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MACROCOSM

Your Speculative Attacks Dollars At Work

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"Nationalization risk" replaces credit risk in the financial sector.

Update to strategic view
US STOCKS, US FINANCIAL STOCKS: The initial shock of the Fannie/Freddie takeover has intensified into loss of confidence in the financial sector, exacerbated by the risk of preemptive government expropriation of shareholder value in the name of dubious emergency. At the same time, the takeover is already having beneficial effects on the mortgage markets. If the present panic can burn itself out without triggering another arbitrary intervention, we continue to think that the takeover will be a net positive catalyst for stocks overall. But for the financial sector, it is also a new Sword of Damocles.
[see Investment Strategy Dashboard]

We continue to think that the Treasury takeover of Fannie Mae and Freddie Mac will have powerful positive effects on the economy, the banking system and the markets. But we warned that the initial reaction in markets would likely be one of shock and fear -- and that's playing out right now, to a greater degree and with somewhat different dynamics than we had anticipated (see "GSE Rescue: First Impressions" September 7, 2008). It's going beyond the expectable but paradoxical knee-jerk reaction that, while the Treasury's rescue is objectively helpful, it reveals the frightening extent of risks that made a rescue necessary in the first place. Now, we think the market is reacting to the ramifications of the sudden and arbitrary way in which the rescue occurred , that is, an expropriation of shareholder wealth without a credible triggering event to justify it (see ”Fannie/Freddie Fallout" September 8, 2008).

In a nutshell, who wants to own Lehman Brothers or Washington Mutual when, at any moment, with or without a true emergency to justify it, some government agency -- maybe the Treasury, maybe the Fed, maybe the FDIC -- will decide that it can't wait for an emergency, that it has to expropriate shareholders preemptively for the sake of the greater public good? Treasury Secretary Paulson is being criticized now for having misled Congress when he justified emergency powers to rescue Fannie and Freddie by saying, "If you’ve got a bazooka, and people know you’ve got it, you may not have to take it out." But he might have been right. The real problem may be that he actually didn't absolutely have to take it out last weekend, but he nevertheless did. And having done so, he extinguished $11 billion in common stockholder wealth. Normally in a takeover, the acquirer has to pay for what he acquires.

In the case of the Bear Stearns takeover by JPMorgan, there was an authentic emergency. There was a run on the bank. Bear Stearns simply couldn't fund itself. So Morgan had to

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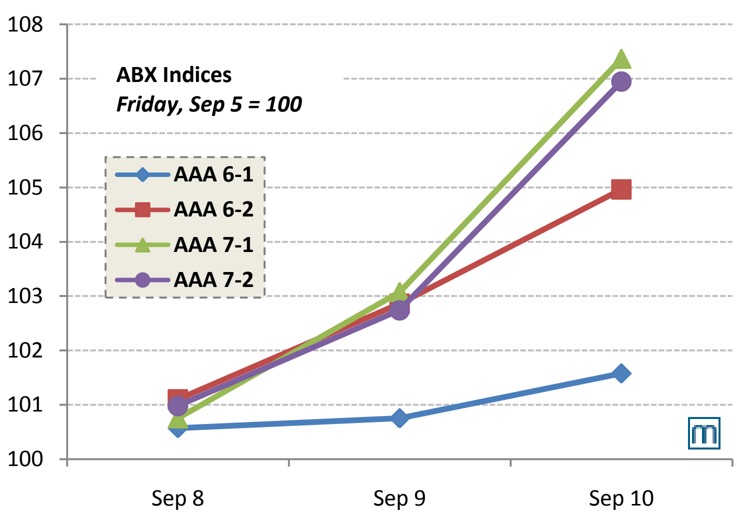
acquire it, and did so with the assistance of the Fed. But Morgan had to pay for it, and indeed ended up paying five times more for it than was originally contemplated when the acquisition was first announced. But the Fannie/Freddie takeover is a whole different political and economic model. It is a preemptive intervention, in which companies can be treated as failures -- and thus caused effectively to fail before they *actually* fail. This is not just a moral hazard -- it is a moral "attractive hazard." A competitor to Lehman who wishes to acquire it on the cheap and with government assistance now doesn't even need to start the kind of run on the bank that toppled Bear Stearns. All that is required now for an effective speculative attack on Lehman is a decline in its stock price deep enough to create a sufficient atmosphere of emergency -- thus triggering government intervention for no better reason that to subjectively restore confidence.

Such dynamics are utterly unpredictable as to their specific outcomes, which is what makes them so dangerous. We're in the realm of the purely emotional and the purely political. What we do know, though, is that at least the *objective* factors of failure for Lehman are far less imposing than those that faced Bear Stearns in March. So far as we know, there is no run on the bank at Lehman. And if there were, Lehman would have access to the Fed's Primary Dealer Credit Facility -- which was created in the aftermath of the Bear Stearns collapse, precisely to give broker-dealers breathing room if they became liquidity-constrained. Based on weekly data published so far, Lehman has not borrowed from the PDCF -- and nor has anyone else, as the balance in the program is zero. New data will be published this afternoon, but our guess is that the balance will still be zero.



It's especially unfortunate that the ham-handed and trigger-happy handling of the Fannie/Freddie takeover is causing so much residual anxiety, because objectively it has already achieved a great deal of good and will likely continue to do so. Yields and spreads on mortgage-backed securities have fallen markedly, which should ultimately translate into lower consumer mortgage rates. We also note that the ABX indices of the highest-rated CDO tranches based on subprime mortgages -- the tranches most sensitive to shift in default risk -- have moved up sharply this week, suggesting that today's very high default rate has at least crested, and may start to subside. That, in turn, would suggest that the endless bank write-offs arising from such mortgages may be nearing an end. So if the present panic -- or speculative attack, or whatever it is -- can manage to burn itself out without another preemptive government takeover, then we will probably be able to look back on the ineptly managed rescue of Fannie and Freddie as a critical positive turning point.

BOTTOM LINE: The initial shock of the Fannie/Freddie takeover has intensified into loss of confidence in the financial sector, exacerbated by the risk of preemptive government expropriation of shareholder value in the name of dubious emergency. At the same time, the takeover is already having beneficial effects on the mortgage markets. If the present panic can burn itself out without triggering another arbitrary intervention, we continue to think that the takeover will be a net positive catalyst for stocks overall. But for the financial sector, it is also a new Sword of Damocles.