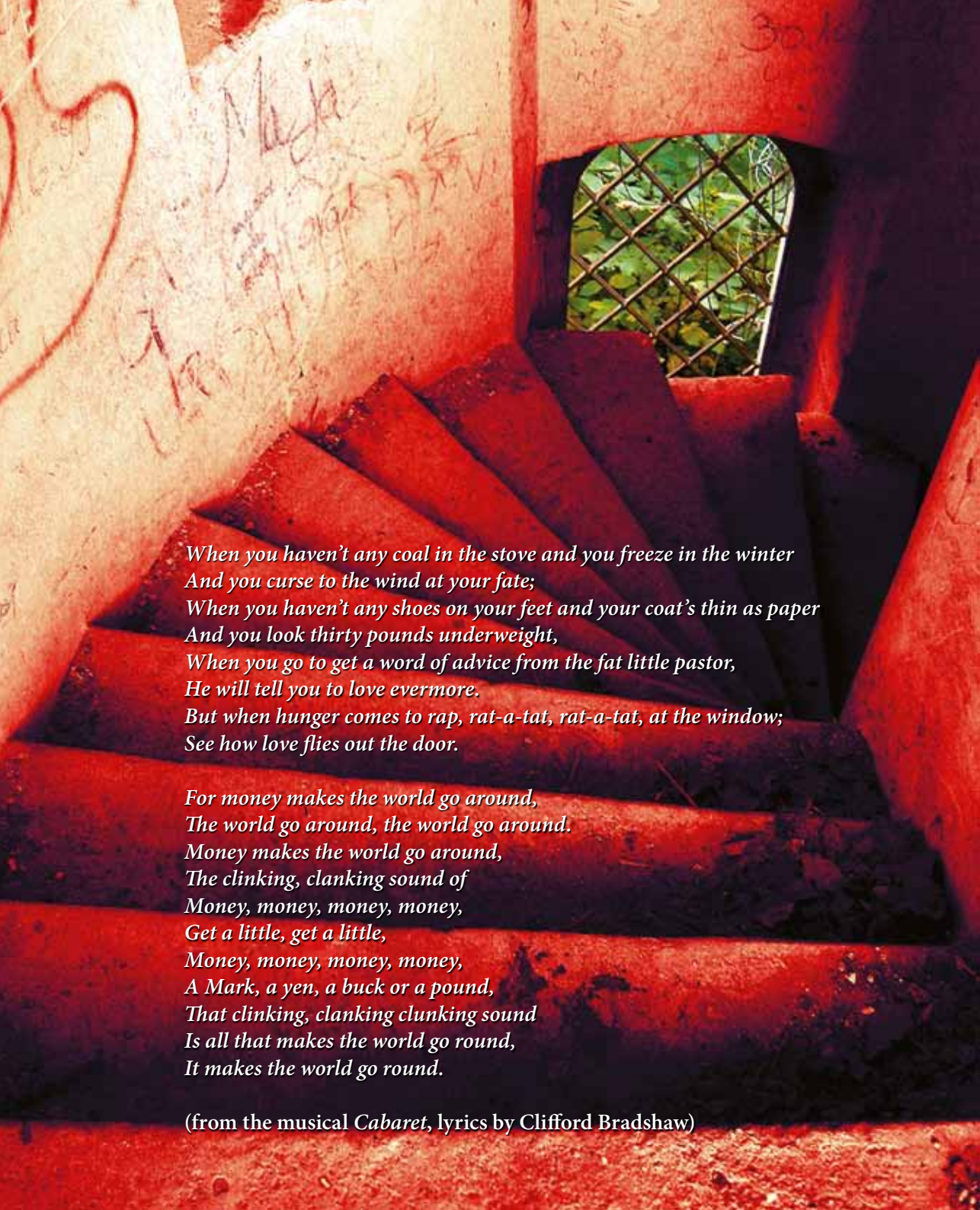




part 1

The New Great Depression





*When you haven't any coal in the stove and you freeze in the winter
And you curse to the wind at your fate;
When you haven't any shoes on your feet and your coat's thin as paper
And you look thirty pounds underweight,
When you go to get a word of advice from the fat little pastor,
He will tell you to love evermore.
But when hunger comes to rap, rat-a-tat, rat-a-tat, at the window;
See how love flies out the door.*

