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MACROCOSM

Quick Thoughts on the New Black Monday

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Donald Luskin

The historic stock drop was more politically manufactured hysteria than reality.

Update to strategic view

US STOCKS, US FINANCIAL STOCKS: With the bail-out bill painted as the only thing standing between us and a new Great Depression, the bill's failure had to set off a panic. The panic itself may get the bill back for another vote, but even if it doesn't, we'll soon learn that there are other means of dealing with the credit crisis through established institutions, and those may have lower long-term costs. With equities now more undervalued relative to bonds than at any time in almost thirty years, we don't see much further downside to stocks.

[see Investment Strategy Dashboard]

Early yesterday morning we warned that the Emergency Economic Stabilization Act of 2008 faced, as President Bush had just put it, a "difficult vote" (see "Peeking Under the TARP" September 29, 2008). And late last week we warned that if "there's no deal, brace for a bad shock in markets" (see "Bail-Out Brinksmanship" September 26, 2008). Nevertheless, we were surprised both by how many House Republicans failed to vote for the bail-out yesterday, having won so many valuable points in the final bill -- and we were horrified by the scope of the stock market's reaction. But we stand by our view of last week, that stocks will be "surprisingly resilient," once the immediate knee-jerk panic response has played itself out. We think that just as it turned out that Saddam Hussein had no weapons of mass destruction, despite urgent warnings by the Bush administration, the banking system and the economy are not really on the verge of collapse, again despite the urgent warnings of the Bush administration. But after two weeks of extraordinarily alarmist rhetoric from the bill's proponents, it's inevitable that the bill's failure would trigger at least a short-term panic.

The panic itself is likely to get the bill back for another vote. But even if that doesn't happen, we don't expect Monday's collapse to be substantially extended, or long sustained. Just as the invasion of Iraq arguably has had some real benefits, the banking bail-out would probably have some real benefits, too. But in both cases those benefits come at enormous cost, and could potentially be attained by more efficient means. The Fed, the SEC, the Treasury and the FDIC already have extensive powers to deal with the credit crisis on a case by case basis. The Fed, especially, enjoys so much independence and has such broad powers, if it wanted to it could implement the Troubled Asset Relief Program (TARP) all by itself with no congressional approval. The Fed's taking onto its balance sheet $30 billion of illiquid MBS from Bear Stearns was cleverly contracted to look like a loan, but it was for all intents and purposes just the kind of purchase contemplated in Section 101 of the bail-out bill. Just do the same thing 22.3 more times -- but with Treasury funding, the

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same way the Treasury is financing the Fed's AIG rescue -- and you've completely implemented TARP.

In the various rescues this year, these agencies haven't always done a perfect job, indeed sometimes they've unleashed unintended consequences that have made matters worse (see, for example, "AIG: Rescue or Bag Run?" September 17, 2008). But these are the same imperfect agencies that will be implementing TARP -- so maybe we're better off with them administering a series of small *ad hoc* operations in which they can learn by doing, rather than a single, vast inflexible program. One thing is for certain -- if the bail-out bill comes back for another vote, but in a new form laden with punitive anti-Wall Street provisions masquerading as "taxpayer protection," we'll surely be better off without it.

BOTTOM LINE: With the bail-out bill painted as the only thing standing between us and a new Great Depression, the bill's failure had to set off a panic. The panic itself may get the bill back for another vote, but even if it doesn't, we'll soon learn that there are other means of dealing with the credit crisis through established institutions, and those may have lower long-term costs. With equities now more undervalued relative to bonds than at any time in almost thirty years, we don't see much further downside to stocks.