A Commercial For Commercial Paper

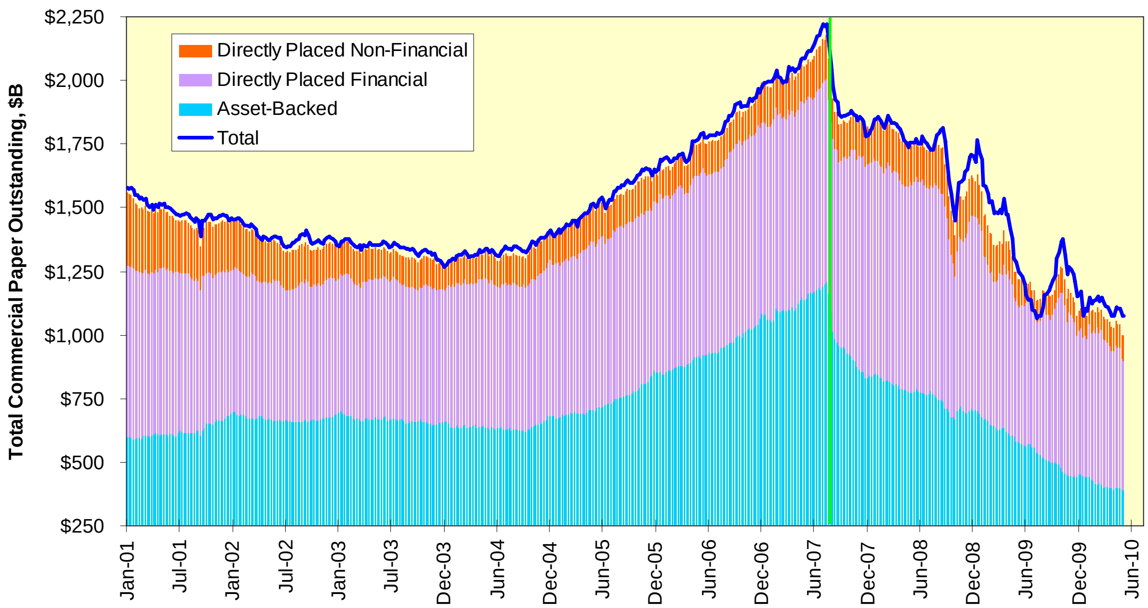
Are you worried about the electrical wiring in the building you are in right now (presuming, of course, you are not reading this on a mobile device)? Probably not; no one worries about the status of their wiring until it short-circuits and creates nasty problems.

This is remarkably similar to the 2007 collapse in the commercial paper market following upon the first wave of failures in mortgage-backed securities. By the time it was all over, the entire class of asset-backed commercial paper (ABCP) including credit card receivables, student loans and auto loans had declined from $1.21 trillion in the August 8, 2007 reporting week to this past week's low of $388.8 billion (A billion dollars? Isn't that what you leave on the table for the waitress?). The August 8, 2007 date immediately preceded the backstopping of BNP-Paribas by the European Central Bank on August 9th and the first emergency rate cut by the Federal Reserve on August 17, 2007.

All of this led to the creation of the Commercial Paper Funding Facility by the Federal Reserve, one of those proliferating programs that defined too-fast, too-furious and indirectly contributed to the decision in December 2008 to put the target federal funds rate near zero and then to have the Federal Reserve virtually take over the mortgage market by March 2009. Good times, good times.

Now let's divide the amount of commercial paper outstanding into ABCP and direct-issue paper from both financial and non-financial firms and mark the August 2007 earthquake with a green vertical line. The "total line" includes some other categories and therefore is larger than the sum of the three major ones.

Commercial Paper After The Earthquake



The overall picture shows some signs of stabilization, and this should not be too surprising. Once the Federal Reserve stops dominating the mortgage market, we should expect at least a modest revival in mortgage-backed securities, and the other components of this category have been killed already and therefore are unlikely to be exhumed, Dracula-style, for the wooden-stake treatment.

What of the directly placed financial paper? Here the answer will have to wait until the eventual renormalization of short-term interest rates, but once that happens, financial firms will have to start borrowing at market-based rates and not the artificially low rates engineered by the Federal Reserve over the past three years. This should mean a revival of this category of commercial paper unless these firms want to reprise the success Bear Stearns and others had with overnight repo as a principal funding source.

Directly placed non-financial paper is the most intriguing category of all. As these funds are used to finance inventories and receivables amongst other operating expenses, they should be a coincident to slightly lagging macroeconomic indicator. While the number should not be over-interpreted, it has increased by 33% since the end of 2009.

As we have seen in recent weeks, we are still living in a world of free-flying shrapnel and therefore should be at least a little cautious about broad market and economic declarations. But in the case of commercial paper, there does not seem to be any indication of anything getting worse and there is a great deal of potential for improvement if and when the financial system finally stops being the cause of so much excitement.