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The Butterfly Effect…
The End of an Investment Banking Era

'It has been said that something as small as the flutter of a butterfly's wings can ultimately cause a typhoon halfway around the world…" – Author Unknown

This clever quote alludes to the popular chaos theory, which states that small variations in a dynamic system can result in large disruptive variations over the long-term. Drawing a parallel to the current financial crisis, this means that the sub-prime mortgage crisis resulted in more than just a domino effect. Rather, it led to a more cataclysmic, hurricane-like series of events. One which typically begins as an ominous windstorm, builds in momentum, mounts to the peak of its destructive fury and eventually dies down with each deathly blow it deals to obstructions in its path. When everyone thought the sub-prime bust of July 2007 was the worst financial crisis to hit global markets in the last decade, little did they know it was just the birth pangs.

The whole sub-prime debacle appeared to have peaked in the calamitous demise of Bear Stearns in February 2008. This was no small event given that Bear was one of the top five independent US investment banks. The Fed rushed in and brokered the sale of Bear to JP Morgan at fire-sale price, but not before the markets took a significant beating. Spreads above US Treasuries shot up, stock indices were down and everyone rushed to place their funds in safer securities such as US Treasuries or gold. In the ensuing months, as some degree of normalcy struggled to return, nothing too untoward seemed to shake the markets. Commodities rallied, Russia attacked Georgia, Chavez discharged the US Ambassador from Venezuela…these all seem to fade into the scenery compared to what we now know was ahead. The world refocused on other pressing events, on rebalancing their economies and the tornado was quietly re-building strength.

And then there were four…

September 2008 now marks one of the worst months in financial history as another, more intense wave of financial crises shook the markets. The month started off with distress signals from Fannie Mae and Freddie Mac, both Government Sponsored Enterprises (GSEs) and the United States' two biggest mortgage companies. The headwinds were gathering. No sooner had the Fed intervened to bailout these two iconic GSEs did Lehman declare bankruptcy sending shock waves through global financial markets. Monday 15 September, 'Meltdown Monday', as it has been coined in some circles saw a plummet of all major indices and by 17 September the EMBI+ index registered unbelievable spreads of 435 basis points above US Treasuries. As if that was not enough, Merrill Lynch underwent a forced sale to Bank of America to dodge a similar bullet as the Fed stood by and held its hand from intervening in Lehman's demise. This marked the end of two more top US independent investment banks. Yet still, more turmoil prevailed as American International Group Inc (AIG) required a US$85billion bailout and Washington Mutual (the largest savings and loan company in the United States) put itself up for auction and was eventually bought out by JP Morgan.

Things are now at critical mass as the eye of the storm beats down on the US economy. The intricately, interrelated nature of our globalised market has long set the stage for contagion. One has only to look around to see the butterfly effect. Sub-prime mortgages originated in the US, so when they went delinquent they hit the US economy and its financial markets hard. The US policy rate was continuously slashed to stimulate growth in a rapidly stagnating economy with little confidence; the US dollar weakened to all time lows; investors sought to hedge risk by investing in commodities; commodities skyrocketed; commodity prices affected the intricate trade balances among global economies; food and energy based inflation spiraled globally; and this further upset the economic balancing act of most economies as they faced challenges to growth alongside climbing inflation. A vicious cycle of global financial distress was set off and it isn't quite finished re-shaping economies and investment financing.

Drastic times call for drastic measures

Practically overnight, the US Securities and Exchange Commission (SEC) halted short selling of US banks, insurance companies and securities firms up to 2 October. The intention was to temporarily suppress potentially abusive short selling tactics that can drive share prices down, thereby giving the market time to re-stabilize in response to the shocks sustained on 'Meltdown Monday'. The Financial Services Authority in the United Kingdom also banned short sales on financial shares for the rest of the year and numerous other countries followed suit. Moving swiftly in the hopes of stopping the financial carnage, US Treasury Secretary, Henry Paulson, and Fed Chairman, Ben Bernanke, jointly proposed a US$700billion bailout plan to attack the root cause of the whole mess….billions of dollars of toxic sub-prime mortgage debt still sitting on the books of numerous major financial companies.

And then there were…two?

Shifting focus back to the last two great US investment banks, Goldman Sachs and Morgan Stanley. Options for a way forward seemed scarce given that fellow major investment banks (unable to sustain a run on assets as rumours grew and confidence fell) yielded to being bought out by 'universal' banks and the US government remained stuck in heated debate over the proposed bailout plan. Acknowledging that confidence in the broker-dealer model was rapidly evaporating, Goldman and Morgan proactively ensured their survival by opting to become regulated bank-holding companies. Goldman, true to its long-standing tactical expertise, further ensured its status in the financial pecking order by securing a vote of confidence (and a US$5billion capital injection) from the 'Sage of Omaha' himself, Warren Buffett.

