Philequity Corner (September 22, 2008)
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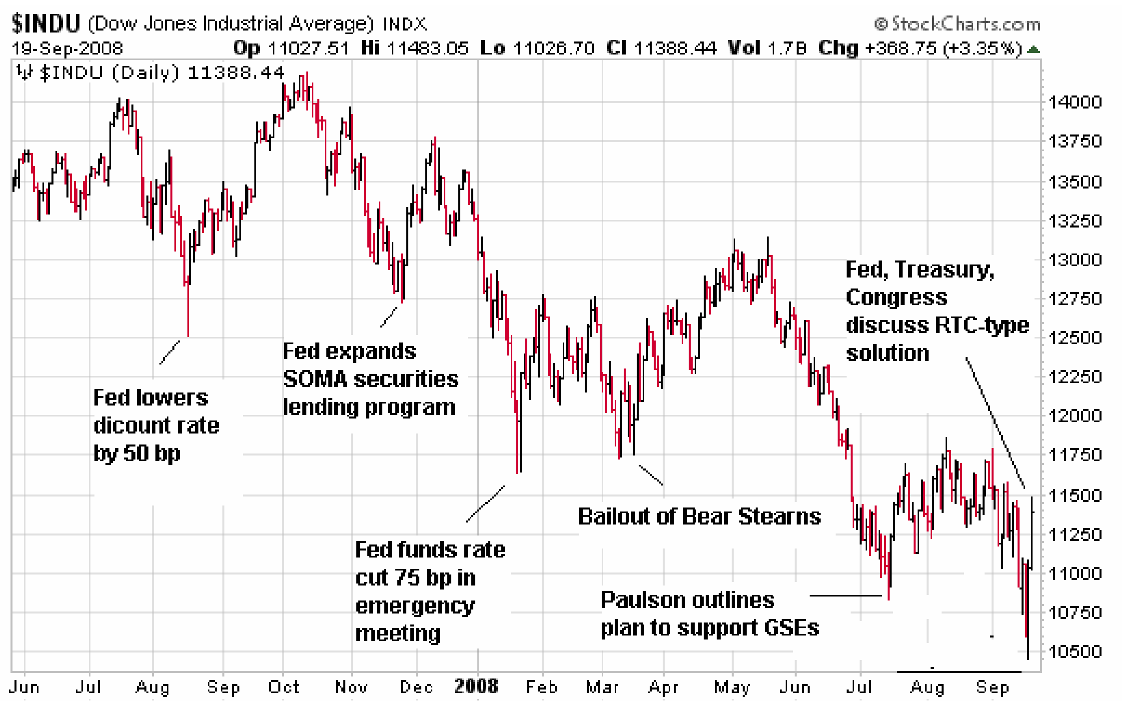
The Rescue

"*We are in the midst of the worst financial turmoil since the Great Depression. Absent bold action, matters could well get worse.*" – Paul Volcker, Chairman of the US Federal Reserve (1979 – 1987)

On the evening of September 18, Fed Chairman Ben Bernanke and Treasury Secretary Henry Paulson met with congressional leaders to seek approval for the biggest government intervention in the financial markets since the 1930s. The plan is for the government to absorb enormous amounts of toxic real-estate paper that are the underlying source of the current stresses in financial institutions and in the financial markets.

The US Treasury or a new governmental body, similar to the Resolution Trust Corporation (RTC) of the 1980s and the Home Owners Loan Corporation of the 1930s, will buy up the troubled paper at fair market values, where possible keeping people in their homes and businesses operating.

History unfolds before our eyes
In the months leading to last week, regulators used every trick in their book. They lowered interest rates, injected money into credit markets, but mortgage woes continued to spread.



As financial firms struggled, regulators decided to help out on a case-by-case basis. It bailed out investment bank Bear Stearns thru a facilitated sale to JP Morgan worth $29 billion. Then, it put mortgage giants Fannie Mae and Freddie Mac into conservatorship costing $200 billion. But rather than easing market angst, the bailouts sent new waves of fear as investors tried to assess what other corporations might suddenly turn insolvent.

