

Stress Tests: The Fix is in

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Results of government-run stress tests of 19 large financial institutions were released earlier this month as part of an overall effort to instill public confidence in the banks. The level of choreography on display during this process is rivaled only by Broadway musicals, Olympic ice dancing and, perhaps most appropriately, professional wrestling.

At least in wrestling the observer is able to differentiate between the good guy and the villain, and occasionally even gets the faint impression that the outcome may actually be in doubt. The outcome of the stress tests, of course, was never in serious doubt. Rather than actual “tests,” these exercises were an elaborate public-relations campaign designed to assist the banks in raising desperately needed capital. Having been told ahead of time that no banks were going to fail the test, it was clear from the very outset the fix was in. The process was so fixed that inside the major banks, the stress tests became known as the “feather tests.”

Critical to the program's success was the government's decision to delay the final results until it could be determined precisely what investors wanted to hear. This was achieved through a carefully orchestrated series of “leaks.” Market reaction to each new tidbit was carefully gauged as the results were revised and fine-tuned for maximum impact. Meanwhile, the banks were instructed to maintain strict silence, lest their public statements frustrate the government's use of the securities markets as a giant focus group. The apparently favorable outcome to all of this demonstrates once again that you really can fool some of the people all of the time.

Though giving the banks a clean bill of health has helped the government attain its short-term objectives, there are serious longer-term implications. For one thing, the banks suddenly have much less motivation to rid themselves of the rotting assets currently clogging their books. This will restrict the banks' willingness to lend and will contribute to further economic weakness. Unfortunately, if these supposedly healthy banks begin to show fresh signs of distress, Congress will be much less willing to provide additional bailout money.

The Picture

Initial euphoria following the stress tests gave way last week to a selloff in the stock market. The chart below shows the S&P 500 index holding just above key support near 875. A break below that level would indicate the rally off the March lows may have run to exhaustion. A continuation of the advance from here, however, could bring into play the important targets of 944 and 1008. These are shown on the chart in green.

recommendations appropriate for you. You should strongly consider seeking advice from a qualified investment professional before deciding to invest, trade, and/or speculate in the markets.