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# Unknown Unknowns

Friday, January 30, 2009

**Donald Luskin**

**Stocks are trying to bottom, but it all depends on the new administration's bank policies.**

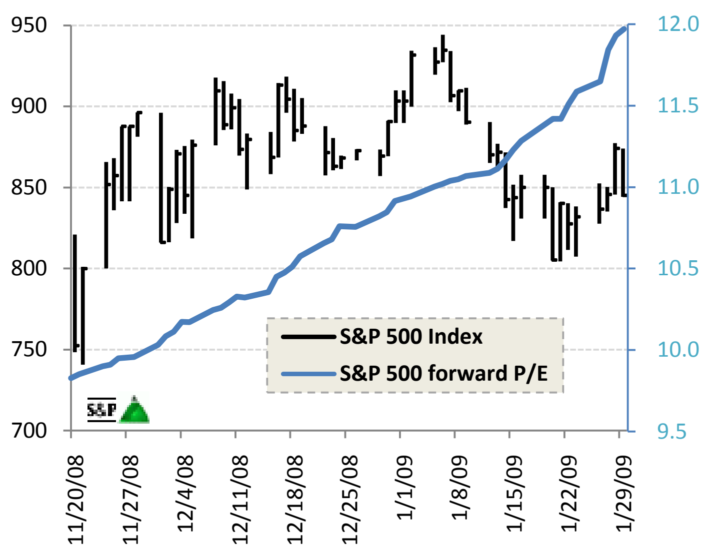
**Update to strategic view**

**US STOCKS:** We have the first "bottom above a bottom" in this bear market. With forward earnings falling, this represents a notable multiple expansion, demonstrating the return of the market's capacity to put money at risk. Further recovery depends on the Obama administration's assurances that its bank intervention policies will not be equity-punitive.

[see Investment Strategy Dashboard]

Stocks continue to flail, awaiting clarity on the one thing that really matters -- how the Obama administration intends to proceed in its support of the banking sector. In the meantime, as we had expected, stocks tested the November lows -- and so far, as we had hoped, they seem to have found support at a higher level (see "Rescue Remix" January 20, 2009). This marks the first time in the bear market from the top in October 2007 that stocks have been able to establish a notable "bottom-above-a-bottom" pattern.

Last week's secondary bottom, if it holds, would be all the more notable for fact that forward earnings have fallen by 17.6% since the primary bottom in November -- the largest drop a single two-month period since 1921. To track that, the S&P 500 ought to have fallen through the 750 November low to about 620. That it did not -- last week's low was at 805 --




implies that investors are willing now to pay more dollars for less earnings than they were two months ago. In other words, multiples have expanded. Or more broadly, the market's willingness to put money at risk has begun to improve. We see the same thing in numerous credit market spreads, and taken together these are tangible signs that the vicious cycle of global economic contraction has started to slow.

The bottom last week was catalyzed by the rescue of Bank of America on equity-friendly terms (again, see "Rescue Remix") similar to the terms for Citibank's

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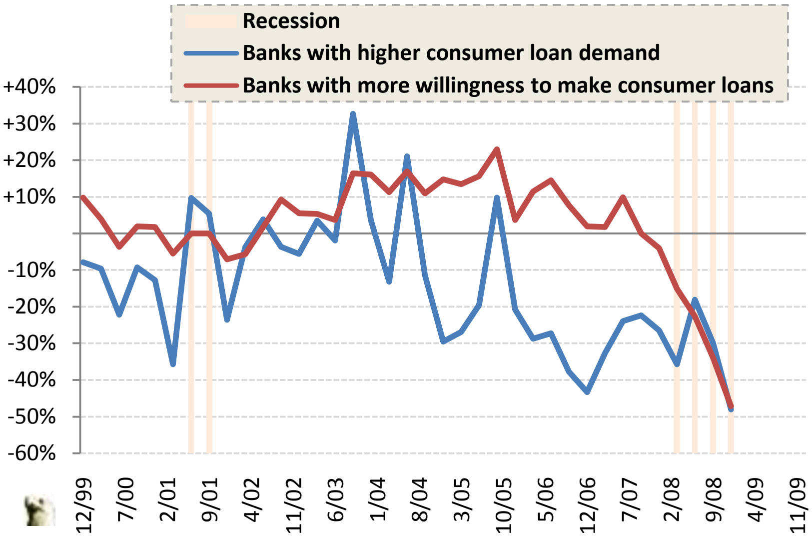
rescue in November. Remember, the generous Citibank rescue, and the nomination of Tim Geithner for Treasury secretary -- the man most likely to bring generous rescue policies forward into the new administration -- marked the primary bottom in November (see "Another Rescue, A New Rescue Ranger" November 24, 2008). For the recovery implied by the rising bottoms pattern from November to January to continue, nothing is more critical than that Geithner deliver on the continuation of those policies, and not return to the equity-punitive interventions of last September -- which more than any other single factor were the catalyst for today's global recession (see "Death by Rescue" November 17, 2008). With that in mind, we consider it fortunate that Geithner was confirmed by the Senate, despite his embarrassing tax issues. Doubly so, in fact -- if we can't have a tax-cutter for Treasury secretary, at least we can have a tax-evader. Seriously, though, all the regrets he expressed to the Senate Finance Committee about tax matters surely apply even more deeply to his key role in last year's deadly bank interventions -- of all the people who might have taken the Treasury secretary role for the Obama administration, he and he alone has learned on the job, he alone knows exactly what *not* to do.

