

# Bond Market Perspectives



August 2, 2011

## Downgrades & Deleveraging

### Anthony Valeri, CFA

Market Strategist  
LPL Financial

#### Highlights

Treasuries remain at risk of losing their coveted AAA rating despite the fact Congress has finally agreed on a debt limit deal.

In the event Treasuries do get downgraded, we do not see the key ingredients of a forced selling environment prevalent in today's financial markets similar to the one witnessed in 2008.

Fears of a 2008-like wave of forced liquidations continue to weigh on the minds of investors should Treasuries lose their coveted AAA rating. Treasuries remain at risk of losing their AAA rating despite the fact Congress has finally agreed on a debt limit deal. As we discussed in last week's Bond Market Perspectives, the ratings agencies may deem the current deficit reduction steps as insufficient to put the United States on sound financial footing for the long term, and therefore may downgrade Treasuries to AA. Is a repeat of 2008 in store for investors should Treasuries get downgraded? We do not think so, and in this week's commentary we review whether the two key ingredients of a 2008-like de-leveraging event — too much leverage and forced sellers — are prevalent in the marketplace.

#### Leverage

By definition a financial system entails leverage and adequately measuring leverage in the financial system is difficult at best. Nonetheless, several key markets and metrics can provide a good picture of whether the financial marketplace is at risk of being overly leveraged.

**The Commercial Paper Market** - Prior to 2008, leveraged investors used the commercial paper market as one way to obtain leverage. The commercial paper market is essentially the corporate version of the Treasury bill market where investment-grade rated corporations go to obtain very short-term financing. Via use of special entities and borrowing conduits, leveraged investors borrowed short term in the commercial paper market to buy longer-term assets. The commercial paper market shrank dramatically in the aftermath of the financial crisis and remains a shell of its former self [Chart 1]. Most of the decline is attributable to a roughly 75% reduction in the amount of asset-backed commercial paper. The commercial paper market has increased in 2011, but the overall size of the market is only half that compared to the peak of the financial crisis. Leveraged investors that used the commercial paper market to obtain financing for a host of more speculative investments have simply not returned.

**Repo Market** - Several media reports recently highlighted disruptions in the repurchase agreement (repo) market as a sign that concerns over the potential loss of Treasuries' AAA rating could force investors to sell. In a repo transaction, a financial institution will obtain cash in exchange for lending out their Treasury holdings (as collateral) often to purchase another higher-yielding investment.

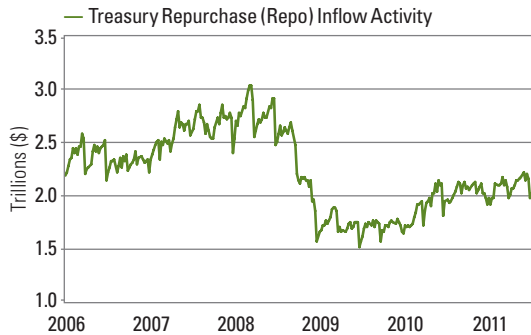
#### 1 Leveraged Investors Have Not Returned to the Commercial Paper Market



Source: Federal Reserve Board /Haver Analytics 08/01/11



**2 Repurchase Agreement (repo) Volume is Down Since 2008**

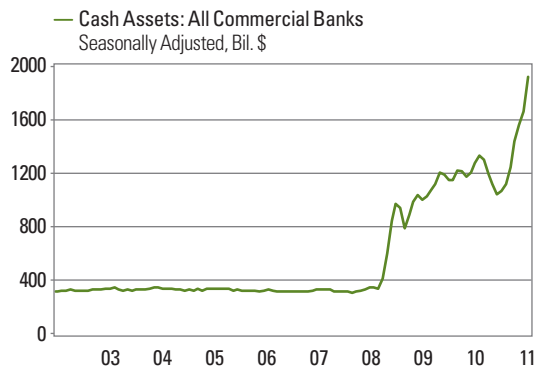


Source: Federal Reserve, Bloomberg, LPL Financial 7/29/11  
Inflow activity represents activity from the 20 primary dealers of Treasury securities as designated by the Federal Reserve.

Since a repo transaction requires posting of collateral in exchange for cash, we do not view this type of borrowing as overly risky but nonetheless, it can be a source of obtaining leverage. However, repo volume is down significantly since the end of the financial crisis [Chart 2]. Although some financial institutions have reportedly recently reduced the amount of cash they are willing to lend in repo transactions, thereby curtailing potential leverage, the reduction is minimal. This is a sign of very modest stress but overall the repo market continues to function normally.

**Banks** - Financial institutions were at the heart of the financial crisis but their financial profile is vastly different today compared to 2008. Banks are still leveraged but have been required to raise capital reserves to be held against future potential losses. The big domestic banks are sitting on record amounts of cash [Chart 3] suggesting that leverage remains in check. The cash stockpile serves as a vital buffer should assets, including bonds, held by the bank decline in price.

