David Malpass
212-876-4400
dmalpass@encimaglobal.com

October 2, 2008

Credit Freeze Deepening the Recession

A key issue in the depth of the recession is short-term credit markets. The new Treasury debt facility (we expect it to pass) won't be able to quickly resolve the problems, though it may help some as will other provisions in the new legislation.

- The short-term credit market problems are slowing economic growth but, given the huge reservoirs of liquidity around the world, we don't think they will break the financial system.
- Many of the credit market issues will gradually work their way out. We expect much less use of financial commercial paper, along the lines of the 2007 decline in asset-backed commercial paper.
- The LIBOR benchmark process is broken. We think either the LIBOR process or existing contracts will have to be modified. Otherwise, the spike in LIBOR will deepen the financial crisis. Regardless, we think LIBOR will decline as a benchmark for loans.

Regardless of the Treasury facility or short-term credit markets, we expect a sharp decline into recession in coming weeks, primarily the result of:

- the May-July commodity spike due to the weak-dollar policy;
- high mortgage rates due to Fannie/Freddie paralysis;
- the negative third-quarter impact of Gustav and Ike;
- and the sequential collapse of financial/insurance firms, still unchecked.

We disagree with the view that this double-dip outcome was preordained by debt, the trade deficit, or the decline in house prices. We think the recession is the hangover from excess liquidity in 2003-2006 plus poor Washington policy choices over the last year, including:

- the weak dollar policy;
- the interaction of the rigid new mark-to-market process with the CDS market, bond rating agencies, regulators, and short-selling;

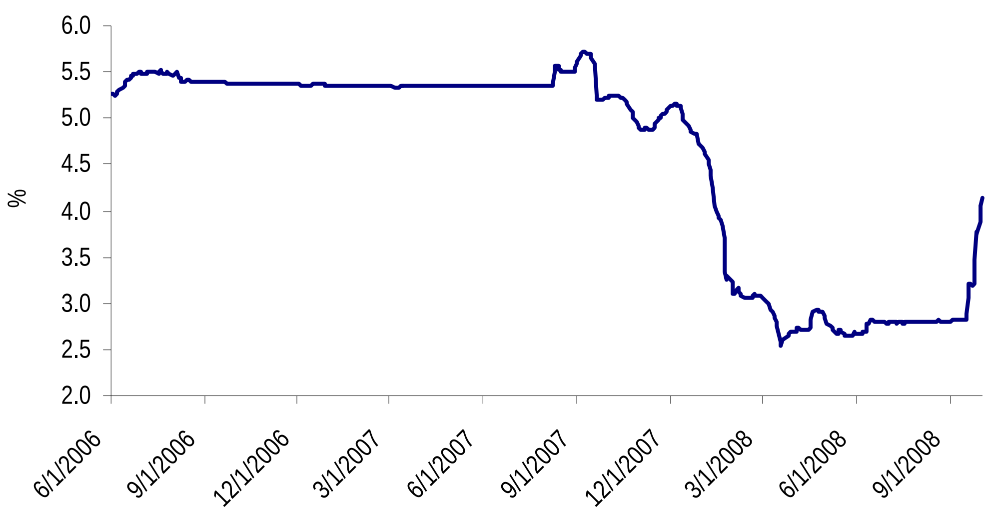
- and Treasury's catch-22, which forced financial institutions to try to raise substantial private equity capital to offset the mark-to-market spiral at the same time that private equity capital was being aggressively extinguished in order to avoid the perception of government bailouts.

Breakdown in LIBOR Process

LIBOR is the London Interbank Offered Rate, the rate banks charge each other for loans. It can be presented as an interest rate (below), the LIBOR/Fed funds spread, or the LIBOR/T-bill spread (the TED spread.)

- Beginning September 18, all three measures became particularly elevated due to banks' lack of confidence in each other, especially after the Lehman bankruptcy on Sept. 15. The small spike in September 2007 was called a crisis at the time, meaning the current spike is a quadruple crisis.

