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## EXTRA CREDIT: Fed Flailing At Ailing Credit Market

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NEW YORK (Dow Jones)--The hefty emergency rate cut by the Federal Reserve won't be enough to stave off the problems that currently ail the corporate credit market - a marked reluctance to lend.

While last year's manifestation of the credit crunch saw banks turn skittish about lending to each other, now concerns have shifted to the broader economy. Lenders - not just banks but also investors - have become reluctant to take on risk, drawing their purse strings tight and sending the economy into a downturn. When that happens, there's very little the Fed can do to keep the credit machine going.

"There's a difference between the willingness to lend and the ability to lend," said Dominick DeAlto, senior portfolio manager at Robeco Weiss Peck & Greer in New York.

Whether official rates are at 3.0% or at 2.0%, the credit market's fundamental problems remain in place. "The issues are credit and who holds what in their portfolio," said Scott MacDonald, director of research at Aladdin Capital Management in Stamford, Conn.

Still, high-grade corporate credit got a boost from the Fed's move, with the benchmark investment-grade CDX index, the Markit CDX IG9, quoted at 117 basis points, after bouncing around in the 125 basis point range earlier in the day, according to market participants.

This highly liquid index, which allows investors to bet on the creditworthiness of a basket of issuers, is the corporate credit market's bellwether index. It has seen a dramatic widening in recent sessions amid tumbling stock prices and widespread losses at financial institutions.

"Everyone is hoping to get a reprieve from the Fed, but the fact that the Fed has come in and cut rates like this is incredibly bearish," said Anders J. Maxwell, managing director at P.J. Solomon in New York.

Fueled by structured finance products like collateralized debt obligations, collateralized loan obligations and structured investment vehicles, the credit markets saw a surge in aggressive, cheap lending. This system began to unravel as the housing boom in the U.S. collapsed and securities backed by subprime loans began to default. Banks holding these securities were then forced to either liquidate them or bring them back onto their balance sheets.

"Over the last 10 years we have created a shadow banking system on which the credit markets have come to depend. Now this system is collapsing on itself and little the Fed does will change this overdue restructuring," Maxwell said.

Chicken Wire And Bubble Gum

As the structured finance markets undergo the painful restructuring process, issuance has dropped like a stone. U.S.

issuance of CDOs dropped to a paltry \$16 billion, an 85% decline in the fourth quarter of 2007 compared with the same period in 2006, according to data provider Dealogic.

Mortgage-backed bonds suffered a similar decline. Issuance fell 76% in the same quarter compared to 2006, according to Standard & Poor's.

"A correction process has started and will continue. It will result in the further retraction of credit and will have an impact on economic development," Maxwell said. "It will happen regardless of the Fed jamming down rates."

For sure, central bankers are well aware of the problems. In the statement accompanying Tuesday's three-quarter percentage point cut, the Fed noted that, while "strains in short-term funding markets have eased somewhat, broader financial market conditions have continued to deteriorate and credit has tightened further for some businesses and households."

But neither the cut in the funds rate - to 3.5%, its lowest since August 2005 - or the similar-sized cut in the discount rate - to 4.0% - is likely to provide much relief to cash-strapped borrowers.

"The Fed has been unable to foster a willingness to lend," said DeAlto.

Market participants warn that volatility will continue as long as investors remain risk-averse.

"The Fed may have put off the day of reckoning, but the credit markets are poised for a very significant downturn, having been held together by chicken wire and bubble gum right now," Maxwell said. "It's pre-ordained that market indexes are braced for further erosion."

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