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At Last: A Bail-out That's a Bail-out

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After six months of destroying financial sector equity, Treasury gets it almost right.

What the Treasury *didn't* do over the weekend set the stage for this morning's very good news about what the Treasury *will* do -- and together with actions from authorities around the world and equity valuations coming from a generational low, the stage is set for a lasting bottom in stocks. How far and how fast a recovery might extend depends on several factors, including the upcoming election and mounting inflation risk -- all of which we will write about subsequently. For now, the important consideration is that the vicious cycle of fear and liquidation seems to finally be broken.

What the Treasury *didn't* do this weekend was wipe out Morgan Stanley in yet another Saturday night massacre -- repeating its My Lai strategy of destroying the village in order to save it, a failed approach begun with Bear Stearns and continued through Fannie Mae, Freddie Mac, Lehman Brothers, Merrill Lynch, AIG, Washington Mutual and Wachovia. What the Treasury *will* do -- according to media stories based on leaks over the weekend, and now confirmed by this morning's statement -- is make a $250 billion capital infusion into banks deemed basically sound. About half of that goes immediately into nine leading banks, an amount equal to about 20% of their collective common stock market capitalization. While Treasury reportedly coerced acceptance of this investment, its structure of callable senior preferred stock and limited warrants has been designed to minimize shareholder dilution. The idea this time seems to be to send the signal that *this* bail-out is really a bail-out, truly intended to stabilize the system, without overly punishing the very

Update to strategic view

US STOCKS, US FINANCIAL STOCKS, US RESOURCE STOCKS: With Treasury's new initiative to inject $250 billion capital into nine banks, the message is: *no more Saturday night massacres*. More important than liquefying the banking system, this could end the vicious cycle of speculation and liquidation that was set in motion by the overhanging threat of *ad hoc* punitive nationalization of troubled but viable firms. If Treasury follows through, then Friday's lows will be a durable bottom for stocks. But the financial sector remains the least undervalued in the S&P 500, and its long-term earnings growth model is very much in doubt. The real beneficiaries are more likely to be cyclical sectors such as energy, industrials and basic materials that have been crushed in the last several month's headlong rush for liquidity, and the sharp retrenchment of global growth expectations.
US MACRO: The US economy has probably finally tipped into formal recession, but a non-punitive bail-out that liquefies the banking sector without destroying it in the process could restore confidence quite quickly. The core economy has sustained very little damage, and is positioned to recover smartly.

[see Investment Strategy Dashboard]

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system it is trying to stabilize. Previous rescues have been based on the principle of *fiat justitia, ruat coelum* -- let justice be done, though the heavens fall. They've been shareholder wipe-outs, designed to punish Wall Street's profligacy even at the price of further destabilizing the system.

This is consistent with what Treasury sources told us late last week -- that Henry Paulson has finally realized why all the previous rescue attempts have made matters worse, that they encouraged speculative attacks and discouraged private capital with the threat of imminent nationalization (see, for example, "Your Speculative Attacks Dollars At Work" September 11, 2008). According to sources, Paulson has feared that a less punitive approach would bring down upon him the wrath of powerful anti-business Democrats in Congress, but after last week's stock market devastation, such worries have evaporated for all concerned. In fact, on ABC's "This Week with George Stephanopoulos" Sunday, Barney Frank bragged the he, not Paulson, was responsible for the authority in the Troubled Asset Relief Program (TARP) to make direct equity injections -- an authority that, in fact, doesn't exist in the law at all, and was pretty much improvised after the law was enacted: "it was the Congress that explicitly added the right to buy the equity. Frankly, the Treasury was not too crazy about that."

It's unfortunate that Treasury's money is being forced upon the nine banks in which it will be invested. It would have been best if the program had been entirely optional, and manifestly they do not all need it -- for example, Wells Fargo certainly didn't require it to pay up to buy Wachovia out from under the government's preferred shotgun bridegroom, Citigroup. But here, too, perhaps Treasury is learning from past mistakes. Its previous botched rescues were all *ad hoc* affairs, each with its own unique distribution of winners and losers. And over the last three weeks, Henry Paulson has erred grievously by talking up the risks to the economy on the one hand, while on the other hand dithering in indecision about how to use his new-found authority (see "Henry Paulson: The Donald Rumsfeld of Bail-Outs" October 6, 2008). Now, by setting a template for capital infusions, and getting it over with all at once in a standardized way across nine major banks, at least Treasury eliminates the uncertainty of what its program will be and whether it will be sufficiently comprehensive -- and now other smaller banks may choose to opt in to the same program, or not.

It may well be that the banking system doesn't objectively require the Treasury's capital, and never did. It may well be that all the banking system needed was to be free of the threat that speculative attackers or panicky shareholders could drive another otherwise viable firm, on any given weekend, into the lethal embrace of the Treasury, the Fed and the FDIC -- and free of the threat that, armed with $700 billion of congressional authority, the Treasury secretary would endlessly float trial balloons about new approaches, dithering about exactly what to do while the system collapsed about his ears (see "The Right to Arm Bears" October 9, 2008). Now perhaps the system is free of those threats -- and it's got $250 billion of Paulson's money, too, whether it needs it or not -- and, just as significantly, now Paulson *doesn't* have it. So that's less damage that a future Treasury secretary can do under TARP authority, and at a, say, ten-to-one capital ratio, that's enough to buy every leveraged loan and high-yield bond, *and* every subprime and Alt-A mortgage not already owned or guaranteed by Fannie Mae or Freddie Mac -- and all at par. If *that* doesn't do the trick, the trick can't be done.

The financial sector may end up being the least beneficiary of all this, perhaps as hinted by yesterday's relative sector performance: of the ten S&P 500 sectors, financials came in seventh and underperformed the broad market. We continue to think that while the financial sector is not going to zero -- certainly not now, with this new bail-out in place -- it represents neither a compelling value proposition (it is the least undervalued S&P 500 sector) nor a compelling earnings recovery story (see "Subprime Lending Was Their Best Idea" June 4, 2008). Financials will have a strong relief rally, but the longer-term winners are more likely to be the economically sensitive sectors such as energy, industrials and basic materials. These have been crushed by collapse of commodity prices driven by both a headlong rush for liquidity and the sudden sharp markdown of growth expectations. If Treasury's bail-out works, the recession that seems inevitable might be very brief and very shallow, considering how little actual damage the real economy has suffered despite Wall Street's agonies

BOTTOM LINE: With Treasury's new initiative to inject $250 billion capital into nine banks, the message is: *no more Saturday night massacres*. More important than liquefying the banking system, this could end the vicious cycle of speculation and liquidation that was set in motion by the overhanging threat of ad hoc punitive nationalization of troubled but viable firms. If Treasury follows through, then Friday's lows will be a durable bottom for stocks. But the financial sector remains the least undervalued in the S&P 500, and its long-term earnings growth model is very much in doubt. The real beneficiaries are more likely to be cyclical sectors such as energy, industrials and basic materials that have been crushed in the last several month's headlong rush for liquidity, and the sharp retrenchment of global growth expectations. The US economy has probably finally tipped into formal recession, but a non-punitive bail-out that liquefies the banking sector without destroying it in the process could restore confidence quite quickly. The core economy has sustained very little damage, and is positioned to recover smartly.