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

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At The Intersection of Main and Wall

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The U.S. investment culture, for journalists at least, is heavily equity biased, which means that Main Street tends to judge aggregate economic, or company specific, health through the prism of the Dow Jones Industrial Average or other equity index, or by stock prices of specific companies. Main Street gets a sense of troubles on Wall Street when widely observed equity market prices drop or fluctuate wildly.

It was, however, the breakdown of murkier – yet far larger – markets that got the attention of governments worldwide and prompted their massive responses. The funding and credit markets had cracked and policy actions were targeted at them. These markets are somewhat obscure to non – participants, and largely invisible to Main Street. Further complicating their troubles and the public's understanding of them is that these markets suffer from a lack of well understood measures as to whether they are functioning properly or not. There is no equivalent closing quote for an S&P 500-like measure for the funding markets.

The funding markets are all about sourcing cash and delivering it to end users. If the lesson from Watergate was "follow the money", it applies here as well. It starts with addressing the ability of banks to access funding from their government or central bank, then the ability of banks to access credit from each other, and finally the mechanisms from which firms and individuals' access credit from banks. A bit about each follows.

Getting Funds to the Banks

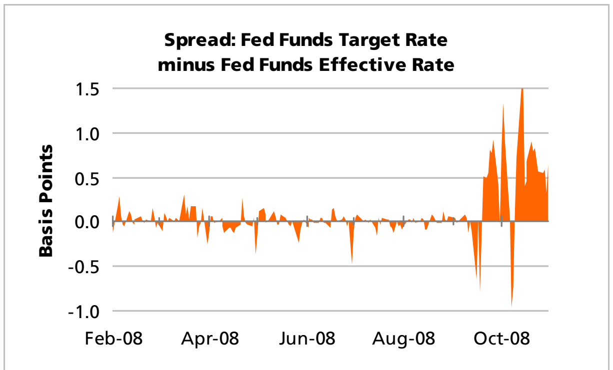
The Federal Reserve has several tools at its disposal to influence the overall tenor of credit throughout the financial system. At its core are so-called Federal funds, which is the market within which member banks can trade among themselves the deposits that they maintain at the Fed.

Banks are required to maintain defined minimums of these (heretofore non-interest bearing) deposits, called bank reserves, but may maintain excess reserves at their discretion. The actual rate at which banks trade these reserves is the "effective Fed funds rate" and the Fed adds or drains bank reserves through open market operations to keep this rate near the "target rate" set by the policymaking Federal Open Market Committee (FOMC). Last week that target rate was lowered by 50 basis points to 1%.

The graph below indicates that target and effective Fed funds rates have gone adrift recently; since mid-September, the divergence between these rates has been without precedent. Risk-averse banks have chosen to maintain enormous excess reserve balances and have been reluctant to trade these excesses to other banks due to uncertainties within the banking community about the soundness of counterparties. The result has been an inability of the Fed to keep the effective funds rate near its target. This divergence can be read as an indicator of inter-bank credit stress and uncertainty.

With the passage of the Emergency Economic Stabilization Act, however, the Fed gained authority to pay interest on bank reserves; this will have the effect of making the Fed the universal counterparty in Fed funds trading (buying and selling banks will, in effect, trade with the Fed rather than with each other) and should enable the reestablishment of a close link between target and effective funds rates.

Fed Funds Target Rate Minus Fed Funds Effective Rate



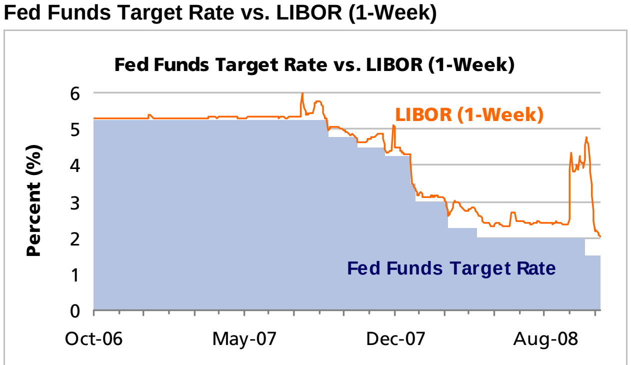
Source: Federal Reserve

Banks Lend to Each Other

In funding markets other than that for bank reserves, banks need to be able to transact with each other if only because on some days some banks have more – and others have less – cash than they need. In looking at how inter-bank lending is working, the best benchmark is LIBOR, the London Inter-bank Offer Rate. The British Bankers Association compiles these rates from trading for numerous major currencies and a LIBOR average rate is fixed daily for a variety of maturities, from overnight out to a year.

