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MARKET Commentary

The Summer of Our Discontent

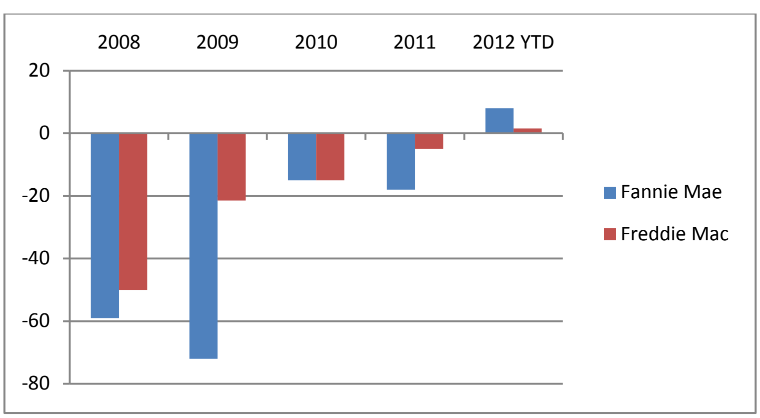
The kids are back in school and Europe is back from vacation – economic data is mixed and central banks are poised for further action. The European Central Bank (ECB) announced an unlimited sovereign debt purchase plan (buying bonds up to three years in maturity) for countries that formally request aid. The source of aid, the European Stability Mechanism, will have its day in German constitutional court this week. If it is found to be unconstitutional, the EU crisis will flare up with renewed intensity, offsetting much of the progress that has been made. Meanwhile, the Federal Reserve meets later this week amid expectations of further easing (either through extended rate guidance or more quantitative easing) especially after the recent weak jobs report. And, lest you forget, there are elections, sequestration, FDIC guarantee expiration and tax hikes to consider as we enter the homestretch of 2012. With that in mind we'll discuss a couple of major developments in the short-maturity fixed income space: GSE support and LIBOR-gate.

Fannie and Freddie Update – Credit Positive

Fannie Mae and Freddie Mac were placed into conservatorship in September of 2008 with U.S. Treasury support established by the Preferred Stock Purchase Agreement (PSPA). Since that time, the two government sponsored enterprises (GSEs) have received almost $190 billion in taxpayer support and paid $46 billion in dividends to the U.S. Treasury (see Figure 1).

The GSEs' prominent roles in the feeble U.S. housing market coupled with the precarious national fiscal position have delayed any meaningful resolution of their status. The Obama Administration had repeatedly stated they support the entities and corresponding obligations. This rhetoric was buttressed by unlimited lines of credit from the U.S. Treasury. The lines are scheduled to be capped after 2012, putting the longer-term viability of each entity into question.

Figure 1: GSE Annual Net Income/Loss ($BN)



Source: GSE Reports

Treasury officials, worried that markets would get skittish after January 1st, changed the PSPA to improve the GSEs' financial footing while ensuring that they would not be resurrected in their old forms. From now on, the mortgage companies will turn over any

September 2012

US Treasuries

As of 31-Aug

Benchmark	Yield
3 Month	0.07%
6 Month	0.13%
1 Year	0.16%
2 Year	0.22%
5 Year	0.59%
10 Year	1.55%
30 Year	2.67%

Bank of America/Merrill Lynch Indexes

31-Jul to 31-Aug

Index	Return
1-3 Yr Gov/Corp ≥ A	0.08%
1-3 Yr Municipals	0.07%
1-3 Yr Agencies	0.05%
0-3 Month UST	0.01%
S&P 500	2.25%

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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, Wall Street Journal quarterly profit to the U.S. Treasury in lieu of paying a 10% quarterly dividend on the government's stake. Additionally, Fannie and Freddie will be required to shrink their investment portfolios of mortgage securities (retained portfolios) by 15% annually, rather than the previous 10%.

These measures significantly improved the credit standing of each entity and spreads compressed to reflect the lower level of uncertainty. Under the new payment scenario, the remaining support available ($125 billion for Fannie and $150 billion for Freddie) should last decades. Investors, including ourselves, had been wary of purchasing longer-duration agency debt at a handful of basis points above Treasuries given the prior funding scheme. The new arrangement provides market participants with solace that the GSEs are more closely intertwined with the U.S. government and that debt obligations will continue to be supported.

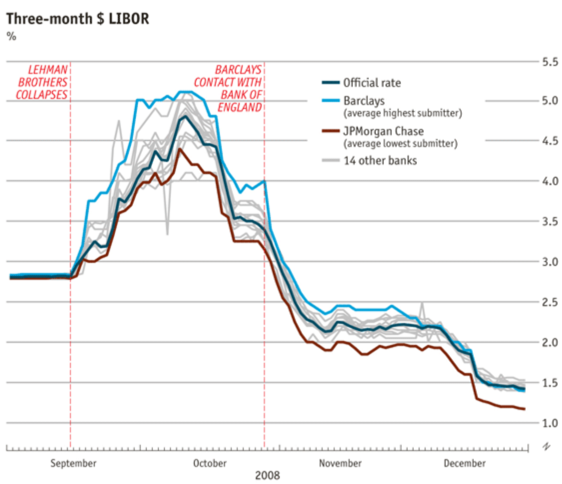
LIBOR's Credibility Problem

The banking industry has become the poster child for bad behavior. The sector's reputation took another hit as details of London Interbank Offered Rate (LIBOR) manipulation emerged from a multiagency investigation into more than a dozen banks. Evidence of manipulation dates back to 2005 and reveals two types of unsavory behavior:

1. Manipulation for trading profits
2. Manipulation to mask weakness during the height of the financial crisis

The first is unacceptable under any circumstances. The second is more complicated given the dislocations of credit during the crisis and the efforts taken to rebuild investor confidence (see Figure 2). Additionally, there is evidence that manipulation in the latter case was supported by regulatory authorities.

