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TRENDMACRO LIVE!

On the Term Securities Lending Facility

Tuesday, March 11, 2008
Donald Luskin

We applaud the announcement this morning by the Fed of a $200 billion Term Securities Lending Facility, just as we applauded on Friday its expansion of the Term Auction Facility (see "On TAF and Jobs" March 7, 2008). Under the new facility, primary dealers will be able to borrow Treasury bills from the Fed, collateralized with other securities including mortgaged backed securities. When the dealers receive T-bills from the Fed, they can sell them for cash, which serves two key functions at once. It allows the dealers to fund their MBS positions, thanks to the Fed stepping in and accepting as risky securities that no one else wants now, buying time for dealers to ride out the hopefully temporary depression in these securities' prices. At the same time, it supplies T-bills to the market, relieving an intense scarcity of a riskless security that seemingly everybody wants. Thus the Fed acts as a risk-bearer of last resort, with the result of erecting a bridge between two types of temporarily intensely risk-averse investors -- those with cash who want only T-bills, and those with MBS who want only cash.

As we commented on Friday (again, see "On TAF and Jobs"), this is the kind of solution to the credit crisis that the Fed should have implemented in the first place. Instead, it wasted critical months with the "Bernanke doctrine" that calls for dealing with banking crises through discount lending at a penalty rate -- which failed, because the discount window is stigmatizing to any bank that uses it. When that failed, the Fed desperately began a series of fed funds rate cuts as the crisis deepened and market expectations demanded them, courting inflation by spraying newly created money across the entire economy in the hopes that some of it would end up helping distressed banks. Today's and Friday's initiatives target liquidity right where it's needed, and without the inflationary creation of new money.

Update to strategic view

US FED FUNDS: The expanded TAF announced by the Fed Friday and this morning's Term Securities Lending Facility are smart moves designed to provide much needed risk-bearing for panicked markets. They probably substitute to some extent for other Fed easing initiatives, so we see now only a 50 bp cut in the funds rate for next week's FOMC meeting.
US STOCKS: With stocks crazily undervalued relative to bonds and the Fed finally starting to do the right thing to address the credit crisis, yesterday's successful test of the January panic lows should mark at least a tradable bottom.
INFLATION PLAYS: The Fed's new liquidity initiatives are not as inflationary as cuts in the funds rate, and to some extent substitute for them. This could significantly lower inflation expectations, and take much of the wind out of the sails of gold, oil, commodities, and resource stocks -- and help the dollar find a bottom. It's too soon to say the inflation theme is over, but this is a cause for caution.

[see Investment Strategy Dashboard]

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Will it work? Friday's announcement didn't have much effect. But perhaps today's beefed up version will. We think it has a good chance of halting the vicious cycle of distressed selling of pariah securities positions that could not otherwise be funded, and the contagion of panic from one market to another. It doesn't get impaired positions off the books of the banks, but at least it allows the banks to hold those securities in hopes that their valuations will recover from artificially depressed levels (see "A Car Wreck Market" March 3, 2008). If nothing else, that should take the panic out of the markets for a while, opening up the mind-space necessary to deal with the issues underlying the credit crisis by means more intelligent than indiscriminate selling.

BOTTOM LINE: The expanded TAF announced by the Fed Friday and this morning's Term Securities Lending Facility are smart moves designed to provide much needed risk-bearing for panicked markets. They probably substitute to some extent for other Fed easing initiatives, so we see now only a 50 bp cut in the funds rate for next week's FOMC meeting. With stocks crazily undervalued relative to bonds and the Fed finally starting to do the right thing to address the credit crisis, yesterday's successful test of the January panic lows should mark at least a tradable bottom. The Fed's new liquidity initiatives are not as inflationary as cuts in the funds rate, and to some extent substitute for them. This could significantly lower inflation expectations, and take much of the wind out of the sails of gold, oil, commodities, and resource stocks -- and help the dollar find a bottom. It's too soon to say the inflation theme is over, but this is a cause for caution.