Weekly Market Review, 04/12/2008

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Major Market Developments

- Treasury yields rise as much as 13 basis points amid light trading volumes and no major economic data releases. After the market close, Alcoa, reports lower-than-expected earnings due to rising energy costs and weaker dollar. (Mon)
- The release of the FOMC meeting minutes garners discussion of the committee's focus on the continued downside risks to growth and their recognition that growth could contract in the first half of 2008; the 2- to 10-year Treasury yield curve steepens 8 basis points. (Tues)
- The ninth TAF auction stops out at 2.82 percent and a bid-to-cover ratio of 1.83. Market participants broadly suggest that the Federal Reserve's TAF results, along with the ECB's dollar auction, underscore the ongoing demand for dollars by both U.S. and European institutions. (Tues)
- Downside risks to economic growth and financial sector concerns weigh on investor sentiment; 2-year Treasury yields decline 10 basis points and the S&P 500 loses 0.8 percent. (Wed)
- As expected, the Bank of England (BoE) lowers its policy rate by 25 basis points and the European Central Bank (ECB) leaves its policy rate unchanged. (Thurs)
- The third Treasury Securities Lending Facility (TSLF) operation stops out at the minimum bid rate and is undersubscribed. Market participants interpret the results as a sign that repo market conditions are improving. (Thurs)
- General Electric reports lower-than-expected earnings and the University of Michigan consumer sentiment declines more than expected; equity indices fall more than 2.0 percent. (Fri)

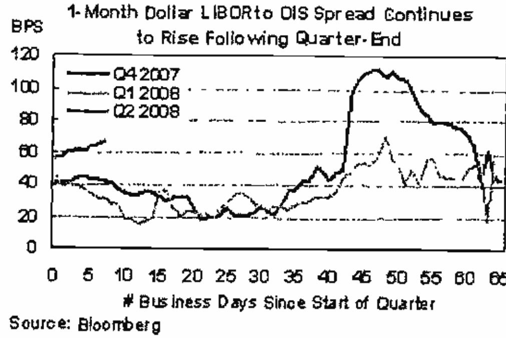
Market Focus

- **Unsecured Interbank Funding Shows Signs of Further Deterioration...**
- **...While Secured Financing Markets Continued to Show Signs of Stabilization**

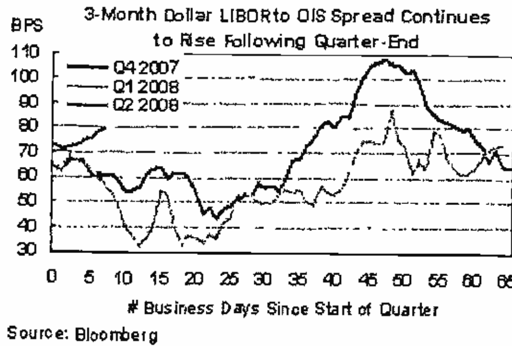
Unsecured Interbank Funding Shows Signs of Further Deterioration...

This week, the Federal Reserve conducted and released results for its ninth Term Auction Facility (TAF) operation, its third Term Securities Lending Facility (TSLF) operation, as well as the weekly borrowings from the Primary Dealer Credit Facility (PDCF) and the Primary Credit Facility (PCF). While there have been some mixed interpretations of the results, market participants have broadly interpreted the news, particularly for the TAF, as indicative of ongoing, or perhaps even increasing, tensions in the unsecured interbank funding market. Notably, term dollar LIBOR to OIS spreads have continued to widen following the March quarter-end, contrary to the narrowing of these spreads evident following the passage of previous quarter-ends.

On the margins, some have suggested that the relatively high stop out rate at this week's $50 billion TAF auction was indicative of the ongoing strains in the interbank market. The TAF auction stopped out at 2.82 percent, or 71 basis points over the minimum bid rate, which is the highest spread since the inception of the TAF program. The stop out rate of 2.82 percent also exceeded the British Banker Association's (BBA) LIBOR fixing rate on that day of 2.72 percent, and the primary credit facility rate of 2.50 percent charged at the discount window.



