Encima Global

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

**September 18, 2008**

# Financial Crisis: Credit Market Update

These are very difficult times for financial markets and especially investment banks. **We don't think the current government actions are sufficient to stop the crisis, but we think additional actions will be forthcoming and will be sufficient.**

- We think Treasury created a spiraling anti-equity catch-22 (companies must raise equity but interventions must wipe out equity holders). The Fed's September 16 AIG intervention reinforced this catch-22 because the Fed became the "owner of last resort" rather than using a bridge-loan as the "lender of last resort". This had negative implications for equity values in other companies, contributing to the September 17 selling attack on Goldman Sachs and Morgan Stanley. **We think the anti-equity catch-22 will be corrected as Treasury and the Fed begin to support equity-favorable outcomes for future interventions.**

- We think discussion of an RTC-like structure (being floated on Capitol Hill) is a helpful signal that Washington wants equities to go up for a change, not down. **However, we don't think it is a likely prospect**. The legal authorities are difficult to obtain, especially in a contentious election year. It wouldn't buy assets until 2009 or 2010. It's unclear how such a structure would get assets – each purchase would create a profit for a private sector holder. Who would decide the amount of profit to grant?

- In the end, we think the Washington solution lies in breaking up the harmful interaction between accounting rules and rating agencies (see our September 12 and September 15 client pieces on the website**.)** **Trend-following bond rating agencies are relying on artificial CDS prices.** It's cheap to drive CDS spreads wider in order to trigger bond downgrades and then equity sell-offs. **This adds to the damage from the new (and unworkable) mark-to-market accounting standards and the heavy regulatory bias in favor of short-sellers**.

**Despite the powerful crisis underway, we disagree with the view that the U.S. is in an unstoppable decline** ("empire in collapse"). The analogous 1970s malaise was turned around by better Washington policies and waves of innovation.

- Our current malaise is specific. It is mostly a hangover from excess liquidity in 2003-2006. This has combined with **several poorly timed or mistaken rules changes: -- in bond rating processes; accounting** (Sarbanes/Oxley, new FASB mark-to-market rules), **banking** (unsupervised bank leveraging after Glass-Steagall repeal, under-regulated mortgage origination), **and trading** (over-the-counter CDS market, elimination of uptick rule in July 2007, opaque short-selling processes).

We also disagree with the renewed use of the analogy between the U.S. and Japan's lost decade of deflationary banking malaise.

- Japanese banks suffered actual cash flow losses but wouldn't write them down for accounting purposes, the opposite of the U.S. problem.

- Compounding Japan's troubles, its central bank pursued a deflationary monetary policy characterized by high real interest rate and a super-strong yen, again no relevance for the current U.S. travails.

## Credit Market Update

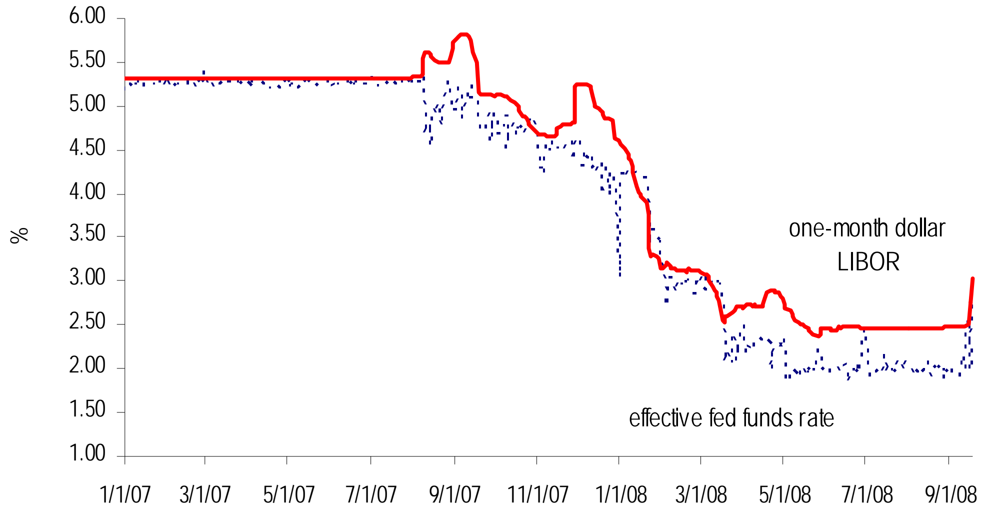
Credit markets are even tenser than they were in 2003 and in August 2007. In 2003, the impetus for the collapse in Treasury yields was the expectation that the U.S. was falling into a deepening deflationary crisis. The June 13, 2003 bottom in the 10-year Treasury yield at 3.1% was quickly overwhelmed by fast growth and rising equity markets. We don't expect a fast recovery this time, but we don't think the low Treasury bond yields prove that we're heading into a sharp new decline.

