clearwater ADVISORS

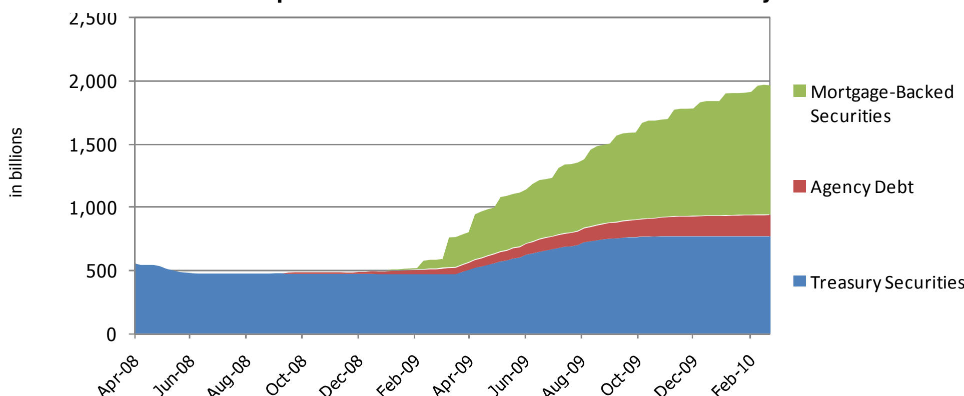
MARKET Commentary

Dr. Bernanke's Dreaded Prescription

March 2010

The Federal Reserve has begun to outline and implement its exit strategy to withdraw excess liquidity from the financial system. In a recent surprise move, the Fed raised the Discount Rate—the rate it charges to financial institutions for direct borrowing from the Discount Window—from 50 basis points to 75 basis points. With every indication of future tightening, the bond market reacts much like you would imagine a small child anticipating the pain associated with receiving a shot. Such fear and anxiety over an imminent rate hike in the near future seems premature in our view, as recent Fed actions indicate that we have only just begun our long journey to the doctor's office. We do not anticipate the Fed raising rates until Q4 2010 at the earliest, and see high probability that action will not be taken until early 2011.

Figure 1: The Fed has increased its balance sheet through security purchases to introduce an unprecedented amount of reserves into the system



Recent actions by the Fed signal a measured return to the normalization of the credit markets. The Federal Reserve's first priority will be to drain the buildup of excess reserves in the system, the main basis for future inflationary pressures. Excess reserves were introduced into the monetary system as a way to enhance market liquidity and encourage bank lending to spur economic activity. The market has been flooded with over $1 trillion of excess reserves by means of emergency lending facilities and asset purchase programs (a.k.a., quantitative easing). Chairman Bernanke and other Fed Governors have indicated that steps will be taken to gradually drain these reserves. Changing sentiment at the Fed marks a clear bias for less support of the financial markets going forward.

In the coming months we expect to see an increase in the scope and frequency of Fed actions to withdraw liquidity from the system. Short-term volatility will increase with each of the Fed moves. These actions will come in several forms:

- Term deposits and reverse repurchase agreements by the Fed with broker/dealers and potentially money funds
- The return of the Supplemental Finance Program (SFP) bringing $200 billion of 8-week SFP-Bills to market by the Treasury
- Continued hikes of the Discount Rate to return the spread between the Fed Funds Target Rate and the Discount Window to its historical norm of 100 bp
- The expiration of various emergency liquidity facilities and potential asset sales of Treasuries, Agencies, and Agency MBS acquired through quantitative easing

US Treasuries

As of 26-Feb

Benchmark	Yield
3 Month	0.12%
6 Month	0.18%
2 Yr	0.82%
5 Yr	2.30%
10 Yr	3.61%
30 Yr	4.56%

Merrill Lynch Indexes

29-Jan to 26-Feb

Index	Return
1-3 Yr Gov/Corp ≥ A	0.22%
1-3 Yr Municipals	0.25%
1-3 Yr Agencies	0.24%
0-3 Month Treasuries	0.00%
S&P 500	3.10%

