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Horizon Cash Management: 'Very Active' in Step-Up Agency Paper

By Yali N'Diaye
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WASHINGTON, Mar 6 (MNI) - With money market rates still at very low levels, it remains a challenge for money managers to generate decent returns for investors.

However, Horizon Cash Management Vice President and Senior Portfolio Manager Jill King brings some optimism, noting that, "Things have normalized to some extent, giving a little bit of latitude and ability to invest in the market."

In particular, "We continue to be very active in the government sponsored enterprises market," she told *Market News International*.

A number of types of structures have taken place in the agency sector, with the "step up" bonds being one of the most popular, she noted. With a step up structure, the initial coupon "steps up" on a set date if the bond is not called.

"The bond is structured to be called. If economic conditions normalize and rates begin to rise, this bond gives the investor interest rate protection due to the higher back end coupon," King said.

"So it gives you a current market coupon now," she continued, and "it gives you the potential to get a higher coupon if the rate environment changes."

King also sees "some opportunity in the TLGP paper".

Through the Temporary Liquidity Guarantee Program (TLGP), the Federal Deposit Insurance Corporation guarantees newly issued senior unsecured debt of banks, thrifts, and certain holding companies, and provides full coverage of non-interest bearing deposit transaction accounts, without limit.

It has been a very active sector, King noted. When it was first announced in November, the first issues to price were JP Morgan and Morgan Stanley. They originally priced 150 basis points and 180 basis points respectively over Treasuries.

Although that paper is now trading around 45 basis points over, it still offers some reward.

"Much of the play in this sector has come and gone, but it does remain an attractive Treasury alternative due to the AAA rating, the FDIC insurance and the full faith and credit of the U.S. government," King argued.

She noted there is indeed appetite for highly rated corporate issues.

"There is appetite for solid credits in the market," she said, such as well regarded non-financial companies issuing regular corporate debt.

For the financial sector, it remains difficult to issue debt outside of the TLGP as investors are still "uncomfortable with financial institutions without the government's guarantee," she said.

And looking at the trajectory of financial institutions' shares, even after significant capital injections from the government and likely more injections to come after the government runs its stress tests, investors' discomfort is understandable.

Bank of America's share, for instance, was trading around \$3.20 Friday at midday, making its \$14.08 closing level at the end of 2008 almost look good, not to mention its \$36.52 level a year ago.

Citigroup was trading at \$1.02 Friday at midday, six times cheaper than its closing level of \$6.71 on Dec. 31 and down from \$21.17 a year ago.

In fact, New York Federal Reserve President William Dudley reminded Friday that the financial deleveraging process is "still far from complete" and said a contracting economy with "considerable downside momentum" is exacerbating financial problems.

He also expects banks "stress tests" to open the way to further government capital injections and the "public-private investment fund" to buy banks' bad assets to "put a floor" under the prices of those assets. However, with no details from the government about how it will effectively clean the banks' balance sheets from their non-performing or illiquid assets -- besides associating the private sector -- the "floor" does not appear in sight.

While investment advisor Horizon Cash Management offers separately managed accounts and not mutual funds, the latest data from the Investment Company Institute show there has recently been a growing interest from both retail and institutional investors in money market instruments.

Money market mutual funds assets have indeed increased from \$3.879 trillion in the week ended February 18 to \$3.906 trillion in the week ended March 4.

Fund flow data provider Emerging Portfolio Fund Research (EPFR) also reported that money market and U.S. bond Funds posted inflows of \$1 billion and \$831 million respectively "while the other four major groups recorded outflows ranging from \$968 million for balanced funds to \$207 million for high yield bond funds" in the week ended February 27.

"Investors snapped High Yield Bond Funds' 12-week inflow streak, removing \$207 million from these funds, and committed fresh money to Money Market Funds for the first time in four weeks," EPFR said.

In fact, U.S. bond funds were the only non-money market fixed income group to post inflows.

"Since the New Year the global economy has been doing its best to stamp out the last embers of investor optimism, churning out a seemingly endless stream of earnings and ratings downgrades, statistics preceded by negative signs, bankruptcies and warnings of future pain," EPFR commented.

Friday's dismal jobs report clearly illustrated the negative stream of statistics, with the U.S. economy having shed a net 651,000 jobs in February, sending the unemployment rate to a 25-year high of 8.1%.

Against this backdrop, liquidity concerns are likely to remain alive, with investors likely to continue to accept lower returns in exchange for preserving their liquidity and cash, a very sought after commodity in the current environment.