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Market Facts

An Update On The Credit Crisis: Is The Fed "Pushing On A String?"

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Over the past few months we have compiled a rather extensive list of charts which we believe to be good measures of stress in the credit markets. Because we are regularly asked for updates to these charts, we thought it would be useful to provide a laundry list of these measures, updating them on a semi-regular basis. Larger versions of all the charts can be found here.

Today's edition focuses on the table below. It shows the effect that the Fed rate cuts have had on important market-based interest rates. It starts on June 28, the last "non-stressful" FOMC meeting, and ends with yesterday's levels.

Pushing On a String

In non-stressful times, if the Fed dropped the funds rate by 75 basis points, commercial paper and Libor would also fall by 75 basis points. Likewise, the move by long-term interest rates would be matched by similar moves by other market-based long-term interest rates.

The table below shows this has **not** been the case since June 28. The yields of safe instruments like Treasuries are down much more than the funds rate. For instance, 2-year Treasury notes are down by 1.19%. Conversely, short-term market-based interest rates have declined only a fraction of the Fed move. For instance, Libor is down only 0.47%.

Some market-based rates are not down at all – High Yield Corporates (up 0.55%), Home Loans (up 0.24%), 1-Year Adjustable Mortgages (up 0.10%) and Jumbo Mortgages (unchanged). Unfortunately these places are where the most relief is needed.

In the 1970s and 1980s many used the metaphor of "pushing on a string" to explain what is happening with the Fed. They are trying to move one end of the string (market-based rates) by pushing on the other end (lowering the funds rate). Instead of moving the end of the string, it bunches in the middle. Likewise, the Fed lowers the funds rate but it does little to restore confidence in the stressed sectors of mortgages and high yield corporates. So these rates do not move and no interest rate relief is offered.

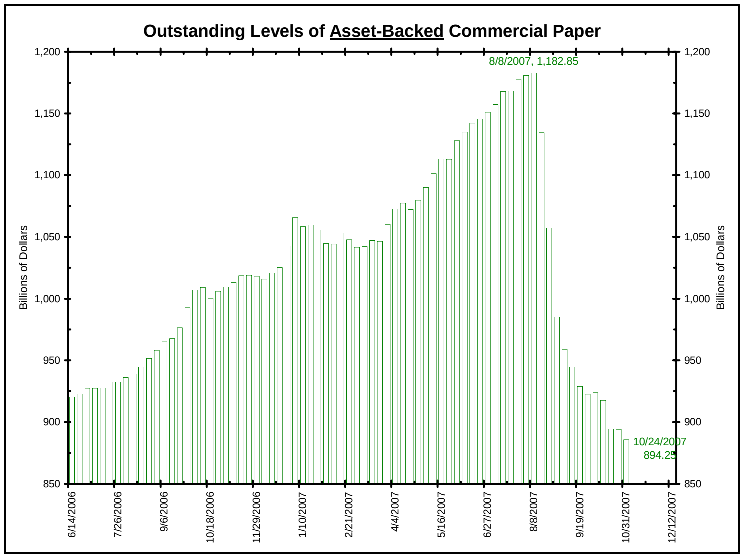
These interest rates are detailed on the following pages.

How Much Has The Fed Helped?

