The Exit Strategy

Steps to Detach the Economy from Government Life Support

Federal Reserve Chairman Ben Bernanke recently laid out his plans to lawmakers on how the Fed will eliminate programs, when needed, that pumped hundreds of billions of dollars into the financial system. In an op-ed piece for the Wall Street Journal, he wrote that the strategy is ready to be put to use, but noted that "accommodative policies will likely be warranted for an extended period," meaning the exit strategies may not be implemented any time soon.

In his article however, Chairman Bernanke did not mention that steps by the government to remove earlier emergency support to the short-term credit markets have actually been in progress for several months now. Although we concur that an increase in the Fed funds rate will probably not happen until some time next year, we also think the pullbacks by the Fed, the FDIC, and the Department of Treasury are indicative of a stabilizing financial system and of better growth prospects for the economy. We welcome these developments and view them as important interim steps toward a more normalized environment for credit investing.

THE BERNANKE EXIT STRATEGY

Chairman Bernanke explained that the Fed's approach to shrinking its balance sheet without raising interest rates will be done through bank lending. In a recovery scenario, bank lending drains the banks' reserve balances at the Fed, thus helping the various lending facilities to wind down. In addition, the Fed has two broad means of tightening monetary policy. First, by raising interest rates paid on reserve balances (currently at 0.25%) and second, by taking action that reduces the stock of reserves.

The interest rate the Fed pays on reserve balances, argues the Chairman, should put a floor under short-term market rates, including the federal funds rate. Raising the rate also discourages excessive growth in money or credit because banks will not want to lend out their reserves at rates below what they can earn at the Fed.

The Fed's strategy of reducing reserves includes arranging large-scale reverse repurchase agreements with financial counterparties and allowing the Treasury Department to sell T-bills, the proceeds of which would be deposited with the

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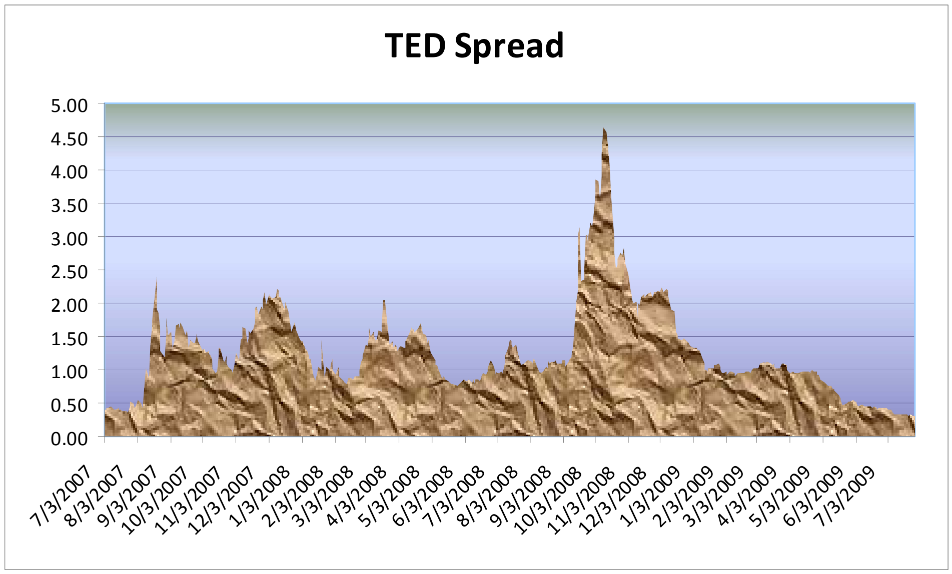
Lance Pan, CFA
Director of Investment Research
Main: 617.630.8100
Research: 617.244.3488
lpan@capitaladvisors.com

Federal Reserve. In both cases, when purchasers pay for the securities, cash leaves the financial system and the central bank mops it up. Other ways to drain money supply could include offering Federal Reserve term deposits to banks or selling its holdings of long-term securities into the open market.

