Trend Macro

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MACROCOSM

Another Rescue, A New Rescue Ranger

Monday, November 24, 2008

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Citi gets TARPed again, and Treasury gets policy continuity for the TARPs still to come.

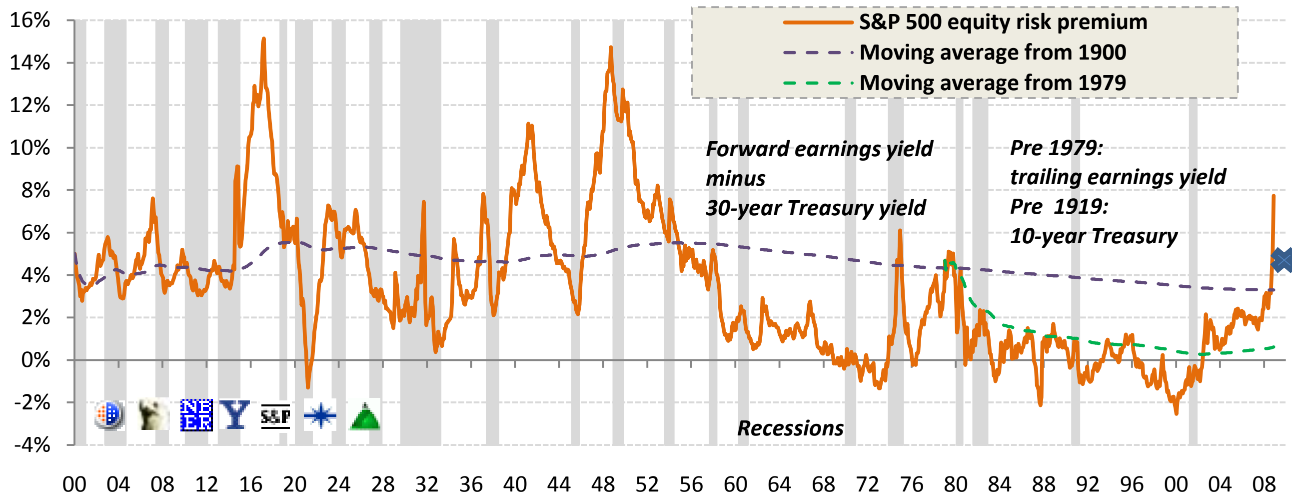
Update to strategic view

US STOCKS: Treasury, FDIC and the Fed have extended the safety net for Citibank, proving that no systemically important institution will be allowed to fail -- and that the rescue will be on terms that don't wipe out shareholder value. Geithner at Treasury represents both continuity with this rescue regime, and partisan neutrality on growth policy. These are positives for deeply undervalued stocks, looking for any sign of certainty as a catalyst for some recovery.

[see Investment Strategy Dashboard]

THE VALUATION CONTEXT Before we talk about the initiative to stabilize Citigroup, and the naming of Timothy Geithner for Treasury secretary, first a word on how extraordinarily undervalued stocks have become. From today's level of undervaluation, almost any development that could offer certainty in today's intensely uncertain environment is a potential catalyst for a significant rally (see "At Least They're Cheap" November 20, 2008).

The equity risk premium -- the difference between the forward earnings yield of the S&P 500 and the income yield of the 30-year Treasury -- has been for several weeks at highs never before seen in the historical timeframe we normally examine, beginning in 1979. We've been limited to that timeframe because good data on forward earnings are not available for earlier years. In order to get a deeper sense of context, we've constructed a longer history using reported earnings rather than forward earnings for years prior to 1979. In that context,



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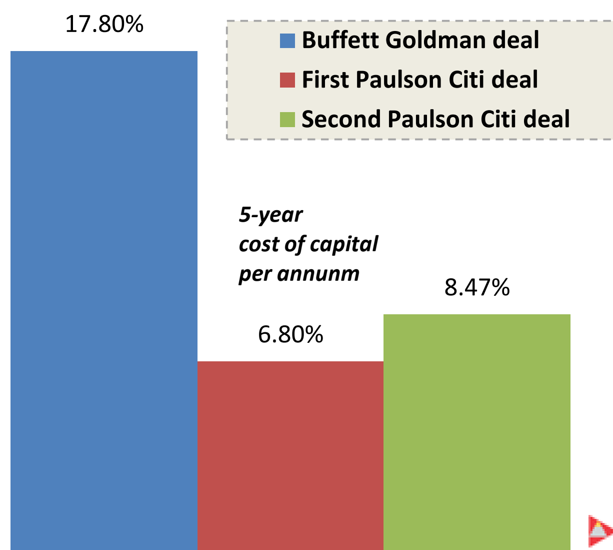
the equity risk premium has risen to levels not seen during the careers, or even the lifetimes, of many of today's market participants. In fact, as it happens, the last time the equity risk premium was a great as it was at the close on Friday was April 1954, the month I was born. At Friday's lows, you would have had to go back even further, to January 1953, to find a risk premium as high. Now, for the risk premium to *only* be as high as it was in the late 1970s, S&P 500 earnings could fall all the way to 60, expressed in index point terms -- indicated by the "x" in the chart on the previous page (see "How Bad An Earnings Hit?" October 23, 2008).

An equity risk premium so great reflects the intense uncertainty of today's environment, concerning both the stability of the banking sector and the policy direction of the Obama administration. The move to stabilize Citigroup announced last night, and the naming of Timothy Geithner as Treasury secretary Friday, are moves in the direction of greater certainty. The Geithner announcement already triggered a substantial rally Friday. The Citi intervention could push that rally further. Just remember that nowadays, a "substantial rally" in percentage terms that would have historically taken weeks or months to play out can now occur, and potentially be over and done with, in a matter of hours.

