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Perpetual motion

After fractious debate, The First Boston Corp. has decided to emphasize merchant banking over securities trading. The firm has apparently decided that, in current circumstances, credit risk is a better bet than market risk. At the margin, it seems to judge lending—in particular lending to highly leveraged borrowers—to be a safer and more lucrative line of business than playing the government bond market.

As luck would have it, First Boston's news shared the front page of *The New York Times* financial section with the Merrill Lynch trading-loss bombshell. Bulls on junk bonds like to work such catastrophes into the conversation whenever talk turns to default risk. They note that, in the long sweep of things, credit-related losses are rare compared to volatility-related losses. And what is worse for the average high-cost bond trading department than too much volatility is too little. "We can make money in a rising market," a fixed-income friend says. "And, these days, we can even do pretty well in a falling market. But there isn't much we can do with a sideways, choppy market—the kind of market we've had, basically, since April 1986."

Very well. The Street has chosen to risk its capital in merchant banking. By merchant banking it means a combination of investment and commercial banking: lending to a leveraged company in expectation that the loan will be repaid through the issuance of junk-grade debt. The lucky merchant banker books fees and commissions and interest income. It is the ideal business until the borrower, through some sub-base-case development, is unable to raise the funds with which to repay the lender.

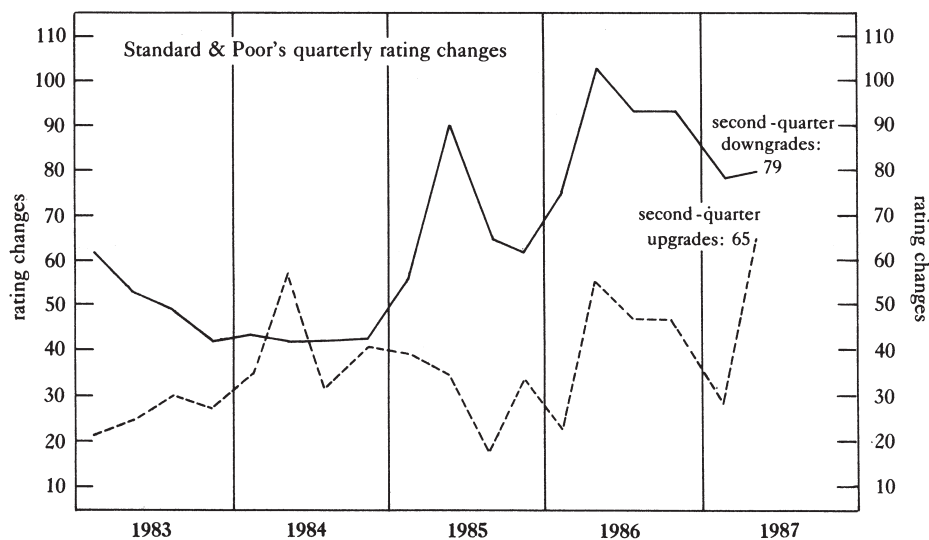
If the Street insists on getting into the credit-risk business, it will want to know about the state of corporate credit. Are lenders vigilant or credulous? What is the trend in bond, rating changes, and what is the condition of banks? Will the future of leverage be as rosy as the recent past?

Constant readers will sense that *Grant's* has asked itself a series of loaded questions. However, times change, conditions change and facts change. Sometimes answers change. It would be odd, on the face of things, if credit quality weren't improving a little. Stock prices are up, and corporate earnings have rebounded. At last report, the market value of all United States equities (\$3,068 billion) was almost double the par value of U.S. nonfinancial corporate debt (\$1,732 million). The na-

tion's composite, mark-to-market balance sheet has strengthened. In the second quarter (see graph), corporate-bond upgrades increased and downgrades leveled off. Improvement was striking in the industrial sector, where downgrades outstripped upgrades by a margin of four-to-one for the five consecutive quarters ended March 31. In the June quarter, however, upgrades and downgrades ran neck and neck, at 34, and Standard & Poor's was able to crack the shadow of a smile: "A fairly balanced trend should prevail for the remainder of the year. Upgrades will reflect steady economic growth, a weaker dollar, and moderate interest rates."

