The Great Commercial Paper Lockdown Of 2007

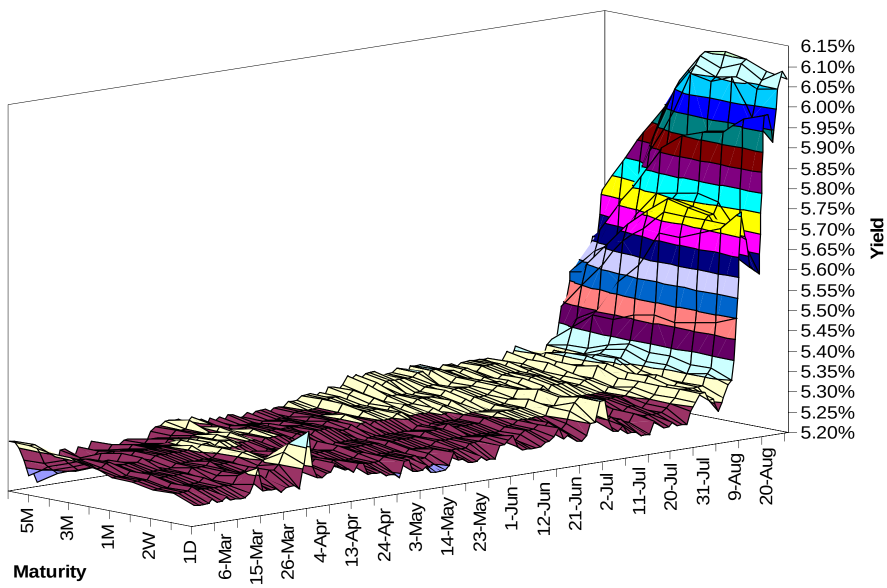
"You shake and shake the ketchup bottle. Nothing comes, and then a lot'll." – Ogden Nash
"I don't worry about countries like Cambodia and they don't worry about me." – Winston Churchill

Well, there you have my attitude in a two nutshells. One moment I was living my life more or less happily and the next moment I was being assaulted by horrid happenings in the commercial paper market. Did it ask for permission to intrude? No, it did not. But like the ketchup in Ogden Nash's doggerel it wound up in great quantities all over the place.

In fact, up until this wretched August of our discontents (Memo to file: Next year, sell in May and go away) I had written a grand total of one column on commercial paper, in November 2003, which we will revisit below. There I noted that slack growth in commercial paper outstanding was prima facie evidence of still-weak commercial credit demand; even by March 2004 this was the consensus view.

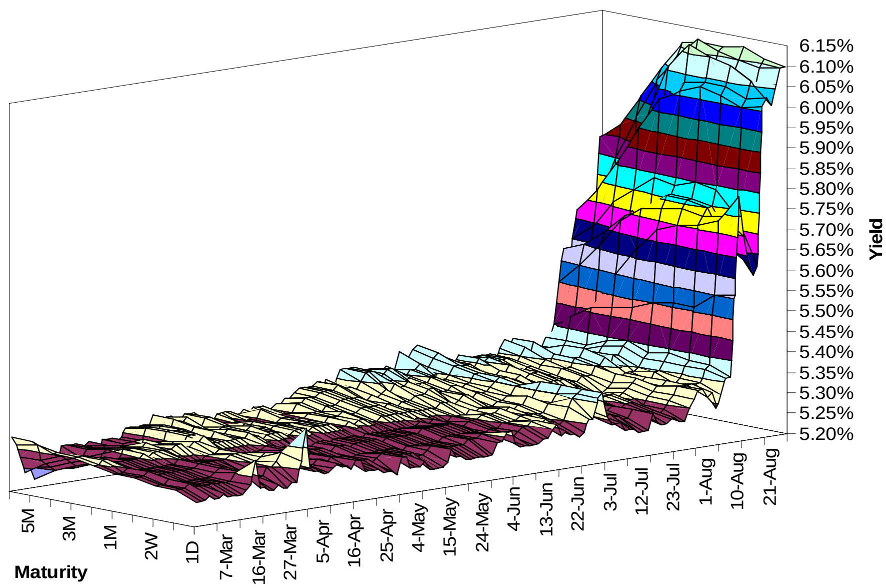
May All Your Assets Be Backed
Three years ago it appeared only two answers were required for everything in finance, "China" and "hedge funds." Today we have added a third, subprime mortgages; they appear to have permeated all markets like mysterious ether. The speed with which they triggered a blowout in asset-backed commercial paper yields is stunning. Let's take a look at the jump in "top top" asset-backed commercial paper (A1+/P1/F1+) across the one-day to six-month maturity spectrum from mid-February onwards. Each color-band represents a 5 basis point interval in yield.

