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

MACROCOSM

Rescue Remix

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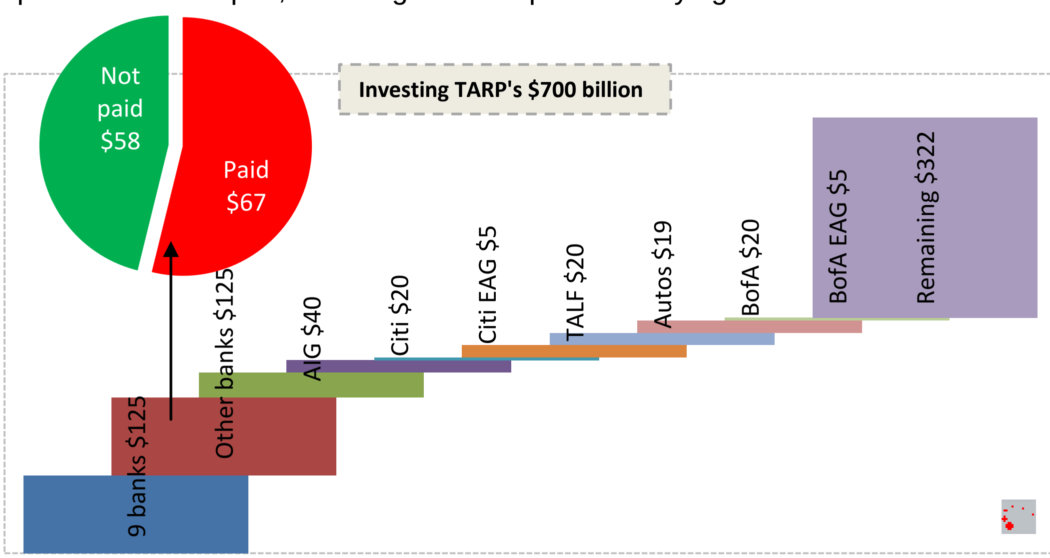
Donald Luskin

We're testing the lows as, once again, government rethinks its approach to bank rescues.

Update to strategic view
US STOCKS: Stocks are testing the November lows. They're so cheap at those levels, we expect success -- but it will depend on resolution of the seemingly endless political bail-out game. **GOLD:** The Fed's already huge balance sheet is the focal point of both deflation-fighting and toxic asset clean-up. Gold should continue to be strong as it looks far forward to the ultimately inflationary resolution of the banking crisis.
[see Investment Strategy Dashboard]

It seems now we're pretty much destined to test the November lows for stocks. As bank earnings experience more stress around the world, what should have been an affirmation of stability and continuity -- the extension of TARP rescue authority, and federal aid to Bank of America on terms similar to that given Citigroup (see "Passengers Survive, But Plane Sinks" January 16, 2009) -- has quickly degenerated into a confidence-crippling free-for-all of policy options set amidst a chorus of political bank-bashing. Once again, investors are facing tremendous uncertainties not only about the intrinsic risks in the banking sector world-wide, but also about how the US government might enact yet another improvised intervention in it. The political backdrop raises the specter that such intervention may be more punitive than helpful, reverting to the capital-destroying mode of the interventions that induced so much instability last September (see "Death by Rescue" November 17, 2008).



