

May 2009

Spring Awakening and Tightened Spreads

By Jill King, Vice President, Senior Portfolio Manager

The London interbank offered rate for 3-month dollar loans (3-month Libor) fell below 1% for the first time as credit markets show continued signs of stabilization. The Libor-OIS spread, a gauge of banks' reluctance to lend money, narrowed to 77 basis points the tightest spread since August 14 (nearly 9 months ago). These indicators signal that confidence is returning to the market. There has been a marked decrease in credit concern, especially about the banks, after their better-than-expected 1st quarter results. We await the Fed's announcement of the result of the "stress tests" of 19 major banks with the expectation that 10 of these banks will have to raise additional capital. Clearly, however, the tides have begun to turn and a sense of cautious optimism has helped restore stability to the market.

One outcome generated by the programs the government has established to stabilize the market, coupled with an extremely low interest rate environment, is a shortage of short paper. A scarcity of short-dated paper, such as Treasury bills and agency discount notes is pushing yields lower and creating supply imbalances for short players. The availability of short-dated, super safe paper has diminished dramatically – disappearing from the Treasury and agency markets and causing yields on bill and discount notes to fall sharply. Treasury bill supply decreased \$4 billion in April while agency discount note supply is down 9% in 2009. This markedly reduced inventory produced a steep drop in market yields, with both 3-month and 6-month bills declining 10 bps since early April. Discount note yields have also plummeted, barely paying anything above T-bill rates. Such circumstances limit the alternatives: one can choose to extend duration or to take on added credit exposure. As a result, the commercial paper (CP) market has experienced increased interest and attention, causing the yield on Tier 1 commercial paper to drop to 10–15 bps overnight.

Lack of supply has also contributed to lower yields on CP. The new issue market for corporate bonds has taken off over the past 3 months. Non-government-guaranteed, fixed rate, new issue corporate notes topped \$75 billion in April. We've observed that companies have been able to "term" out their funding needs, thereby reducing their reliance on the CP market. Investment grade corporate bonds, according to the Barclays' Capital Credit index, have outperformed duration-matched Treasuries by 460 basis points – the best monthly performance on record. This is a sure sign of investors' rekindled interest in, and comfort with, corporate bonds.

Longer dated agency securities have not escaped dramatic spread tightening, either. 2-year bullet agencies have tightened 45 basis points versus Treasuries in April. Last month, a 1-year bullet structure (non-callable) Federal Home Loan Bank (FHLB), Federal National Mortgage Association (FNMA) or Federal National Mortgage Association (FHLMC) would have yielded 1%; currently, the yield on these structures is .65%. To get paid 1% in today's market, it's necessary to extend out to November 2010. With no volatility in the short end of the curve, callable bonds have become very expensive, as well. With these diminished inventories and narrowed spreads, has the "spring awakening" in the credit markets left any attractive opportunities?

We think so. One structure that we find quite attractive in this environment is the "step-up" bond. You start with a slightly lower-than-market coupon that "steps up" to a higher coupon on predetermined dates. It is also callable on the step-up dates. This structure not only provides attractive current return but the opportunity to protect against rising rates down the road.

Make no mistake: we continue to operate in an extremely challenging environment. If it isn't one thing (extreme volatility), it's another (no yield). But as the first green shoots of economic recovery have begun to appear, we've intensified our efforts to maximize alpha in our portfolios while remaining steadfast to our core philosophy of capital preservation.

Opinions expressed are those of Horizon Cash Management and are not intended to be a forecast of future events, a guarantee of future results or a recommendation. Horizon makes no assurance that securities discussed within will remain in or out of portfolios. Investing involves risk, including possible loss of principal.