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MACROCOSM

If You're Short, Abort

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With the SEC's ban on short-selling, two wrongs could make a right.

Update to strategic view
US STOCKS, US FINANCIAL STOCKS: By banning short-selling, the government is attempting to remedy the unintended consequences of its nationalizations of Bear Stearns, Fannie, Freddie and AIG -- stimulating speculative attacks by short-sellers on any firm that is "too big to fail." The ban should halt the cascade of financial sector failures, and create a time-out for sober reappraisal of the real value -- and the real risks -- in these firms. This should lead to a substantial recovery in stocks, both from short-covering in specific companies by attackers whose strategies have been thwarted, and in stocks overall as the risk of a further cascade of firm failures is sharply reduced.
[see Investment Strategy Dashboard]

The Securities and Exchange Commission has announced a temporary ban on most short-selling of financial stocks, and a requirement that short positions be reported. The market bottomed yesterday just when the UK's Financial Services Authority announced such a move. On a day of coordinated liquidity injections by all the world's central banks, it seemed logical that our SEC would follow suit, and now it has. At the same time, there appears to be a possibility that congress will quickly act to socialize the risk of distressed assets in a program similar to the Resolution Trust Company of the 1990s, and to federally insure money market fund deposits. Both are game-changers, but at the moment only the short-selling ban is a sure thing, so these comments written several hours before the opening of US markets Friday morning will be limited to that.

We don't normally applaud interference with the free functioning of markets, but we have to make an exception in the case of banning short-selling at this time. First, it complements private sector efforts already underway, the voluntary decision of several large pension funds to stop lending the shares of financial firms from their portfolios. But more important, a short-selling ban is a move to redress the Fed's and the Treasury's dangerous error of structuring the rescues of Bear Stearns, Fannie Mae, Freddie Mac and AIG as what amount to nationalizations. Doing so created an incentive for speculative attacks, in which short-sellers learned they could drive the stocks of pivotal firms thought to be "too big to fail" down to a point that would trigger nationalization, wiping out shareholder equity for the good of the public (see "Your Speculative

Key documents
SEC order banning short-selling SEC order requiring reporting of short positions
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Attacks Dollars At Work" September 11, 2008 and "AIG: Rescue or Bag Run?" September 17, 2008). For example, the AIG nationalization Tuesday night resulted first thing Wednesday morning in savage speculative attacks on Morgan Stanley and Goldman Sachs. At this point, the only way the government can fix its first mistake -- creating an incentive for speculative attack by short-sellers -- is to make a *second* mistake to offset the first one: ban short-selling.

Yes, short-selling is an important element of "market completeness." It is useful for investors with negative information about a given stock, who don't happen to have a pre-existing long position in it, to nevertheless transmit that information into the market by shorting. In that spirit, it rang true when a smart client told us Wednesday morning that any time a CEO complained publicly that his company was being unfairly beset by short-sellers, you can be sure the company was rotten to the core and not long for this world. Ironic that later the same day, a memo to Morgan Stanley employees from CEO John Mack said just that: "short sellers are driving our stock down." And it seemed then that, indeed, Morgan was not long for this world, as it ran for cover into embrace of another crippled firm, Wachovia, even as Mack bragged about Morgan's "strong capital position." But Mack is not your garden-variety whiner. He wrote, "You should know that the Management Committee and I are taking every step possible to stop this irresponsible action in the market. We have talked to Secretary Paulson and the Treasury. We have talked to Chairman Cox and the SEC." It seems that Mack's lobbying worked -- no doubt with an assist from parallel efforts by Goldman, a firm that can count on a respectful hearing in the office of the secretary of the Treasury.

We said on Wednesday that markets won't turn around until it's proven "that Morgan and Goldman have the resources to defend themselves" (again, see "AIG: Rescue or Bag Run?"). Perhaps it has turned out that they do.

BOTTOM LINE: By banning short-selling, the government is attempting to remedy the unintended consequences of its nationalizations of Bear Stearns, Fannie, Freddie and AIG -- stimulating speculative attacks by short-sellers on any firm that is "too big to fail." The ban should halt the cascade of financial sector failures, and create a time-out for sober reappraisal of the real value -- and the real risks -- in these firms. This should lead to a substantial recovery in stocks, both from short-covering in specific companies by attackers whose strategies have been thwarted, and in stocks overall as the risk of a further cascade of firm failures is sharply reduced.