THE TED SPREAD LEADING THE WAY

Graph A. TED Spread



Data Source: Bloomberg

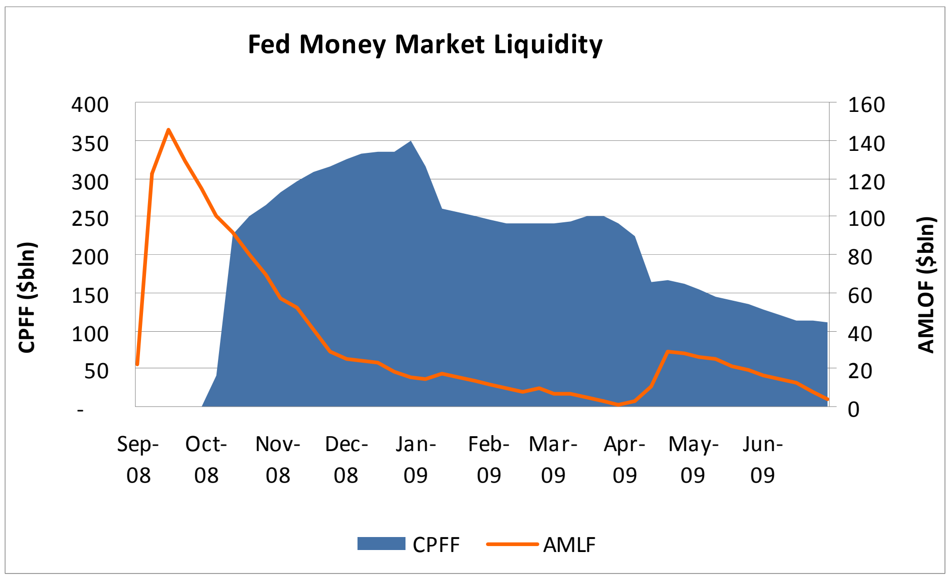
A more fundamental question is why the timing is right to mop up the excess liquidity. We think the return of the short-term credit markets to more normal conditions is a necessary condition for the government to relinquish its babysitting role.

The so-called TED (Treasury to Euro Dollar) spread is a classic "panic" meter for credit markets. Under normal conditions, the spread between three-month T-bill and LIBOR (a Euro Dollar proxy) rates is typically between 0.20% and 0.50%. As depicted in Graph A, the spread had a few dramatic spikes as the financial crisis deepened. It reached a peak of 4.64% in October 2008, before steadily declining towards the current level of 0.31% in July 2009. Thus, the credit market is signaling to authorities that it is now operating under more normal conditions.

CAPPING THE MONEY FUND COOKIE JAR

It is logical that as credit markets improve, some of the emergency measures must be phased out. It seems counterintuitive, therefore, that on June 25, the Fed extended some of the liquidity programs scheduled to expire later this year and in early 2010. A closer examination however, reveals that the Fed, while granting the extensions, has made these facilities much harder to tap. In other words, they were extended as true emergency backup plans.

Graph B. FED Money Mark Liquidity



Source: Federal Reserve's H.4.1 statistical release titled "Factors Affecting Reserve Balances"

Graph B shows the balances at the Federal Reserve in money market fund related facilities: the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) and the Commercial Paper Funding Facility (CPFF). The graph clearly shows that the use of the emergency programs has been reduced dramatically from September 2008 to June 2009.

AMLF was set up by the Fed in September 2008 in response to runs at major money market funds. It allowed the funds to borrow from the Fed indirectly by using the funds' asset-back commercial paper (ABCP) holdings as collateral. After reaching $145 billion in October 2008, balances steadily declined through April of this year except for a brief episode in May. In extending the program to

February 2010, the Fed requires that money funds access the facility only if they experience redemptions of at least 5% of net asset values in a single day, or 10% in a five-day period. A recent JPMorgan report showed 7% of the fund families reached the one-day threshold and 27% reached the five-day threshold last September, after the Reserve Primary Fund losses. These statistics suggest that the facility is now all but closed short of a genuine run scenario.

Cost is a natural deterrent, too. The sponsor bank borrows from the Fed at prime credit rate, currently at 0.50% and lends to a money market fund at the yield at which the collateralized ABCP was initially purchased. Since ABCP yields are generally less than 0.50% nowadays, tapping the facility would represent a cost to the sponsor bank.

The extension of the CPFF to February 2010 carries big economic disincentives. It is a facility that allows top tier (A-1/P-1 rated) commercial paper issuers to borrow from the Fed when a private source of financing becomes unavailable. It was set up last October as the lender of last resort in the short-term credit market. Although issuers can continue issuing paper into the facility, its high fees and a better functioning credit market make it all but irrelevant.

For example, unsecured CP issuers pay a 1.00% yield premium over a three-month index rate (the overnight indexed swap (OIS) rate, currently at 0.30%) plus a 1.0% surcharge. ABCP issuers pay a 3.00% yield premium over the OIS swap. These rates work out to be 2.30% for unsecured CP and 3.30% for ABCP, far exceeding the going rates on the open market for credit-worthy issuers. Again, short of sudden market disruptions, the Fed effectively has shut down this liquidity facility as well.

