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# Testing the Safety Net

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**Another bank crisis is brewing, there's no Treasury secretary, and Congress and Obama spar over TARP.**

The "new bull market" for stocks that began from the November lows -- if, in today's climate of volatility, an upmove of 24%-plus even deserves that designation -- is being severely tested. We think it's only in part due to the continued outpouring of negative economic data. Other than this morning's retail sales report, which came in worse than expected, it seems that the forecasting consensus has finally begun to anticipate how bad the numbers are going to be. Instead, the key to understanding the larger part of the stock market's decline may be to recognize that it began the very day the 111th Congress convened, and from the first moment set about sowing uncertainty about the continuity of the federal government's commitment to effectively backstopping the banking sector. Leaders of both parties in Congress have been heaping abuse on Henry Paulson for everything that has been good about his implementation of TARP -- the generosity of the terms of the government's capital investments in banks, and the speed and flexibility with which Treasury has been able to act. And with Timothy Geithner's confirmation in doubt, it seems Obama will take office without a Treasury secretary.

| Update to strategic view |
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| **US FINANCIAL STOCKS:** It's a test of the November lows, and perhaps another bank crisis to a test the incoming Obama administration's commitment to bank rescues that don't disincentivize equity investment. Tim Geithner's confirmation has been put into play, and beyond that we don't know yet the extent to which the administration will have to bow to anti-bank populist impulses in the Congress. Values in the financial sector are beginning to be extremely attractive again, so favorable resolution of these political uncertainties has considerable upside potential. |
| [see Investment Strategy Dashboard] |

Considering the absolutely critical importance of stabilizing the banks, and the fact that the government's botched interventions through last September contributed so much to destabilizing them in the first place (see "Death by Rescue" November 17, 2008), the stock market has little choice now but to test the government's conviction. The only way to do that is to edge toward another crisis. The turnaround in stocks last November came when the Citigroup crisis proved the government's commitment to rescuing banks on terms that didn't wipe out equity investors (see "Another Rescue, A New Rescue Ranger" November 24, 2008). Do we have to go through that again, this time with Bank of America? Or will it be Citi one more time?

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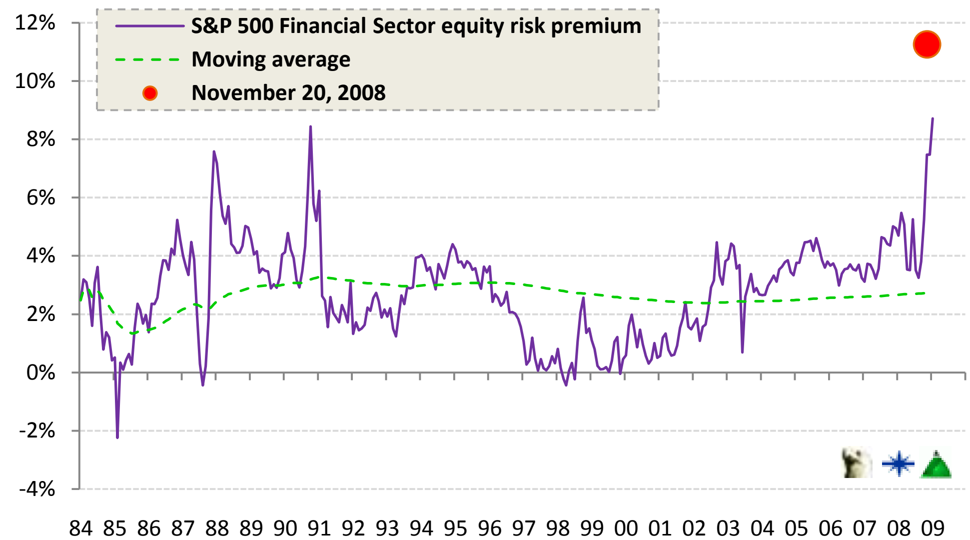
The incoming Obama administration is trying to get into position for a successful test, or ideally to make the test unnecessarily in the first place by bolstering confidence in its readiness. On Monday, operating through the incumbent Treasury staff, the Obama administration started the process for authorization of the second of two $350 billion spending authorities under TARP (see Treasury's Section 115 Report on our Client Resources page). Yet while it inspires confidence to see this kind of support structure being put in place, at the same time it can't help but erode confidence that the authorities must believe it is necessary. An accompanying letter on Monday to Congress from Lawrence Summers, Obama's appointee to head the National Economic Council, had the disturbingly alarmist tone of Henry Paulson during the legislative fight to enact TARP, saying the situation is "imminent and urgent" (see Summers' letter on our Client Resources page). Yesterday President-elect Obama underscored the importance of getting this authority by telling congressional Democrats that he would veto any bill blocking it (under the TARP legislation, the authority is granted unless it is blocked).

