The Arrival of Two New Government Acronyms

What do they mean to corporate Treasurers?

EXECUTIVE SUMMARY:

The FSP, ARRA, and the flurry of new programs and details in February may not provide the immediate shot in the arm financial markets were looking for, but some of the programs should have substantive, long-lasting positive attributes that could certainly provide a tug in the right direction in the current credit market tug-of-war. We caution that the housing market remains unstable and investor confidence remains low. For the vigilant corporate cash investor, it could mean that although some good opportunities may soon emerge in the non-government credit sectors, research is imperative and patience is a virtue. Tread lightly, but tread nonetheless.

Published: March 2, 2009

Lance Pan, CFA
Director of Investment Research
Main: 617.630.8100
Research: 617.244.3488
lpan@capitaladvisors.com

The Arrival of Two New Government Acronyms

What do they mean to corporate Treasurers?

For better or for worse, the Obama Administration's one-two punches for the sagging U.S. economy are here: the Financial Stability Plan (FSP) was unveiled on February 10, and the American Revitalization and Reinvestment Act (ARRA) were signed into law on February 17. While market responses in the following days were anything but positive, these government measures were not without merit, in our opinion. While it gets confusing and sometimes futile to try to keep track of the new government acronyms, we actually think this coolly-received new development has quite a bit of substance. Our interest, of course, is on how the new programs will impact the corporate treasurer and, more specifically, how they may influence the short-term credit markets?

A Major Breakthrough for Structured Credits:

A key component of the Treasury Department's plan is the revised Term Asset-Backed Securities Loan Faculty (TALF) run by the Federal Reserve Bank of New York. By expanding Treasury's investments in the program from $20 billion to $100 billion, the program could provide up to $1 trillion in liquidity to a key part of the credit markets that has been frozen solid. By including commercial and non-agency residential mortgages as eligible collateral and investment funds (read hedge funds) as eligible investors, the revised size of the program will partially offset the lost securitization volume seen over the last two years and kick start the consumer credit markets.

To investors (i.e. lenders) of asset-backed securities, the program is what the various liquidity and credit facilities (TAF, TSLF, PDCF, CPFF, AMLF, MMIFF) are to banks, brokers, money market funds, and commercial paper issuers. Slated to start in a matter of days, the program will likely have a direct impact on liquidity in the short-duration credit market. With the Fed lending its balance sheet, investors may feel safer to come back to the market for the non-toxic asset backed securities investments, and market makers may find some room on their own balance sheets to bid back some bonds.

The government's bold move to jump start the securitization market also sends a strong signal that the asset-backed market remains essential to the nation's credit generation and financial system stability. Investors must note however that there is a clear distinction between plain-vanilla ABS and the toxic, more leveraged varieties. Good opportunities may be close at hand when the credit environment improves.

FSP Strengthens Senior Creditors of Banks:
More details emerged after the Treasury unveiled its plan to replace or enhance the existing TARP programs to bolster the financial condition of the bank system. We think that, undoubtedly, the senior debt holders of the so-called "systemically important banks" are the direct beneficiaries of the FSP.

The plan's Capital Assistance Program will provide banks short on capital with the remainder of the $700 billion TARP money in the form of mandatory convertible preferred securities after the banks undergo the now infamous "stress tests." Regulators have identified 19 banks with assets over $100 billion that may be eligible to receive the new capital. Details of the stress tests and how the preferred stock will be converted into common shares are quieting some of the earlier chatter of concerns with bank "nationalization." In a nutshell, the new capital funding represents the front-loading of a "capital buffer" that will prepare the banks for a much worse than expected economic environment beyond 2010. That, we think, is a positive development for bank senior debt holders.

A quick recap on bank capital structures: bank holding companies often issue senior and subordinated debt, hybrid securities, preferred and common shares. Operating banks within the holding companies can also issue senior and subordinate debt. Deposit holders have the most senior claims against a bank's

assets, followed by senior debt holders of the bank and of the holding company. Preferred and common stockholders have much less protection in comparison. Since banks' short-term borrowing consists of deposits and commercial paper, a form of senior holding company debt, the interest of such creditors is insulated from potential losses by the existing preferred and common shares. The new CAP program does just that, providing a greater capital buffer to protect senior claims holders by converting its preferred shares into common shares.

