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First Trust

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Monday Morning Outlook

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FASB Pivots on Mark-to-Market

On Friday, the Financial Accounting Standards Board (FASB) voted to release a staff proposal that strongly suggests companies may use contractual cash flows to value an asset that does not have a liquid market. Although this is being described as a "clarification" rather than an outright change in mark-to-market accounting rules, it has the potential to curtail the financial crisis without spending another dime of taxpayer funds.

The story was first reported in the mid-afternoon on Friday. While the market did not react immediately, late in the trading session the Dow Jones Industrials Average surged 800 points. It faded in the last 25 minutes of trading as investors took cover going into the weekend. At the close, the Dow was still up about 400 points from the bottom, and it has continued to rally Monday morning.

While many accountants argue that mark-to-market accounting provides transparency, the markets know differently. Fair value accounting in the past year has caused nothing but problems, and in the end has created the opposite of clarity.

In illiquid markets, short-sellers can use fair value accounting as a tool to destroy the financial firms in which they are short. Short-sellers are sophisticated enough to understand that if they put a low-ball bid on securities held by the firms they are short this could force assets to be written down with mark-to-market accounting rules to the level of the low-ball bid.

An interesting debate between James Chanos, president of New York City-based short seller Kynikos Associates, and William Isaac, former Chairman of the FDIC took place on CNBC last Thursday. Isaac argued that fair value accounting based on asset prices in illiquid markets has destroyed $5 trillion in bank lending capacity, while Chanos argued against any change in the rules.

Chanos interrupted Isaac consistently, and said at one point, "…mortgage pools that we [Kynikos] might be interested in at 10 or 20 cents on the dollar are being offered at 70 cents…they are illiquid if the spread is so wide. If the bid was 20 and the offer was 25, we might have liquid markets…"

We take this to mean that Chanos understands the impact these prices have on vulnerable financial firms. He believes the offer side should come down to 25 cents to make a liquid market. But his argument can also be made the other way, in that if he lifted his bid to 60 or 65 cents, the market would be liquid as well.

So far, the short-sellers' view of the world has dominated, with many pundits arguing the "real" price of subprime loan pools should be down in the 20s, where the bids are found. However, with at least 75% of subprime loans still performing, a cash flow analysis of these pools would allow them to be priced closer to the 70 cent offer.

What this means is that if financial institutions are able to argue cash flow analysis to the auditors, the fire sale write downs of illiquid loan pools will no longer erode financial market capital. This will not impede transparency because knowledgeable investors understand how to value assets. What they can't deal with is the risk that an accounting rule could drive a firm out of business. The short sellers gorged themselves on this accounting rule, while potential investors ran away from it.

With FASB suggesting to auditors that maybe they have been too hard-nosed, and seemingly offering them a safe harbor interpretation, the balance of power will no longer be tilted toward the short sellers.

But this does not mean all the problems in our economy are magically over. There has been serious damage done to consumer psychology. For the first time in possibly 100 years, a serious credit crunch has impeded the normal working of the economy. We still expect fourth quarter real GDP to fall at an annual rate of 1.5%, but, if firms avail themselves of the breathing room provided by FASB, financial markets could heal relatively quickly.

With the Federal Funds rate at 1.5%, a commercial paper support operation at the Fed ramping up, and the Treasury prepared to provide capital directly to financial institutions, the major dominoes should stop falling. We suspect the worst of the financial mess may be behind us.

It is now our view that a bottom in equity prices was found on Friday with the Dow down at roughly 8,000. Despite what many believe, the US economy is more resilient than it appears. It's hard to say we will go straight up from here, but the odds of that are much better now that FASB has finally understood the damage that its accounting rules have caused.

There is one potential problem. It is clear that FASB is acting in this way because it does not want egg on its face. It does not want any part of the current financial crisis laid at its doorstep. As a result, it is trying to allow flexibility in an innocuous way, while at the same time telling anyone who will listen, that it has not changed the rules. If this keeps auditing firms from actually allowing the use of cash flows to value assets, the problems may not yet be solved.

It is still preferable that the SEC exercise its right to suspend mark-to-market accounting for illiquid assets. No auditor wants to be "Arthur Andersen-ed," and the easiest way to relieve them of that fear, and therefore the least costly approach to solving our problems is to put the rule to rest for good. It makes things look better than they should in the good times and much worse than they actually are in the bad. Get rid of it. We've run out of time and space to worry about who gets the blame.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
10-15 / 7:30 am	Retail Sales - Sep	-0.7%	**-0.8%**		-0.3%
7:30 am	"Core" Retail Sales - Sep	-0.2%	**-0.4%**		-0.7%
7:30 am	PPI - Sep	-0.4%	**-0.8%**		-0.9%
7:30 am	"Core" PPI - Sep	+0.2%	**+0.2%**		+0.2%
7:30 am	Empire State Mfg Index - Oct	-10.0	**-10.0**		-7.4
7:30 am	Business Inventories - Aug	+0.5%	**+0.6%**		+1.1%
10-16 / 7:30 am	CPI - Sep	+0.1%	**+0.0%**		-0.1%
7:30 am	"Core" CPI - Sep	+0.2%	**+0.2%**		+0.2%
7:30 am	Initial Claims - Oct 11	470K	**478K**		478K
8:15 am	Industrial Production - Sep	-0.8%	**-0.8%**		-1.1%
8:15 am	Capacity Utilization – Sep	77.9%	**77.9%**		78.7%
9:00 am	Philly Fed Survey - Oct	-10.0	**-6.7**		3.8
10-17 / 7:30 am	Housing Starts - Sep	0.870 Mil	**0.873 Mil**		0.895 Mil
8:45 am	U. Mich. Consumer Sentiment	65.0	**67.0**		70.3