

Boldly Going Where No Governor Has Gone Before¹

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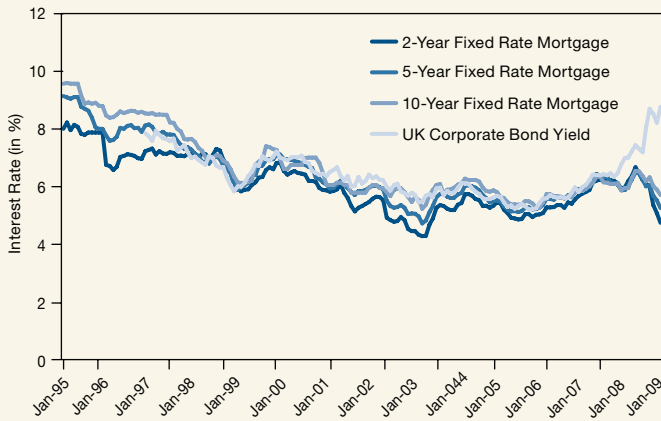
We are truly in uncharted territory. The Bank of England's main policy rate sits at 0.5%. This is a new low in its 315-year history, having been cut by 4.5 percentage points in the last six months. Meanwhile, the Bank has embarked on a new programme to further support the corporate bond markets, alongside the recent announcement to commit to buy £75bn predominantly in UK government bonds over the next three months. Suffice it to say that the Bank, under Governor Mervyn King, has indeed boldly gone where no Governor has gone before. Is it working already? Will it work if given time, or does the Bank need to do even more?

Aggressive Within Limits

First off, we should applaud the efforts of the Bank to stem the downward slide of the UK economy. With the benefit of hindsight we can all say that more should have been done earlier. But to be fair, the Bank set out its reasons for initial caution, and once those fears dissipated it acted with impressive decisiveness. However, there is one area where the Bank has yet to win its colours, and if it doesn't, our road to recovery will be a significantly longer one. To date the Bank has been aggressive but it has been aggressive largely within its comfort zone. The time has come to move decisively beyond that comfort zone.

So far the Bank has been active in three areas – it has cut rates, it has bought gilts and it has committed to buy corporates. We are already seeing some signs of success in the mortgage market, where rates have already come down significantly. This is excellent news for hard-pressed homeowners, and hopefully in due course for first time buyers (if the banks can lend them the money...). However, other parts of the private sector are not seeing borrowing rates drop. Indeed, as Chart 1 shows, the corporate bond market still sees rates rising, despite all the measures we have highlighted. How can this be? Can the Bank be on the hook for corporate rates? Should it try to lower them?

UK Private Sector Interest Rates



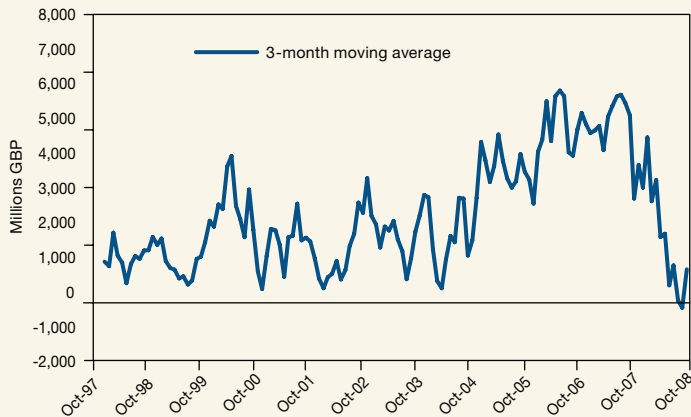
Source: Bank of England, Merrill Lynch, as of end of February 2009

Chart 1

A Plan with a Hitch

The corporate bond market comprises a number of different constituents, not only industrials, retailers and utilities, but also financials (banks and insurance companies in particular). With corporate rates so high it is clear that finance to the corporate sector is in very short supply indeed, as Chart 2 shows.

