

INVESTMENT UPDATE

The past couple of weeks may have been fun for somebody (Yankees fans, maybe?), but it sure has been a big pain in the neck for bond investors.

First, mounting foreclosures (and a bleak forecast for future losses) among subprime home loans crushed the prices of bonds backed by these mortgage loans. Highly-levered funds (the big buyers of this *dre*) scrambled to sell what they could to meet liquidity needs, so they flooded the market with high-quality corporate bonds and mortgage-backed bonds (MBS).

Prices for Treasury bonds soared, as investors sought a safe haven.

The next shoe that dropped was the collapse of the asset-backed commercial paper market (see top chart), the market that provided mortgage originators (Countrywide being the largest and best-known) the short-term funds they needed to finance the loans in their “pipeline.” Buyers of commercial paper balked at “rolling over” these notes as they came due, as they began to worry about the creditworthiness of the loans that constituted the collateral for the commercial paper. They were rightfully distrustful of extending credit (even short-term) to mortgage originators who were hoping to securitize loans that nobody now wanted.

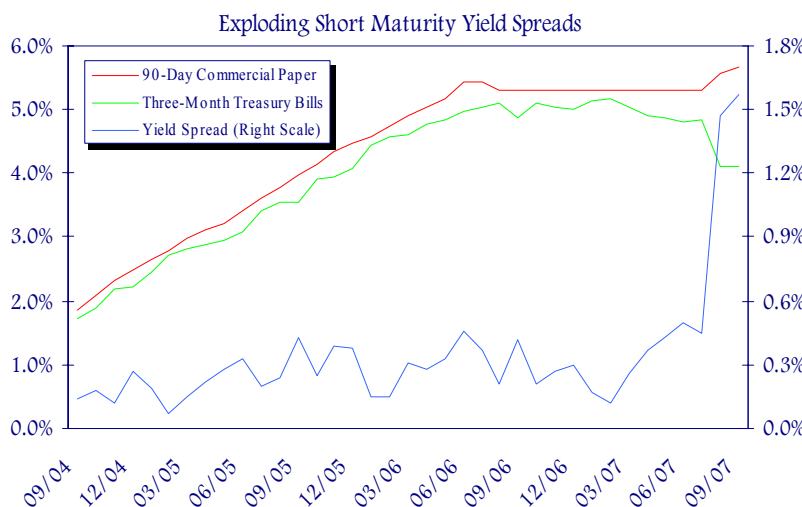
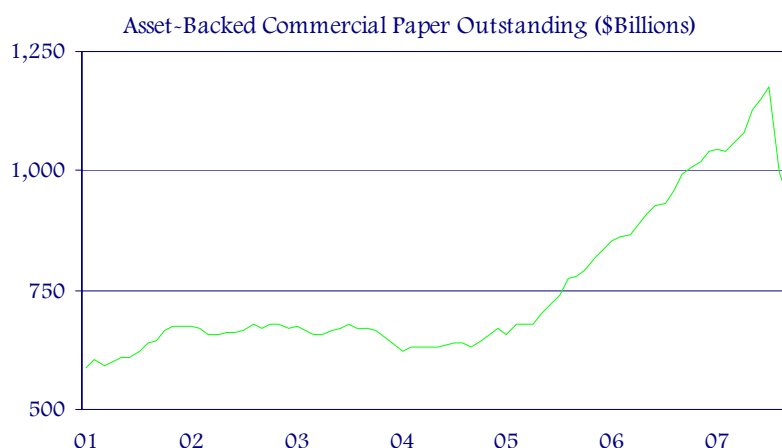
Lenders in the commercial paper market (dominated by short-term money market funds) are by definition risk-averse; for them, capital preservation is essential. Prices on

adjustable rate notes and other short-term paper plummeted, dragging down the most risk-averse investors in the capital markets. One high-profile “stable value” fund recognized 20% in losses since mid-year due to the dramatic re-pricing of the short maturity subprime-related notes in their portfolio.

As the second chart on this page shows, there was a significant flight to Treasuries as investors fled the commercial paper markets in mid-August.

The spread between three-month Treasury Bills and three-month A1/P1 commercial paper (the highest rating), which had averaged approximately 30 basis points (0.30%) over the past three years, spiked to more than 160 basis points by August 17th. This yield spread was not just the highest in three years, but also the widest margin between these two money market yields in more than a decade, a period that includes both the Long-Term Capital Management/Asian currency meltdown in '98 and the 2001-02 Enron/WorldCom (*et al.*) credit crisis.

