day, wrote a letter to investors, noting: "It is our understanding that recent volatility in the structured credit markets is apparently related to the unwinding of an unprofitable CDO [collateralized debt obligation] tranche correlation trade by one or more parties. . . . The purpose of this letter is to inform our investors that Highbridge has no exposure to the trades." Highbridge was bought up last year by U.S. megabank JP Morgan Chase. Sovereign Capital, a British hedge fund, is closely linked to Lazard Brothers. The fund is heavily involved in East Asian markets, and news of the possibility of its collapse had caused panic among Asian bankers. Sovereign Capital's chairman, John Nash, formerly worked for Lazard. Since May 10, the "LTCM-word" is in everybody's mouth. Asam Capital Management is based in Singapore and reportedly has lost most of its investors' money.

Top Banks Involved

The stocks of the same large banks that participated in the 1998 LTCM bailout, and which are known for their giant derivatives portfolios—including Citigroup, JP Morgan Chase, Goldman Sachs, and Deutsche Bank—were hit by panic selling on May 10. Behind this panic was the knowledge that not only have these banks engaged in dangerous derivatives speculation on their own accounts, but, ever desperate for cash to cover their own deteriorating positions, they also turned to the even more speculative hedge funds, placing money with existing funds, or even setting up their own, to engage in activities they didn't care to put on their own books. The combination of financial desperation, the Fed's liquidity binge, and the usury-limiting effects of low interest rates, triggered an explosion in the number of hedge funds in recent years, as everyone chased higher, and riskier, returns.

There can be no doubt that some of these banks, not only their hedge fund offspring, are in trouble right now. And the top banks are starting to point fingers at each other. Particular attention has been paid to Deutsche Bank. On May 17, Merrill Lynch issued a report noting that Deutsche Bank probably has suffered significant derivatives losses following the GM and Ford downgrading. The report states that Deutsche Bank will not be able to maintain its rosy performance, culminating in a pre-tax return on equity of 30% in the last quarter. Not only has the volume of bond emissions managed by Deutsche Bank dramatically declined during the second quarter, but the bank may have suffered reduced business from hedge funds because of the "recent turbulence" in the credit derivatives market, as well as losses in its own trading positions. "Deu-

Glossary of the Global Financial Casino

Hedge Fund: A form of mutual fund used by wealthy individuals and institutions to engage in aggressive speculative activities prohibited to ordinary mutual funds. Hedge funds are restricted by law to no more than 100 investors per fund, and these investors are presumed to be sufficiently knowledgeable to understand the risks. Most hedge funds have extremely high minimum investment amounts ranging from $250,000 to well over $1 million.

Derivative: A financial contract whose value is derived from the performance of assets, interest rates, currency exchange rates, or indexes. Derivative transactions include a wide assortment of financial contracts including structured debt obligations and deposits, swaps, futures, options, caps, floors, collars, forwards, and various combinations thereof.

Credit Derivative: A contract between two parties which uses a derivative to transfer credit risk from one party to another, in exchange for a fee. For example, an investor who owns bonds issued by General Motors might buy a credit derivative from his investment bank, which will pay off should General Motors default on the bonds. In return, the investor pays the investment bank a fee, which the bank considers sufficient to run the risk that it will have to pay. If there is no default, the bank makes a tidy profit.

Collateralized Debt Obligation: CDOs are securities backed by pools of assets, mainly non-mortgage loans or bonds. In exchange for interest charges, buyers of the CDOs bear the credit risk of the collateral, which means that if any of the loans or bonds in the pool are not repaid, the holders of the CDOs take the loss. CDOs are made up of tranches, with various maturities and risk characteristics, with the equity tranches carrying the most risk, and therefore paying the highest interest rate to the buyer.

Capital Structure Arbitrage: A form of arbitrage which exploits differences in the pricing of a company's stock price and its debt. These bets are growing rapidly because of the development of the credit derivatives market.

Over-the-Counter Derivative Contracts: Privately negotiated derivative contracts that are transacted outside of organized exchanges.

Exchange-Traded Derivative Contracts: Standardized derivative contracts transacted on an organized exchange, and which usually have margin requirements.

Off-Balance Sheet Derivative Contracts: Derivative contracts that generally do not involve booking assets or liabilities (for example, swaps, futures, forwards, and options).

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tsche must be taking some pain at present," concludes the report, which appeared just one day before Deutsche Bank's annual shareholder meeting in Frankfurt. According to Merrill Lynch, about 17% of Deutsche Bank's clients in its debt sales and trading business are hedge funds.

