

PUBLIC PRIVATE INVESTMENT PROGRAM

The U.S. government has explicitly stated its goal to kick start access to credit so as to set the stage for economic stabilization. This edition of the Marker reviews the latest U.S. policy aimed at countering economic weakness.

MORE ACRONYMS...

After TARP I and II (Troubled Asset Recovery Program), the Obama Administration recently announced a new program aimed at injecting credit (economic leverage) into the U.S. economy. The PPIP seeks to create leveraged capital for investors to agree to purchase assets described by the government - in an effort to avoid using the term toxic - as "legacy troubled assets". Using a share of the capital initially allocated to TARP, this program will fund the vast majority of private investors' cost of acquiring depreciated assets currently clogging up lenders' balance sheets, in the hope of getting lending markets open to new loans again. The highlights of the plan are outlined in the table on the right.

ASSESSING THE PROGRAM

A next round of initiatives was feverishly anticipated by investors. Several large investment managers have confirmed their intention to participate. These swift announcements were both a show of support - probably in part pre-orchestrated by the government - and the recognition of a good deal when it becomes available. The dissenters however place forward potent arguments, which we use here to gain a better understanding of the dynamics surrounding the application of the program. First, this plan isn't implemented by the authorities on an economic basis. As such, it will amount to a transfer of wealth from the general public to selling banks and astute private purchasers. Given that non-recourse, government-funded financing will cover over 80% of the purchase price buyers are in fact being sold an option on the recovery value of assets to be priced for distress. A large majority of losses will be assumed by the government (via TARP), while the gains will accrue mostly to private investors. Furthermore, legacy credit securities (CDO's, CMBS, etc.) should amount to the bulk of the assets sold and purchased under PPIP, as these have already been marked down in contrast to bank loans. Selling a bank loan on which interest is current would entail a large write-down for the seller and would wipe out more capital. It follows then that the banks with large in-house capital market activities will benefit the most. The prime beneficiaries should be Citigroup, Bank of America (Merrill Lynch), et al.

PREPARING FOR THE NEXT PHASE OF THE CYCLE?

One line of analysis worth pursuing is the fact that the government may be creating PPIP today to pave the way for a surge in bank takeovers by the FDIC. With the economic slowdown raging and commercial real estate markdowns still to come, authorities may be creating some dry powder to allow the FDIC to dispose of seized assets (average sale price on majority of such assets so far was approximately 37.5% of par¹), and thereby recycle its balance sheet for more bank failures.

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Dealing with problem assets starts with creating transparency on the nature and quantity of such assets, in order to achieve price discovery. Only once these two steps have been taken care of can supply and demand meet at a clearing price. Authorities may be preparing for the next round of bank seizures and resulting need to clear assets through the financial system. PPIP is unlikely to be the single answer to current credit issues in the U.S. It may however prove to be a useful additional tool in the coming months.

Michael Quigley, CFA, CAIA
Senior vice president, Distribution

Three Basic Principles of the Public-Private Investment Program for Legacy Assets

- 1. Maximizing the Impact of Each Taxpayer Dollar**
By using government financing in partnership with the FDIC and Federal Reserve and co-investment with private sector investors, substantial purchasing power will be created, making the most of taxpayer resources.
- 2. Shared Risk and Profits With Private Sector Participants**
The Public-Private Investment Program ensures that private sector participants invest alongside the taxpayer, with the private sector investors standing to lose their entire investment in a downside scenario and the taxpayer sharing in profitable returns.
- 3. Private Sector Price Discovery**
To reduce the likelihood that the government will overpay for these assets, private sector investors competing with one another will establish the price of the loans and securities purchased under the program.

Source : Treasury Department, press release <http://treas.gov/press/releases/ta65.htm>

FINANCIAL MARKETS

RETURNS AS AT APRIL 9, 2009 (%)	MTD	QTD	YTD	RATES AS AT APRIL 9, 2009	
S&P/TSX	5.48	5.48	3.37	CAD/USD	1.23
S&P 500	4.39	4.39	-3.77	CAD/Euro	1.62
S&P/TSX Small Cap	3.46	3.46	-0.35	US Treasuries yield 10-yr/30-yr	2.92/3.76
Russell 2000	7.62	7.62	-5.18	GOC bond yield 10-yr/30-yr	2.94/3.65
MSCI EAFE	3.77	3.77	-8.98	Fed Fund Rate (target)	0.25
MSCI World	4.29	4.29	-6.39		
DEX Universe Bond	-0.34	-0.34	1.18		

Note: Returns in Canadian dollars, London 4h exchange rates. Source: Datastream, PC Bond, MSCI-Barra, and Bloomberg. PC-Bond, a business unit of TSX Inc. Copyright © TSX Inc. All rights reserved.

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¹ Ex.: Bridgewater Asset Management - Daily Observations