MARKET Commentary

House of Cards

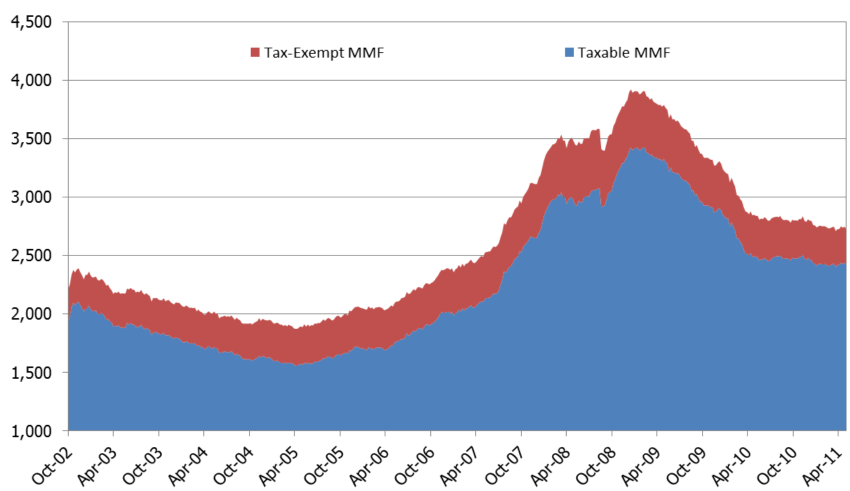
June 2011

Money market funds play a significant role in the "shadow banking system" joining the growing influence and increasingly important function that a number of non-depository institutions have in facilitating and extending credit to the global financial markets. The systemic risk that these institutions pose, as evidenced by the fallout following the financial crisis of 2008, has ushered in a new era of regulation aimed at preventing a similar scenario from recurring. However, as financial conditions in the U.S. and Europe show pronounced signs of continued weakness, confidence in the extraordinary measures to stabilize and strengthen these crucial funding markets is fading rapidly. In this period of deteriorating global credit conditions, we again urge investors to examine closely portfolio holdings, particularly those in prime money funds, for distressed credits in troubled regions. Investors will most certainly discover that the risks and problems lurking deep in the shadows of their fund holdings are more widespread than presumed.

Cheap Credit

Money funds provide nearly $3 trillion of credit to a vast array of borrowers including governments (federal, state and local), corporations and financial institutions. This asset class is larger than any global financial institution. Despite a sharp contraction from its peak in 2008, money funds continue to be a large provider of funding to this diverse group of borrowers, helping to sustain impressive houses of leverage built over the last decade. The Wall Street Journal reports, for example, that 65% of all short-term state and municipal debt is now owned by money market funds. Perhaps the largest consumers of the cheap credit offered by these funds over the last several years have been European banks.

Figure 1: Growth of Money Fund Assets from 2002-2011



Source: Bloomberg

US Treasuries
As of 31-May

Benchmark	Yield
3 Month	0.05%
6 Month	0.11%
1 Year	0.16%
2 Year	0.47%
5 Year	1.70%
10 Year	3.06%
30 Year	4.23%

Bank of America/Merrill Lynch Indexes
29-Apr to 31-May

Index	Return
1-3 Yr Gov/Corp ≥ A	0.36%
1-3 Yr Municipals	0.40%
1-3 Yr Agencies	0.33%
0-3 Month UST	0.00%
S&P 500	-1.13%

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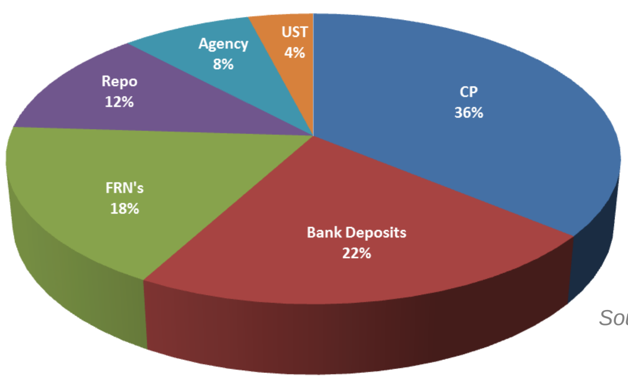
Source: British Bankers' Association, Federal Reserve, FDIC, US Treasury, Bloomberg, Barclays, Financial Times, JP Morgan, The Economist, S&P and Center on Budget and Policy Priorities

European banks continue to seek cheap dollar funding in the commercial paper and deposit arena. Barclays estimates that, between deposits and commercial paper, 44% of prime money funds' exposure is to European banks. Those same European banks hold almost €100 billion of Greek debt and €630 billion of Spanish debt. These figures are alarming and highlight the potential contagion risk of Europe's woes on dollar-denominated prime money market funds. Additionally, according to Dealogic, those same banks need to refinance $1.3 trillion of maturing debt by the end of 2012. The Fed shares our concern, with Federal Reserve Bank of Boston President Eric Rosengren recently warning on June 3rd that money market funds "are potentially sensitive to a disruption in the European banking system, should one arise from the fiscal and sovereign-debt problems we are seeing in some European countries" and that they "still remain vulnerable to an unexpected credit shock".

