

Details of the Current Plan

While all details of the plan are still unknown, some specifics have been released.

The plan, currently in draft, segments the \$700 billion in three parts:

- \$250 billion available immediately upon enactment of the legislation
- \$100 billion upon “presidential certification of need”
- \$350 billion subject to congressional review

The current plan would prohibit executives from receiving multi-million dollar “golden parachutes” It also gives the US government (as owner of the mortgages) authority to modify the terms of the underlying loans, and has provisions aimed at assisting small businesses by helping the community banks that often provide small business loans.

As yet, it is unknown how the Treasury will determine the purchase price for these assets; at what price associated financial institutions will be willing to sell; how the securities will be bought and sold; and how and when the government will unwind these purchased assets. However, the ultimate cost may be less than the original price tag of \$700 billion, whether the securities are held to maturity or sold prior to maturity. Conceivably, the Treasury could profit on the sale of these securities, as direct Treasury involvement inherent in the bailout brings pricing and liquidity back into the mortgage markets. In terms of the US budget deficit (currently expected to be well over \$500 billion next year) the impact may end up being minimal if the Treasury can recoup some or all of the bailout costs.

What’s the Intended Impact?

This massive bailout is intended to help end the downward spiral of de-leveraging (getting rid of bad debt) and forced selling that has crippled the financial system and led to the demise of several major financial institutions. In turn, it could also help facilitate new mortgage lending and bring some relief to the housing market. Equally important, it may quell some of the panic mentality evident in the markets as investors, fearing what might happen next, scramble for what they believe are safer investments. But with a program as massive as this, it would not be prudent to deny the possibility of longer-term consequences.

Potential Effects on Fixed Income

If it succeeds in bringing some calm to the debt markets, the plan could help bring down yield spreads (the difference between the interest paid on government versus non-government debt) demanded by investors for assuming the additional risk. That could benefit non-government bonds (such as securitized debt, corporate debt, high yield bonds), helping recoup some of their recent underperformance, a result of investors’ flight to quality toward “safer” US Treasuries. However, in Asian and European trade, so far credit markets have remained seized up, not helped by weekend news of the forced nationalization of mid-sized UK mortgage lender Bradford & Bingley and the government rescue of Brussels-based banking and insurance group Fortis. Mortgage sectors with exposure to riskier loans such as sub-prime and so-called Alt-A loans (which required less documentation of credit worthiness) are the most direct targets of the government’s plan and have had virtually no buyers over the past year. The plan could provide a floor in the pricing of these sectors, which have been in free fall. More importantly, it is hoped that this could be an important step in improving overall liquidity (buying and selling) in the recently dysfunctional debt markets. The corporate bond sector could also stand to benefit, but to a lesser degree.

Potential Effects on Equities

In Asian trading overnight there was some evidence of improved sentiment toward financial stocks as a result of US government efforts. However, this was largely overshadowed by other negative news for financials. Property companies in Hong Kong fell following a rise in mortgage rates, while news of the nationalization of Bradford & Bingley and the government rescue of Fortis weighed on the financial sector in the UK and Europe. US equity futures also fell, indicating declines when US markets open later.

Potential Effects for the Markets and the Economy

Short-term

While the hope is that the bailout will restore a sense of calm to the equity markets and grease the wheels of the credit markets (especially if it frees up inter-bank lending) this has so far not been the case. Cash is still king, and many banks could still be suffering from a lack of adequate capital, despite the helping hand from the US Treasury. However, it remains to be seen what the reaction will be in US markets, where the plan should have the most direct impact.

Long-term

Markets will probably be affected for some time to come by lower levels of debt being employed for investment purposes (leverage). We could also be facing an environment of greater regulation in the years ahead. These factors could have a negative impact on corporate profits and investments. It appears likely that this bailout will result in a huge increase in the supply of US Treasury securities, which may put upward pressure on funding costs by crowding out other borrowers. This is evidenced by the spike in Treasury yields following the initial announcements about a potential bailout plan.

Conclusion

The financial crisis is not going to be declared over as a result of this plan, and other factors contributing to a potential recession remain—such as rising unemployment and falling consumer demand. There may yet need to be further government initiatives and it is conceivable that more financial institutions will fail. But, considering the alternatives, this bailout is good news; at least in the short-term, for the US economy and financial markets, and economies and markets around the globe. As details of the plan are released, we will provide additional commentary about its impact.