**10 Year Treasury Yield (last obs. September 18, 2008)**

Source: Haver; Encima Global

- The one-month US LIBOR has spiked to 3.03%, in part due to a spike in the effective Fed funds rate. We expect Fed liquidity additions to pull both rates down.

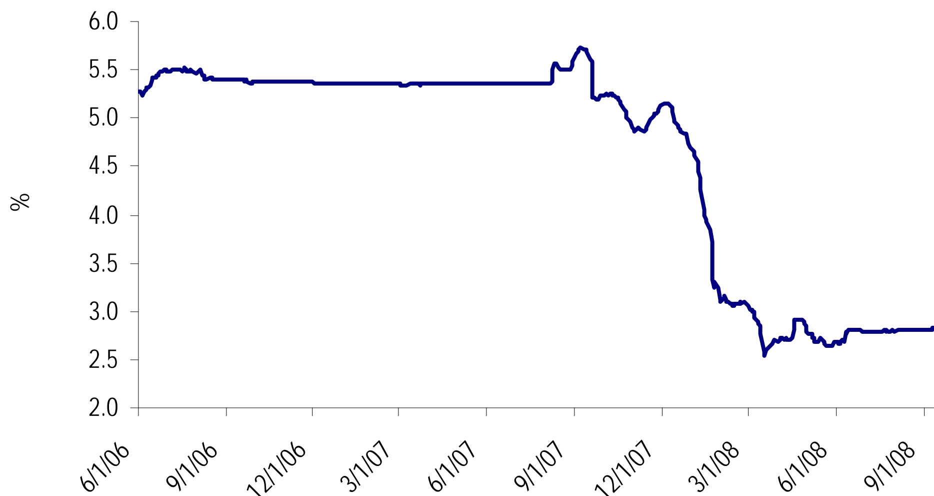
**1 month U.S. LIBOR and Fed Funds Rate (last obs. September 17, 2008)**




Source: Haver; Encima Global

- The three month LIBOR has jumped over the last two days to 3.06%. Since June, it had hovered around 2.8% with relatively little variation, a still-wide 0.8% spread to the 2% Fed funds rate.

**Three month U.S. Dollar LIBOR (last obs. September 17, 2008)**




Source: Haver; Encima Global

- The three-month TED spread (euro-dollar minus Treasury yield) reflects bank confidence in each other. It spiked to 3%. We expect it to narrow as Treasury sells more Treasury bills and, over time, banks resume trading with each other.

**TED Spread (last obs. September 17, 2008)**

Source: Haver; Encima Global

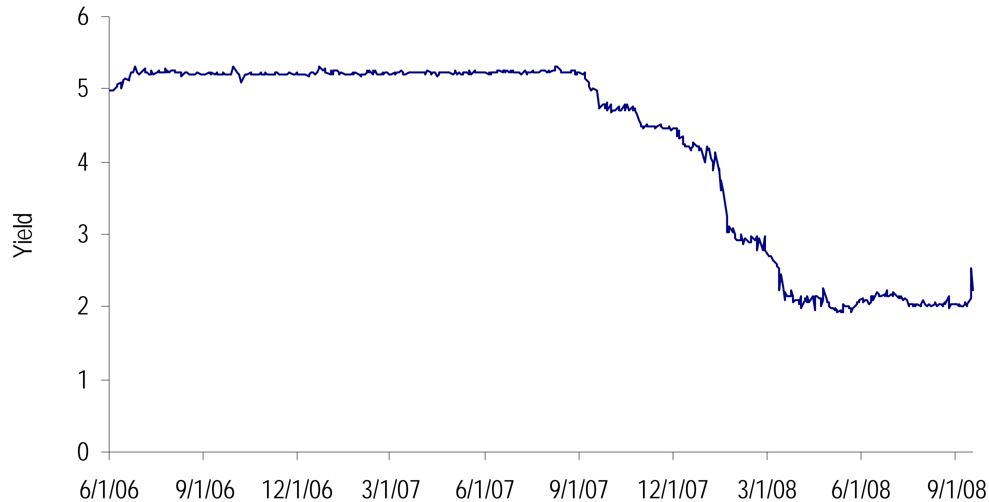
- The 10-year swap spread reflects commercial bank willingness to enter long-term swaps with each other.

**10-year swap spread (last obs. September 17, 2008)**

Source: Haver; Encima Global

- Yields on nonfinancial commercial paper have risen to 2.22%, about 20 basis points in the last two weeks.

