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A Socially Responsible Investment Adviser

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Bailed Out or Outfoxed?

Secretary of the Treasury Paulson has offered a dramatic new rescue plan. Most Americans hate it. Stock markets love it. When the plan was carefully leaked last Thursday it produced what was probably the biggest two day advance ever in global stock market prices. Since then stocks have soared or swooned at each indication that the plan might or might not be approved.

Meanwhile outside the world of angry citizens and perpetually optimistic stock market investors, events have unfolded at a frightening pace. On Wednesday, while Congress was debating whether to advance $250 billion to the Paulson plan, the Federal Reserve had lent over $400 billion to banks, investment banks and money market funds in an effort to prevent the collapse of any of these institutions. This was more than double the troubled week before and about 20 times the average amount in the first half of last year and before. And this does not count the money the Fed and other central banks have poured into the monetary system with temporary or permanent purchases of securities. Banks have stopped lending to each other or to anyone else. Businesses with existing lines of bank credit are taking all the cash now before the bank can change its mind, led by General Motors which took down all of its $3.5 billion line of credit. Bank deposits are stagnant and banks have been unable to refund their short term borrowings which have been shrinking at the rate of $50 billion per week.

The true value of the mortgages and other loans owned by the banks has been declining as default rates rise, buyers of risky assets disappear and foreclosure sales drive down the price of homes and other collateral, sometimes, as in California last month, at a rate already steeper than in the Great Depression. Many banks find it nearly impossible to raise more capital and are hoping to avoid writing down their loans to true values, which would seriously reduce, sometimes eliminate, their capital safety cushion. The real economy has entered a serious recession.

It seems too late, it may have been all along, to avoid an extended period of slow or negative growth with an on going process of paying down debts and driving down the prices of assets to do so. It may even be too late to avoid a credit system melt down, similar to the Great Depression. Economists from Milton Friedman to Ben Bernanke have employed a device economic historians call a counter-factual. In other words they ask what would have happened in the early 1930's if the Federal Reserve had not allowed banks to fail. And they purport to prove that the Great Depression would have been only another brief recession. Now the counter factual is the fact: so far central bankers and other government agencies have avoided failures in which depositors, or now also money market fund investors, have lost any money. But so far this real world experiment is not conforming to the theory. The force of debt reductions, lending

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reductions and forced sales of assets that drive down their prices, has been more than enough to cripple the money markets and send the U.S., Europe and Japan into recessions.

There is still no doubt that governments have the power to avoid a general collapse of banks or destruction of people's money. This is what the Paulson plan was supposed to accomplish. But, it is seriously flawed and not just by its instant unpopularity. The sad truth is that banks have far more than $700 billion of bad loans on their books not only in mortgages but also credit card debt, car loans, and various exotic instruments invented in collaboration with corporate America, hedge funds and private equity. The only way the Paulson plan could deal with this magnitude would be to sell the first $700 billion of bad loans that it bought and use the money to buy as much again, and again and probably again at least once more. If the Treasury could sell the loans that easily then clearly the banks could do it themselves and the problem would not exist.

Worse still, if the Paulson plan buys troubled mortgages at their fair value, this will trigger a wave of write downs for the selling banks and all other banks holding similar assets, thus adding to the stress on banks instead of alleviating it. If the Treasury paid more than the loans were worth, it would be stuck with them and the taxpayers would be stuck with a loss, all for an exercise that would not seriously reduce the current danger. Like his earlier plan to have the banks get together and form a new entity to which they would contribute money and then sell their bad loans, the Paulson plan clearly contains more Wall Street hype than genuine hope as befits a former head of Goldman Sachs. If it is adopted and fails, it will be even more difficult to get additional money from Congress to finance a better alternative.

The best way to solve this problem would be for the Treasury to buy a special preferred stock in all troubled banks that would be designed to be liquidated at a profit after the crisis has past. This could give the banks another $700 billion of capital, which would add about seventy percent to their current capital. This might enable them to write down their bad assets by about 25% and then go on to make new loans to households, businesses and each other. Unlike the Paulson plan this is an approach that has been used successfully in the U.S. in the 1930's and in Sweden and Japan in the 1990's. Why won't Bush, Obama or McCain embrace this efficient and effective solution, sure to get better results at far less cost to taxpayers? Government ownership of the banks is Socialism. And being soft on Socialism is the political equivalent of being soft on Iran or North Korea.

Another solution which also has a far better chance of succeeding is for the government to deal directly with distressed home owners, offering them new mortgages at lower rates or for longer terms in an amount sufficient to pay down much of the existing mortgage or perhaps to liquidate it at a fraction of face value. This would solve another problem in the Paulson plan in which the government would end up owning mostly mortgage backed securities which usually represent only partial ownership of the underlying mortgages. This in turn would prevent the government from actively promoting renegotiation of mortgages rather than foreclosures. In addition, this plan would directly support the prices of homes by cutting off the flood of foreclosures and forced sales, thus eliminating the principal force that is causing higher defaults and lower values for the banks' mortgage portfolios. It has been endorsed by the registered anti-Socialist conservatives including several economists at the American Enterprise Institute and the distinguished Martin Feldstein, chairman of Ronald Reagan's Council of Economic Advisers.

So why isn't this alternative on the Washington radar screen? It is clearly a political winner. Perhaps it has to do with election year calculations in the close and high-stakes presidential race. Perhaps bankers still think they can escape from this mess without recognizing the full losses on their mortgage portfolios. Perhaps the genial Washington bi-partisan approbation of wealth and distrust of the poor stays the hand that might provide succor directly to the poor borrower at the expense of the campaign contributor's bank.

The bottom line is that we are at a sorry and dangerous pass. The momentum of debt contraction and price declines for houses and commodities now seems self-perpetuating. The implosion of credit markets and financial institutions is accelerating. Recession is underway. And political deadlock has re-emerged in strength, caused in part by narrow political interests and in part by the stand off between an angry electorate and a rich donor base, each snarling from opposite sides at a very frightened Congress and executive branch all underneath a sky which may well be about to fall.

This is unquestionably a very bad and dangerous environment for common stocks. We have reduced common stock holdings in all of our accounts to much less than half of a normal position, except where tax considerations were too large. In most of the portfolios we manage cash is now the largest portion. We have invested in money market funds and short-term notes with careful attention to safety issues. We also maintain our favorable view of high-quality bonds. Inflation is likely to extend its recent decline which is good for bonds. While the U.S. government will be increasing its borrowing, the amount of private debt will decrease at an even greater rate.

As always, our first commitment is to avoid losses rather than take risks for big gains. Our performance in the current quarter has not lived up to this standard. But we think our clients are now well positioned to avoid most of any future losses in global stock markets or low quality securities.