

Thought for the Week: Monday, April 4th, 2011

The Government, Banks and the Yield Curve

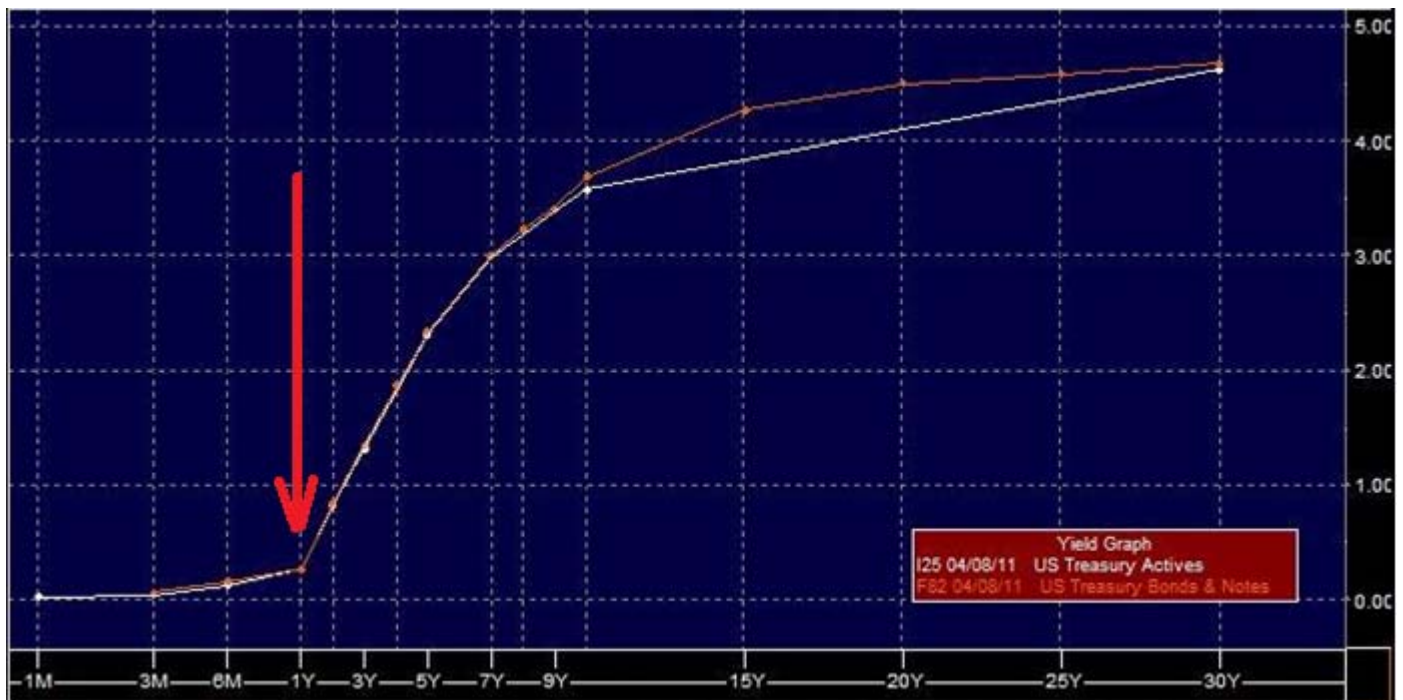
A Yield Curve is generally a chart showing **the relationship between the Interest Rate and the Time to Maturity of a Bond**. It is widely used by Fixed Income investors and economists as **an economic prediction tool**.

This week's Thought provides background to support the theory that **the end of Quantitative Easing may not be as bad as many think**. Those forecasting the end of economic recovery once the Government shuts off the monetary faucets may be premature. Quantitative Easing has really been about supporting the banking system, not creating jobs and stimulating the general economy.

The Yield Curve

The **current yield curve for U.S. Government Treasuries is shown below**: the longer the maturity, the more yield (or interest) an investor requires as compensation for the longer holding period and the additional risk this may entail.

As an example of how this helps economists, a steeper curve as you move to the right usually signifies a higher probability of future interest rate rises. Look at the arrow below; current expectations are for a steep climb in interest rates about one year out from now.