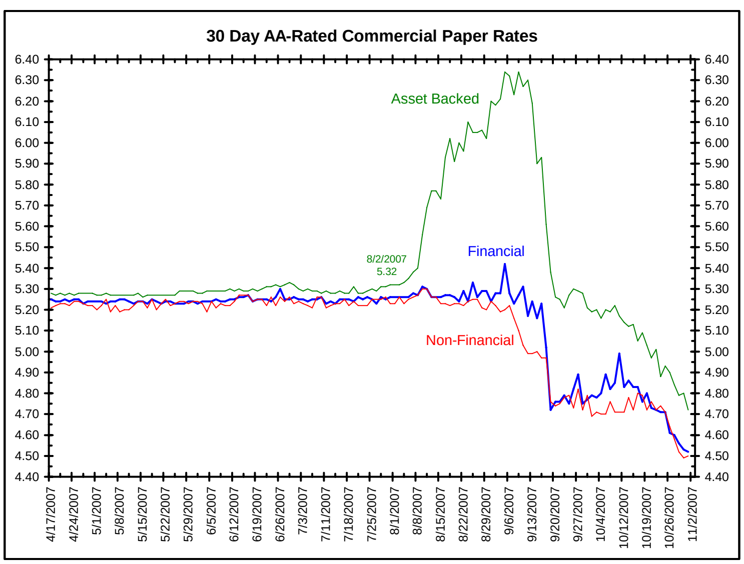
Interest Rate	6/28/2007 FOMC Meeting	11/1/2007 FOMC Meeting	Change
U.S. Government Rates			
Target Federal Funds Rate	5.25%	4.50%	-0.75%
3-Month Treasury Bill	4.76%	3.79%	-0.97%
2-Year Treasury Note	4.94%	3.75%	-1.19%
10-Year Treasury Note	5.10%	4.35%	-0.76%
Long-Term Corporate Rates			
Merrill Investment Grade Corporate Master	6.08%	5.75%	-0.34%
Merrill High Yield Master 2 Index	8.11%	8.66%	0.55%
Short-Term Corporate Rates			
Overnight Eurodollar Rates	5.40%	4.64%	-0.76%
3-Month Eurodollar Rates	5.36%	4.88%	-0.48%
30-Day Asset Backed Commercial Paper	5.33%	4.72%	-0.61%
30-Day Non-Financial Commercial Paper	5.26%	4.52%	-0.74%
30-Day Financial Commercial Paper	5.25%	4.50%	-0.75%
Mortgage Rates (National Average)			
1-Year Adjustable Rate Mortgages	5.50%	5.60%	0.10%
30-Year Fixed Rate Conforming Mortgages	6.29%	5.91%	-0.38%
30-Year Fixed Rate Jumbo Mortgages	6.50%	6.50%	0.00%
Home Loans	7.69%	7.93%	0.24%

Commercial Paper

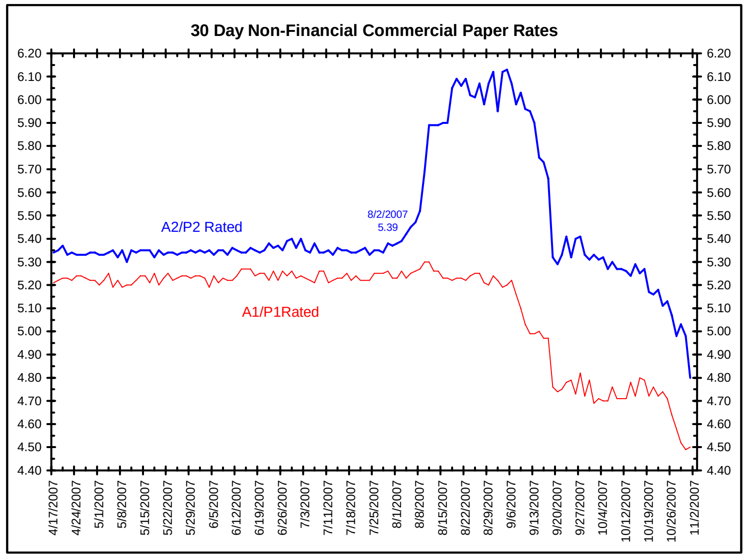
The credit crisis has taken a different twist in the last 75 days, focusing itself more on short-term debt. The biggest issue here, and the most important chart to be looking at is below – "The Outstanding Levels of Asset-Backed Commercial Paper." It has declined from $1.18 trillion to $894 trillion, so that is a decline of nearly $275 billion.



Commercial paper spreads are shown below. Both charts are on a 30-day basis. Asset-backed commercial paper is the green line (top chart), and the blue and red lines are financial/non-financial. Yes, they have come down, but look at how narrow those spreads were. Look at how narrow the difference was between asset-backed and financial/non-financial, say, in April, May, and June – just 5 or 10 basis points. And now it's still 20 or 30 basis points.

