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INTELLECTUAL AMMUNITION

Fannie/Freddie Fallout

Monday, September 8, 2008

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The takeover heals near-term crises, but raises serious long-term questions.

Yesterday, Sunday, before global markets opened, we speculated that the first-blush reaction to the Treasury's takeover of Fannie Mae and Freddie Mac might be one of fear and shock, and that appreciation that the move will ultimately stabilize credit and housing markets would come later (see "GSE Rescue: First Impressions" September 7, 2008). As it has turned out, the immediate reaction overnight was exuberant, but as the US trading day has proceeded, some measure of fear and shock has blunted the festivities. We do think that the takeover of the GSEs, and the Treasury's effective guarantee of their commitments in mortgage, bond and credit markets will likely provide both the capital and the risk-bearing capacity necessary for the financial system to right itself. But at the same time, much uncertainty remains. The disparate and volatile responses of various markets today to the GSE Mac takeover likely attests to the many unanswered questions about the conservatorship and the Treasury's commitment to buy MBS, and what they will mean for the final disposition of the two companies.

Update to strategic view
US MACRO: Markets are struggling to process the many uncertainties in the Fannie/Freddie bailout. While no doubt helpful to housing and credit markets, it is an alarming expansion of government economic power, expropriating private ownership in a takeover that can only be justified as a response to extreme emergency. In the longer-run, this imposition of federal authority will only be worthwhile if it leads to real reform -- specifically to privatization of the mortgage securitization industry.
[see Investment Strategy Dashboard]

Such a sweeping imposition of government economic authority is, in its own right, breathtaking and alarming. We are not at all sanguine about the long-term economic implications of this unilateral acquisition of federal control in the bailout. But purely as a short-run matter of relieving systemic risk and restoring some semblance of financial stability, the intervention might be considered justifiable. The consensus has become that it was simply untenable for the undercapitalized GSEs to endure the rash of falling housing prices, mortgage defaults and foreclosures, so *something* had to be done. A failure of either or both could have been catastrophic. A key question now is whether the right lessons are learned from the circumstances that put the GSEs into this position in the first place, so that the proper reforms are instituted to keep it from happening again. And at the same time, it is key that this episode not be taken as an object lesson in the necessity of government control of the financial system.

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The Fannie/Freddie model is an archetype of moral hazard. The implicit government guarantee in the public/private structure encouraged the companies to extend their risk profile far beyond the point that could be supported by their capital base. If worst came to worst, as it now has, the taxpayers would cover it. A sweet deal for private shareholders who felt their risk was ultimately underwritten with other people's money -- and just as sweet a deal for populist politicians who pushed the GSEs to make ever-riskier investments for the supposed social good of "housing affordability."

In our view, the ultimate resolution of this imbroglio should be complete privatization of Fannie and Freddie. By leveraging their implicit government backing, the companies have been able to completely dominate the mortgage market, severely limiting competition and squelching innovation. There can no longer be any justification for allowing the companies to maintain such privileged positions. If this exercise of federal power in bailing out the companies is to have any longer-term economic benefit, the GSEs must be put on course to completely severing their government ties. But such long-term goals are completely outside the range of the Treasury's current actions. Explicitly, the Paulson Treasury understands that the final chapters of this story will be written by the next administration. That leaves the stench of uncertainty in the air breathed by financial market participants -- especially those forced to the sidelines who might otherwise now be laying the groundwork for fundamental innovations that could define the markets of future.

An especially disturbing element of the Treasury's action is that it amounts to an expropriation of property from common and preferred shareholders. Common shares of the two GSEs had a combined market value of about $11 billion at the close of trading Friday, 80% of which was effectively seized by the Treasury through its new position in warrants and senior preferred stock. It can be argued that there is a public purpose in the Treasury's takeover, but the Fifth Amendment of the Constitution forbids that "private property be taken for public use, without just compensation." We raised this issue with Treasury officials yesterday, and received only the *pro forma* reply that the action had been approved by the boards of both GSEs. Not credible, considering that those same boards had resisted raising capital in public markets at current stock prices, precisely because to do so would be so ruinous to existing shareholders -- and because the GSE's present funding situations didn't justify it. Yet now those same boards apparently embrace ruinous dilution simply to obtain the Treasury's *future commitment* of financing -- without the Treasury actually investing a single penny. The same issues were begged by the JPMorgan takeover of Bear Stearns in March. In that case, the government was not the acquirer, but the takeover by a private firm was only made possible by the Fed's effectively purchasing $30 billion of risky assets. Disenfranchised stockholders eventually managed to get the acquisition price raised from $2 to $10. By the time the full story of the GSE takeover is finally written, we don't doubt that there could be constitutional challenges that could drag on for years.

For the moment, the Treasury's action is generally condoned on the grounds of emergency. But what was the emergency over the weekend that hadn't existed a week ago or a month ago? Putatively, it was the discovery of an accounting technique that could plausibly be claimed to have deliberately and significantly exaggerated Freddie Mac's capital position, a discovery that was leaked on Saturday to the *New York Times* in advance of the release of the Treasury's plan the following morning. Hard to believe that such highly regulated, audited and previously scandal-plagued entities would have such major irregularities at this point. But this was the Treasury's "Reichstag fire," an apparent *force majeure* that could be used to justify the sudden use of emergency powers -- not only with Freddie, but with Fannie Mae as well, where the same accounting issue raised relatively minor capitalization issues. For all that, it's not clear that Treasury actually has a handle on whether or not the GSEs' capital positions are really all that parlous. Under the terms of the Senior Preferred Stock Purchase Agreement, Treasury capital

injections will be made when a GSE's net worth becomes negative on a GAAP basis, not a regulatory basis. We asked Treasury officials on Sunday where the GSEs stood on a GAAP basis today -- and they simply didn't know. So with all this, we end up being skeptical about the extent to which the Treasury's intervention -- coming at so high a price to stockholders -- was really motivated by exigent circumstances, and how much by political considerations.

As to the varying and jumpy market responses to the deal, with stocks paring their initial euphoric gains, the dollar rallying after initially selling off, and gold dropping after initially rallying, the common denominator is surely uncertainty. By reducing systemic risk and taking out a major contributor to recent financial market turmoil, the Treasury takeover of the GSEs can be considered bullish for equities. By the same token, it could also cut safe haven flows into the dollar, supporting gold and commodity prices. However, the plan could boost the dollar and put a drag on gold if it has the effect of putting into play speculation about the Fed entering rate-hiking mode sooner than had been anticipated. We've seen a hint of that in today's response in fed funds futures markets, but so far we have only inconclusive results as to how the takeover will really influence the monetary policy outlook.

BOTTOM LINE: Markets are struggling to process the many uncertainties in the Fannie/Freddie bailout. While no doubt helpful to housing and credit markets, it is an alarming expansion of government economic power, expropriating private ownership in a takeover that can only be justified as a response to extreme emergency. In the longer-run, this imposition of federal authority will only be worthwhile if it leads to real reform -- specifically to privatization of the mortgage securitization industry.