A Challenging First Quarter Ended with Optimism and Growth

The first quarter began with a declining global economy and sustained government interventions to achieve quantitative easing, and ended with moderate equity recovery. Central banks in Canada, Europe, Australia and Asia lowered interest rates aggressively in an effort to stimulate growth. The United States enacted multiple policy initiatives to increase liquidity and strengthen the economy, including the Public-Private Investment Program, the commitment to purchase up to 1.75 trillion of agency mortgage backed securities, agency debentures and Treasuries, and a $789 billion fiscal stimulus package. The United Kingdom embarked on quantitative easing programs; Japan and Korea announced multibillion-dollar jobs packages; and China enacted its own fiscal stimulus measures. The G-20 Summit also pledged $1 trillion in emergency aid to prevent a further financial meltdown. These efforts, combined with positive United States housing data and several major banks announcing that early 2009 profits were exceeding expectations helped equity markets recover off of multiple-year lows during the last few weeks of March. As the quarter ended, global growth was still declining, but its rate of descent moderated. Directional and dividend trading in the U.S. and Asia Pacific, and capital raising in Europe supported favorable equity lending opportunities, while fixed income general collateral met mixed demand.

Portfolio strategy remained focused on liquidity as the foremost concern within each individual account, with fixed rate investments out to 95 days delivering incremental alpha for clients.

“Back to Basics” for Owners and Agents

The volatility of the first quarter reemphasized strong risk management principles for all participants in the market, leading to a “back to basics” approach to identify, understand and manage risk. The industry’s “back to basics” approach has distilled the key value of securities lending agents, prioritizing liquidity, capital preservation, transparency and customization. Securities collateral management and cash collateral investment across the industry returned to more conservative standards, whereby high-rated, liquid securities are preferred and we continue to actively work with our clients to define cash and securities collateral guidelines for each account to reflect every owner’s unique portfolio strategy. We continue to strive to help all clients optimize portfolio returns within the construct of individual risk preferences and constraints and to provide transparent reporting that facilitates our clients’ management of their accounts. Indemnification against borrower default and an agent’s ability to honor its indemnity have been tested and proven effective. The stronger the capital base of an agent, the more confident clients can be of their indemnification protection. Global trading and distribution around the world continue to offer important revenue opportunities, and throughout 2009 we will continue to expand our global reach by launching operations in new markets that provide the appropriate risk and reward. Throughout a difficult quarter and into hopefully less challenging market conditions for the remainder of 2009, we plan to remain focused on the fundamental strength of our business – expertise, superior client service and the pursuit of incremental alpha for our clients in return for the appropriate risk.
J.P. Morgan saw significant liquidity return in the money markets in the first quarter as investors sought short-term opportunities against an extremely steep yield curve. The overnight target rate versus three month LIBOR remained above 75 basis points at quarter end. Activity steadily increased with counterparties reporting strong daily volumes.

J.P. Morgan’s investment desk remains focused on fixed rate investing out to 95 days. Floating rate investments targeted U.S. Agency issuance, FDIC guaranteed names and other government guaranteed issues with maturities out to 2 years. The preferred index remained three month LIBOR. The portfolio strategy remained focused on liquidity as the foremost concern within each individual account. The secondary market remains dislocated making it difficult to create liquidity. The desk maintained overnight liquidity in the 2 to 30 day maturity range as well. The 95 day investment strategy allowed J.P. Morgan to build liquidity following year-end by focusing purchases in the 1 month sector and then expanding purchasing to 2 and 3 month investments.

Accounts that incorporated only overnight to 30 day investments were challenged to find lending opportunities. The increased liquidity in the market kept investment levels relatively flat from overnight to 30 days. Accounts weighted toward the shortest duration investments were more dependent upon the intrinsic value of their underlying portfolios for lending opportunities. This is important because as the Treasury continues with increased issuance creating an environment where intrinsic value remains difficult to find.

Looking forward the desk expects continued improvement in the market environment. The program will see considerable maturities of pre credit crisis investments in the first quarter. These maturities will allow the continued building of liquidity while also providing the opportunity to invest in the market out to 95 days. J.P. Morgan looks forward to continued conversations around our program-wide investment strategy as well as opportunities that are available for your account specific needs.
From the Lending Desks: Equities

Market Recap

After a brief start-of-year rally, equity markets were soon in negative territory again, before ending the quarter with moderately increased investor optimism. Equity markets fell 15 to 25%, reaching their lowest levels of the crisis in early March, on the back of dividend cuts and concerns about financial companies. Toward quarter-end, economic data suggesting that the pace of the economic decline had started to ease, positive news regarding early-year revenues from financial companies, and optimism after the G-20 summit cumulatively helped spur a strong rally in the market. However, speculation that the rally was driven by short-term traders rather than by long-term investors suggested that investor sentiment had not substantially improved. At quarter end, equity prices remained down by 40 to 45% versus one year ago.

