

## **Market Update – November 30, 2009**

I'm back...after four months of not writing, I've decided to get the blog going again. I appreciate all of the people who have written to me and asked me to resume writing. If I didn't respond to you...sorry. If I'm going to blog, I really can't respond to individual emails about the blog.

The purpose of this blog continues to be financial education. Hopefully, we will use current events as well as academic research to think about financial issues.

### **Why Dubai Matters**

In the past week, we have seen world markets decline and this drop has been attributed to Dubai and their desire to delay their debt payments. Yet, if you look at the amount of debt involved (probably close to \$80 billion) and the fact that this will not be a total loss (the collateral is worth something), it seems strange that world markets could drop so much. As a result, it's interesting to think about what is really going on.

This paper is divided into four sections:

1. Background on Dubai and Dubai World
2. What Happened This Past Week
3. The Market's Reaction to The Events
4. Lessons Learned

## **Part I: Background on Dubai and Dubai World**

1. Dubai is one of seven emirates (think of these as territories) that comprise the United Arab Emirates. It is the second largest emirate; Abu Dhabi is the largest.
2. Dubai's state-owned investment entity is Dubai World. Dubai World has been Dubai's main driver of growth.
3. Dubai World has interests in real estate, ports, casinos (working with MGM Mirage to develop the \$8.5 billion City Center in Las Vegas), golf courses (Scotland and South Africa) and retail (Barney's in New York).
4. Dubai World's real estate subsidiary is Nakheel. Nakheel has built Dubai's palm-tree shaped island which is full of luxury condos and hotels.
5. Dubai World also owns 77% of DP World. DP World operates the Middle East's largest container port. DP World was in the headlines in 2006 when they bought an entity that owned some US ports. DP World sold the right to those ports.
6. Dubai doesn't have much oil. As a result, they financed Dubai World with debt. Dubai World has approximately \$60 billion of debt. This is the vast majority of Dubai's \$80 billion of debt.
7. Dubai World's real estate subsidiary (Nakheel) has a \$3.5 billion bond that matures in December.
8. Dubai's real estate sector has collapsed and this has left the country in crisis. Real estate prices have fallen 50% since last year.
9. International speculators have left the market because they are unable to obtain credit. That killed demand. At the same time, supply is growing at a crazy rate. Even after many projects were canceled, new construction is expected to double Dubai's supply of office space by 2011.
10. Office occupancy rates are 41% for projects that have recently been completed. Prices for office space are 58% lower than last year.

## **Part II: Last Week's Events**

1. Last week, Dubai's government said that it would restructure Dubai World and asked creditors to accept delayed payments. The government asked investors to wait six months for interest payments on \$60 billion of debt.
2. The government's goal is to negotiate with creditors during the next six months. There are \$20 billion of loans coming due in the next 18 months.
3. The company said that the restructuring would not include DP World (the port business).
4. Investors were surprised by this news because the government had been making positive comments. Investors believed that Dubai and the UAE (the federal government) would step in. Just last Wednesday, Dubai said that it had raised \$5 billion from Abu Dhabi banks (and apparently this was part of a UAE bailout). (Abu Dhabi has oil money while Dubai has very little.)
5. It is estimated that European banks have \$40 billion of exposure to Dubai. This is part of the \$83.7 billion of exposure that these banks have to the UAE.

## **III. The Market's Reaction to Recent Events**

1. The \$3.5 billion bond that was issued by Nakheel dropped by approximately 50%. This had been trading at 110 cents on the dollar prior to the news. On Friday, it traded for approximately 57 cents on the dollar.
2. The cost of insuring \$10 million of Dubai's sovereign debt for five years (i.e., credit default swaps) increased to \$664,000 per year. On Tuesday, prior to these events, the cost was \$318,000 per year.
3. The cost to insure Abu Dhabi bonds rose \$83,000 in the past few days to \$183,000.
4. Insurance on other risky governments (such as Bahrain, Qatar [\$120K], Hungary, Turkey [\$207,500], Greece, Russia [\$207,500], Bulgaria, Brazil, Mexico and Ireland) also increased significantly.
5. After the government's announcement, S&P put four Dubai banks on credit watch because of their exposure to Dubai World. Wow...they really saw this coming didn't they? At the same time, S&P predicted that Barack Obama would be elected President in 2008.

#### **Part IV: What Everyone is Thinking About**

1. Emerging nations may have trouble paying their debt, even as the global economy improves. (Personally, I'm not sure why everyone is simply talking about emerging nations – the US will never be able to pay back its debt either.)
2. A default by Dubai World may set a dangerous precedent that will result in other government defaults.
3. Governments change the rules when they feel the need. Governments may be less predictable than we had thought.
4. There is a tremendous amount of debt that is facing governments and private businesses. Government intervention in the bond markets (as well as government stimulus programs) have helped bonds rally. But this intervention will have to stop and that shouldn't be good for interest rates.
5. Governments are facing slower economies with less tax revenue, more people in need of government assistance and pressure to control their debt levels. This is a horrible combination.
  
6. There may be many aftershocks to the global financial crisis.
7. This could be the start of higher interest rates, as credit markets start to perceive more risk.
8. Markets generally overreact (on the negative side) to uncertainty. Dubai made a big mistake in making this announcement prior to their Eid holiday – thereby limiting the market's access to information. There is incredibly uncertainty as to what the government plans to do, the value of the assets, who holds the debt and what will happen in the legal system.
  
9. There is fear that banks may face a series of possible defaults similar to this situation. In other words, Dubai World may be the first of many similar problems. This may be analogous to late July / early August 2007, when two Bear Stearns hedge funds went under. These two hedge funds weren't large enough to impact the market – but their failure sent a clear message.
10. International banks saw the Middle East as a pool of oil money and this may turn out to be false.
11. Be careful of extravagance. Much has been written about the Dubai Chairman Ahmad bin Sulayem hosting a \$20 million party to celebrate a property opening. Whenever we hear of these financial disasters, we often also hear of extravagant expenses prior to the disaster.

12. There may be end-of-year profit taking and the money may flow out of riskier assets.
13. The real risk will occur in the next two years as governments cut back on their support and subsidies. In addition, investors may start to focus on government deficits.
  
14. The UAE is apparently unwilling to bail out corporate entities. There may also be strife between the emirates and the UAE.
15. The banks that have made loans in Dubai will have losses and that will hurt future lending.
16. There will be increased distrust of doing business in the Middle East. Fortunately, investment bankers have a three-month memory.