*For money makes the world go around,
The world go around, the world go around.
Money makes the world go around,
The clinking, clanking sound of
Money, money, money, money,
Get a little, get a little,
Money, money, money, money,
A Mark, a yen, a buck or a pound,
That clinking, clanking clunking sound
Is all that makes the world go round,
It makes the world go round.*

(from the musical Cabaret, lyrics by Clifford Bradshaw)

Everybody knows now. Worldwide we are in an economic recession that is turning into a depression, maybe the worst we have experienced since the Great Depression of the 1930's. So let's label the forthcoming period of economic hardship the New Great Depression. In 10 years time we may re-evaluate to check the accuracy of this label.

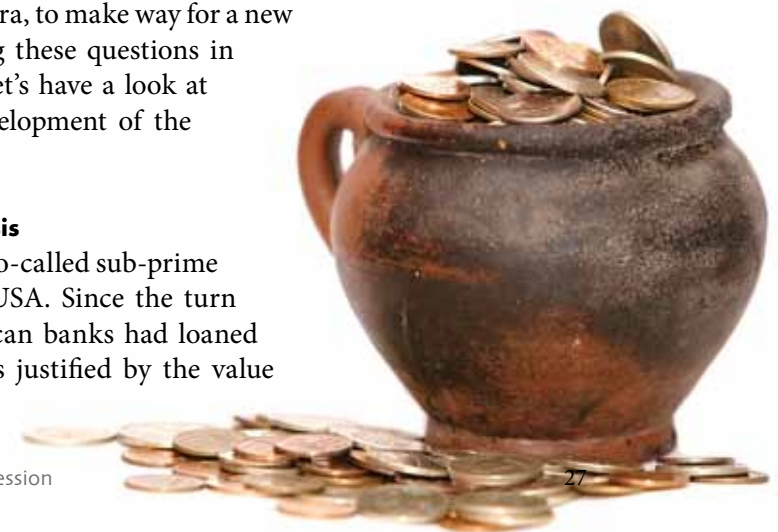
The first signs of the present economic downturn appeared in the financial industry in 2007. Because of "bad debts" a lot of banks got into trouble with their liquidity, and stopped lending money to each other. This phenomenon is known as "the credit crunch," simply meaning a severe shortage of money and/or credit.

Because of the credit crunch stock markets plunged, the trust of investors disappeared, and the financial security of millions of people was endangered. College- and retirement-savings, along with trillions of paper stock market wealth, vanished into thin air. The present recession, now turning into the New Great Depression, is destroying jobs, bankrupting businesses, and displacing homeowners. Nearly everybody is a victim of the present crisis, although there are some sectors and professions that are gaining from the situation, for example lawyers, accountants, and government contractors that are involved in government bailouts.

How did all this misery start? Can we point a finger to a small group of unethical bankers who caused this exceptionally deep crisis, or did we all simply borrow too much money? Or is the present economic downturn part of the inevitable cycles of capitalism? Is a crisis like the present one necessary to clean up the remains of an old technological and economic era, to make way for a new one? Before answering these questions in part II of this book, let's have a look at the chronological development of the present crisis.

Sub-prime lending crisis

It all started with the so-called sub-prime lending crisis in the USA. Since the turn of the century American banks had loaned people more than was justified by the value





of the collateral, often using so-called step-up-loans, i.e. loans that start with a very low interest rate (mostly 1%) that automatically increases over time. Because the price of houses had been rising for almost two decades, banks thought this would not be a problem, they assumed that if the lender was unable to pay the interest, the increased value of the collateral would make up for

the loss.

At the same time mortgage providers started lending money to people with a poor credit history. In the USA, like in many other countries, the credit history of mortgage applicants is checked through a credit-rating system. People with a poor credit history are called sub-prime borrowers. Even though banks knew that a lot of these mortgagees would get into trouble, they continued issuing the mortgages.