3 Month U.S. Dollar LIBOR (last obs. October 2, 2008)



Source: Haver; Encima Global

We don't expect the LIBOR problem to be resolved in a way that allows a return to past practices (which placed heavy reliance on bond ratings and too-big-to-fail). Instead, we think the banking and financial systems are flexible and, over time, will cause the LIBOR system to evolve or diminish in importance.

- Under current LIBOR procedures, **few new loans will be based on LIBOR**, shifting instead to other floating-rate bench marks. This will reduce the impact of LIBOR over time in the same way that LIBOR took over from the prime rate as a benchmark.

- Perhaps the British Bankers' Association (which polls banks to determine the daily LIBOR fixing used for contracts) will redefine LIBOR to reestablish it as a benchmark (for example, only poll top-rated banks that are actively making interbank markets with each other).

- In the meantime, **cash-rich banks may make more direct loans, buy commercial paper or hold interest-bearing reserves at the Fed (authorized in the new legislation)**.

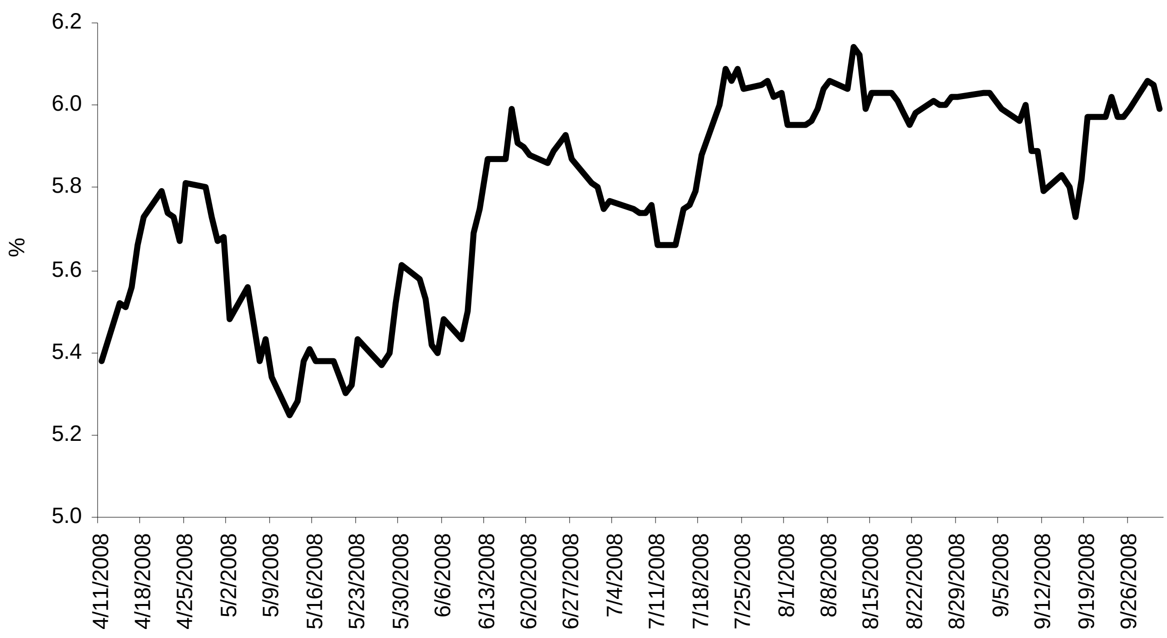
- Cash-poor banks (who would normally tap the interbank market) may cut back on lending or borrow from a central bank using the new facilities and the reduced stigma. The U.S. discount rate is only 2.25%.

- Thus, **we don't think the new-lending aspects of the LIBOR spike present a major problem for GDP growth or endanger the financial system**. During the transition period away from LIBOR, it benefits cash-rich banks relative to cash-poor banks, but we think that profit differential will dissipate over a few months.

