First Trust
Monday Morning OUTLOOK
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Say “Thanks” to Barney Frank

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Four years ago, on March 9, 2009, the House Financial Services Committee (chaired by Barney Frank, D-MA, now retired) announced a hearing to be held on March 12, 2009. The hearing was with representatives of FASB and the SEC and the topic of discussion was mark-to-market accounting (M2M), also known as “fair value” accounting.

Since that day, when investors realized M2M accounting would finally be changed, the S&P 500 is up 151% on a total return basis. In addition, the economy has experienced 13 consecutive quarters of positive real GDP growth.

Call us crazy if you want, but we do not believe that this is a coincidence. Forcing banks to mark assets to illiquid market prices was a recipe for disaster. If the rule had not been changed, the US financial system would still be under massive stress today.

Conventional wisdom does not believe this. It argues the $700 billion Troubled Asset Relief Program (TARP), which was signed into law on October 3, 2008, combined with Quantitative Easing by the Fed saved the economy.

However, the S&P 500 fell 38.5% between the date TARP was signed into law and March 9, 2009, when it bottomed at 676.53. During that same time frame, the S&P 500 Financials Index (which includes 81 companies) fell 67%, while real GDP collapsed and unemployment soared.

Quantitative Easing (QE) was officially announced on November 25, 2008 as a $600 billion Fed program that would buy mortgage-backed securities from banks to alleviate pressure on capital.

In other words, the combined $1.3 trillion of firepower (a bazooka, as Treasury Secretary Hank Paulson called it) failed to stem the decline in economic activity, the stock market or financial stocks in particular.

It wasn’t until early March, when FASB finally agreed to change M2M accounting that things turned around. The reason for this is simple. As long as assets were priced to illiquid market prices, the banking system would continue to contract because lower marks would lead to less capital, which would lead to more selling and less liquidity, which would lead to lower prices. It was a vicious, and unstoppable, downward spiral. Private investment money dried up. Both TARP and QE were designed to fill the hole left by this ill-advised accounting rule.

To put this in perspective, AIG, the poster child for those who believe in the conventional wisdom, had a $550 billion portfolio of credit default swaps. When marked to the market in the winter of 2008-09, this portfolio had a massive hole (loss) of more than $100 billion. However, once the economy settled down, mark-to-market rules were relaxed and liquidity returned, this hole disappeared, prices increased, and the portfolio actually turned a profit.

It was the accounting rule itself that dried up liquidity in the winter of 2008/09. Even if cash was flowing, just the idea that it could stop pushed prices down. As a result, M2M accounting rules kept investors away because they threatened a vicious downward spiral in the financial system.

Milton Friedman explained in his book “The Great Contraction” how mark-to-market rules, not bad loans, caused bank failures in the early 1930s. In 1937, FDR eliminated M2M accounting. Between then and 2007, the economy has avoided panics and depressions. We do not believe this is a coincidence. Some argue that with no strict rules, banks can hide losses. But this is not true. A bad loan is a bad loan, and more than 2000 banks and S&L’s failed between 1983 and 1994 without having strict M2M rules.

We have written about this extensively over the years, and believe fully, that if M2M rules had never been instituted in November 2007 (or had been corrected in early 2008), the financial crisis would have been much less severe. Instead, the Treasury and the Fed, along with politicians who supported TARP and QE, have argued that the economy was saved by government action.

This is a dangerous argument. Conventional wisdom believes that without government intervention the free market economy is nothing more than a casino. This is just not true…the history of the past few years proves it and we can all thank Barney Frank, of all people, for helping us see that.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
3-19 / 7:30 am	Housing Starts – Feb	0.916 Mil	**0.922 Mil**		0.890 Mil
3-21 / 7:30 am	Initial Claims – Mar 16	340K	**345K**		332K
9:00 am	Existing Home Sales – Feb	4.995 Mil	**4.980 Mil**		4.920 Mil
9:00 am	Leading Indicators – Feb	+0.3%	**+0.2%**		+0.2%
9:00 am	Philly Fed Survey – Mar	-4.0	**-4.5**		-12.5