All to the good, of course, but there's the familiar-sounding downside to report, as well. Third World debt quotations continue to sag and lending

Corporate bond upgrades rally



source: C.J. Lawrence

margins, both domestic and foreign, remain under pressure. The president of Robert Morris Associates, the national organization of bank lending officers, recently warned his colleagues against reckless credit extension. "A lot of higher-risk loans are being made that ought not to be made," said Malcolm T. Murray Jr. "Over the longer term, it's almost certain to snowball into a problem." (For much the same reasons, U.S. Trust recently abandoned the corporate lending field—see below.) Meanwhile, the Federal Savings & Loan Insurance Corp. is broke, and commercial banks continue to drop dead on the federal government's doorstep. "Rate of Failures Grows, but Concern Doesn't," a headline in the *American Banker* said recently, summing up both the problem and the level of concern about it. By midyear 1987, 96 banks had shut their doors, up from 66 in the middle of 1986. The surprise, arguably, isn't that corporate-bond ratings have improved, but that recovery in the visible signs of corporate credit-worthiness has been so grudging.

Odd to report, however, it is just this decline in the conventional measures of balance-sheet strength that a number of equity bulls find so bracing. The thinking goes: The greater the volume of corporate restructurings, the greater the volume of equity retirement and the greater the market's up side. A new research essay on the possibilities of this kind of perpetual motion was recently published by First Boston (the noted merchant bankers) under

the epochal-sounding headline, "John Maynard Keynes vs. Benjamin Graham: LBO Supply/Demand Overwhelms Historical Value Notions."

The essay, by James L. Freeman, contends that old-fashioned, value-type investing is out the window. Stocks are commodities. And while the demand for these commodities is stable or rising, the supply (thanks to the recent wave of equity retirement) is falling.

Adding up the funds already raised, or about to be raised, for various LBO-type financing pools, Freeman comes up with \$17.5 billion. He cautions that the number is approximate, but suggests it is reasonable. In any case, it is merely for openers:

Equity financing pools can be leveraged 10 to 15 times the base amount, while mezzanine pools run around 3:1 for them to earn their 1% to 2% annual fees and build their 20% carried interest—managers are going to have to buy some \$140 billion worth of equity. The vast majority of these purchases will be publicly traded stocks. . . .

To put this all in perspective, we estimate institutions hold some \$1.3 trillion of equities. Although it is a narrow sampling, a well-followed survey showed that cash positions held in equity accounts are presently 8%-plus (which I think is low). If we add in the buying power of these funds at a conservative eight-times leverage factor (because some will buy debt or more public equity), the institutional cash position is closer to 20% or \$255 billion.

Which, says Freeman, is really all you have to know. He concludes that the bull market doesn't need the public or the Japanese. "The real [fuel] for higher prices comes from mergers and acquisitions, restructuring and corporate repurchases. So the question is not if the market is going up, but how soon and how much."

Freeman may be right. We dare say that the bulls have made a better living by imagining new-era thoughts than the bears have by denying them. It may be that \$17.5 billion of blind-pool seed money will yield \$140 billion worth of stock-market buying power, that some phenomenal volume of junk-grade debt will be forthcoming at the snap of a broker's fingers. One question, however: If corporate restructuring proceeds as Freeman has outlined and if, in general, the quality of corporate credit continues to slip (as the late Benjamin Graham, an old-era guy, would measure slippage)—if that comes to pass, is First Boston, the merchant banker and bearer of credit risk, really better off? If the nation is going to play ducks and drakes with balance sheets, won't credit risk intensify? Is it absolutely out of the question that First Boston or Morgan Stanley or Merrill Lynch will get caught with its balance sheet in the breeze?

A friend recently asked why the brokerage stocks were so weak when the Dow was so high. Maybe the market knows more about credit risk than the brokers do.

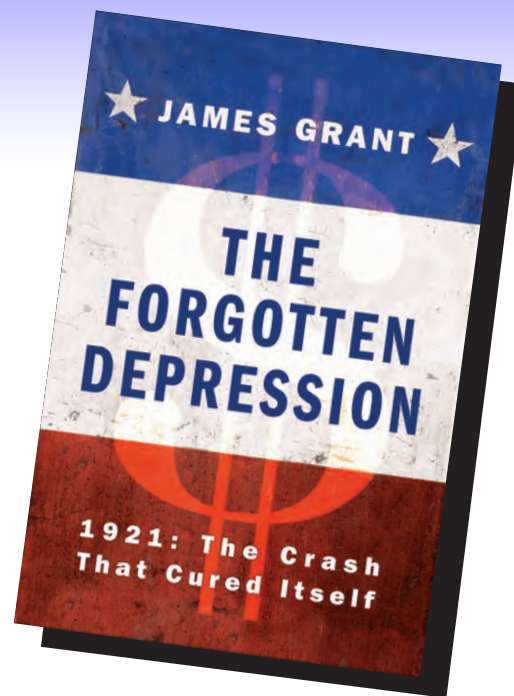
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