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

MACROCOSM

Geithner Gets a Do-Over

Tuesday, March 24, 2009

Donald Luskin

Markets applaud PPPIP, but the Fed signals that enough is enough.

The "tradable rally" we called for two weeks ago (see "Quantum of No Solace" March 10, 2009) continues, with the S&P 500 making it back above the 800 level with a 7.3% one-day gain following the announcement of the Treasury's Public Private Partnership Investment Program. We think the celebration was not so much about the program's particular excellence, but rather the great relief that PPPIP continues the subsidy-driven, non-punitive and non-dilutive template of bank assistance begun by Henry Paulson with TARP's Capital Purchase Program (see "At Last: A Bail-out That's a Bail-out" October 14, 2008). In today's witch-hunt political environment supercharged by the AIG bonus controversy, such a generous program represents an impressive profile in courage for Timothy Geithner and the Obama administration. So it's appropriate that stocks would reprise their reaction on November 21 of last year, when from then-new bear market lows, the S&P 500 surged 8.0% in less than an hour, crossing the 800 level just as it did yesterday, on the news that Geithner was to be nominated as Obama's Treasury secretary (see "Another Rescue, A New Rescue Ranger" November 24, 2008). At last, Geithner has delivered the mature policy continuity that markets signaled they expected of him last November. Hopefully this will rehabilitate Geithner from the status of clown, to which he'd been reduced by a hellish Senate confirmation process, his botched introduction of his Financial Stability Plan (see "Two Strikes for Tim" February 11, 2009), and the AIG bonus controversy. The only quarter from which there came no applause for Geithner yesterday was the Federal Reserve, a matter which we will discuss later in this report.

Update to strategic view

US FINANCIAL STOCKS: PPPIP is an upside surprise in that it follows the subsidy-driven, non-punitive and non-dilutive bank rescue template put in place under Henry Paulson. It demonstrates that Tim Geithner is, after all, an agent of policy continuity, and that the Obama administration is capable of delivering capital-friendly policy. Up almost 60% in three weeks, the "easy money" is out of financial stocks. From here we must assess the extent to which PPPIP will really benefit the banks, and see how the Obama administration handles the witch-hunt over bank compensation.

[see Investment Strategy Dashboard]

We won't rehash the specifics of the three complex interlocking programs that make up PPPIP (all the details can be downloaded from our Client Resources web page). The important thing to know about PPPIP is that it is a subsidy. We don't say that pejoratively. Quite the contrary -- any successful bail-out is necessarily a subsidy, or it won't work. PPPIP subsidizes the value of

Key documents
Treasury press release **Fed press release** **White paper** **PPIP fact sheet** **Legacy securities terms** **Legacy securities FAQs** **Legacy loans terms** **Legacy loans FAQs**
[Client Resources home]

distressed securities in two ways. *First*, it provides leverage to potential buyers who, in an environment of intense credit constraints, can't get leverage any other way -- and wouldn't be interested in these securities on a cash basis. *Second*, through non-recourse financing, it provides insurance against much of the risk of these securities. Taking full advantage of the complex structure of PPPIP, investors can pyramid non-recourse financing to achieve very high degrees of leverage -- and, counter-intuitively, since the financing is non-recourse, the more leverage one uses the less risk one takes. All this should raise the bid under so-called "toxic assets" to the point at which some existing holders will be willing to take their losses and sell them. To that extent, they will have been effectively taken off the books of the banking system and put onto the books of the US government, at least in terms of downside risk.

For banks, that's the extent of what is to be gained from PPPIP -- it remains to be seen whether, at this point, with so many other interventions in credit markets already in place, it will make much of a difference. The big upside, if any, should the toxic assets recover, would accrue mostly to leveraged private investors who avail themselves of PPPIP financing (and the Treasury, to the extent that the structures within PPPIP that involve equity co-participation are utilized). The only way for banks to get any substantial upside would be to use PPPIP financing *themselves* to buy the toxic assets from other banks at the Treasury's risk. One can imagine banks getting together pair-wise to do this -- essentially, to swap toxic assets with each other using PPPIP as a conduit, achieving in the process a free guarantee against the downside while preserving the same upside they had before.