When it was named as one of the victims of the GM/Ford fall-out, Deutsche Bank chief financial officer Clemens Börsig was forced to claim at a New York conference on May 11, that the bank "has no cash lending exposure to hedge funds." Deutsche Bank's "exposure is fully collateralized." Börsig said that the bank's global markets unit "has no investments in hedge funds." The bank has a "conservative" approach to its business with the funds and "very strict criteria" for choosing clients, he added. Nevertheless, according to its own 2004 annual report, Deutsche Bank at the end of that year held derivatives positions, mostly interest rate derivatives, of a nominal volume of $21.5 trillion. That is about ten times the GDP of the German economy.

'Hedging' to Death

The unprecedented downgrading to junk of almost half a trillion dollars in corporate debt, which doubled the total volume of U.S. junk bond debt, had devastating consequences for different kinds of derivatives bets. In particular, the downgrading hit the credit derivatives market, which provides insurance against bond defaults. In the recent period, hedge funds have sharply increased their exposure to a form of credit derivative known as a collateral debt obligation (CDO). CDOs are pools of loans, bonds, and other debt titles from hundreds of different corporations which are bundled and sold to investors in much the same way as mortgages are turned into mortgage-backed securities. In exchange for hefty fees, many hedge funds have taken to selling insurance against corporate defaults. If there is no default during the life of the contract, the seller pockets a lucrative fee, but in the event of a default, the seller must pay out the face value of the contract. To raise that money, the hedge fund must often sell its most liquid assets, and that, often, in the face of a falling market. Such "distress selling" by several hedge funds was actually observed on May 10 and subsequent days. Europe is extremely vulnerable to the current crisis in the credit derivatives market, as 50% of all CDOs are euro-denominated. The same kind of financial instruments led to the Parmalat collapse in Italy last year.

A related kind of derivatives scheme is the so-called capital structure arbitrage (CSA). It's one of the latest inventions in the derivatives casino. CSAs also involve bets on corporate debt titles, or the derivatives on that debt, such as CDOs. But the overall bet is made more complex by adding another element: the stock price of the respective corporation. Usually, when the prices of corporate bonds or their derivatives falls, the stock price of the respective corporation goes down as well. By combining the bond or credit derivative with a bet on a falling stock price, the CSA investor can try to "hedge" against potential losses. More convincing for hedge funds than the limiting of risks, is the empirical discovery that once a corporation runs into trouble, the stock price often plunges much more violently than the bond price of the same corporation. And that is exactly the condition under which a CDA contract generates profit.

Now comes the problem: By the very combination—in the same week—of Kirk Kerkorian's announcement for a partial General Motors takeover, boosting the GM stock price by almost 20%, and the downgrading of GM debt to junk by Standard & Poor's, crashing the GM bond price, the arbitrage traders suffered the worst of all possible disasters.

Nobody knows how many hedge funds have already gone under in May. Further complicating matters is the fact that many hedge fund investors, faced with all the news and rumors circulating about derivatives losses, are panicking, and are right now pulling out their money—if they can. Hedge funds often allow withdrawals of funds just once a quarter. The next date is July 1. But how to pay out investors, when cash reserves are gone and every dollar of capital is tied up in highly leveraged derivatives bets? To be able to meet redemption demands, hedge funds are forced to liquidate contracts under the present, extremely distressed, market conditions.

Swap: A deal in which two counterparties agree to swap the cash flows from different financial instruments, such as securities paying fixed and variable interest rates. A Credit Default Swap is a form of credit derivative in which the buyer pays the seller in exchange for an agreed-upon payment should the specified "credit event," such as a default or the breaking of a loan covenant, occur.

The reader is advised that the technical descriptions above do not begin to do justice to the insanity of the processes they describe. Credit derivatives, for example, do not really provide protection against a default, since the institutions which issue them are often in precarious financial positions themselves, and sell the derivatives because they are desperate for the cash flow. In the current environment, a credit derivative is mainly used to provide the accounting fiction that certain mostly worthless assets on a company's books still have value. The derivatives market, overall, is designed to *hide* the bankruptcy of the system by providing virtual assets to paper over gaping holes in the system, as well as garnering cash flow from selling mafia-like protection to companies ravaged by market manipulations. One of the chief agencies of such manipulations are the hedge funds, which act as front men for the Anglo-American central banks and their sibling financial institutions. George Soros is a prime example of this phenomenon.—*John Hoefle*