Full Faith And Credit

I noted in a Columnist Conversation posting two months ago, on the date of the first Fannie Mae and Freddie Mac backstopping, how the U.S. government was running a significant risk by extending its balance sheet to all and sundry in its various financial crisis rescue operations.

At the time of this writing, which happens to be late Sunday night after Bank of American offered to buy out Merrill Lynch and after various rescue plans for Lehman Brothers collapsed, it seems as if the both the Treasury and the Federal Reserve took themselves out of the bailout business. The Federal Reserve agreed to accept additional collateral on loans, including equities, but we now recognize not everyone can be saved.

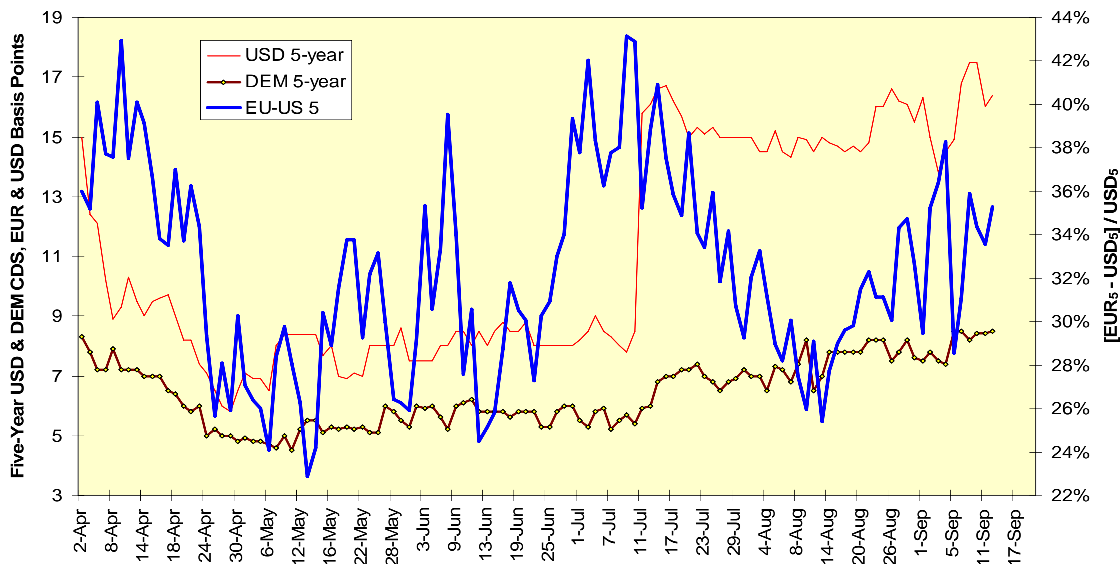
AIG asked for a $40 billion bridge loan from the Federal Reserve, even though they are not a bank. I suppose when all is said and done on this unbelievable chapter in financial history, Wall Street will look very different. I am beginning to understand, for example, why the Glass-Steagall Act of 1933 separated investment and commercial banking. How well have any of these financial conglomerates managed their businesses? We call it "too big to fail," but in reality, it is too big to succeed. We now know Hank Greenberg and Sandy Weill could juggle, for a while at least, all the separate businesses at Citigroup and AIG, but that none of their successors could.

Sovereign Credit Risk

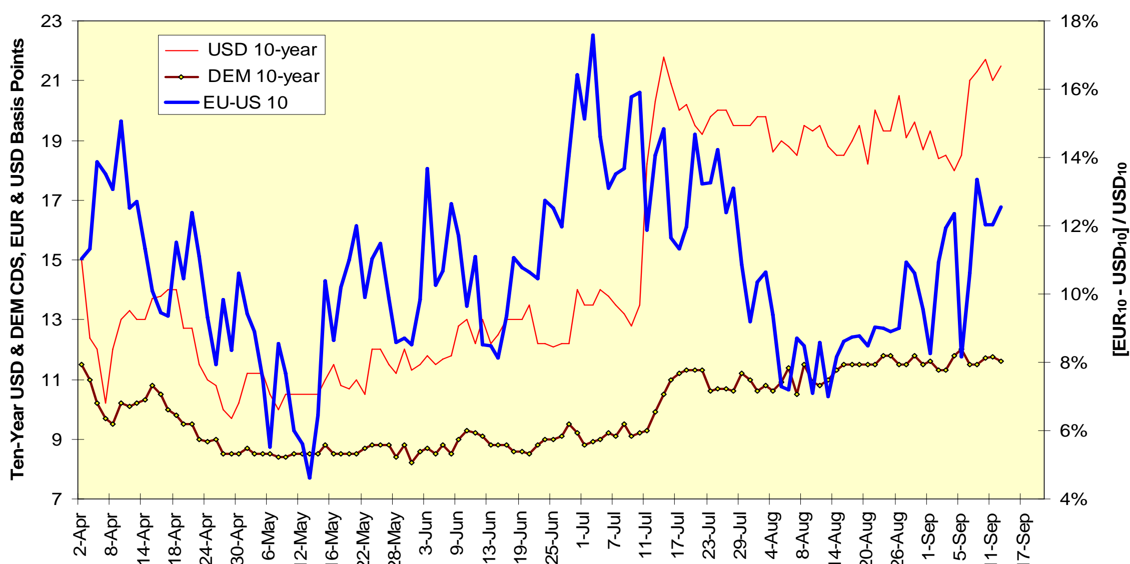
As I noted in another, more recent, Columnist Conversation posting, good intentions and good policy often are different things. We can and most surely will survive this current crisis, but the one thing we should protect at all costs is the credit rating of the United States. The country might not have survived the presidency of George Washington had Alexander Hamilton not worked to establish and maintain the good faith and credit of the fledgling U.S. government. We say it's all about the Benjamins, but in reality it is and always has been all about the Alexanders.