FDIC INSURANCE AT HIGHER PRICE TAGS

In the heat of the financial system meltdown last October, the FDIC introduced the Temporary Liquidity Guarantee Program (TLGP) and the Transaction Account Guarantee (TAG) Program to guaranteed bank debt and deposits. In March 2009, the federal agency extended the deadline to issue TLGP debt from June 2009 to October 2009, and the expiration of the guarantees from June 2012 to December 2012. In doing so, the FDIC raised the price tag of the guarantees from 0.75% annualized for all debt to 1.00% for debt maturing longer than a year. It also imposed surcharges up to 0.25% a year for certain debt. Relative to the normal insurance premium of 0.12%, the new fees provide a strong incentive for banks to pursue other funding channels, thus weaning them off the government guarantees.

The FDIC exit strategy doesn't end there. In a proposed rule extending the TAG program through June 2010, the agency suggested that during the extended duration of the program, the insurance premium on bank deposits would increase from 0.10% to approximately 0.25%. If adopted, the rule would allow banks to opt out. Because of the already high insurance burden on healthy banks and the improved funding environment in the market, we expect many will choose to opt out of the program, thus preventing another government program to arise.

TREASURY'S MONEY FUND GUARANTEES WILL LIKELY EXPIRE

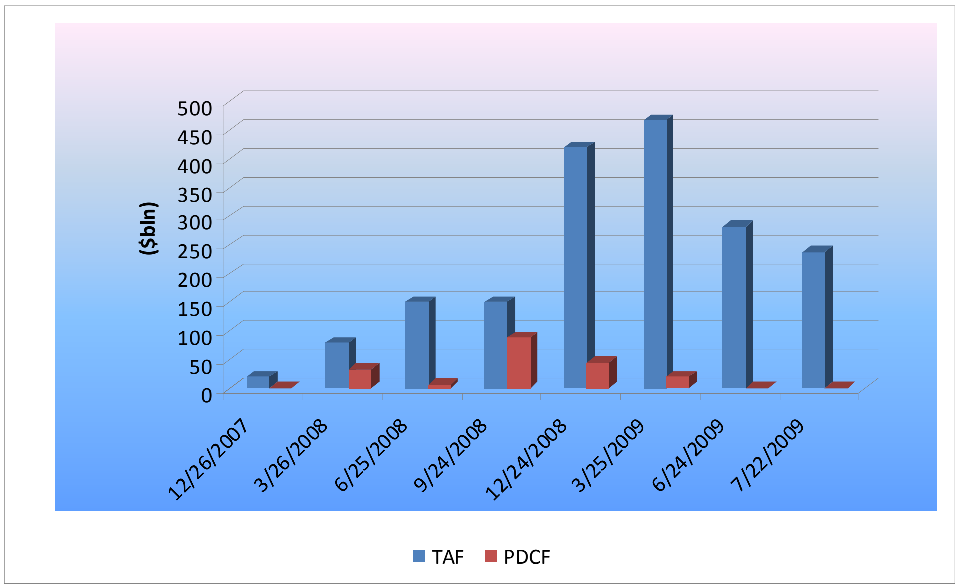
The Department of Treasury's temporary guarantee program for money market funds is likely to expire at its scheduled expiration date this September. The program was introduced in September 2008 to halt investor stampedes out of money market funds, and was designed to be renewable quarterly through September 18, 2009. When the Treasury Department extended the program last March, the majority of the fund families decided to opt out of the insurance for funds investing in government securities.

In the current low yield environment, a good number of funds are earning 0% yield. At 0.04% or 0.06% annualized rate, the guarantee fees represent a major expense item to be subsidized by fund sponsors. It is thus widely expected and proposed by a recent fund industry working group that the government program should be allowed to "sunset" at its scheduled date. If that's the case, it will be a good indication of better investor confidence in the fund industry without government support.

THE EXIT WILL CONTINUE

Since late 2007, the U.S. government devised quite a number of support programs that, when used in concert, ultimately proved to be successful in stabilizing the country's financial system. As the system recovers and the real economy starts on the road to recovery, it is logical for the government to deploy strategies to methodically and carefully exit the private stage. While higher short-term interest rates may not come in the near future, the government's initiatives in removing support from the short-term credit market are well on their way. We think their steps are prudent and reflect the current economic reality.

Graph C. TAF and PDCF



Source: Federal Reserve's H.4.1 statistical release titled "Factors Affecting Reserve Balances"

Graph C indicates that the use of some of the largest government programs, the Term Auction Facility (TAF) for banks and the Primary Dealer Credit Facility (PDCF) for broker-dealers, has been on a steady decline since last spring, reflecting a healthier financial system and lower stress levels from participants.

We applaud the use of economic disincentives to wean market participants off of government support. We also think these are signs that credit market conditions are stabilizing, and may suggest that better investment opportunities away from the government guaranteed sector are developing. As credit investors, we are still mindful of the impact of looming consumer loan losses and distress in the commercial properties market on financial issuers. However, we think opportunities for strong diversified issuers are systemically important as U.S. banks have become more appealing.