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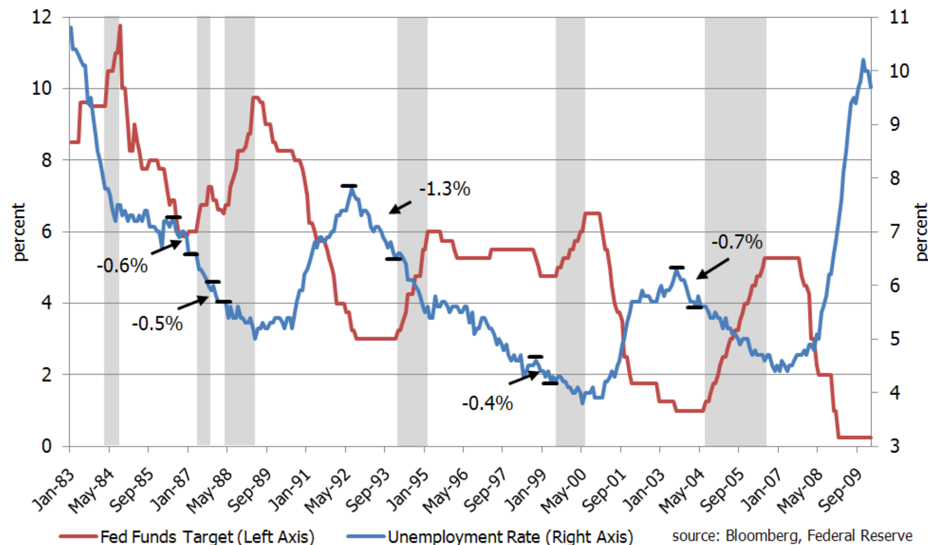
Source: British Bankers' Association, Federal Reserve, FDIC, US Treasury, Bloomberg, Barclays, Financial Times, JP Morgan

We believe rate action will only take place after the recovery has proven sustainable with diminishing government support and measurable improvement in the labor market. The Fed has been very firm about voicing this point in particular. A recent study by the Federal Reserve has shown that past periods of rising rates following a recession have only occurred after significant improvement in jobs. With unemployment projected to remain elevated in 2010, we believe Chairman Bernanke when he says that the Target Rate will remain low for an "extended period" and do not expect rate action until Q4 2010 at the earliest.

Figure 2: Unemployment will have to come further off its high before the Fed moves on the target rate. The brackets show the drop in unemployment from relative peaks preceding a period of rising interest rates.



One of our greatest concerns remains the implications and effects that diminished government support and regulatory overhaul will have on weaker financial institutions and the industry in general. In this environment, prudent credit risk management should receive as much, if not more, scrutiny as interest rate management. As the market draws ever more attention to the potential for rising interest rates, we caution about potential credit risks that remain hidden under the mask of government support. While adverse interest rate movements may temporarily affect the value of a portfolio, adverse credit events, including default, may affect a portfolio's value permanently and also have a significant impact on a portfolio's liquidity. Credit concerns should also apply to institutions in which companies transact or hold deposits.

The loss of direct and implied support and increased regulation could have wide implications on perceived credit risk and spreads of select institutions. Financial institutions have received an unprecedented amount of assistance to weather the financial crisis. Assistance to these institutions has come in the form of explicit FDIC debt and loan loss guarantees, access to liquidity facilities, direct loans from the Fed and Treasury, and large capital infusions to keep them solvent. Without these measures we are convinced that several of these institutions would have failed at the height of the crisis. A new period of diminished government support and increased regulation prompts us to steer clear of these still fragile institutions.

Standard and Poor's recently commented on the potential future downgrade of two of the largest financial institutions in the U.S., Bank of America and Citigroup. S&P cited diminished implied support as a key risk. The proposed regulations currently seek to abolish the "too big to fail" doctrine and break up commercial banks, thus limiting their ability to engage in proprietary trading and various investment banking activities. S&P commented that Bank of America and Citigroup have three notches of implied rating support. Both institutions are rated single A at S&P, and a two- to three-notch downgrade would take these institutions into BBB territory. A downgrade of their unsecured rating into this territory would also have strong negative implications for their short-term ratings of A-1.

A short-term rating downgrade could severely impact these institutions' ability to fund in the wholesale market. As large borrowers in the short-term market, funding costs would rise as counterparties would require additional collateral to be posted for derivative contracts and secured transactions. As large borrowers in the CP, CD and repo market, this could be detrimental to obtaining funding from large buyers of short-term debt, such as money funds and

corporate cash investors, as minimum rating requirements would often disallow short-term debt instruments from these issuers. S&P has stated that they will continue to monitor the situation and look to issue updates over the next two years.

Unsecured Bank of America and Citi are just two examples of the numerous banks that we seek to avoid. These institutions generally have a high dependency on wholesale and short-term borrowing, as well as a continued reliance on implicit and/or explicit government support. The inherent risks in these institutions are manifested in the higher rates that they must pay to fund operations in money market instruments relative to their peers. This makes them prime targets for money funds looking to buoy historical lows on fund yields. For a list of these banks, an institutional investor need look no further than a typical prime money fund's holding report: Natixis, RBS, Dexia, and Lloyds, to name a few.

Looking Forward

The market will experience short-term volatility in preparation for the inevitable shot delivered by Dr. Bernanke and company. We do not, however, see this happening in the near term and expect to see additional landmarks and signals before we actually arrive at the doctor's office. We see the current volatility as a limited opportunity to take advantage of higher rates. By the time the Fed decides to raise the target rate the economic environment will look much more stable than it does currently, tempering the pain of such a shot.

We continue to monitor the pending regulation and the effects as liquidity and government support is gradually withdrawn from the system. While the credit markets have improved markedly we view the current landscape as one in which to be extra vigilant in prudent credit risk management.

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