

## Washington's Next Fight: Wall Street Securities Reform

As this is being written, the House of Representatives has passed its version of health care reform, which will go to reconciliation with the Senate version. The final product will then be presented to the President who will presumably sign it into law. After this the law will be either repealed or reinforced with subsequent legislation.

The next battle *royale* in Washington will be over reform of the banking and securities laws. This campaign will be an effort to guarantee that another bailout of financial institutions of the size of last year's is not required. The goal of the legislation is a combination of restricting what banks (which carry FDIC insurance) can invest in to writing rules that may even limit the size of the larger institutions.

In the health care debate the Democrats were the advocates for change while the Republicans were the champions of the status quo. As many people were content with their health insurance and feared change the burden of proof was borne by the Democrats to prove that change was necessary or even desirable.

In the financial system reform debate the roles are similar but the burden of proof is on the Republicans to justify the status quo. With much of the bailout of the banks occurring before the 2008 elections, the popular perception is that the banking crisis occurred on President Bush's watch and the Republicans are defending the institutions and the *laissez-faire* philosophy they championed for eight years in the spirit of free markets.

Financial reform will take several fronts. The banks face regulations making them utilities for their acceptance of FDIC insurance on their deposits. Matters of what they can invest in and in what proportion will become more of a factor going forward.

Employees of securities firms will have to either acquiesce to becoming fiduciaries for their clients or better explain to their customers their current role of salesmen for their employers. In addition to this decision, insurance companies face the potential of Federal oversight. This was something they successfully avoided in the last securities upheaval in the 1930s.

There is a push to create a Government consumer finance oversight department. While this has a great deal of political appeal in certain quarters, its role is ambiguous at best. Any attempt to regulate consumer interest rates or terms will impact the availability of consumer credit itself. Perhaps this should be called the Loan Sharks Employment Act as such persons may be the only parties making loans in some quarters.

The intent of all this legislation is to avoid the repeat of the financial bailouts of the past two years. The public has a low tolerance for use of public money to salvage private institutions, especially those whose executives were bailed out to the tune of several million dollars each. This perception is grounded in fact. According to a recent *Harvard Law Review* study, the average top executive of Bear Stearns and Lehman Brothers earned a total of \$250 million in compensation from 2000 to 2008. To have such incomes while unemployment approaches ten percent is seen by many as an outrage, especially given that the companies these people ran turned out to be a house of cards.

Banking itself has changed greatly over the years. In 1980 the ten largest banks in the US held ten percent of the country's deposits, while the top twenty banks held twelve percent. Now the top ten banks hold 50 percent of the country's deposits and the top twenty hold 60 percent. As banks grow larger their impact should they run aground increases. The best way to insure this does not happen is to more closely supervise their activities. In a similar fashion the securities industry has changed. In 1990 the majority of income for most Wall Street firms came from raising capital for companies. Now the bulk of the income comes from trading their own capital, often against the accounts of their own clients.

The philosophical question is whether Government involvement is needed and if so how much. Certainly the Federal Government has a vested interest in any institution whose deposits are insured by them. Making sure the Government is not stuck with a bill should managements take excessive risk requires dictating the type and amount of investments to be made by them as well as stringent and ongoing oversight. For institutions that do not receive FDIC insurance, the argument for Government influence becomes weaker. At the same time, the argument for Government bailouts of the same institutions should be rejected. Any organization that resists Government oversight when times are good should not be supported when times are not. Capitalism cannot function if institutions are not allowed to fail.

At the end of the day, the advocates for free markets unfettered by Government influence were made to look a bit duped. What they forgot was that, without an institution around to keep everyone honest, free markets can tend to bring out the darker side of human nature. At the same time, over-expansion of the role of Government has its own costs and consequences. The trick is to find the balance of what the Government needs to regulate and what the market needs to punish and reward. The former becomes similar to a utility while the latter succeeds or fails based on its own merits.

## **The Economy**

Economic activity continues to slowly rebound. While the average person has not seen a rebound, business activity itself is getting stronger. Businesses will need to max out use of existing employees before additional staff is added.

Exports, manufacturing and health care are the leading factors of the economic upswing. Farm goods are in very strong demand, as are commercial aircraft. Health care has been a strong source of growth that will be stronger still after the recent legislation.

## **Interest Rates**

The Federal Reserve is in the process of terminating its program of purchasing securities to add liquidity to the economy. As much as \$1 trillion has been injected into the economy in this manner which will be drained out in the next year or so.

Thus while an interest rate increase is perhaps 6-9 months off, the termination of the securities purchase program will begin the process of increasing interest rates by reducing the supply of funds in circulation. Mortgages will be the first to feel the effects of this change. While timing of interest rate increases is in dispute, the direction is up. Forecasts call for a Federal Funds rate of 2.5-3.0 percent by the end of 2011.

## **Inflation**

At this juncture there is still no credible evidence of inflation domestically. While energy and commodity prices are rising, such elements are not large factors in a developed economy driven by services.

The key to domestic inflation is wages. With high unemployment there appears to be little chance of wage inflation in the near term. This could change if there is another push to increase the minimum wage, but so far there is no sign of any movement in that direction. Higher interest rates can also be a component of inflation but as yet this does not seem to be a contributing factor.

## **The Stock Market**

Stocks seem to have found a trading range since November. However, with profits increasing there is the potential for a breakout on the upside.

Driving stocks higher will be two factors. The first is the demand for stocks. With trillions of dollars of retirement funds looking for a place to earn returns it would appear that demand for stocks is almost certain if not a given. Second, the supply of stocks at this time is relatively subdued. There are no major industries issuing shares aside from the emerging markets. Thus the supply/demand equation looks good for equities.

At this time there does not seem to be any sector that has assumed market leadership. Most relative outperformance is the result of relative underperformance in prior years. Financial stocks are the most prominent example of this. Sectors that have interesting profiles include utilities, commodities, energy and select retail. While most people are arguing over the optimal asset allocation, those who pick specific stocks look to improve on the performance of their asset class.

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March 24, 2010

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