We should note that our analysis does not pertain to FDIC-insured deposits or bank debt guaranteed by the FDIC's temporary liquidity guarantee program (TLGP), both of which carry the full faith and credit of the U.S. Treasury and are unaffected by the latest developments. As a result of the new program, we are more wary of regional bank debt as the Treasury has not clearly indicated whether it would accept additional banks beyond the initial 19 banks.

Municipal Governments Also Benefit:
State and local governments enduring the perfect storm of falling tax revenues, rising benefits payments and frozen credit markets also may find relief in the new stimulus package. The new legislation allocates more than $220 billion through 2010 to assist municipal entities through direct funding, tax credits and other provisions that may help the broader municipal market. Specifically, states will receive nearly $150 billion in funding through 2010 that may prevent them from severe credit downgrades. The funding goes towards support for K-12 and higher education as well as to partly close the budget gaps in fiscal 2009 and 2010. Qualified school construction bonds and increased tax credits for qualified zone academy bonds should make it easier for local governments to access the credit markets.

Infrastructure-related municipal entities such as airports, ports and toll road operators, also received some benefits, including $16 billion in new capital grants. Colleges facing severe credit downgrades may find some relief from the $54 billion stability fund set aside for state governments. Another $30 billion will go to help students pay for college expenses. Lastly, not-for-profit hospitals that serve low-income patients will benefit from the temporary expansion of $87 billion in Medicaid funding.

In short, we do see some immediate benefits to municipal issuers in the short-term funding markets. Over time, we expect the strain on municipal debt issuers

to be marginally alleviated by the new ARRA legislation when fully implemented. We recognize, however, that the temporary relief may require state and local entities to provide future funding to complete the very projects the Federal dollars will help them begin. A recovery in the municipal sector can only be sustained through a recovery in the overall economy. On balance, the positive impact on the municipal sector is more subtle, in our opinion.

Will Money Market Funds Benefit?

While not directly, the answer is most certainly yes. Consider that the health of the money market fund industry relies upon the asset quality of the underlying investments and the financial health of their corporate sponsors. Improved liquidity in structured, financial and municipal credits should have positive impact on the funds' portfolio credit quality. Improved liquidity in the credit markets also may lessen the strains on the Treasury funds thanks to their higher yield levels. Investors in bank-sponsored funds may also feel a bit more at ease with the depth of their bank sponsors' pockets in providing further liquidity and credit support, provided that they are on the list of the 19 banks, of course.

Market's Response:

The drop in the equity indices following the administration's new announcements seems to suggest that the latest programs were a public relations disaster. Responses from the short-term credit markets, however, were more muted. For example, the 30-day commercial paper rate barely moved, rising from 0.50% on February 10 to 0.52% on February 24. The 30-day ABCP rate rose 0.05% to 0.61% in the same time period. In comparison, the one-month Treasury bill rate dropped 0.03% to 0.21%. This offsets the 0.03% rise in the one-month LIBOR rate, a more generic barometer for credit risk in the money market world.

No Panacea, But Programs Deserves More Credit than Perceived:

In summary, the FSP, ARRA, and the flurry of new programs and details in February may not provide the immediate shot in the arm financial markets were looking for, but some of the programs should have substantive, long-lasting positive attributes that could certainly provide a tug in the right direction in the current credit market tug-of-war. We caution that the housing market remains unstable and investor confidence remains low. For the vigilant corporate cash investor, it could mean that although some good opportunities may soon emerge in the non-government credit sectors, research is imperative and patience is a virtue. Tread lightly, but tread nonetheless.

The information contained in this report has been prepared by Capital Advisors Group, Inc. ("CAG") from outside sources, which we believe to be reliable; however, we make no representations, express or implied, as to its accuracy or completeness. Opinions expressed herein are subject to change without notice and do not necessarily take into account the particular investment objectives, financial situations, or particular needs of all investors. This report is intended for informational purposes only and should not be construed as a solicitation or offer with respect to the purchase or sale of any security. CAG is under no obligation to make changes or updates to this report and therefore disclaims any liability should the information or opinions contained herein change or subsequently become inaccurate. Past performance is no guarantee of future results.

© 2009 Capital Advisors Group, Inc. All rights reserved. This report may not be reproduced or distributed without CAG's prior written consent.