Many commented yesterday that it may be difficult to get private investors to participate in PPPIP, given the government's violation of written bonus contracts with AIG executives (see "Number of the Beast" March 18, 2009), and its imposition of retroactive compensation rules for TARP participants (see "On the New Bank Bonus Restrictions" February 15, 2009). The only comfort specifically given in the Treasury's briefing materials yesterday was the statement that "The executive compensation restrictions will not apply to passive private investors" -- leaving it an open question whether they would apply to entities who sold assets into PPPIP, managed PPPIP funds, or took PPPIP non-recourse loans. A source at Treasury told us yesterday that the restrictions won't apply *at all* to entities involved with PPPIP, unless they applied already by virtue of TARP participation. We are told that Treasury is relying on a legal opinion from the Department of Justice that the restrictions only apply to *dealings with Treasury exclusively*, such as the receipt of capital under TARP. Dealings with Treasury *in combination with other agencies* such as the FDIC or the Fed are exempt.

As we anticipated (see "China Calling" March 17, 2009), PPPIP's non-recourse loan structure is closely modeled on the Treasury/Fed TALF program (see "TALF -- The Fed Gets One Right" March 6, 2009). In fact, the expansion of TALF itself to include legacy RMBS and CMBS securities is the centerpiece of PPPIP. So we found it extremely peculiar yesterday morning that the Fed didn't put out a press release announcing this important change to TALF, or at least put out one jointly with Treasury. It was announced in a press release from Treasury alone.

Then after the close of the market, the mystery was explained by a Fed/Treasury joint press release. Not even mentioning PPPIP specifically, the press release was instead what amounts to a reply to critics -- like us -- who have worried that the Fed is losing its political independence in its many bank rescue operations undertaken with Treasury (see, for example, "AIG: Rescue or Bag Run?" September 17, 2008). Titled "The Role of the Federal Reserve in Preserving

Financial and Monetary Stability," it declared that while the Fed "will continue to use all its tools working closely and cooperatively with the Treasury and other agencies as needed to improve the functioning of credit markets" -- emergency or no emergency -- "loans or securities purchases that influence the size of its balance sheet, must not constrain the exercise of monetary policy."

The Fed is not saying here that it objects to the vast expansion its balance sheet has undergone in the last several months. If the drop in the gold price this morning is based on that, then we think it is a mis-reading of the Fed's message. After all, it was just days ago that the FOMC announced it would expand its assets by more than $1 trillion with agency debt, agency RMBS and Treasuries (see "Ben Boldly Goes" March 19, 2009). But to the extent that the balance sheet is expanded at the Treasury's behest -- that is, not for the Fed's own intrinsic monetary policy purposes -- then the Fed will look to the Treasury's Special Financing Program and other tools to "sterilize the effects of its lending or securities purchases on the supply of bank reserves."

The press release concludes:

> In the longer term and as its authorities permit, the Treasury will seek to remove from the Federal Reserve's balance sheet, or to liquidate, the so-called Maiden Lane facilities made by the Federal Reserve as part of efforts to stabilize systemically critical financial institutions.

Here the Fed is referring to the *qualitative* consequences of its allowing itself to be used as an instrument of Treasury policy, not the *quantitative*. Apparently the Fed wishes to make it known that there are limits to the extent to which it will allow its balance sheet to be polluted by the non-investment grade assets it has had to buy at the Treasury's behest -- starting with the RMBS portfolio of Bear Stearns, then the portfolio of God-only-knows from AIG, and now PPPIP via the expanded TALF. Remember, originally, TALF was designed only to fund AAA-rated assets. Under PPPIP, RMBS funded by TALF only have to have been AAA-rated at the time of original issue.

BOTTOM LINE: PPPIP is an upside surprise in that it follows the subsidy-driven, non-punitive and non-dilutive bank rescue template put in place under Henry Paulson. It demonstrates that Tim Geithner is, after all, an agent of policy continuity, and that the Obama administration is capable of delivering capital-friendly policy. Up almost 60% in three weeks, the "easy money" is out of financial stocks. From here we must assess the extent to which PPPIP will really benefit the banks, and see how the Obama administration handles the witch-hunt over bank compensation.