“Stop the World—I Want to Get Off” isn’t just the name of a Broadway musical. It can also be used as a refrain for what portfolio managers have had to endure since the fourth quarter of 2008. And that includes the most conservative of community bankers, as no part of the yield curve or derivatives thereof (for example, agency debt, mortgage markets, municipal issues) have been immune to the volatility.

If you’re looking for a culprit, however, you may want to begin at the schizophrenic behavior of the figurative “parents” of the credit markets: the U.S. Treasury and the Federal Reserve. They have been both kind and harsh. They have acted and spoken in support of debt instruments and have alternatively acted and spoken to hammer them. Sometimes they have done both at the same time.

The Week that Was
The second week of September 2008 is a good place to start. In a three-day period, it was announced that Lehman Brothers would be allowed to disappear, Merrill Lynch would be purchased by Bank of America, AIG would receive a massive liquidity injection, and the Fed and the Treasury both offered tangible support to the money markets in the wake of the Primary Reserve Fund breaking the buck.

Investors in Treasury securities, which include very few community banks, saw yields whipsaw as never before. The two-year Treasury note fell in yield on Sept. 15 alone by 42 basis points in flight-to-quality trading, but closed on Sept. 19 with just a 2/32nds (0.0625 percent) increase in price for the week. The volatility in longer maturities was even greater.

What is more relevant to portfolio managers is spreads on GSE debt securities. For the week being discussed, two-year bullet (that is, non-callable) spreads initially widened by about 23 basis points, but narrowed to about nine by Friday, Sept. 19.

The Peak of the Wides
Yield differentials between Treasuries and all other debt, which is to say spreads, have not returned to their pre-September levels. Yield spreads reached their widest, though, on Nov. 20, as the stock markets globally melted down. That day, the Dow Jones Industrial average lost 445 points and all financials were battered.

Investors fled everything for the safe haven of Treasuries, and even our two-year bullet issue widened out to a spread of 191 basis points. For reference, its six-year average is only 35 basis points. Simple mortgage-backed securities did the same, as 15-year agency MBS were available at 311 basis points over the curve, compared with its longer-term norm of about 128.

The parents, the Treasury and the Fed, actually
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