Cash and the Credit Crisis

A Market Update for Cash Investors

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BLACKROCK

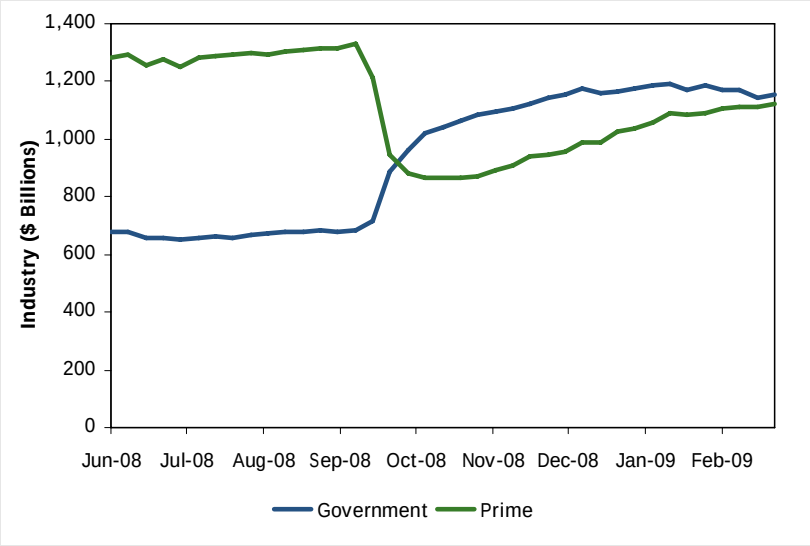
Today, almost two years after the subprime mortgage crisis first made headlines, cash investing has undergone significant change. In our special report of November 2008, "The Credit Crisis: U.S. Government Actions and Implications for Cash Investors," we discussed the evolution of the credit crisis and its impact on the cash market. This report provides an update on market conditions and some considerations for cash investors in the months ahead.

Background

In September 2008, the cash market was swept into the center of the ongoing credit crisis. Investors were withdrawing assets at a record clip on the heels of the Lehman Brothers bankruptcy filing and, subsequently, news that the Reserve Primary Fund "broke the buck" — only the second money fund ever to see its per share NAV drop below $1 in the nearly 40-year history of money market mutual funds. This event gave rise to a pronounced flight to quality in the cash markets. The industry saw investors rotate out of prime funds and into government funds as they sought the safety and security provided by exclusive exposure to obligations of the US government and its agencies. In a single week, prime funds across the industry lost $347 billion (-26%) in assets as a result of this flight to quality, and the four-week Treasury yield approached 0% as risk aversion became widespread. Overall, the cash industry lost $37 billion in investor assets in the third quarter of 2008. This masked the much larger phenomenon — prime fund assets declined by $331 billion, while government fund assets rose by $311 billion.

The government was quick to take action to stem the damage. As a result, and relative to other asset classes, the cash market has staged a fairly brisk recovery. In the fourth quarter, spreads tightened and fund flows took a decidedly positive turn, with $356 billion in inflows. The rotation into government funds slowed, with 21.7% growth in government funds accompanied by 16.4% growth in prime funds as well.

Figure 1. Institutional Money Market Fund Assets Seen Normalizing



Source: iMoneyNet Weekly Assets. 3 June 2008 – 24 February 2009

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Government Programs in Support of Market Liquidity

Temporary Guarantee Program for Money Market Funds: Guarantees investor balances (value as of 19 September 2008) in certain 2a-7 funds for those funds that opted to participate.

Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF): Provides liquidity to 2a-7 money market funds by allowing them to sell eligible high-quality asset-backed commercial paper to banks and bank holding companies. Banks can borrow funds from the Federal Reserve Bank to finance these purchases.

Troubled Asset Relief Program (TARP): Conceived as a $700 billion vehicle to buy distressed securities from financial institutions; later revised to allow for capital infusion into the banking system via a Capital Repurchase Plan.

Temporary Liquidity Guarantee Program (TLGP): FDIC program guaranteeing certain senior unsecured debt of banks, thrifts, and certain holding companies. Also provides full coverage of non-interest-bearing bank deposits, regardless of amount, until the end of 2009.