As even the most highly-liquid sectors in the US bond market ground to a halt, the Fed stepped in to provide liquidity, announcing on August 17th that they were lowering the discount rate by 50 basis points, to 5.75%. The discount rate, you will recall, is the rate that the Fed charges to depository institutions for borrowing overnight funds. In recent years, the discount rate has been maintained at a rate approximately 1% higher than the Fed funds rate; by lowering the discount rate to 5.75%, the Fed cut that difference in half. In addition to lowering the discount rate, the Fed also



temporarily extended the borrowing term to up to thirty days in order to accommodate institutions (including mortgage originators) who needed funding for more than a day or two.

Institutions who borrow from the Fed's discount window must put up collateral as security. Interestingly, the assets that qualify for collateral include all types of securities as well as "performing" loans, including subprime loans and asset-backed commercial paper, as long as the depository institution is in "generally sound financial condition." Even lower-quality institutions can borrow at the discount window, although they would only be eligible for "secondary credit," which carries a higher rate and is more constrained. There is no limit to the amount that an institution can borrow from the Fed for primary credit, as long as the collateral is acceptable. There is, however, a difference in the amount of collateral that must be pledged; for example, an institution can borrow 98% of the market value of their short-maturity Treasuries, but only 60% of subprime credit card receivables.

When the Fed announced the lower rate and extended terms, they noted that "financial market conditions have deteriorated, and tighter credit conditions and increased uncertainty have the potential to restrain economic growth going forward... The Committee is... prepared to act as needed to mitigate the adverse effects on the economy arising from the disruptions in financial markets." They must have been disappointed in the lukewarm response they got from the markets to their actions; while there was a blip in discount window borrowing (from \$10 million to \$1.2 billion, well above the 2007 average of \$147 million) in the days following the announcement, it paled mightily next to the \$1.2 trillion of asset-backed commercial paper that was outstanding at the time. If borrowers were having trouble rolling their commercial paper, they weren't desperate enough to go to the Fed for a loan.

Most measures of market liquidity improved in the days immediately following the Fed's inter-meeting announcement, but after a week or so, it was clear that the market was not satisfied with the Fed's response. Just to back up a bit, we should note that Fed Chairman Bernanke has stated in the past that the discount rate should be used to manage liquidity, while the Fed funds rate should be adjusted in order to manage overall economic growth and inflation. In Bernanke's way of thinking, the current liquidity crisis should (at least in theory) be managed by adjusting the controls at the Fed's discount window, exactly what they did on August 17th. Bernanke now faces the harsh reality that the capital markets (and the participants whose actions drive those markets) don't really care much for theory. They want assurances that when they put money to work they're not going to take a beating. And right now, the meltdown in the mortgage market has led to distrust, fear and exces-

sive risk aversion, producing knock-on effects never envisioned by our chief central banker.

We don't mean to pick on Bernanke; forecasting is a thankless business, and nobody can know the unpredictable behavior of humans to the very predictable problems that arise in the normal course of the credit cycle. But it's time for him to put away the textbook and take a more pragmatic approach to calming the markets.

The first step is to consider how consumer leverage will be unwound. Forget about "saving" the subprime market; we all agree that loans were made to uncreditworthy borrowers, and those loans were snapped up (both in whole loan and securitized form) by investors who ignored the obvious risks. Neither party should be bailed out. But the current adjustment in the broad US housing market is not unwinding in a normal, orderly fashion that we all envisioned a few months ago, as even credit-worthy borrowers are being locked out of the market. Furthermore, consumers aren't the only segment of the economy suffering from a credit squeeze, as high quality companies are paying much higher rates for borrowed funds.

While the half-point cut in the Fed funds rate this month was both necessary and inevitable, and sent the message that the Fed is committed to steering the economy on a steady growth path, it may not be enough. And that's the most difficult thing for all of us—central bankers, investors, candlestick makers—to come to grips with. The markets are currently mired in a very negative mindset, where fear and mistrust rule the day, and as we've seen in the past, when this takes hold, the outcome is uncertain, and resolution comes slowly. The "run on the bank" at Northern Rock, one of the UK's largest home lenders, is as symptomatic of the lack of confidence in lending as it is revealing of the interconnectedness of the global capital markets. What can a 50 basis point cut in the Fed funds rate do for depositors in England who don't think their money is safe at their local bank?

The resolution will come when the degree of financial leverage currently in the system once again aligns itself with the risk tolerance of lenders. Leverage will either have to come down, or lenders will have to re-gain their confidence, or both. Short-term debt, where possible, will be termed out in order to satisfy investors (including stockholders) who are concerned with a company's liquidity position. In any case, the Fed, in their role as the world's most powerful and influential central bank, is taking the first steps in assuaging investors' collective psyche, which should buy time while personal balance sheets are repaired. There is no quick fix.

