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MARKET Commentary

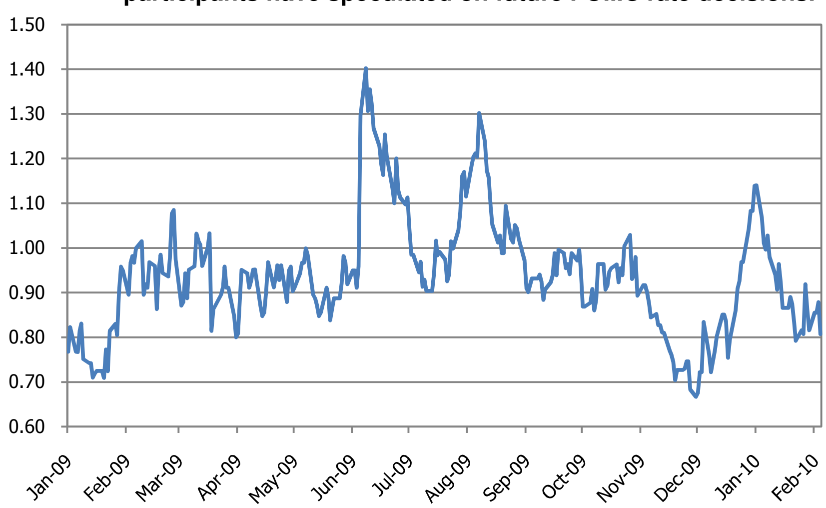
One of These Votes Is Not Like the Others

February 2010

Kansas City Federal Reserve Governor Thomas Hoenig's dissenting vote at the January Federal Open Market Committee (FOMC) meeting was interpreted by many as an unsettling sign of things to come. Governor Hoenig cited that economic conditions had improved sufficiently to warrant the removal of a prominent phrase in the official statement that the Fed Funds target rate would remain exceptionally low for an "extended period." This particular phrase had been included in every FOMC statement since the March 18, 2009 meeting and had been a main factor in convincing the markets that monetary policy would remain accommodative with interest rates bound by the current 0.00-0.25% range. The debate will intensify into 2010 over whether Governor Hoenig's vote is a sign of changing sentiment at the Fed to focus more on inflationary pressures, or a misdiagnosis of the true state of the economic recovery.

Governor Hoenig's dissension sent ripples through the markets as uncertainty grows surrounding the tradeoff the FOMC faces between ensuring a sustainable recovery and containing future inflation. Upon the release of the FOMC decision, the 2-year Treasury note, a leading indicator of Fed Funds, sold off 10 basis points. This reaction to such a development is certainly not unexpected. The bond markets have experienced several of these "false starts" in which market participants have believed that the FOMC would take action to raise interest rates much earlier than justified.

Figure 1: The 2-year note has experienced severe movements as market participants have speculated on future FOMC rate decisions.



Source: Bloomberg

After the FOMC lowered rates to record lows in 2009, the 2-year note experienced several sharp movements as market participants speculated on future Fed actions. When the 2-year note sold off 49 basis points in 3 days in June 2009, we addressed the unlikelihood of FOMC action in our July Market commentary **Whip Inflation Now?** Our view at the time was that the FOMC would not raise interest rates with rising unemployment, contracting credit, and rising defaults among virtually every asset class, despite the potential inflationary pressures caused by pumping reserves into the system through the Fed's quantitative easing programs.

We cannot discount that the FOMC has clearly begun to gradually implement an exit strategy. However, with the unemployment rate still elevated at 10 percent and pressure from the White

US Treasuries

As of 29-Jan

Benchmark	Yield
3 Month	0.07%
6 Month	0.15%
2 Yr	0.82%
5 Yr	2.33%
10 Yr	3.59%
30 Yr	4.49%

Merrill Lynch Indexes

31-Dec to 29-Jan

Index	Return
1-3 Yr Gov/Corp ≥ A	0.78%
1-3 Yr Municipals	0.27%
1-3 Yr Agencies	0.62%
0-3 Month Treasuries	0.01%
S&P 500	-3.60%