The bigger LIBOR problem, in our view, is for existing contracts. Starting September 18, the spike in LIBOR has caused an increase in the interest rate on existing loans tied to LIBOR.

- The longer the spike lasts, the more loans will be reset to the higher rate, including floating-rate business loans and adjustable rate mortgages. If unaddressed, this will add to the financial crisis.

5 year adjustable mortgage rate [ARM] (last obs. October 1, 2008)



Source: Haver; Encima Global

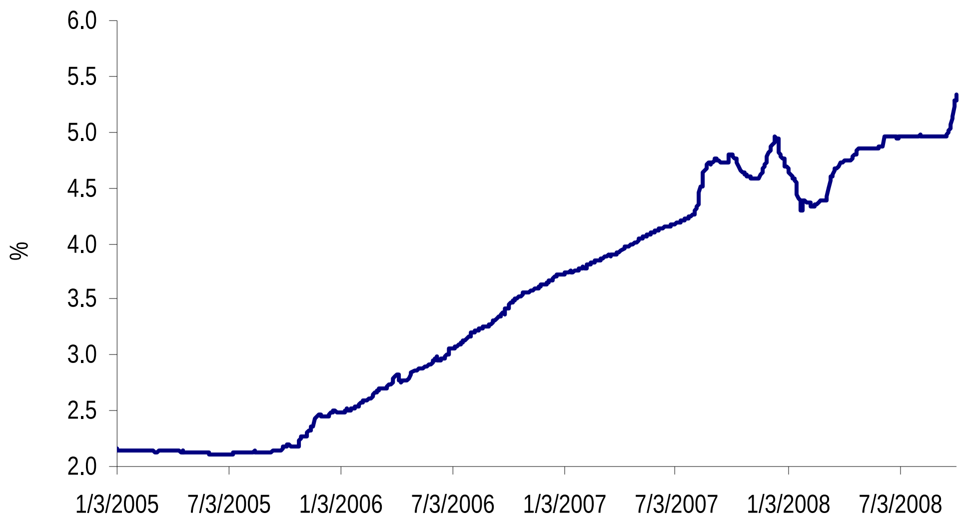
- We think it is urgent that governments address the contractual problem presented by the breakdown of the LIBOR process. Given the unprecedented decline in LIBOR volumes and crisis in the financial system, it may take courts or other extraordinary steps to redefine or reinterpret the LIBOR benchmark.

Linkage with Europe's Problems

Europe's short-term credit markets are suffering problems similar to those in the U.S.

- Euribor, the euro-denominated equivalent of LIBOR, has risen from 4.973% on September 17 to 5.330% in the October 2 London fixing.

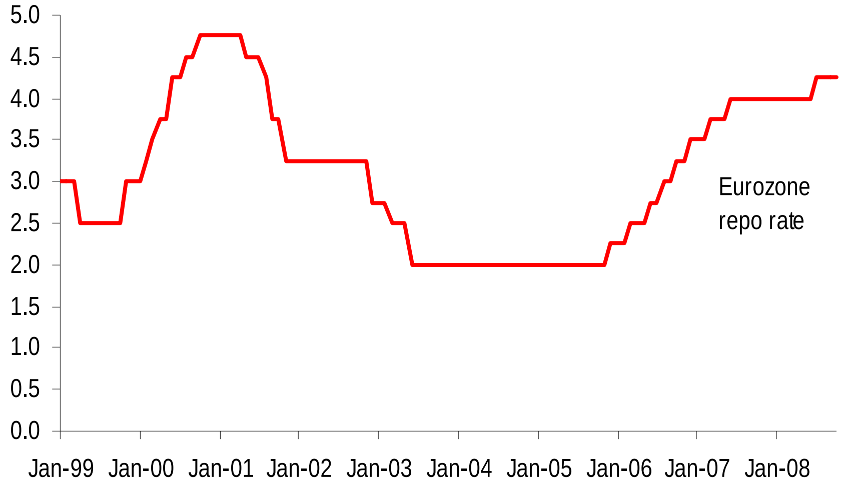
Eurozone EURIBOR 3 Month (last obs. October 2, 2008)



