

August: Prelude to ‘Conservatorship’

Market Summary

August 2008

nevertheless as the prelude to the U.S. government’s largest-ever intervention in the financial markets. On its own merits, August’s most significant development likely was the sustained retreat in energy prices, a welcome development that had nudged into view in late July. That prompted an advance in the stock markets, until it sunk in on the trading floors that the cooling in energy prices was attributable in large part to a cooling in the world’s economy. People are driving less, and also spending less.

But overshadowing the economic news, at least in the near-term, was the question of what the U.S. Treasury would do to shore up the two beleaguered government-sponsored mortgage-lending agencies, Fannie Mae and Freddie Mac. In recent months it has become clear that these two behemoths—holders or guarantors of about \$5.2 trillion in home mortgages—had not quite kept themselves out of the financial Mardi Gras surrounding “subprime” mortgages that wounded or wrecked a number of private investment banks. Restrictions on Fannie and Freddie’s underwriting practices kept them out of the gutter during the revelry, but did not keep them off the street. “Alt-A” mortgages—a.k.a. “liar loans”—issued to borrowers who can’t quite document their qualifications, were held in large (but as-yet unspecified) quantities by the two agencies. Losses reported over the past year—including \$3.1 billion declared in August—sum to more than \$14 billion, and market insiders suspect another \$36 billion lurking in the books from delinquencies and repossessions. The implicit federal guarantee behind the agencies’ huge (and

August did not quite live up to its etymology—it means “the exalted” in the original Latin—but it will be remembered

highly leveraged) portfolios has kept them relatively high in the queue of financial institutions circling the subprime mortgage drain, but investors, including many of the world’s central banks, had grown increasingly antsy. The agencies’ need for continuing access to credit markets—e.g., \$200 billion in bonds to be rolled over in September—made the situation untenable.

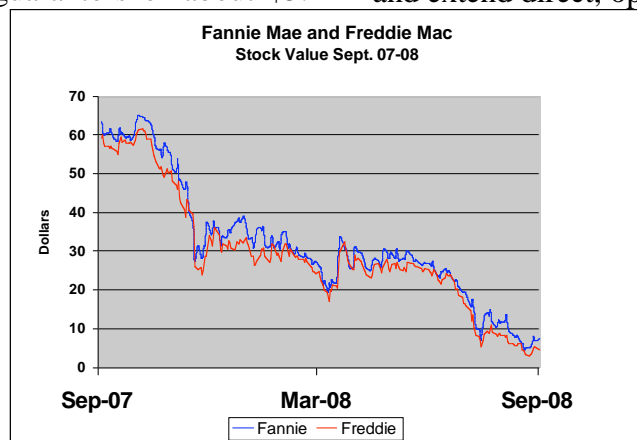
A gigantic housing bill enacted at the end of July empowered the Secretary of Treasury Henry Paulson to fix the two agencies by whatever means—open-end loans, massive infusions of equity capital, or direct takeover. Mr. Paulson likened this power to having “a bazooka in your pocket,” the very caliber of which he hoped would make it unnecessary to “take it out.” It worked the other way around, however, as the markets refused to believe that such powers could remain dormant.

Mr. Paulson threw in the towel shortly after Labor Day, announcing that Fannie and Freddie would be taken into “conservatorship,” a more benign form of receivership. The terms call for the Treasury to prop up the market in agency bonds and extend direct, open-ended credit to Fannie and

Freddie through a new loan facility available until the end of 2009. The Treasury also will buy up to \$100 billion in new preferred stock, taken as needed when one of the agency’s net worth dips below zero.

Fannie and Freddie’s last month of independence was rollicking. With the full faith of the U.S. government behind them, they were able to issue senior two-year bonds, but only at yields nearly 100 basis points above comparable Treasury notes. Spreads on subordinated debt burgeoned to 490 basis points, as ratings were slashed from AA to near-junk.

The agencies’ equity—already reduced in near-perfect parallel to penny-stock values (see chart)—washed from peak to trough throughout August, as the markets assumed (correctly) that stock holders would take the brunt of any federal



intervention. The conservatorship will not wipe stock holders out, as would a genuine bankruptcy, but dividends have been eliminated for both preferred and common shares. Anticipating this, the markets had driven prices on preferred shares down to the point of yielding above 17%. J.P. Morgan Chase & Co. recently announced a 50% write-off in the \$1.2 billion it invested last year in new issues of perpetual preferred stock. Another \$23 billion (face value) of older vintages reportedly remains at large, much of it held by regional banks that could ill-afford a wholesale devaluation. Perhaps with that in mind, the Treasury plan extends credit to the 12 privately held Federal Home Loan banks.

Economy Subdued (Still)

Making mortgage payments is not getting any easier, as news for the economy as a whole and housing in particular continues glum. The S&P/Case-Shiller Home Price Index for 10 metropolitan areas fell 0.6% from May to June, which made for another record decline of 17%, year-over-year. For those willing to grasp at straws, the incremental drop from May to June was less than the 1.0% drop from April to May. The decline in the index for 20 metropolitan areas also shows signs of slowing up. It dipped 0.5% from May to June—15.9% year-over-year—which also was slightly less than the 0.9% it fell from April to May. Both indices consistently fell 2-2.5% per month earlier this year.

Unemployment Hits 5-year High

There was no straw to grasp in unemployment data as the jobless rate hit 6.1% in August, highest since 2003. The Labor Department reported that non-farm payrolls shrank by 84,000 in August, and by 605,000 for the year. Consistent with that, the Institute for Supply Management reported its index of manufacturing activity had slipped to 49.9 in August, indicating a slight contraction. July's reading was a dead-even 50.0.

Imports Imperiled

The one robust sector of the economy—exports—also got the good news/bad news treatment in August. Exports fueled a rise in the demand for durable goods in the latest data, but those numbers come from July, and are generally attributed to the

long-standing weakness of the dollar. More recently, world economies, like ours, have been stricken by high oil prices, spiking inflation, a slump in housing and a consequent economic cool-off. Furthermore, as foreign economies have weakened, so have their currencies, substantially reducing the dollar's comparative advantage. The net effect is a severely curtailed appetite for American exports.

Fed Stands Pat

The Federal Reserve left its key lending rate at 2.0% at its August meeting, meaning the downbeat economic news was weighed more heavily than the 5.6% year-over-year jump in the CPI reported in July.

International Markets Punched; U.S. Solid

International stock and bond markets were pummeled in August; all benchmarks dropped with the sole exception of the JPM Emerging Market Bond Index, which gained 0.7%.

Hardest hit was the MSCI Emerging Markets Free Index, which dropped 8.0%. The larger-cap EAFE Index fell 4.1%; Pacific Rim Ex-Japan, 5.0%

U.S. stocks performed very respectably, despite the generally bad economic news. Value indices out-ran growth, and smaller-caps out-performed larger. The Russell 2000 Value Index led with a 4.8% gain; the Russell MidCap Growth index brought up the rear with a 0.9% gain.

The Lehman Long Government Bond Index returned a robust 2.3%; the Lehman Aggregate Bond Index brought 0.9%.

The Dow Jones Wilshire REIT Index returned 2.3%; the NAREIT (All REITS) Index 2.0%. The Goldman Sachs Commodities Index dropped 7.1% and the DJ-AIG Commodity Index fell 7.3%, the biggest drop among the benchmarks we survey.



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