Source: Bloomberg



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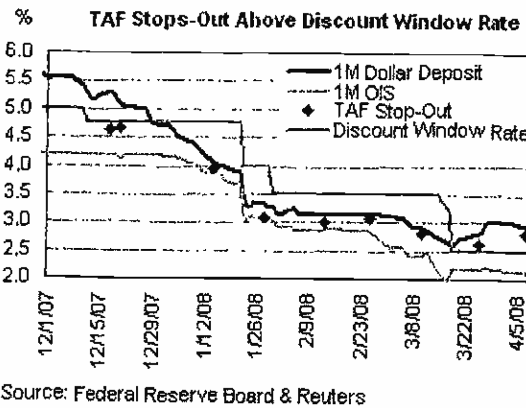
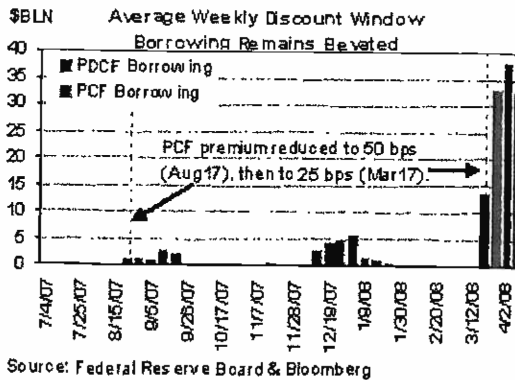


Source: Federal Reserve Board & Reuters



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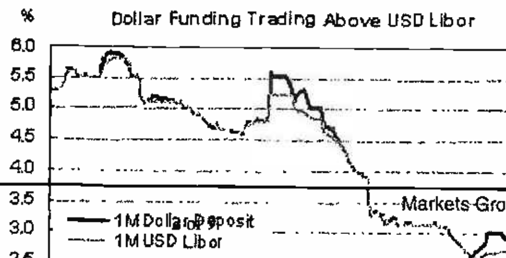
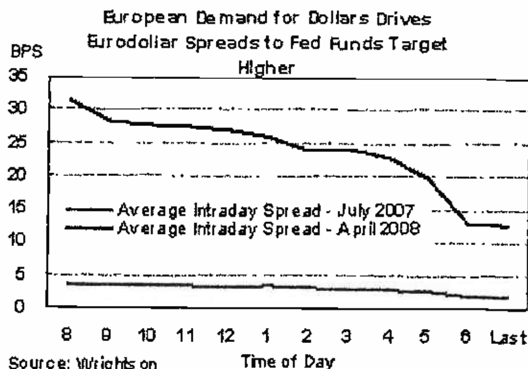
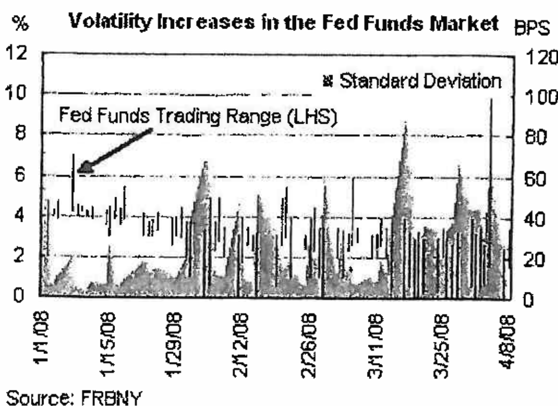
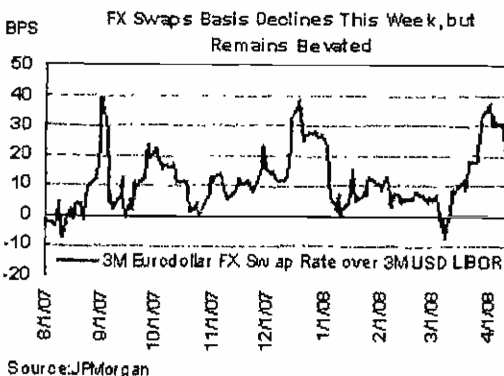