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The Treasury Yield Curve is also an indication of future interest rate policy in that it shows **the ‘risk-free’ investment return available by buying a Bond which is backed by the U.S. Government.**

Anyone buying or selling debt has to compete with this curve. For example, if the U.S. Government will pay you 3.6% a year to loan it money, why would you consider an income investment yielding any less? You wouldn't, you would **ask for a higher return to compensate you for the higher risk.**

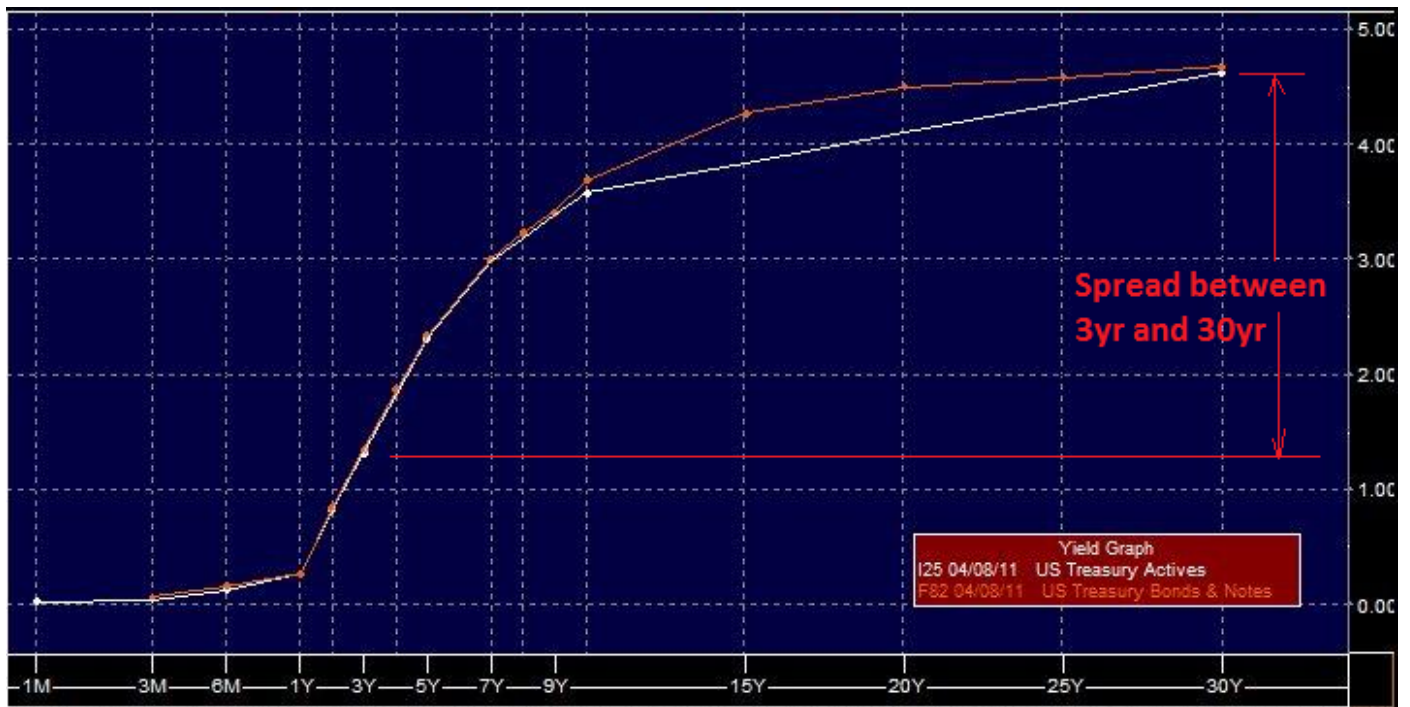
The higher the implied risk, the larger the yield “spread” between the competing investment and the U.S. Treasury of the same maturity. **Corporate Bonds**, which carry the risk of corporate failure and default on interest payments, have **similar shaped yield curves but feature higher interest rates.**

One important feature of **the current yield curve is the “near-zero” short term level.** If you loan money to the U.S. Government for between one and three months, they will pay you virtually zero interest. The interest rate only goes above 1% for loans of three years or more. Normally, short term interest rates are 2% to 3%.

Banks and the Treasury Yield Curve

Banks generally borrow at the short end of the yield curve and lend at the long end. Therefore, their profit margin depends on the difference or spread between long term and short term interest rates.

For example, if a bank issues a 30-year mortgage at 6.6% (the 30-year Treasury plus 2%) and borrows the money from the Government at 1.3% over 3 years, they make a 5.3% margin in return for managing the difference in loan maturities and the difference in risk between lending money to a home owner and borrowing from the U.S. Government.

