Perspective on the Latest Market Events

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The massive and virtually uniform campaign among global central banks continued today with the Swiss National Bank announcing that it would a) provide a $5.2 billion (U.S.) direct capital infusion to UBS, that country's largest financial institution and b) support as much as $60 billion (U.S.) in "toxic assets" currently held on the UBS balance sheet.

The Swiss announcement is just the latest example of the dramatic government intervention the 15-month old banking and financial crisis has invoked. This intervention now includes the near universal guarantee of the following: retail bank deposits, loans between banks, debt issued by banks and short-term debt (commonly referred to as commercial paper) issued by all types of financial and industrial companies. This week, the scope of government intervention expanded to include direct capital injections in the form of preferred stock investments in many of the world's leading and largest financial institutions. As described in this message, we think this latest development will mark an important turning point in the global banking and financial crisis.

An extraordinary and in many cases unprecedented level of government intervention has been required after more than a year's worth of both traditional and nontraditional monetary policy responses proved insufficient. In the United States, the Federal Reserve lowered short-term interest rates over the past year from 5.25% to 1.50%, a 70% reduction. The Fed also introduced several new lending programs (notably the Term Securities Lending Facility for commercial banks and the Primary Dealers Credit Facility for investment banks) that were designed to increase financial system liquidity. The world's other major central banking authorities, the Bank of England and European Central Bank in particular, enacted similar measures. Thus, for most of the past year, the primary policy response to the global banking and financial crisis has been to make more money available to financial institutions (i.e., increase the system's liquidity) and make that money available more cheaply by lowering interest rates.

But as we have learned, no amount of liquidity can encourage financial institutions to lend when counterparty trust and confidence evaporates as has occurred during the past 15 months. This loss of trust and confidence has two primary sources: first, going back to the beginning of this crisis, the balance sheets of many financial institutions, large and small, are full of sub-prime mortgage and other types of exotic or "structured" bonds. In most cases, the composition of these securities is opaque, rendering objective valuation attempts difficult if not impossible. As a result, financial institutions have curtailed or altogether stopped lending to one another because they've lost confidence in each other's intrinsic net worth and ability to repay loan obligations in full and on time.

The second factor complicit in the erosion of counterparty confidence has been the U.S. government's ad hoc approach to company-by-company challenges. Specifically, the inconsistency of this approach has kept new capital on the sidelines, and given short-sellers a strong financial incentive to press these struggling institutions to the proverbial wall. For example, the government's response to Bear Stearns' collapse was different than its approach with Washington Mutual, which was different than its approach with mortgage giants Fannie Mae and Freddie Mac, which was different than its approach with mega-insurance company AIG. In the case of Lehman Brothers, the U.S. government simply let the world's largest fixed income broker-dealer file for bankruptcy, representing yet another unique iteration in this year's daunting series of financial company failures.

Inconsistent government responses have produced the unintended but highly adverse consequence of allowing a "death spiral" to develop for struggling financial institutions: these firms' stocks were pummeled for fear of ever-greater bad debt write-offs, which in turn prompted credit downgrades from the rating agencies, which then shut these firms off from access to the capital they so desperately needed to stabilize their business models.

Recognizing that the array of policy responses deployed so far had still not crossed the sufficiency threshold, U.S. Treasury Secretary Henry Paulson and Fed Chairman Ben Bernanke introduced the Troubled Asset Relief Program (TARP) late last month. After a bitter, rancorous debate in Congress, TARP was passed and signed into law, giving Treasury the ability to buy from financial institutions up to $700 billion in "troubled assets" (i.e., the same opaque securities that impaired both individual firm's and the collective financial system's balance sheets). However, and due primarily to widespread skepticism of TARP's effectiveness (skepticism aimed at ambiguity surrounding the pricing mechanism Treasury would use to value and purchase these so-called troubled assets), the enactment of TARP in its original form failed to reassure global financial markets, which then spectacularly declined another 20% in five trading days.

Earlier this week, and the principal focus of this message, Treasury Secretary Paulson called an audible[1] with respect to how the first round of TARP proceeds would be used. Instead of using the first traunch of TARP proceeds to buy troubled assets, Treasury would instead use $250 billion of TARP to make direct capital injections into nine large U.S. financial institutions. This capital will arrive in the form of preferred stock investments, similar to how Warren Buffett recently provided capital to both General Electric and Goldman Sachs.

The importance of this change in strategy is that the preferred stock approach Treasury will now employ effects an immediate and direct capital infusion as opposed to the original TARP plan, which provided capital slowly and indirectly via the troubled asset purchases. A medical analogy might be that making these preferred stock investments is similar to a shot of adrenaline into a patient's main artery, whereas the original troubled asset purchase plan would be tantamount to a slow, intravenous drip.

Unlike British authorities, who announced their own direct investment plan days before Treasury Secretary Paulson, the terms of the U.S. preferred stock purchases are not overly punitive. In fact, with a coupon rate of only 5% for the initial five-year period, the U.S. government's preferred stock investments represent very cost-effective capital for the recipient institutions; moreover, these preferred stock investments may be called and replaced at any time by the recipient institutions

[1] For those not familiar with American football, an "audible" is when the quarterback calls a play in the huddle, but then changes the play at the line of scrimmage after surveying the opposing team's defensive configuration.

using funds raised from private investors. Firms accepting the government's preferred stock investments cannot pay dividends to common shareholders until the government's preferred dividends have been paid, but unlike the British plan, the U.S. government does not have voting rights and cannot exert board-level control unless a recipient firm misses six quarters of preferred dividend payments.

Bottom line, we think the preferred stock investment program Treasury Secretary Paulson announced this week is an extremely important milestone in the global banking and financial crisis. This program provides a large and direct capital infusion to participating institutions without punitive cost and control terms, and should immediately help stabilize the U.S. banking system. Upon receipt of this new capital, participating firms can begin mending their battered balance sheets, an essential first step before they can resume lending among each other and with other commercial enterprises. In other words, the preferred stock investment program should be the catalyst to restart the process by which Fed-created liquidity is delivered to the real economy – through banks' lending activities.

We believe this direct investment program, especially when combined with global governments' other major policy initiatives (e.g., the guarantee of retail banking and money market deposits and the guarantee of interbank loans and commercial paper issuance) will finally establish a firm floor under the downward vortex that had developed in financial companies' stock and bond prices, causing significant damage to global financial markets. However, this new approach does shift credit and default risk from investors to taxpayers, which is why Treasury Secretary Paulson referred to the U.S. government's actions as essential to restoring confidence in financial markets but "objectionable to most Americans, including me …."

As Northern Trust's Chief Investment Officer, Orie L. Dudley Jr., recently described, the pernicious and protracted nature of the banking and financial crisis now also has damaged the global economy. Financial markets, stock prices in particular, have quickly transitioned from the huge relief rally on October 13 (a rally based on the belief that financial Armageddon had been avoided) to a sober recognition that global economic growth has stalled and in most developed countries has begun to contract sharply. Corporate profit estimates will be cut, in some cases significantly, and all barometers of economic activity will be closely scrutinized to determine the probable depth and duration of the unfolding recession. Accordingly, we continue to advocate a heightened focus on risk management in our asset allocation and portfolio construction recommendations.