The Bond Buyer of Last Resort

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So much money, so little to show for it! Has that thought run through your mind over these last two Stephen King-like months? After all, the Fed and the Treasury have announced roughly 20 different programs with well over $1 trillion committed to various liquidity facilities. And yet the financial markets continue to stagger notwithstanding the occasional bear market rally.

The reason for this is likely that, for the most part, the government has been busy treating the symptoms of the illness rather than the disease itself. It's abundantly clear that the root cause of this cataclysm we've gone through has been falling asset prices.
First it was housing, rapidly followed by mortgage debt, but now almost every investment category—save treasury bonds—has fallen prey to the devastation.

Particularly damaging has been the surge in corporate bond yields which, of course, means their prices are plunging. Incredibly, interest rates on the debt of leading companies are now trading at spreads over treasuries not seen since the darkest days of the Great Depression. This is especially harmful because it dramatically raises the cost of capital for corporate America.

A yield spike such as we've seen in the last two months also places enormous pressure on financial institutions that are now being damaged by the segment of their investment portfolio they believed was largely bullet-proof. Instead they are finding it to be bullet-riddled, causing the formerly complacent, but now trigger-happy, rating agencies to threaten downgrades based on these extraordinary price declines. As ratings are cut, even more forced selling occurs, driving prices yet lower, which causes further involuntary liquidation--in other words, the classic self-perpetuating downward spiral.

There is no doubt the situation is exceedingly precarious, but it is definitely not hopeless. In fact, it could be rapidly reversed by one simple but dramatic measure: aggressive open market purchase of high grade corporate debt by the Fed. Their goal would be to both accelerate the normalization of credit spreads and earn a profit for taxpayers. It is likely this can have an immediate and highly positive impact on yield levels.

The Fed recently showed that they are willing to act in a bold and innovative way by directly acquiring commercial paper from corporations. In doing so they avoided a disastrous liquidity crisis. Now they need to move further out the maturity scale (i.e., yield curve) in order to bring credit spreads back down. This is likely to have a dramatically beneficial impact on all financial markets as well as on the real economy.

The best part about this concept is that it's relatively easy to do, it would make substantial profits for the government, and it would actually serve to slightly reduce overall outstanding debt (because most of the corporate bond universe is trading at discounts from face value). The math is straightforward: The government can borrow in the short-term debt markets at rates around 2%. They can then invest in high-grade corporate bonds that return 9% and, in many cases, over 10% (note: the Fed's charter needs to be altered to let them buy corporate debt with maturities longer than 180 days). This exceedingly wide spread between the government's cost of capital and corporate bond yields would produce immediate and substantial profits for taxpayers.

Additionally, they would almost certainly realize significant capital gains as bond prices return to levels associated with low inflation and a recessionary economy. This appreciation could be as much as 40% based on the current exceedingly depressed state of the corporate bond market.

This is one of those rare times when the federal government can enjoy a high rate of return while simultaneously producing an extraordinary societal benefit. Most of us, myself included, would prefer that the capital markets be allowed to function free of government intervention. However, past history also teaches us that there are times when the financial markets become dysfunctional. While they always right themselves, periods of extreme price declines can have horrific economic considerations as we are vividly seeing today.

Capitalism is the best economic system ever devised but as Pimco's legendary Bill Gross points out it has a huge flaw: it is inherently unstable. As he concisely put it recently: "It is during these periods of potential bankruptcy and accelerating instability…that capitalism becomes particularly vulnerable. Confidence is replaced by fear."

We are clearly at the stage of this credit calamity where fear is in the driver's seat. It needs to be unceremoniously thrown out of the car through the financial market equivalent of shock and awe: an overwhelming display of power by a buyer with unlimited resources. Once such force is displayed, confidence in the bond market will return and the vast sums of money, currently being hoarded by shell-shocked investors in low-yielding money funds, will be emboldened to begin buying debt securities again from our finest corporations.

For those of you like me with either some gray or missing hair, you probably remember the old Fram oil filter commercials: pay me now or pay me later. That's pretty much the situation we've got with interest rates right now; if they stay as elevated as they are currently, an increasing number of crucial companies will encounter extreme distress and/or bankruptcy. This will cost the government (i.e., you and me) massive amounts of money through direct bail-outs, lost tax revenue, and enormous unemployment benefits.

Let's encourage those in positions of authority, especially the new Treasury team now being assembled, to seriously consider a solution to this crisis that cuts right to the heart of the problem—imploding bond and mortgage prices causing disastrously high interest rates. The fact that the Fed and the Treasury can also produce a windfall for taxpayers makes this remedy even more compelling. One thing we all know for sure—the government's going to need every dollar it can lay its hands on.