While U.S. Treasuries are still AAA-rated, we can say the various extensions of Treasury credit and the Federal Reserve's acceptance of everything up to baseball card and comic book collections as collateral in exchange for loans of its holdings of Treasury securities has pressed credit default swap (CDS) rates higher on U.S. Treasuries. These CDS are priced in euros on the logic that if the U.S. defaults, the dollar will be worthless. Similarly, there are CDS on both German and Japanese government bonds priced in dollars for the equal and opposite reason.

Those CDS costs have been rising; they were in the neighborhood of ten basis points for ten-year notes back in April and have moved north of 20 basis points now. The five-year note CDS for both U.S. Treasuries and German bunds both moved higher last week.



Ten-Year CDS Costs On U.S. & German Bonds Vs. Normalized Yield Spread



A third line, marked in blue, was added to the charts below to illustrate a fascinating phenomenon, which is how the normalized yield spread, the rate gap between German and American bonds divided by U.S. interest rates, has been widening out while CDS costs on American bonds have been rising. You might think the U.S. would have to pay more for its paper if its credit quality was deteriorating; that would be consistent with that whole risk and reward thing we all know and love so well.

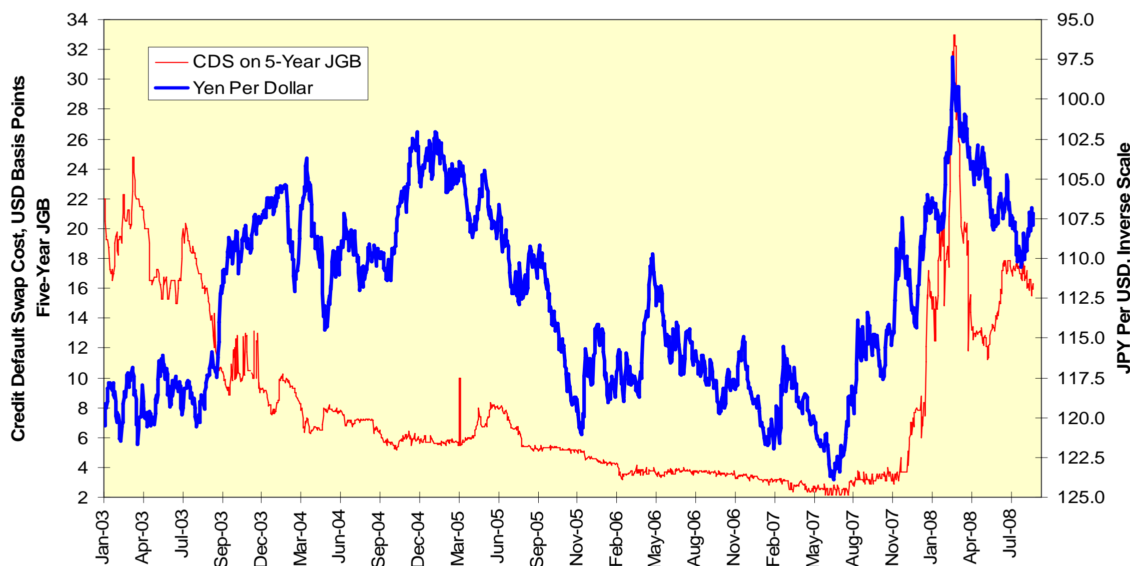
Why is this occurring, not only in the U.S. but in Germany and Japan as well? The answer is quite simple: As investors flee risky assets, Treasuries, bunds and Japanese government bonds all become more attractive by virtue of their promise to return the nominal principal. While this is referred to often as a flight to quality, it is in reality far more a flight to the printing press. As credit spreads widen and push the total cost of capital higher for corporations, a phenomenon I discussed in May, sovereign bonds become more attractive on a relative basis and, unintentionally I am sure, draw capital away from the private sector.

Global Linkage

Not only are investors fleeing to sovereign bonds while sovereign credit risks are rising, an action lemmings might find curious, they are fleeing back to their home markets wherever and whenever possible. Let's return to our old friend, the yen carry trade, last discussed here in September 2007. As global investors flee risk and unwind yen carry trades in the process, they have to buy back borrowed yen. That pushes both the option volatility on yen higher and also pushes the yen itself higher.

Yen Volatility Rose With Sovereign Credit Risk

Yen Strengthened As Sovereign Credit Risk Rose



The unwinding of these yen carry trades pushes the value of risky assets worldwide lower and makes sovereign bonds look even more attractive in comparison.

Will governments make good use of the money flowing to them at ever-lower interest rates, especially in an environment where risk-seeking is not the flavor of the month? On a short-term relief basis, maybe. On a long-term growth basis, almost assuredly not. The historic precedent here is clear as well: The financial calamity of the Great Depression led to transference worldwide of economic responsibilities to governments and away from markets.

The citizenry will look at Wall Street's never-ending crises and say, "Enough!" A heavy dose of regulation and restraint will look appealing. But when the crisis is over, the regulation will remain. Restated, change is coming.