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MACROCOSM

Bernankruptcy

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Donald Luskin

It's a wonderful panic, with Ben Bernanke playing Donna Reed. How will the movie end?

Here's the *bad* way of looking at Bear Stearns getting acquired for $2 a share by JP Morgan. If Bear is worth only $236 million, then *why is anything worth anything?* And if a venerable firm can be felled by a liquidity crisis which, by all accounts, was precipitated not by fact but by the self-fulfilling momentum of sheer emotion, then *why can't the same thing happen to any company, at any moment?* The awful truth is that, in the ultimate sense, nothing is worth anything unless people say it is. And all firms are dependent on customer confidence, so they can be destroyed at any moment by the withdrawal of that confidence for any reason or no reason. At the

Update to strategic view
US STOCKS: The rapid collapse of Bear Stearns and its firesale acquisition by JP Morgan is rattling, but it's good news that a deal got done that averted a massive counterparty default and the dumping of illiquid assets. We can't rule out a run on another bank, perhaps even one deliberately set in motion by a competing bank looking for a cheap Fed-sponsored acquisition. But the Fed's strong intervention here ought to set the stage for a durable bottom. We acknowledge the risks, but would be buyers into weakness here. **FED FUNDS:** With the shocking collapse of Bear Stearns, the Fed won't have the courage to disappoint expectations at tomorrow's FOMC meeting. We now expect a cut of at least 75 bp, and probably 100. **US RESOURCE STOCKS, COMMODITIES, GOLD, OIL, US DOLLAR:** The Fed's new Primary Dealer Credit Facility, and the likelihood of a sharp funds rate cut tomorrow, put the inflation game into extra innings. With the Fed's checkbook wide open, we expect a further rise in gold, oil and commodities, and further dollar weakness. Resource sectors such as energy and materials should continue to be the strongest performers.
[see Investment Strategy Dashboard]

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end of the day, every company is as fragile as the Bailey Building & Loan in *It's A Wonderful Life*.

Here's the *good* way of looking at Bear Stearns getting acquired for $2 a share by JP Morgan -- *that it got done at all*, because the alternative would have been far worse. First, thanks to the deal, the financial system has been spared the trauma of the default of a major transaction counterparty, as all of Bear's obligations have been assumed by Morgan. Second, the market has been spared the disruption that would have arisen from the indiscriminate dumping of Bear's approximately $30 billion in illiquid securities -- mostly mortgage-related -- as under the deal, the Fed has agreed to non-recourse funding of those assets. Third, the Fed, recreating the Donna Reed role in *It's A Wonderful Life*, announced yesterday (at the same time as the Bear acquisition was announced) that it will immediately extend overnight funding to broker-dealers for a broad range of collateral at the discount rate, through a new Primary Dealer Credit Facility (PDCF). As the joke of the day goes, it's not a bankruptcy -- it's a Bernankruptcy.

Another *good* way of looking of looking at Bear Stearns getting acquired for $2 a share by JP Morgan is that Morgan is probably getting a helluva deal -- a Madison Avenue skyscraper, a portfolio of human capital and a rolodex of customer relationships for $238 million in stock and something like $6 billion in costs and obligations (with the worst risks beyond that underwritten by the Fed). The deal is so good for Morgan, and arose under such coercive circumstances in which Bear had no bargaining power whatsoever, it raises the question of whether it was, so to speak, a bear raid. It wouldn't be the first time in this credit crisis. Under similarly coercive circumstances, just before he gave away three fifths of his company right at the bottom, Ambac's CEO said, "This is Wall Street, good old capitalism; the objective is to leave you with your socks and a smile."

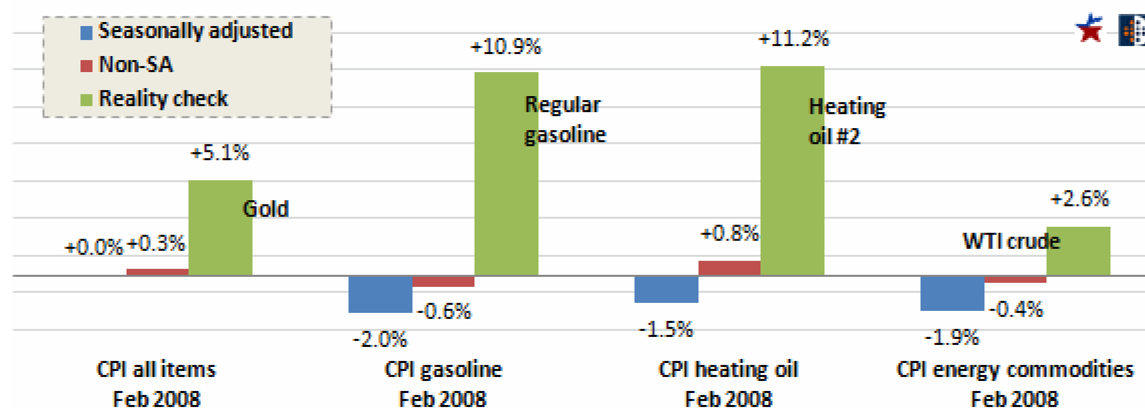
Recall that the credit crisis was set in motion in the first place last July when JP Morgan demanded more collateral from one of Bear Stearns' distressed hedge funds, and ultimately served a default notice. Morgan was at the scene of the crime again last Friday, when it acted as middleman in the Fed's rescue of Bear Stearns -- the announcement of which resulted in an immediate 50% drop in Bear Stearns' share price. Now JP Morgan is there again, at the *denouement*, with a bid for Bear Stearns at 10% of the firesale price that had been widely estimated by market observers up until a few minutes before the deal was announced. As the old saying goes, "The first time is happenstance. The second time is coincidence. The third time is enemy action."

