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Nightmare on Wall Street

Federal bailout probably won't turn things around anytime soon

SUMMING IT UP

William Rutherford

The fear and trepidation surrounding the financial markets came to realization in the month of September. The broad market fell 8.9 percent in the month, with the average U.S. equity mutual fund down 10.5 percent. This brings the market down 25.6 percent from its Oct. 9, 2007 high through Sept. 30, 2008. Credit markets seized up. Bank failures continued. Auto sales plummeted. Unemployment rose.

The Secretary of the Treasury, Hank Paulson, and the Chairman of the Federal Reserve, Ben Bernanke, told President Bush and Congress of the dark peril that faced the U.S. if a massive aid package was not adopted. The epiphany for Paulson came as he watched his trading screens flatline across global credit markets. The London Interbank Offered Rate soared as banks hoarded cash and declined to loan even to one another. Commercial paper activity, the lifeblood of industry, dried up and rates soared. America stood on the brink.

Paulson and Bernanke brought a massive recovery package to Congress that included granting extraordinary powers to the Secretary of the Treasury.

Alan Greenspan, in an interview with Maria Bartiromo on CNBC, volunteered himself to serve on a committee as yet unnamed, presumably as chair, to be given extraordinary powers over the economy. It is not known if anyone accepted his offer.

Congress was asked to pass the sweeping legislation just weeks before an election. Presidential candidates were asked to take a position. The measure was dubbed a bailout of Wall Street. All of this was nearly too much for the democratic process. John McCain suspended his campaign and flew to Washington to take charge. Congressional leaders of both parties labored to find enough votes to pass the legislation that Bernanke and Paulson had proposed.

The leaders of the House apparently believing that they had the votes for passage, brought the measure to the floor on Monday, Sept. 29. Whether they had the votes is unclear. Before the vote, the House Speaker, Nancy Pelosi, gave a speech that seemed to presage failure; apparently it also made many Republicans angry. Liberal Democrats and conservative Republicans joined to vote against the bill in sufficient numbers to defeat it. As a result, the Dow Jones industrial average suffered its worst point loss ever. (October 1987 – Alan Greenspan's debut as Fed Chairman – still holds the record as the largest percentage drop since the Great Depression). Over a trillion and a half dollars in wealth, savings and retirement plans disappeared in a single day.

In Oregon, Democrat congresswoman Darlene Hooley and Republican congressman Greg Walden voted for the recovery package. Democrats David Wu, Earl Blumenauer and Peter DeFazio all voted against the measure. DeFazio later offered his own recovery bill, but by then no one was listening. Fear was everywhere. A run on Washington Mutual, perhaps started by TV talking heads, led to the largest bank failure in U.S. history. Banks in Europe failed. Ireland was forced to guarantee all deposits in Irish banks, putting the pressure on other European governments to follow suit.

The Republicans used the financial crisis to hand the election to Barack Obama. John McCain looked ineffective and uncertain in his meetings regarding the package. The House Republicans made ideology, not the economy their lodestar at a time when action was needed. No doubt they managed to make their business constituency angry too.

Locally, congressman Wu made for an interesting study. Originally opposed to the recovery bill because he said it did not protect taxpayers, he ended up voting for essentially the same bill after a Christmas load of goodies was added. So much for taxpayer protection. Perhaps because he represents the district of Oregon that has a collection of the largest employers and therefore employees in the state, he may have rethought how far he was willing to go to sink the savings, retirements and even jobs of his constituents. Without jobs there would be no taxpayers to protect.

Oregon's Gordon Smith supported the measure in the Senate and Ron Wyden opposed it.

President Bush leaves yet another legacy of unfinished business to his successor. Add an economy in disarray to an unfinished war.

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FDIC insurance for deposits in qualified institutions was increased from $100,000 to $250,000.

The SEC, which has repeatedly demonstrated its incompetence, indicated it might revert back to the uptick rule; the commission abolished it last summer after no policy discussion or reason for doing so. (I criticized this change in this column when the rule was abolished.) McCain says he will fire Chairman Christopher Cox. Obama should join McCain. A housecleaning at the SEC is in order. It was the SEC, of course, that allowed investment banks to take on unprecedented leverage, which contributed to their demise, and along with the Federal Reserve allowed a $60 trillion unregulated market in credit securities related to housing loans to proliferate.

Additionally, the "mark-to-market" rule, may be jettisoned, thus making Wachovia an interesting target for Wells Fargo after the FDIC had brokered a takeover by Citigroup. The mark-to-market rule, although well intentioned, has caused enormous accounting losses for financial institutions and has damaged their balance sheets and capital.

Also, look for the Fed to cut interest rates, in practice, if not in policy.

If the SEC had not allowed investment banks to take on enormous leverage, if the mark-to-market rule had not been in effect, if FDIC insurance had been higher, we probably would not have seen the demise of Bear Stearns, Fannie Mae, Freddie Mac, Lehman or Washington Mutual and the jobs and savings loss that went with them. What a different world we would be living in if policy makers had been ahead of the problem instead of behind it. Look no further than Wachovia for proof.

Looking ahead, the markets will stabilize after a lot more work by the U.S. Treasury and Federal Reserve. Whether the Europeans will join in a global rate cut is unclear as they quarrel among themselves. There will be more pressure on the Euro, and a strengthening dollar. Some even question the continued viability of the Euro as the European governments go their distinctive ways.

Barack Obama will be our next president. Congress will be overwhelmingly Democrat. In his first six months in office, Obama will see remarkable legislation come to him from Congress as it retaliates for eight years of George Bush. A tax increase will be among the bills. Some of the bills will be difficult for even the new president to swallow, but he will sign them.

Prime Minister Vladimir Putin will challenge the new president somewhere in the world, likely in a state of the former Soviet Union, perhaps one of the Stans, Georgia, Ukraine or Belarus. Next year will be rocky, and not just for the economy.

In a recent interview in Barron's I opined that if we got a 10-percent earnings increase next year that would be a very good year. Many economists are more optimistic, but I think we will see a recession.

William Rutherford is the founder and president of the Portland company Rutherford Investment Management, listed in Barron's as one of the leading separate account managers in the country and recipient of a four-star rating from Morningstar. He is also the author of a critical appraisal of Alan Greenspan's term as Fed chief, "Who Shot Goldilocks?" Contact him at 888-755-6546 or wrutherford@rutherfordinvestment.com.