

F.I.R.S.T. Fixed Income Research and Strategy Trends

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Got Capital?

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Inadequate capital: That's what's messing this all up. There is plenty of cash around and, specifically, there are loads of dollars available for investing at all sorts of domestic and international entities. But that isn't the same as capital. Capital gets put at risk and supports the balance sheet. Liquid cash is appearing in places, but generally it is being positioned in risk-averse investments, hiding until the storm blows over: a storm that might take a while.

We have witnessed a rolling sequence of asset classes that are in the process of de-levering. Each then infects an adjacent market, which then de-levers. Sub-prime lending topped in the face of declining housing valuations. Market participants quickly became frightened of the leverage and the lack of market transparency. Then more varieties of structured products became dysfunctional, followed by commercial and jumbo mortgages and leveraged corporate credit. Yield spreads over Treasuries for all these sectors gapped wider and then wider again. More recently, auction rate preferred and municipal bond markets broke down. Add in margin calls and there seems to be little market support, limited bottom fishing, and a very real scarcity of capital willing to be put at risk to support these markets.

The FOMC has lowered rates and lowered them again. It appears to be pushing on a string. While Fed funds have declined, and Fed funds adjusted for inflation have declined further (reflecting a bit higher inflation) credit and mortgage market rates have not followed, as show in the table. The easing of monetary policy has not fed through to end users as fear re-prices yields higher on these investments. Lower rates have not contained the credit crisis.

A small digression to the background environment puts some light on a big part of the problem. Securitization provided a method for financial institutions to be in the "moving" business. Assets were gathered, packaged and sold as securities. Credit card receivables, auto loans, mortgages of all shapes and sizes, LBO loans, and funding for all sorts

of enterprises dressed up as commercial paper or notes were sold to a host of willing institutional, retail and mutual fund buyers. Funding was found, projects were financed, and the economy grew. Yield spreads compressed as the flush-with-cash buyers couldn't get enough of these securities -- until the credit crisis. Now the "moving" business is largely over and we are presented with the "storage" business.

These same institutions cannot absorb the obligations of their failed structured investment vehicle (SIV) enterprises, and finance the leveraged loans they committed to for LBO shops but never sold, and suffer the losses in their mortgage and high yield accounts, without leaning heavily on their capital. There isn't enough. Capital adequacy regulations require certain levels of capital to be held against risk assets. In the moving business, risk assets were sold off. Now the banks are storing unsold assets and are obliged to allocate capital to hold them on their balance sheets. Financial institutions can only make markets in securities if they have the ability to absorb some excess buyers or excess sellers. They do this by taking some positions themselves, long or short. This process is also breaking down because investors are concerned about the underlying fundamental and technical support of many debt markets and dealers are putting less capital at risk in these market-making activities. As a result, many markets have become dysfunctional. The death of the auction rate securities markets is a result. The prospect of banks having

How Tight are Financial Conditions?

	Sep-07	Mar-08	Change
Fed funds	5.25%	3.00%	-225 basis points
Real Fed funds*	3.45%	-0.70%	-415 basis points
Ten year yield	4.63%	3.50%	- 113 basis points
BBB rated US Corporate bonds	6.25%	6.40%	+15 basis points
US High Yield	8.60%	10.60%	+200 basis points
Jumbo Mortgage	7.18%	7.13%	-5 basis points
S&P 500	1525	1300	down 15%

* Real Fed funds is Fed funds minus the US Personal Consumption Expenditure Core Price Index.
Merill Lynch indices sourced from Bloomberg. Data as of 3/7/2008.

to refinance all these assets in new markets creates fear that they might be hung with storing even more unsold securities.

As for the Fed, it can only continue to lower rates. While banks have been able to attract some capital, sourced globally, it is not yet enough to support the type of market functionality and economic growth that we have witnessed recently. While excesses are certainly being wrung out, it may also take some time and new financing methodologies to get things running again. Rate reductions so far have not pulled down consumer and corporate lending rates. Until they do, the Fed has to continue to lower rates.

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