

# Gold and oil prices soar, dollar slumps, Carlyle Group fund collapses

Barry Grey  
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Just two days after the Federal Reserve Board announced an emergency \$200 billion debt-relief plan for distressed Wall Street finance houses, markets in the US and internationally were shaken by the collapse of Carlyle Capital Corporation (CCC), a publicly traded investment fund established by the Carlyle Group private equity fund.

The Carlyle debacle was accompanied by other developments pointing to both recession and rising inflation. Crude oil prices hit a new record of \$111, gold futures breached the \$1,000-an-ounce mark, and the dollar fell to record lows versus the Japanese yen, the euro and the Swiss franc.

“It’s very strongly the deterioration in the dollar, which is a function of the credit crisis,” said Jim Steel, senior vice president and metals analyst with HSBC. “The dollar is under siege right now.”

Confirming the slide into recession, the US Commerce Department reported that retail sales in February fell by 0.6 percent, far more than had been anticipated, and a new report said US home foreclosures last month were up by 60 percent from the previous year. In addition, a survey of home prices in California reported dramatic falls in February, including a drop of 17.9 percent in Southern California.

Also on Thursday, Standard & Poor’s revised its projection of banking write-downs of subprime-related investments from \$265 billion to \$285 billion.

The Carlyle Group is a Washington-based investment company with close ties to the Washington establishment, including the Bush family. At various times, former president George H. W. Bush and his secretary of state, James Baker, have served as advisers to Carlyle. The Carlyle Group manages some \$75 billion across 59 funds, and is considered one of the most important financial players on Wall Street.

After a week of emergency negotiations between the Carlyle Group and the major creditors of its Carlyle Capital Corporation fund, CCC announced late Wednesday that it had defaulted on about \$16.6 billion of debt. It said its lenders had begun seizing its assets and it would shortly be in liquidation.

The crisis at CCC erupted when some of the world’s largest banks, including Deutsche Bank, JP Morgan Chase, Merrill Lynch and Bear Stearns, demanded that it increase its cash equity from 1 percent to as much as 5 percent. Such an increase on outstanding loans of \$20 billion amounts to several hundred million dollars. CCC said it had failed to meet more than \$400 million of margin calls from its bank creditors on mortgage-backed collateral that had plunged in value.

The collapse of Carlyle Capital has far-reaching implications. In the first instance, it shows to what extent the credit crisis has extended beyond the subprime market. CCC did not hold subprime-based securities. Its portfolio consisted exclusively of AAA-rated mortgage-backed securities issued by the US government-sponsored home loan companies Fannie Mae and Freddie Mac. These securities are considered to have the implied guarantee of the US government and have always been deemed highly secure.

However, the value of Fannie Mae and Freddie Mac securities has been plummeting of late because of fears that the two companies are in financial trouble and because hedge funds hit with margin calls by their bankers have been forced to unload these securities on the market, driving down their price.

Carlyle Capital’s creditors, in the face of the falling value of the collateral they held on loans to the investment fund, demanded more cash, which the fund was unable to provide.

At the same time, the hard line taken by the fund’s

bankers demonstrates how nervous the biggest financial institutions have become about their own loan exposures. Increasingly, banks hit by billions of dollars in write-downs and losses have begun issuing margin calls to hedge funds and other borrowers, leading to a further decline in the market prices of many forms of debt and assets.

Carlyle Capital's collapse also reveals the immense levels of debt taken on by investment funds and other speculative institutions. Twelve banks had lent the fund about \$21 billion, twenty times the amount of initial capital.

As the *Wall Street Journal* web site reported on Thursday: "Like so many other hedge-fund blowups, Carlyle's troubles came from borrowing too much money. The secret to making money was borrowing massive sums. Carlyle Capital managed only \$670 million in client money, but used borrowings to boost its portfolio of bonds to \$21.7 billion. Until last week, when the dealers started selling the fund's collateral, it was about 32 times leveraged, a level one mortgage-company analyst called 'astronomical.'"

Carlyle Capital is only the most spectacular in a growing list of foundering hedge funds and private equity firms. Drake Management LLC, a New York-based firm, said Wednesday it might shut its largest hedge fund, and GO Capital Asset Management BV blocked its clients from withdrawing cash from one of its funds. Other funds facing default include an affiliate of Peloton Partners LLP, a mortgage fund of Tequesta Capital Advisor, and Focus Capital Investors LLC.

But fears are growing on Wall Street that much bigger firms are heading for bankruptcy. Last week, prior to Fed announcements of capital injections totaling \$400 billion into roiled credit markets, rumors were rife that Bear Stearns, one of the major investment banks, was about to run out of cash. According to an article posted on the *Times* of London web site Thursday, those rumors have intensified in the wake of Tuesday's Fed action, agreeing to loan Treasury bonds to major investment banks in return for tarnished mortgage-backed securities.

The newspaper quoted Simon Maughan, an analyst with MF Global in London, as saying, "The only reason the Fed would do this is if they knew one or more of their primary dealers actually wasn't flush with cash and needed funds in a hurry."

He pointed out that while financial stocks rose on average by 7.5 percent on Tuesday, following the Fed's announcement, Bear Stearns rose by only 1 percent. "The market is telling you it's Bear Stearns," Maughan said.

The *Times* went on to quote Lena Komileva, a Tullet Prebon economist, as saying the Fed's action was a response to a "specific counterparty risk." She continued, "... it seems the Fed really reacted to prevent a Northern Rock-style problem in the US."



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