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First Trust

Feb 7, 2011

Monday Morning Outlook

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FASB Surrenders - America Wins

If an accounting rule falls down and decays in the woods, and the business punditry and politicians completely ignore it, does it still have an impact on the economy?

The answer is YES. Especially when that rule is Mark-To-Market Accounting – aka: Fair Value Accounting. Everyone should breathe a huge sigh of relief…we are.

The Financial Accounting Standards Board (FASB) wanted to broaden the reach of its fair value accounting rules. Somehow it believes that marking everything to market (even when that market is illiquid) will somehow make the world a better and safer place. So, even after almost destroying the economy in 2008, FASB was pushing to have banks mark their loans – yes their loans – to a bid in the market place.

The good news, which went virtually un-reported on January 25, 2011, was that FASB surrendered on fair value accounting for loans. In the face of overwhelming opposition, banks will be allowed to carry loans on their books at amortized cost, reflecting cash flow (payments), as well as reasonable estimates of likely loan losses.

This decision is a huge win for the markets and the economy. Like the sword of Damacles, mark-to-market accounting has been hanging over the head of the economy. As long as it could be broadened, or brought back in the form it took in 2008, the risk of turning the next recession into a panic or even a depression was very real.

Most people don't know this, but mark-to-market accounting played a role in the Great Depression. According to Milton Friedman (in his book *The Great Contraction*), fair value accounting was the predominant force for bank closures in the early stages of the Depression. These bank failures fed on themselves making the Depression worse.

In 1938, Franklin Roosevelt ended mark-to-market accounting and the economy recovered. There is absolutely no academic research on the role of MTM accounting in the Great Depression, but the more we study the issue the more convinced we become that it played a major role in that fiasco and the recovery from it.

One reason that its role is ignored is that government wants the story of economic crisis to be a simple one that blames business and praises government (or at least blames government for something that requires more government). Conventional wisdom blames a bubble in the stock market, greedy business people and a lack of government oversight for the Great Depression. This story-line led to the creation of the SEC and many other government agencies, programs and regulations.

Nothing has changed. Back in 2009, Congress passed the Dodd-Frank financial regulation bill based on a flimsy theory of the crisis's causes even before the report from The Financial Crisis Inquiry Commission. But that report would not have changed much policy anyway. On January 24, 2011 – the same week as FASB's surrender - the FCIC said that the debacle was caused by a combination of stupid and unscrupulous business practices mixed with lax oversight by regulators. No surprise there.

Clearly, some people in the private sector made mistakes in assessing the riskiness of loans. That's easy to see in hindsight. But, government's role was much more detrimental than this, but was totally ignored by the FCIC majority.

A dissenting opinion was penned by Peter Wallison. He blames Fannie Mae, Freddie Mac, the Community Reinvestment Act, and mark-to-market accounting for creating the crisis. We completely agree, but we would also add the policy of 1% interest rates by Alan Greenspan to the list. If the federal funds rate would have been left at 3.5% or above, the bubble in housing would have likely never existed or would have been much, much smaller.

It was on March 9, 2009 that Barney Frank's committee announced a hearing on fair value accounting. FASB was brought to the table and forced to correct its misguided rule. The stock market bottomed on that day and has virtually doubled since then. The recession was not ended by stimulus, TARP, regulations, PPIP, or any of the other alphabet soup government programs. It was ended by the correction of mark-to-market accounting. The risk of another Depression ended on that day and the economy and market have done nothing but move higher ever since.

With FASB finally giving in on the issue for good, the future looks a lot brighter than most people suspect. The accounting rule fell, it has been ignored by most, but the impact of that fall is very good for America.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
2-7 / 2:00 pm	Consumer Credit - Dec	$2.5 Bil	**-$1.0 Bil**		$1.3 Bil
2-10 / 7:30 am	Initial Claims - Feb 5	410K	**412K**		415K
2-11 / 7:30 am	Int'l Trade Balance - Dec	-$40.2 Bil	**-$37.6 Bil**		-$38.3 Bil