

To: MetWest Clients
From: Tad Rivelle
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Re: Is the Fed Still the Lender of Last Resort?

Since Ben Bernanke's appointment as Chairman of the Federal Reserve, many investors have drawn comfort from his deep knowledge of the causes and consequences of the Great Depression. Seen from this point of view, the mounting incoherence of government policy toward the financial markets is all the more puzzling.

Many are familiar with the controversies that surrounded Federal government action—or the lack thereof—in the wake of the 1929 equity market crash. Call the two camps the "Hooverites" and the "Rooseveltites." The Hooverites were proponents of an all-private-sector solution to the chaos and economic decline, while the Rooseveltites understood that the economic imbalances were of such a magnitude that Federal help was needed. While it would be inappropriate to compare current economic conditions to those of the Great Depression, the experience gained during that period may have lessons for the financial markets and for central bankers.

The Hooverites were prototypically defined by steel magnate Andrew Mellon, then Secretary of the Treasury under Hoover. He famously advised President Hoover to adopt a laissez-faire attitude toward the mounting crisis. He held that the deleveraging needed to run its course: "Liquidate labor" he advised, "liquidate stocks, liquidate the farmers, liquidate real-estate ... it will purge the rottenness out of the system ... people will work harder, live a more moral life ... and enterprising people will pick up the wrecks from less competent people."

As appealing as such an approach might sound to some, the social and economic costs of liquidating your economy may be far higher than any are truly prepared to bear and far higher than might be necessary. A financial system operates on confidence. At the root of the system lays the dynamic that intermediaries—be they commercial banks, insurance companies, Wall Street broker/dealers—borrow short and lend or invest long. Just as no financial institution can survive a full-scale run on the bank, the Fed cannot survive a full-scale run on the system. For this reason, investors must have some assurance that if a run does occur somewhere that a lender of last resort will step in to prevent essentially solvent financial institutions from suffering a crisis in confidence (liquidity) that leads, in turn, to bankruptcy and ruin.

When the lender of last resort—the Fed—doesn't lend, then our government is, in effect, throwing its lot in with the Hooverites. When the house is on fire, whatever the cause, whomever's to blame, the matter at hand is to douse the fire. The simple reality of financial busts is that they are caused by the booms that preceded them. Yet central bank policy had, under Alan Greenspan, adopted the view that the Fed does not target asset prices, only inflation and unemployment. Millions of actors—homeowners, construction companies, mortgage brokers, real-estate speculators, and the various institutions that responded to market-based incentives—were ultimately "at fault." The legacy, then, of the Greenspan Fed was an overvalued housing market and a financial system overlevered to a variety of financial instruments including SIVs, asset-backed commercial paper, CDOs, lower tiers of subprime securitizations, and credit default swaps.

Now that the Hooverites have effectively taught the stockholders and bondholders of Lehman a "lesson" by putting the fourth largest broker/dealer out of business, all of us have to live with the consequences of a seemingly capricious action. What was the point of the Bear Stearns "rescue" operation and the establishment of a discount window mechanism put in place for the purpose of preventing a run on Wall Street only to let a larger and arguably stronger franchise such as Lehman fail catastrophically?

Lehman's failure raises yet another question: if Lehman's \$600 Billion balance sheet wasn't too big to fail, then what exactly were our policymakers trying to tell us? That AIG's \$1 Trillion balance sheet isn't too big either? What about Citi's \$2 Trillion balance sheet? If no one is too big to fail, then as a policy measure we are telling the markets that they should trust no one. While this may sound like a prudent attitude in the midst of a financial maelstrom, it is impractical. How can there ever be sufficient transparency into a thirteen-digit balance sheet?

Government policy needs to be coherent. As it stands, we have two options. We can collectively determine that those "immoral" investors in asset classes facing pricing pressure must now be punished for their actions even if that means letting the global system of finance implode and punishing many innocents along with the guilty. Or we can decide that the job of the Fed during a crisis is to take all actions necessary to maintain confidence in the system.

Ominously, the actions of the Fed in recent days have sent the markets an "eenie-meenie-mynie-moe" message. Bear Stearns? We'll subsidize the sale to JPMorgan by agreeing to absorb some amount of future losses from the balance sheet of Bear, and we'll protect the bondholders and hand the equityholders \$2—no, make that \$10—per share. For Fannie and Freddie, did they misbehave worse than Bear? We'll protect the bondholders (maybe because foreign central banks own hundreds of billions of their debt as does probably every money market fund in the nation), prime the preferred, and more or less wash away the stockholder. For Lehman—we'll just let everyone go down—then we'll let Barclays buy the broker/dealer for a pittance of \$250 million. Finally, for AIG, we'll prime the bondholder with \$85 Billion in new super senior debt at distressed debt level pricing and wipe out the shareholder.

Is it any wonder that the market can't tell if the Fed and the Treasury are coming or going? The oldest saw in the markets is that uncertainty is generally worse than even the certainty of bad news. So, if we have decided to liquidate the investment banks, liquidate the insurance industry, liquidate the GSEs, liquidate houses, and maybe the rest of the national economy, please send us the memo. If, on the other hand, we have determined that you don't fix a leaking roof during a Category 5 hurricane, then the Fed and the Treasury need to focus on stabilizing investor confidence.

Like it or not, that will require the lender of last resort to, well, lend. Is that asking too much?

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