Commercial Paper Funding Facility (CPFF): Provides a liquidity backstop to US issuers of commercial paper through a special purpose vehicle (SPV) that will purchase 90-day commercial paper directly from eligible issuers.

Money Market Investor Funding Facility (MMIFF): New York Fed's promise of up to $540 billion in funding to a series of special purpose vehicles established by the private sector to finance the purchase of CDs, bank notes, and commercial paper with maturities of 90 days or less from US money market funds.

Market Update

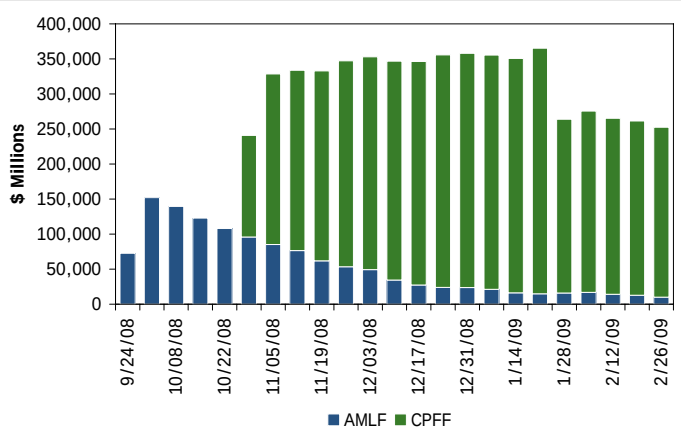
So far in 2009, liquidity continues to improve in the short-term markets and more limited use of the government programs provides evidence of broad-based market healing.

The spread between LIBOR and the one-month Overnight Index Swap (OIS) rate, a proxy for the expected federal funds rate, has tightened. As of 27 February 2009, the spread had narrowed 312 basis points from its high on 10 October 2008, and 125 bps since the end of November. The spread on 27 February was 26 bps, and the tightening trend offers signs of reduced risk and increasing liquidity in the marketplace. See Figure 2 below.

Utilization of the Commercial Paper Funding Facility (CPFF) has declined. During the week ended 25 February 2009, the CPFF purchased only $13.2 billion of commercial paper issued for 81 days or longer. (CPFF only purchases 90-day commercial paper.) By comparison, the program (which began on 27 October 2008) purchased $243 billion in its first eight days of operation. In the week ended 26 February, $243 billion was held in the facility, compared to $350 billion at the program's peak on 21 January 2009.

The Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) continues to shrink. The AMLF provides liquidity to 2a-7 money market funds by allowing them to sell eligible high-quality asset-backed commercial paper to banks and bank holding companies. In the week ended 26 February, $10 billion was held in the facility, compared to $49 billion at the end of November and $152 billion at the program's peak on 1 October 2008. Figure 3 illustrates the declining use of AMLF and CPFF.

Figure 3. Use of AMLF and CPFF Shrinks



Source: www.federalreserve.gov

Figure 2. Credit Spreads Narrow

OIS vs. LIBOR, Asset-Backed Commercial Paper and Eurodollar Deposits (One-Month Maturity)								
	OIS	LIBOR	Spread	ABCP	Spread	Eurodollar Deposits	Spread
10/10/2008	1.21%	4.59%	3.38%	4.44%	3.23%	6.00%	4.79%
28/11/2008	0.39%	1.90%	1.51%	2.00%	1.61%	2.75%	2.36%
27/2/2009	0.24%	0.50%	0.26%	0.56%	0.32%	0.80%	0.56%

Source: Bloomberg

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The Temporary Liquidity Guarantee Program (TLGP) has seen substantial issuance and some money market funds have been buying securities issued under this program. Most issuance, however, has been in longer-dated maturities that are beyond money market eligibility. Outstanding obligations under the TLGP bear the full faith and credit of the US government, and eligible issuers have benefited from this available funding source. Total term funding needs from TLGP issuers through 30 June 2009 will likely range from $350 billion to $675 billion. Estimated USD issuance in the sector exceeded $76 billion through 23 February 2009.

