THE TRILLION DOLLAR GAMBLE

by Steve Brown

We had a crazy dream last night. We walked into a casino, wandered up to a slot machine, pumped in a silver dollar, pulled the handle and the wheels began to spin. Cha-chink, cha-chink, cha-chink, click. We stared in amazement as the wheels locked up in the window with a red 7-7-7. Bells rang, people came out of everywhere to watch the commotion and lo and behold, a pit boss also wandered up. Unfortunately, just when we thought he was there to assist us in collecting the dollars spitting out of the bottom of the machine, he waved to a group of security guards. They came over, pulled night sticks from their belts and a big ugly one in the front said "sit tight and this won't hurt very much." We awoke with a start, glad it was only a dream. As our eyes cleared from a deep sleep, it was like reliving yesterday all over again. Here is where things stand now.

The 777 point drop in the stock market was the largest single point drop in history and wiped out $1.2T in wealth (the 1st trillion dollar loss for a single day in U.S. history). Meanwhile, the S&P 500 Index fell by the largest amount since "Black Monday" back in 1987. This led the price of gold to surge above $900 an ounce, pushed oil prices down $10 and hammered the yield on the 3M Treasury Bill down to 0.14%. Capital preservation and safety were the focus of virtually every investor.

In the banking sector, things were downright ugly, as regional bank stocks dropped an average of roughly 15% in a matter of hours. It began when news came that Citigroup had taken over Wachovia and picked up speed after the Congressional vote failed. Interestingly, the Wachovia deal wasn't driven by deposit outflows, but rather the expectation of deposit outflows. The story goes that major credit rating agencies were preparing to cut Wachovia's ratings, which bank executives felt could put a strain on funding and even lead to deposit outflows. Since Wachovia had billions of dollars of debt rolling over, the impact of such a downgrade could have been catastrophic. This led Wachovia to try and hammer out a deal (reportedly with Wells Fargo, who pulled out at the last minute), that eventually landed in Citigroup's lap with government assistance. As turmoil spread in the banking sector, it continued around the world. This led the Federal Reserve to step in and flood foreign central banks with $620B in dollars (up from $290B) and increased the amount it would lend to U.S. banks through the TAF program by $300B. Despite the efforts, European governments were forced to bail out a few banks on their shores, while stock markets worldwide dropped sharply.

Where are we now? To begin, we have lost a lot of confidence in our so-called "leaders" on Capitol Hill. They simply don't understand the gravity of the situation and seem to be about as brightly lit as a 20 watt light bulb. We don't like government bailouts either, but if something isn't done soon, $700B will look like chump change. Let's hope they can get it together on Thursday when they return for yet another vote.

Next, the economy going forward has slammed on the brakes. The 3Q looks like we will be lucky to be positive on GDP and the 4Q is deteriorating sharply. Business hiring is slowing and it will get worse unless something happens in Congress. The markets are frozen up, but ironically there is so much money sloshing around from the Federal Reserve that bank to bank lending in the Federal Funds market is routinely trading at 1% (and at the end of the day billions move around between banks at 0%). Despite that, the difference between Libor and Treasury yields (TED spread) has ballooned out to a record 400bp, as buckets of money have flowed into the safety of Treasuries and Libor climbed higher. Liquidity worldwide has been choked off and both consumers and businesses are feeling the impact.

Congress has shown it obviously likes to gamble, so perhaps Thursday will bring them to their senses. Let's all hope that as with poker, they will know when to fold and they won't push all of our economic chips to the center of the table and go "all-in" with the economy.

BANK NEWS

Bailout Package

While many in Congress are taking a breather for Rosh Hashanah holiday, the behind the scenes work to get the package passed is rumored to be gaining ground. A popular trend on both sides of the aisle is the move to raise FDIC insurance from $100k per account to $250k.

World Wrap Up

Ireland took the extraordinary move to guarantee all bank deposits and debt at 6 of the largest banks. Dexia becomes the latest European bank to be bailed out, as Belgian, French & Luxembourg Govt's injected $9B in capital.

Money Market Program

The Treasury department has officially rolled out its Temporary Guarantee Program for Money Market Funds. The program guarantees share prices of publicly offered eligible money market mutual funds held as of Sept. 19. Participating firms will be charged a 1bp to 1.5bp fee. The plan is set for review after a 3 month period.

OTS

Washington Mutual's closing puts into question the viability of the Office of Thrift Supervision. Wamu accounted for 20% of assets and 12% of the OTS budget.