

May 24, 2011

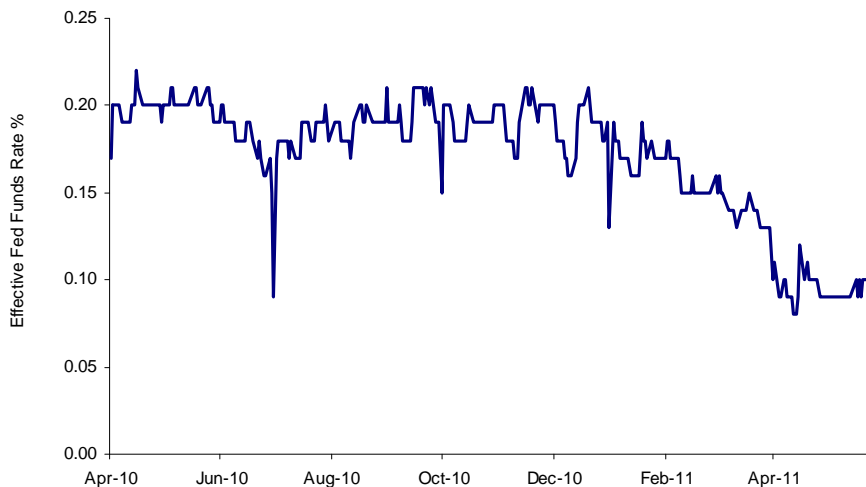
Fed To Borrow From Fannie/Freddie Reducing Credit Market Disruption

We think financial markets are being distorted by concerns about the end of QE2 (which we think will go quietly like Y2K) and the debt limit (which we think will be increased when necessary and will not achieve many spending cuts.)

Adding to these distortions, a combination of factors has strained short-term interbank credit markets. They have traditionally been an important part of the financial system but can't function normally in a near-zero interest rate environment (see Near-Zero Rates Are Hurting the Economy, December 4, 2009 WSJ).

In part to address this problem, **the Fed today announced that it would allow Fannie Mae and Freddie Mac to participate in the Fed's reverse repo program. This will in effect allow the Fed to borrow from and pay interest to the GSEs.** Until now, the GSEs have sold their excess cash (often over \$150 billion per day) in the repo market, or else the fed funds market where the effective rate has been pushed down to only 9 basis points (0.09%).

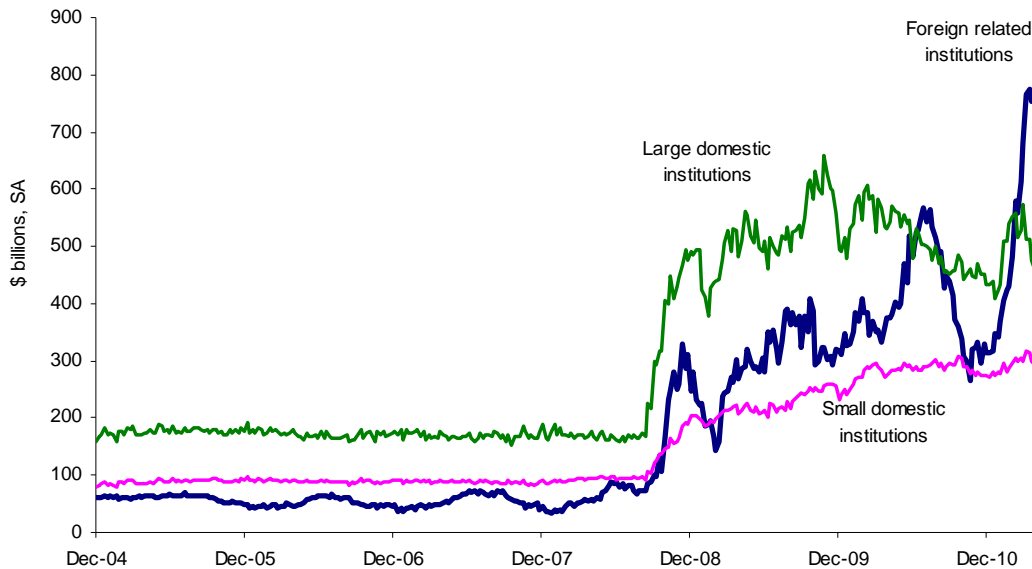
Effective Fed Funds Rate (last obs. May 24, 2011)



Source: Federal Reserve; Encima Global

The Fed's inclusion of the GSEs in its reverse repo program should channel some of the GSE cash to the Fed. This works around the GSE's ineligibility to lend to the Fed through excess reserves (which pay an above-market 0.25% interest rate to domestic and foreign banks.)

