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Stress Test Stress

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The risk of a near-term "bag run," and a long-term drag on the whole banking sector.

Update to strategic view

US STOCKS: March probably marked the bottom for stocks, but the surge from the lows is likely over, with some testing now ahead as we endure another period of uncertainty about bank interventions. Congress is back in session, and progress is contingent on the runaway train of anti-growth policy not gaining speed again.

US FINANCIAL STOCKS: The market will now distinguish between good banks and bad banks, but until the "stress tests" are behind us, the sector will be under a cloud. Longer term, the bad banks will to some extent infect the good.

[see Investment Strategy Dashboard]

The "tradable rally" we called for in early March (see "Quantum of No Solace" March 10, 2009) hit a wall yesterday as investors suddenly focused on the upcoming results of the Treasury's "stress test" of major banks -- and processed the implications of potentially damaging government response for banks that don't pass. Since the March bottom, investors have been willing to see banks holistically, to believe that they can *earn their way out* of capital inadequacy -- in essence that a solvency crisis can be converted to a mere liquidity crisis, given a little patience. But hints -- and wild rumors -- emerging about the stress tests are risking the suspension of this belief, and a return instead to the dangerous monotheistic worship of tangible common equity, the artificial notion that the only true test of a bank's worthiness is if it could survive immediate liquidation at fire-sale prices -- as though a bank were nothing but a balance sheet. Besides ignoring the fact that a bank is also an income statement, this approach contains a dangerous embedded option -- what amounts to a stop-loss order -- in which, when an arbitrary contingency is met, the bank is forced to sell common equity. We have seen before in the credit crisis how such embedded options can cause cascading firm failures, as they create an incentive for short-sellers and panicking longs to push troubled firms toward the stop-loss (see "AIG: Rescue or Bag Run?" September 17, 2008). The most recent victim was Citigroup, driven to announce a coercive exchange offer in late February -- wiping out 75% of value for common shareholders without raising a penny of actual new capital -- only to be followed just two weeks later by its CEO's statement that the bank was having its best quarter in years (see "Citi's Common Misconception" March 2, 2009).

The government's stress test risks more of this mischief. Bank capital will be tested under two scenarios of progressively negative economic performance. The underlying macroeconomic assumptions have been known for almost two months, but what is unclear until the Treasury

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reveals details in several days is how capital adequacy will be defined -- and we likely won't know until next month exactly how banks deemed inadequate will be treated. The worst case is that capital adequacy will be harshly defined in terms of tangible common equity, calculated using fire-sale pricing assumptions for assets, and ignoring the possibility of earning one's way out. The consequence of this would be to force banks to follow in Citi's footsteps: diluting common shareholders by converting preferred to common, a pointless act of obeisance to accounting conventions that contributes no actual new capital -- and all in the name of a mark-to-model exercise envisioning a negative scenario that may never materialize. Bank of America's CEO Ken Lewis captured the anxiety of the moment perfectly, when he said in yesterday's earnings conference call that the decision to convert the Treasury's preferred stake to common is “now out of our hands."

75 years ago today... *The Chicago Tribune*, April 21, 1934
[click for larger image]

Forcing banks to convert preferred to common is made all the more likely by the Obama administration's budget constraints, given that TARP has less than $150 billion left in its authorization, and that congressional approval for more funding is highly unlikely. On a Sunday talk-show, White House Chief of Staff Rahm Emanuel said "some [banks] are going to need resources. We believe we have those resources available…" Surely he was referring to the ability of the Treasury to convert its *existing* investments in banks' perpetual preferred stock into common stock -- just as it did with Citi -- an option hinted at in a *New York Times* story the same day. The potential for government taking more common stock in banks is especially infuriating because it allows the administration to put on a show of "doing something" even when it is doing precisely nothing -- and at tremendous cost in dilution of existing shareholders. At the same time, it leaves the government with a large voting stake, and raises serious risk of more government influence in the banks' business decisions.

This is a non-trivial risk for the entire banking sector, not just for the most troubled banks that may end up with the government as a voting equity partner. It cuts against the very good news that has emerged in the last several weeks, that the banking sector -- seen not so long ago as a monolithic class of failing firms -- is in fact made up of winners and losers. The banks who have reported earnings first in this earnings season -- Wells Fargo, JPMorgan and Goldman Sachs -- have distinguished themselves as survivors. But as we warned, these great earnings stories did not generalize (see "All's Not Wells" April 13, 2009). With each passing day as more banks have reported, the earnings stories have gotten weaker. On the face of it, that's great -- we have visibility on the reality that there are good banks and bad banks, just as there are always good firms and bad firms. The problem is that as the bad banks become increasingly beholden to the government for their survival, banks as a class will lose their ability to effectively lobby against the punitive regulations that are surely in the offing.

A possible test case is the battle against legislation enabling judicial modification of mortgages in bankruptcy -- so-called mortgage "cramdown." If the banking lobby could maintain a unified front, there is probably enough opposition in the Senate to kill it (a bill has already been passed in the House). But Citigroup, the bad bank already most beholden to government for aid, broke ranks on cramdown several months ago, and now others are negotiating with Senator Dick Durbin, its leading advocate, for a watered-down version -- which undermines the efforts of Republicans such as John Kyl to defeat it entirely.

Recommended reading
Why Capital Structure Matters Michael Milken, *Wall Street Journal*, April 21, 2009 *It May Be Time for the Fed to Go Negative* N. Gregory Mankiw, *New York Times*, April 19, 2009
[Recommended Reading home]

That brings to top-of-mind a larger issue. We explained the equity market panic in late February and early March as a sensible reaction to the destabilizing effects of the runaway train of anti-growth economic policy being rushed into law in the name of "emergency" and under a mandate for "change" (see, again, "Quantum of No Solace"). Since then, that runaway train has been braked, as it appears the political class has deliberately pulled back from the "edge of chaos," having realized that it was causing an outright panic (see "Number of the Beast" March 18, 2009). Now Congress is back in session, after a two-week Easter recess during which stocks performed beautifully, carrying our "tradable rally" to a gain of as much as almost 30%. We'll see now how aggressively Congress and the administration are able to push the agenda of "change" -- on the one hand, with the license of knowing it stands a safe distance from the brink of panic, but on the other hand, not having the same atmosphere of "emergency" with which to rationalize its hasty actions. Those considerations delimit the options for the equity market, probably creating reasonably assurance that the March lows will not be violated -- but at the same time putting a cap on the potential upside.

BOTTOM LINE: March probably marked the bottom for stocks, but the surge from the lows is likely over, with some testing now ahead as we endure another period of uncertainty about bank interventions. Congress is back in session, and progress is contingent on the runaway train of anti-growth legislation not gaining speed again. The market will now distinguish between good banks and bad banks, but until the "stress tests" are behind us, the sector will be under a cloud. Longer term, the bad banks will to some extent infect the good.