

(Comment by Keith Sharp: Day after Bear Stearns investment bank disintegrated , seemingly on **REPO** problems (below). Bear had borrowed billions on a day-to-day basis using repos)
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Posted by David Gaffen



The stock market may not be off a cliff today, but the **various measures of risk protection out there suggest that those in the credit markets are definitely freaked out.**

A good indication of this? The yield on the three-month bill is currently 0.78%. So if you put away \$100 in this instrument, **one year later you'd get back an extra 78 cents (or 20 cents after about three months).** That's the investment equivalent of doing quarterly searches **under the couch pillows and scouring the sidewalks for coins.** "It's outlandish that this is where we are," says Joseph Brusuelas, chief economist at IDEAGlobal. The 10-year note, meanwhile, was yielding 3.37%, lowest since 2003 (see chart)

Other indicators suggest that banks remain wary of lending to one another due to liquidity concerns. To wit: **the three-month option-implied spread, or OIS, on the federal-funds rate was trading at around 1.80%.** That's the anticipated federal-funds target three months from now.

By contrast, three-month U.S. dollar LIBOR, which is a popular rate banks charge each other for loans, was fixed at 2.57% overnight, **for a difference of 0.77 percentage point.** This rate is usually around 0.1 to 0.2 percentage point above the expected funds rate; the gap underscores the liquidity concerns investors have.

"One of the problems with liquidity is that it's **sort of a self-fulfilling prophecy – when they get nervous they pull their lines,**" says Guy Lebas, fixed income strategist at BNP Paribas. "Because it's so psychologically driven, there's every reason it could happen again."

Much of the activity among lending institutions is done through short-term repurchasing agreements, or repo, agreements, of which \$4.5 trillion was outstanding as of March 5, according to Miller Tabak. Of that, \$3 trillion was through overnight borrowings, which illustrates how a firm can tumble so quickly if nobody wants to fund their borrowing.

Currently, **the 20 primary dealers in Treasuries** held about \$400 billion in various types of securities, including \$156 billion in mortgage-backed debt; the various facilities established by the Fed would seem to suggest they have enough capital to finance dealer needs.

But that doesn't mean the Fed can solve every problem. "The Fed can provide ample liquidity to try and mitigate counterparty risk, and it can partly influence the cost of capital to underpin aggregate demand in the real economy," writes David Rosenberg, chief North American economist at Merrill Lynch. **"The Fed can't prevent price discovery on all the assets that are faced with inadequate free-market liquidity."**

