

Ron Insana: After the Mauling of the “Bear,” has the Bull Market Begun?

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Ron Insana is the founder and Managing Director of Insana Capital Partners, a RIA with approximately \$100 million under management. He currently serves as a regular contributor on CNBC, providing commentary on market and political events. Previously, he was the editor of CNBC’s Street Signs.



Insana was the keynote speaker at the Reuters Advice Point Forum in New York on April 9. Below is a summary of his presentation.

Insana believes we are now in the most complex environment the financial markets have ever experienced. “It is decidedly different from the crash of 1987, mostly because the issues are more opaque and downright confusing. This is true for all participants, including the top money managers,” he says.

“Now we are confronted by the combined effects of financial engineering, leverage, and liquidity,” says Insana. The world GDP is \$50 trillion (a quarter of which is the US economy), but there is an estimated \$750 trillion in notional value in derivatives. Insana qualifies this estimate by the fact that some double-counting may be involved but, even after adjusting for possible double-counting, the size of the derivatives market and the inherent leverage in the system is “staggering.” Insana cites \$25 trillion in credit default swaps where, in some cases, the party on one side of the transaction does not know the identity of the counterparty.

Insana refers to the sub-prime crisis as the “tip of a fuse that goes to multiple incendiary devices.”

On the subject of leverage, Insana notes that Goldman Sachs recently decreased its leverage from a “mere” 32x to 27x. The insignificance of this is evident from the fact that Long Term Capital Management’s leverage was 25x at the time of its failure.

Insana believes the crisis is more than a sub-prime crisis. He cites \$240 billion in bank write-offs, but estimates the figure will ultimately be as high as \$1 trillion. The failure of Bear Stearns boiled down to counterparty risk which became “extraordinarily large.” The failure of one major financial institution, such as Bear Stearns (the fifth largest investment bank) could have brought down the financial



system, and Insana believes the Fed acted appropriately. “The Fed did not break its charter,” he says. Insana believes the LTCM failure was “peanuts” compared to the Bear Stearns failure, where “we would have had something from which we could not have emerged.” Counterparty risk is also the central element behind the Bank of America/Countrywide and J.P. Morgan/Bear Stearns transactions. In both cases, the acquirer was buying the firm with which it had the greatest counterparty risk. “Nobody can write down a sizable amount of debt and maintain tier one capital requirements,” he said, which is essential for an investment bank to remaining in business.

“Bernanke spent his entire life studying financial crises, and should be eminently prepared for the kind of events we are experiencing,” says Insana. Ultimately, Insana believes regulators (some combination of the FHA and other Federal agencies) will buy or otherwise “extinguish” the bad mortgages. “The Fed will have no choice but to monetize the bad debt,” he said. In the meantime, the securitization markets are frozen, and home loans are not closing.

Insana does not believe Bear Stearns’ failure represents a turning point for the sub-prime crisis or for the markets. “Everything that needs to be done to resolve the crisis has not yet been done,” he said, adding “there is more plumbing to be fixed.” He believes we are probably in the 4th inning of a 9 inning game.

“In my gut I do not feel we have reached a cathartic bottom,” he said, adding “economically, we are not strong enough.” Some analysts are forecasting 10% drops in housing values in each of the next three years, the effect of which Insana characterizes as “catastrophic.” It is something he fears and believes is possible. “The pipes are just too clogged,” he says. “How deep this gets – I just don’t know.”

Many institutions are lying about their exposure, and Insana cites Korean and Japanese institutions as examples. He notes “European banks may blame their problems on rogue traders and then attempt to bury the true cause of their problems, and we will never know the truth.”

The Fed may be contemplating more unorthodox measures, including some which might take interest rates to zero. “Ultimately, this could be where we are headed,” he said. The overall impact of the Fed’s moves is to “quarantine Wall Street’s problems to Wall Street.”

In reference to the purported marijuana smoking of Bear Stearns’ CEO Cayne during critical periods, Insana added some levity, commenting that Cayne was culpable if he was high while his firm was low. He called out former Merrill CEO O’Neil for similar culpability, in reference to his extensive golf outings during the



time when Merrill dramatically increased its exposure to the CDO markets. "But it's the employees that suffer," he said.

Insana believes we have been in a recession since December, although he notes some aspects of consumer spending appear to be unaffected. Disneyworld, during Insana's recent family vacation, was "as crowded as ever." Insana expects huge layoffs on Wall Street, and predicts Citicorp will layoff another 30,000 employees. Cumulative layoffs could approach those following the 1987 crash, when 80,000 people lost jobs on Wall Street. "The recession could be deep and short, deep and protracted, or characterized by a downward bumpy ride," he said.

"The pendulum swings much more rapidly now than before," Insana noted in regard to the ability of the financial industry to create products and elevate the level of risk in the system. Both regulators and technology are behind the curve in their ability to cope with increased risk. "When the social consequences of a systemic failure become so large the Fed has to step in."

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