



RICHMOND CAPITAL MANAGEMENT
Experience, Knowledge, Service

First Quarter 2009

Interest Rate Trends

Quarterly Newsletter

Interest rates rose in the first quarter and the yield curve steepened. At another point in the cycle, fixed income players might take that news as a negative. But in this “still fearful” environment, many view any kind of modest reflation as positive. For the record, the 2 year note rose 4 basis points over the period, while the 10 year was up 45 basis points and the 30 year up 85 basis points. At the end of March, the yield differential between 2 years and 30 years stood at 273 basis points (up from 192 at year end).

Index Returns			
	Qtr.	1 Yr.	3 Yr. Ann.
Barclays Aggregate	0.12%	3.13%	5.78%
Barclays Govt/Credit	-1.28%	1.78%	5.47%
Barclays Int. Govt/Credit	-0.05%	1.96%	5.62%

Source: Barclays Capital

As of March 31, 2009

Economic Indicators

Treasury Market Yields		
	3/31/09	12/31/08
2 Year	0.80%	0.76%
5 Year	1.66%	1.55%
10 Year	2.66%	2.21%
30 Year	3.53%	2.68%
Commodities		
Oil (\$ bal)	\$49.66	\$44.60
Gold (\$/oz.)	\$925.00	\$884.30
CRB Index	\$220.40	\$229.54
Spread Product (Spread to 10 Yr. Treasury)		
10 Yr. “A” Corp	+3.76%	+4.11%
GNMA Current Coupon	+1.34%	+1.84%
10 Yr. “AA” Municipal	+0.72%	+1.44%

➤ On April 3rd, the March **Payroll Report** showed the loss of another 660,000 non-farm payroll jobs. The unemployment rate rose to 8.5%. Since September of 2008, monthly declines in employment have been quite large. Unfortunately, the trend is expected to stay in place for the foreseeable future since employment data is a lagging indicator. Other demand related statistics must rise before hiring picks up.

➤ Final **GDP** for the 4th quarter of 2008 was reported at -6.3%. This large contraction coincides with the big drop in the stock market and the jobs market. Prior to the 4th quarter, GDP was modestly positive for 2008. Going forward, economic growth will largely depend upon the success of the government’s stimulus programs.

➤ **Consumer Confidence** as measured by the Conference Board Series hit an all-time low in February at 25.3. The March 31 release showed a slight bounce, coming in at 28.0. Consumer confidence (or the lack thereof) reflects the weak jobs market and also the big decline in the housing market.

➤ The **housing market** is still trying to find a bottom. The March 31 release of the S&P/Case Shiller Index of 20 large cities printed at -18.97% year over year. This index is down 29% from the 2006 peak. Interestingly, no matter how volatile a given local real estate market, almost all localities report prices at 2003 levels.

➤ **Inflation** as measured by the Core PCE Deflator (Personal Consumption Expenditure) has held below 2% year over year for the past three months. The most recent number was 1.8% which happens to match the latest Core CPI

reading. Looking forward, the implied CPI rate determined by the U.S. Treasury TIPS market also forecasts subdued inflation. That “implied” number is 1.4% over 10 years.

Federal Reserve

The announcement concluding the Federal Reserve’s most recent policy meeting on March 18th set off a big bond rally (the 10 year Treasury rate fell 47 basis points to 2.5%). In that announcement, the Fed revealed plans to purchase \$300 billion in U.S. Treasury debt. “Quantitative easing,” as this non-traditional step is called, allows the Fed to influence longer term rates. Many market observers believe that the Fed has effectively “capped” 10 year rates at 3.00%.

Conclusions

Treasury rates have been pinned at the short end of the market by the Fed’s “near zero” Fed Funds policy. Further out the yield curve, rates have remained relatively low thanks to the quantitative easing and also because of “safe haven” demand from investors concerned about the global recession. Nevertheless, 10 year rates have begun to drift higher again. The recent steepening of the yield curve might bode well for the health of the U.S. economy, indicating an expectation of reflation. On the other hand, the higher yields may be nothing more than the price of increased Treasury financing needs. In the month of April alone, \$150-\$200 million in Treasury securities will be auctioned.

Government Liquidity Programs: Try to Keep Up

As the credit crisis morphed into a full blown global recession, governments worldwide have implemented liquidity strategies to restore confidence in the financial markets. **In the United States, the U.S. Treasury, the FDIC and the Federal Reserve have been extremely active in implementing a number of programs to avert a financial sector meltdown and provide liquidity to the capital markets.**

After the surprising demise of Lehman Brothers, the U.S. Treasury moved into high gear, guiding a banking sector rescue plan into law called the Troubled Asset Relief Program (TARP). **The initial TARP was designed to rid troubled banks of toxic assets which inhibited their ability to function as lenders. With the financial markets quickly deteriorating, the Treasury Secretary altered the program from buying toxic assets off of the banks' balance sheets to the government's purchase of preferred stock in financial institutions.** This plan increased the banks' capital and thus gave the banks additional cushion to absorb losses on securities and loans held on their balance sheets.

The commercial paper market fell into disarray when the Reserve Fund, the oldest money market fund, "broke the buck" due to owning Lehman Brothers commercial paper. The short term money markets have been a key source of financing for corporate America. With investors withdrawing large amounts of money, liquidity evaporated overnight and the short term markets froze. The Treasury stepped in to provide a temporary guarantee for money market funds to halt the run on these investments. The Federal Reserve followed by enacting the Commercial Paper Funding Facility (CPFF) which allowed the Fed to purchase three month A1/P1 rated commercial paper directly from issuers thus providing a lender of last resort.

To provide liquidity to the beleaguered banking sector, the FDIC stepped in to guarantee newly issued senior unsecured debt of FDIC approved financial institutions. Initial guarantees are limited to new issuance of 3½ year maturity notes. Financial institutions have issued close to \$300 billion in FDIC guaranteed debt to date.

The current administration has recently unveiled their latest effort to alleviate the global crisis with the Financial Stability Plan of 2009. In this plan, the government has enhanced the Term Asset-Backed Securities Loan Facility (TALF) which initially allowed the Federal Reserve to purchase direct debt of Fannie Mae, Freddie Mac, Federal Home Loan Bank, agency mortgage-backed securities and AAA-rated asset-backed bonds. **The expanded TALF allows the Fed to purchase up to \$1 trillion in AAA-rated asset backed securities collateralized by consumer and small business loans, residential and commercial mortgages.** Additionally, the Financial Stability Plan instituted the Capital Assistance Program which allows the Treasury to purchase additional bank capital via preferred shares, which would be convertible to common shares for banks that fail a new stress test. Finally, **the Treasury announced the much awaited government plan to help banks sell toxic assets held on their balance sheets. The Public-Private Investment Program (PPIP) provides government capital and financing to leverage private capital for the purpose of buying "legacy assets".** These "legacy assets" include both loans and securities which have clogged the balance sheets of companies throughout our financial system.

The goal of all these programs is to provide a foundation for the financial system which will ensure that credit is available to large and small businesses as well as the consumer. **Ultimately, that financial system may need some regulatory overhaul, but the U.S. government realizes that stable financial markets are the first step towards a sustained economic recovery.**