The Elephant(s) in the Room

Amidst financial distress, one must act quickly. The government has problematically socialized risk and much has already been written on the topic. Like a film critic who can neither write nor direct, we cannot claim to know the best path, but can certainly point to potential problems in the current proposal being considered by Congress. The U.S. Treasury with the approval of the Federal Reserve has proposed to create a $700-billion fund so as to inject liquidity into our frozen banking system via the purchase of illiquid and problem assets from our nation's troubled lenders, a latter-day Resolution Trust Corp. (RTC). Ostensibly, the banking institutions that will take advantage of the government's largess will then have the liquidity to make new loans. Does anyone see the elephant in the room? We see more than one.

Jumbo: The 1880s P.T. Barnum elephant that gave the origin to the word but now understates the challenges we face.

The U.S. Treasury's proposed plan only provides liquidity, not the necessary hundreds of billions of new capital that will have to be replaced. Unless of course, the Treasury foolishly purchases illiquid assets at a premium to the "real" underlying value – a gift to the banks from the U.S. taxpayer. The U.S. Treasury will hopefully pay a discounted price (hopefully discounted enough) for financial institutions' problem assets in the hope that, by converting assets from frozen to liquid, loan growth will get the economy moving again. This in fact, however, may precipitate additional bank failures. An asset that is marked down will reduce equity capital and push certain banks below minimum capital requirements and into the hands of the FDIC. Total FDIC-insured tangible banking assets of $12.8 trillion at June 30 are supported by tangible equity capital of $870 billion, a leverage ratio of 14.7x (inversely, tangible equity to tangible assets equals 6.8%). That does not leave much room for additional write-downs. It is clear that there is not excess capital in the banking system today so an asset that gets written down will have a commensurately negative impact on equity, possibly offset by a tax break. (For those institutions that fall below mandated capital requirements and are unable to raise new capital, that tax deduction will prove worthless.). According to a study conducted by the FDIC and published in Managing the Crisis: The FDIC and RTC Experience, the RTC took control of $403 billion of bank assets in the period 1989 to 1995. The loss on those assets totaled $88 billion, or 21.8%. Let us assume that the banking system absorbs $240 billion of losses this time around, i.e., 2.7x the losses on assets of FDIC depository institutions that are 2.7x greater today – but probably way too conservative a point of view, given what are on average lower-quality and more esoteric assets today. Assuming that we are correct in concluding that our banking system has no room for additional write-downs given their capital requirements, then for each dollar that equity is reduced, there will be a corresponding impact on assets. A bank requires something like $6.80 of equity for every $100 it lends. If the $6.80 disappears, so does the $100. Therefore, if $240 billion of equity disappears, then there will not be enough capital to support $3.5 trillion of existing loans (14.7:1), let alone allow banks to underwrite new loans.

Should this vague proposal pass, we can only hope that the Treasury will not purchase impaired assets with too optimistic an eye as to their worth, let alone at face value, obviating the need for asset impairment charges at an unfathomable social expense. Liquidity will be there if the asset is priced for an acceptable rate of return for the investor, but at the moment there is a huge spread between the Bid and the Ask. We, among many others, will be happy to invest some of our capital in assets that are presently frozen, but at the right price. That will cause the equity of the seller to decline but, as in the past; capital will ultimately be replaced – just not immediately. Bank earnings and some reduction and elimination of dividends will replace some of this lost capital over time but it will not be enough. The banks must continue to raise additional capital – a necessity not highlighted by the Treasury – and the new capital will come at a very high cost. We suspect that most will come at prices well below where the average bank stock trades today, diluting existing shareholders, and would not be surprised to see foreign investors, including the sovereign wealth funds, play a large role in this recapitalization of our banking system. Two apparently necessary but dilutive deals have been announced this week alone, pairing the two remaining independent investment banks, Morgan Stanley and Goldman Sachs, with Mitsubishi Financial and Berkshire Hathaway, respectively. These are examples of a free market economy at work. In each instance, the buyer and seller jointly determined a clearing price. The buyer gets his required rate of return and the seller agreed that the cost of that capital was acceptable. With Berkshire Hathaway receiving a 10% yield on preferred stock, plus warrants to purchase common stock at a discount, the cost of capital is at least mid-teens for the venerable Goldman, a high but essential price to pay.

Goldman Sachs and Morgan Stanley also just requested on their own volition that they be allowed to convert to bank holding companies. They will now subject themselves to far greater regulatory supervision, for the ongoing right to take advantage of the Federal Reserve and to gain the ability to have more stable funding with their own deposit base. Bank examiners will now begin to scrutinize the heretofore secret, clubby world of the investment banks, sounding the clarion that closes what began in the Gilded Age. Greater regulatory oversight will likely translate into lower profits.

Castor and Pollux: Eaten by the starving public during the 1870 siege of Paris. An unfortunate image of a public led astray by its government.

