Global Markets' Morning After

SUMMARY: The electronic wedding of the world's financial capitals seemed like a dream come true, bringing a period of startling growth. But recently, many of the forces that promised a glowing future for the markets — internationalized investment, hybrid securities, a shift away from bank lending, deregulation, expansion — have begun to lapse.

By now, it is widely agreed that 1988 will be a year of navel contemplation by global financial markets. After five years of breathless growth, the people who run the world's banks and securities houses are asking the trillion-dollar question: Has fear finally overtaken greed as the prevailing mood among investors?

Investment firms hired thousands on a bet that greed would predominate forever in the new electronic marriage of the world's financial capitals. Many are now wondering if they bet wrong. As one prom-

MERRILL LYNCH & CO. INC

Rotberg: Dollar plays important role.

inent investment banker told a group last February, the industry is waking up from the dream that "the business of Wall Street, money, is an emerging growth industry."

In recent months many of the trends that fed the frenetic growth of the 1980s have begun to backslide. Among them:

Globalization: "We've heard a lot of rumors about flights to home currencies by global fund managers, and I think they're true," says a Federal Reserve System official. "But it's not just a product of one day's declines in the stock markets. It's the product of a whole series of seize-ups in the international markets over the last two years."

International investing was touted as a way to lessen risk, but investors are discovering unforeseen pitfalls. On Black Monday, for example, the collapse of one stock market was quickly echoed by collapses in the others, mocking the idea of diversification. Even the best-laid "portfolio insurance" plans were of no avail. At key exchanges, trading ground to a halt for hours at a time, including the ultrareliable New York Stock Exchange, where 10 percent of the business is with foreign investors.

But international investors were [illegible]uring even before the collapse. In the Eu[illegible]omarkets, a global network through which borrowers, lenders and middlemen can juggle a wide variety of instruments and currencies, such crunches have recently become epidemic. Whole sectors of the market have dropped from sight, leaving holders stuck with billions in unsalable securities. Investors in junk and municipal bonds in the United States have ended up in similar straits, as markets have all but dried up.

Innovation: "Many of the innovations and gimmicks of the last few years have been revealed as hollow," says Robin Koskinen, a senior vice president at Nomura Securities International Inc. "Their liquidity is suspect."

As stock and bond markets raced skyward, Wall Street's so-called rocket scientists created a panoply of exotic new securities (stripped mortgage securities, naked gold warrants, floating rate Euronotes, etc.) designed to capture savings for borrowers, higher yields for lenders and fatter fees for investment bankers. But with financial markets in disarray and the economy's future uncertain, investors are dropping the newfangled items like hot potatoes, preferring safe investments such as Treasury bonds and insured savings accounts. The demand for exotica has faded.

And that may be just fine with investment bankers, who found that their creativity outstripped their management skills. In the past year some of Wall Street's biggest names lost billions when hybrid securities or hedging techniques backfired. Overseas, Euromarket firms were clobbered when the market for perpetual floating rate notes, a specialized security favored by banks, disappeared overnight.

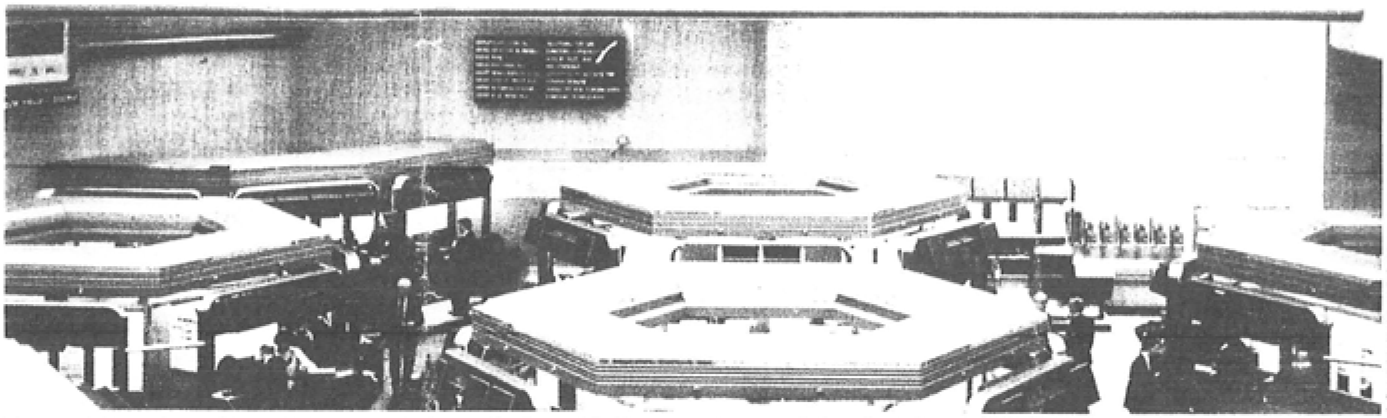
The grist for innovation is vanishing, too. Once there were huge backlogs of mortgages, car loans and even unpaid credit card balances, all waiting to be packaged into securities and peddled. Now the supply is running out. "They've stripped away a lot of the quality assets," says Albert Lord, chief financial officer of the Student Loan Marketing Association.

Disintermediation: A key feature of modern finance has been the shift away from bank lending (banks are intermediaries between lender and borrower, hence the ungainly term) and toward direct lending by investors in the form of notes and bonds. During the 1980s, competition and the need to bolster reserves against bad loans drove up the cost of bank funds. As a result, with the help of clever investment bankers, corporations and governments found it cheaper to issue their own paper. That trend fueled the dramatic growth of the financial markets, until recently.