Source: Haver; Encima Global

- We think the Fed and the European Central Bank have powerful tools which they will use as necessary to protect the financial system. The Fed's balance sheet is expanding rapidly, in part due to massive swap arrangements with foreign central banks. **We expect the ECB to cut interest rates soon to 4% from 4.25%.**

Eurozone repo rate (in percent, last obs. October 2008)



Source: Haver; Encima Global

Low Treasury Bill Yields

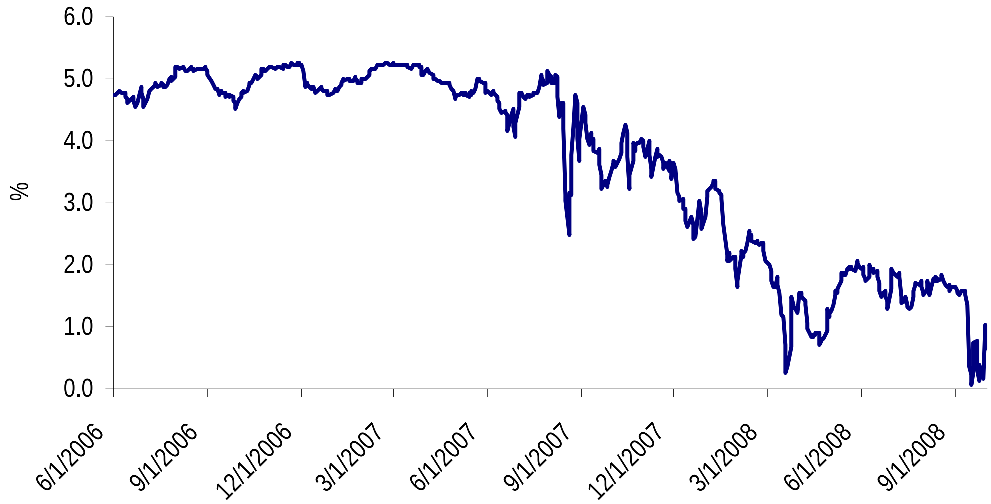
We disagree with the view that low Treasury-bill rates are a major problem. They reflect risk-aversion and the limited supply of Treasury bills relative to massive global credit markets. Using conceptual numbers to illustrate, a small shift toward risk aversion in a $100 trillion short-term global credit market can drive the yield on a $2 trillion T-bill market near zero without having much impact elsewhere or meaning much in terms of the growth outlook.

- We think the new legislation will raise T-bill yields. The legislation allows the Fed to pay interest on reserves held by banks at the Fed. The interest rate the Fed offers will influence/control the T-bill rate, raising it toward the Fed funds rate.

- The net budget impact on the U.S. government of the Fed paying interest should be low. Banks can lend to the Fed instead of buying Treasury bills. The Fed is always profitable, returning a portion of that profit to Treasury, so this will probably mean a smaller remission but correspondingly lower Treasury interest payments.

- If low Treasury-bill yields are a problem, we think Treasury and the Fed could easily address them by Treasury issuing more T-bills and depositing the proceeds at the Fed (expanding the Fed's balance sheet); or by Treasury making explicit the equivalency between agency paper and Treasury paper; or by Treasury replacing agency paper with Treasury paper.

