Agincourt Capital Management, LLC

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INVESTMENT UPDATE

"Nature abhors a vacuum," or so the adage goes, which may help explain why the Federal Reserve has been so active in recent months, stepping in to fill the void where a normally-functioning capital market once stood. Yet, while stepping in, the Fed may have overstepped, as recent events show an uncomfortable (we won't say "unconstitutional") expansion of their regulatory reach.

It may be helpful to briefly recall the history of the Fed. The Federal Reserve was established with the passage of the Federal Reserve Act of 1913, in order to restore confidence in a US banking system that had been wracked by regular episodes of financial panic. Under this Act, the "Fed," as it came to be known, was given the responsibility to issue currency ("Federal Reserve Notes") backed by the US Treasury, provide liquidity to nationally-chartered banks, regulate these same banks, and generally maintain the stability of the US financial system.

The legislation was a compromise, appealing to both private and public interests—establishing twelve privately-operated Fed regional banks with their own boards of directors, as well as a centralized Federal Reserve Board (now called the Board of Governors), whose members would be appointed by the President. After the 1929 stock market crash, the Federal Open Market Committee (FOMC) was created, comprising the seven Fed Governors and a rotation of five of the twelve regional Fed Presidents. The FOMC is what most investors refer to when they talk about the Fed—it is the FOMC that sets overnight borrowing rates (the Fed funds rate) as well as the rates and reserves that member banks must adhere to. Fed Chairman Ben Bernanke is, officially, Chairman of the Board of Governors of the Federal Reserve System.

From a bond investor's standpoint, the main concern, at least since the rise of monetarism during the Paul Volker era of the late 70's, has been monetary policy. After all, monetary policy determines the "short end" of the yield curve, setting the level of interest rates for overnight lending. In addition, the Fed's (actually, the FOMC's) monetary policy decisions impact the broader economy—recall that the FOMC has the dual mandate of "maximum employment" and "price stability." The FOMC's decisions to ease or tighten the supply of money and credit creation by adjusting the Fed funds rate and (to a lesser extent) the discount rate and reserve requirements impact not just the level of short interest rates, but the pace of economic growth, and therefore affect corporate profitability, currency markets, credit quality, and a host of other factors important to bond investors. Traditionally, the Fed's other duties, the oversight and regulation of the US banking system, have not had as big an impact on bond investors.

There was one episode from a few years back that might have prepared us for the Fed's changing role over the past year, and that was the Fed's involvement in the liquidation of Long Term Capital Management (LTCM), the notorious hedge fund whose collapse in 1998 threatened to take down Wall Street. Eyebrows were raised when the then-President of the New York Federal Reserve Bank, William McDonough, stepped in to arrange the orderly takeover of LTCM's assets by a group of commercial and investment banks (Bear Stearns not only refused to chip in, they demanded their money back from LTCM—more on this later). This was a clear case of the Fed stretching its traditional role as a quasi-Government regulator and monetary authority.

Speaking just a week after the takeover, former Fed Chairman Alan Greenspan had this to say to Congress:

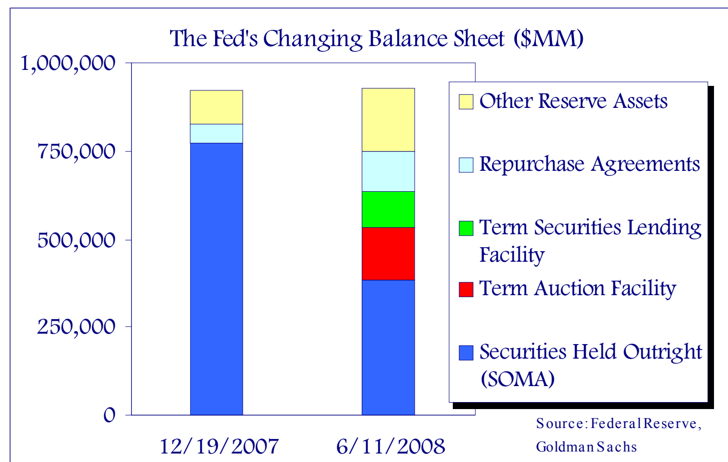
> Of course, any time that there is public involvement that softens the blow of private-sector losses—even as obliquely as in this episode—the issue of moral hazard arises. Any action by the government that prevents some of the negative consequences to the private sector of the mistakes it makes raises the threshold of risks market participants will presumably subsequently choose to take. Over time, economic efficiency will be impaired as some uneconomic investments are undertaken under the implicit assumption that possible losses may be borne by the government.