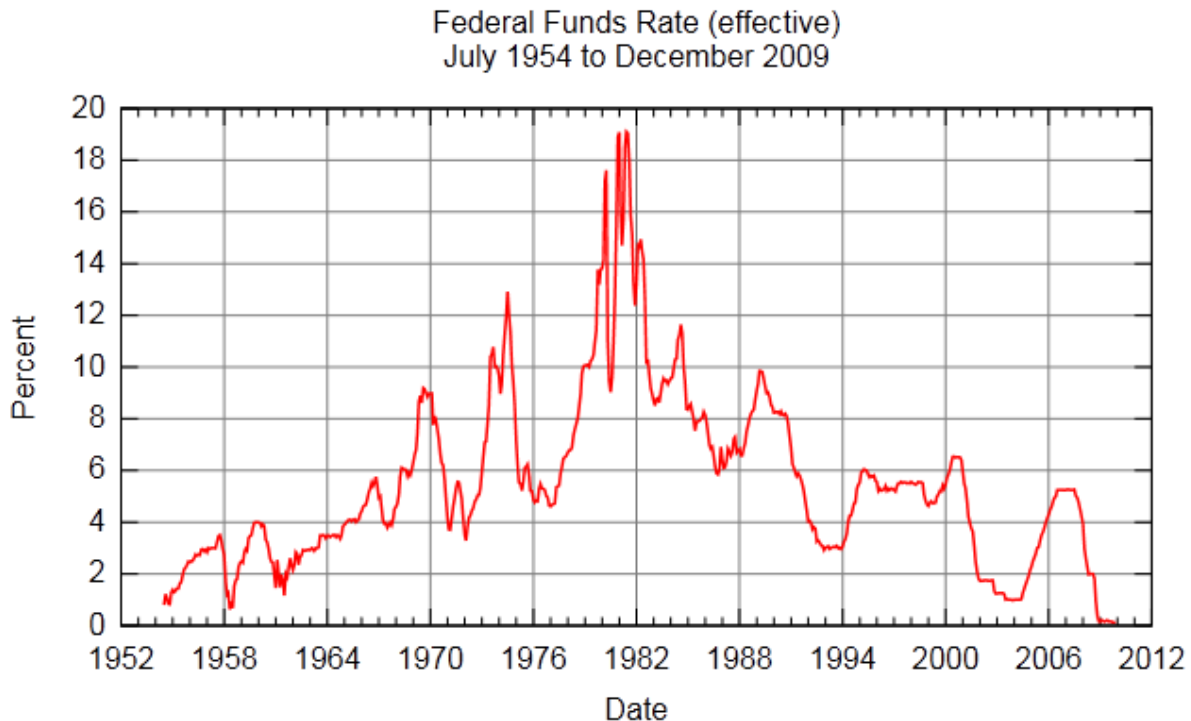


Note: Pretty much all loans are related to the Yield Curve because all lenders have to compete with the risk-free rate of return offered by the U.S. Government.

Federal Funds Rate (FFR)

In reality, **banks borrow money from other banks at the Federal Funds Rate (FFR)** which is controlled, but not set, by the Federal Reserve.

The chart below shows the recent history of bank borrowing rates:



The Fed influences the FFR by controlling the supply and demand for Treasuries. To cut a long and complex story short, this control manifests itself in the low short term rates in the above yield curve.

A cursory glance at the chart above suggests the FFR is currently exceptionally low and should rise soon.

Bottom Line: The Federal Reserve is lending money to banks, through Quantitative Easing, at near zero short term rates.

The Net Effect of Quantitative Easing

1. **Re-liquify the Banking System:** The net effect of quantitative easing has been to **pump liquidity into the balance sheets of the banking system**. Questionable derivatives, mortgages and loans have been replaced by high quality Treasuries. Banking net capital ratios now look much better. The money created **by the government has purged a great deal of the “bad” derivatives** from the system.
2. **Deficit not Debt:** Easing has moved the banking liabilities from the balance sheet of the banking system to the balance sheet of the Government. This is probably **acceptable if we can get the deficit back in order**. We are a big enough economy to carry a large debt; however, we need to

get the annual deficit down. **This may no longer be a debt problem; it may be a spending problem.**

- Banks may now Help Stimulate a “Back to Normal” Economy:** Banks have not been making many home and business loans recently. This is because the FFR is so low, banks can make large profits by borrowing from the Government at near to zero interest rates then using the money to buy longer maturity Treasuries paying higher rates. Borrow at 0.25% and buy a 10-year T-Bill paying 3.6% provides a nice low risk return.

This may seem like a lower margin than the original mortgage example above, and it is. However, the Government allows banks to employ much higher leverage on the purchased Treasuries, thereby greatly multiplying the return.

Banks are starting to lend again, partly because they have to find other ways of making money as the Treasury spread game disappears. The Fed is starting to reduce the levels of borrowing available and “abnormally” low interest rates may be about to end. **Once the low short term rates reset at higher levels, the cost of borrowing increases for the bank** but their income from loans stays the same – their **margins therefore shrink**.

Quantitative Easing created an abnormal environment, as this unwinds and normality returns, **banks should be able to help stimulate growth** by reinstating lending to expanding businesses and other deserving causes.

- Create a Potential Price Bubble for Treasuries:** The Federal Reserve controls the FFR by controlling the supply and demand for Treasuries. They have **succeeded in reducing short term rates** to nearly zero which means the **price of short term bonds must have increased. We fear for investors in short term Government debt** when the short end of the yield curve reverts to normal levels.

This will **inevitably raise the short end of the yield curve** which will probably exert some upwards pressure on the long end of interest rates.