Bank Lending to Private Non-Financial Sector Companies



Source: Bank of England, as of end of February 2009

Chart 2

It was to tackle precisely this problem that the UK Chancellor announced the creation of a £50bn Asset Purchase Facility: If corporate rates came down alongside mortgage rates and the commercial banks were able to resume lending, economic growth could stabilise and the economy could start to look to the future with optimism. That's the plan.

Tackling the Wrong End

The Asset Purchase Facility is already up and running, and indeed the Bank has started to commit these funds to the corporate market by buying commercial paper with up to three months' maturity. Whilst this is laudable, it is not the same as lowering long-term corporate bond yields. After all, commercial paper matures after three months, and what corporates need now is not short-term liquidity but stable long-term financing. Companies need to be able to borrow for years, not months. So how can yields for long-term borrowing be lowered? Answer: get the Asset Purchase Facility to buy corporate bonds.

To date the Bank has set out preliminary guidance on how they will select appropriate corporates to be purchased by the Asset Purchase Facility. Eligible bonds must be of investment grade quality and senior bonds (i.e., the Facility will not buy bonds that are subordinated to other creditors in the event of default). The plan seems pretty sensible – buy the safest ones, and if rates come down on the safest ones, other investors will be forced to buy slightly riskier ones. Then rates on those slightly riskier ones come down and so a virtuous circle is created. While it sounds perfectly sensible, it

doesn't address the root cause of the problem in the corporate market: lack of confidence.

What sort of signal does it send if the Bank, with explicit credit support from Her Majesty's Treasury, is only willing to buy the safest possible assets? In a world where nobody has the confidence to lend to anyone else, try to look at it from an investor's perspective. If all the Bank is willing to buy are the safest of bonds when it can pass on any losses to HM Treasury, why should an investor who doesn't have HM Treasury's safety net join in the virtuous circle?

Moving Beyond the Comfort Zone

Having gone so far down the road of unconventional policy tools, it is now incumbent upon the Bank to take the next crucial step.

To add confidence to the financial system, the Bank should address the areas of the market where the greatest uncertainty exists – senior and subordinated bank bonds. To date, the government has injected £37bn of equity into the UK banks, provided a £250bn government-guaranteed bond programme, insured £302bn of assets in Royal Bank of Scotland and £250bn of assets on the Lloyds balance sheet. Meanwhile, the Bank of England has lent these same banks £185bn secured against those banks' assets. All of this is to restore the capital and liquidity positions of the major UK banks. And these are big numbers.

All of the major commercial banks also raise money in the bond markets. They issue at the senior level (where bonds rank alongside

our personal bank deposits) and they issue bonds subordinate to those senior bonds. Yet despite the Treasury (and the Bank of England) committing hundreds of billions of pounds to UK commercial banks by injecting equity, the Asset Purchase Facility does not buy these banks' bonds. The message the bond market investor hears, if the Bank of England is not willing to buy the government-supported banks' bonds as well, is a very negative one that could undermine market confidence further and erode the benefits of the government (equity) support provided to major commercial banks.

Whatever It Takes

Having won so many plaudits for its recent responses to the crisis, the Bank of England shouldn't balk at adding to the government's position on the UK commercial banks. With monetary and fiscal policy becoming ever more closely entwined, adding UK bank debt to the corporate bond buying programme would be another laudable step in the development of the UK policy response to the crisis. To date the policy response of both the Bank and the UK government has been clear and coherent. Maintaining that coherence would be most powerful should the Bank of England buy the bonds issued by the UK commercial banks, at both the senior and subordinate level. The message of support for the UK banking industry could not be clearer. Given that the UK banks have lent £1,000bn directly to UK corporates there is no better way of supporting the UK corporate industry than supporting the

UK banking industry. Such a move would not only strengthen confidence in the banks but it would also bring longer-term rates for UK bank bonds down, allowing banks to obtain cheaper financing in the market. As a result, we might see fewer headlines about further weakness in the UK banking industry, and who knows, the

combined action might even start to restore some confidence into the financial system as a whole. This could even bring some light to the end of the 'economic' tunnel.

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