The fact that banks have paid a premium over the primary credit facility rate at the TAF and in the wholesale market reflects the ongoing stigma associated with the primary credit facility. This is especially true at a time when market participants are particularly sensitive to rumors about financial institutions. Aggregate average levels of borrowing at the Federal Reserve's primary credit facility and the PDCF declined modestly over the week ending Wednesday to $32.6 billion, respectively, though primary credit facility usage remains elevated relative to historical levels. If not for the perceived stigma, borrowing at the primary credit facility could be even higher.





Further, the fact that the TAF stopped out above LIBOR has also triggered a significant amount of questions over the accuracy of the BBA's LIBOR fixing rate. Over the past few weeks, the 1-month term dollar deposit rate and the 1-month LIBOR fixing have diverged by as much as 30 basis points. The divergence between the two rates is similar to that observed during prior periods of heightened market stress, most notably in August and early December 2007. Our contacts at LIBOR contributing banks have indicated a tendency to under-report actual borrowing costs when reporting to the BBA in order to limit the potential for speculation about the institutions' liquidity problems.



Considering the level of cash rates at the time of this week's TAF auction, the stop out rate was approximately 10 basis points below 1-month term dollar deposit rates obtained from brokers. Given this alternative benchmark, a few analysts have interpreted the TAF's results less negatively.

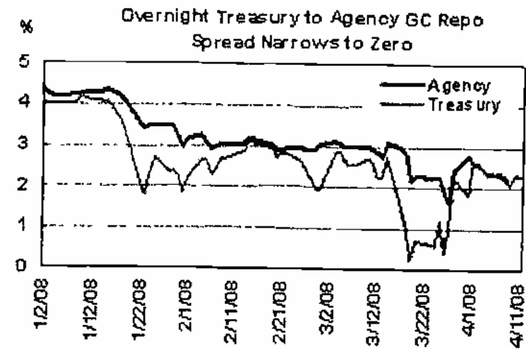
Though a different set of contributors than the LIBOR panel, data collected by the Federal Reserve Bank of New York on actual brokered fed funds trades may provide a more complete picture of the dispersion of rates paid for dollar funding. This data shows that over recent sessions some banks have paid as much as 10 percent for overnight funds. However, the fed funds effective rate has been closer to the target this week compared to recent weeks and the standard deviation around the effective rate has declined significantly.

Market participants continue to suggest that demand from European banks for dollar funding is contributing to the tensions in money markets. Some cited the higher-than-expected bid-to-cover ratio of 2.05 percent at the ECB's $15 billion dollar auction this week as consistent with this. Further, the intraday pattern for rates on dollar funds tends to reach its highest late in the European trading session, but then tends to decline through the U.S. session as U.S.-based banks more actively lend cash to each other.

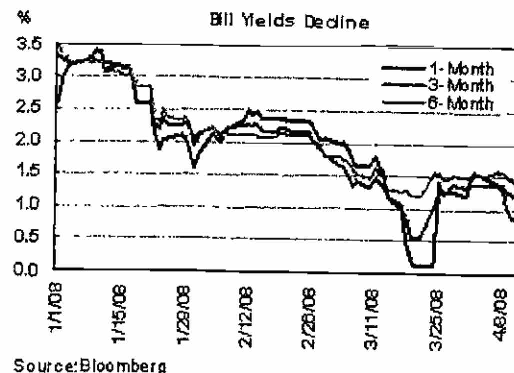
The euro-dollar FX swap basis also remains at very wide levels, implying stronger demand for dollars. The basis spread measure of the implied dollar cash rate on a 3-month euro-dollar FX swap over the 3-month dollar LIBOR fix is currently around 22 basis points, still near the wides reached in August and early December 2007. This likely suggests that certain financial institutions with relatively easier access to euro funding may be contributing to the demand for dollar funding.