With the second $350 billion of TARP authority released by Congress,

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

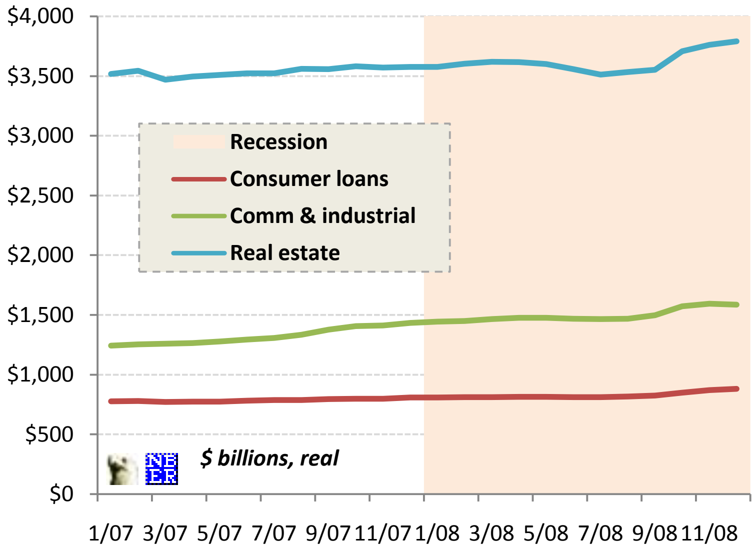
there's now enough money for the Treasury to simply make a tender offer to acquire total common equity ownership of the top 12 banks by market capitalization at Friday's closing prices (including Morgan Stanley and Goldman Sachs), with $14.5 billion left over -- indeed, with even more left over after this morning's carnage. That would take current common equity-holders out at market-determined fair value, and from there *the whole system becomes the "bad bank,"* with government responsible for all its risks. Current management could stay on as "dollar-a-year men," and be awarded the Medal of Freedom when things eventually stabilize and the banks are restored to private hands. We don't relish the idea of government asserting eminent domain over virtually the whole banking industry, but at least this way we'd have done with it, and at least the government would have paid "just compensation" for this "taking" (to use the language of the Fifth Amendment to the US Constitution). Is there a simpler way to simultaneously end uncertainty both about the banking system itself *and* about what the government will do with it?

A radical thought experiment to be sure, and admittedly not really as simple as we make it sound. But it might be preferable to the endless politicized debate about how to use government money to both bail out and control the banking system while it remains predominantly in private hands. No sooner had Congress released the second $350 billion in TARP authority, and Treasury, the Fed and the FDIC jointly announced assistance to Bank of America under substantially the same template that had been in November with Citigroup, then press reports started to appear to the effect that the government was rethinking everything from scratch. There was talk of creating an "aggregator," a "bad bank" or a "government bank" to buy up the deteriorating risk-assets from the banking system -- a new vocabulary for describing exactly the same plan originally underlying TARP, when it was enacted in October. Its attractions are clear enough -- if impaired assets could somehow be taken off bank balance sheets once and for all, then there'd be no more negative surprises, and no need for additional capital injections to cover losses. And in one important sense, government is the ideal buyer of these assets -- its infinite investment horizon and extremely diversified asset and income portfolio make it the best bid for almost *any* asset (see "It's Not the RTC -- It's a $700 Billion LBO" September 22, 2008). But this approach was ultimately discarded as too complex, too slow and insufficiently leveraged, and was replaced by direct capital injections (see "At Last: A Bail-out That's a Bail-out" October 14, 2008).

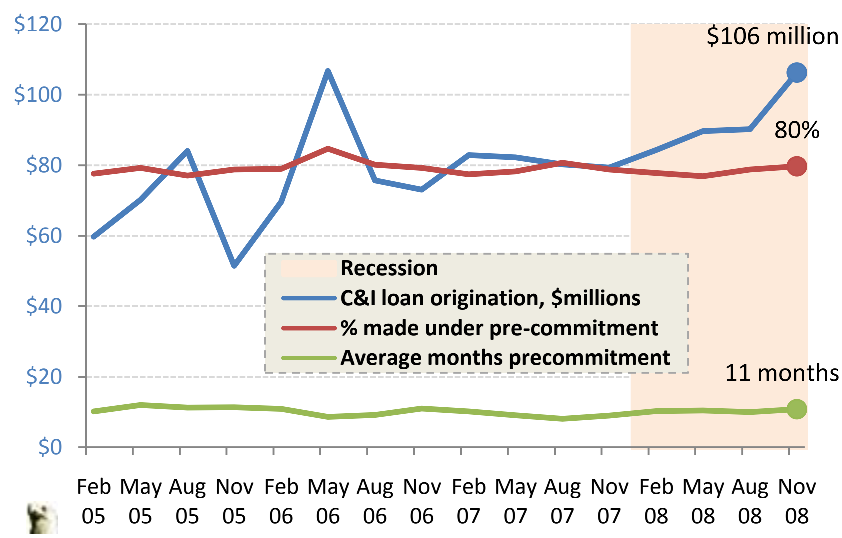
Everything that was wrong with buying troubled assets in October is still wrong with it now, but it's in play again nevertheless. Its major exponent seems to be the FDIC's Sheila Bair, whom our senior contacts at the Fed and the Treasury regard as something of a loose cannon, willing to roil markets by going to the press to promote her pet ideas as though they represented a consensus of the relevant regulators. So we somewhat discount her statement in a *Wall Street Journal* interview on Friday that "It's beyond hypothetical… I think we would all like to have something in place in the not too distant future." As Bair conceives it, it really is a harebrained plan. She told the *Journal*, "Financial institutions that wanted to sell assets into the bank could also perhaps take part of their payment as an equity interest in the aggregator bank to provide an additional cushion. If you sold $1 of assets into the bank, you would get 80 cents in cash and you would get 20 cents in an equity interest in the bank." How would it be an "additional cushion" for you to take, instead of cash, an interest in a bank that holds nothing but toxic assets that you just sold?

