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# The Big Guns

Written by Jeff Thredgold, CSP, President, Thredgold Economic Associates

After applying one financial band-aid after another in recent days, weeks, and months, the U.S. Government was forced to bring out the really big guns during the past few days...

...the net result will be the largest government intervention into the private sector since the Great Depression

What makes the story even more interesting is that the steps proposed by the U.S. Treasury Department to help strengthen distressed financial institutions by buying up their "toxic" real estate loans and investments is actually the lesser of two evils...

...the alternative would be a massive meltdown of domestic and global financial markets, likely leading to widespread global panic, despair, and ultimate depression... scary stuff indeed

## The Proposal

The U.S. Treasury Department, with the expected and necessary approval of the U.S. Congress, would buy up to \$700 billion of tarnished real estate loans and securities from U.S. commercial banks and investment firms. The Treasury Department has requested no restrictions on its ability to buy and sell mortgage debt as a means of expediting the clean-up. The Treasury Department is also working with foreign

governments to develop similar programs to assist foreign-owned banks doing business in the U.S. and around the globe.

These firms, mostly financial giants, have been forced to revalue these toxic assets still on their balance sheets at much lesser values during the past 12-18 months, leading to enormous losses. As a result, these firms' interest in overall lending has been largely muted.

## The Secretary

"The credit markets are still very fragile right now and frozen," noted U.S. Treasury Secretary Henry Paulson. "We need to deal with this and deal with it quickly."

He noted in another interview, "I hate the fact that we have to do it, but it's better than the alternative." "This is a humbling, humbling time for the United States of America."

## "Bad" Assets

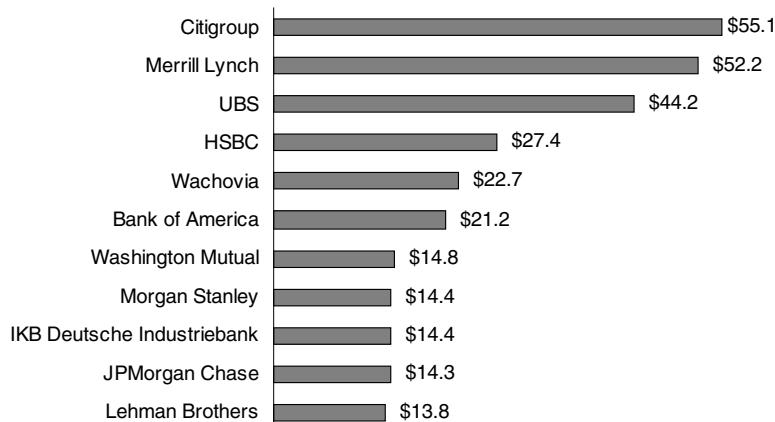
Those firms that have previously elected to sell such assets from their balance sheets have been met with miniscule, if any, bids. For example, a few weeks ago Merrill Lynch sold off billions of "bad" assets at 22 cents on the dollar, and provided most of the financing for the purchases at favorable rates to the buyer.

Financial firms stuck with such poor

assets have been largely reluctant to lend or invest in numerous other sectors in recent months, inhibiting the necessary flows of credit for many sectors beyond housing. To suggest that domestic and global credit markets have behaved irrationally since August 2007 is a massive understatement. To make matters worse, already limited credit flows had tightened even more in recent weeks.

## Wall Street Write-Downs and Losses

of leading banks and securities firms since the mortgage-financing crisis began a year ago, in billions



Source: Bloomberg News

## Band-Aids

Prior moves by the U.S. Treasury, the Federal Reserve, and by the Congress to enhance global and domestic credit flows and remove financial market uncertainty had done little to solve the enormous challenges facing credit markets:

- The Government's takeover of massive public/private entities Freddie Mac and Fannie Mae in early September did temporarily lead mortgage interest rates lower. This occurred in part because it settled the discussion of what the Government would do in just such a "what if" scenario
- The Government's decision not to rescue 158-year old Lehman Brothers was a major surprise (particularly to Lehman Brothers), following the Federal Reserve's assistance with JPMorgan Chase's takeover of failed Bear Stearns six months ago
- Seeing Lehman's "handwriting on the wall" was enough for Merrill Lynch leaders to jump into the arms of Bank of America the same weekend, particularly while Merrill Lynch still had substantial market value. Did ML really want to be acquired by Bank of America, or any other firm? Not a chance. However, ML leaders knew they were likely the next primary target of aggressive short sellers
- Insurance giant AIG, a \$1.1 trillion company with 74 million customers, had already been pushed into the gutter, with its stock falling more than 97%. When no private sector white knight was to be found, the Federal Reserve agreed to loan the company up to \$85 billion, with an interest rate exceeding 11%, and in exchange for 79.99% of the company. What AIG got was "time" to sell off its most valuable pieces
- The Fed, along with other major central banks around the globe, had provided global financial markets with tens of billions of dollars of additional market liquidity in recent days, only to see their efforts go for naught. The availability and price of credit can be almost irrelevant in markets where terrified players refuse to play
- Moves by investment firms Goldman Sachs and Morgan Stanley in recent

days to become bank holding companies is just one more previously unthinkable development

## History Repeats

The current proposal to deal with the credit crisis is being compared to the savings & loan crisis in the late 80s/early 90s. At that time, the Government created the RTC (Resolution Trust Corporation) to acquire failed S&Ls and eventually sell them to stronger financial institutions. Such a comparison is valid, although many of the details are quite different.

The current proposal is much larger in scale, and hopefully will address much greater challenges to global economic and financial well-being. Financial market conditions on Monday, September 15 and on Wednesday, September 17 were as threatening to global financial health as ANY since the Great Depression.

Enormous pressures will rest this week on the U.S. Congress to deliver a "clean" bill that is largely void of the traditional ornaments and pork barrel spending found on too many bills. Democrats will have a hard time giving the Treasury Secretary the broad mandate he wants. However, getting something done very quickly is in the best interests of all.

## All Borrowed Money

Needless to say, massive new borrowing of up to \$700 billion for the current crisis, on top of previously approved spending to assist homeowners and to strengthen Freddie Mac and Fannie Mae, will push an already bloated budget deficit much higher. Note, however, that much of the \$700 billion in proposed spending will be repaid when such real estate loans and securities are sold to investors in (hopefully) more rational markets.

## Action is Essential

Substantial action is required immediately. Casting blame for this financial debacle can, and will, come later.

Last week's stock market roller coaster was somewhat a culmination of emotion, both negative and positive, as to where we are at this point. How highly partisan politicians respond in coming days will be critical as to where financial markets and the economy go from here.



## "TEA"ser

Maybe it's true that life begins at 50. But everything else starts to wear out, fall out, or spread out.

—Phyllis Diller



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