

Editor's Brief
**Managements Refrain From Deep Workforce Cuts;
Postponing the Inevitable?**

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Executive Summary

Wall Street's year-end financial results revealed a good deal more sub-prime poison than banks were willing to admit before their books closed. The resulting balance sheet damage is prompting institutions to reassess strategies across a wide range of business lines. However, despite additional layoffs in the weeks bracketing the turn of the year, total headcount for the U.S. securities industry set record highs in both December and January. Record payrolls leave investment banks vulnerable to much bigger waves of layoffs if economic or market conditions deteriorate in coming months.

Background

As constrained liquidity and wide credit spreads extend into 2008, Wall Street decision-makers are caught up in a combination of house-cleaning and soul-searching. Along with re-pricing and selling troubled assets, investment banks are overhauling their operations and business mix. Morgan Stanley is eliminating 1,000 jobs, primarily in asset management and wealth management, but reportedly is determined to stay the course in proprietary trading. Merrill Lynch is withdrawing from structured finance and collateralized debt obligations. UBS is doing much the same, and getting out of real estate and some commodity markets. Bank of America disclosed plans to sell its equities prime brokerage and will cease doing investment banking deals in a number of industries, though it will remain active in others where it's thrived.

Despite the well-publicized cutbacks, the securities industry's total U.S. headcount ended 2007 at an all-time high of 857,200, according to revised, seasonally adjusted data released by the Labor Department on Feb. 1. The industry added another 4,900 jobs in January, even while the U.S. economy as a whole lost jobs. Since June 2007, while the sub-prime meltdown was chewing up earnings and equity, securities, commodities and investment firms added a net 12,600 jobs.

Apparently, Wall Street's animal spirits are still frisky enough that chief executives smell a dollar of fresh opportunity in one business segment for each dollar they yank out of another. As long as those spirits hold up, and new capital continues to reload the risk-taking guns, this process of creative destruction can continue. But if a cyclical downturn is really here, investors and employees alike may come to wish their managements had shown less animation and greater sobriety once the skies began to darken.

What Would Down Cycle Look Like?

If the economy sinks into recession, the worst for Wall Street jobs is still to come. In the cyclical downturn that ended in 2003, the industry lost a total of 92,400 payroll jobs - 11 percent of its work force.

A recession would pull down the asset class that's done the most to cushion investment bank profits: the equity market. In a typical recession and equity bear market, trading, underwriting and M&A businesses suffer sharp declines and remain depressed for two to four quarters. A sustained downturn in equity prices would also put a damper on asset management and private wealth management - two activities that defied the credit turmoil roiling securities and trading businesses. Emerging markets, another refuge thus far, could suffer as global investors shy away from risky assets.

In a recessionary environment, managements can be expected to cut staffing and compensation far more than they have to date. From a recruiting perspective, the bright side is that candidates will enjoy far less bargaining power than they've grown accustomed to in recent years.

The sudden involvement of sovereign wealth funds removed the immediate impetus for investment houses to retrench in a big way, as they did in 2001-02. The critical question now is whether industry fundamentals will recover soon. Or, did the \$40 billion sovereign equity injection merely postpone an inevitable day of reckoning?

Where to Look For Clues

The outlines of an answer will gradually emerge from two places: the next round of quarterly financial statements and pre-announcements, and the overall direction of the U.S. economy.

For the last several months, the Wall Street hiring outlook mirrored the deterioration of balance sheets. We expect that pattern to persist for at least the first half of 2008. Fourth-quarter asset write-downs propelled banks' and investment firms' cumulative toll of sub-prime mortgage losses beyond \$120 billion, according to The Wall Street Journal. A number of institutions appear to have marked down, hedged out or sold off enough of these assets that they have relatively little exposure left at this point. But the story doesn't end there. Now, warnings are sounding about other fixed-income asset buckets. The areas of greatest concern are "monoline" insurers, commercial mortgages, non-conventional home mortgage obligations of prime borrowers, and credit card debt. Each has the potential to cause further losses in the tens of billions.

The looming removal of triple-A credit ratings from monoline (bond) insurers such as MBIA, FGIC and Ambac could force Wall Street to take "a sizable volume of assets, especially municipal securities, onto their books," Fed Chairman Ben Bernanke warned in a Feb. 4 letter to a member of Congress. Oppenheimer & Co. analyst Meredith

Whitney estimates that credit rating downgrades of monoline insurers could expose Wall Street to \$40 billion of fresh write-downs.

A second emerging weak point is commercial mortgages. Goldman Sachs analyst James Fotheringham predicts that U.S. banks will incur \$60 billion of mark-to-market losses this year from commercial real estate assets, including \$20 billion attributable to commercial mortgage-backed securities (CMBS) and collateralized debt obligations that include them.

Alt-A mortgages and other types of risky residential loans that aren't classed as sub-prime represent a third trouble spot. And, recent weakening of the broad U.S. jobs market plus decidedly soft sales figures reported by major retailers in both December and January raise red flags for consumer credit card debt - assets that underpin another huge reservoir of structured-finance bonds. If credit card defaults soar the way mortgage debt did, Wall Street would suffer yet another body blow.