But Bair's is not the only voice. The same "bad bank" concept was mentioned early last week in a speech by Ben Bernanke, so we certainly don't rule out that it's actually dominating the government's current thinking. In fact, the idea may have its best possible realization in Bernanke's hands. If the Fed were to be the institution that bought the impaired assets, then we could kill two birds with one stone -- the assets would be taken off the bank's balance sheets, and the Fed would have bulked up its firebreak against the risk of monetary deflation. The strong recovery in the price of gold Friday as policy chaos re-emerged, and today on dismal banking news from the UK, may be a hint that such a thing is not too far-fetched to imagine (see "Why Isn't Gold at $1500?" December 10, 2008).

A dangerous current underlying all this is the new bank-bashing narrative that banks are misusing the capital they've received under TARP. A *New York Times* story on Sunday captured it perfectly -- headlined "Bailout Is a Windfall to Banks, if Not to Borrowers," the idea is that banks are not using the government money to make loans, but rather to make acquisitions or simply strengthen their capital positions. This amounts to an abuse of TARP, because as the *Times* story says, "Congress approved the $700 billion rescue plan with the idea that banks would help struggling borrowers and increase lending to stimulate the economy…" Two members of the Obama administration picked up this theme the same day with a somewhat threatening tone, with Lawrence Summers saying on *Face the Nation* that banks receiving government capital would be "expected to lend above their baseline levels"., and David Axelrod saying on *This Week*, "We don't want them to sit on any money that they get from taxpayers."



There is the risk that this amounts to bank-bashing, and aggravates the market's already strong concerns about the anti-business bias of the Obama administration -- or its power to rein in such impulses in the heavily Democratic Congress. Increasing lending was not mentioned among the enumerated "Purposes" of the legislation enabling TARP, so the idea that banks aren't lending money they got from the government is a poor rationale for judging TARP a failure, and necessitating an entirely new and more coercive approach. And besides, it's not true that banks aren't lending. According to the weekly statistics on commercial banks' loans and leases published by the Fed, real estate, commercial and industrial, and consumer lending has been gradually growing throughout the present recession. To be sure, other non-bank credit channels have become deeply impaired, and the gentle growth in bank loans may not be taking up the slack. But the claim that banks are not lending is simply false, and any new government strategy designed to punish them for hoarding their lending capacity -- or forcing on them an "industrial policy" of accelerated lending, whether or not it is prudent or even demanded by the market -- is entirely inappropriate.



By the way, we have heard many times in conversations with investors that the growth in commercial and industrial lending is something of an illusion, as it is merely the draw-down of lines of credit committed long ago when lending was more generous -- thus it does not reflect current credit conditions. In point of fact, as the chart on the previous page shows, the Fed's quarterly survey of the terms of business lending reports that the fraction of commercial and industrial loans made under previous commitments has been no greater during this recession and credit crisis than it has at any other time in the past few years.

The ink is still wet on the government's capital injection in Bank of America, and there's talk of a completely different template for government bank assistance. TARP is deemed a failure half-way through the program because banks aren't lending, when increasing lending was never the purpose of TARP -- and in fact banks *are* lending. At the same time, there remain very serious risks to the balance sheets of many large banks. Until the government's thinking stabilizes, we can't expect much stability in the financial sector or stocks overall. As we've said before at similar junctures, at least they're cheap (see "At Least They're Cheap" November 20, 2008).

BOTTOM LINE: Stocks are testing the November lows. They're so cheap at those levels, we expect success -- but it will depend on resolution of the seemingly endless political bail-out game. The Fed's already huge balance sheet is the focal point of both deflation-fighting and toxic asset clean-up. Gold should continue to be strong as it looks far forward to the ultimately inflationary resolution of the banking crisis.