THE CITIGROUP DEAL Our initial take on the term sheet for the Citigroup intervention announced last night is that, thankfully, it is not the kind of punitive wipeout of shareholder value that characterized the government interventions in Bear Stearns, Fannie Mae, Freddie Mac, Lehman Brothers, Merrill Lynch, AIG, Washington Mutual and Wachovia, all of which ultimately served to worsen the banking crisis they were intended to resolve (see "Death by Rescue" November 17, 2008). Instead, the Citi deal is in the generous spirit of the capital investments in banks made in mid-October under TARP (see "At Last: A Bail-out That's a Bail-out" October 14, 2008).

The Treasury's $20 billion perpetual preferred stock investment in Citi bears an 8% dividend, no redemption premium, and 10% warrant coverage at a strike-price considerably out of the money. That implies an 8.47% per annum cost of capital for five years (excluding the value of the zero redemption premium). That's slightly higher than the 6.8% cost of the $25 billion Treasury investment in Citi and eight other banks announced in mid-October. But it's still a below-market cost of capital for Citi, benchmarked against the 17.8% charged Goldman Sachs by Berkshire Hathaway in late September.



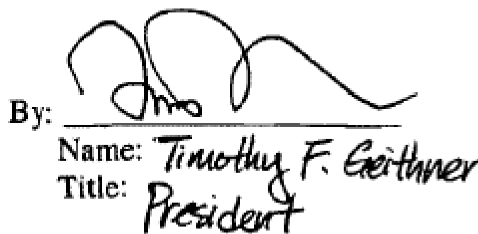
The deal also includes what amounts to a put-spread against losses in a $306 billion mortgage-backed securities portfolio. Specifically, the government will cover 90% of $15 billion in losses beyond the first $29 billion, up to $44 billion. In exchange for this protection, Citi issues to the Treasury and the FDIC $7 billion in preferred stock on the same dividend, redemption and warrant terms as described above. Based on our quick-and-dirty estimate, Citi is buying protection at about fair value.

Finally, the deal includes funding from the Fed for the remaining $262 billion of portfolio value with a 90% non-recourse loan priced at OIS plus 300 bp. Here, too, based on our quick-and-dirty estimate, Citi is buying protection at about fair value. As a separate matter, we do not know yet how or when the Fed intends to fund this $262 billion loan. Absent the Treasury's renewal of its Special Financing Account, or the Fed's ability to attract the deposit of excess reserves, the Fed will have to simply print the money (see "Deflation Takes Center Stage" November 19, 2008).

There will be debate about whether this intervention is big enough to stabilize Citi's enormous balance sheet. But at the very least, this move buys Citi a great deal of time, and on terms that will themselves not further destabilize the bank. And the government has now sent an unmistakable signal that it will do whatever it takes to backstop systemically important institutions, and on terms that don't destroy them in the process of saving them. In that sense, the crisis of Citi has been a critical test, and one that has been passed successfully. It seems that the Treasury, the Fed and the FDIC have learned that the punitive interventions of the past don't work -- that a bail-out, in order to be a bail-out, must be a bail-out. A big question remaining is whether other banks will request assistance similar to that just given to Citi -- and how much panic they engender in the process of requesting it. If that happens, Treasury still has $35.5 billion remaining in the first $350 tranche of TARP that can be invested without additional Congressional approval. And the Fed's checkbook is, as always, infinite.

A TECHNOCRAT FOR TREASURY It seemed on Friday that the announcement of Timothy Geithner for Treasury secretary is what catalyzed the dramatic late-session rally. For us that's credible, given that naming Geithner removes a considerable uncertainty from a very risky political environment. The most salient thing about Geithner is that he represents strong continuity with Henry Paulson in the administration of the Treasury's role as a safety net for the banking system. As president of the New York Fed, Geithner was a key player in all the government interventions in faltering financial firms, starting in March with Bear Stearns. Some combination of Paulson and Ben Bernanke may, in fact, have been calling the shots -- but Geithner was at the head of the negotiating table, and it's his signature that appears on key documents such as the agreement for the New York Fed to acquire, under the guise of a loan, $30 billion of busted mortgage-backed securities from Bear Stearns.

THE FEDERAL RESERVE BANK OF NEW YORK


By:

Name: Timothy F. Geithner

Title: President

We believe that most of the interventions with which Geithner was involved made matters worse, not better. And they exceeded, or at least severely strained, the statutory limits of what the Fed may do, and they compromised the Fed's independence by making it an instrument for Treasury policy. But the good news is that markets can hope that Geithner, like Paulson, has learned from the misadventures with Bear, Lehman, AIG and others. And based on his rocky past in these matters, Geithner is likely to feel especially on the hook for successful outcome of future interventions. He's far preferable to someone who has had no hands-on experience with these interventions, and about whom the market has no sense of what to expect when and if further banking emergencies arise.

Also on the plus side, Geithner is definitely not an overt liberal ideologue like say, Robert Rubin, and that is a relief for markets braced for anti-growth policy initiatives from the Obama administration (see "Bearack Obama" October 31, 2008). He is not a partisan, having served in

various Treasury capacities in every administration from Ronald Reagan to George W. Bush. Geithner has no Wall Street background, unlike say Paulson or Rubin. And he is not an academic economist like say, Lawrence Summers, having only a masters degree in international economics, not a doctorate. He is a seemingly neutral career technocrat, and in a period where market structure and regulation take center stage, that may not be too bad a thing.

BOTTOM LINE: Treasury, FDIC and the Fed have extended the safety net for Citibank, proving that no systemically important institution will be allowed to fail -- and that the rescue will be on terms that don't wipe out shareholder value. Geithner at Treasury represents both continuity with this rescue regime, and partisan neutrality on growth policy. These are positives for deeply undervalued stocks, looking for any sign of certainty as a catalyst for some recovery.