In recognition of the improved market liquidity, the SEC chose not to extend amortized cost "shadow pricing." In October, the SEC had allowed money market funds to price certain portfolio securities (those with less than 60 days to maturity) by reference to their amortized cost value rather than using market quotations. The program expired 12 January, and the SEC's decision not to extend it signals recognition of improved market conditions.

Meanwhile, AMLF, CPFF, and MMIFF have all been extended to 30 October 2009, as has the Term Securities Lending Facility (TSLF), which was introduced in March 2008. The Treasury's Temporary Guarantee Program for Money Market Funds (i.e., money market fund insurance) was extended through 30 April 2009. Notably, a rise in money market fund balances signals an increased investor confidence in the industry, since only investor balances as of 19 September 2008 are insured under the Treasury program. Overall, the money fund industry grew by 23%, or $462 billion, from 19 September 2008 to 27 February 2009, while assets in prime funds grew by $161 billion (17%).

While the eventual expiration date of government programs is not known, we expect that market participants will be given ample notification prior to termination. We expect that all programs will remain intact until it is clear that the markets are stable with minimal volatility.

Considerations for Cash Investors

Although the cash market has clearly taken a turn for the better, we would echo the sentiment of our November report and remind investors that cash investing is not a "no-risk" activity. With the economy in recession and financial market volatility expected to remain elevated, now is a good time to examine your approach to cash management to ensure it is meeting your needs and risk tolerance. At this time, investors have expressed a number of concerns:

Are short-term Treasury yields expected to remain at 0%?
On 16 December 2008, the Fed lowered its target overnight rate to an all-time low range of 0%-0.25%. We expect that range to hold for several months and, as such, short-term Treasury levels could remain at or near zero for some time. Even with a slightly positive yield, the real return on cash may be negative (given corporate Treasury expenses). Money funds may need to waive some portion of fees on Treasury funds to avoid delivering a negative net yield to shareholders.

How long can rates remain at these historic lows?
While a turnaround in rates is dependent on a number of factors — e.g., the government's stimulus package, budget deficits, Treasury supply, economic weakness/strength, and consumer confidence levels — current conditions support our view that low interest rates are likely to remain for a while and, consequently, a focus on capital preservation is warranted.

When rates do rise, what is the likelihood that they will rise sharply in a short period of time?
Many investors have expressed concerns about an abrupt rise in rates and how this would affect the underlying value of their cash investments. In our view, a sudden, sharp rise in rates is unlikely. We do not believe the Federal Reserve would be inclined to shock the system with unanticipated large upward moves in rates. Historically, these moves have been well telegraphed in advance and, for that reason, generally have been priced into the market prior to the actual rise. It is also worth noting that the maturity restrictions on 2a-7 registered money funds are designed to limit the effect that large swings in short-term interest rates would have on fund net asset values.

How do I measure the interest rate risk of my money market fund?
Traditionally, money market funds measure interest rate risk through average weighted maturity (AWM). The AWM calculates the average amount of time it would take for a portfolio to reset to market rates by aggregating this measurement across all individual securities held in the portfolio. The way in which AWM is achieved can vary from fund to fund — and can be critical to determining how individual funds react to changes in interest rates. Therefore, a change in the shape of the short-term yield curve or a shift in the curve (up or down) may have a significantly different effect on one fund versus another. We recommend that this question be part of the dialogue with your fund manager. It is important to understand a fund manager's approach to managing all elements of risk in stable value strategies.

What is BlackRock's cash management strategy in the current environment?
We continue to focus on the fundamentals of capital preservation and liquidity as the overarching objectives of risk-managed cash investing. We consistently apply rigorous credit and risk analysis in our approach. This focus has enabled us to weather the market tumult of these past 18 months, and remains unwavering today.

Notably, recent events have not inspired a reevaluation of our methods for managing this vital asset class; rather, they have reinforced our commitment to the approach we have employed for more than 30 years. The markets may change, as may our tactics or strategies, but our core values will not.

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