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Fixed Income: U.S. GSE Bailout & Implications

What

- The long-awaited government bailout of Freddie Mac and Fannie Mae in the U.S. has finally arrived, bringing an effective end to the duck-billed platypus of the financial world (the entities incongruously combined being publicly listed with a government mandate and implicit backing by the government).

- The announcement was made by the Treasury Department on Sunday morning EST – what has quickly become a witching hour of sorts for government interventions because it narrowly precedes Asian market openings, yet affords enough time for regulators to think and evaluate conditions while the markets are closed for the prior day. Fed Chairman Bernanke quickly issued a note of endorsement for the plan.

- The two GSEs have not been nationalized, per se, but rather have been put into conservatorship, which means that regulators have complete managerial control of the company without having complete ownership. The intent of conservatorship is to put an entity into “a sound and solvent condition” and to “carry on the Company’s business and preserve and conserve the assets and property of the Company.” The CEOs have stepped down and the boards have been replaced.

- While it was surely tempting for the U.S. government to simply inject capital into the entities but to remain otherwise uninvolved, this likely would have proven ultimately quite costly to the government because the GSEs would still be paying quite wide spreads when they borrowed in the market, thus necessitating repeated injections. At the same time, it is clear that the U.S. government did not want to outright nationalize the entities. Conservatorship presented a happy medium, in which the market could be soothed by government involvement without the government having to take on all of the GSEs debt forevermore.

- Although nationalization has not occurred, nor is the new development completely different. The government now possesses warrants for a 79.9% stake in the GSEs. It has also received $1B of senior preferred shares in each entity. The government has committed towards ensuring that the entities retain a positive net worth, which could require further injections of capital for preferred shares. The government will inject up to $100B into each entity, as needed. As a cost-saving mechanism, dividends will be eliminated for both preferred and common stock.

- As a parallel effort, the government will also start to purchase some of the GSE’s outstanding debt, with $5B to be purchased immediately. A secured lending facility has also been arranged as a backstop in the event that the GSEs cannot independently roll their debt. As a result, there is no theoretical maximum to the government’s obligation, aside from limits imposed by Congress on the size of the U.S. government deficit. Presumably, the net obligation will be at least $50B, and quite possibly run into the hundreds of billions.

No Surprise

- In our opinion, this development is not especially surprising, and there wasn’t much of a choice for regulators. There are three reasons for this.

- First, Freddie and Fannie were quite simply **too big to fail**. As morally undesirable as it is to bail out entities that created their own troubles, Freddie and Fannie collectively hold or guarantee almost half of U.S. mortgage debt, and in recent time have been responsible for three-quarters of new home mortgages.

- Second, the government had been **signalling** its intentions. Recall that in July, the Treasury had received permission from Congress to aid the GSEs via loan or equity investment. This set the stage from a regulatory standpoint.

- Third, the two entities were in a **downward spiral** that would have been nearly impossible to escape without outside help. The entities have struggled mightily, both because of worrisome exposure to the weak U.S. housing market (resulting, for instance, in Freddie's investment rating being downgraded from A1 to Baa3) and because of diminishing market confidence that becomes a self-fulfilling prophecy. It had become quite costly for both entities to raise debt, and neither could reasonably raise equity with rock-bottom stock valuations, which is a kiss of death for publicly-traded entities. It is conservatively estimated that as much as $50B is needed to cover expected losses at the entities, and this could not be raised in their previously perilous state on top of the need to roll ordinary debt.

General Market Implications

Short-Term Outlook

- Clearly, the gut market reaction has been for stocks to rally, government bonds to sell off, and spreads to come in. The motivation for this move comes from three considerations:

- First, the government intervention has **psychological** implications, and has boosted market morale, much as earlier inter-meeting rate cuts and assorted actions by the Fed did. The stock market, especially, had been stuck in a downward spiral, and the timing of this announcement will do much to reverse that trend and to prompt a relief rally.

- Second, from an **economic perspective**, it is clearly good news that Freddie and Fannie have not gone under, given how crucial the U.S. housing market is to the U.S. economic outlook, and the clear importance of the GSEs to that market.

- Third, from a **supply/demand** perspective, it is clear that the U.S. government has taken on an increased burden, prompting a selloff in government bonds. Simultaneously, the strengthening of the implicit guarantee for Freddie and Fannie by the government suggests that their credit spreads should narrow, as they have done.

Medium-Term Outlook

- However, and crucially, we are not convinced that these short-term responses are entirely justified, nor that they can last forever. We would suggest fading some of these moves once the market settles down.