"Two or three years ago, banks didn't need to exist in international business," says a bank regulator. "It isn't like that today." With hard times looming in many people's crystal balls, investors are less sanguine about the creditworthiness of many borrowers. Rather than paying a "risk premium" to these nervous bond buyers, companie[s] are borrowing from commercial bank[s] again. Syndicated loans, in which severa[l] banks fund a credit for a single borrowe[r] are enjoying their best year since 1983.

Still, experts are far from sure what [it] all means. "The distinction between bank[-]ing markets and securities markets is get[-]ting really fuzzed up," says the Feder[al] Reserve official. For example, Euro-offe[r]ings are routinely coupled with standb[y] credit from banks. As fewer offerings fi[nd] buyers, more of the deals resemble straig[ht] bank loans.

Deregulation: The 1980s have seen n[a]tions throwing open their financial marke[ts] to new competitors, both foreign and d[o]mestic. The goal: to prevent business fro[m] fleeing to friendlier climes. A few yea[rs] ago, stung by Deutsche Bank AG's d[e]cision to move its underwriting operatio[ns] to London, West German regulators quic[k]ly dismantled many local restrictio[ns.] France, Canada and others have follow[ed] suit. Last year, the Big Bang went a s



Deregulation strengthened London exchange's ties with Euromarkets and the city's image as capital of the financial world

further, blowing away most of the regulatory barriers between British markets and the Euromarkets and fortifying London as the capital of international capital.

The United States and Japan have lagged behind. The New York Stock Exchange unfixed brokerage fees in 1975, but regulations still draw a sharp line between investment and commercial banking. Japan still has fixed brokerage fees, segregated markets and rules to keep foreign investment firms at bay. Black Monday may thwart progress in both countries.

As domestic deregulation falters, another trend is emerging. From their birth in the early 1960s, the Euromarkets have thrived by offering financial firms, borrowers and investors a haven from regulation. Now the markets are getting their first taste of official supervision.

The Bank of England is drawing up disclosure rules for London-based Eurodealers. Meanwhile, bank regulators from 12 countries are working out common standards for international banks. Among other things, the banks will have to start putting aside capital when they engage in currency swaps, interest rate swaps and backup credit. Such off-balance-sheet instruments help grease the wheels of international finance, making it less risky for clients to borrow in one currency and pay back in another. The new rules will make these services more expensive.

Expansion: Globalization was a decade-long jobs program for young people with stamina and dreams of getting rich. But now thousands are being laid off. Salomon Bros. Inc., the leading Wall Street bond house, recently lopped off its whole municipal finance department. Virtually all of its competitors have been cutting back, too.

The Euromarket firms are in worse shape. Shrinking demand and cutthroat competition long ago pared profit margins to the bone. Since the stock market collapse, one of the last thriving sectors has closed: the underwriting of Eurobonds linked to warrants that permitted investors to benefit from rising stock prices. Postcollapse offerings have been limited to old-style Eurobonds floated by a few high-class borrowers, such as the Italian government or Toyota Motor Corp. "People are kind of looking around and trying to find some business to do," says one market observer.

Nobody doubts the accumulating evidence of a sharp break in the momentum of financial globalization. But its significance is a matter of dispute. While a minority worries that protectionism or a worldwide economic slowdown will drive international traders and investors into full retreat, most believe that the setbacks to globalization will prove temporary.

Eugene Rotberg, a former treasurer of the World Bank and a pioneer in international financing techniques, believes that slack markets are a symptom of uncertainty about the world's most widely used medium of exchange, the dollar. Because of the way international financings are structured, dollars have an important role even in deals priced in other currencies.

"You've got a great deal of distortion right now," says Rotberg, who recently joined Merrill Lynch & Co. Inc. as an executive vice president. "That's why you hear a lot of talk about deglobalization. What they are really talking about is weak demand for dollar-denominated assets." He predicts a strong resurgence in international borrowing and investing once markets are convinced that the dollar has stabilized.

Others agree that the dollar's weakness has been a problem for global markets but they also foresee structural changes. Investors are beginning to heed warnings about the return of so-called stagflation: slow economic growth combined with high inflation, the odd couple of the 1970s. If globalization and growth of the securities markets continue, the primary fuel no longer may be the paper IOUs of governments, corporations and other borrowers. It will be assets that can withstand inflation. "As an international investor, you can't just put your portfolio in Treasury securities and stocks," says Fred Peck, a vice president of First Boston Corp. "You have to look elsewhere now."

He believes real estate is a ripe target for the next wave of globalization, as growing numbers of Japanese bargain hunters take advantage of the strong yen to buy up office buildings in the United States. "So far, most of it has been by large corporations and very sophisticated international investors. But we're going to be seeing some broadening in that ownership." The most likely method is packaging real estate ownership into paper shares that can be bought and sold by smaller investors.

Cloudy or bright, the economic future may alter the speed, but not the course, of globalization. Pension funds, insurance companies, mutual funds and corporate treasuries now dominate the financial markets, and few of these huge investing machines can afford not to spread their bets among different currencies and national economies. What investors demand, financial wizards will supply. "If you can buy it and sell it, you can globalize it," says Peck.

— *Holman Jenkins Jr.*