

State of the Cash Markets

11/13/2008—Paul McCulley, a PIMCO managing director and head of PIMCO’s cash strategies, analyzes the state of cash markets in the wake of the Lehman Brothers default of September 2008.



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Beginning with the bankruptcy of Lehman Brothers on September 15, 2008, the financial crisis entered an acute phase marked by failures of many prominent American and European banks and efforts by governments worldwide to belatedly seize the initiative and rescue beleaguered financial institutions. The bankruptcy of Lehman Brothers was an extraordinary market event that effectively caused investors to disengage from the markets and refuse to “play” at any price. In a recent PIMCO conference call, Paul McCulley discussed some of the implications for the money market sector in the wake of Lehman’s default. Some highlights of this conference call follow.

Implications for Money Market Sector after Lehman Brothers Default

- In the wake of the Lehman Brothers default, the Reserve Primary Fund “broke the buck,” an unprecedented event for such a large, well-established money market fund. (A money market fund is said to “break the buck” when it suffers a decline below \$1 in share price.) A money market fund’s share price may break below a dollar if a major decline occurs in the value of securities owned by the fund.
- As a result, other money market fund managers stopped buying term commercial paper. The reason: No manager wanted to risk breaking the buck. Even high-quality commercial paper was not being purchased for fear that redemption requests would force managers to sell commercial paper at less than amortized cost (which would effectively result in breaking the buck). This was a problem for both buyers and issuers.

- Interbank lending also effectively stopped. LIBOR vs. Fed Funds, LIBOR vs. T-bills (TED Spread) and LIBOR vs. OAS all reached unprecedented levels.

Policy Responses

- *Insurance for money market funds:* This was funded via the Treasury’s Foreign Exchange Stabilization Fund, a \$40 billion pool available to Treasury Secretary Henry Paulson.
- *Commercial Paper Fund Facility (CPFF):* This allows all select issuers of commercial paper to roll or sell commercial paper to the Federal Reserve. This very powerful program supports asset-backed commercial paper (ABCP), financial and non-financial issuers, with an allowed maximum of \$1.3 trillion. This program allows issuers to bid their own paper (effectively providing liquidity to the holders of their paper prior to maturity).
- *Money Market Investor Funding Facility (MMIFF):* This was designed explicitly so that select money market funds can sell their commercial paper assets into this program at amortized cost. Effectively, this provides liquidity for money market funds. This is even more powerful than the CPFF. That is because, while the CPFF gives corporate issuers the ability to bid back their paper, MMIFF gives explicit liquidity to commercial paper holders of this paper at amortized cost. In other words, money market funds don’t have to worry about breaking the buck.

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- *New FDIC Program:* Extends guarantee on unsecured debt of deposit-gathering institutions for up to three years. In other words, banks can get a full guarantee on all their issuances. The charge is only 75 basis points for this guarantee, which we believe is “an absolute bargain” in this marketplace. This should help strengthen the financial structure of deposit-gathering institutions.

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Update on the Markets

- The combination of the above policies has been helping the short-term market significantly. The money market sector is in “healing mode” (out of intensive care and in a regular hospital room). Once the MMIFF fully weighs in, markets should be in an even better position.
- Once this happens, we should start to see the rest of the risk market begin to heal. Note that we are still heading into an economic recession, which means that there are going to be challenges.
- If you have cash that does not have to trade at face value, consider looking at some ultra short-term portfolios. While money market funds are still appropriate for investors’ “grocery money” (money that will be needed immediately), for a “cash allocation” (which we think of as “permanent cash”), the ultra-short universe is attractive. We see good opportunities at the front end of the yield curve.

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GLOSSARY

Asset-backed commercial paper (ABCP) –

This is a form of commercial paper that is collateralized by other financial assets. ABCP's are typically short-term investments that mature between 90 and 180 days and are typically issued by a bank or other financial institution. They are designed to be used for short-term financing needs.

Breaking the buck – This is a decline below one dollar in the share price of a money market fund. A money market fund share price may break a dollar if a major decline occurs in the value of securities owned by the fund. For example, a corporation may default on commercial paper held by a fund.

Commercial paper – Commercial paper is a very short-term security issued (sold) by large banks and corporations to get money to meet short-term debt obligations (for example, payroll), and is only backed by an issuing bank or corporation's promise to pay the face amount on the maturity date specified on the note. Commercial paper is sold at an original discount to full face value.

Federal funds rate – In the United States, the federal funds rate is the interest rate at which private depository institutions (mostly banks) lend balances (federal funds) at the Federal Reserve to other depository institutions, usually overnight.

London Interbank Offered Rate (LIBOR) –

This is a daily reference rate based on the interest rates at which banks borrow unsecured funds from banks in the London wholesale money market (or interbank market). It is roughly comparable to the U.S. federal funds rate.

Option Adjusted Spread (OAS) – This is the spread (additional interest required) over Treasury bonds of similar duration or interest rate sensitivity. This concept can be applied to mortgage-backed securities, options, bonds and any other interest rate derivative.

TED Spread – The TED Spread is the difference between the interest rates on interbank loans and short-term U.S. government debt (T-bills), and is commonly used as a gauge of creditworthiness among banks.

Yield curve – The yield curve, a graph that depicts the relationship between bond yields and maturities, is an important tool in fixed-income investing. Investors use the yield curve as a reference point for forecasting interest rates, pricing bonds and creating strategies for boosting total returns. The yield curve has also become a reliable leading indicator of economic activity.

Past performance is no guarantee of future results and current and future portfolio holdings are subject to risk. Each sector of the bond market entails risk. The return of principal in bond portfolios is not guaranteed. Such portfolios have the same interest rate, inflation and credit risks that are associated with the underlying bonds within a portfolio. Bond portfolios and individual bonds with a longer duration (a measure of the expected life of a security) tend to be more sensitive to changes in interest rates, usually making them more volatile than securities with shorter durations.

Money market funds are not insured or guaranteed by the FDIC or any other government agency, and although these funds seek to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in money market funds.

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