So as a first order matter, we know that the Obama administration is strongly committed to a continued bank backstop -- and that's good, if at the same time worrisome that it is necessary at all. What we can't be certain about, and what the markets may need to test here, is whether the new administration will be committed to doing it right. In our view, doing it right means the government living up to its long-standing explicit and implicit commitments to systemic stability in a way that does not punish the very institutions it is purporting to stabilize, inadvertently creating a disincentive to private sector equity investment in banks (again, see "Death by Rescue"). We think Paulson, Ben Bernanke and Geithner came to understand that, as evidenced by the generous terms of the Capital Purchase Program under TARP (see "At Last: A Bail-out That's a Bail-out" October 14, 2008). And we think that Obama intended to signal continuity with that approach by nominating Geithner for Treasury secretary (again, see "Another Rescue, A New Rescue Ranger").

But now the Senate's confirmation of the Geithner nomination is in doubt, due to minor tax and household employment infractions. Obama will likely take office without a Treasury secretary, raising serious issues about the administration of TARP in an emergency. And even if he is confirmed, we won't know until and unless a crisis is upon us to what extent the Obama administration will have to bow to the Congress's populist bent. It is not possible to shore up capital-constrained banks and, at the same time, do what the Congress would seem to require, based on statements of legislators like Barney Frank -- that banks loan out any new capital, and allow their portfolios to be destroyed by arbitrary mark-downs of secured mortgage debt by bankruptcy judges. Summers' letter to Congress isn't dispositive. On the one hand, apparently recognizing the counterproductive pre-TARP interventions, he says "our actions must always support, rather than impede, the orderly restructuring of our financial system." Yet when he refers to "the failures of the past" he could just as likely be talking about what he says has been "too much upside for shareholders." But then again, he talks of the need to "maximize the role of private capital."

We've been bearish on the financial sector for a long time, arguing that even when the current difficulties have passed it will have a difficult time producing earnings growth (see, for example, "Subprime Lending Was Their Best Idea" June 4, 2008). And through most of the bear market from October 2007, market caps in the sector had just tracked forward earnings lower, thus not opening up the outstanding equity risk premium found in most other sectors. That changed in November in the Citi crisis, when finally the equity risk premium in the financial sector expanded, even exceeding its early 1990s peak at the climax of the savings and loan debacle. We wrote then, assuming correctly that the Citi crisis would resolve favorably, "for the first time in this bear market one can bottom-fish in this sector with a straight face" (see "At Least They're Cheap" November 20, 2008). As of this writing mid-day, the financial sector is still ahead 12%

from its November lows. We're glad of any gains, but at the same time that means that values today aren't at the extreme levels we saw in November. But excluding the November peak, they're still at the best levels seen in 25 years. As each day drags on with no certainty on this, the odds of a violent test of the lows for the sector can only increase. Any emanation from the incoming administration or the Congress that would seem to favorably clarify the government's rescue philosophy -- for instance, an indication that the confirmation of Geithner is likely to proceed -- could catalyze a powerful reversal to the upside.




**BOTTOM LINE:** It's a test of the November lows, and perhaps another bank crisis to a test the incoming Obama administration's commitment to bank rescues that don't disincentivize equity investment. Tim Geithner's confirmation has been put into play, and beyond that we don't know yet the extent to which the administration will have to bow to anti-bank populist impulses in the Congress. Values in the financial sector are beginning to be extremely attractive again, so favorable resolution of these political uncertainties has considerable upside potential.