We have had three appointed officials giving testimony to Congress. One of them offers himself up in the role of omnipotent savior. Mr. Paulson, should his proposal pass, will have unparalleled power without supervision, legal liability, or recourse. Our constitution was written by the people for the people, but we are not hearing from the people, those who both understand and can help. There are billions of dollars on the sidelines in investment firms and corporations waiting to invest. Let us hear from them. All we need to do is let the market-based system continue to function. Corporate America (non-financial) has more than $600 billion of cash on its books today, more than at any point in time in history. Some of that capital may be part of the solution. Let us use American capital and allow a Wal-Mart to finally have the banking license they have coveted for years. In a free market economy, you cannot expect to reap untoward benefits in the good times without paying the price in the bad times. We must have bankruptcies to help the system in its realignment, and for that we must experience short-term pain for the long-term gain. We can appreciate, in some instances, the idea of the government playing the role of facilitator, but only to a limited and temporary degree. We believe that the necessary capital injection will come. The capital is already there. The price has just not yet been agreed upon. We cannot let our system get hijacked by those who believe entrenched government involvement is the solution. Our country will be the worse for it.

Babar: Animated character who brought the "benefits" of civilization to the jungle. The jungle seems safer at the moment.

While some liquidity will be restored, the banks still cannot be forced to lend. Banks, like us, are fearful of what economic chaos may lie around the corner and will likely lend cautiously. For new loans, banks will demand higher spreads over their cost of funds and they will operate under stricter guidelines with respect to borrowers' credit quality than they have in the recent past. Unfortunately, we do not expect to see rapid loan growth. According to the FDIC's website, total loans for banks and thrifts were $2.98 trillion in 1989, but then declined 10% over the next three years and took until 1994 to get back to that level, a total of five years! In that time, the U.S. experienced a shallow recession that began in 1990 and continued into 1991, short and sweet. With more of a systemic problem today, along with a much more meaningful amount of assets at risk, we would not be surprised to see the economic downturn prove both deeper and longer than in 1990-1991. We are still early in this downturn. The consumer has only but stumbled to date. We believe they will fall harder and consumer credit losses that are still well below past peaks will likely cause financial institutions to take significant additional charges.

There will still need to be a ready and willing borrower. That may prove a mite more difficult than originally thought as the consumer has more credit-card and mortgage debt than at any point in time in history. Desire and capability to borrow will be hamstrung by what is likely to be higher unemployment. The unemployment rate has already begun to tick up, from a low of 4.7% in 2006 to 6.1% today. Fewer jobs = less income = fewer people that qualify for a loan.

Horton: The protagonist from Dr. Seuss' Horton Hears a Who! He saved a society. Let us hope.

The Treasury is operating under two key assumptions regarding the assets put to them: 1) that they can value them; and 2) that they will be able to find a buyer who agrees with that value. The problem assets both on and off the books of our financial institutions are many orders of magnitude larger than the problem assets with which the RTC had to contend, and are infinitely more complex and will prove extremely difficult to value. More than 75% of the RTC assets were real-estate related, simple loans and property owned, as compared to the byzantine structured products and derivatives that exist today.

Shep: Friend of George of the Jungle. We could use some friends right about now.

As Congress assesses the merits of the bailout, the future level of interest rates do not appear problematic to either the public or the government. Running with a $400-billion-plus annual budget deficit, combined with what we guess will be more than $1 trillion that the Treasury might ultimately throw at problem financial assets and institutions, will further increase our national debt that already approaches $10 trillion. We recognize that what the Treasury provides as support will not be a total loss, but do not believe that their losses will compare favorably to the RTC era's losses of 21.8%. With big government getting bigger and taking control of some parts of what was once largely a free market economy (albeit one with a financial backbone that was both poorly understood and overleveraged), we expect that debt will increase to levels as a percent of GDP that will exceed the Reagan/Bush years and send us back to levels not seen since Eisenhower. Such a push to reflate the pricked bubble of the U.S. economy will likely prove inflationary and detrimental to the U.S. dollar. Despite a printing press or maybe because of it, governments, like corporations, that have bad balance sheets have higher borrowing costs, and higher long-term interest rates will likely result.

Dumbo: Need we say more.

The disbursement of the aforementioned hundreds of billions will be at the sole discretion of the Secretary of the Treasury, not just Mr. Paulson, but whoever comes next. We appreciate the need to act quickly and decisively but it seems hasty and irresponsible to not have appropriate oversight. Poor oversight is what got us into this mess.

We would guess that other industries outside financial services will benefit from the U.S. taxpayers' unwitting generosity. For example, unemployment in the auto-industry-dependent states of Michigan and Ohio stands at 8.9% and 7.4%, respectively, and polls reflect that these swing states are too close to call. The political will is there to bail out the auto industry. Our government traverses a slippery slope. History has shown that governments are not good managers of businesses and that governments can be like pit bulls when they sink their teeth into an industry. Better that they don't bite at all, rather than to have to learn to wriggle free from their locked jaws.

Looks like a herd of elephants to us. We seek refuge from a stampede as we continue to thoroughly research investments and prudently deploy capital as we determine the risk/reward see-saw is tilted in our favor. We correctly predicted the current crisis and believe we have done an admirable job of protecting client capital to date. As much as it is our nature to buy when others are selling and as much as we detest the sound of those calling "it's different this time," we do feel that the unknown at this time dictates that we maintain a cautious stance in our clients' portfolios. Remember that the RTC was formed in 1989, a year and a half before the recession and it that it took four to five years before unemployment began to trend down from its peak, for loan growth and GDP to get back to the levels seen in the years preceding 1990. The stock market will bottom before the economy but with larger, more complex issues this time around, we don't mind being patient.

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