

February 27, 2009

Washington Accelerating the Equity Slide

The S&P 500 closed at 735, below the November intraday low of 741, signaling a technical breakdown and still-worsening economic prospects. With tight monetary policy, bad fiscal policy and frozen credit markets, we think deflationary pressures will continue to spread. (See Deflation Deepens Despite Gold Bubble on 2-19 and Market Retest on 2-23.)

- Fourth quarter GDP was revised down to -6.2% from -3.8%, showing the rapid deterioration of the economy during the fourth quarter and the difficulty that economic data is having in keeping up with the post-Lehman economic collapse. Without a major change in Washington's approach, we are now thinking the recession will start being called a depression as negative quarters persist and unemployment, currently 7.6%, rises above 9%.
- **Citibank, now basically a ward of Washington, slid all day, closing at \$1.50 and dragging Bank of America down with it. Both banks have huge piles of cash but are suffering non-cash mark-to-market write-downs that seem bottomless and threaten equity dilution and forced shrinkage in lending and balance sheets. Shorts won big-time on the Citibank deal,** as Washington forced a conversion of preferred shares into common shares causing a devastating equity dilution. The pretext for the conversion was to increase "tangible equity capital" (as distinct from equity capital which includes preferred shares). TEC is a meaningless economic and regulatory concept, the latest chapter in the year-long string of Washington mistakes draining capital from the banking system.
- The financial sector index, XLF, fell to \$7.60, decimated by banks and **a dismal day for life insurance companies. Many of their bonds were downgraded yesterday,** continuing the harmful pro-cyclical interplay between falling stock prices, mark-to-market accounting, bond raters, and the opaque CDS market.
- Our concern is that the downward equity and economic momentum is self-fulfilling for both equities and the economy, not cleansing. **We don't think there's a natural bottom and note the rapid expansion of the commercial real estate crisis in recent weeks, the shakiness of life insurers as long-term counterparties, and the prospect of years of highly-litigious debt restructurings.** We disagree with the equity-negative calls to "let the market work" or to have Washington "stop changing the rules." The current rules are badly broken, causing non-market processes in regulatory accounting, the CDS market, the bond-rating monopoly and the short-selling bias. We think there will have to be aggressive Washington intervention to stop the spiral.

Contributing to the January-February collapse, we note:

- **Washington still hasn't made any constructive announcements** on the deep problems with credit default swaps, the drain on regulatory capital from mark-to-market accounting, pro-cyclical bond ratings, the uptick rule, or lax short-selling enforcement. Instead, the Obama Administration has planned federal spending increases, temporary tax rebates, permanent tax increases, mortgage restructurings and mortgage cram-downs, all distinctly harmful to the equity and growth outlook.
- **Mortgage rates have remained high, a Washington travesty** given the impact of lower rates on housing and mortgage securities. Lower mortgage rates would help stabilize house prices, encourage first-time home-buyers, and improve the value of mortgage securities by increasing mortgage prepayments as people refinance or switch homes. Yet effective mortgage rates rose year-to-date due to extra fees. We think Washington should lower conforming mortgage rates by 1%. This is a **fairer, faster and lower-cost way to help housing** than the Administration's proposals. As discussed in previous pieces, Washington controls Fannie and Freddie and, through them, the mortgage rate. To lower Fannie/Freddie funding costs and their commitment rate for mortgage purchases, Washington could encourage MBS buyers to return to the market and clarify the government's guarantee of GSE MBS.
- **Monetary policy has tightened severely** despite Fed Chairman Bernanke's excellent January 13 "credit easing" speech. The Fed shrank its assets nearly \$400 billion from the December peak through February 25, even though the deepening credit market freeze calls for hundreds of billions more in liquidity to offset the collapse in monetary velocity. The Fed delayed the new TALF liquidity into late March at the earliest and added complexity, raising the risk of further delays. With CPI inflation declining to 0% year-over-year in January, **real interest rates for most of the private sector (those without direct access to low-rate Fed loans) are high and rising.**
- **We think the Fed should buy GSE MBS faster than its \$4 billion per day pace, completing the planned \$500 billion purchase in March rather than stringing it out through June. Instead of TALF, it could then buy FDIC-guaranteed assets, part of the much-needed monetary stimulus to offset the credit market freeze. By buying safe, guaranteed assets, the Fed's injection would then cause the private sector sellers to choose the next best frozen asset class (ranging from corporate bonds to CMBS to private-label RMBS to sovereign debt). This process forces the right decisions on the private sector, avoids the complexity of TARP and TALF, could be carried out fast, and would be highly profitable for the taxpayer.**

Notes

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