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MACROCOSM

GSE Rescue: First Impressions

Sunday, September 7, 2008
Donald Luskin

The Treasury's move will help stabilize housing and credit markets, and take pressure off the Fed.

The US Treasury's announcement this morning of Fannie Mae and Freddie Mac being placed into conservatorship, its specific commitment to inject equity capital, and its plan to directly buy mortgage-backed securities ends almost two months of agonizing uncertainty for markets. Now that the standby rescue announced July 14 has been activated, and the operational details of it are known, investors can stop worrying about whether or not and how the Treasury will act -- and instead focus on the significant relief in credit and housing markets that this move likely represents. *This is being written before global markets have opened for Monday trading. We will follow up with additional comments on Monday.*

Update to strategic view

US MACRO: The Treasury's plan to put the GSEs into conservator ship, inject capital, and buy MBS should be very effective in stabilizing credit and housing markets. **US STOCKS:** Based on past experience such as the Fed's March intervention in the Bear Stearns collapse, the initial reaction by markets to the Treasury's GSE rescue may be one of shock and fear. But we think that will be short-lived if it even happens at all -- as much of it may have already been absorbed in mid-July when the plan was first contemplated. This should be a substantial positive catalyst.

[see Investment Strategy Dashboard]

At this moment we don't see any reason to fundamentally change our views expressed two months ago (see "Will the GSE Rescue Work?" July 14, 2008).

Key documents

Housing and Economic Recovery Act of 2008
Conservatorship Q-and-A
Treasury Senior Preferred Stock Purchase Agreement
GSE Mortgage Backed Securities Purchase Program
GSE Credit Facility
Paulson statement
Bernanke statement
Lockhart statement
Banking agencies joint statement

From our Client Resources page

- First, existing shareholders will have to endure a great deal of dilution. But then again, that was in the cards even if additional capital had been raised in private markets. Who's to say that shareholders wouldn't have had to give up even more than the 79.9% stake that Treasury is taking through warrants? Over the coming weeks we'll see just how much of that was already discounted in the stock

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prices of Fannie and Freddie.

- Second, this move should have a very positive effect on credit market sentiment. It commits the Treasury to make good on the GSEs' various mortgage guaranties (though if specifically falls short of a "full faith and credit" commitment. And it rules out distressed selling of assets from the GSE retained portfolios, by directing that those portfolios be reduced over time by natural attrition, at an attrition rate lower than today's.
- Third, the amounts of money involved in the Treasury's various commitments here are modest in the grand scheme of things, and are not unfeasible in budget terms.

There are other important implications of today's announcement.

- The Treasury will have to issue bonds to fund its various commitments under the plan. At the margin, and all else equal, this will put upward pressure on Treasury yields. But this new Treasury debt will have a special character. Yes, Treasury purchases of MBS will be recorded in the federal budget as "outlays," just like, say, subsidy payments to farmers would be. But buying fully-collateralized securities is an investment, not an expense -- even though that fact cannot be reflected in the federal budget, because budget accounting has no balance sheet, only an income statement. We think a more important upward pressure on yields will result not from additional issuance, but rather from the wholesale upward revision of growth expectations that will follow restoration of confidence in housing and credit markets.
- The Treasury's plan does not mean that the "full faith and credit" of the United States is being put behind the GSEs' obligations. Treasury officials confirmed this to us today emphatically, saying that the Treasury's commitment pertain only to the restoration of the GSEs' capital accounts and only to the extent announced today, that is, $100 billion for each entity.
- The Treasury's plan relieves the Fed of solely carrying the burden of trying to keep mortgage rates as low as possible while the housing market is under duress. With risk spreads so wide, the Fed's only way to do that has been to keep the funds rate low -- so low that significant inflation pressures have begun to accrue. It would be counterproductive to the government's intentions for the Fed to immediately offset any drop in mortgage rates with a fully offsetting hike in the funds rate. But at the margin, the Treasury's intervention means that the funds rate can begin to normalize sooner than it would have otherwise. Perhaps that is an element in the strengthening of the dollar and the drop in commodity prices that began in mid-July in the immediate aftermath of the Treasury's first announcement of its intentions to rescue the GSEs.

BOTTOM LINE: The Treasury's plan to put the GSEs into conservator ship, inject capital, and buy MBS should be very effective in stabilizing credit and housing markets. Based on past experience such as the Fed's March intervention in the Bear Stearns collapse, the initial reaction by markets to the Treasury's GSE rescue may be one of shock and fear. But we think that will be short-lived if it even happens at all -- as much of it may have already been absorbed in mid-July when the plan was first contemplated. This should be a substantial positive catalyst.