...While Secured Financing Markets Continue to Show Signs of Stabilization

The results of recent Fed operations and certain market indicators continue to suggest that secured funding markets have stabilized. Most notable were the results of this week's $50 billion TSLF auction against "Schedule 2" assets, which includes private label RMBS and CMBS. The auction stopped out at the minimum bid rate of 25 basis points and was undersubscribed at a bid-to-cover ratio of 0.68. Market participants broadly interpreted the results of the auction positively and suggested that this auction, combined with the Federal Reserve's other liquidity operations, may have helped to alleviate primary dealers' demand for funding of lower quality assets. Additionally, market participants have cited the Federal Reserve's $65 billion in outstanding term single-tranche open market operations as helping to alleviate pressures in the agency MBS market.



Financing rates in the repo market were little changed this week, with the overnight Treasury, agency, and agency MBS repo rates close to fed funds and trading within a few basis points of each other. Some market participants have suggested that the TSLF's provision of Treasury collateral may have offset any downward pressure on Treasury GC rates ahead of next week's April tax data and the associated expected decline in publicly-held bill supply. Bill yields declined as much as 60 basis points this week in anticipation that bill supply could decline from the current level of over $1 trillion to approximately $850 billion over the next month.



The implied financing cost for agency MBS from the dollar roll market has declined by 40 basis points since mid-March. Agency MBS traders have highlighted the TSLF and the single-tranche term open market operations as alleviating some of the funding pressure in their market. Further, financing costs for private-label RMBS have also stabilized. For example, 1-month AAA private-label RMBS was funded at roughly 2.40 percent this week compared to 2.80 percent last week.

However, some market participants' interpretation of the Federal Reserve's actions were less sanguine. Some have suggested that the list of eligible Schedule 2 assets is too narrow, limiting participation in the auction. In particular, hedge fund contacts have suggested that the program does little to improve financing conditions of the broader non-investment grade and non-agency ABS markets. Further, this week, the American Securitization Forum and the Securities Industry and Financial Market Association (SIFMA) sent a letter to Chairman Bernanke and New York Fed President Geithner encouraging them to accept student loan asset-backed securities at the TSLF to ensure the continued functioning of this market.

Other Updates

Global Monetary Policy

- As expected, the ECB Governing Council unanimously voted to leave its policy rate unchanged at 4.00 percent. In its statement, the ECB continued to highlight the risk of higher inflation, in line with recent commentary. Additionally, market analysts noted that, as expected, the ECB slightly emphasized downside growth risks, while recognizing that its base scenario remains for "moderate but ongoing GDP growth." Market participants also focused on President Trichet's emphasis on the possibility that "the level of uncertainty resulting from the turmoil in financial markets remains unusually high and tensions may last longer than initially expected." On balance, expectations for future policy rates were little changed, with the 1-month forward EONIA swap curve reflecting one 25 basis point cut in late 2008.
- As widely expected, the Bank of England monetary policy committee (MPC) cut its policy rate by 25 basis points to 5.00 percent, citing tightening credit conditions and a slowdown in the economy. The accompanying statement highlighted the MPC's expectation for inflation to rise further in the near-term and the risk that it could remain above the Bank's inflation target. However, the statement also indicated that financial market conditions could lead to a slowdown in the economy that will bring inflation back below the target. According to one dealer's model, overnight index swaps imply a 40 percent chance of a 25 basis points cut at the May MPC meeting.
- As expected, the Bank of Japan (BoJ) left its policy rate unchanged at 0.50 percent. More notably, this was the first policy meeting led by newly appointed BoJ Governor Shirakawa. The Governorship had been vacant since former Governor Fukui's term expired in mid-March, as the Japanese legislature failed to appoint a replacement due to an ongoing power struggle between the country's two leading political parties. While some believe the BoJ could cut rates in the next year if the domestic economy decelerates further, few expect Governor Shirakawa to advocate a material change in the BoJ's current stance to a modest policy tightening bias. This bias has been supported by recent increases in the y.o.y. change in core CPI to 1.0 percent, the highest reading in almost a decade. Nevertheless, overnight index swap rates imply a 40 percent probability that the BoJ will ease the policy rate 25 basis points by December 2008, though this has been pared back from a 60 percent probability at the time of the BoJ's March policy meeting.

