

# A View from the Trenches

Toronto, Wednesday, June 10<sup>th</sup>, 2009

Good morning,

Yesterday was a relatively quiet day, and judging by the closing of the session, ominously bullish. At close, swap spreads had compressed with mortgage prices regaining some lost ground across the curve, and equities, as we had been expecting, remained stagnant. The CDX IG12 and the High Yield 11 indices closed 1bp and 17bps tighter respectively. At 4pm, crude oil touched \$70/barrel and the S&P500 was +35%, at 942.43pts. Treasuries, however, resumed their falling trend, with the curve steepening. Apparently, the market is now realizing an increase in interest rates is almost impossible in 2009. With this calm environment, the VIX (implied volatility of S&P500 options index) fell to 28pts.

As much as you, I keep thinking what we can expect next. In this regard, I thought that perhaps there is an event that the market is not paying attention to, but which is relevant nonetheless. I am speaking of the repayment of TARP funds. The U.S. Treasury confirmed that 10 of the financial institutions participating in the Capital Purchase Program qualify for repaying the TARP funds, an expected \$68BN. These institutions, including JPM, GS, MS, AXP, BNY, BBT, COF, NTRS, STT and USB indicated that they will repay the TARP funds... This is what I ask myself: *If that the mechanism through which the Capital Purchase Program was put in place had a profound economic impact, should we not also expect some lateral effects, if the TARP funds are returned to the Treasury? If so, what technicals can we expect from the repayment of TARP funds?*

I review the process, in the graph below, where I look at the balance sheets of the stakeholders involved in the transaction, at an aggregate level: the Treasury, the US Financial sector, the Fed, and the Non-Financial Sector (US and non-US):

	Treasury		Financial sector		Fed		Non-Financial Sector	
	Assets	Liab + Equity	Assets	Liab + Equity	Assets	Liab + Equity	Assets	Liab + Equity
1	↑ Cash	Treasuries ↑			↑ Treasuries	Cash ↑	↑ Treasuries	Cash ↓
2	↑ Warrants	Cash ↓	↑ Cash	Warrants ↑				
3			↑ Cash	Bonds ↑			Cash ↓	Bonds ↑
4	Cash ↓	Warrants ↓	Cash ↓	Warrants ↓				

**Steps 1 & 2:** The US Treasury issued debt to raise cash, and buy warrants from insolvent banks. The cash was provided both by the Fed (inflationary) and the Non-financial sector. This was bullish of the USD, now demanded, and prevented the credit and equities markets from further bleeding. With the raised cash, the US Treasury purchased the warrants, capitalizing the banks. The net effect was a transfer of cash from the Fed and the Non-Financial sectors to the Financial sector. This capitalization reduced systemic risk: Libor decreased, the LIBOR-OIS spread tightened, credit rallied and equities stopped plunging. Those with access to TARP money gained a competitive advantage over those who didn't (as we always say, inflation is non-neutral). Loans underperformed, as they were sold to clean balance sheets.

**Step 3:** The reduction in systemic risk and credit rally opened a window of opportunity for the institutions to issue non gov.-guaranteed debt to repay TARP funds. The market favors the banks that can repay TARP funds over those who cannot. The credit rally made Treasuries expensive: Profit taking took place in Treasuries, triggering convexity hedging in mortgages. Equities can only remain stagnant, given the effect of rising yields in mortgages over home prices.

**Step 4:** The banks that issued bonds, use the proceeds to buy the warrants from the Treasury, repaying TARP funds... **WHAT WILL THE TREASURY DO WITH THE MONEY? HOW FAR CAN \$68BN GET YOU IN THIS MARKET? If the money is used to withdraw debt, will that be bullish of the USD. If it is bullish of the USD, could this trigger a spiraling recovery process this summer? What if more institutions apply to repay TARP funds?**

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