



Value Concepts from the ML Trading Desk

You Can Only Die Once

A number of years ago, near the boarding gate for your flight, there was a Mutual of Omaha vending machine that sold single trip airline insurance. You would stuff a few dollar bills into a small envelope, along with your name and flight number, and be insured against a fatal crash. I never purchased this type of insurance. I was not interested in placing a bet where I would win if I die !!! (This also begs the question of how your spouse would know to collect since there was no traceable record of the transaction, but I digress.)

Why is this story relevant today? Because market participants are busily placing massive bets that will pay off if the world financial system crumbles, such as credit default swaps on the USTreasury. Let's be real here, if these trades prove profitable, I promise you will NOT feel like a winner.

Why are investors willing to place these sorts of bets: Because the USGovernment has not taken the necessary steps to halt the current market instability. **To review, we do NOT have price (interest rate) problem, we have a trust problem.** It is NOT that investors require a higher yield to lend to AIG (or LEH or BSC), it's that investors will NOT lend money at any price. The grand super problem is not that more brokers or insurance companies go under, it is the possibility that consumers become so worried that they begin to pull their money out of the banking system, ala, *It's a Wonderful Life*. This must be averted at any cost, and I do mean ANY cost. We will not be given a second chance to fix this problem, since you can only die once.

In no particular order, let me tell you what must, and therefore will most likely occur:

- 1) **Financial transactions that profit from negative events must be restricted.** This specifically includes significantly raising the margin requirements on OTC transactions such as CDS, CDX, ABX, CMBX, etc. There will also be total position limits placed on these instruments, similar in form to the current CFTC rules for Commodities.

- 2) **The Ratings Agencies must become heavily regulated.** The Rating Agencies raison d'etre is solely derived from ERISA regulations for Pension investing. If the Government regulates the criteria for investing, it MUST also regulate the creation of those criteria. A company the size of AIG cannot be collapsed by a capricious change in its credit ratings by a few individuals. Moreover, justifying a downgrade by a change in the company's stock price is circular and can be easily "gamed" by those not subject to "shorting limits" (see #1 above)
- 3) Without any finger pointing as to how we came to this situation, the market needs to de-lever. However, there is currently no "balance sheet" available. **As such, the USGovernment must become the balance sheet of last resort.** Lower interest rates will NOT create balance sheet, buying assets at transactional prices (that means low prices) will. This can be accomplished one of two ways. Either Government style bonds are issued via an RTC vehicle or, and you will love this, the Social Security Trust Fund can sell their USTreasuries and buy distressed assets.
- 4) To totally remove any possible motive for retail consumers to pull money from the banking system, **FDIC insurance must be massively increased for qualifying institutions.** This one is tricky since it was the increase in FSLIC insurance in the 1980s that presaged the last banking crisis in 1989.
- 5) Feed the beast. If investors are willing to lend to the USGovernment at less than a tenth of a percent (Three month T-Bills) while full faith and credit GNMAAs can be had at over 5%, just give it to them. **Issue \$500 billion T-Bills and buy MBS.** The risk is already on the balance sheet. Place some skin in the game and tell the market "enough is enough".

Many of you may think the above are wild and off the mark. But as noted in the beginning, you only die once. We will NOT be given a mulligan. The USGovernment has been wary of stepping into the private sector for a host of reasons. But presently a massive firewall must be constructed well past the edge of the current inferno. This action must be so massive that it will shock the markets and stop-out the short sellers and other manipulators. Trillions of dollars of wealth and capital have been wiped out in the past few weeks; this must be stopped at any cost. The time for action is now.

As a reminder, this letter solely represents my personal opinion
 September 18, 2008

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