# Business Briefs

### *Banking*

## Euro Central Bank Fears Hedge Fund Collapse

The latest semi-annual "Financial Stability Review" of the European Central Bank (ECB), for the first time, includes a chapter on the hedge fund sector. The report warns that an "idiosyncratic collapse of a key hedge fund or a cluster of small funds" poses one of the key risks for new shocks that could trigger fresh disruptions in financial markets.

The London *Financial Times* reported June 2 that the ECB review put a hedge fund collapse "in the same category as a possible bird flu pandemic as the type of shock that could trigger fresh disruption of financial markets."

In addition to "potentially high leverage," there is another area of grave concern: Hedge funds increasingly tend to use exactly the same kind of strategies. A measure for the correlation of hedge fund strategies has gone up sharply since summer 2003 and reached an all-time peak in 2005.

"In fact, the levels reached in late 2005 exceeded those that had prevailed just before the near-collapse of Long-Term Capital Management (LTCM), a very large hedge fund, in September 1998."

This "raises concerns that a triggering event could lead to highly correlated exits across large parts of the hedge fund industry." Already last year, during April, and then again during October, a number of hedge funds were suddenly suffering from heavy losses, with the April 2005 events being triggered by the downgrading of GM and Ford.

A particular section of hedge funds—those specialized on "convertible arbitrage strategy"—thereby on average "lost about 40% of capital under management in 2005."

A possible trigger for new turmoil could be an "unexpected end of the recent global search for yield" due to the "tightening of global liquidity conditions." This could "cause investors to withdraw their money abruptly, thereby exerting funding liquidity pressures on individual hedge funds. This could trigger substantial sell-offs and challenge perceptions regarding the degree of liquidity prevailing in affected markets. Moreover, hedge funds could flood their prime brokers with large and simultaneous credit demands at a time when brokers themselves could be suffering from corrections in over-extended markets."

The *Financial Times* featured the ECB report in a front page story headlined "ECB warns of hedge fund threat to stability." It describes the ECB report as "the blutest official statements yet on the rapidly growing sector."

The German-language *Financial Times* added that a confidential paper by the European Union economics and financial committee is circulating among officials, warning that the Euro-zone, because of the mix of national and supranational supervision structures, is "badly prepared for a financial crash."

### *Hedge Funds*

## Reuters, Too, Says It's Locusts' 'Meltdown May'

It's 'Meltdown May' For Hedge Funds" is the headline of a May 29 Reuters story, confirming what Lyndon LaRouche and *EIR* have said about the wild gyrations in the hyperinflated commodities markets during May, which are endangering hedge funds. "Many of the world's roughly 8,000 funds lost between 3% and 6% in the first three weeks of May alone, with some having seen swings [losses] of 10% or more, investors and researchers said," according to Reuters. Its source emphasized that the losses are getting worse, and "could trigger another round of closings" of hedge funds. One hedge fund manager pointed to the potential breakdown of trading on these markets, saying " 'The rest of the year will be much more difficult to trade, with people becoming more sensitive to risk.'

"Losses weren't confined to metals, however, and that's what is making the month so treacherous," the report continues. "Global macro funds that bet on currencies, commodities, and interest rates are said to have given up roughly 25%. Funds specializing in emerging markets and even mid-cap stocks, were said to have given back as much as 50%."

"Meltdown May" is not the invention of the Reuters headline writer, but the catchphrase now current throughout the hedge-fund world.

The financial *Heuschrecken,* or locusts, are now like another insect, Byron's famous "scorpion begirt by fire," which stings itself to death.

### *Housing Bubble*

## Huge Declines in Sales Continue Across U.S.

For the third month in a row, pending home sales in the United States have fallen: 3.7% in April compared to March, and down 11.7% compared to a year ago. The steepest declines were in the Midwest and West, according to National Association of Realtors. Pulte Homes, the largest U.S. homebuilder, reported that orders in April and May plunged 29% from a year ago.

In its cover story May 29, *Barron's* wrote of the collapse of the housing market. Entitled "The Big Glut: Trouble in Paradise," it focuses on the "second home" market, describing at great length the element of speculation involved. In a notable understatement, *Barron's* quips that the "second home market could use a second wind." A realtor noted that "if you want to sell, you have to go back to 2004 prices."

"The danger is that if enough of those [secondary home] investors decide the market has peaked, they could trigger a selling frenzy throughout the second-homes market."

Unstated in the coverage was the degree of dependence of the U.S. banking system on the housing bubble, which is not only deflating in price, but is being impacted by rapidly rising mortgage default rates.