Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MACROCOSM

Passengers Survive, But Plane Sinks

Friday, January 16, 2009

Donald Luskin

Saving the banking system won't make big banks into interesting businesses.

Another flight from New York to Charlotte has crash-landed in freezing water -- Merrill Lynch's acquisition by Bank of America. The good news is that rescue efforts have been deployed, and there will be no fatalities. But that plane will never fly again.

Results from Bank of America and Citigroup this morning are horrible, confirming that the strategic prospects for such megabanks remain dismal, no matter how many rescues are mounted, and no matter how they may try now to shrink their way to greatness (see "Subprime Lending Was Their Best Idea" June 4, 2008). But this week's panic in bank stocks has also been about uncertainty about whether and how the government's safety net under the banking system will operate going forward, under a new administration and with a new Congress (see "Testing the Safety Net" January 14, 2009). With yesterday's Senate vote extending TARP authority by another $350 billion, and the announcement of aid to Bank of America on terms similar to those granted Citigroup in November, at least that concern can to a large extent be put to rest.

Update to strategic view
US FINANCIAL STOCKS: With the government safety net under the banking system extended with relatively few strings attached, a fundamental risk is taken out of play. Markets are focusing now on the ongoing strategic impairment of the big banks, which no safety net can make go away. But with the equity risk premium in the financial sector approaching the highs of November, bottom-fishing here may yet be a profitable short-term game.
[see Investment Strategy Dashboard]

The second $350 billion in TARP authority comes with more strings attached than did the first $350 billion. A letter yesterday from Lawrence Summers to Congress outlined the incoming administration's undertakings, including the allocation of $50 to $100 billion to foreclosure mitigation, and somewhat more rigorous controls on executive compensation, dividends and acquisitions. Presumably all this was required to secure the defeat of a Senate resolution to block the new TARP authority. We would have liked to see no strings attached, but we see these conditions as more cosmetic than substantive. Similarly, the aid to Bank of America is on slightly less generous terms than those extended to Citigroup in November. But all in all, the signal from the Obama administration -- whom we see as the driver of all this now, even though it has had to work through the Paulson

Key documents
Bank of America term sheet Summers' January 15 letter
From our Client Resources page

Treasury -- is that there will not be a return to the punitive interventions that so destabilized markets and the economy last September (see "Death by Rescue" November 17, 2008).

At mid-morning today, with this mix of bad news and good news, we are surprised to see bank stocks trading sharply lower. We would have expected that Bank of America's and Citi's results would have been more a purgative than a depressant. And with the confirmation of the presence of the government safety net, and the wide equity risk premium in the financial sector generally, we expected an upside reaction that would last longer than the few minutes following this morning's opening. That may yet happen as all this is digested, and bottom-fishing into this reaction is an intriguing short-term game. But we reiterate our oft-repeated caution that even with systemic risk contained, the banking sector's business model is fundamentally broken, lacking any clear path to earnings growth after stability has been achieved. A safety net is an urgently important thing, but it is *only* a safety net -- it's not a way to generate earnings.

BOTTOM LINE: With the government safety net under the banking system extended with relatively few strings attached, a fundamental risk is taken out of play. Markets are focusing now on the ongoing strategic impairment of the big banks, which no safety net can make go away. But with the equity risk premium in the financial sector approaching the highs of November, bottom-fishing here may yet be a profitable short-term game.