One month T-Bill rate (last obs. October 1, 2008)



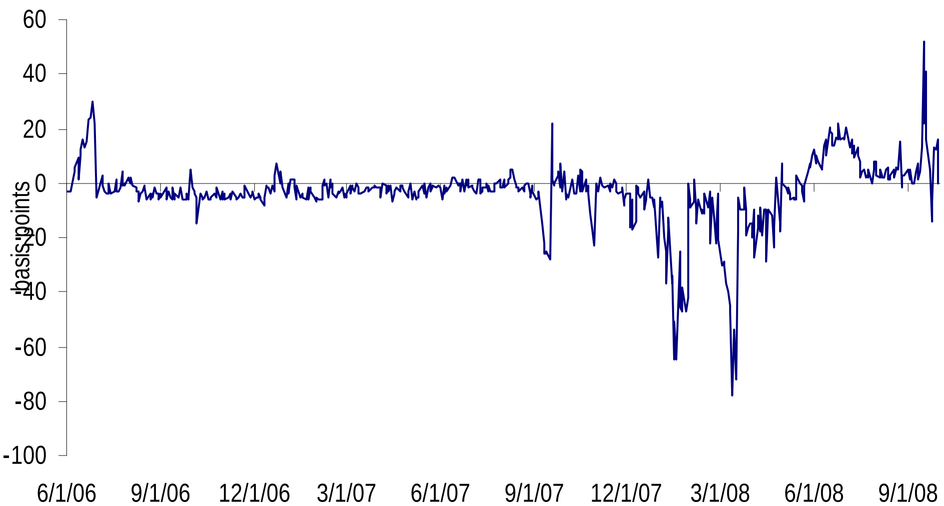
Source: Haver; Encima Global

Commercial Paper and Muni-Paper Problems

We don't think problems in the commercial paper market are critical to the outlook.

- Non-financial commercial paper came under intense pressure on September 16 in the wake of the September 15 Lehman bankruptcy, but has since settled down.

Spread between 1-Month Nonfinancial Commercial Paper and Fed Funds Target (last obs. October 1, 2008)



Source: Haver; Encima Global

Money market funds came under pressure on September 17 and 18 over concerns that failed Lehman commercial paper was causing funds to break the buck.

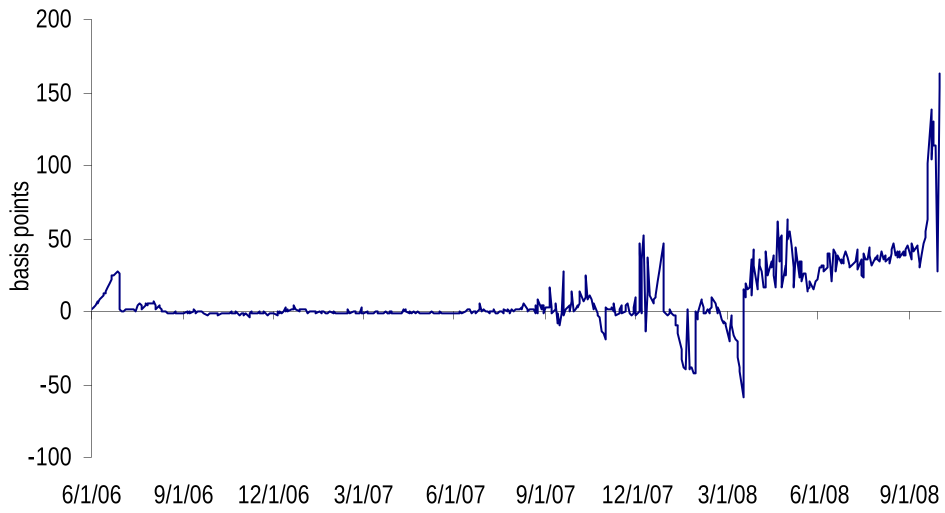
- The Fed announced a new facility on September 19, taking $150 billion of commercial paper onto its balance sheet by October 1.

- Treasury guaranteed money market funds using the 1934 Exchange Stabilization Fund, which authorized it “to deal in gold, foreign exchange, and other instruments of credit and securities.”

- The new legislation has a provision confirming the Treasury guarantee of money market funds. The legislation authorizes Treasury to reimburse the XSF from the new $700 billion facility and separately prohibits Treasury from using the XSF for a future money-market guarantee program.