- From a **psychological** perspective, we note that previous government interventions proved to be only stop-gap measures, and did not ultimately engineer a permanent reversal away from stock market losses, nor did they succeed in bringing credit spreads permanently inward. In fact, we find it instructive to think of the credit crunch as having hosted a serious of very bad developments (Bear Stearns failure, Freddie and Fannie troubles, etc), each of which has been addressed by a good offset (govt bailouts, mainly). But through this tit-for-tat, good-for-bad sequence, LIBOR has remained wide, bank lending has remained tight, and the basic essence of the credit crunch has remained. We expect more of the same in the future – more bad developments, more ad hoc solutions, and – importantly – more generally negative credit conditions simmering beneath the surface.

- From an **economic** perspective, it is undeniable that avoiding failure for Freddie and Fannie is a hugely positive development for the economy. But we think the

market hasn't thought about this properly. There was never even the remotest risk that Freddie and Fannie would be allowed to fail. As such, what's new? We knew all along that they would continue to exist. It isn't truly good news if it was inevitable.

- Moreover, Freddie and Fannie are hardly going to be the saviours of the U.S. housing market given new requirements. The new plan stipulates that the mortgage portfolios of the two entities can grow only a little further (to a maximum of $850B by year-end 2009, or another 6.5% for Freddie and 12.1% for Fannie), and then that they must begin shrinking by 10% a year until they reach just $250B. This means 10% declines every year for over a decade. To the extent that Fannie and Freddie have been huge participants in the securitized-mortgage market, this will greatly limit securitization in the U.S. market in the future. In the near term, the limit will hit Freddie more than Fannie insofar as Freddie grew by 10.8% over the past year, whereas it can just grow at an 8.5% annualized rate through to year-end 2009, whereupon it must begin shrinking. Fannie appears able – at least according to this criterion – to grow somewhat more quickly, and just as fast as it did in the past year (though this was just 3.8% over the past year). Still, we should not realistically expect the GSEs to prop up the U.S. housing market any longer.

- From a **supply/demand** perspective, to the degree that there has always been an implicit guarantee of GSE debt extending from the U.S. government, this suggests that this debt has always implicitly existed on the U.S. government balance sheet. Again, what is new here? That debt was always lurking in the shadows, and now it is simply illuminated a little more clearly. It remains unlikely that a full nationalization will occur, and so we do not expect to ever see the entirety of the debt fully on government books.

- It is undeniable, of course, that the money to be injected into the GSEs will result in a bigger U.S. deficit. As a result, some Treasury selloff was appropriate due to this factor. If $300B of government money proves necessary (on the high side, if anything) spread out over two years, this would increase the U.S. fiscal deficit-to-GDP ratio by 1 percentage point in each year. But bear in mind that the government should eventually recoup the majority of its loans and some of its equity investments. Also, the ownership stake the government is taking in the entities affords a 10% dividend on the preferred shares. This could make the transaction profitable for the government if the rescue goes according to plan.

- Furthermore, and to the degree that foreign investors were heavily involved in the GSE market, we postulate that if a bailout had not occurred, there might still have been a flight away from the U.S. market (and Treasuries). Heads you lose, tails I win.

Product-Specific Implications

- Given our views, we think the magnitude of the recent selloff in **Treasuries** may not stick, and that the grim reality of a weak economy and declining inflation may soon dominate once again and drive U.S. government yields lower. The 5yr sector may prove somewhat more resistant to this view, however, as this is presumably where a fair swath of government fundraising is going to have to come to purchase GSE debt.

- **Fannie and Freddie** debt appears to us to be not much riskier than Treasury debt, even if there is no explicit guarantee. Similarly, it appears that the Treasury will now be buying some of the product. As such, we believe spread compression here can be sustained. Perhaps a risk to this is that when the entities eventually emerge from conservatorship you could see spreads widen somewhat again, but this is not likely to occur for at least a year, and likely much

longer. Moreover, unless they are outright sold off to a private entity, that implicit guarantee will always exist.

- From a **Canadian bond market** perspective, it strikes us that some sympathy selloff is probably appropriate for Canadian government bonds insofar as the two economies are linked, and thus the avoidance of a U.S. disaster is good news for Canada, too. However, we believe that the Canadian selloff has been somewhat overdone relative to the U.S. – after all, this is clearly a made-in-the-USA story. The Canadian move should be perhaps 50% of the magnitude of the U.S. market response, and yet it is currently larger than this fraction. That said, we should note that Canadian bonds appear rich due to other (economic) considerations, and so we would not look to fight the selloff too hard. We also don't believe this announcement has huge implications for Canadian CMBs – no bailout appears necessary for Canada, and so recent compression may not be sustainable on this factor alone.

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