A LIBOR rate reflects the willingness of banks to lend among themselves on an un-securitized basis for a given term. Differing from reserves because they are not held at the Fed, LIBOR-traded cash is transferred between selling and buying banks.

Fed Funds Target Rate vs. LIBOR (1-Week)



Source: Federal Reserve, British Bankers Association

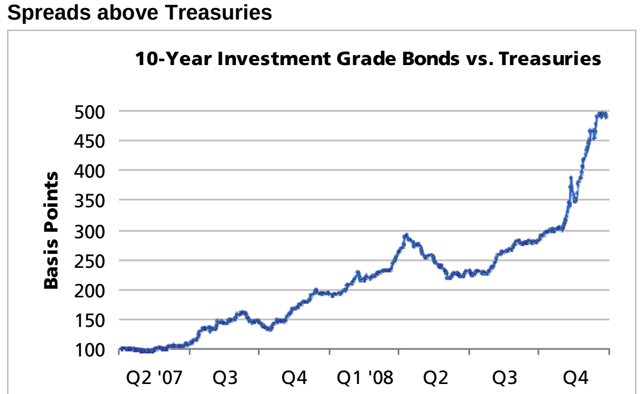
The graph above indicates one-week LIBOR compared with the target Fed funds rate. Historically there was a reasonably stable relationship in the spread, or difference, between these two rates. More recently, there has been a wider gap as banks have hoarded cash and/or have been unwilling to lend to other banks whose balance sheets may be as opaque as their own. In such circumstances, the spread in this inter-bank market gaps from that of the risk-free Fed funds market.

Recently LIBORs have reset lower, an indication of some healing in this market. Numerous reasons for this include the explicit government support for banks as witnessed by their direct equity investments as well as the variety of liquidity measures available at the Fed and other key central banks. The process continues and it appears the tide is turning.

Funding Institutions and Individuals

There are numerous relationships indicating the health of lending to institutions and individuals. While lacking the general level of public awareness that equity market headline measures have, quoted yield spreads of mortgages and corporate bonds over Treasuries are good barometers. The first graph shows the yield spread of an average ten year maturity investment grade corporate bond over Treasuries. Corporate borrowing costs started to rise relative to Treasuries last year and have soared in 2008. As in the case of bank funding markets, the gapped out spreads here indicate reluctance by corporate bond investors to accept credit risk and therefore a requirement on the part of borrowers to pay exceptional risk premiums over benchmark yields in order to access credit.

Ten-Year Investment Grade Corporate Bond Yield Spreads above Treasuries

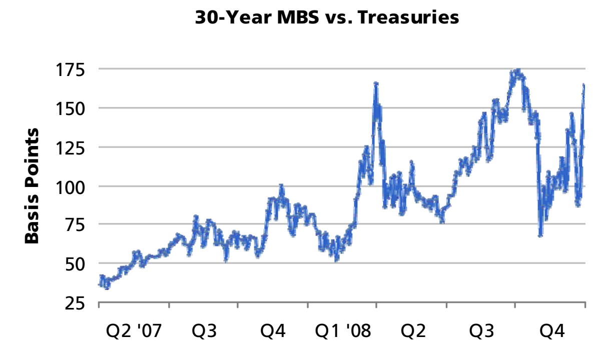


Source: Barclays, ING IM analytics

At this writing, there have been a few days of stability and even narrowing of these corporate credit spreads, which is a glimmer of hope, although these remain historically expensive levels at which to fund business organizations.

On the consumer side, much of residential mortgage floating-rate lending is based off a spread above LIBOR levels. For 30-year fixed rate lending, mortgage-backed securities are good proxies. The graph shows the stress and volatility in the MBS market.

Thirty-Year Mortgage-backed Security Yield Spreads above Treasuries



Source: Barclays, ING IM analytics

The volatility has been staggering and the stress apparent; rather than settling down, mortgage rates are still expensive. The Fed's easing campaign has not had much effect here: the monetary policy transmission mechanism has not worked its way to lower mortgage rates.

In sum, for the general public, there is limited visibility of the links that connect the creation of funds and their subsequent distribution to end users. The financial crisis has been revealed clearly in funding markets but did not show itself with much clarity for much of the public. The linkages discussed here are critical ones and the signs of breakdown and stress are real. While significant public policy and private sector efforts have been made to bring about healing, it will take time for balance sheets to be repaired, for trust to be restored, and for funds to flow freely once again. ■