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MACROCOSM

Brace for Another TARP Debate

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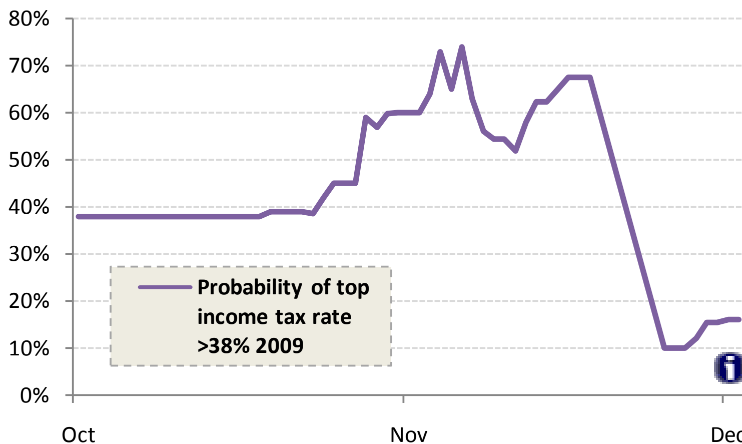
The rescues are working, and Obama moves to the center -- but the Big Three are going to re-open the wounds to market confidence.

In most ways the political risk picture has improved dramatically in the last two weeks, and that ought to help stocks to stabilize and work higher -- especially as the equity risk premium is now greater than at almost any time during our lives. Cutting against that is the uncertainty generated by the near-exhaustion of the first $350 billion authorized for the Troubled Asset Relief Program (TARP), aggravated by the prospect of a public horror-show designed to coerce Congress into funding the Big Three automakers -- perhaps tapping TARP to do it.

Update to strategic view
US STOCKS: Some political risks have markedly improved, and the equity risk premium is near once-in-a-lifetime highs, offering an extraordinary incentive for bearing uncertainty. But stocks will now be tested by a new round of political risk as the first tranche of TARP nears exhaustion, and the second tranche gets put in play by the Big Three automakers.
[see Investment Strategy Dashboard]

FIRST, GOOD NEWS ON OBAMA Since election day, president-elect Barack Obama and his transition team have consistently surprised on the upside in economic policy. This militates against one of the key dynamics of the present bear market, which developed as Obama arose as a uniquely charismatic political figure, threatening to usher in a tide of anti-growth policy (see, earliest, "Obamanation" February 5, 2008).



- The Obama economic team has been staffed with sensible centrists, not populist ideologues. Most important, Tim Geithner as Treasury secretary represents continuity in the execution of bank rescues -- and the preservation of valuable knowledge about what works and what doesn't, acquired on-the-job.
- It is now likely that Obama will not seek to repeal the 2003 tax cuts

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prior to their 2010 sunset. According to the online political futures contracts traded at Intrade, the probability of the top personal income tax rate rising above 38% in 2009 -- that is, the early repeal of the 2003 tax cuts -- has fallen to about 15%, from as high as about 75% on election day.
- Obama has abandoned his intention to create a $1000 per household energy subsidy, funded by a tax on the domestic oil industry that would have effectively eliminated its profits.

These policy shifts may be no more than grudging concessions to the rigors of recession, but they are nevertheless positive developments. And at the same time, yesterday's decisive victory by the Republican candidate in a Georgia run-off election makes it impossible for the Democrats to achieve a filibuster-proof majority of 60 seats in the Senate. So at the least, the very worst policy risk is off the table for now.

SECOND, THE GOOD NEWS ON BANK RESCUES We continue to believe that the Capital Purchase Program under TARP, and last week's capital injection and risk guaranty for Citigroup, marked a very positive fundamental turning point in the execution of bank rescues. As the excesses of the housing and credit bubbles began to unwind early this year, the series of misguided government interventions in troubled financial firms -- Bear Stearns, Fannie Mae, Freddie Mac, Lehman Brothers, Merrill Lynch, AIG, Washington Mutual and Wachovia --unintentionally created irresistible disincentives to equity ownership, eventually turning the unwind into a prolonged financial panic (see, earliest, "Bernankruptcy" March 17, 2008; and comprehensively, "Death by Rescue" November 17, 2008). That changed with the advent of the Capital Purchase Program, in which the intervention served, for the first time, not to *destroy* equity value in the target firms but rather to *enhance* it (see "At Last: A Bail-out That's a Bail-out" October 14, 2008). With the extremely equity-friendly intervention in Citigroup, it is entirely plausible to think that a very positive pattern has been firmly established, indicating that the Treasury, the Fed and the FDIC have learned from their mistakes (see "Another Rescue, A New Rescue Ranger" November 24, 2008). Will another big bank need help like Citi? Perhaps, and that's not a good thing. But now there's good reason to expect that such a bank would be *saved* in its time of need, not *destroyed*. That's a very significant positive change from the pattern that prevailed from March to September, and we don't think that the market has fully taken cognizance this good news yet.

