

C *Economic & Market* Commentary

Dancing with the Bear

Last week the Troubled Asset Relief Program (TARP) was signed into law. By any measure, \$700 billion is a massive amount of money and, when added to the piecemeal efforts to date, this bailout could cost us well over \$1 trillion. If you consider that the Federal Government may be buying “troubled assets” for about 30 cents on the dollar, \$700 billion could translate into about \$2.3 trillion in face value of “troubled assets” being taken off the books. In the past we have stated that Bernanke and Paulson would “do what it takes” to stabilize the ship, but we never expected to see these kinds of numbers.

I read the initial 110-page Bill that failed to pass the House on September 29th and didn’t see any truly objectionable content, considering its primary goal. Elected officials on both sides of the Senate aisle were responsible for the additional 341 pages of refinements and add-ons that made the bill look more like a well adorned Christmas tree than the original three-page bill. In their efforts to forge “perfect legislation” during an election year, officials delayed passage of a good bill which would have hit the mark without all the drama.

There will be ample commentary dedicated to dissecting the package, drawing historical correlations to the current economy and markets, and assessing blame to greedy corporations, inadequate regulation, or poorly thought out accounting rule changes. While I have been guilty of writing similar commentaries in the past, I’d like to explore what things may look like when we’re out of the woods.

In earlier commentaries I have described our current environment as a deleveraging cycle. This cycle is deeper and more widespread than many, including myself, anticipated and the impact will be likely felt for a few more years. As lenders struggle to secure their balance sheets and manage their risk profiles while the value of investments they hold as capital drops, they must either raise more capital or reduce outstanding credit to stay in business. Some lenders are able to raise capital and continue to extend credit, others cannot and must shrink outstanding credit, and some can do neither and must close their doors. The damage has not been well contained and the ripple effects of these issues are being felt in all corners of the world and across many industries.

Lenders reducing the size of revolving credit lines for businesses, reducing or canceling home equity lines of credit for homeowners, or not creating new loans as existing ones are paid off are all examples of deleveraging. This hurts the economy in the long run as borrowers that effectively manage revolving debt may be forced to carry too much fixed debt to be efficient or to forgo new business due to lack of available capital.

With the mega-mergers in the investment and retail banking businesses and the relative inability of smaller and community banks to raise new capital, creation of credit is being reduced and future

economic growth will suffer. During this time there are a number of firms that will be able to increase their influence by buying weaker competitors or simply being the “last man standing”. Examples of this are already showing up in the banking industry. A closer look at two “super sized” banks like Bank of America (which absorbed Merrill Lynch and Countrywide Credit) and JP Morgan Chase (which absorbed Bear Stearns and Washington Mutual) reveals that these firms will be well positioned when the economy emerges from the current mess. There are similar examples of this in other industries as well.

As the recent volatility in stock prices proves, it is difficult for anyone to place a value on a company’s stock or bond in today’s environment. We have seen unprecedented price volatility and I have seen more conflicting commentary in the last few months than I can remember. Economists have vacillated between fears of inflation and recession, making it difficult for almost anyone to figure out where to invest money. The dramatic short-term moves in the perceived value of many investments makes it tough for investors to stay focused on a long-term investment strategy.

To date, leaders have strategically avoided repeating monetary policy mistakes made during similar economic periods. They have kept short-term interest rates low and accommodative to maintain economic activity in the face of rising commodity prices, and are addressing impaired capital levels at our financial institutions. The dramatic run-up in commodity prices could have lured the Federal Reserve into fighting the wrong battle by raising interest rates to fight inflation which would have been restrictive and would have slowed the economy. If we had to contend with impaired capital levels combined with restrictive monetary policy, we would be faced with a much worse economic scenario.

The Resolution Trust Corporation was a government entity created in 1989 to “bail out” savings & loans and banks from a commercial real estate crisis and had an initial cost of about \$500 billion. It took a few years to eventually reverse the tide and the Government made money on the investment. TARP creates a version of the RTC which addresses the issue at hand, and will likely need a few years to work through the system. Although the recovery package will not magically cause the economy to reverse course, it should be a catalyst for stability, which is needed. We should then see a return of confidence, resulting in a less leveraged, and initially slower-growth version of the economy than we have been accustomed to seeing. Stay tuned . . .

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