**3 Big Banks Have Built a Buffer Against Future Losses**



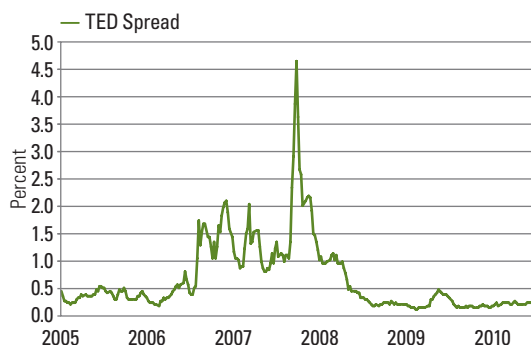
Source: Federal Reserve Board /Haver Analytics 08/01/11

**Bank Funding Stress and the TED Spread** - Finally, a key gauge of inter-bank lending pressures remains subdued. In 2008, the yield differential between three-month Libor, a key inter-bank lending rate from which banks borrow from one another, and the 3-month Treasury-bill, a risk-free rate, began to increase steadily before finally peaking in the fall of 2008. An increase in the “TED” spread is a sign of lending pressures as banks demand more to lend from each other. The TED spread is currently not signaling any stress [Chart 4] and at a current 0.19% is not far from the normal low level, well below the 4.5% of fall 2008 or even the 0.5% witnessed during May 2010 and the initial flare-up of European debt fears.

**Forced Sellers**

Forced selling is the other required ingredient for a wave of selling to hit the bond market. A review of large investors suggests a Treasury downgrade to AA indicates minimal, if any, required selling.

**4 The TED Spread Does Not Show Any Bank Funding Stress**



Source: Bloomberg, LPL Financial 08/01/11

**Money Market Mutual Funds** – Perhaps the greatest concern for a downgrade stems from what would happen to this most liquid and safest of mutual fund categories. Per SEC rules, money market mutual funds must hold “top-tier” securities and government securities qualify. There is no stipulation for rating. Only in the event of a downgrade to single A (a two notch downgrade from the current AAA rating) would a security become classified as “second-tier” but we view such a severe downgrade as highly unlikely.

**Mutual Funds, Pensions, and Endowments** – Similar to money market funds, our sample review of bond mutual funds and institutional investors, such as pensions and endowments, indicates they have flexible mandates that allow holdings of government securities, again without stipulation for ratings. Although some mutual funds are required to hold a minimum average rating, any security, not just Treasuries, could be sold should minimum rating criteria be violated. Nonetheless, we believe the potential sells from such a condition would still be limited.



**Banks** – Government bonds can be a key source of banks’ minimum required reserves to be held against future losses. Currently regulators assign zero credit risk to government holdings and do not specify a minimum rating. We do not envision regulators changing the criteria in the event of a downgrade, which could trigger banks to sell Treasuries as they change the composition of their reserve holdings. Over time regulators could take a more hardline view, especially if Treasury ratings were to degrade further, but we view this as a longer-term potential risk.

**Foreigners** – With 50% of outstanding Treasury bonds held by foreigners, the behavior of this investor group is of particular interest. Given the size of the Treasury market and related government bond issuers such as Fannie Mae, Freddie Mac, and Ginnie Mae, a downgrade would be unprecedented for global bond investors. There is no relevant historical comparison. Although Japan was downgraded to AA, the vast majority of its government debt was, and still is, held domestically and not subject to the whims of foreign investors. According to Barclays data, U.S. government related debt comprises roughly 50% of the global supply of AAA-rated debt and totals approximately \$18 trillion. Foreign investors would simply have no other market to find an alternative to replace that debt and any portfolio changes, if any, would likely be done gradually.

To be sure, a ratings downgrade to Treasuries is best averted to avoid even a modest disruption to financial markets. There is also what we view as modest pressure on short-term markets due to the uncertainty of a potential downgrade. Three-month Libor has increased recently even if only a modest amount by historical comparison. We continue to monitor these conditions closely and believe the bond market movements will be more in response to expectations of economic growth or lack of it as the case may be now. In our opinion, the markets are getting used to the prospect of a downgrade but more importantly, in the event Treasuries do get downgraded, we do not see the key ingredients of a 2008-like forced selling environment prevalent in financial markets today.




---

**IMPORTANT DISCLOSURES**

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise, are subject to availability, and change in price.

Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of a fund shares is not guaranteed and will fluctuate.

An obligation rated 'AAA' has the highest rating assigned by Standard & Poor's. The obligor's capacity to meet its financial commitment on the obligation is extremely strong.

Mortgage-Backed Securities are subject to credit, default risk, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of prepayment risk, and interest rate risk.

The TED Spread measures the difference between 3-month LIBOR rate and the yield on 3-month Treasury bills. This is an effective measure of the liquidity available to banks. With bank capital adequacy near the center of the current crisis this is an important gauge of the stress in the banking system.

Credit Quality: One of the principal criteria for judging the investment quality of a bond or bond mutual fund. As the term implies, credit quality informs investors of a bond or bond portfolio's credit worthiness, or risk of default.

Investing in mutual funds involve risk, including possible loss of principal. Investments in specialized industry sectors have additional risks, which are outlined in the prospectus.

**Investors should consider the investment objectives, risks, charges and expenses of the investment company carefully before investing. The prospectus contains this and other information about the investment company. You can obtain a prospectus from your financial representative. Read carefully before investing.**

**An investment in the Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the Fund seeks to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in the Fund.**

This research material has been prepared by LPL Financial.

The LPL Financial family of affiliated companies includes LPL Financial and UVEST Financial Services Group, Inc., each of which is a member of FINRA/SIPC.

To the extent you are receiving investment advice from a separately registered independent investment advisor, please note that LPL Financial is not an affiliate of and makes no representation with respect to such entity.

Not FDIC or NCUA/NCUSIF Insured | No Bank or Credit Union Guarantee | May Lose Value | Not Guaranteed by any Government Agency | Not a Bank/Credit Union Deposit