The administration's statements about what it *will* do are vague, and press reports are all over the lot. It seems that many alternatives are under consideration, and that ultimately policy may not focus exclusively on any single one of them. But the *tone* coming from the administration is quite encouraging. Suddenly, gone are the warnings of "economic catastrophe," the claim of "imminent and urgent" need, and the plan to get "tough" with banks, found in Lawrence Summers' January 12 letter to Congress seeking extension of TARP's spending authority. Now, instead, comes a chirpy Treasury press release announcing TARP's funding of 23 "healthy local banks," to aid them in "increasing the flow of financing available to small businesses and consumers" -- complete with a glowing testimonial from the CEO of the United Labor Bank who, with $5 million from TARP, plans to lend $50 million. The new tone seems to be more about *stimulating* the credit system, rather than *saving* it -- and most important of all, rather than *punishing* it.

There is already a template for moving forward that is nearly perfect. And it avoids the enormous Treasury-funded acquisition costs of the "bad bank" idea (which Charles Schumer asserts could be as much as $4 trillion; Goldman Sachs reportedly says $5 trillion). For Citigroup and Bank of America, the Fed has written an "eligible asset guarantee" -- what amounts to low-cost standby agreement for a non-recourse loan against more than $350 billion in toxic assets, not triggered unless and until those assets in fact show a loss (see the Citi and BofA EAG term sheets, from our Client Resources Page). Why seek Congressional approval to issue Treasury debt to acquire such assets, using dubious auction and pricing processes, when with no approval at all, and nearly process-free, the Fed can simply guarantee them? In a nutshell, who needs a "bad bank" when the Fed already *is* one?




Whatever approach is taken, the goal now seems to be the oft-repeated mantra to "get banks lending again." But this should be understood as only a crude symbol of a deeper goal. As we've pointed out, bank lending is, in fact, already growing in real terms, while in most recessions it shrinks (again, see ["Rescue Remix"]). And even if that's not enough, if banks ought to be lending even more given what's happened to non-bank credit markets, it's by no means clear that the problem is the unwillingness to lend. The same surveys that show lending officers tightening their credit standards also show sharply falling *demand* for loans. The idea here is to eliminate the crippling risk aversion that has browned out the power-grid of credit world-wide (see ["Is This a 'New Era' Recession?"] December 29, 2008).

MIT economist Ricardo Caballero usefully characterizes the current economy as beset not by risk in the usual sense, but instead by "Knightian uncertainty" -- referring to the pathbreaking work on risk by Frank H. Knight in the 1920s. Caballero convincingly argues that the private sector doesn't have the capacity to insure itself against "unknown unknowns," to use Donald Rumsfeld's notorious phrase. When faced with them, it has no alternative but to shut down, and in so doing it self-fulfills its worst fears. So it is an appropriate role of government to create the insurance against "unknown unknowns" that the private sector cannot, and thus re-enable feasible risk-taking in the face of garden-variety "known unknowns." We risk repeating ourselves on this point, but it is the essence of the moment and it must be understood -- *the worst "unknown unknown" has been government itself in its bank interventions*. Whatever the government does from here, so long as it commits itself to a stable program that rules out outright confiscation, we are likely to experience tangible improvement in investor risk tolerance, and the economy and the markets can right themselves more rapidly than anyone currently expects.

**Recommended reading**

**Clients are talking about:**
*Let's Stimulate Private Risk Taking* by Alberto Alesina and Luigi Zingales
*Animal Spirits Depend on Trust* by Robert Shiller
**We recommend:**
*Fiscal Stimulus, Fiscal Inflation, or Fiscal Fallacies?* by John Cochrane
*A Global Perspective on the Great Financial Insurance Run: Causes, Consequences, and Solutions* by Ricardo Caballero

[Recommended Reading home]

**BOTTOM LINE:** We have the first "bottom above a bottom" in this bear market. With forward earnings falling, this represents a notable multiple expansion, demonstrating the return of the market's capacity to put money at risk. Further recovery depends on the Obama administration's assurances that its bank intervention policies will not be equity-punitive.