But meanwhile a rise in interest rates triggered a slowdown in the American housing market. Between 2004 and 2006 US interest rates rose from 1% to 5.35%. Homeowners that could only barely afford their mortgage payments when interest rates were low began to default on their mortgages. The impact of these defaults was felt all across the financial system, as many of the mortgages had been bundled up into portfolios, together with other loans, bonds or assets. These portfolios, the so-called Collateralized Debt Obligations (CDO's), were sold on to investors globally. Because investors were suffering losses, they became reluctant to take on more CDO's. Rating companies have been the focus of intense criticism for their role in granting top "AAA-ratings" for complex bonds that later plummeted in value.

Credit markets froze, as banks became reluctant to lend to each other, not knowing how many bad loans could be on their rivals' books. Losses were felt all over the world, especially by investment banks in rich countries. Firms started canceling sales of bonds worth billions of dollars, citing

market conditions. In February 2008 leaders from the G7 group of industrialized nations warned of worldwide losses stemming from the collapse of the US sub-prime mortgage market. Dark clouds appeared over our prosperous heads and banks and investors held their breath. The sub-prime lending crisis, which in the beginning only seemed to affect the US housing and mortgage market, had turned into a worldwide credit crunch.



Credit Crunch

By the end of the summer of 2007, central banks all over the world started intervening in the financial industry. They didn't want to take the risk of big banks collapsing, which eventually might cause the collapse of the whole financial and monetary system. In August the European Central Bank pumped more than €200 billion into the banking market, to improve liquidity. The American central bank, the Federal Reserve, and the Bank of Japan took comparable measures. In the following months the amounts that central banks were funding got bigger and bigger. But the short-term help did not solve the availability of cash for banks, as banks remained cautious about lending to each other.

At the same time central banks started lowering interest rates for lending to banks. But all this hardly helped. Instead of also lowering interest rates, the banks increased their rates for inter-bank credit, because they were worried whether the other bank would survive or because they needed the money urgently. In the beginning of 2008 the first bond insurers, who guarantee to repay loans if the issuer goes bust, got into trouble. Because of this, banks had to announce another round of losses. More and more banks got into trouble.

Big investment banks, that for years had reigned supreme and were seen as the heroes of our prosperous era, got into trouble. In March 2008

Wall Street's fifth-largest bank, Bear Sterns was on the brink of collapse, and eventually was acquired by rival JP Morgan Chase for \$240 million, while a year earlier the bank had been worth more than \$25 billion. Later that year other famous investment banks followed Bear Sterns in its downfall.

In April 2008 the International Monetary Fund warned that the effects of the crisis were spreading from sub-prime mortgage assets to other sectors, such as commercial property, consumer credit, and company debt. They were right. In six months' time the credit market came to a near stand still, not only for banks, but also for companies and individuals. Following the USA, the rest of the world now saw a fall in house prices, because it became more difficult to get a mortgage and buyers started to postpone their purchases. In the UK house prices fell by 10.5% between August 2007 and August 2008. At the same time the US labor market figures showed an unemployment rate rising to 6.1%, a figure that was to rise to 7.2% in December. Stock markets all around the world started suffering from steep falls. In 2008 the DAX in Frankfurt lost 40.4% while the CAC 40 in Paris dropped 42.7%. Because of all this bad news businesses and the man in the street got more and more nervous and worried. Businesses suddenly could not get credit for necessary investments and were confronted with shrinking sales and eventually bankruptcy.

People got worried about the price of their houses, about the threat of job loss, and about the value investments, pensions and savings. In the UK, clients of Northern Rock started a "run on the bank" after the Bank of England had granted their bank emergency financial support. In a few days depositors withdrew £1 billion from Northern Rock. Panic is a bad counselor, but people will always be people, meaning they act like sheep. When some panic, the rest follow. The crisis in the financial industry had become a crisis for all of us.



Credit insurance stronger than ever

Well into its second century, credit insurance continues to evolve and increase its value to businesses selling products to other business enterprises. In the twentieth century, credit insurance began to take root as companies, throughout Europe in particular, sought opportunities to sell their products to businesses in neighboring countries. Companies like Atradius, whose predecessor companies acquired more than 15 businesses across the globe between 1990 and 2005 to more effectively meet the needs of these international traders, epitomized the industry's move to globalization.