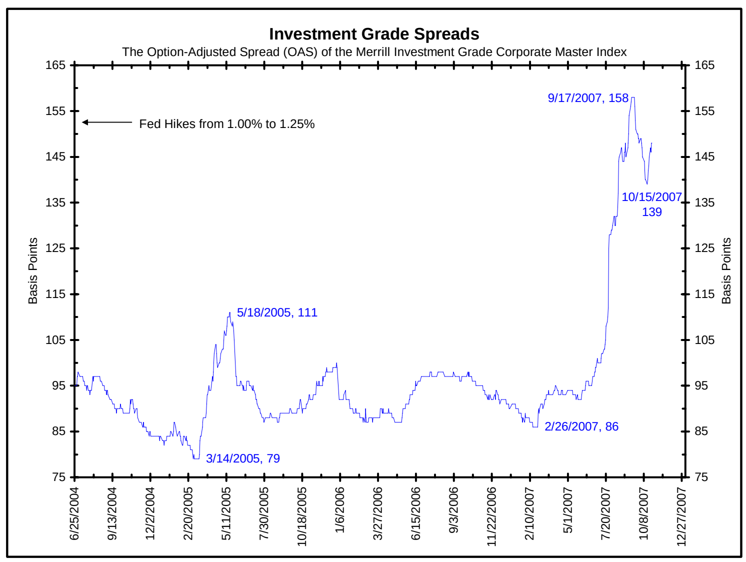


The same holds true for A-1/P-1 and A-2/P-2 commercial paper (below).

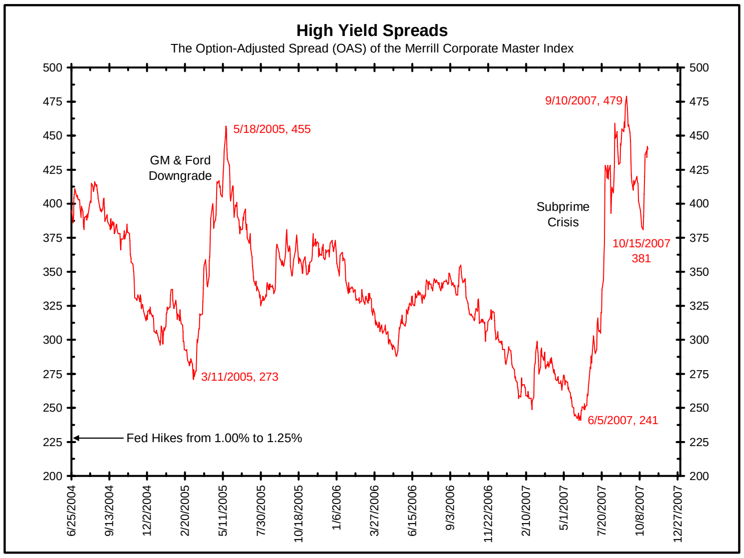


Credit Spreads

The chart below shows investment-grade spreads. They have narrowed a little bit from their peaks back in late August, from roughly 160 to 145. This is hardly a level that suggests the crisis is over.

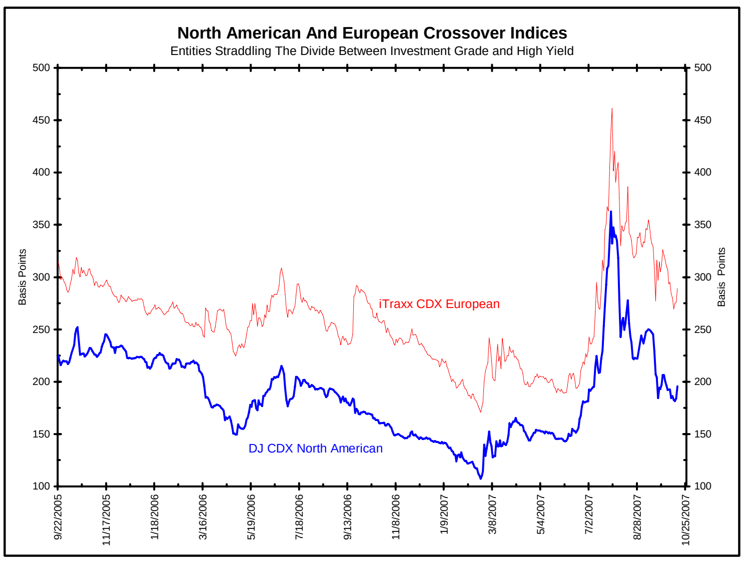


The same applies for high-yield spreads (below). These spreads have narrowed somewhat, but are still at levels seen during the 2005 downgrade of Ford and GM.