The regulatory environment continued to be challenging, with an ongoing focus on short-selling. Although we had hoped the short-sale bans would largely expire by the end of the first quarter, several countries, as detailed below, continued to restrict naked and covered short-sells. When the bans are lifted, we expect heightened oversight and new regulations. Several reviews of short selling are either in progress or have reported initial findings, and the International Organisation of Securities Commissions, a forum for regulators, proposed common principles to help create a globally consistent approach to short selling.

Hedge fund performance generally improved, redemptions declined, and some investors increased their exposure to the sector. Trading activity amongst the funds also moderately increased, although remained at historical lows. Because hedge funds were long cash (i.e., not fully invested), borrowers continued to prefer cash collateral, reflecting a complete reversal from quarter three and four 2008, when noncash was preferred.

Europe, Middle East and Africa

Active first quarter deal activity throughout Europe and particularly in the U.K. emphasized capital-raising as companies sought to shore up their balance sheets. Rights issues by companies such as HSBC Holdings Plc of the United Kingdom, SEB AB and Nordea Bank AB of Sweden, Compagnie de Saint-Gobain of France and by the U.K. REIT sector offered significant discounts to market prices, leading to arbitrage and directional trades. Although M&A activity in the U.K. was at its lowest since 2004, at roughly half of its 2008 level, arbitrage opportunities created by takeovers generated further borrowing demand. The U.K. government bailout of RBS Group and Lloyds Banking Group did not generate increased lending to those companies; instead, investor demand focused on Barclays and HSBC. Deutsche Bank AG became the most heavily shorted stock in Europe when it announced a fourth quarter loss. Commerzbank AG came in second place, with heavy losses in its Dresdner unit, acquired in January. Other financials in demand included Banco Popular Espanol and Banco De Sabadell of Spain, and SEB AB of Sweden, off the back of its rights issue. Outside of financials, Actividades de Construcción y Servicios SA of Spain, EADS of France and Volvo AB of Sweden all generated high revenue from trading activities.
The European dividend season brought lower or cancelled dividend payments, with overall revenue lower than 2008. Markets traded include Finland, Sweden and Switzerland, along with some early-paying German stocks.

Several countries continued to restrict the short-selling of financial companies, banning naked short sales in Austria, Belgium, France and Germany, and covered and naked short sales in Italy and Netherlands. Switzerland and the United Kingdom both lifted their restrictions.

Western Hemisphere

U.S. equity activity focused on directional trading of financial and auto stocks, with deal activity almost nonexistent. Sentiment swung between positive and negative, depending on the latest news, as government bailout plans were announced and analyzed by the market. Citigroup Inc became J.P. Morgan’s highest earning security in March as the U.S. Government announced its intention to convert its holding in the company from preferred to common stock. Ford Motor Co traded special the entire quarter with revenue spiking in March, as the deadline for its debt for equity swap approached. Levels dropped rapidly once the swap was completed and additional shares hit the street. General Motors Corp traded at very high fees the entire quarter, as the possibility of a structured bankruptcy increased. Other high-earning securities included M&T Bank Corp, Sears Holdings Corp, Factset Research Systems and Wynn Resorts Ltd. General collateral balances remained under pressure as agent lenders competed for cash to fund investments. General collateral continued to trade at or above the Federal Funds Open rate, compared to a spread below the rate during normal market conditions. Outside of the U.S., Wal-Mart de México was a directional trade, earning good revenue throughout the quarter.

As with equities, American Depositary Receipt trading focused on directional demand, especially in the Far East and in the alternative energy and entertainment sectors. Highest-earning securities included LDK Solar, Suntech Power, Yingli Green, Shanda Interactive and Melco Crown Entertainment. Yield enhancement activity resembled that of other international markets, with good demand from borrowers, but revenue significantly impacted by lower dividend payments.

Asia Pacific

Directional and dividend trading in pockets of Asia Pacific generated favorable lending activities, although continued short selling restrictions in Australia and South Korea weakened regional demand. First quarter saw strong demand for dividend trades, with borrowers trading the arbitrage created by the stock discount on dividend reinvestment plans. CapitaMall Trust of Singapore announced a rights issue leading to strong borrowing demand. In Japan, balances increased due to the end of March dividend record date, as borrowers swapped domestic loans into low-dividend offshore stock (i.e., reducing dividend cost of their shorts). On the specials side, high revenue earners included Resona Holdings, Mitsubishi Motor Corp and Mizuho Financial for convertible arbitrage and directional trades. Hong Kong was our most active market with directional trading in the sectors hit by the recession and credit crunch. Top earning securities included Industrial & Commercial bank of China Ltd, China Construction Bank Corp, China National Building Material Co and Alibaba.com Ltd.

