At the time of writing, moreover, it isn't only the continued satisfactory performance of European and Asian economies that has captured the attention. In the US, after very weak winter quarters, it now looks as though reported GDP for the second quarter and maybe the third quarter too will come in a fair bit stronger than might have been expected a short while ago. To a large degree, the UBS economics view is also that this will reflect the effect of inventory swings, especially in automobiles. If that's most of the reason, then markets may well be nearer to another re-think about the economy than they believe – that is, by the time the holiday season is over and we start trying to assess sources of economic growth and economic drag towards the end of the year and 2008, the glass really may be half full or even less. But for now, optimism about the economy, even if not unbridled, remains.

Profit growth may be slowing down, but not yet to the sound of alarm, and real interest rates have edged up a bit in the last month or two, though not reflecting higher inflation risk premiums. For the most part, real rates have moved as investors have re-assessed – in effect priced out – the probability of the Fed lowering interest rates. And the reason for that is partly expectations that the US economy isn't being ground down by housing alone and partly the Fed's insistence that it sees no evidence yet that the risk of higher inflation has been extinguished.

Maybe lack of inflation is the most important, but this is a Pandora's box. That said, the absence of an overt inflation threat in the obvious places remains an important reason for credit markets to weather another storm. It's the principal reason for the neutrality of the Fed and the unwillingness of other central banks to raise official interest rates aggressively. The actions of European central banks and the BoJ and the inactivity of the Fed send a message to asset markets in general that is either benign or only marginally worrisome.

But this is something of a Pandora's box. You don't have to have noisy inflation to have sharply rising interest rates and financial instability. Nordic countries in the late 1980s and early 1990s, the US and UK in the early 1990s, Japan in the 1990s (when inflation was declining from previously elevated levels), and the Asian economies in 1997-98 all endured financial instability and economic consequences without experiencing any marked or serious acceleration in inflation. As is well known, this 'conundrum' of instability without inflation has spawned a very serious policy debate about whether central banks should alter their monetary policy templates to take into account domestic financial imbalances including asset bubbles – in other words, they might strike preemptively against the risk of rising inflation and inflation expectations, for two reasons. The first is that if asset inflation remains unchecked, the likelihood of a rise in general inflation may increase. The second is that, even without more general inflation, a credit cycle contraction with low inflation, as in 2001-03, runs a serious risk of a deflationary credit bust and rising real debt burdens, which lower nominal interest rates might not reverse on an acceptable time frame.

To a degree, the Bank of England, ECB, Swiss National bank and the central banks of Sweden, Norway and Australia have taken on board, however loosely, the idea that unrestrained asset inflation (especially debt-financed) carries stability and inflation risks which are theirs to manage. The Fed is mostly quiet on these issues by comparison, and of course for now remains focused on different and more conventionally defined economic and inflation metrics, though the publicly voiced debate about whether headline or core inflation should be the Board's preferred focus is new and potentially of consequence.

Getting closure – or closer...?

The bottom line here is the same as it was a few months ago: namely, that there are always and only two ways in which credit cycles are brought to a close with or without stirring the ghost of Minsky. The first is the traditional one of rising inflation, which triggers an increase in the price of money, which at some stage

exposes over-leverage and balance sheet stress and sets in motion an economic cycle of income and spending restraint. The second is an endogenous decline in asset prices (house prices, credit instruments, other financial assets), with a milder increase in official interest rates in the background, which triggers more dramatic financial instability as leverage and liquidity are pared back and credit supply is interrupted.

Here in the early summer of 2007, monetary accommodation is slowly being tightened in many countries and, in the US, both short- and long-term interest rate levels look mildly restrictive (e.g., interest rates relative to nominal GDP growth). On the other hand, a more global perspective on liquidity flows and their impact could not but highlight the beneficial – though by no means cycle-proof – role played by Asian and other central banks and the still reasonable or high levels of corporate savings. An inflation-induced and sharper tightening of monetary policies is still a risk, but it isn't the most likely outcome in the view of UBS economists.

On asset markets and endogenous asset price movements, the risks are probably bigger. It's quite possible that financial markets will absorb adverse credit market developments and return to higher risk premiums and higher volatility without any major discontinuities or economic dislocations. But even without higher US short rates, the leverage cycle is turning, and with it we should expect to see default rates rise, and not only in US sub-prime housing. Financial markets might well be obliged to re-assess US economic and housing market prospects again later this year (to the downside). The on-going softness of US capital goods orders and the shortcomings of capacity-building capex in the US and Europe/Japan in particular is a worrying sign in the light of the glowing reports about corporate balance sheets, even though the contemporary impact on share prices is positive. Or, conversely, markets might have to adjust to a stronger-for-longer scenario with renewed inflation implications. Either way, the subsequent implications for the credit cycle will be unequivocally negative and, probably exacerbated by large leveraged investment positions, the use of untested derivative and other hedging instruments, and the opaque nature of key products in the market place.

The IMF has called attention to the rising correlation of asset classes to the S&P 500 index, which may aggravate any shock from either the economic and or financial spheres. In measuring the daily return performance of Asian currencies and the JPY, commodities and 10-year US Treasury bonds, correlations were significantly higher in 2006 than, for example, in 2004-05. The exceptions were found in Asian equities, where the correlation was slightly lower, and Japanese equities, where it was roughly unchanged. Clearly that's an observation and not necessarily a forecast, but the essence is that more highly correlated asset classes invoke possibilities of increased portfolio risk, crowded trades in which investors don't want to stay, and assets and loans that lenders may become less willing to finance or support. In this event, of course, financial market developments will likely aggravate whatever economic weaknesses brought about the initial disturbances in credit markets in the first place.

A Minsky moment doesn't look to be imminent, but we should be prepared to view current developments in the context of a, so far, slowly unfolding denouement of the credit cycle in which caution is gradually replacing gung-ho attitudes towards leverage. The economic environment doesn't look as though it's going to spring negative surprises on us for a while, and it may be late in the third quarter or towards the end of the year that expectations will be more volatile and uncertain. The main message, though, remains one of 'buyer and lender beware'. Credit cycles usually turn slowly, but their capacity to intensify once they do turn is legendary.

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