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MACROCOSM

Will the GSE Rescue Work?

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The rescue is feasible, and should go a long way toward restoring confidence.

There is much that remains unknown about Sunday evening's announcements by the Treasury and by the Fed backstopping Fannie Mae and Freddie Mac. But one thing seems plain: the two GSEs that are so central to the financial and housing markets will not be allowed to fail or even to stop functioning. That has to be good news for markets that last week had to discount some substantial possibility of a very bad systemic breakdown. The immediate market reaction overnight has been positive. But it has not been spectacularly so, perhaps because markets also are having to absorb the risk implications of the failure of IndyMac announced by FDIC Friday afternoon. And, significantly, the Treasury's GSE initiative has still to be enacted into law by Congress, and so little is known about how it would actually be carried out -- especially as it impacts existing Fannie and Freddie shareholders. We don't see how those shareholders can avoid enduring a great deal of dilution, at the very least. But we are hopeful that the government's now fully evident commitment to staving off systemic collapse will catalyze a restoration of confidence, and that stocks -- now deeply oversold, we believe -- could experience a meaningful recovery here. Pending more information, here are some of our immediate thoughts.

TREASURY'S GSE RESCUE IS FEASIBLE AND AFFORDABLE While no one knows yet just how, when and on what terms the Treasury would potentially acquire equity stakes in Fannie or Freddie, as a general matter we think that the two GSEs can be stabilized with fairly modest capital injections.

Update to strategic view

US MACRO: The Treasury's and the Fed's plan to rescue the GSEs should work, as the scope of the problem is much smaller than last week's panic seemed to indicate. There may be a devil in the details, especially for existing GSE shareholders. But we expect the GSEs will continue to operate and carry out their missions for the mortgage markets without significant impairment or shock.

US STOCKS: Deeply oversold stocks should react well to the government's commitment to prevent systemic failure, as details of the rescue become understood this week.

US FINANCIAL STOCKS: Fannie and Freddie shareholders will probably have to endure great dilution, at least, as the Treasury steps in as equity-holder. But the GSE rescue could catalyze a nice bounce in the distressed financial sector. We caution against treating it as anything more than a trading move -- this is a broken sector.

US RESOURCE STOCKS, GOLD, OIL, COMMODITIES, US DOLLAR: If the GSE rescue can restore confidence, perhaps the Fed will find the scope to begin moving rates back toward equilibrium levels. If not, we remain on the verge of calling for a worst-case inflation scenario and another leg up for commodities and resource stocks, and down for the dollar.

[see Investment Strategy Dashboard]

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We've seen repeatedly in the press the scare story that this would have to be a "$5 trillion bailout" which would "double the national debt." We believe that is patently absurd, as it relies on the idea that the federal government would buy up and hold all the outstanding mortgage-backed securities issued by Fannie and Freddie -- rather than simply bolster the GSEs' equity, which is in fact what the rescue entails. Just how much of a capital commitment might the Treasury have to make? We think the answer is surprisingly small. *(Note: some of the totals below are off due to rounding.)*

- The two GSEs currently have $81 billion in regulatory core capital ($43 billion for Fannie $38 billion for Freddie).
- By our quick-and-dirty estimate, if every subprime and Alt-A mortgage held or guaranteed by both GSEs *currently in default* were to yield no recovery whatsoever, the loss would be $42 billion ($21 billion for Fannie, $22 billion for Freddie).
- Then if every subprime and Alt-A mortgage held or guaranteed by both GSEs *currently 60+ days delinquent* were to default, and then were to yield no recovery whatsoever, the additional loss would be another $53 billion ($25 billion for Fannie and $27 billion for Freddie).
- Thus the worst-case total loss from subprime and Alt-A exposure would be $95 billion ($45 billion for Fannie and $50 billion for Freddie).
- The two GSEs' non-subprime and non-Alt-A book of business is worth about $4.4 trillion ($2.6 trillion for Fannie and $1.8 trillion for Freddie).
- If we assume a historically high default rate of 2% for this business, and assume these defaults would yield no recovery whatsoever, the loss would be another $88 billion ($51 billion for Fannie, $36 billion for Freddie).
- Putting together all these losses, the worst-case total is $182 billion ($97 billion for Fannie and $85 billion for Freddie).
- Existing loan loss reserves at the two GSEs are $8 billion ($4 billion for Fannie and $4 billion for Freddie).
- *The bottom line: the worst case net loss total across the two GSEs is $175 billion ($93 billion for Fannie and $82 billion for Freddie).*

To be sure, $175 billion is a lot of money -- especially from the perspective of existing Fannie and Freddie shareholders, who own stakes in companies with market capitalizations now just $10 billion and $5 billion, respectively. But it's nothing like the $5 trillion number being bandied about. In fact, it's about on a par with the revenue cost of the present "economic stimulus" tax rebate program. In the grand scheme of things -- and sad to say -- it's a drop in the bucket. And we think it is very much as worst-case number.