Clearly, the Fed knew they were going out on a limb, but their options were not pleasant, as allowing LTCM to fail could have set in motion an explosive daisy-chain of defaults that would have spread through the commercial and investment banking system, as counterparties to LTCM's trades would be forced to sort out "who owed whom." Even with the benefit of a decade of hindsight, it's impossible to conclude that the Fed made a mistake; we simply don't know how ugly things might have gotten in the wake of a forced liquidation of LTCM's *one trillion dollar* notional derivatives exposure to various markets.

Yet one thing seems clear: This intervention by the Fed ten years ago (and Congress' tacit approval of the Fed's han-

dling of this event) had the exact effect that Greenspan predicted—investors were emboldened. The brokers and banks who had lent hundreds of millions to LTCM were saved from seeing LTCM's operations collapse, and avoided heavy losses for making what amounted to bad loans.

Rolling the clock forward to 2007, we arrive at yet another crisis, this one related to the extension of credit to non-creditworthy homebuyers, and faulty assumptions used to value bonds backed by these crummy mortgages. Although the root causes of the past year's financial troubles are entirely different than those in 1998, the Fed was once again presented with a bond market struggling with a massive imbalance between those needing to borrow and those willing to extend credit. By early August of last year, it was clear that there were big problems—LIBOR (London Interbank Offering Rate, the lending rate that international banks offer to their best customers) hit a 20-year high relative to Treasury Bill rates as lendable funds dried up. In response, the FOMC cut the Fed funds rate and the discount rate (the interest rate charged to member banks who borrow from the Fed) even more, and extended the term that banks could borrow from the "discount window" to 30 days.



This helped, but only a little, and by last December the Fed was forced to go back to the drawing board and come up with some new ideas**.** Banks don't like to borrow from the discount window, as there is a long-held stigma that such borrowing shows institutional weakness. So the Fed rolled out the Term Auction Facility (TAF) in December, where banks could participate in biweekly auctions anonymously, pledging collateral and receiving liquid funds, with rates fixed for 30 days. The TAF has been very well received by member banks, with $150 billion outstanding currently in this facility (see chart).

Unfortunately, by mid-March more liquidity concerns arose, as Bear Stearns' lenders began pulling financing, putting the brokerage firm on the brink of bankruptcy. Over the weekend of March 15th, the Fed (backed by Treasury Secretary and ex-Goldman Sachs CEO Henry Paulson) arranged for the purchase of Bear Stearns by JP Morgan Chase. In some ways, this deal was similar to the LTCM liquidation, except that this time the chairs had been re-arranged. Paulson was there when Bear refused to help LTCM, and was in no hurry to help a firm known as one of the main architects of subprime market. According to a recent article in *The Wall Street Journal*, Paulson advised Morgan CEO Jamie Dimon, "I think this should be done at a low price.," at which point Morgan's bid for Bear dropped to two dollars per share.

The next day, on Monday March 17th, the Fed announced another new lending facility, the most aggressive yet. For the first time in its history, the Fed would lend to non-banks. Specifically, the Fed announced the opening of the Term Securities Lending Facility (TSLF for short), a sort of discount window for brokerage firms. Under the TSLF, non-banks could exchange less marketable securities for Treasury collateral for a fee of between 10 and 25 basis points. This program has done much to ease investors' concerns of liquidity problems among the brokerages, even if the actual borrowing has fallen short of Fed expectations.

Why didn't the Fed announce the TSLF the previous week, when Bear was clearly struggling to keep their financing lines open? Our best guess is that officials at both the Fed and the Treasury didn't want to be seen as "soft" in dealing with Wall Street, especially given Bear Stearns' well-known involvement with the subprime mess. Once again, central bankers were cognizant of the "moral hazard" question—whether Government involvement had gone too far. In order to demonstrate that poor risk management leads to losses not just for individuals, but for institutions, they needed a sacrificial lamb. Bear Stearns' shareholders filled the role perfectly (although bondholders were effectively bailed out, as Bear's debt was assumed by JP Morgan).

Despite the Fed's assurances that these new liquidity vehicles are temporary, we don't expect to see the Fed backing off the expanded role that they've carved out for themselves. Tighter controls over those who get government assistance is essential in order to preserve fairness and to keep the financial system from being overrun by cowboys who hope to enjoy all the upside of risk-taking and none of the downside, operating under the assumption that the Government will bail them out of their mistakes. Already, the Fed is taking steps to broaden their oversight of hedge funds (even if that means stepping on the Treasury's toes), including setting new standards for the clearing of credit derivatives.