Below are the iTraxx and the Dow Jones North American CDX indices. Both of these are crossover indices meaning they have a split rating of both high-yield and investment grade.

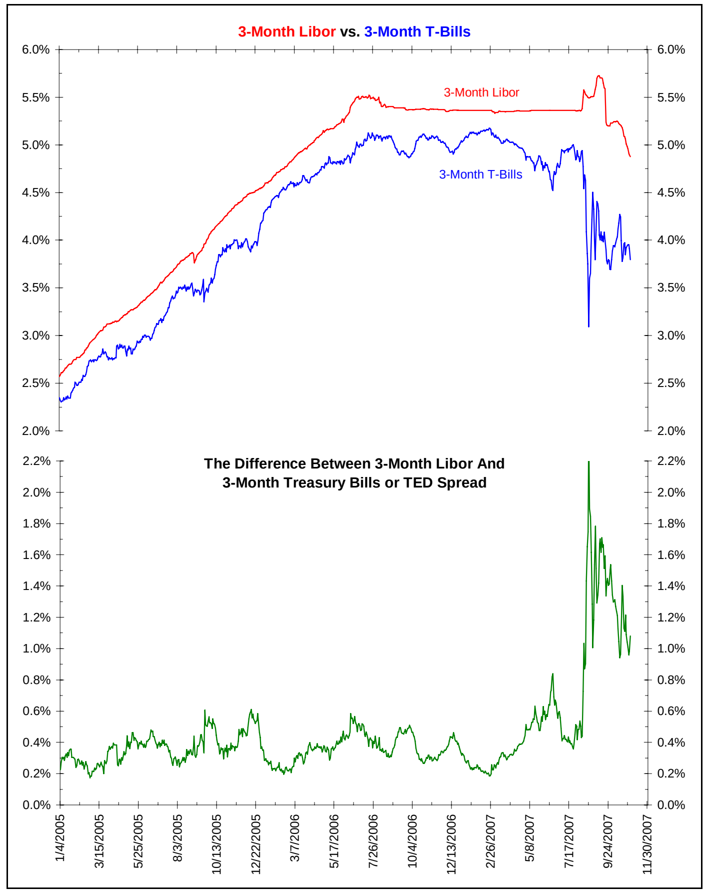
These spreads have narrowed considerably. Remember, however, that these are more speculative instruments, which means they have a higher beta and a wider range of outcomes than the cash indices on the left. That said, current levels are still higher than we have seen over the last several years. We have little comfort the problem has been resolved.



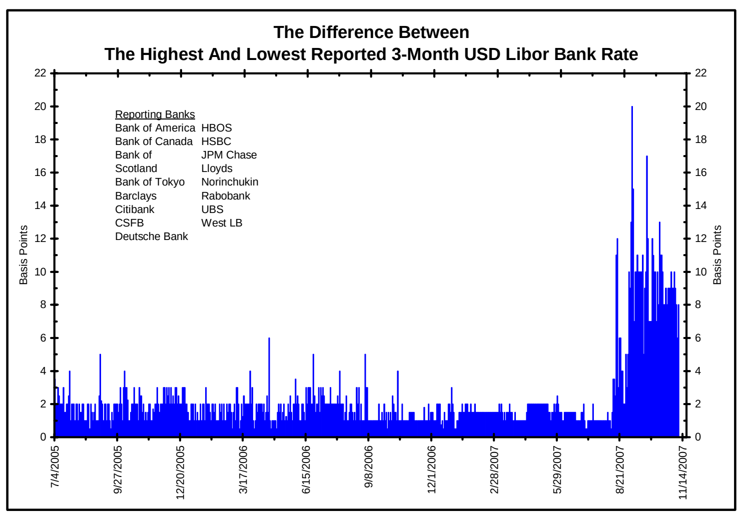
Libor

The nearly $275 billion of financing lost by the commercial paper has gone into the banking system.