- Remember, the $175 billion assumes no recovery whatsoever from assets taken in foreclosure. It treats the entire value of the defaulted mortgage as a dead-weight loss. Recoveries could cut the losses in half, easily.
- Remember, these losses would be taken over many years, potentially decades. The GSEs' commitments are generally to guarantee timely payment of principle and interest, and most of these payments are far in the future. So the *present value* of the losses we have calculated is necessarily far lower than the nominal value we have presented.
- Remember, the GSEs would continue to generate income from their core businesses, which would offset the losses.
- *The bottom line: these losses, even if they are reduced by the factors just mentioned, are sufficient to significantly dilute the positions of existing shareholders. But they are not so large as to make an investment by the Treasury unfeasible, or to impose*

extraordinary new burdens on taxpayers. Getting in at the bottom, the Treasury might even show a profit on its GSE equity someday.

As an aside, if we are right about these numbers, then perhaps this rescue wasn't really necessary at all. Perhaps the capital markets could have recapitalized the GSEs without government intervention. We'll probably never know, unless the Treasury sets up its GSE equity-acquisition process in such a way as to permit private capital to compete at auction when new GSE shares are issued and sold.

THE FED IS DOING THE RIGHT THING, AND PROBABLY IN THE RIGHT WAY Early Friday we suggested (see "Fannie and Freddie Fan Inflation Fire" July 11, 2008) that the Fed permit Fannie and Freddie to borrow from the discount window. We suggested it set up what we called the Government Sponsored Entity Credit Facility, or GSECF -- much as it had set up in March, in response to the Bear Stearns crisis, the Primary Dealer Credit Facility, or PDCF (see "Bernankruptcy" March 17, 2008). Mid-day on Friday a press report emerged that the Fed would be doing this -- but the Fed quickly denied it. Then on Sunday the Fed announced it *will*, in fact, do a version of this, with the exact mechanism left unspecified.

The purpose of this new facility would not be for the Fed to acquire mortgage-backed securities (although, as Ben Bernanke made clear in his famous 2002 speech on deflation risk, the Fed does have the statutory authority to do so). Its only purpose would be to lend cash to the GSEs, with the loans fully collateralized by Treasury and agency securities, to assure that the GSEs have access to the cash required to meet their short-term obligations, should their liquidity become impaired as they work through their present difficulties. The knowledge that this facility is available -- "should such lending prove necessary," in the circumspect words of the Fed's announcement -- will probably go a long way toward preventing for the GSEs the kind or liquidity crisis or "run on the bank" that destroyed Bear Stearns. In fact, as we've noted before, if the PDCF had been in place *before* Bear Stearns collapsed, it may never have collapsed in the first place (see "Fed vs ECB -- the ECB Wins" April 23, 2008).

If the Fed's lending to the GSEs does "prove necessary," that is probably no reason to be concerned about new inflationary money creation. From the outset with its new liquidity facilities -- the Term Auction Facility, the Term Securities Lending Facility, and the PDCF -- the Fed has undertaken to sterilize its lending. Every dollar lent through these new facilities has been funded by the Fed's selling or redeeming Treasury securities in its portfolio, rather creating new money. We don't know yet whether the Fed will pursue the same policy with lending to the GSEs, but that's our baseline expectation. Similar expectations are probably why the immediate initial reaction to the Fed's announcement on Sunday by the inflation-sensitive gold and forex markets was been pretty much no reaction at all.

That said, it remains to be seen whether the Treasury's and the Fed's GSE intervention will restore confidence sufficiently to give the Fed scope to begin raising the funds rate back toward an equilibrium level. As we wrote last week, the re-emergence of the credit crisis has put the Fed in the dangerous position of fearing to hike the funds rate at all, when a move toward more normal levels is absolutely essential to stabilizing the dollar, commodity prices and equity markets (see "From Correction to Test to Bear Market" July 10, 2008). As details of the Treasury's rescue initiative, and the markets' reaction to it become clearer this week, we hope will get the telemetry we'll need to definitively make the call on whether a worst-case inflation scenario is on the table or not. At least it's a hopeful sign that as US markets head toward the opening bell, gold and oil are trading lower and the US dollar is trading higher -- these most inflation-sensitive markets are moving a little bit toward a relaxation of their extreme tensions of last week.

BOTTOM LINE: The Treasury's and the Fed's plan to rescue the GSEs should work, as the scope of the problem is much smaller than last week's panic seemed to indicate. There may be a devil in the details, especially for existing GSE shareholders, but we expect that Fannie and Freddie will continue to operate and carry out their missions for the mortgage markets without significant impairment or shock. Deeply oversold stocks should react well to the government's commitment to prevent systemic failure, as details of the rescue become understood this week. Fannie and Freddie shareholders will probably have to endure great dilution, at least, as the Treasury steps in as equity-holder. But the GSE rescue could catalyze a nice bounce in the distressed financial sector. We caution against treating it as anything more than a trading move -- this is a broken sector. If the GSE rescue can restore confidence, perhaps the Fed will find the scope to begin moving rates back toward equilibrium levels. If not, we remain on the verge of calling for a worst-case inflation scenario and another leg up for commodities and resource stocks, and down for the dollar.