Risky Business

It is very unnerving, in our opinion, that money funds continue to purchase the debt obligations of problematic banks in these troubled regions. Undoubtedly, motivation for the sustained allocation to riskier credits arises from money fund efforts to remain atop the yield tables and to buoy historically low fund yields to remain viable. The money market continues to face formidable challenges created by the current period of exceptionally low money market rates and the heightened regulatory environment. Recent SEC amendments to rule 2a-7 (to tighten liquidity and weighted average maturity rules), combined with sparse supply of short-term product, are pushing asset managers into similar portfolio composition and causing further yield compression as major players seek out the same opportunities.

Figure 2: Sector Allocation of Prime Fund Holdings (% of Total)



Source: iMoneyNet (04/11)

With the U.S. government perilously close to hitting the $14.3 trillion debt ceiling, the Treasury has curtailed T-bill issuance, further reducing the supply. Since the beginning of the year, 90-day T-bill yields have declined to 3 basis points from around 15 basis points. Considering the additional rhetoric from the FOMC that rates will remain exceptionally low for an extended period, there has been no shortage of catalysts to push money market rates lower.

As a result of historically low money market yields, money funds have turned to alternate sectors, such as higher-yielding finance paper and taxable variable rate demand notes (VRDNs). Our analysis of the largest prime fund, the JP Morgan Prime Fund, revealed that roughly 98% of the assets are exposed to finance paper. Additionally, the fund utilized repo agreements backed by riskier, non-traditional collateral as opposed to the standard Treasuries and Agencies. Over 50% of the fund is invested in European financials and nearly 15% of the total fund consisted of exposure to Credit Agricole, BPCE (a.k.a Natixis), Lloyds, Royal Bank of Scotland, Commerzbank and Societe Generale – names in which Clearwater chooses not to invest. This concentration increases when indirect exposure to asset-backed commercial paper and the aforementioned non-traditional repo transactions are factored in for these institutions.

New financial regulations such as Basel III also cast dark shadows on VRDNs, which are heavily used by money funds. Consequently, we feel investors need to be aware of credit risk and bank exposure going forward. VRDNs gained prominence after auction rate securities (ARS) failed spectacularly in 2008. These securities, as opposed to ARS, offer a put feature that provides liquidity to the holder and is often facilitated by a letter of credit (LOC) provided by a bank. Proposed Basel III guidelines, set to go into effect in 2015, would make these LOCs more costly to carry from a bank's standpoint, and could potentially cause trouble for many VRDN issuers as a large number of LOCs mature in 2013 and 2014. Additionally, many managers (and consequently, investors) are not monitoring the additional exposure to banks that is gained by holding VRDNs. We encourage investors to perform the necessary due diligence in monitoring overall bank exposure by looking through the LOCs to the liquidity provider in order to accurately quantify the additional financial risk present in the fund.

Looking Forward

In this period of deteriorating global credit, we have outlined what we think are some of the key risks to money market investors; however, these are hardly the only risks that face the industry in the days and months ahead. Other concerns are still pending – such as the future of the stable NAV, mandatory capital requirements, regular stress test and private – and public-sponsored bailout funds. These new regulations could be game changers for investors who have traditionally looked at money funds as a stable and safe vehicle for short-term cash investment.

While we will continue to monitor these developments, the most important immediate concern remains the credit risk in the holdings of these portfolios. We do not anticipate that the European crisis and possible contagion risk into global banks will subside in the near future. If the recent past – bailouts growing in scope and size and talks of debt restructuring – serves as an indicator of the future, we are in for a long, bumpy ride. We strongly believe that a major disruption in the global financial markets would affect money funds much like we saw in late 2008. We hope that investors will not wait for such an event to examine the risks lurking in the shadows. We continue to maintain that custom managed solutions allow the flexibility to steer clear of many of these issues and provide a real and viable solution to most liquidity needs.

Please feel free to contact the desk with any questions or comments.

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