Philequity Corner (April 7, 2008)
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US Gets a Dose of Its Own Medicine

Back in 1997, former Malaysian Prime Minister Mahathir Mohammad accused George Soros and other hedge funds - which he called the "highwaymen of the global economy" - of ruining Malaysia's economy with massive currency speculation.

In an editorial piece that appeared in the Sept. 23, 1997 issue of the Wall Street Journal, Mahathir said:

"*Whole regions can be bankrupted by just a few people whose only objective is to enrich themselves and their clients… We welcome investments. We even welcome speculators. But we don't have to welcome share- and financial market manipulators. We need these manipulators as much as travelers in the good old days needed highwaymen*." Note that in the olden times, highwaymen were criminals who robbed people traveling by stagecoach.

Fast forward to 2008, it's now the US financial institutions' turn to taste doses of their own medicine, accusing hedge funds for spreading false rumors which sent Bear Stearns to near collapse.

Again this episode of citing the hedge funds' role in bringing down established institutions is history reenacting itself, just like the way it was in 1997. (See our previous articles: "*The US can learn from the 1997 Asian financial crisis*" and "*US credit crisis & bailouts – Reminiscent of the 1997 Asian financial crisis*" on the Jan. 21, 2008 and March 17, 2008 issues of **The Philippine Star**)

Bear Sterns collapse – a deliberate effort?

Blackrock Inc. CEO Laurence Fink, in an interview from Barron's, suggested that the collapse of Bear Stearns was aided by hedge funds. Moreover, Fink implied that hedge funds not only created the collapse but profited from it through short-selling.

Fink said in the interview:

"*The fall of Bear Stearns was a liquidity crisis. It has been rumored that there were hedge funds promoting hostile and negative comments, which accelerated the fear of doing business with Bear Stearns. I believe it would be prudent if the SEC investigated these rumors. Bear Stearns was a very fine institution destroyed by a profiting few. In a normalized market, Bear Stearns would have never fallen like this. The rating agencies caused the ultimate fall of Bear Stearns.*"

In light of these rumors, the US Securities and Exchange Commission (SEC) Chairman Christopher Cox, in a testimony to the Senate Banking Committee, said that the SEC is taking these allegations very seriously and has already opened probes last month.

Meanwhile, three US watchdogs said they will vigorously and aggressively investigate such cases. In a joint statement last week, the Financial Industrial Regulatory Authority, NYSE Regulation and the Options Regulatory Surveillance Authority said they won't tolerate intentional spreading of false rumors or engaging in collusive activity by their members to impact an issuer's financial condition.

Proving market manipulation, however, is tricky. It is so hard to separate out the manipulative intent from what would be a normal investment purpose. Moreover, tracking down such rumors is very difficult, particularly in today's uncertain markets. The rumor mill is much larger with everything in turmoil.

Thunderous whispers

Bear Stearns survived a major liquidity challenge in June 2007, when two of its hedge funds went under during the early stages of the sub-prime mortgage crisis. Since then, the company had worked hard to repair its balance sheet and improve its financing.

Last month, however, whispers of Bear Stearns itself having liquidity problems started circulating in the market. A major bank – accounts differ on which - was said to have rejected Bear Stearns request for a short-term $2 billion loan on March 7 (Friday). The firm promptly denied the rumors on a press release on March 10. At that point, Bear Stearns indeed had some $17 billion in cash. But with an $11.1 billion in equity capital supporting $395 billion in assets (or a leverage ratio of more than 35 to 1), the company will surely be in dire straits if credit starts to dry up.

On the morning of March 11, Goldman Sach's delivered the coup de grace when it told its hedge fund clients via email that it would no longer step in for their Bear Stearns derivative deals. By the end of the day, most banks refused to issue any further credit protection on Bear Stearns debt.

As the rumors accelerated over the next two days, Bear Stearns executives tried to convince Wall Street that everything was under control. But when word of the Goldman email leaked out, hedge funds and other Bear clients stampeded their way out. On March 14 (Friday), Bear's stock dropped by 47.3 percent to $30 per share. On the following Monday, the stock price fell to as low as $2.84.

Lehman recapitalizes, financials rally

The bailout of Bear Stearns brought back confidence in the market. In addition, the Fed's innovative measures such as opening its borrowing window to non-bank institutions, extending and expanding its swap arrangements, as well as the 300 point cut in the fed funds rate over the past six months have provided the much needed stimulus to the market.

As a result, Lehman Brothers successfully raised $4 billion in capital last week through a convertible preferred share offering that was well oversubscribed. Meanwhile, financial stocks led the a 391-point surge in the Dow Jones Industrial Average on March 31 even as UBS AG and Deutsche Bank AG announced further sub-prime related write-downs.

Markets will recover

Just like in 1997, we are probably seeing the latter stages of this current bear market. After the Asian governments bailed out their financial institutions, the Asian economies and the Asian markets recovered after a period of time. While we don't know how long it will take for the US to recover, we know that in time it will also bounce back, especially with the Fed fighting all out to ease the credit crisis and shore up the economy.

PSE should re-think short-selling

With the current squeeze on global liquidity, the Philippine Stock Exchange (PSE) may have to rethink its plan to allow short-selling under the approved Securities Borrowing and Lending (SBL) Scheme. Just like what happened to Bear Stearns, such scheme could be used by unscrupulous market players to spread false rumors about listed firms and to profit from the market's adverse reaction. With short-selling, market prices could stay depressed longer than usual, especially in times of crisis.

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