Early last week, markets took a turn for the worst when regulators let 145-year old Lehman Brothers fail. Lehman, which survived The Great Depression, two World Wars and numerous financial crises, was the second casualty (after Bear Stearns) from the so-called Big-5 investment banks. On the same day, Merrill Lynch became the third when it was absorbed by Bank of America. If not, Merrill would have been the next to go bankrupt.

Of the Big-5, only Morgan Stanley and Goldman Sachs were left standing but they were under severe pressure last week, losing 30 to 40 percent of their stock price in one day before the announcement of the "Resolution Trust" meeting between the Treasury, the Fed and the United States Congress.

AIG, the world's largest insurer, became the next recipient of a bailout on Tuesday. Deemed as too large to fail, the US government agreed to lend as much as $85 billion in exchange for a 79.9 percent stake. If not it would have gone bust and the potential domino effect could have reached around the world.

Unprecedented flight to safety

The collapse of several financial icons shook confidence across markets that even the safest of investments, money market funds, saw big outflows last week.

On Tuesday, the Reserve Primary Fund, a money market fund, saw big outflows when it fell below $1 per share. This situation was never supposed to happen because money-market funds buy only safe and short-term debt instruments. Similarly, Putnam Investments had to close its $12.3 billion Putnam Prime Money Market Fund because of massive redemptions.

Meanwhile, the yields to short-term Treasury bonds fell to near zero, meaning investors were willing to accept no return on their investments if they could guarantee just getting their money back.

In the midst of all this chaos, there was a massive jump in gold prices because of panic and distrust of the financial instruments. Gold was up 13.2 percent last week.

Unprecedented market gyrations

As a consequence of these events, stock markets across the globe also saw unprecedented moves in just a span of a week. Some of the memorable moments include:

1) The largest one-day loss since the 9/11 attacks (Monday).
2) The largest one-day gain since October 2002 (Thursday).
3) The largest two-day gain since March 2002 (Thursday-Friday).
4) The largest volatility as measured by the VIX October 2002 (Thursday).

Outside the US, Russia experienced the biggest one-day loss for its MICEX 10 index (-20 percent on Monday) and biggest one-day gain for its MICEX 10 index (+36.7 percent on Friday). Russia had to stop trading and close the stock exchange for two days due to the huge declines earlier in the week. Upon resumption, it announced a proposal to use $20 billion to support the market.

Unprecedented concerted central bank & regulatory intervention

To ease extreme liquidity crunch following Lehman's bankruptcy and AIG's takeover by the US government, the Fed, ECB, Bank of England, Bank of Japan, Bank of Canada and the Swiss National Bank decided to pump in $247 billion funding in the interbank market.

At the same time, the US Securities and Exchange Commission announced a general ban on short-selling stock over the next two weeks. This followed the Financial Services Authority of UK's decision to ban short-selling of financial shares for the rest of the year.

This, in effect, changes the rules of the game, giving the longs an extra edge over the short-sellers. Just like in an Ateneo-La Salle basketball finals, it meant giving the losing team extra points and altering the rules in their favor so that they can win the ballgame.

From crisis to crisis, to a rescue plan

Up until last week, the steps taken by the US government have failed to regain the trust and confidence in the financial system.

But crisis times require bold and unprecedented measures. The final resolution, in our view, rests on the resurrection of the RTC. RTC-like mechanisms have worked well in the past because it addressed the root of the problem.

Together with the concerted actions of global central banks, an RTC-rescue should arrest the vicious downward spiral in asset prices and prevent a systemic failure in the financial system. We may very well have seen the bottom of the US market with these unprecedented moves.

Once in a lifetime event

Allan Greenspan said that we are in "a once-in-a-century type of event." It definitely is once in a lifetime, one for the books. For sure, books will be published for this tumultuous and historic moment.

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