



Finance hits another low point

Matein Khalid wonders if the lawsuit brought against Goldman Sachs is enough to change the face of global finance forever. Where to from here?

It is surely ironic that the Wall Street investment bank that is the alma mater of ex-Treasury secretary Paulson and Rubin, World Bank president Zoellick and some of the world's billionaire hedge fund managers is now the target of a Securities and Exchange Commission (SEC) fraud charge. It is also ironic that Goldman Sachs, which emerged relatively unscathed from the carnage of the 2007-2009 credit tsunami – unlike Lehman, Bear Stearns, Citigroup, UBS, Merrill Lynch and RBS – should become the target of an SEC fraud charge just when the world financial markets had priced in Goldilocks in April 2010, light years away from financial Armageddon only a year ago. It is ironic that the SEC charges that Goldman Sachs deliberately created and sold toxic mortgage-pooled investments (the ill-fated CDO) with John Paulson, who won fame for earning history's biggest paycheck of US\$3.5 billion, by shorting CDO excreta at the height of the credit

bubble that were secretly designed to fail.

While buyers of the Goldman CDO lost US\$1 billion, Paulson pocketed US\$1 billion and Goldman Sachs netted a cool US\$20 million for creating a product that spelt disaster for its clients. It is ironic that Goldman Sachs, a firm that constantly preaches ethics as the DNA of its corporate culture, now finds itself in the glare of the SEC and a hostile Obama White House. The Goldman case, whatever happens to the SEC civil charges, will change the world. The regulation of investment banks, the design and marketing of financial products, relations between Wall Street and the world's largest hedge funds, the pricing of risk in financial markets, the politics of the credit crisis in Washington (and global capitals of hot money) will all be transformed by the legal black swan that has ensnared Goldman.

It is a well-documented fact that Goldman Sachs' proprietary traders netted US\$4

billion in 2008, shorting complex subprime mortgage structures its deal-obsessed investment banking executives had created. This is nowhere more true in the opaque but highly lucrative synthetic CDO mortgage market. The idea that Goldman Sachs would deliberately design and sell a CDO in the full knowledge that it would fail, allow Paulson to choose the weakest pools of mortgages in its inventory to put into the CDO and not inform its clients that Paulson intended to short the product is a tale of deceit reminiscent of Niccolò Machiavelli.

A blunder

Goldman, with its often professed devotion to its client interests, stands accused of cynically exploiting its role as a trusted middleman to financially skewer its client interests. In fact, Bear Stearns, the late Wall Street bank known for its gritty trading process, actually refused to sell synthetic CDOs on behalf of Paulson

compounded its ethical lapse when its marketing material claimed Paulson was owning the CDO, when he was short the product in a deal brokered by Goldman Sachs itself. The ultimate smoking gun is Goldman vice-president Fabrice Tourre's email in which he claimed that he was in "the middle of all these complex, highly leveraged, exotic trades he created without necessarily understanding all of the implications of these monstrosities". It is never prudent for bankers to send chest-beating, triumphalist emails when engaged in the practice of fleecing their clients.

The Goldman case means securities fraud charges on the subprime mortgage debacle will now be regularly presented by the SEC to the captains and kings of Wall Street. This means a protracted blow to investor confidence in the financial markets. This means that risk assets such as gold, copper, equities, the Australian dollar and high-yield debt will all fall this summer. I envisage gold down at least US\$200 an ounce, below US\$1000, and copper down to US\$6000 from the current US\$8000. The Australian dollar could fall from 92 to 88 cents to the greenback. I believe that emerging markets, particularly expensive interest-rate-hike vulnerable markets like China, India and Brazil could easily experience a 15-20 per cent correction. A Goldman Sachs settlement in the SEC in the US\$200-400 million range is my base scenario, though downside risk could be far more sinister and systemic, implicating other high profile CDO arranger banks. Above all, Goldman's cosy relations with the American government, relations that earned it the nickname "Government Sachs", cannot survive a disaster of such epic magnitude. The Volcker Rule could well be exhumed by Obama to ban leveraged financial risk trading. After all, Goldman is the ultimate fat cat with whom Obama promised to fight in his fateful press conference in December that triggered a global stock market correction. Could history repeat itself with the latest Goldman scandal? Yes, it can!

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and Company since it guessed that the hedge fund intended to short the product. Yet, Goldman Sachs, the self-styled oracle of high ethics and devotion to client interests, willingly designed this financial landmine, a product designed to benefit Paulson at the expense of investors/clients all over the world. To quote Prince Talleyrand, the French statesman, it was worse than a crime; it was a blunder.

Goldman Sachs not only designed the CDO that Paulson cherry picked with toxic mortgage pools; it then sold them to its global client as a safe product even as it allowed Paulson to short the structure. In fact, it brokered the billion-dollar deal with the hedge fund. There is nothing ethical and transparent in this practice and the Goldman Sachs case could doom US senator Chris Dodd's attempt to tone down the punitive regulation bill now in Capital Hill.

The implications of the Goldman Sachs lawsuit will change the ecosystem of Wall Street on the largest scale since the failure of Lehman Brothers and the shotgun marriage of Merrill Lynch with Bank of America. The SEC has a winnable case, if the facts it has presented and Goldman has not denied are true. Goldman Sachs

shares lost 25 points or US\$10 billion on the night the SEC publicly disclosed its charges. Even though Goldman Sachs trades at eight times earnings and a mere 1.2 times book value (down from 10X and three times book in the pre-credit crunch golden age), I am convinced Goldman Sachs shares could drop as low as 130 or even lower.

Ramifications

A blizzard of private lawsuits from the shareholders of the German Landesbank IKB, which bought the Goldman CDO and went bankrupt, is inevitable. CDO league table stars like Deutsche Bank, Citigroup, UBS and Morgan Stanley shares were sold off because the markets fear contagion among finance/broker sales, let alone a systemic SEC investigation against other guilty global money centre banks. The SEC is determined to maximise the global impact of its lawsuit, since it did not announce a settlement with Goldman Sachs, unlike the Merrill-Bank of America charge it filed earlier.

Goldman hit a material fact that Paulson, who was shorting CDOs with its trading desk, was busy designing pool structures for its policy targets. In fact, Goldman