Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MACROCOSM

Tough Love for Lehman

Sunday, September 14, 2008

Donald Luskin

The Fed takes a big chance in order to break the cycle of "immoral hazard."

Update to strategic view
US STOCKS: It's going to be a difficult week, but with the Fed no longer stoking the vicious cycle of predatory acquisitions, short-selling and panic-selling, the stage could well be set for the climax bottom we've been waiting for throughout the credit crisis. **FED FUNDS:** The FOMC has every excuse to cut rates on Tuesday. But we're hoping that the discipline and courage the Fed showed this weekend will carry over to the FOMC, and that the funds rate will remain unchanged.
[see Investment Strategy Dashboard]

The Fed has made a very bold decision here, by letting Lehman Brothers go into bankruptcy rather than put its own balance sheet at risk, as it did in March to prevent Bear Stearns' bankruptcy. The judgment must surely be that there is something more to be feared than systemic risk as counterparty positions are unwound, and orphaned assets are dumped. Specifically, the Fed must now urgently wish to stop another kind of systemic risk that the Fed itself unwittingly created, and which now threatens several financial firms: the cycle of predation and fear that consumed Fannie Mae, Freddie Mac and now Lehman, and threatens several other firms as well.

We first warned about it the day the Fed stepped in with $30 billion to facilitate the predatory takeover of Bear Stearns by JPMorgan Chase (see "Bernankruptcy" March 17, 2008). And we warned about it last week in the aftermath of the Treasury's own predatory takeover of Fannie Mae and Freddie Mac (see "Your Speculative Attacks Dollars At Work" September 11, 2008). It's a new breed of moral hazard -- "immoral hazard," actually -- in which the government is so averse to systemic risk that, in order to avoid it, it will expropriate shareholders in firms thought to be weak enough to pose a systemic threat. That makes otherwise viable firms vulnerable to speculative attack by competitors or short-sellers, and even their own fearful shareholders. In addition to unattractive valuations even at today's prices and poor prospects for earnings growth once the credit crisis is eventually resolved, this vicious cycle dynamic has been a key reason we've repeatedly cautioned against bottom-fishing in the financial sector (for example, see "Subprime Lending Was Their Best Idea" June 4, 2008).

Monday is undoubtedly going to be a very tough day, as markets absorb the unexpected reality that the Fed isn't going to be the distressed-assets investor of last resort. The Fed is doing plenty to ease the pain and assure that markets will be able to absorb the unwinding of Lehman's positions. According to an announcement late today, the Fed is broadening the types of collateral it will take in the Primary Dealer Credit Facility and the Term Securities Lending

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

Copyright 2008 Trend Macrolytics LLC. All rights reserved. This document is not to be forwarded to individuals or organizations not authorized by Trend Macrolytics LLC to receive it. For information purposes only; not to be deemed to be recommendations for buying or selling specific securities or to constitute personalized investment advice. Derived from sources deemed to be reliable, but no warranty is made as to accuracy.

Facility, and is enlarging the TSLF and holding its auctions more frequently. Also, the Fed is apparently willing to turn a blind eye to capital ratio issues arising from Bank of America's acquisition of Merrill Lynch, an acquisition which takes a large potential blow-up off the table. Finally, it was reported late today that the distressed insurer AIG has asked the Fed for a loan of up to $40 billion while it finds ways to raise new capital. The Fed may well acquiesce in this request, as it has the authority under section 13(3) of the Federal Reserve Act to lend money to any firm or individual under exigent circumstances -- and making such a discount window loan would not be an asset acquisition such as the one made in the Bear Stearns deal. If the Fed is betting correctly -- that systemic risk will actually be *less* if Lehman goes bankrupt than if the Fed bails it out -- then once the dust settles, all the pain we're probably going to experience in markets this week will have been worth it, and it may well prove to be a climax bottom in stocks.

But there's another element in play -- there is an FOMC meeting Tuesday. It's not unlike the sequence of events that unfolded in March, when the Bear Stearns acquisition by JPMorgan was announced on a Sunday night, and there was an FOMC meeting the next Tuesday. In that instance the Fed galvanized markets by cutting rates less than expected, signaling that its new tools such as the TSLF and the PDCF would, to some extent, substitute for rate cuts, and thus give the Fed fewer inflationary options for dealing with the credit crisis (see "Three Quarter Profile In Courage" March 19, 2008). But now, while PDCF and TSLF have indeed been expanded, the Fed is signaling it will no longer wield the other tool it employed in the Bear Stearns crisis -- using its balance sheet to be the distressed-asset buyer of last resort. So the question now is: does that mean the Fed will go back to rate-cutting?

As of this writing late Sunday night, the fed funds futures markets has responded to the Lehman bankruptcy by moving to price as much as an 80% chance that the funds rate would be cut by 25 bp on Tuesday. In our view, rates are already too low, and lowering them further is unlikely to help the credit crisis as much as it is likely to worsen inflation pressures. With the price of oil having fallen 42% from its highs, and the dollar having rallied 10% from its lows, the Fed may feel those pressures have subsided enough to set inflation concerns entirely aside. That would be a mistake, and the fear of it would seem to be reflected in Sunday night's sharp drop in the dollar and rally in gold.

BOTTOM LINE: It's going to be a difficult week, but with the Fed no longer stoking the vicious cycle of predatory acquisitions, short-selling and panic-selling, the stage could well be set for the climax bottom we've been waiting for throughout the credit crisis. The FOMC has every excuse to cut rates on Tuesday. But we're hoping that the discipline and courage the Fed showed this weekend will carry over to the FOMC, and that the funds rate will remain unchanged.