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Another Leg Lower

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The monoline insurer crisis is uniquely dangerous, and the Fed is losing credibility at the same time.

Update to strategic view
US STOCKS: The panic in stocks has extended well beyond our expectations, fueled by the crisis in monoline insurers. Prompt action from the Fed could quickly help stocks find a bottom while the difficult monoline problem is worked out. **FED FUNDS:** Bernanke as much as promised at least 50 bp in rate cuts in two recent speeches, so at this point there is little reason to wait to execute them. A cut of 50 bp or more could come as soon as tomorrow -- and if it doesn't, the Fed chairman will have created a dangerous credibility problem for himself.
[see Investment Strategy Dashboard]

With stocks down sharply in Asia and Europe, it looks like the panic that started to grip equity markets last week is picking up speed. We are very frustrated to have called this one wrong (see, for example, "The End of the World, Part 3" January 7, 2008). The panic is lasting longer and going deeper than we anticipated. In this report we will discuss the dynamics powering this new move lower in stocks, and the possibility that the Fed will respond by cutting rates before the January FOMC meeting in order to stem the panic.

- The trigger for this new leg down in world equities is the crisis in monoline insurers. In our view, this particular development is a uniquely dangerous one -- *it's the first one in the present credit crisis that can't easily be fixed just by throwing money at it*.
- With Ben Bernanke having virtually promised to cut rates by at least 50 bp in two recent speeches, it seems more nonsensical with each passing day for the Fed to wait until the January FOMC meeting to do so -- and we think *chances are good that a cut of 50 bp or more could come as soon as tomorrow*. The disconnect between Bernanke's breaking precedent by signaling future rate moves so clearly while, at the same time, standing on ceremony by waiting for the next scheduled meeting, is contributing to the market's sense of panic by eroding confidence in the Fed chairman.

We have argued that, in the case of the impaired balance sheets of large banks, broker-dealers and GSE's, it would be a simple matter to get restorative capital infusions in this world of excess global liquidity -- and indeed that has been the case (see "Rescue Rangers" December 10, 2007). For those institutions, the crisis has been an opportunity for non-US sovereign investors to deploy significant blocks of capital to acquire minority stakes in US franchise businesses,

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ones in which their participation at that scale would not ordinarily have been welcome. But if, in that sense, institutions like Citigroup and Merrill Lynch were too big to fail, monoline insurers like Ambac are now *too small to rescue*.

The capital infusions required for the insurers to maintain their coveted AAA ratings are quite modest in the grand scheme of things -- for example, Ambac would have needed merely $1 billion. But that exceeds the company's entire market capitalization of $630 million, so accepting that new capital in the form of equity would dilute existing shareholders down to a 38% stake in the company. With a book value of $5.6 billion (or more by the company's reckoning), Ambac is worth more dead than alive -- its existing shareholders are better off accepting the loss of the AAA rating and operating the company in "run-off" mode. An existing shareholder has already seen his share price lose 95% of its value this year -- so why not bet that, in "run-off," you get half of that back? Would it really be smart to take 38% of the upside instead of 100% of the upside, in exchange for whatever small advantage $1 billion in new capital might convey? At the moment, Ambac management seems to see it that way, announcing on Friday that it is suspending its efforts to raise new capital.

The same thing is true, more or less, for all the monoline insurers. At Friday's prices, the market capitalization of the entire publicly traded monoline industry was just $5.4 billion. An Asia or Middle East sovereign fund could easily buy the whole thing, lock stock and barrel, with money left over to bolster the insurers' balance sheets and preserve their AAA ratings. That would be great for the holders of insured CDOs, RMBS and municipal bonds, who would thereby avoid having the insurers' downgrades cascade into similar downgrades of insured securities. But for existing shareholders of the monolines, it would be tantamount to being wiped out right at the bottom. And while the US Senate has cleared sovereign investments that result in small minority stakes in huge firms, it's not clear that it would so easily approve, say, Abu Dhabi owning 62% of Ambac.

The good news in this is that it all rests on the premise that, at current stock prices, the monoline insurers are undervalued. They may not be well enough capitalized to meet current standards for a AAA rating, but existing shareholders who don't want to be diluted are saying that they *are* sufficiently capitalized to actually meet the claims that are likely to arise. But the problem remains that it is difficult to see a simple or quick structural solution that preserves both the AAA rating *and* the prerogatives of existing shareholders. That said, the need for a solution is great -- and Wall Street is clever, and government regulators are powerful. Property rights aside, if it is the case that aggregate losses from cascading downgrades would far outweigh the opportunity costs to existing shareholders from dilution, a solution that sacrifices the existing shareholders may end up being imposed.

Against the backdrop of the intractable problem of the monolines, and with world equity markets falling, we would not be surprised to see the Fed cut interest rates by at least 50 bp, perhaps more, before the scheduled January FOMC meeting. The way things are going, the cut could easily come tomorrow (that is, Tuesday). Bernanke has already virtually promised a 50 bp cut (see "Helicopter Ben Takes Flight" January 11, 2008), so at this point waiting until the meeting to implement it almost seems like bureaucratic priggishness.

We have not been supporters of the Fed's easy-money approach to the current financial crisis. But now the issue is beginning to move beyond questions of how tight or how loose the Fed should be to accomplish this or that objective. It's a question of credibility. Bernanke has delivered on his promise to bring transparency to the Fed -- but that transparency is not translating transparently into action. Having promised a 50 bp cut, right or wrong, and with the FOMC meeting only 9 days away, *what possible reason can he have for not just doing it?*

A long article on Bernanke in yesterday's *New York Times Magazine* captured the spirit of this crisis of credibility at what is possibly a key moment in forming public opinion about the Fed chairman. While most of the article is a fairly dry assessment of Bernanke's background, his approach, and the unique challenges facing him -- challenges that would test anyone, even the sainted Alan Greenspan -- the story nevertheless portrays Bernanke as lacking certain necessary qualities of leadership. In one passage, the author describes Bernanke during an interview with him, and notes that "his hand trembled slightly." How very much the opposite of the cliché so often cited in describing Greenspan -- "a firm hand on the rudder."

We don't envy Bernanke's situation. But we think that at this point he's becoming part of the problem, rather than the solution. A credit crisis is, by its very nature, a crisis of confidence. It does not help that Bernanke let it be known last week that he and Don Kohn intend to give more frequent policy speeches. Markets now need Bernanke to talk less, and to take more bold, decisive and surprising actions if he intends to restore confidence. We probably won't have a sustainable solution to the credit crisis until he does.

BOTTOM LINE: The panic in stocks has extended well beyond our expectations, fueled by the crisis in monoline insurers. Prompt action from the Fed could quickly help stocks find a bottom while the difficult monoline problem is worked out. Bernanke as much as promised at least 50 bp in rate cuts in two recent speeches, so at this point there is little reason to wait to execute them. A cut of 50 bp or more could come as soon as tomorrow -- and if it doesn't, the Fed chairman will have created a dangerous credibility problem for himself.