Most SIVs have been drawing upon bank lines of credit. And one of the effects of that has been the widening spread between three-month LIBOR and Treasury bill rates (below).

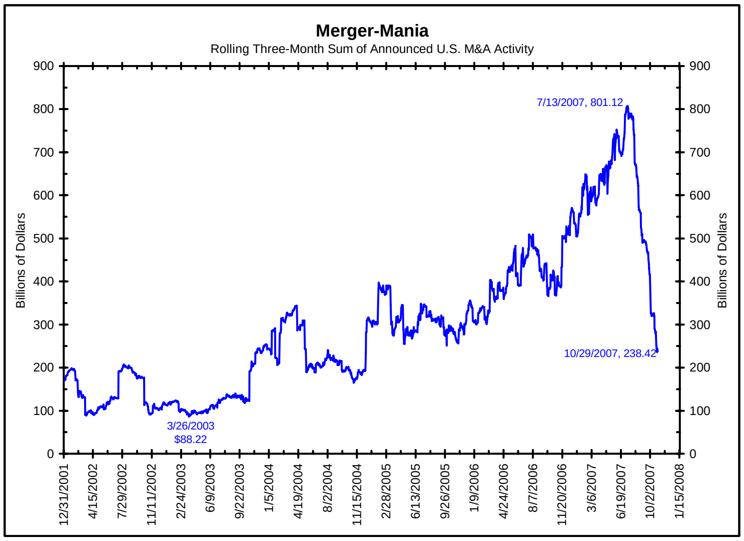


Another way of looking at the stress is to look at the range of three-month LIBOR. Sixteen banks offer up their rates. The four highest and the four lowest are dropped, and the eight in the middle are averaged. What we show below is the range between the highest and the lowest rates. The banking system is starting to differentiate among large-money center banks.