Now more than ever, globalization is driving international trade and the challenges of growing a business internationally will increase demand for protection of trade receivables. All businesses would like to be able to do business on a cash basis, but to gain a competitive advantage the ability to offer products and services on payment terms can give a company an edge. Trade receivables are an important asset and growing risk management requirements like Sarbanes Oxley highlight the importance of protecting them. The more flexible the terms, the higher the risk and the greater the need for protection.

The need for a global footprint means entrance barriers are high. We may see new local players entering the market, particularly in emerging markets, but building the required infrastructure to compete for business internationally requires long lead times and big investments. To compete effectively, these small players will need to become part of an international network. Only the top 3 credit insurers have these networks in place and antitrust laws make consolidation of these 3 players unlikely.

The need for protection against political risks has increased following changes in political environments in many countries. Though the post cold war era has enjoyed 20 years of political stability, this is not expected to last. Competition is no longer primarily a local event. Fierce international competition will be brutal in determining who will and will not survive. The increasing complexity of global economies requires sophisticated global knowledge of buyers to predict who the winners and losers will be.

Companies have to operate efficiently at all levels to survive. That means credit insurance has to be cost efficient. A more complex risk environment and regulations like Solvency II will play a significant role in the future of credit insurance driving the price of risk protection up. Alternative tools like credit default swaps may be attractive for a small number of companies, but there are few effective substitutes for



protecting against defaults stemming from commercial and political risk. Viable substitutes are unlikely and credit insurance will therefore remain the most valuable tool available to protect trade receivables. □

Isidoro Unda is CEO of Atradius.

Governments step in

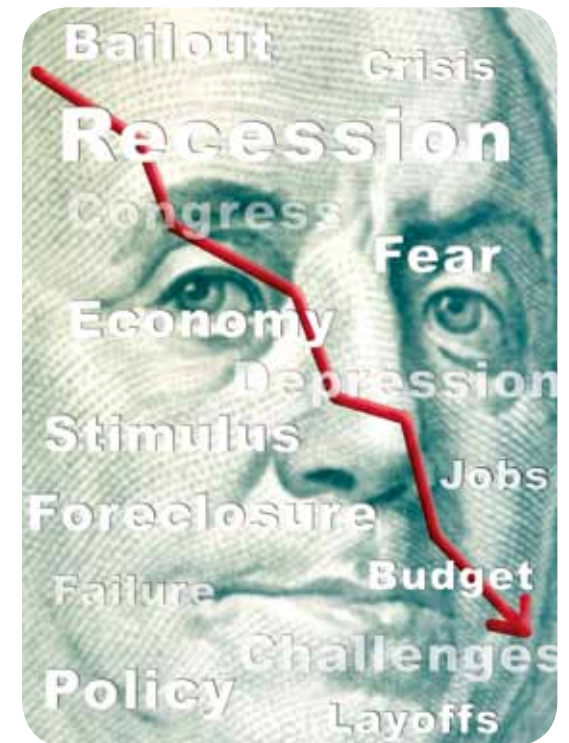
In the summer of 2008 banks started announcing their losses on assets linked to the US mortgage debts. Swiss bank UBS, one of the worst affected by the credit crunch, announced the loss of \$37 billion. In July financial authorities in the USA decided to assist the two biggest mortgage banks in the country, Fannie Mae and Freddie Mac, that were about to collapse. Worth \$5 trillion of home loans and accounting for nearly half of the outstanding mortgages in the USA, they are crucial to the US housing market, and the authorities agreed that their collapse would threaten the financial stability of the country. On September 7 the US Treasury Department bailed out Fannie Mae and Freddie Mac. But a few days later it was announced that Lehman Brothers was in big financial trouble. Lehman was the first real casualty of the Credit Crunch and went bankrupt on September 15. In the following weeks other investment banks were taken over by competing banks, for example Merrill Lynch by Bank of America for \$50 billion. But banks were not the only victims of the crisis. Insurance companies also got into trouble. AIG, America's biggest insurer, was saved by an \$85 billion rescue package from the Federal Reserve (Fed). The Republican Bush administration, which had never been keen on government interference, now couldn't refuse because the whole financial system was at risk.

