The Week

WACHOVIA SECURITIES

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Far Better than the Alternative

- Market reaction to the Bush administration plan (a.k.a. Troubled Asset Relief Program, "TARP") for the U.S. Treasury to acquire up to $700 billion of illiquid mortgage-related loans was – at first -- very strong. The urgency of the current financial situation resulted in what appears to be a clear willingness of legislators on both sides of the aisle to cooperate with policy makers and regulators to craft a solution to the impending crisis.

- Last week's relief rally was largely based on confidence that cooperation in Washington would overcome the immense challenge facing us now, and a weekend poll by the Pew Research Center underscored that view. Fully 57% of the respondents supported the idea of "the government potentially investing billions to try and keep financial institutions and markets secure," while only 19% believe the government is doing a good job so far in dealing with financial problems on Wall Street.

- As is often the case, the devil is in the details. On Tuesday, the Senate Banking Committee allowed lawmakers to respond to the Treasury's initial "bare bones" proposal. Concerns arose over how Congress should oversee the program, executive compensation at the institutions likely to participate in the plan, what the ultimate cost might be, and how to determine the right price at which to acquire the troubled assets.

- These and other considerations pose a more complicated path for the proposal than the market initially thought. With the near-term prospects for the financial markets hanging in the balance, we are confident that Congress recognizes the need to act swiftly to provide the Treasury with the needed authority, and thus stocks and other credit-sensitive assets should eventually benefit from this action.

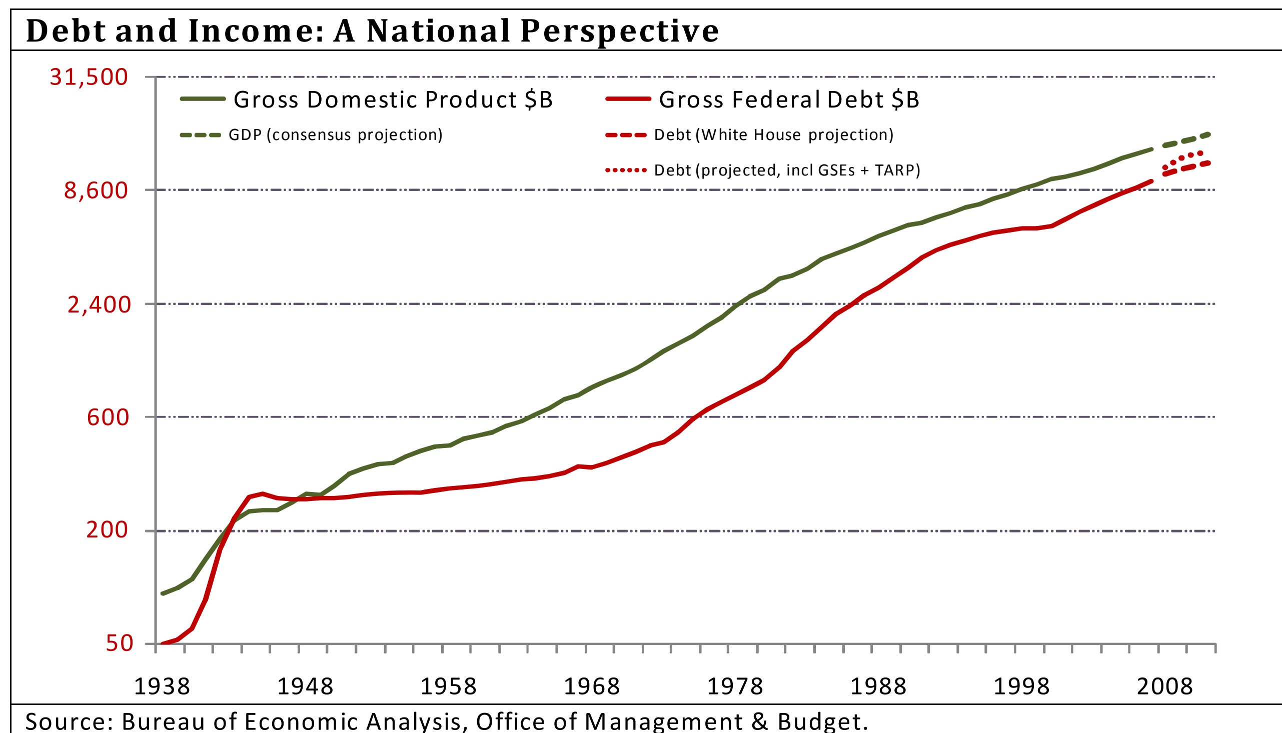
The TARP program is designed to remove troubled loans from the balance sheets of financial institutions so they can proceed with their primary activity of providing new credit – appropriately meted and priced – rather than to allow the questionable loans from tying up their capital and thus interfering with future lending decisions.

