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Short-Term Fixed Income Research Note

- **The Fed's ABCP facility will provide much needed liquidity to the money markets**
- **With ABCP becoming more liquid than unsecured money market product, look for yields to contract relative to certificates of deposit and discount notes**

Fed support should rally ABCP yields

With opening day for the Fed's ABCP Money Market Mutual Fund Liquidity Facility (AMLF) behind us, it is clear that this program should bolster liquidity for money funds in the short-term markets. The facility is a unique way to allow Rule 2a7 registered prime money funds to access the discount window via the banks.

The purpose of this facility is to provide liquidity for money funds faced with redemption pressures from investors. **The AMLF allows banks to purchase qualifying ABCP from the funds and then finance that ABCP at the primary credit rate (currently 2.25%) via maturity-matched non-recourse loans with no valuation haircut¹.** Over the past week, prime money funds experienced outflows of \$352 billion with just less than half of this sum reallocated to government funds. The rest is presumably residing in time deposits or other securities, waiting on the sideline while investors comb through fund holdings, ensuring they are comfortable with the securities therein.

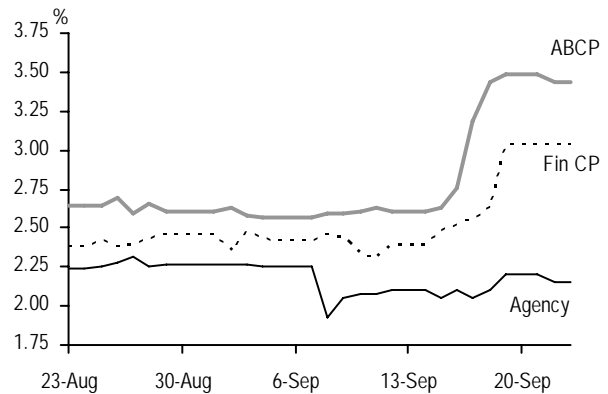
The Fed's extension of its balance sheet via a non-recourse loan to banks to purchase ABCP is evidence that the underlying problem is not about credit, but rather liquidity, the ability for money fund managers to sell a security back into the market and repay redeeming investors.

Whether or not the ABCP is actually sold to a bank, the AMLF creates market liquidity because of the ability given to money fund managers to immediately liquidate ABCP. Money market funds currently hold nearly \$290bn of ABCP, a substantial percentage of which is

¹ For full details on the AMLF, see the Federal Reserve FAQ sheet www.frbdiscountwindow.org/mmmf.cfm.

Chart 1: With Fed-enhanced liquidity, ABCP provides excellent value vs comparable money market securities

Yields on 30-day tier 1 ABCP, Unsecured financial CP, and agency discount notes



Source: Federal Reserve, Bloomberg

eligible for this facility. For this reason new issue ABCP should begin to price at a premium to other credit sensitive assets since ABCP liquidity for qualifying programs is effectively backstopped by the Fed. ABCP yields should now be less than yields on unsecured bank paper. Relative to other money market credit instruments, yield-seeking investors should, over time, gravitate toward other assets, such as bank deposits. We would look for the gap between ABCP and discount notes to contract, without actually converging since discos enjoy a much broader investor base. **This ABCP facility should, for the time this program stays in place, provide greater liquidity to the banking system, making it easier for banks to refinance much of the debt they have maturing in the coming months.** As with the TSLF, PDCF, and TAF, this facility also expires on January 30, 2009.

Investors should buy ABCP. Quarter-end pressure and recovery from last week's redemptions are likely to keep ABCP yields high through next week but then they should tighten in. This provides an opportunity for investors to purchase arguably the most liquid money market security at yields of 130bp higher than agency discount notes, the other Fed backstopped security.

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