Figure 2: LIBOR Manipulation?



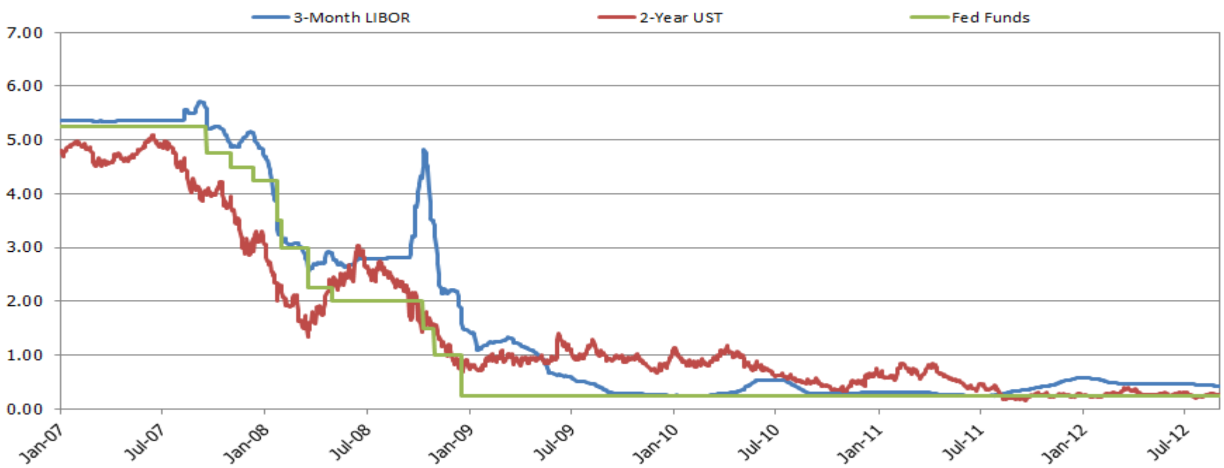
Source: Bloomberg, Economist

Libor, a fixture in the financial world since 1986, is supposed to measure the interest rates at which banks borrow from each other. Sixteen banks submit their estimated borrowing rates (across several currencies and durations from overnight to a year) to the British Bankers' Association. The highest and lowest rates are discarded while the remaining 50% are averaged to work out the Libor rate. The market for Libor-based securities is not insignificant. The CFTC reported that $800 trillion of financial instruments are linked to Libor, including $350 trillion in swaps and $10 trillion in loans. Therefore, charges of manipulation have led to large fines as evidenced by the $450 million Barclays recently paid after confessing that it lowered its quotes below its true borrowing costs during the 2008 financial crisis. Barclays was the first bank to come under the gun as it offered to fully cooperate with regulators. Citigroup, JPMorgan Chase, UBS, Deutsche and HSBC are among the names next in line. Expect further lawsuits, large settlements, and little to no admittance of guilt.

Calls for an alternative or modifications to Libor are growing. A recent Bloomberg survey found that 44% of financial market participants expect Libor to be supplanted by a more regulated alternative while 34% believe the banking benchmark will live on unchanged. One option calls for a hybrid rate that blends the submitted bank quote with actual transaction rates.

Some feel adding more banks to the Libor panel would be beneficial. Others have called for market derived rates like the overnight indexed swap (OIS) to replace Libor. The British government has hinted that government regulators would join banks on a new supervisory committee overseeing the rate-setting process. Its chief market regulator, Financial Services Authority chief Martin Wheatley, is looking at potential options to bolster Libor and is due to present his findings at the end of September. More oversight is coming; the CFTC could impose reporting requirements on all Libor banks that require them to keep track of all rate submissions subject to annual audits by an independent party as they did Barclays recently.

Figure 3: Fed Policy Pulls Risk-Free Benchmarks Lower



Source: Bloomberg

Look for changes to be announced in the ensuing months to ensure Libor remains a key benchmark rate. From an investment perspective, we find value in purchasing high-quality securities, like asset-backed securities, priced off of Libor due to its higher yield and short duration (see Figure 3). Consequently, the higher yield translates to higher costs for borrowers utilizing the benchmark as many of our clients may be aware of.

Looking Forward

Much of this summer's rhetoric will require actionable follow-through in the next several months. This is especially true in Europe, but also here and in developing countries that have hit growth speed bumps. The European situation will continue to lurch along. Greece is due for another round of financing with its requisite fireworks later this month. The landscape for short-maturity investors continues to shift – the SEC punted on money market reform while the unlimited FDIC guarantee is still set to expire at year-end. Look for the Financial Stability Oversight Committee or, ultimately, the Federal Reserve to rein in money funds. The Fed has been very vocal about the need for further money fund oversight and can't be too pleased at the SEC's inaction. We expect little domestic political productivity until after the election, introducing a fair amount of uncertainty given all that has been pushed to 2013 (sequestration, Bush tax cuts, payroll tax reduction, etc.). Finally, market action will to continue to be driven by central bank policy as economic activity remains weak.

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