The focus of the commercial paper problem now appears to be in financial commercial paper. It came under heavy pressure beginning September 19 as the ramifications of the Lehman bankruptcy deepened.

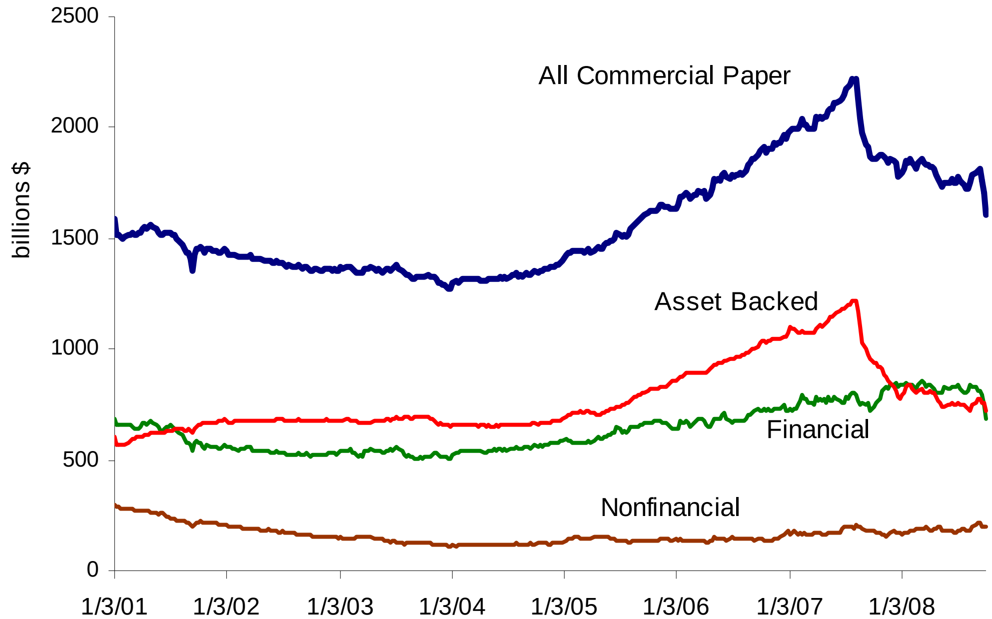
Spread between 1-Month Financial Commercial Paper and Fed Funds Target (last obs. October 1, 2008)



Source: Haver; Encima Global

- Commercial paper outstanding has declined sharply since September 19.

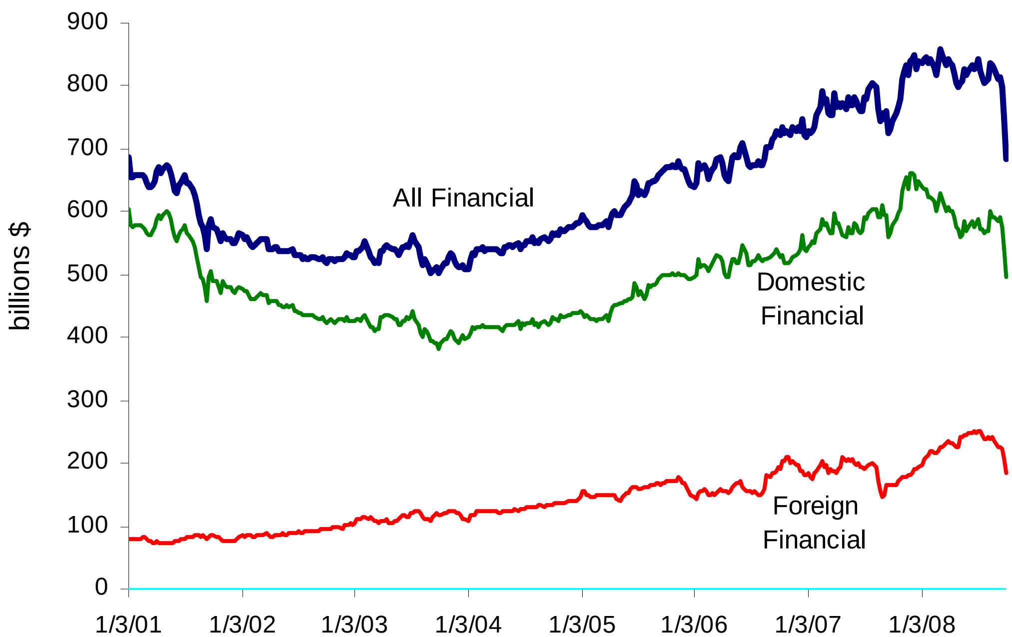
Commercial Paper outstanding (last obs. October 1, 2008)