Credit Markets

- S&P downgraded the financial strength ratings for the mortgage insurers MGIC, PMI and Radian to A, A+, and A, respectively. Market participants will focus on the reaction of the GSEs to the downgrades. Historically, the GSEs required a minimum financial strength rating of AA- from two major rating agencies in order to conduct business, although the GSEs recently announced that there is some flexibility around this minimum requirement. S&P is the first rating agency to downgrade the mortgage insurers below AA-. Analysts indicate that even if other rating agencies follow S&P's actions, they expect the GSEs to continue to accept business from the recently downgraded mortgage insurers since these companies comprised nearly 60 percent of the mortgage insurance industry's marketshare as of 2007. Still, some expect GSE business going forward to be more concentrated in PMI and MGIC since Radian is viewed as having the weakest capital position among these big three firms. Shares of MGIC, PMI and Radian were 15, 2, and 10 percent lower on the week, while Radian's CDS spread widened 170 basis points.

ABCP

- Following Moody's move last Friday, S&P downgraded the long-term ratings of Gordian Knot's Sigma SIV to AA- from AAA, while affirming its short-term debt ratings at A-1+. Moody's downgraded Sigma's long-term ratings to A2 from AAA as well as its short-term ratings to P2 from P1. Both firms cited uncertainties around Sigma's ability to continue funding amid current market stresses. Sigma has been essentially shut out of the commercial paper and medium-term note markets since last year and has instead raised funding via $26 billion of repurchase agreements to roll over maturing liabilities and fund its $40 billion portfolio. According to the Moody's press release, Sigma has $23 billion in long-term debt and $325 million in commercial paper outstanding, about $20 billion of which will mature before the end of September. Both ratings agencies have kept Sigma's ratings on review for further downgrade.

- Canaccord Capital announced that it will purchase nonbank Canadian ABCP from clients holding less than CAD 1 million of the securities if the clients support the Montreal Accord to restructure these securities. Canaccord's clients eligible for the plan make up nearly three-quarters of the 2,000 small investors in Canada's nonbank ABCP market and have been the main holdouts to the restructuring agreement. Obtaining the approval of small investors is key to moving forward with the restructuring since each investor has one vote, irrespective of the size of their stake in nonbank ABCP. Investors are expected to vote on the restructuring agreement on April 25, which, with the support of eligible Canaccord clients, is likely to meet the majority vote needed to pass.

Currencies

- The majority of market participants do not expect any material change in the G-7 statement related to foreign exchange at this weekend's meeting of G-7 finance ministers and central bankers in Washington D.C. However, they will be highly attentive to comments from U.S. Treasury officials regarding the dollar, given its recent sharp depreciation and heightened commentary from euro-area officials expressing concern regarding recent price action. Specifically, analysts highlight that both ECB and euro-area officials have increasingly expressed a common tone and stance regarding the depreciation of the dollar. Market participants also expect this weekend's discussions among policymakers will likely focus on current issues in global funding and credit markets and may result in the announcement of a coordinated global central bank effort to address these issues.

On Deck Next Week

Next week, the economic data calendar picks up with several key releases including retail sales, CPI, the Empire State and Philadelphia manufacturing indices, several housing-related releases, and the Fed's Beige Book. Retail sales data are likely to be a key focus as market participants attempt to gauge the extent to which the consumer has been hit by recent financial market and economic stresses. At least 6 Federal Reserve officials will speak on various topics, including the economic outlook, monetary policy, credit markets, liquidity, and systemic risk. Notably, Governor Kohn speaks next Thursday on the implications that the current market turmoil have on banking. In addition, earnings releases by several large banks are likely to garner significant attention. On Tuesday, Washington Mutual and Bear Stearns reports Q1 earnings, while JP Morgan Chase reports on Wednesday, Merrill Lynch and MGIC on Thursday, and Citigroup on Friday.

