Market Update

Evergreen Investments

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## Fannie Mae & Freddie Mac – Part Deux

Background - Fannie Mae and Freddie Mac are the largest purchasers and insurers of mortgages in the U.S., accounting for approximately half of the total mortgages outstanding. These Government Sponsored Enterprises (GSEs) were created by Congress to provide low- and middle-income Americans with the opportunities for home ownership. Fannie and Freddie buy and guarantee mortgages from banks, some of which are pooled as securities and sold to investors, adding to the cash available for total mortgage lending. While chartered by Congress to support the mortgage market, they have always been, and remain, owned by shareholders. The *implicit* backing of the government, though, enabled them to attain lower interest rates than their competition in the mortgage industry. As the housing recession and the credit crisis worsened in the past year, mortgages defaulted at an alarming rate, resulting in billions of dollars of losses for the GSEs. Given their razor-thin capital ratios, the markets questioned the willingness of investors to keep rolling over their debt, possibly leading to a "run on the bank" similar to Bear Stearns last March.

The July Plan - As a result of this brewing crisis, Fannie Mae and Freddie Mac received *explicit* support from both the Federal Reserve and the U.S. Treasury Department last July. Fed Chairman Ben Bernanke and Treasury Secretary Henry Paulson announced steps in order to shore up investor confidence and support the GSEs, which either own or guarantee more than $5 trillion in mortgages. The original plan involved liquidity measures, including allowing Fannie Mae and Freddie Mac to borrow from the Fed's discount window as well as extending the Treasury's line of credit to the GSEs. Treasury also received approval from Congress to purchase equity stakes in Fannie Mae and Freddie Mac, if necessary, to further ensure their access to capital. It was also determined that the Federal Reserve would have a consultative role in any future government actions relating to the GSEs, including the setting of capital requirements.

At the time, we wrote that Treasury and the Fed developed the "least-worst" steps available to them, but faced several obstacles to their plan, including Congressional approval, which occurred in August. Criticism of the GSEs had been prevalent for years as many investors questioned the privatization of profits, but the socialization of risk.

The September Action – On September 7th, aspects of the July plan became reality after the GSEs failed an accounting review which showed lower than expected capital levels. As a result, several steps were taken by the Federal Housing Finance Agency (FHFA) and the Treasury Department regarding the GSEs.

1. The FHFA placed Fannie Mae and Freddie Mac into their conservatorship, essentially a government takeover of the daily operations of FNM and FRE. The two GSEs will have new CEOs who will oversee a modest increase in their mortgage-backed securities (MBS) portfolios to support the housing market through 2009, after which they will gradually reduce their MBS portfolios at the rate of 10% per year.

2. Treasury created a senior preferred stock purchase agreement to support the companies by investing up to $100 billion in each of the agencies, which includes warrants which could effectively give it control of up to 80% of the two GSEs. It is important to note that this move now places Treasury between the debt holders and the holders of common and preferred equity.

3. Treasury also created a debt facility from which the GSEs and the federal home loan banks (FHLB) can borrow on an as-needed basis based on their collateral as an "ultimate liquidity backstop," which is also effective through 2009.

4. The Treasury Department also developed a facility through which it could purchase up to $5 billion in MBS, as conditions warrant, in order to support the mortgage market by helping to narrow spreads.

5. The Fed, with its balance sheet already extended, did not specifically take part in this plan, but did provide consultation and expressed satisfaction with its details.

Key Takeaways - We believe these moves finally address the main problem of the year-long financial crisis, i.e., getting the banks to turn assets into capital. The crises in housing and credit frequently prevented the value of real estate, which has obviously been in question, from being pledged as capital for business and consumer loans. The Fed's aggressive steps in cutting rates and creating a variety of lending facilities may finally, with help from the Treasury's GSE actions, enable banks to start lending again. Given these developments, we want to highlight ten key takeaways for investors.

1. In our view, the Fed had already done enough to address this financial crisis and it was therefore critical for Treasury to take the lead in improving confidence in the economy and the financial markets. The central bank needs the assets on its balance sheet to manage monetary policy, but it had already potentially exposed almost half those assets over the past year to address the credit crisis.
2. We believe the government had no choice but to step in once the GSE's capital deficiencies, long suspected by many investors, were verified late last week. The companies have lost more than $14 billion over the past year and their stocks had declined by more than 90%.
3. Failure of these two mortgage giants would have been catastrophic for the financial system since they dominate the primary and secondary mortgage markets. Under the new structure, Fannie and Freddie can grow their fee-based businesses and expand the retained mortgage portfolios on their books up to $850 billion over the next 15 months.
4. Treasury's actions are intended to provide mortgage market stability and to protect the senior and subordinated debt holders of the two mortgage giants. Existing preferred shareholders have been further subordinated.
5. Many regional banks and insurance companies hold preferred shares of the GSEs and are at risk, yet the Fed and Treasury have suggested that regulators will work with these companies to help restore their capital
6. Common shareholders may be virtually wiped out as ownership is further diluted. Dividends on both common and preferred shares at both companies have been eliminated.
7. Given these "least-worst" actions, free-market aficionados may struggle with these developments. While we would have preferred that these steps had not been necessary, we believe the consequences of inaction would have been much greater.
8. The boldness of the plan should also be viewed as a net positive for both the Financial Sector and the markets, as these steps reinforce our belief that the balance sheet may replace the income statement as the primary incentive for long-term investors coming out of this crisis.
9. The privatization of profits and the socialization of risk has been a problem that had been brewing for years in Washington. The extent of Treasury's support, and its impact on taxpayers, may serve to limit further economic stimulus plans coming from Congress as the federal budget deficit continues to surge in the months ahead.
10. A tightening of mortgage spreads will likely be a key determinant of the plan's success for the economy and the financial markets.

Conclusion - What may prove to be the worst financial crisis ever, has resulted in the largest government intervention in history. While we do not expect these steps to cure the credit crisis, they do go a long way in minimizing the underlying risks to the economy and the financial system. We look for the yield curve to steepen further based on two counter-prevailing trends: improving investor confidence may result in a decline in flight-to-quality trades, but concerns about new issuance of Treasury debt may also increase market yields for longer-dated maturities. Either way, a steep curve will likely allow banks to do what it is they love to do best: borrow short and lend long. The more this is done, in our opinion, the closer we will be to the end of this credit crisis.

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John is a Managing Director and Chief Market Analyst for Evergreen Investments. A member of the firm's Investment Strategy Committee, John uses a top-down, macro-economic approach in his analysis of the financial markets. He has been featured in various media outlets, including CNBC, BusinessWeek, CNN-Money, Bloomberg News and The Wall Street Journal.