

September 8, 2008

Resolution/Capitulation

Well it's now a done deal. Acknowledging that Fannie Mae and Freddie Mac were short of capital, that the U.S. Government itself had fostered investor reliance on the implicit guarantee of Agency debt, and that the current period of uncertain U.S. Government support left mortgage affordability at unacceptably low levels, the U.S. Treasury stepped in to takeover the Agencies under a conservatorship arrangement. Among the various scenarios postulated by investors, the U.S. Treasury took the most aggressive path, leaving no doubt that the U.S. Government now fully supports all senior and subordinated debt obligations of the Agencies, as well as their mortgage-backed securities (MBS). The U.S. Government may inject up to \$100 billion in preferred equity capital that will be senior to existing common and preferred shareholders who will bear all future losses. The Agencies will now be run with the sole purpose of rehabilitating their financial health without regard to shareholder profitability.

Treasury Secretary Paulson made it clear that the key motivation for the takeover was to improve mortgage affordability. Not only will the takeover eliminate any uncertainty about the creditworthiness of the Agencies, but the Agencies themselves will be instructed to increase their purchases of MBS over the next 15 months, and the U.S. Treasury will also (newly) purchase MBS for its own account in order to lower mortgage interest rates. Improved affordability is key to any recovery in the housing market, and a stronger housing market is key to any sustainable recovery in the broader economy. From an economic and capital market perspective, the news is unambiguously positive.

Why now? The Treasury felt it needed to step in now to stem growing systemic risks, to address growing concerns that the Agencies' dubious accounting had inflated their already-skinny capital adequacy, and to shore up continued support from foreign central banks who had begun to pull back from the market thereby underwriting future funding requirements. All actions are temporary, leaving some degree of uncertainty about the Agencies' future status – will they be fully privatized (e.g. no government involvement)?, will they be permanently nationalized?, or will they remain government-sponsored entities?. Government leaders made it very clear that the next Administration/Congress will need to find a long-term solution which tackles the “inherent conflict of serving shareholders and a public mission”.

What does this mean for Agency and MBS debt? It means immediate gains relative to Treasuries as spreads narrow significantly in response to the newly obtained U.S. government support. As can be seen in the chart below, Agency and MBS spreads had widened to record levels this year amid growing credit concerns and ambiguous government support. Agency spreads should now trade below levels which prevailed a year ago. Their debt is slightly less

liquid than Treasuries, and so future spreads will merely reflect liquidity differences but will no longer reflect any credit differences. Subordinated debentures are also now fully supported and they should see the strongest price performance as they are treated similarly to senior debentures. MBS will also enjoy a lift as the abnormally wide basis between senior Agency debentures and MBS normalizes. MBS will continue to trade at wider spreads than Agencies given the inherent duration variability of their cash flows.

An additional hurdle for MBS will result from a new mandate that will force the Agencies to reduce their MBS portfolios by 10% per year beginning in 2010 (perhaps paving the way for a future privatization). New incremental demand will need to materialize in 2010 to make up for the potential \$160-170 billion of annual shrinkage in the Agencies' MBS holdings.

Overall, today's news is highly supportive for all spread sectors as a result of the reduction in risk/uncertainty it brings, and the improved prospects for the U.S. economy. While underlying credit fundamentals in the economy remain quite challenged, credit spreads may still narrow as a result of the large prospective increase in Treasury issuance that will be needed to fund the Agencies' capital requirements. We are very pleased with this outcome.

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