

Virus on Wall Street

The swine flu continues to spread, but there appears to be another ailment afflicting many Americans. There are two strains. The first has been dubbed America Firsters, but is different than the isolationists of the '30s and '40s and more contemporary times. When inquiring into nearly all of the world's problems, the illness makes them typically blame America first and foremost. Those harboring left of center views often appear more susceptible to this strain.

The second can be called Slippery Slopers. More common on the center-right of the American political spectrum, it typically spreads through communication channels. The strain has affected wide swathes of people at various television networks (no, it was not quarantined at Fox) and media outlets, including the blogosphere and radio. It has decimated Wall Street. The symptoms include a profound sense of persecution and paranoia. Many have been seen and heard ranting about how government policy is going to make it more difficult to do business in America, incentives to innovate will be destroyed; and this will all hasten America's decline.

The strains share the common origin of American exceptionalism, an idea traceable to Alexis de Tocqueville's 19th century recognition of America's uniqueness. Over time, this sense of being the proverbial city on the hill, or having a special mission from Providence has mutated into the viruses that now infect us.

The America Firster strain is widely commented on and reported. The Slippery Slopers go largely unobserved and the ailment tends to grow unchecked. So it is there that we will focus.

Reform

The crisis has forced American and European policy makers to take seriously the need to overhaul the financial regulatory environment. Many of those infected by the Slipper Slopers virus have greater olfactory sensitivity. Any significant increase in regulation smells like socialism to them. Of course, the illness causes an exaggerated response.

There is little doubt that there will be greater and different regulation going forward. It is also clear that the differences between the regulatory regimes in Europe and the US were not sufficient to prevent a similar type of crisis. House prices in European and US cities tended to rise in unison since at least 2000. The US economy has contracted roughly half as much as many countries in Europe and close to a third as much as Japan.

European banks may not have granted subprime mortgages as US banks did. However, they had greater leverage and loaned to corporations and developing countries at interest rate spreads which hindsight shows contemporaneously reflected a mispricing of risk similar, and arguably with greater magnitude, than US banks.

Out of the Frying Pan, Into the Fire

Slippery Slopers are unable to appreciate that the real contest is not so much between the markets and US regulators but between US regulators, on one hand, and European regulators on the other hand.

Consider the originate-and-distribute model under which banks and other financial institutions create asset-backed securities, collecting fees and then selling them to other investors. There has been some vague talk in Washington to abolish this practice. Lenders are more prudent and responsible if they retain some exposure and are accountable in some real way for their actions. But the sick warn that this is an attack on financial innovation and the price will be slower growth. In their delusional state some of the more serious cases warn of a capital strike against the US. Oh really?

The EU parliament recently passed measures that will force banks and other financial institutions to maintain at least a 5% stake in any asset-backed security they create. Moreover, no European could buy an asset backed security in which the originator did not maintain 5% ownership. This will not only impact Europe, but also US businesses wanting to sell financial products in Europe. At the peak, European investors owned more than \$500 billion of US asset-backed securities. The Slippery Slopers may succeed in diluting the US efforts, but their ocular impairment prevents them from seeing implications of operation in a global marketplace.

Executive Compensation

One issue that really aggravated the Slippery Slopers was US government efforts to curb compensation schemes. The sick warned that such onerous policies would put American businesses in an uncompetitive position. How could they attract the needed talent? After much debate, Treasury Secretary Geithner suggested that shareholders in firms receiving TARP money can have non-binding resolutions about executive compensation.

Now consider what Germany did. The ruling coalition gave supervisory boards, where shareholders and employees are represented and appoint and oversee the management board, the power to set executive salaries. It doubled the period after which stock options can be exercised to four years and mandated that bonus payments be spread over the life cycle of an investment (almost like an annuity or residual). Managers found guilty of negligence could be fined the equivalent of eighteen months pay, though bonuses were excluded from the sanctions as a compromise.

Too Big To Fail

Some institutions grew so big and were so woven into the very fabric of the economy and its financial aspect that their failure would threaten the entire system. Policy makers recognize the dangers of such a situation and the moral hazards involved. The Obama Administration's approach to this issue is not yet known, but perhaps will be discussed by what has been called Plan C, an internal project at the US Treasury reportedly for identifying potential future systemic risks.

The Slipper Slopers are worried. Take a pill and chill. Look at what is happening in Switzerland. The total assets of the top two banks are reportedly around six times larger than the country's GDP. This is the highest ratio among the major industrialized countries (G10). A modest 5% decline in asset value would cost 30% of GDP.

In the middle of June, Philipp Hildebrand, the Vice Chairman of the Swiss National Bank, suggested financial firms not be allowed to get too big. At a press conference he warned "There can be no more taboos" in addressing the risks posed by banks considered too big to fail. He complained that the large banks still have too much leverage.

The Dollar

America Firsters and Slippery Slopers think America is in decline. They are among the perma-dollar bears. Yet insofar as foreign exchange reflects one country's currency in terms of another, then it is the ultimate relative value trade. As severe as the US economic and financial challenges are, the situation in Europe and Japan appears even more so. Productivity and long-term demographic considerations are also less favorable in Europe and Japan. The regulatory reforms being pursued in Europe seem far more aggressive than what will emerge from the US.

Some of those stricken Slippery Slopers have warned of the risk of a capital strike against the US. Yet the massive debt sales by the US have been fairly well absorbed. Earlier this year, bond auctions failed in the UK and Germany and twice this week there were not enough buyers at Chinese auctions. Over the past month, the US 10-year yield has fallen 60 basis points, while the 30-year yield has fallen 50 basis points. This effectively cut in half the rise in US yields over the past three months.

There is no known cure for the Slippery Slopers. The strain appears immune to antibiotics and rational discourse. Time is the great healer. Over time, as developments in Europe impinge more than US regulatory responses, the symptoms will likely subside. The myopia will ease. With time, as US interest rates rise when compared to Europe, investors will be paid to be short dollars. The greenback will find better traction and the Slippery Slopers will sleep easier at night.

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