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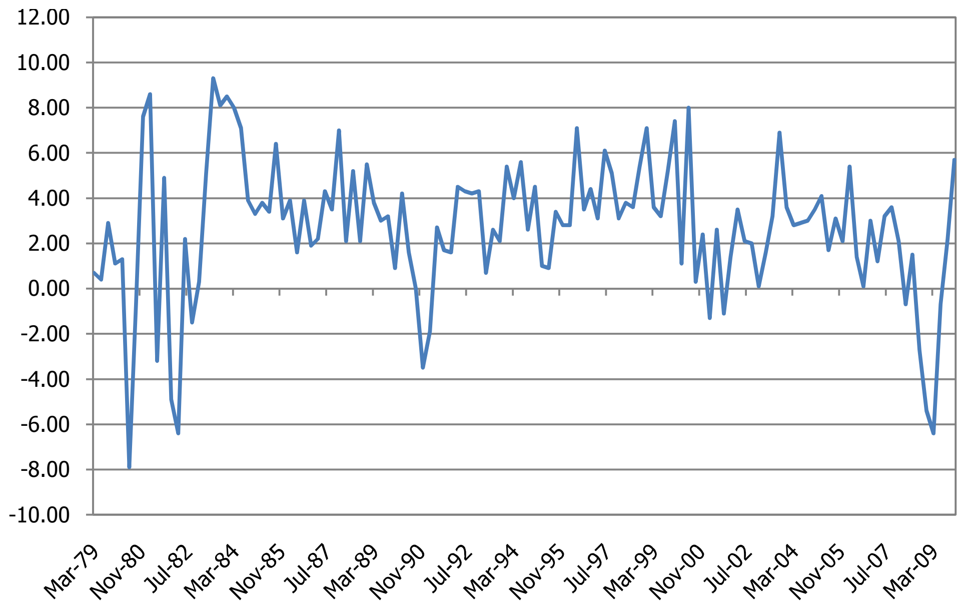
Source: British Bankers' Association, Federal Reserve, FDIC, US Treasury, Bloomberg, Barclays, Financial Times, JP Morgan

House to push a pro-job agenda in the coming year, we do not foresee the Federal Reserve moving on interest rates until the second half of 2010 at the earliest. Merrill Lynch/Bank of America and JP Morgan analysts do not predict the first move occurring until early 2011. Inflationary signs remain muted and the economy—which showed strong gains from the positive contribution of various stimulus programs and the rebuilding of depleted inventories—will continue to face headwinds in 2011. Estimates suggest that 3.4 percent of the most recent 5.7 percent GDP figure came from companies replenishing depleted inventories, dampening some of the excitement surrounding such an upbeat print.

Figure 2: GDP has rebounded with strong gains in recent quarters as the government stimulus efforts has helped to prop up the economy



Source: Bloomberg

2a-7 Regulation Announced

The market was presented with several new and proposed regulatory changes in January. The most relevant for short-duration investors has been the SEC announcement of changes to the rules governing 2a-7 money market funds. The new rules will change the way that money funds operate in an attempt to prevent another industry debacle like the one experienced when the Primary Reserve Fund broke the buck.

Some of the most important changes to 2a-7 funds surround the new liquidity constraints with which funds will now be forced to comply. Money funds will be required to have 10 percent of the portfolio mature daily. In addition, 30 percent of the portfolio must be in cash, Treasuries, other government securities that mature within 60 days, or other securities that mature within 7 days. In this low interest rate environment, this change in liquidity requirements is estimated to put further pressure on fund yields potentially reducing prime fund yields by up to 10 basis points as mentioned in a recent Wall Street journal article. Prime funds will be hit hard as they typically keep a very low allocation to Treasuries and Agencies and many prime funds have already waived management fees to keep their funds afloat. The official rules will be published in the coming weeks at which time we will be able to get more clarity on these and many other issues. *For a full list of announced changes please refer to the attached article.*

The Effect of Rising Rates on Money Funds

With much attention surrounding the timing of rising interest rates and changes to money funds in recent weeks, we thought it appropriate to discuss how a money fund might perform in a rising rate environment. Money funds are considered to have a duration of 0 because they are often seen as a substitute for cash. Much of this perception is born from the fact that money funds are required to have a stable NAV which means that principal is "technically" not lost when interest rates change (we say "technically" because the portfolio value actually does change, but the change is simply not reported).