In other parts of the world similar government interventions followed. In Europe a lot of governments decided to nationalize banks that were on

the brink of collapse. In September 2008 the UK mortgage bank Bradford & Bingley, worth £50 billion in mortgages and loans, was nationalized. The same month the Belgian-Dutch bank and insurance giant Fortis was partly nationalized, as were Iceland's third-largest bank Glitnir and the French-Belgian bank Dexia. But regardless of all the actions of governments the shares of a lot of banks plunged. In November the shares of the American banking giant Citigroup lost 60% of their value in one week. Suddenly all the newspaper headlines were about the crisis in the financial industry and its bailout, paid for with taxpayers money. The ethics of the industry were questioned and CEO's were criticized for reaping huge salaries and bonuses. Not only banks collapsed. Iceland's entire banking system collapsed and the IMF had to grant a \$2.1 billion loan to prevent the country from going bankrupt. More countries, especially those that had been living on credit for years, nearly succumbed to their load of debts.

Recession

By the end of 2008 economies all around the world had shrunk. After years of economic growth we slid into a recession. Most governments announced additional plans to pump billions of dollars, yens, pounds and euros into the financial sector and the economy in general. The US government agreed a \$700 billion bailout to buy up Wall Street's bad debts in return for more transparency and a stake in the banks, using money borrowed from world financial markets. But the question remains whether this is enough, because an estimated \$2 trillion (!) of mostly mortgage-related debt still threatens to topple the entire





banking sector – the bedrock of US capitalism. Some experts think the Obama administration could need as much as another \$750 billion to save the banking system. Many of us wonder where this will end. The UK government launched its own bail-out, making £400 billion extra capital available to eight of the UK's largest banks. All around the world governments are trying to save their own banks with public money.

In addition to bail-outs of banks, a lot of countries have chosen plans to stimulate the economy in general. A massive stimulus measure by the Obama administration started the flow of \$787 billion toward infrastructure projects, health care, renewable energy development and conservation programs. The plan is split into 36% for tax breaks and 64% in spending and money for social programs. The Chinese government set out a 2 year \$586 billion economic stimulus package to help boost its economy by investing in infrastructure and social projects and by cutting corporate taxes. French president Sarkozy unveiled a €26 billion stimulus plan to help the country fend off financial crisis, with money to be spent on public sector investments and loans for the country's troubled carmakers, while the government of Europe's largest economy Germany, announced an economic stimulus package worth about €50 billion. But despite all these measures, the number of bankruptcies and levels of unemployment all around the world continued to mount, and exports kept on falling. In 2008 China's exports registered their biggest decline in a decade. All countries heavily dependent on exports, for instance Germany and Japan, are threatened by a collapse of vital sectors like the car industry. The global focus of a lot of countries suddenly turned into a national focus. National businesses were protected. Migrant workers were sent home. International trade slowed down. Globalization turned into "slowbalization."

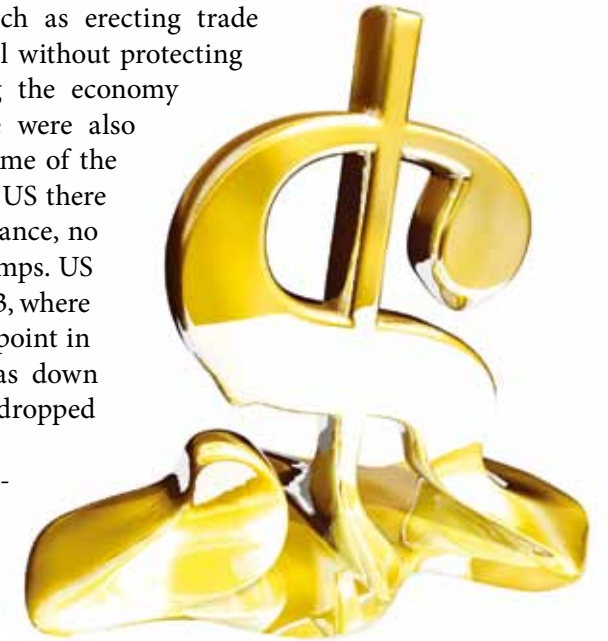
A New Great Depression?