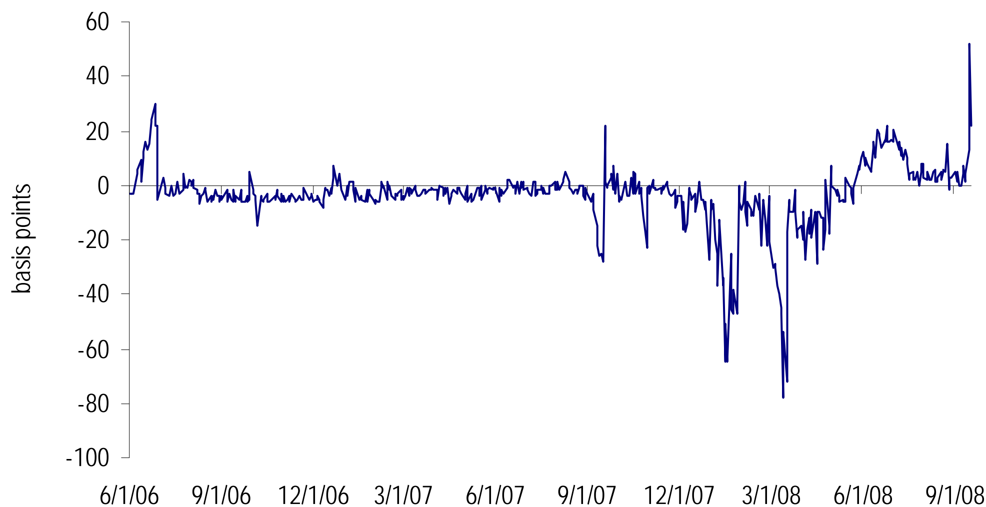
**Yield on 1month Nonfinancial Commercial Paper (last obs. September 17, 2008)**




Source: Haver; Encima Global

- Relative to the Fed funds rate, the yield on non-financial commercial paper reached 52 basis points on September 16. This would be a major economic problem if it persists, but we expect Fed liquidity additions to overnight markets to help substantially.

**Spread between 1-month Nonfinancial Commercial Paper and Fed Funds Target (last obs. September 17, 2008)**




Source: Haver; Encima Global

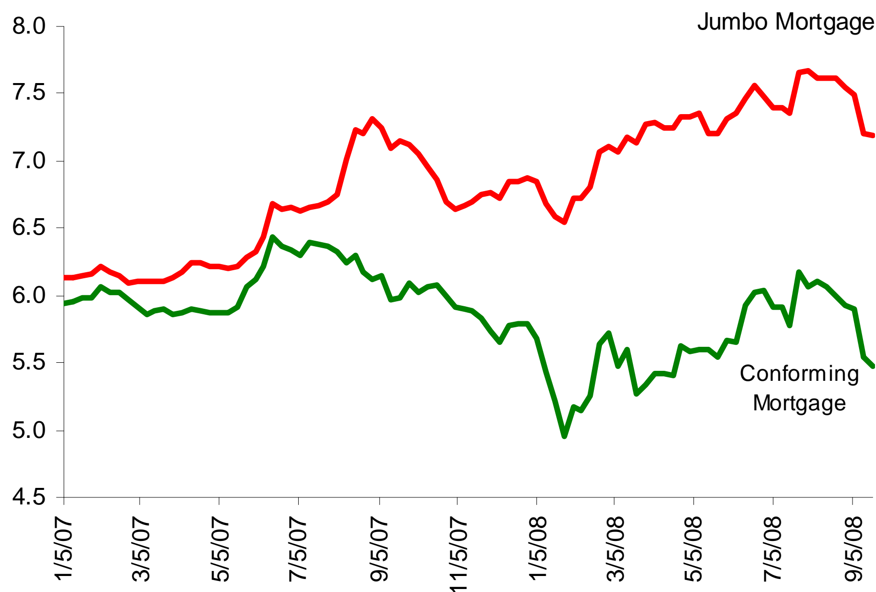
- The yield on high-yield corporate bonds has risen 76 basis points in the last two weeks to an effective yield of 12.29%.

**High Yield Corporate Effective Yield (last obs September 17, 2008)**

Source: Haver; Encima Global

- Mortgage rates continue to decline, dropping dramatically after the government takeover of Fannie and Freddie. Applications for mortgage refinancings jumped in the data released September 17. We expect waves of mortgage refinancings in coming months as Fannie Mae and Freddie push mortgage rates down.

**Jumbo and Conforming Mortgage Rates (last obs. September 17, 2008)**




Source: Haver; Encima Global

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