Market Data

Key Indicators: [1]

	Current	Change on Week	Weekly Percentile Change	12 Weeks Ago
3rd Fed Funds Contract	1.84%	-0.05	82%	3.35%
2Y Treasury	1.75%	-0.06	42%	2.35%
10Y Treasury	3.47%	0.00	3%	3.63%
10Y Bund	3.95%	-0.03	33%	3.97%
10Y JGB	1.38%	0.04	50%	1.44%
10Y TIPS	1.15%	-0.01	12%	1.42%
EUR-USD	1.5799	0.4%	22%	1.4622
USD-JPY	101.03	-0.4%	34%	106.87
S&P 500	1346	-1.8%	75%	1325
BBB Corp. Spread (bps)	314	-8	33%	251

Other Significant Movers on The Week: [2]

	Current	Change on Week	Weekly Percentile Change	12 Weeks Ago
Canadian Dollar	1.0216	1.3%	78%	1.0273
Singapore Dollar	1.3572	-1.7%	99%	1.4382
S&P 500	1346	-1.8%	76%	1325
Wilshire 5000	13587	-1.7%	76%	13308
Topix Bank Sub-Index	259	-3.9%	80%	276
Korea Composite Index (KOSPI)	1702	3.4%	80%	1864
DJ Euro Stoxx Index	353	-2.3%	76%	373
U.S. 2/10s Slope (bps)	165.00	-14.30	96%	123
France 2/10s Slope (bps)	54	9	90%	39
Canada 2/10s Slope (bps)	86.6	12	92%	57
Hong Kong 10Y Yield	2.43%	-0.23	92%	2.61%
Hong Kong 2/10s Slope (bps)	119	-11.9	81%	83
Denmark 2Y Yield	3.83%	-0.11	82%	3.80%
Denmark 2/10s Slope (bps)	34	8	83%	30
Spain 2/10s Slope (bps)	61	6.7	82%	49
Sweden 2/10s Slope (bps)	20.6	10	89%	31
Switzerland 2/10s Slope (bps)	132	6	79%	92
Move Treasury Options Index	128	-12	91%	137
2Y Swap Spread	82	3	78%	68
30Y Swap Spread	35	3	79%	51
EMBI+	277	-14	80%	222
10Y Fannie Spread	66	4	83%	55
10Y Freddie Spread	73	5	82%	57
Fannie Stock	$26.91	-11%	94%	$32.15
Freddie Stock	$24.03	-13%	96%	$27.66
Front Month Oil	$109.53	$3.30	86%	$90.57
Front Month Gasoline	$1.54	-$0.08	76%	$1.50
Front Month Heating Oil	$3.17	$0.18	98%	$2.51
CRB Commodities Index	408	13	97%	361

Central Bank Watch

	Last Move	Current Policy Rate	Implied 3-month rate on June-08 interest rate futures contract	Next Meeting
Federal Reserve	-75 bps (3/18/08)	2.25%	2.465%	April 30
ECB	+25 bps (6/06/07)	4.00%	4.625%	May 8
Bank of Japan	+25 bps (2/21/07)	0.50%	0.810%	April 30
Bank of England	-25 bps (4/10/08)	5.00%	5.570%	May 8
Bank of Canada	-50 bps (3/4/08)	3.50%	3.165%	April 22

[1] For each asset, 12 pm Friday price/yield is shown, along with change since previous Friday's close, percentile rank of the week's move, and level from three months ago. Percentile rank, a measure of the significance of the change on the week, is calculated from a series of weekly price/yield changes over the previous five years. Percentile rank of positive and negative moves are calculated separately. For example, a 10 bp weekly increase in the 2-year Treasury yield with a percentile rank of 60 percent indicates that this change on the week is greater than 60 percent of all weekly yield increases for the 2-year note over the past five years.

[2] This table displays similar information as in the Key Indicators table for all assets with a weekly change that falls within the 75th or higher percentile ranking over weekly moves over the past five years.