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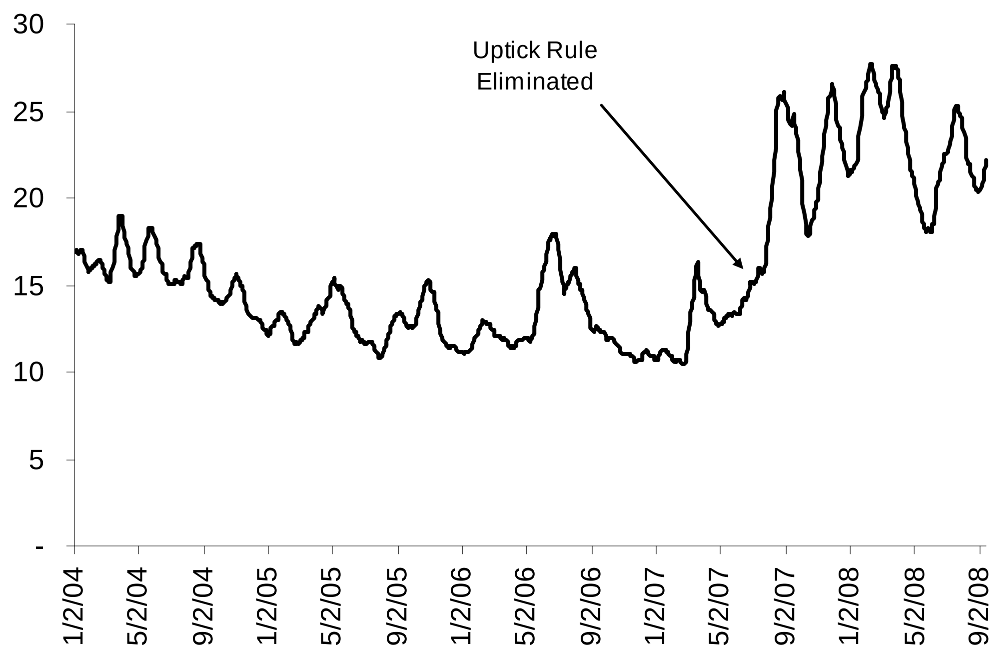
Short-Selling More Damaging than Weak Retail Sales; a Catch-22 for Equity Capital

August retail sales were weak, but we think the more important problem in the outlook is the sequential collapse of major financial companies. This week, losses moved rapidly from Lehman to Merrill and AIG.

We think the playing field is tilted toward short-selling:

- The new mark-to-market rules are creating capital shortages by valuing assets as cautiously (meaning low) as possible, without a reasonableness test.
- The mark-to-market rules discourage takeovers (the bane of short-sellers) by forcing prices for post-merger assets to be lowered overnight (when reasonableness would argue that their value would increase due to the deeper pockets of the acquirer).
- The short-sale uptick rule was eliminated in July 2007, coincident with a surge in the VIX volatility index; higher volatility adds risk, lowering equity prices.

Volatility Index –VIX 15 day average (last obs. September 12, 2008)



Source: Bloomberg; Encima Global

- The enforcement of restrictions on naked short-selling (selling a share that hasn't been specifically identified) hasn't been aggressive, making short-selling a major growth industry and center for financial innovation.

- Relatively new restrictions on information disclosure are hampering companies (no touting allowed) more than short-sellers.

Observations:

- With each collapse of a financial firm, **the half-life of government intervention has been shortening** – a few weeks short-selling respite after Bear, a few days after Fannie.

- The rules and regulations aren't making any distinction between cash losses and accounting losses. **Lehman doesn't appear to be accessing the Fed's discount window/TLSF facility** – it apparently faces a capital problem rather than a cash problem or a run on the bank.

- **Treasury has created a Catch-22** – companies must attract more equity capital, but Washington will only help after a company's share-price goes near zero (which prevents the injection of equity capital).

- The cover story in the current issue of Business Week ("Right Stuff", September 15) is about **the 50 best companies to launch a career. Four of the top five are accounting firms**.

- We think it's critical for Washington to clarify the new mark-to-market rules toward a reasonableness test, consider reinstating an uptick rule, and actively monitor naked short-selling practices.

Notes