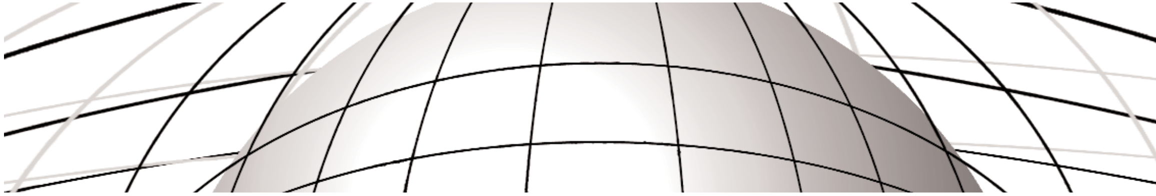
Mariner Special Report



The $700 Billion Question Mark

October 07, 2008

The Deed is done—so why do we feel so unsettled?

Last Friday the U.S. Congress passed, and the president signed, a $700 billion financial rescue plan (“bailout”) designed to unlock seized credit markets and restore confidence to the nation’s banking system. So why isn’t the stock market celebrating? Perhaps investors suddenly became mindful of the fact that this bill represents the government’s largest intervention in the private marketplace since Franklin Roosevelt’s New Deal. The Standard & Poor’s 500 Index signaled its concern by having its worst week since the 2001 terrorist attacks, and followed through on Monday with another selloff.

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What exactly is in this bill?

In addition to the $149 billion in sweeteners (some would call pork) added after the bill’s first defeat, the legislation gives the Treasury Department unprecedented discretion to buy $700 billion worth of “troubled assets” from financial institutions. Most of this toxic debt (so-called because of its lack of tradability) involves mortgage-backed securities, but could also include auto and student loans.

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The program is completely voluntary—no institutions will be forced to participate—but the chance to get this debt off of the company’s books should result in huge transfers taking place. Foreign firms may also participate in the rescue plan. The primary aim of the bailout package is to lubricate the capital markets and get money flowing through the system again.

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What will the government pay and how might taxpayers benefit?

The term “taxpayer benefit” is typically an oxymoron, as money finding its way to Washington never seems to find its way back to the point of origin—the wallets it was taken from. And let there be no mistake—this costly bill will add some $2,300 in government debt for every American citizen. However, the argument laid forth by drafters is that the government is not buying worthless paper; it is buying ownership of tangible assets that should (eventually) go up in value.

What will the government pay for these assets? That is a huge question and the concrete answer remains unknown. The Treasury Department will negotiate with the seller (the financial institution) a set price. There is an awful lot of wiggle room, but the agreed-upon price will be somewhere between the current (severely depressed) market price and the face value. It is Treasury’s stated goal to buy these assets at such a price so as to leave plenty of room for taxpayers to benefit when the assets are ultimately re-sold.

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As an added caveat for those footing the costs, the bill will forbid any financial institution from paying “golden parachute” severance packages to executives while the company is participating in the program.

Can a government deal really lead to a profit?

It is important to remember that buttressing the securities being purchased by the government will be actual, tangible assets. These assets have certainly been depressed as home values have fallen, but they should increase in value over time, allowing the government to sell them later at a profit. The Treasury will also receive warrants allowing them to purchase shares in participating companies at a preset price. While the thought of the government owning such a stake in private companies is a disturbing specter for a free society, taxpayers could—at least in theory—benefit as those share prices climb.

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Is there any accountability to soothe taxpayer concerns?

Yes. If, in five years, taxpayers have lost money in the deal, the president will be forced to submit legislation to recoup losses. This would most likely come in the form of a fee on financial institutions. There will also be an oversight board set up immediately to monitor where the money is going, and the treasury secretary must submit a report to Congress after each $50 billion batch of money is spent.

The bill also creates an inspector general, to be appointed by the president, who will oversee the program.

How will we know if the plan is working?

Lending between banks has essentially seized up. It will be a very good sign that the bill is having a positive effect if the inter-bank lending rates (LIBOR) begin to drop. Following that, there should be a nice increase in the volume of activity within the commercial paper market. Commercial paper simply represents the “plain vanilla” financing which takes place between the banks and businesses. Although this bill is not designed to be a panacea for the credit crisis, it is designed to jump-start activity in the private sector.

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In search of a silver lining

If we know anything from studying the past, it is that the prevailing outlook is often very wrong. Investors should always consider “what if” scenarios, and not just the negative ones. Yes, there is a deep gloom pervading the marketplace right now, and every past rally of late has found a way to fizzle. However, there are positive signs on the horizon. For example, despite the carnage in the financial sector, corporate earnings have been far more resilient than many expected. Coupling that with the market selloff equals a recipe for extremely “cheap” stocks, at least by historical standards.

Another potential catalyst could be a new round of interest rate cuts by the Fed. With commodity prices plummeting and the world economy slumping, inflation concerns are beginning to feel like a thing of the past. If inflation and interest rates do move lower, “fair value” for equities could move higher.

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Be a student of the past

Although every crisis is different, we have survived all that we have faced in the past and we will survive this one. While it is impossible to predict a market “bottom,” it is interesting to remember what previous troughs have led to. During the Watergate days of 1974 the Dow hit a bottom of 577 only to rocket up 42% the following year. A year after the October crash of 1987 the Dow was up 23%. In 2002 it seemed as though the bad news would just not stop. Those who had the fortitude to stick with their long-term plans were rewarded with a 33% market gain over the following year.

We are living through tough economic times, and we grow weary of the same answers. However, history has always rewarded those who persevere with their plan and refuse to succumb to the fear of the moment.

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