

Lehman Brothers Commentary

Barring a last-minute solution on Lehman, riskier financial assets are likely to be weaker, but I believe these assets will stabilize before long for a number of reasons, shown below. Current conditions emphasize yet again the challenges that investors face in investing from the bottom up and why knowledge of the macro situation is essential today.

1. Market participants have had ample warning on Lehman and have likely already taken the precautions they felt were necessary to guard against risks Lehman's potential failure might pose.
2. This weekend's deliberations by the nation's top financial firms will help cushion the blow. For example, the International Swaps and Derivatives Association (ISDA) on Sunday between the hours of 2 p.m. and 4 p.m. orchestrated a so-called netting trading session enabling transactors in credit, equity, foreign exchange, and commodity derivatives to "reduce risk associated with a potential Lehman Brothers Holding Inc. bankruptcy filing." If there is no filing, the trades cease to exist, the ISDA said. The banding together of counterparties on Sunday almost certainly extends beyond the derivatives market into other vital areas such as the \$4 trillion repo market, where dealers go to obtain the short-term financing they need to carry their securities positions.
3. The Federal Reserve's Primary Dealer Credit Facility is available to Lehman to assure a more orderly disposal of its assets. Recall that \$29 billion of Bear Stearns' assets were parked in a limited liability company called Maiden Lane, which was formed to acquire assets of Bear Stearns to help facilitate a more orderly liquidation of the assets. A similar setup can be made for Lehman, although indications are that the Treasury and Fed view this as a last resort. The point, nonetheless, is that Lehman's assets are unlikely to be sold at a firesale, which would put mark-to-market pressures on other financial firms.
4. If the Fed and or Treasury decide against taking any actions on Lehman, it would strongly suggest that authorities felt, after a thorough review of Lehman's balance sheet and in consideration of actions taken and or pledged to be taken by those with direct and indirect exposure to Lehman, that failure of the institution would not ripple through the financial system and could be contained.
5. Moreover, inaction by authorities would strongly suggest that officials of both the Treasury and the Federal Reserve were in touch with foreign central banks and other major foreign financial institutions vital to the U.S. and that officials were able to obtain assurances of their continued commitment to U.S. financial assets.
6. Both the Fed and the Treasury know more than anyone all that exists on Lehman's balance sheet and if the Fed and Treasury felt that a disorderly liquidation of Lehman could still occur even after this weekend's meeting of financial firms, the Fed and the Treasury would almost certainly take counter-actions aimed at facilitating an orderly liquidation. Again, this means that inaction is a sign that authorities view the situation as likely to be contained.
7. Conditions at the root of the financial market's problems were extraordinarily favorable last week. Specifically, mortgage rates plunged, agency spreads tightened, and consumer confidence surged in response to a restoration of purchasing power resulting from the decline in commodity prices. These conditions are vital to home prices.
8. Dealer positions have already been shrunk substantially, reducing pressures to sell assets. For example, New York Fed data show that aggregate dealer positions in Treasuries, agencies, MBS, and corporates have shrunk more than 25% to about \$310 billion.
9. The U.S. dollar's rally since the Bear Stearns rescue shows that foreign investors fully recognize the inter-connectivity that exists of the global financial system and have not been able to center on an alternative to the dollar in the current climate, particularly given the massive unwinding of commodity-linked trades I suggested months ago would be a boon to the dollar.
10. We on Wall Street are sated with about as much negativity as we can take and we can't take it anymore! Seriously, though, the nation is looking ahead as it always does in a presidential election year, and this means it is time to look forward and not back. This is always the case in the financial markets, but the need to do so is greater now because the masses are beginning to look ahead and America is set to do what America does and move forward. The deep interest in this year's exciting campaign is clear evidence of this.

Looking forward

Expect confidence levels to keep increasing into the winter and for these problems in financial markets to thaw with the snow in the spring. By then the Case-Shiller index will show clear signs of slower price drops and a floor will finally be underneath home prices. It is inevitable so long as the population keeps growing and building completions stay low. Watch closely the mortgage and agency market for any setbacks. As for rate cuts? Maybe, but the Fed should not do too much. This way, Treasury yields, which rarely cross the funds rate without a rate cut, can fall a bit. Do too much and the dollar weakens and commodities rally. The Fed must keep pressure on these fronts and help retain some of the regained lost purchasing power.