More on the Citi rescue

The ambiguous publicly disclosed terms of the Fed's backstop of the residual risk of Citi's $306 billion MBS portfolio turn out to be even more generous than we initially understood. According to sources, the Fed's non-recourse funding of the portfolio, and the low fee Citi must pay for it, won't kick in until and unless losses are experienced. That means it amounts to a standby agreement at no cost -- for Citi, it's a free call on a cheap put.

THE BAD NEWS: RESCUE RISK REMAINS Then again, maybe markets have moved on to new worries. The fly in the ointment now is that the Treasury's initial $350 billion authorization under TARP is now almost exhausted, with just $15.5 billion remaining. That's still a lot of money -- enough to do one more rescue about two-thirds the size of last week's

enormous Citigroup deal. But it's discomfiting for markets to think that Henry Paulson is nearly out of bullets. To reload, Treasury must request that Congress authorize a second $350 billion, which is automatically granted unless Congress specifically rejects it within 15 days. Reportedly, Paulson is hesitant to make the request. He believes that a majority of Republicans in the House would reject it outright (just as they voted against the original legislation in October), and that Democrats would insist that the funds be used for mortgage foreclosure relief and other purposes that Paulson opposes. The Obama team reportedly is unlikely to endorse another $350 billion blank check for Paulson. While key team-member Geithner represents continuity and experience in rescues, that doesn't mean that he would support a blank check either, especially since every dollar Paulson puts to work in his six weeks remaining in office is a dollar that won't be there for Geithner. And we don't know where Geithner stands personally, but we do know from sources that the Fed in general has looked very unfavorably on some of Paulson's rescue initiatives -- especially the ill-fated "super-SIV" -- and various Fed players have been repeatedly annoyed by the aggressive and unilateral style of Paulson and his staff.

Paulson knows he is in a weak position to argue authoritatively for or against any particular use of the funds, because -- of necessity, and we think ultimately for the good -- he has had to improvise a great deal so far, not using the funds in the manner he himself so strongly advocated when the legislation was first being debated. So Paulson must feel he is torn between two alternatives, neither of which is good for market confidence. He can expose markets to the risk of his being nearly out of bullets, or he can expose markets to a rancorous public debate and, possibly, outright rejection of the second $350 billion.

Even if Paulson demurs, there will be a rancorous public debate on TARP, instigated by the Big Three automakers' insisting that their very survival depends on government assistance by year-end. In submissions filed with Congress yesterday, Ford is not asking for any immediate funding to meet urgent liquidity needs, but General Motors is asking for $4 billion and Chrysler is asking for $7 billion. Together, at $11 billion, this would consume almost all that remains in the initial TARP authorization -- so we expect that Paulson intends to leave such funding to Congress. But as Congress considers it -- and the Big Three's larger purported needs beyond immediate liquidity -- the debate will inevitably turn to TARP as a potential source of funds. Paulson and Geithner will surely be drawn in, whether or not they wish to be, and the future of TARP will be up for grabs.

Markets will have to endure the fact that TARP is going to be put into play. And they will have to suffer through the same orgy of fear-mongering that characterized the initial debate over TARP, and last month's debate over bailing out the Big Three. Just when so much in the policy domain that was so bad has turned out so well, markets are going to be exposed to considerably more uncertainty. But then again, that's what a once-in-a-lifetime equity risk premium is for.

BOTTOM LINE: Some political risks have markedly improved, and the equity risk premium is near once-in-a-lifetime highs, offering an extraordinary incentive for bearing uncertainty. But stocks will now be tested by a new round of political risk as the first tranche of TARP nears exhaustion, and the second tranche gets put in play by the Big Three automakers.