Top Top-Rated Asset-Backed Commercial Paper



The picture is not materially different at the next-highest credit rating, A1/P1/F1, or "top." It did not matter how short the maturity of the paper or the credit rating of the collateral (snicker); if it was linked at all to mortgages, it was taken out and shot.

Top-Rated Asset-Backed Commercial Paper



I would be remiss if I did not note mortgages are not the only collateral behind asset-backed commercial paper. You can have auto loans, manufactured home loans (trailers, including that double-wide of your dreams) and credit card receivables, too. These markets have thrived for years with full knowledge there is a default rate on these loans. In fact, they would not be very interesting to yield-hungry investors without such a default rate; that would mean the lenders were not being aggressive enough in the pursuit of new business.

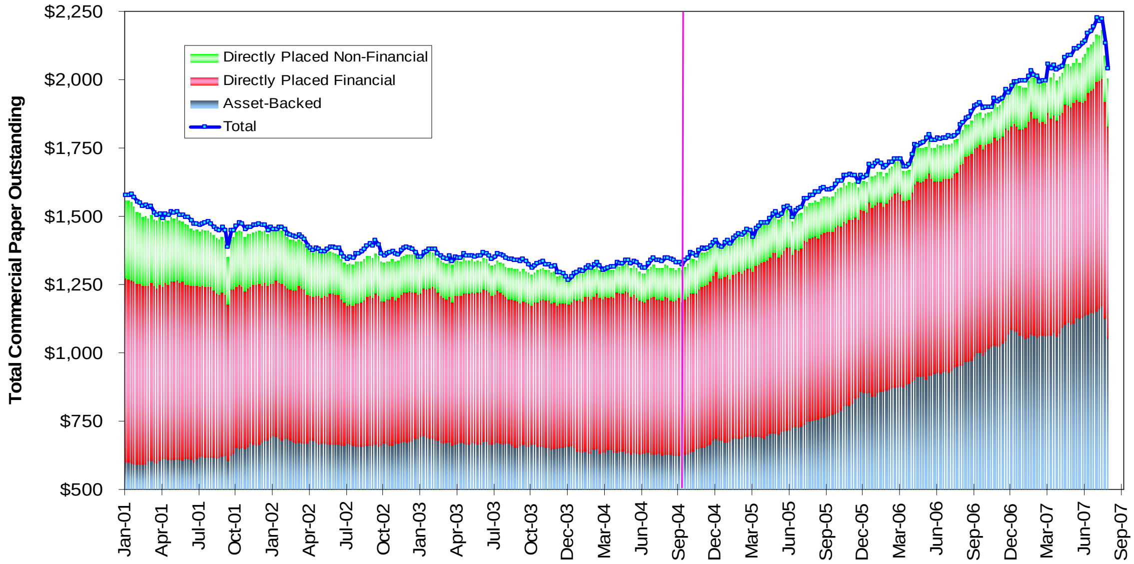
Those who profess shock – shock! – that their money market fund contained such tripe should do themselves a favor and read the prospectus to see what their funds contain. Most money funds are full of commercial paper, bankers' acceptances, repurchase agreements, floating-rate and inverse floating-rate loans and all manner of other short-term instruments. This has been true for a quarter-century. The financial system relies on these instruments for cash management.

Go ahead, read a prospectus. RTFP, as the bumper stickers say. Otherwise, who knows, someone might be hiding something in plain sight.