The program as described thus far is comparable – in its ideal form – to the Resolution Trust Corp. of the early 1990s, but with an important difference: back then, the government seized real estate assets as they absorbed bankrupt Savings and Loan institutions. In the current reincarnation, the TARP will buy illiquid mortgage-related assets (whole loans, securities, etc.) through a reverse auction process. But we believe the means of acquisition is less important than the end: the extraction of these assets from the pipeline of credit creation in a competitive, capitalistic economy.

The recent extended sub-par performance of the Japanese economy stands as an example of the risk we face. Despite its attempts, the Japanese government never managed to extract troubled property debt from banks' balance sheets after the 1990 real estate bust. For this reason probably as much as any other, credit creation has been stymied, and growth in Japan has suffered.

See page 3 for important disclosures and disclaimers information.

Chart of the Week:



As part of the program, the Federal debt ceiling will need to be increased to $11.3 trillion. This is nearly 80% of the current Gross Domestic Product (GDP) of $14.4 trillion, and thus marks the highest level of debt for the U.S. – as compared to GDP – since World War II. To finance the purchase of existing private market debt, the TARP program will cause a jump in the Federal debt above and beyond what some are concerned will be several years of soaring budget deficits.

As the above chart shows, GDP (our income as a nation) and Federal debt (which is an aggregate amount rather than an annual figure) have tended to rise at somewhat similar rates over time – one reason why analysts consider the ratio of debt to income as a useful metric. Just as banks should properly consider a borrower's annual income in determining the appropriate amount of debt one can reasonably manage, we believe our trading partners – who have been lending aggressively to the U.S. government and consumers for decades – should consider our aggregate indebtedness relative to our income as a measure of our ability to service the loans and also to grow at a rate fast enough to shrink the debt over time.

Investors with a sense of history will note that while the growth in our debt (the slope of the line) is not nearly as steep as the 1940s or the 1970s, neither of those two periods were friendly to stock investors. Once we get back on a clear growth trend, it will probably make sense to reduce the Debt/GDP ratio.

What should we be hoping for as taxpayers,? First, would be an efficient and equitable process for the Treasury to identify and acquire the most attractively-priced assets and to manage those assets in a way to maximize their value. Of course, stakeholders in some institutions may prefer to see the Treasury overpay for certain assets, but this would amount to an unwarranted re-capitalization (a true bailout) of the company to the detriment of taxpayers and raise issues of moral hazard.

Of course, the path of house prices is the single most important determinant of the need for – and the ultimate cost of – the TARP program. But the transaction prices are also very important. Determining value for customized, illiquid securities will likely pose concerns about conflict of interest, and the initial proposal seeks to avoid any oversight or review of the Treasury's actions to acquire or dispose of mortgage assets. These points may prove nettlesome, as the impending election seems likely to thrust political considerations into the debate about the merits and urgency of the proposed solution.

If purchases are made at "fair value," then taxpayers should expect a positive rate of return, appropriate for the level of risk. In this case, one might argue that the TARP program is not a "bailout," but instead, an "investment." Ultimately, the success of that investment depends on housing prices.

Some financial institutions may be unable to sell certain mortgage assets at current market values without registering a loss that may deplete their capital. Can accounting rules be modified – even temporarily – to facilitate participation by all holders of troubled mortgage assets without onerous accounting treatment? If the TARP purchases assets above market value, the program appears more like an expenditure than an investment unless taxpayers are fairly compensated for overpayments, perhaps by receiving a portion of the equity of the revitalized entities.

Thoughts on the Short Selling Rules

Last week's ban on short-selling of financial stocks and new periodic disclosure requirements for large short positions appear to be having significant negative implications already. The imposition of these limits on short selling coincided with the monthly and quarterly expiry of stock index futures, stock options and other derivative products (so-called "triple witching") and the announcement of a "comprehensive approach to market developments," which incorporates a proposal for the Federal government to acquire and manage up to $700 billion of troubled mortgage assets (more on this below).

The simultaneity of these announcements contributed to a strong "relief rally," once it became clear that the urgency of the financial situation had resulted in what appears to be a clear willingness of legislators on both sides of the aisle to cooperate with policy makers and regulators to craft a solution to the impending crisis. It is likely that some short sales were unwound as the market rallied – resulting in losses for those covering – and almost certainly fewer short sales initiated as the market celebrated. So the new rules probably contributed – in the short run -- to last week's "rally back from the brink." Whenever the rules are changed, prices will likely adjust.

But to equate the new short selling rules with a sustainable rise in equity markets is probably a mistake. Short sales are an essential mechanism for hedging strategies, and most investors that hedge are committing significantly more capital to the "long side" of the stock market than the "short side." Even market participants that concentrate their transactions, research and investment acumen primarily on the short side contribute importantly to our capital markets. Without the opportunity for investors to gain when securities fall in price, a crucial element of an efficient market – those willing to play the part of the small child in Hans Christian Andersen's tale "The Emperor's New Clothes" – may be lost. The market needs a wide range of opinions to determine the right price for individual securities given all of the information available, the risk of loss, and the apparent returns available on competing investments.

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