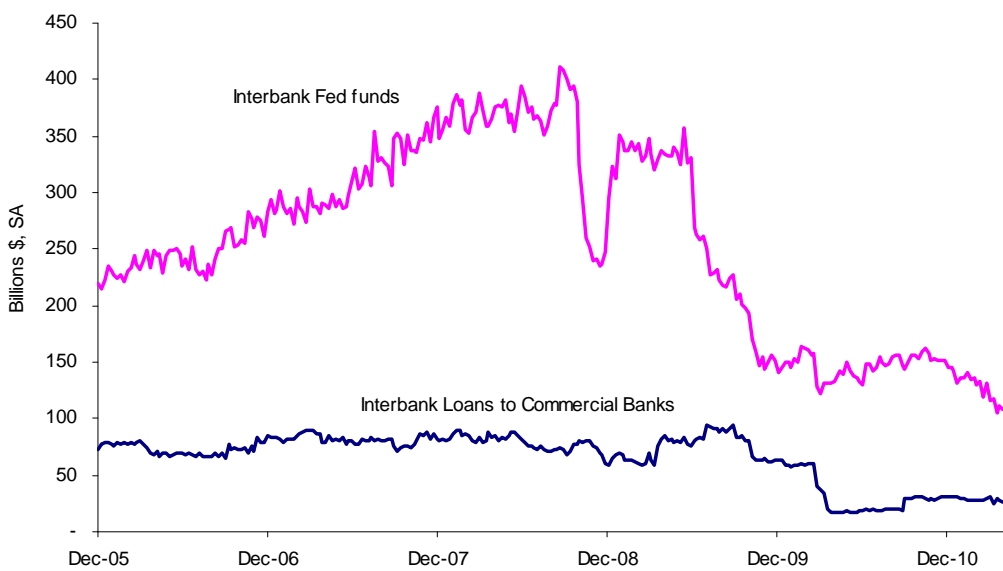
Sources of Fed's Excess Reserves (last obs. May 11, 2011)



Source: Federal Reserve; Encima Global

GSE participation in the Fed's reverse repo program should increase the effective Fed funds rate and probably the volume in the interbank market. Volumes have fallen in both the interbank market (where banks lend directly to each other at LIBOR, now 13bp) and the Fed funds market (where banks and the GSEs lend and borrow with the Fed as an intermediary). With interest rates in these markets near-zero, there's been little incentive for banks to lend to each other, part of the disruption facing small and regional banks from near-zero interest rates.

Interbank Lending (\$ billions, last obs. May 11, 2011)



Source: Federal Reserve; Encima Global

The decline in very short-term interest rates has been putting downward pressure on the short end of the Treasury curve. The one-year Treasury bill hit an all-time record low of 0.16% on May 9 and stands at 0.17% today. For comparison, the one-year Treasury, starting in the 1950s, hadn't been below 3% until the 2001 recession and hadn't been below 1% until the 2008 crisis.

12 Month T-Bill Rate (last obs. May 24, 2011)



Source: Federal Reserve; Encima Global

Bottom line: We think the Fed's invitation to Fannie and Freddie to participate in the Fed's reverse repo market later in the year is positive for those concerned about QE2 ending. An expanded reverse repo market makes the Fed less dependent on excess reserves, emphasizing its ability to hold the QE2 assets and also laying the groundwork for more bank lending later on. It should increase the effective Fed funds rate which should increase LIBOR (at 13 bp today) and may add to volumes in the interbank market. It may also improve the function of the Treasury repo market which would relieve some of the strain in Treasury bond markets allowing Treasury yields to rise. We thought that would happen earlier in the month, but weak economic data and European debt issues have continued to hold Treasury yields down. One negative of GSE participation in reverse repos is that it further entwines the Fed in the GSEs and the functioning of short-term credit markets, but that is a relatively small additional expansion in the Fed's role given its dominance of the MBS and Treasury bond markets.

Notes: This email and attachment are confidential and intended solely for the use of the individual to whom they are addressed. Encima Global LLC does not accept liability for the content, or for the consequences of any actions taken on the basis of the information provided. The information is not necessarily complete, and we make no warranty as to its accuracy.