So how are we to interpret all this in terms of investment strategy for US stocks? Obviously our call on Tuesday morning for a "tradable rally" just after the Fed announced its Term Securities Lending Facility (see "On the Term Securities Lending Facility" March 11, 2008) was short-lived, at best -- as have been all of our attempts to rationalize a bottom in the sharp decline following the October 9, 2007, top. But we're nevertheless tempted to say that once market participants shake off the shock of witnessing how rapidly a blue chip Wall Street firm can be stampeded into failure, and the low valuation at which it can then be forced to liquidate itself, we could find a durable bottom, and a rally longer-lived than the abortive one last Tuesday . After all, with the PDCF, the banking system comes out of this with what amounts to a blank check from the Fed as the repo counterparty of last resort, and the guarantor of deal-risk. That dramatically reduces the risk of a systemic meltdown that has always been the worst-case scenario of the credit crisis, and probably explains much of the extraordinarily high present level of the equity risk premium.

The conventional wisdom is that the Bear Stearns collapse is so shocking that it will set in motion similar runs on other banks. No doubt over the coming weeks we will have to endure constant rumors to that effect -- and further, to endure the knowledge that the rumors

themselves have something of the property of self-fulfilling prophecies. And we'll have to live with the possibility that such rumors might be deliberately spread by acquisition-minded banks looking to take out a competitor at cents on the dollar, with deal-risk underwritten by the Fed. So while in our heart of hearts we would be buyers of stocks into weakness here, we fully acknowledge that now, in an important sense, it's in the hands of the gods.

What we're certain about is the inflationary cost of the Fed's open checkbook. As soon as the Bear Stearns acquisition by JP Morgan and the Fed's PDCF was announced, the most inflation-sensitive markets reacted strongly -- gold rallied $25 to new highs, oil rallied $1 to new highs, and the trade-weighted dollar fell to new lows. We had wondered last week whether these markets might undergo corrections of their large moves of the last several months, given that the Fed might have found a way to relieve Wall Street's funding stresses without new money creation, through the self-sterilized Term Securities Lending Facility (again, see "On the Term Securities Lending Facility"). But the new PDCF is not self-sterilized. And given the turbulence of the last several days, and the turbulence likely to play out in the coming week, it now doesn't seem possible that the Fed would dare to disappoint expectations by failing to cut the funds rate 75 bp at tomorrow's meeting, probably 100 bp. That's made all the more likely by Friday's Consumer Price Index report showing zero inflation in February, which will give the Fed cover to keep turning a blind eye to its duty to ensure price stability (see "Well Anchored?" March 5, 2008). February's CPI was a statistical aberration, driven by seasonal adjustments, and featuring such anomalous results as a 2% decline in gasoline prices in a month when spot gasoline rose by 10.9%. CPI inflation will surely accelerate next month when those anomalies wash out. But be that as it may, with the new PCDF and likely further sharp funds rate cuts, the inflation game is going into extra innings. There will no doubt be turbulence in the "inflation plays" this week -- indeed, oil has already turned lower as world stock markets fell overnight -- but we think that now, more than ever, they are the place to be invested.



BOTTOM LINE: The rapid collapse of Bear Stearns and its firesale acquisition by JP Morgan is rattling, but it's good news that a deal got done that averted a massive counterparty default and the dumping of illiquid assets. We can't rule out a run on another bank, perhaps even one deliberately set in motion by a competing bank looking for a cheap Fed-sponsored acquisition. But the Fed's strong intervention here ought to set the stage for a durable bottom. We acknowledge the risks, but would be buyers into weakness here. With the collapse of Bear Stearns, the Fed won't have the courage to disappoint expectations at tomorrow's FOMC meeting. We now expect a cut of at last 75 bp, and perhaps 100. The Fed's new Primary Dealer Credit Facility, and the likelihood of a sharp funds rate cut tomorrow, put the inflation game into extra innings. With the Fed's checkbook wide open, we expect a further rise in gold, oil and commodities, and further dollar weakness. Resource sectors such as energy and materials should continue to be the strongest performers.