As regulated bank holding companies under the US central bank, this means that Goldman and Morgan will have to abide by more stringent regulations especially in terms of capital requirements. The independent investment bank structure built on a broker-dealer model, which involves high levels of leveraging, can no longer withstand the high levels of solvency risk involved in an environment with flailing investor confidence. So is this it? Is this the end of high yielding investments and brilliantly engineered structured products? What about aspirations for lofty careers in this highly revered field?

What we can expect

Investors have lost faith in high yielding, highly leveraged, wholesale funding models. As we continue to witness the reshaping of the financial landscape we can expect a new funding model to emerge involving a greater use of deposits. Greater regulation will overshadow this model with more stringent requirements for disclosure. Strangely enough, had the up-tick rule (abolished in July 2007) still been in place there might not have been need for a ban on short selling. The rule would have basically required any short sale to be entered only at a price higher than the last trade. That way it would have been more difficult for short-sellers to abuse the system and drive down share prices. But this is only one aspect of the regulatory melee. Much more regulation is needed to tame the, "…crazy culture of greed and overreaching and overconfidence in trading algorithms," according to Charles Munger, longtime business partner to Warren Buffett.

Because of the relationship between risk and return, we should expect that this new, less-risky, deposit-based model will also yield lower returns. Investment banks boomed over the last few years not only due to high leverage models but also to constant innovation with new dynamic investment instruments like mortgage backed securities (MBSs), collateralized debt obligations (CDOs), Adjustable Rate Mortgages (ARMs) and the likes. Unfortunately, insufficient regulation together with inadequate risk assessment and understanding of these complex assets led to the chaos that financial markets have now found themselves in. It will be some time again before new exotic investment structures come to the market and even more time for markets to warm up to them. The world will vividly remember, for some time yet, the merciless battering that this last wave of structured products had to offer.

As for careers in the investment banking field, there is likely to be a re-assessment of the generous remuneration packages investment bankers now enjoy. There is a call for greater corporate governance, which would essentially require greater accountability for actions and decisions that affect investors. The field of investment banking basically grew phenomenally at unsustainable levels, which encouraged 'rushed jobs' that churned out new products whilst paying little attention to risk details and associated repercussions. The financial sector is now undergoing a consolidation phase where we see more mergers and acquisitions as banks try to re-coup and re-strategize. The careers are still there, albeit not as lofty as before, and will come with added pressure to engineer products that can generate returns within acceptable levels of risk under more stringent regulations.

Like the seemingly insignificant flutter of a butterfly's wing, one structured product – Sub-Prime Mortgage Backed Securities – tanked; affecting every other structured product that had spun off from it; dragging the whole US economy down; realigning world economic orders; affecting global financial markets and coming full circle to reshape the very field that created it: Investment Banking.

FINANCIAL & ECONOMIC INDICATORS

As at 25 September, 2008

Exchange Rate/US$	Closing Value	Previous Week
Yen	106.56	105.44
Euro	1.46	1.43
Jamaica	72.47	72.30
Guyana	204.50	205.20

Commodity Prices	Closing Value	Previous Week
Crude oil (US$/bbl)	108.02	97.88
Natural Gas (US$/mmbtu)	7.63	8.11
Gold (US$/Troy Ounce)	877.90	850.84

Eurobond Indices (Return % YTD, as of 25-September-08)	
Lehman Brothers Global Aggregate Index	1.23
JP Morgan EMBI+ (percentage change)	46.80
CMMB Eurobond Index	n/d

Policy Interest Rates (%)	Closing Value	Previous Week
United States	0.50	0.25
Euro Zone	4.25	4.25
Japan	0.55	0.55
Brazil	13.75	13.75
Trinidad	8.50	8.50
Jamaica	13.50	13.50
Barbados	4.50	4.50

Market Interest Rates (%)	Closing Value	Previous Week
US 90-day T-Bill	0.75	0.08
US 10-Yr Treasury	3.86	3.55
3-month UK Libor	6.28	5.98
Japan 90-day T-Bill	0.53	0.53
Brazil 90-day T-Bill	13.95	13.90
TT 90-day T-Bill	7.30	7.30
Jamaica 90-day T-Bill	14.26	14.81
Barbados 90-day T-Bill	3.48	3.63

Sources: Bloomberg, CMMB, Central Bank of Trinidad and Tobago, Bank of Jamaica, Central Bank of Barbados, www.lehman.com