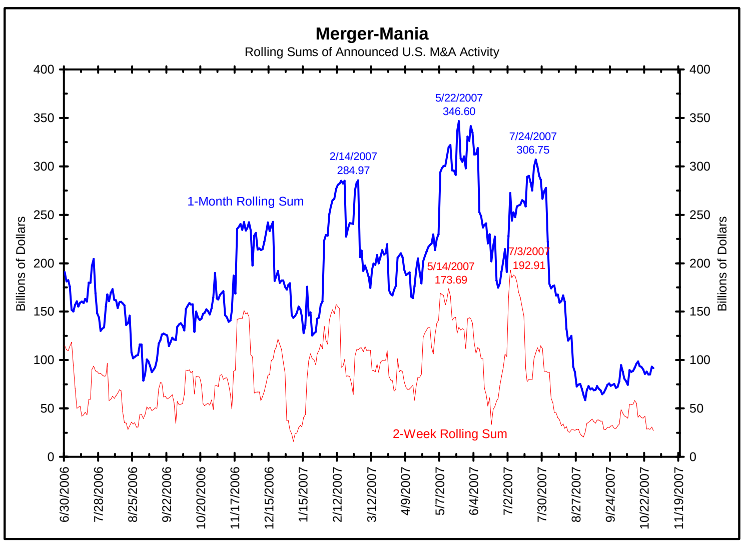


M&A And Issuance

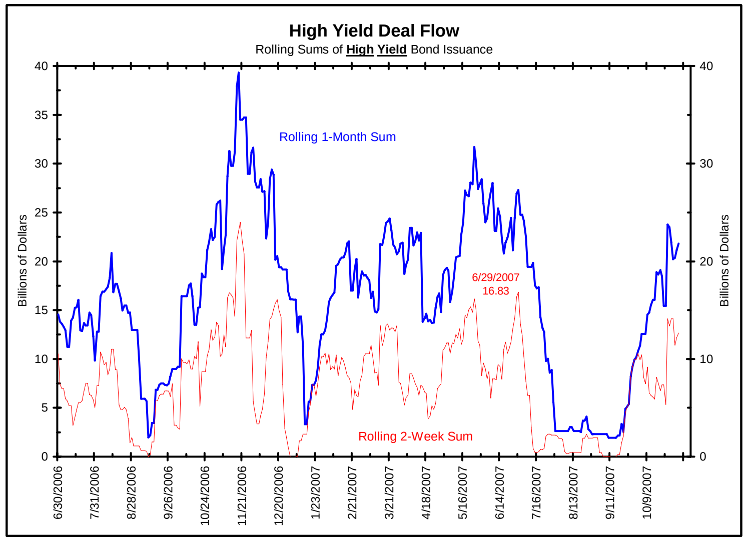
As the chart below shows, the 3-month rolling sum of announced M&A activity peaked on July 13, 2007, and ceased being a primary driver of the U.S. stock market immediately thereafter.



The next chart shows that M&A activity is **not** bouncing back.



Finally, the chart below shows that high yield issuance "bounce-back" has stalled at levels well below earlier this year.

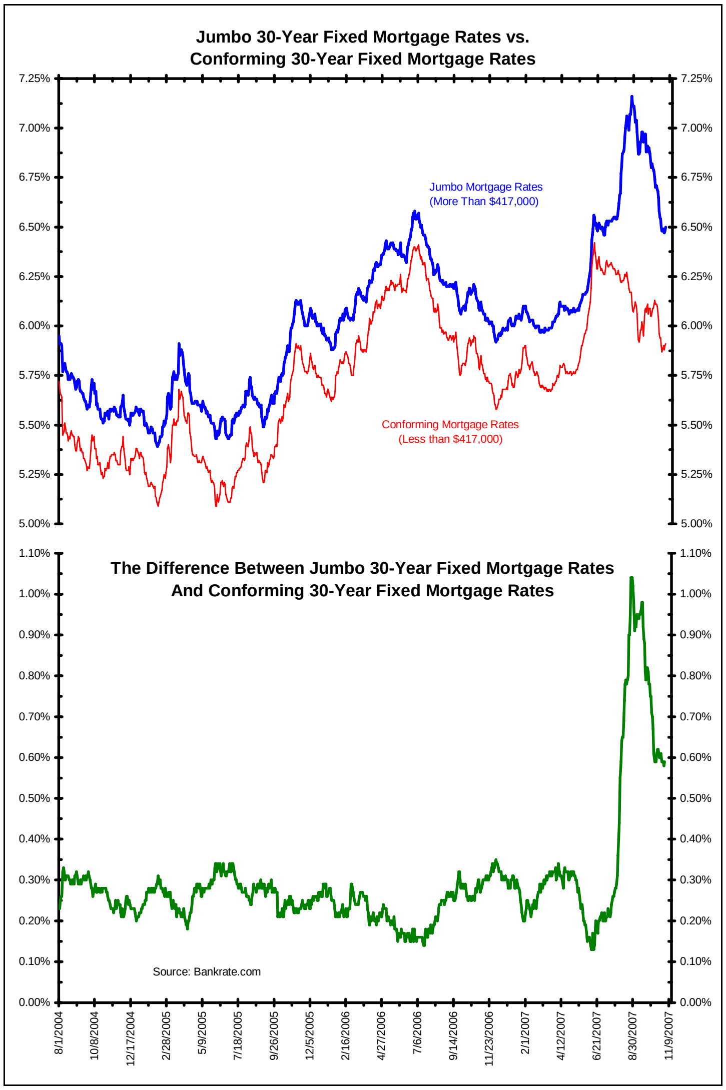


Jumbo vs. Conforming Mortgages

The jumbo mortgage market is still under stress but is improving.

Conforming mortgages, all mortgages less than $417,000, have an implied guarantee from Fannie and Freddie. They charge about 40 basis points for that implied guarantee. Investors are still buying those mortgages and structures because of this guarantee.