Contraction In Action

The Federal Reserve (Motto: Can you hear us now?) reported last week, the volume of commercial paper outstanding dropped by the largest amount since 9/11. If we break the total amount outstanding down into the issuer categories of directly placed financial paper, directly placed non-financial paper and asset-backed paper, we can glean some information about trends in the market.

Credit Bubbles Produce Credit Crunches



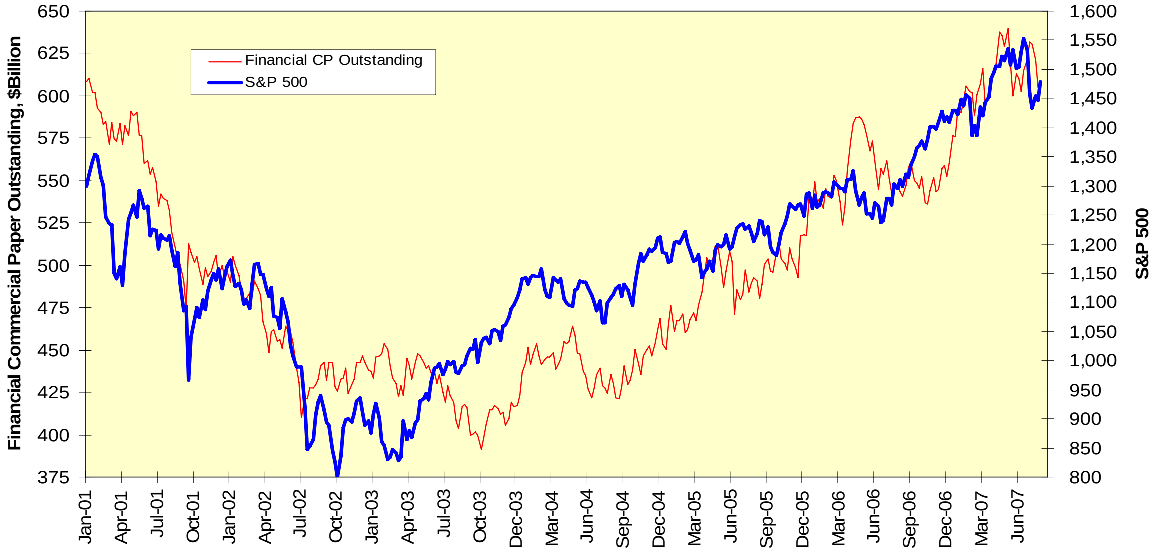
First, the four-week drop in total amount commercial paper outstanding was 8.2%. Asset-backed commercial paper fell 8.6% and paper placed directly by financial firms fell by 7.2%. Directly placed non-financial paper outstanding declined in volume by a mere 1.7%. The commercial paper market locked down for financial firms almost as much as it did for asset-backed securities. Wall Street was hoist on its own petard.

But was this downturn the problem or was it the long boom in asset-backed commercial paper issuance from September 2004 onwards? Between September 2004 and July 2007, the volume of asset-backed commercial paper increased by more than 85%; comparable figures for directly placed financial and non-financial paper are 47% and 38%, respectively. By September 2004, the Federal Reserve was into its rate-hike campaign, but short-term rates were not at a neutral level until sometime in late 2005. This “too easy, too long” gap was the golden age of subprime goofiness. Without the credit bubble we would not be talking about the credit crunch.

Money Matters

It should come as no surprise to anyone that stock prices benefit from the leverage in the financial system; this was one of the conclusions reached in the above-referenced November 2003 column. It remains true today; financial commercial paper outstanding appears to be a slightly lagging indicator of stock prices. Firms leverage themselves up after the bull market becomes apparent and not a moment before.

Stocks Benefit From Financial Credit



Given all this, we should look first to a restoration of health in the commercial paper market only after investors regain confidence they are not going to be on the hook for worthless or bid-less subprime-linked commercial paper and after we can blow the all-clear whistle for stocks. Neither factor will happen by the end of this week.