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

TRENDMACRO LIVE!

On Obama's Bank Regulation Proposal

Thursday, January 21, 2011

Donald Luskin

Banks become regulated public utilities, forcing the Fed to be looser than ever.

Stocks and all risk-assets are down sharply on the revelation of the Obama administration's proposal to prohibit proprietary securities trading by commercial banks, and to limit the size and complexity of financial firms. The proposal consists of only a couple paragraphs of generalities, and ultimately the content of any new regulations will be up to Congress. But Senate Finance Committee chair Chris Dodd and House Financial Services Committee chair Barney Frank were present at the announcement this morning, indicating their general buy-in. Paul Volcker was there too, and press reports have positioned him as the proposal's architect and chief White House advocate. Former Bush SEC chair William Donaldson was also on hand -- quite ironic considering that he signed off on the liberalization of consolidated entity risk-based capital adequacy rules for broker-dealers that was the starter's pistol for the great leveraging-up of Wall Street in the mid-2000s.

Update to strategic view
US FINANCIAL STOCKS: Today's Obama proposal for bank regulation signals a potential unholy alliance between the White House and anti-bank GOP populists. It's another step in the ongoing conversion of the financial sector from a growth story to a regulated utility. **GOLD:** Increased momentum for deleveraging and down-scaling banks puts all the more pressure on the Fed to keep credit conditions loose -- more fuel, longer, for the inflationary pressures motivating the bull market in gold.
[see Investment Strategy Dashboard]

In one sense this development is just another element in the theme of reregulation that has made us long-term negative on the financial sector as a growth opportunity -- indeed, banks are on the way to being turned into regulated utilities (see "Regulation Road" June 18, 2009). Without proprietary trading, leverage and vast economies of scale, how exactly are banks supposed to generate earnings growth, or for that matter to generate earnings at all? And will any of it help systemic stability anyway? A more atomized banking sector, and one that relied primarily on conventional lending for its earnings, didn't prevent the systemic banking collapse of the late 1920s and early 1930s.

Key documents
White House statement on bank regulation
[Client Resources home]

What worries us especially is that this particular proposal comes two days after Scott Brown's upset win in the Massachusetts special election (see "A Scott Heard 'Round the World?" February 19, 2010), indicating that it may be Obama's first move in his strategic response to that seismic political development. Obama may read Brown's victory as a triumph of the GOP's post-TARP anti-bank populism. By clamping down on banks, he may believe he can both steal

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

Offices:
Menlo Park CA
Charlotte NC

Phone:
650 429 2112
704 552 3625

some of the GOP's thunder and enlist their support in reregulatory initiatives he wanted to pursue anyway. A quick bi-partisan legislative victory in bank reregulation, he may reason, could take some of the sting out of the imminent demise of health care "reform." This Obama strategy would be a form of calling the GOP's bluff -- it would be tricky for the Republicans to pivot back to a free-markets position here, in order to differentiate from Obama, at the cost of abandoning the populist anti-bank rhetoric that they may see as having been quite successful for them.

This interpretation is supported by today's brief report that the Senate will not vote this week on Ben Bernanke's confirmation to a second term as Fed chair, which hit the wires the very minute that stocks took their big leg down this morning. It is populist Republicans who are primarily responsible for holding up the Bernanke vote, and they are playing with fire to do so. If he is not confirmed before his term expires on January 31, markets will have to deal with the uncertainty of there being no clear statutory basis on which Bernanke could continue to act as Chair, although there is historical precedent for him to do so.

We note that while today's developments have hit all risk-assets, as of this writing gold has lost less than stocks have, after having begun the day losing more. We've expected stocks to correct for quite a while now, and all the more so coming into an earnings season that is bound to disappoint (see "Under-Seasoned" January 15, 2010). Gold, on the other hand, is reacting to the deflationary implications of the deleveraging implied in today's Obama proposal. Yet ultimately gold should prove to be a beneficiary of today's political developments. As the White House and the Congress pursue policies that effectively tighten credit conditions, all the more burden is placed on the Fed to keep them as loose as possible -- with inevitable inflationary consequences that should be reflected in a higher gold price. And don't forget that the Fed itself is in the cross-hairs of financial reregulation. In an election year, facing that threat, the Fed is all the more likely to stay extremely easy (see "Easing -- As in Appeasing" November 23, 2009). We continue to believe that 2010 will emphatically not be the year of the exit strategy for the Fed.

BOTTOM LINE: Today's Obama proposal for bank regulation signals a potential unholy alliance between the White House and anti-bank GOP populists. It's another step in the ongoing conversion of the financial sector from a growth story to a regulated utility. Increased momentum for deleveraging and down-scaling banks puts all the more pressure on the Fed to keep credit conditions loose -- more fuel, longer, for the inflationary pressures motivating the bull market in gold.