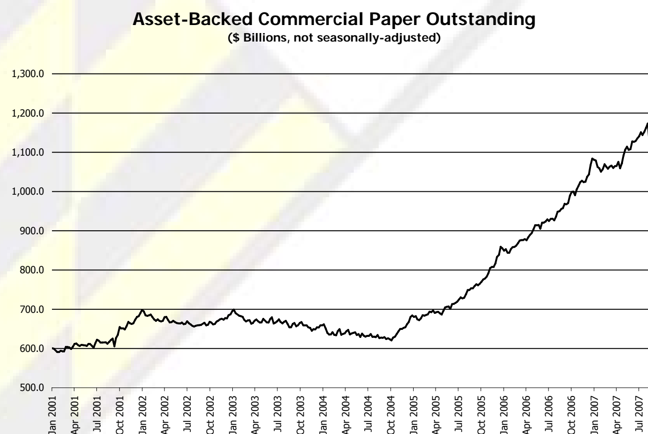
INVESTMENT COMMENT — August 21, 2007
A Crisis of Confidence in Money Markets

The media has widely-reported on many important market events since our August 6th **INVESTMENT COMMENT**. At that time we said "…this problem has now moved beyond the sub-prime mortgage market, with implications for the broader economy and financial markets". Since then, the Federal Reserve has intervened in the bank lending markets to calm fears and stem what the New York Times called "A New Kind of Bank Run"[1]. Is this just a catchy phrase to help newspaper circulation? No, it alludes to the fact that markets are experiencing fear and loss-of-confidence in leveraged finance vehicles that have, in large part, replaced our traditional bank lending system. As investors, we must appreciate these modern financial vehicles in order to properly understand portfolio risk and reward.

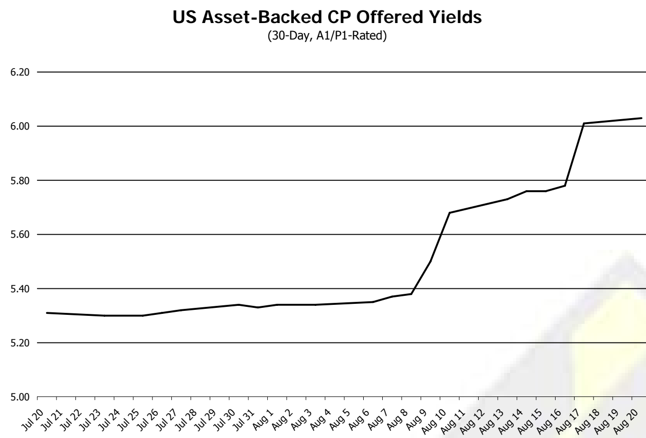
First, a few comments:

- ***Last week we instructed our custodial firms to change the money market election in client accounts to funds that invest only in short-term US Treasuries.***
- As we said in our August 6th **INVESTMENT COMMENT**, the Fed may lower interest rates "…but it is not likely unless a major financial institution is in peril."[2] ***Countrywide Financial (Symbol: CFC) became that financial institution and the Fed has begun a process of lowering rates and providing liquidity to the banking system.***
- The Fed's most-recent and most-significant action was Friday's lowering of the Discount Rate from 6 ¼% to 5 ¾%. This had an immediate positive impact on stocks, but ***the real story is not the stock market – it is the bond market***. Stocks are merely the "tail being wagged" by credit concerns with debt instruments.

In our August 6th INVESTMENT COMMENT we described how the sub-prime mortgage problem was linked to structured investment vehicles such as CDOs and CLOs. These entities and other financial companies fund their operations by issuing equity and debt. Their debt is a mix of long-term notes and a significant amount of short-term commercial paper (CP). ***The CP market is now the problem – and it is big.*** The primary cause for concern is CP issued by financial companies and the afore-mentioned structured investment vehicles – a segment called Asset-Backed Commercial Paper (ABSCP). How important is ABSCP to our financial system? Chart 1 shows outstanding issuance is over $1.1 Trillion. It is a huge market, largely owned as a cash substitute by corporations and money market funds. CP buyers began avoiding ABSCP last week – driving market yields much higher (Chart 2). Despite Friday's Fed action, former buyers of ABSCP have preferred the safety of US Treasury Bills. ***Issuers of ABSCP have been unable to sell their paper to replace their upcoming maturities of outstanding ABSCP.***



Maryland Capital Advisors Inc.
1A Chester Plaza ◊ Chester, Maryland 21619 ◊ (410) 604-2741



The fundamental problem in the structured products market is that buyers have traditionally trusted the due-diligence of major rating agencies, and that trust is damaged. Previous rating agency projections of delinquencies and defaults on sub-prime mortgages have shown their models are fallible. A loss of confidence in ratings has caused the current “flight to quality” in credit markets – investors are replacing credit risk in their portfolios with US Treasury bills, notes and bonds. ***Our client portfolios have had virtually no credit exposure since, as we have explained previously[3], the “safe” yield of US Treasuries out-weighed the diversity benefits of riskier bond classes that offered only slightly higher yields.***

When markets react to a fundamental problem by avoiding all credit risks, there can be significant strain on the financial system. The Fed clearly knows what it is doing and is working in an incremental fashion to resolve the issue, but how is it working so far? As of today, not so well. They are, essentially, providing the necessary liquidity to the banks to allow the system to replace the lost financing from ABSCP. The Fed knows that commercial banks have provided “insurance” (lines of credit) to commercial paper programs in the event they can not issue CP. In a 1998 research paper, Fed economists wrote:

> “Although the insurance that banks provide against "rollover risk" reduces the probability that a severe liquidity crunch could occur, the insurance also, however, transfers the liquidity risk from commercial paper issuers to the banking system. This guarantees that any potential liquidity crisis would be much more severe. It's this risk of a systemic shockwave that makes it necessary for the Fed to keep an eye on the commercial paper market…”[4]

The bottom-line is that the Fed is in the process of providing liquidity to stabilize the banking system, but it seems certain there will be more financial firms that fail in the coming weeks and months. The environment of the past several years, where investors were comfortable taking risks that offered too little yield is over. The current financial market “re-pricing” will give rise to reallocation and rebalancing opportunities. ***As passively-managed, asset-class diverse investors we have no concentrated risks that may force us to sell at lower prices. Rather, we continue to measure risk allocations and rebalance where prudent.***

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[1] “A New Kind of Bank Run Tests Old Safeguards”, New York Times, August 10, 1997
[2] “Update on our Passive, Asset Class Balanced Strategy”, www.marylandcapitaladvisors.com
[3] See, for example, “2006 Fourth Quarter Asset Class Report”, www.marylandcapitaladvisors.com
[4] “The Commercial Paper Market: Who's Minding The Shop?”, Stojanovic and Vaughan, Federal Reserve Bank of St. Louis, 1998

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