Many people wonder if the forthcoming crisis will be as bad, or even worse than, the Great Depression of the thirties. Most of us know the frightening images of the poverty of that era, and some of us have heard the personal stories of grandparents who experienced the hardship.

Every crisis is different. The comparison of the current depression with the Great Depression is striking in that it started with failures in the financial system, and not with the ups and downs of the business cycle. A big difference, though, is the rapidity of the fall and the breadth of the crisis. Because of the present interdependency of economies, caused by globalization, the Credit Crunch and the consequent depression, spread like wildfire. Stephen Schwarzman, CEO of private equity firm Blackstone, has said that between 40% and 45% of the world's wealth has evaporated in less than a year and a half: "This is absolutely unprecedented in our lifetime."

Another big difference with the situation in the thirties is that governments react a lot more accurately now. Back then Washington made major political mistakes, such as erecting trade barriers, letting too many banks fail without protecting depositors, and hardly stimulating the economy by pumping money into it. There were also far fewer social safety nets in the time of the Great Depression. Back then, in the US there was no federal unemployment insurance, no Medicaid and there were no foodstamps. US unemployment peaked at 25% in 1933, where it is around 7.5% now. At its lowest point in the thirties the American GDP was down 25% from its 1929 high. So far, it has dropped only about 2%.

But there are also striking similarities between then and now. One parallel is that it's worldwide. In the 1930's, the gold standard transmitted the crisis from country



to country. Now, global investors and banks transmit the crisis around the globe. Yet, the consequences are the same. In the fourth quarter of 2008, global industrial production fell at a 20% annual rate from the third quarter, according to the World Bank. Just as in the 1930's, there's a global implosion of credit going on right now. And, as during the Depression there are quarrels over who's to blame and what should be done – disputes that could fuel protectionism and economic nationalism.

A final similarity with the Great Depression is the psychological effect. Ordinary people are feeling a great deal of fear.. The word depression causes a general alarm and as a result consumers are trying to protect themselves by conserving their cash and slashing their spending.

All around the world people are anxious that we are falling into a deep economic ravine from which escape will be difficult. These worries may prove ill founded, but until they do, they promote pessimism and the hoarding of cash, by consumers and companies alike, that further weakens the economy.

Multiple crises

One of the reasons why a lot of people are very pessimistic right now, is the coinciding of several crises. Since the turn of the century people in western countries have become used to the threat of terrorism, mainly by Muslim fundamentalists. The image of the crumbling Twin Towers is one the main icons of our era, and that attack on the heart of western capitalist society was unbelievable to many people. Were we so vulnerable? Could we be hit by a terrorist attack every time we stepped onto a bus or train, or entered a shopping mall, many wondered. The attacks that followed in the next year on public transport in Madrid and London confirmed these fears. All in all the attacks brought a lot of tension into western societies, especially in those countries that had big Muslim minorities. The danger that used to come from faraway countries like the USSR now seemed to live in our midst. Most Europeans and Americans feel a lot less safe than they did in the time of the Cold War.

Another crisis that is looming is the warming of the climate. Since 2007 we have become used to headlines proclaiming an inevitable climate change, resulting in melting icecaps, rising sea levels, droughts resulting

in deserts, extreme weather and other natural disasters. News like that doesn't make you happy. Take my own situation: I live in Amsterdam, the capital of the Low Countries. The Dutch have always protected their country against the sea by building dykes, but with the prospect of sea levels rising dramatically in the coming decades, we now wonder if we should relocate to higher ground. Amsterdam is already located below sea level. In 2040 I may only be able to live in the top two floors of my house, and I may need to travel around Amsterdam by boat. For other low areas around the world, the same risk exists. With hurricanes getting stronger and stronger the dykes that protect New Orleans may not be sufficient. In other countries people wonder if they will still have water to drink, because of the enduring heat and the lack of rain.