A jumbo mortgage does not have that implied guarantee, which accounts for the wide spread (green line, lower panel). The complexity and hard-to-value nature has investors demanding a premium to hold these structures.

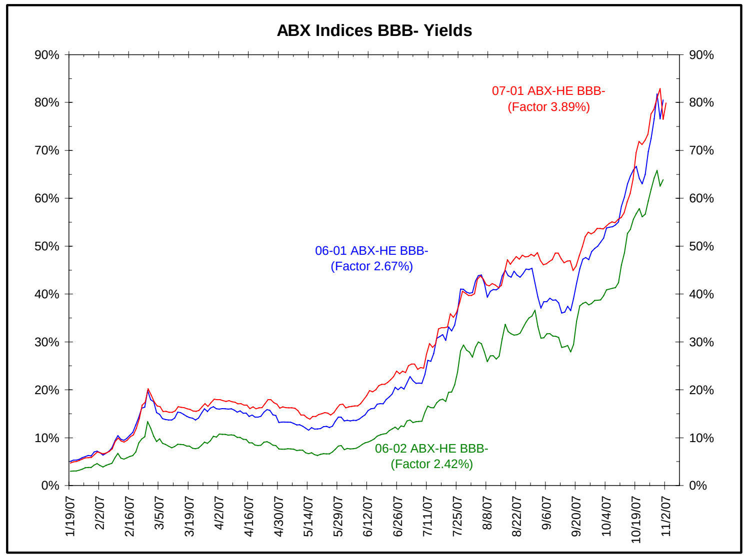


ABX Indices

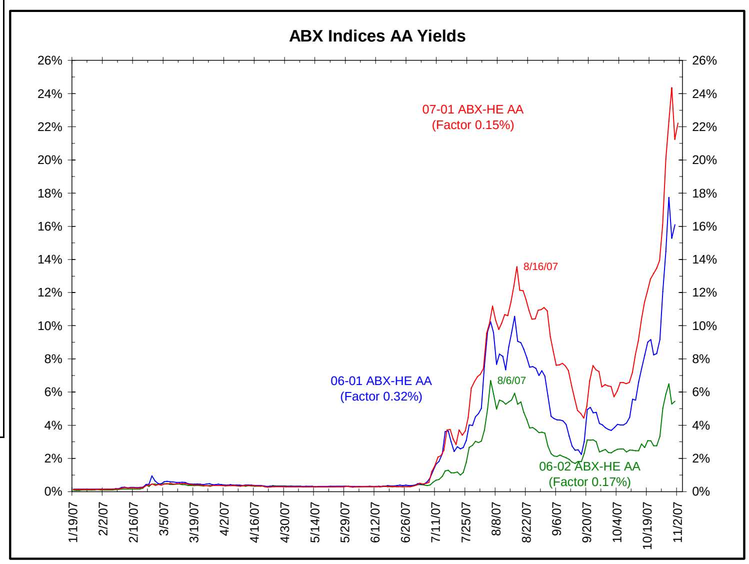
The ABX indices are based on subprime mortgages. The 06-01 series are mortgages that originated in the second half of 2005. Their prices have been falling at an accelerated rate.

What does this collapse mean? Just as is the case for bonds, higher yields. The first chart depicts the yield of the BBB- indices for 06-01, 07-01, 06-02, and the second chart depicts the yield of the AA indices.

BBB- indices currently yield around 70% or 80%. That means that if you want to buy or to obtain credit default protection for your subprime tranche, it's going to cost 50% to 60% **a year.** This means in less than two years, buying protection will cost more than the nominal value of the subprime tranche.



The bottom chart shows the 07-01 AA tranche's yields are as high as 25%.



The market implicitly is assuming that the BBB- and the BB tranches are going to default, with the only question being when. At 50% a year for five years for default protection, no one is going to pay two and a half times the price of their underlying securities to buy protection against default. In other words, the market thinks that default is going to come soon. The market is giving even money that the A-rated tranches are going to default. The AA and AAA tranches are safe from default … for now.

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