Source: Haver; Encima Global

- Financial commercial paper outstanding is down $128.5bn or 15.8% from a month ago. Foreign financial commercial paper issuance was down 18% during the same period.

Financial Commercial Paper outstanding (last obs. October 1, 2008)



Source: Haver; Encima Global

- We expect the issuance of financial commercial paper to decline substantially (similar to the decline in asset-backed commercial paper in late 2007.) Financial institutions will increase their reliance on deposits.

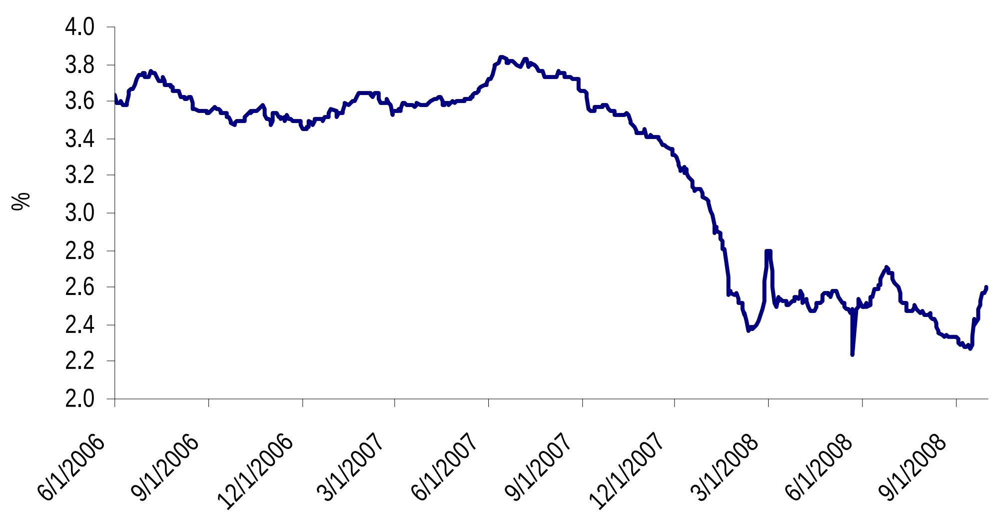
- We don't expect major negative GDP consequences from this shift, though it will cause market dislocations while the old pipeline of financing runs off prior to the new pipelines being fully established.

Short-term debt of municipalities has spiked as well. Anecdotal evidence suggests a freeze in short-term issuance, forcing states and municipalities to draw on reserves or self-finance using pension funds, both clearly temporary stopgaps.

- Unlike LIBOR (where we think the market will be fundamentally altered) and financial commercial paper (where we expect a substantial decline in issuance), **we think the muni market will revert to more normal conditions after the current crisis subsides**.

- Municipal finances will be under severe pressure for years due to the developing recession, but we think the current elevation in the spread between short-term muni interest rates and the Fed funds rate will prove temporary.

2 year Muni AAA bond yield (last obs. October 1, 2008)



Source: Haver; Encima Global

Notes