Finally I want to mention the forthcoming crisis that is predicted by the Mayan calendar. I don't know if you have heard about the disasters that are in store for us between now and 2012. It all has to do with the transition of one age to another, a transition that should result in a new and higher state of consciousness for mankind. According to the Maya such a transition is always accompanied by the extinction of the old world order.

A long time ago, the era of the dinosaurs was brought to an end by a meteor. Now, because of extremely high activity in the sun and the accompanying destabilizing effects on the magnetic poles, some geologists expect a shift in these poles. This is something that has happened several times in the long history of the earth and it has a very disruptive effect on nature, causing the gulf streams in the ocean, the winds, and the climate in general to change. Other prophets of doom expect one of the super-volcanoes we have on earth, for example the one below Yosemite National Park or the one in the Canary Islands, to explode, resulting in years of semi-darkness.





The 2012 theme used to be something that was linked to woolly new-agers, but in the last few years the belief in this astrological crisis has spread like wildfire. The number of hits on the Internet when you google for “2012” is astronomical. Nowadays there are a lot of professionals, including bankers and businessmen, who believe in the 2012 story. There are insurance companies that don’t want to provide insurance on the east coast of the USA anymore, because they expect the Canary Island super-volcano to erupt before 2012, resulting in an enormous tsunami that will wipe out everything on that coast. We’ll have to wait and see what, if any, of this is true, but it certainly adds to the general feeling of crisis that marks our day and age.

Every crisis brings chances

But after it gets worse things will get better. In the Chinese language, the word crisis means risk/danger and chance at the same time. Every crisis brings chances. From the ruins of the old system a new system will appear, like a phoenix rising from its ashes. The old car industry, which has been tied to the oil industry since the production of the Model T Ford, will disappear and will be replaced by an industry that produces more sustainable forms of transport. The greedy banking culture that marked the last two decades will be replaced by a more responsible and maybe even old-fashioned kind of banking culture. New technologies like robotics, bio, and nanotechnology will replace old technologies. We have to come through the years of crisis and prepare ourselves in the meantime for the next era. We have to get creative again, take up the challenges, and find solutions for the present problems. And there is nothing wrong with challenges or with being creative.

Hedge Funds: A Modern Day Gold Rush

A day doesn’t go by without hedge funds being mentioned in the papers. The phrase is now synonymous with a group of savvy investors who try to gain by short-term transactions on any markets. Amongst professionals this strategy is known as Global Macro: investing in global macro-economic trends and profiting from it. Besides this strategy there are a dozen other strategies that hedge funds use. From Long/Short to Event Driven, all these strategies are different from those of the traditional fund manager who invests in an asset class and waits for a profit to arise when the investment goes up in price.

The mutual fund industry is growing, but the growth of the hedge fund industry is staggering. Sociologist, author and financial journalist Alfred Winslow Jones is credited with setting up the first hedge fund in 1949. Jones was followed by people like Soros, Steinhardt, Robertson and many other historic names. Where there were only a couple of hedge funds in the 1960’s, nowadays there are around 10,000 with estimated assets under management of approximately \$1.5 trillion, and with new funds hitting the markets every day.

Analysts say the main reason for this popularity is the difference in fee structure. Where normal mutual funds, depending on the asset class they invests in, charge a fee of 1-2%, hedge funds go by the golden rule of 2/20, which stands for a management fee of 2% and a performance fee of 20%. The performance fee means that the hedge fund manager is entitled to 20% of the profits above certain performance goals.

Many portfolio managers say money has no loyalty and it flows to where it thinks it will get the highest return. In today’s world, investors have become more opportunistic and they seem to be chasing short-term gains. The stellar growth of hedge funds and the attention they receive from private and institutional investors is a result of some exceptional examples.

James Simons’ hedge fund Renaissance Technologies charges a management fee of 5% and a performance fee of 44%. Expensive you say? The fund has approximately \$30 billion of mainly institutional assets under management. For this cost structure investors receive probably the most advanced black boxes in investing around today. The total capacity of Renaissance is said to be \$100 billion. Yes that is \$100,000,000,000.

