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

MACROCOSM

The Stress Tests' Hidden Mickey

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Donald Luskin

An unappreciated feature rules out another "bag run" on banks.

Update to strategic view
US FINANCIAL STOCKS: The Treasury has issued what amounts to a free put option on the banking sector, effectively capping the cost of new capital for banks, thanks to a little-known feature of its convertible preferred security design. This significantly reduces the risk of "bag runs" as we near the revelation of the "stress test" results, and allows investors to make rational distinctions between healthy banks and unhealthy ones.
[see Investment Strategy Dashboard]

As we get closer to the revelation of the results of the Treasury's "stress tests" of the 19 largest bank holding companies, there seems to be very little of the anxiety that abounded several weeks ago (see "Stress Test Stress" April 21, 2009). Apparently the Treasury has done a good job of assuring markets that the Fed's design of the tests is rational and reasonable, getting the word out that very few banks have "failed" -- and that even those should not be considered "insolvent" -- and that, by implication, it's time to recognize that there are important distinctions between healthy banks and unhealthy ones (see "All's Not Wells" April 13, 2009). Even the delay in releasing results (it was originally supposed to be today) is being successfully narrated as a positive -- it is because banks have had a fair chance to push back on initial results with which they disagree.

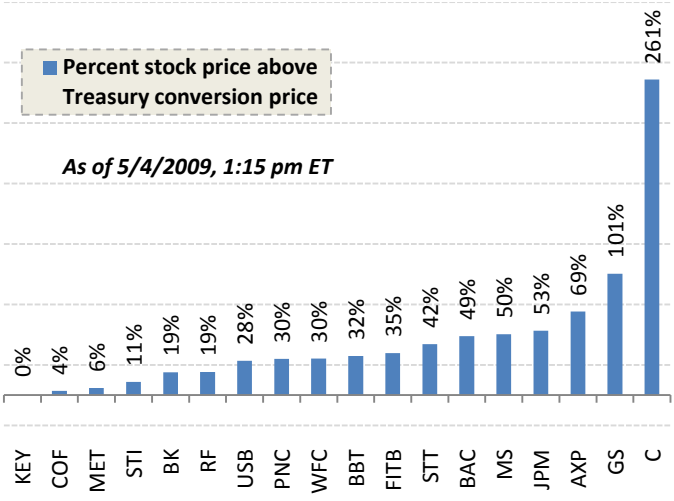
There's another generally unappreciated element that we think could explain the market's equanimity in the face of what would otherwise be the threat of a new round of destructive government intervention in the banking sector. It is a critical yet unheralded feature in the design of the securities that the Treasury will buy from banks who fail the stress test. On February 10, when Tim Geithner first announced the stress tests to what was then thunderous disapproval by markets, he said that the Treasury would buy mandatory convertible preferred stock that would convert into common at a "conversion price set at a modest discount from the prevailing level of the institution's stock price as of February 9, 2009." At the time we criticized Geithner for revealing this bit of seeming fine-print as part of a plan otherwise so painfully lacking in detail (see "Two Strikes for Tim" February 11, 2009), but we have since come to understand its significance. Now, if we fault Geithner, it is for communicating so badly the supreme importance of this very positive feature -- and the multiple ways that distressed banks can take advantage of it. "Hidden Mickeys" are for Disneyland, not bank policy.

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

In essence, by pinning the conversion price to the stock price prevailing at a particular date, the Treasury is issuing a free put option struck at that price. In other words, it is guaranteeing a minimum stock price for every bank. We have long argued that in a world of rampant "Knightian uncertainty," such guarantees are far more valuable than actual capital injections or the acquisition of troubled assets (see "Unknown Unknowns" January 30, 2009). That means that any bank facing the need to issue common equity has a choice -- to issue it to the public market, or issue it to the Treasury via convertible preferred stock -- and it will choose one or the other depending on whether its stock price is above or below the Treasury's guaranteed conversion price. Indeed, the fact that the Treasury's guarantee exists nearly assures that the bank's stock price will be at or above the guarantee. As of Friday's close, all but one of the 18 publically traded banks subject to the stress test were, in fact, trading at or above the Treasury's guarantee (see the chart below) -- the average bank was 47% above it. By the way, in documents published on February 25, the Treasury clarified that the conversion price will be "90% of the average closing price for the common stock for the 20 trading day period ending February 9, 2009, subject to customary anti-dilution adjustments."



The Treasury's free put option can be accessed by banks without actually selling new preferred stock to the Treasury. According to sources, the Treasury stands ready to exchange the non-convertible preferred stock acquired from banks last October for the new convertible preferred -- allowing banks instant access to new common equity at non-ruinous prices, *or, at their option, not at all if the worst-case scenario envisioned in the stress test doesn't happen*. Alternately, according to the same sources, Treasury will exchange its existing preffered stock for common at the guaranteed price, effectivelty treating its non-convertible preferred as though it were convertible -- allowing banks who need common equity *right now* to get it at non-ruinous prices. Since the market knows that banks *can* access the guarantee three different ways, there may well be no reason for a bank to actually do so in order for its stock to be effectively supported at or above the guarantee price. Thus banks that find they must raise new capital as the result of the stress tests have an option to raise it from private sources on equivalent or better terms -- avoiding further engtanglement with government, yet made possible in the first place by the government's guarantee.

Last summer, systemically important financial firms were the victims of "bag runs," as their stocks were driven lower both by short-sellers and evacuating longs, provoking panicked government takeovers that priced firms virtually at zero (see "AIG: Rescue or Bag Run?" September 17, 2008). The Treasury's guarantee shifts the incentive structure from favoring sellers to favoring buyers. This doesn't turn the banking sector into a growth story again. But ruling out being driven to zero is an important game-changer.

BOTTOM LINE: The Treasury has issued what amounts to a free put option on the banking sector, effectively capping the cost of new capital for banks, thanks to a little-known feature of its convertible preferred security design. This significantly reduces the risk of "bag runs" as we near the revelation of the "stress test" results, and allows investors to make rational distinctions between healthy banks and unhealthy ones.