Proposals to restrict fails pose longer term challenge, if implemented. Singapore announced a proposal to buy in failing trades on settlement date, effectively giving an investor only until noon to settle a transaction. If this proposal is adopted, it will make lending very difficult, with a very short timeline to settle a loan return and a client sale. South Korea also demonstrated concern over fails.
First quarter 2009 began with the Federal Funds Target rate at historical lows of 0.0% - 0.25% and market uncertainty where Treasuries would trade in a near-zero-rate environment. Negative rebate rates were expected since Treasury general collateral typically trades below the Fed Funds Rate; however, massive Treasury issuance caused funding pressure and, for the majority of the quarter, Fed Funds traded at the high end of the new target range (.25%). Ultimately, Treasury general collateral traded 3 to 6 basis points above the opening Fed Funds Rate.

Treasury issuance this quarter was extremely large, accommodated by an expanded auction schedule and reinforcing need for additional primary dealers. The monthly seven-year note returned to the Treasury auction schedule after a 16-year absence. (Last quarter, the monthly three-year note returned.) To meet its ever-increasing financing requirements, the Treasury also increased issuance size and/or frequency of regular weekly, monthly and cash management bills, and coupon security offerings. Meanwhile, the number of primary dealers decreased again to sixteen, as the Merrill Lynch/Bank of America merger was completed. With the continued contraction in primary dealers over the past year and an expected $2 trillion of additional debt issuance this year, the Federal Reserve Bank of New York continued talks with at least four firms (including MF Global, Nomura Securities, Jefferies & Co. and RBC Capital Markets) to expand the list of primary dealers.

Demand from borrowers became cyclical, demonstrating stringent month-end balance sheet and compliance requirements, with net borrower demand continuing to decline. Toward month-end, borrowers unwound positions and returned securities, putting pressure on lenders to compete for borrowers’ remaining balance sheet. Balance sheet restrictions also dampened borrower appetite for term trades longer than one month, leaving premiums for longer trades unsupported by borrower demand. Newly formed commercial banks, such as Morgan Stanley and Goldman Sachs, were subject to additional regulatory restrictions, with the net effect that borrower demand for collateral remained limited.

The expected $2 trillion of Treasury borrowing in 2009 motivated dealers to price balance sheet exposure even more conservatively, with first quarter term bids exceeding the overnight collateral rebate rate by 15 to 18 basis points. J.P. Morgan kept term balances at a minimum, and engaged only in short-dated trades to focus on liquidity management over critical month-end periods.

Agencies and mortgage-backed securities maintained a 5 basis points spread to each other for the majority of the first quarter. Increased margin requirements for borrowers resulted in higher capital charges, and consequently higher term lending rates. In an attempt to reduce mortgage costs, the Federal Reserve Bank continued purchasing Fannie Mae, Freddie Mac and Federal Home Loan Bank debt, although the financing market remained unchanged.

Corporate bond balances fell for the first two months of the year with continued borrower deleveraging, before balances leveled off in March. As financial and auto companies remained in the headlines, borrowers showed little appetite for risk or for general collateral of any sector. Given the lack of demand, traders focused on cleaning up failing trades, particularly hard-to-borrow issues. Specials generally traded

Highlights

- Treasury issuance spiked in first quarter 2009, with $2 trillion total issuance planned for year, facilitated by increased frequency and issuance size of U.S. auctions.
- Balance sheet restrictions and risk aversion limited appetite for U.S. general collateral, although high quality general collateral in international markets met relatively higher demand.
- Central banks were very active in international markets, taking multiple actions to achieve quantitative easing.
The lending markets generated strong demand for high-quality general collateral, with few opportunities to invest in specials. In emerging markets, lending opportunities remained limited to those clients with broader reinvestment guidelines, since most issues traded at or above the Fed Target range. Specifically, Russia and South Africa were the most actively traded markets. However, intrinsic value increased across the European corporate loan book with the majority of bonds trading upwards of 30 basis points (against an average over previous months of 15 basis points). European government bonds traded with little or negative value to overnight repo, but lending German, French or Dutch general collateral generated spread, particularly during the flight to quality following the news that Greece, Ireland, Portugal and Spain were having their credit ratings cut by one notch. Interest renewed for the term general collateral markets, with constant interest out to three months. The Gilt market also started the year with fewer specials than in 2008, as dealers pared down balance sheet usage. J.P. Morgan remained fully lent in most of the shorter maturities throughout the quarter, but returns gradually decreased versus noncash collateral. Clients who accept GBP cash collateral averaged 80 basis points throughout this period.

International Fixed Income

First quarter 2009 brought extensive central bank activity, with the U.K. taking multiple actions to facilitate quantitative easing. The Bank of England cut interest rates by 150 basis points to 0.50%, created a permanent “discount window,” at which lenders can exchange on demand a wider range of collateral for T-Bills, and followed the Fed’s example of buying commercial paper from the non-financial sector. The Chancellor also granted permission to commence quantitative easing via the purchase of Gilts and corporate bonds up to a total of £150 billion. The European Central Bank reduced its benchmark rate down to 1.5% and, in a bid to revive the interbank market, announced measures to widen the corridor between the rate of the marginal lending facility and the overnight deposit facility to 200 basis points (from 100 basis points previously), effective January 21.

From the Lending Desks : Fixed Income (cont’d)