Market Insight Series

Market Bulletin

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Roadblock to Recovery

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What Happened

Yesterday's historic "no" vote to the proposed Troubled Asset Relief Program (TARP) puts yet another roadblock in our collective path towards recovery from this period of economic slowdown and market turmoil. The market reaction was clear, as the Dow tumbled by over 777 points, its worst single-day point loss in history.

The measure, which was intended to stem further economic woes by stabilizing the financial sector, needed 218 votes for passage, but came up 13 votes short. About 60% of Democrats voted in favor of the plan, while about one-third of Republicans voted in favor.

About the TARP Plan

If passed, the proposed program would have aimed to give banks an opportunity to expunge their balance sheets of difficult-to-value assets – some of which are tied to defaulting mortgage loans – by selling them to the government's TARP program. Given the uncertainty as to how much some of these balance sheet assets are worth, lending has all but dried up as banks are wary of one-another's solvency.

By getting these troubled assets off of their books, banks would become more appealing as business partners and as investments, with more transparent balance sheets. This would likely result in an increased volume of bank-to-bank lending at the federal funds target rate, potentially restoring liquidity and giving consumers and companies the ability to borrow the funds they need to pursue new opportunities.

Opposition to the Plan

The plan has encountered tremendous opposition from both sides of the aisle in the last two weeks, and politicians have been flooded with phone calls, mail and e-mails from constituents urging them to vote down the proposed plan. It appears as though much of the American public views the bill to be a bailout of Wall Street "fat cats," and not a plan designed to protect the interests of Main Street Americans.

This is in some ways a misunderstanding by the public, as the plan is effectively an asset swap whereby the government is creating a market for these unmarketable and illiquid securities where a previous market did not exist. The government would ultimately buy these difficult-to-value securities from banks at what would likely be a deep discount, reducing the end-cost of the program substantially. According to some, the government (and the taxpayer) could potentially turn a profit on this deal. In any event, the program should not cost anything like the full $700 billion that is proposed to be allocated.

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What's Next

Some are suggesting that the most likely scenario will involve the President and Congressional leadership working to make changes to the bill in order to achieve a majority "yes" vote. The Senate was originally scheduled to vote on the plan this Wednesday, after the Rosh Hashanah holiday. At this point, another House vote on a revised bill would likely not occur until after the holiday.

While many voted against this plan, the market's reaction may cause some of the legislators to reconsider. After all, most of the stock out there is not held by Wall Street CEO's, but rather, by hard working Americans in 401K's and IRA's – in other words, their constituents.

That being the case, it would not be surprising to see politicians eyeing the political incentive to identify common ground, and to arrive at a modified version of the bill. Then, they will have killed the "bad" bill, just like the voters wanted, but worked in a bi-partisan way to put forth a "good" version, which would be positioned as something which helps Main Street and soothes market volatility.

Market Implications

Clearly the failure of the bill's passage yesterday makes it likely that volatility will continue. Investors hate uncertainty, and more than anything, yesterday's vote has only created more questions.

That said, consolidation in the financial sector continued this week, and when this period is behind us, the companies which make it through to the other end of this dark tunnel will emerge as dominant players on the financial playing field. Diversification continues to play a role, and some investors may see low stock prices as an opportunity to buy quality companies at a discount.

While legislators' interests in protecting the taxpayers are noble, if credit markets continue on their current path toward a grinding halt, businesses will struggle to find the capital to fund their growth, jobs will be lost and taxpayers may have ultimately been protected at the cost of an increasingly uncertain future.

Data as of September 29, 2008.

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