Renaissance uses computer-based models to predict price changes in easily traded financial instruments. The predecessor to Renaissance was a hedge fund called Me-



dallion. This fund has managed to return an unbelievable 35% annual rate of return (after fees) since 1989 and is viewed by many as the most successful hedge fund in the world. Unfortunately it is closed to outside investors and nowadays Medallion only manages the money of the em-

ployees of Renaissance.

It is no surprise that James Simons ranks among the highest paid hedge fund CEO's with an estimated net worth of \$6 billion. In 2007 after 3 years in the lead, he had to accept being second best and the first place was taken by John Paulson. He made his fortune by betting against the sub-prime market in the period 2006 to 2008. From 2006 to 2007 one of his funds managed to return almost 600% to its investors. Of course his investors weren't the only ones to benefit. Paulson earned a staggering \$3.7 billion in 2007 and was the top earning hedge fund manager.

The story continues: a star manager at fund house GLG gave up \$250 million in stock to set up his own hedge fund; Transtrend, Holland's most successful hedge fund was sold to Robeco and so on. Such successes attract the attention of many entrepreneurs and of course the occasional opportunist. Not surprisingly many traditional fund managers are becoming hedge fund managers, as are research analysts and some people with no experience at all. All of them aim to do well, either for investors or for themselves. The higher fees in hedge funds lure new managers, and they are justified by the more complex investment processes and higher fees charged by top consultants and lawyers for brokering deals.

This world does not only have success stories. For every success story there are 10 failures. Permal Investment Management, one of the largest and most respected fund-of-fund hedge fund managers in the world says they are only looking at 1-2% of the hedge fund industry to invest their money in. Being a hedge fund manager they only invest in other hedge funds, after over 35 years of experience they have seen more failures than success stories. One of the biggest failures was the Long Term Capital Management collapse of 1998, supervised by Noble Price winners Myron Scholes and Robert Merton, who lost \$4.8 billion. More recently Brian Hunter from Amaranth lost a record of around \$6 billion from investors in 2006 by betting in commodities. Even the brightest minds from Goldman Sachs lost billions of dollars in

the 2007 market slump. At the very top of these failures is the giant Ponzi scheme run by Bernie Madoff and his family. The latter is a perfect example of people wanting to believe in an endless money machine with little or no risk at all. For the latest updates on imploding hedge funds <http://hf-implode.com/> provides a clear and present picture of the state of the hedge fund world.

Given the unregulated environment, hedge funds and the black boxes they sometimes operate, offer looming risks. The odds seem to be against finding a successful hedge fund.

Harry Kat of the Cass Business School in London has been the biggest hedge fund critic. He argues that many of the high fees can't be justified by the simple composition of certain portfolios and their performances. By using low cost products that are highly traded and transparent, Kat has proved that many hedge funds overcharge their clients and that the returns they generate do not relate to the high fees charged. Kat is one of the most highly read business authors on the Internet and at www.fundcreator.com he provides a model by which people can replicate their own hedge fund returns using certain given parameters. He developed this model, to demonstrate how to generate the returns at much lower costs. This new phenomenon is seen by many as the next evolution in this industry.

Although many (new) hedge fund managers will claim their investment process is unique, and it could be, the future returns will remain a mystery. Even inferior investment processes can do well when marketed the right way. This world has changed from being all about investing to being all about marketing. For the future it is highly likely that more money will be concentrated among the top hedge funds and beside them a large pool of smaller hedge funds will exist. A pool which, in the current economic crisis, is getting smaller by the minute.

There is no doubt that this industry is the latest Gold Rush, one bigger than ever seen before. We will probably read lots more about hedge funds in the years to come... □



*) *Ricardo Fakiera MSc wrote this column on personal signature. In daily life he is Vice President of Merrill Lynch International Bank in the Netherlands. He has his roots in Europe, India and South-America.*

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and the blockade

out
of Iraq and Afghanistan
Stop the War Centre
www.stopwar.org

**WE'RE
ALL
DOOMED**

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ALREADY
TOO LATE**

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