In a rising rate environment, investors want their portfolios to be short to allow a portfolio to best take advantage of rising interest rates. Because money funds do not report a floating NAV like a separately managed account or ETF, duration is not the best indicator of how a fund will perform in a rising rate environment. A better measure of a portfolio's ability to rollover into higher rates is the weighted average maturity (WAM) of a portfolio.

Since money funds must meet redemptions daily, much of the portfolio is kept very short. This also means that in order to offer a competitive yield, money funds must also allocate a large amount of the portfolio out to the longer end of the 2a-7 curve, such as the 6-9 month area or increase their allocation to repo. This has become particularly true in the current environment with record low interest rates and money funds struggling to cover basic management and operating fees.

The fight to cover operating expenses in this low rate environment has driven funds to currently maintain longer WAMs even at the cost of potentially being caught on the wrong side of an interest rate movement. If money funds maintain longer WAMs as interest rates begin to rise, they will not be well positioned to capture the higher rates and the lag effect in money fund yields will be longer than historical averages.

The graph below shows the spread differential between a typical prime money market fund and the Fed Funds target rate for different periods of rising and falling interest rates. A typical prime fund will provide a book yield higher than Fed Funds in a period when the Fed Funds target rate is being cut to promote economic growth. Money funds are able to accomplish this in falling rate environments due to their allocation to securities farther out the 2a-7 curve. This scenario has occurred in the two extended falling-rate environments we experienced in the last 10 years: 2000-2003 and 2008-2009 (these periods are marked in green).

Figure 3: Selected prime money market fund book yield over Fed Funds

Source: Bloomberg

When interest rates are rising, however, money fund yields lag rate movements as the allocation to the longer end of the curve prevents opportunistic and frequent reinvestment at higher rates. This can be seen in the periods in which the market experienced a prolonged rising rate environment in 1999-2000 and 2004-2006 (these periods are marked in red). In these periods, the prime funds lagged Fed funds by roughly 48 days on average—meaning that for a 25 basis point move in Fed Funds, it would take a prime fund roughly 1.5 months to increase book yield by 25 basis points.

Managed Liquidity Accounts

The changes to the money fund industry have prompted our clients to seek safe alternatives to 2a-7 funds. One alternative is a managed liquidity account (MLA), which is a separately managed account structured to replace the need for money funds. MLAs are managed to provide liquidity and transparency by eliminating commingled fund risk and offering daily reporting. MLAs also offer reduced fees when compared with funds. The reduced fee structure allows for MLAs to compete with money fund yields without the additional duration risk money funds assume to offer competitive yields with the higher fee structure.

Many factors will go into determining when one dissenting vote at the FOMC will eventually become the majority opinion. While no one knows when rates will actually move, managed liquidity accounts allow the flexibility for managers to position portfolios to better take advantage of rising rates. With the money fund industry undergoing intense changes in 2010, we expect fund balances to continue to decline as investors seek safer and more transparent alternatives.

Looking Forward

Many people cite January as the month that sets the tone for the rest of the year. January saw several announcements that, if implemented, will put forward pressure on banks' earning power and will most certainly affect sector ratings. These new regulations include a tax on bank earnings to make up lost taxpayer funds under the TARP rescue program, as well as a plan to potentially break up the banks to limit risk taking. These measures should add to the volatility in 2010.

We continue to keep a close eye on unemployment and proposed legislation surrounding job creation. While indicators have shown that the economy has improved markedly from 2008 and 2009 levels, we remain cautious as an era of new regulation and increasing debt burden could significantly impact the recovery going forward.

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