INVESTMENT MANAGEMENT

Morgan Stanley

MarketPulse

16 July 2008

What Are the Implications of The U.S. Government's Plan To Shore Up Freddie Mac and Fannie Mae?

In a bold move aimed at shoring up confidence in the nation's two largest mortgage finance companies, the U.S. Treasury has asked Congress to approve legislation broadening the government's capability to provide financial assistance to Freddie Mac and Fannie Mae. Separately, the Federal Reserve has temporarily opened its discount borrowing window to the two mortgage giants, granting them immediate access to an emergency credit line while Congress considers the Treasury's proposed aid package.

As U.S. home prices have fallen and mortgage delinquencies have risen, Freddie Mac and Fannie Mae—which are government-sponsored enterprises, or GSEs[1]—have come under heightened pressure lately as investors grow increasingly concerned about the credit quality of the two companies' portfolios, which together account for about US$5 trillion, or nearly half of all outstanding mortgage loans in the country.

In our view, both the Fed's and the Treasury's actions are positive steps towards restoring investor confidence in the GSEs, especially regarding concerns about whether these institutions would have enough capital to support daily operations.

First, access to the Fed's discount window could provide these institutions with instant access to an emergency credit line and allay short-term market concerns about their access to liquidity. Second, the government's proposed plan—which will be attached to the housing bill and is expected to be voted on later this week—will, if approved, allow the government to: a) increase its credit line to Freddie Mac and Fannie Mae from the current US$2 billion—an amount set by Congress almost four decades ago—to up to US$300 billion, and b) gain the authority, according to the Treasury plan, to make equity investments in the two institutions so as to enhance their capital cushion.

We believe that the immediate implications of these measures—when taken in aggregate—are basically twofold:

- They emphasize the government's commitment to Freddie Mac's and Fannie Mae's senior-debt solvency and long-term financial health; and
- They open the option for the government to nationalize the two institutions.

In this article, we analyze the potential impact of these measures on the equity and fixed income markets—both in general and for the GSEs' investors in particular—as well as the overall macro implications for the U.S. economy.

Macroeconomic Implications

Despite the rescue package, we believe that the current financial woes faced by Freddie Mac and Fannie Mae could still have a dampening effect on economic activity. "Ongoing losses in mortgages and uncertainty about the ability of the GSEs to provide support for mortgage markets could tighten financial conditions another notch," said Richard Berner, chief U.S. economist, and David Greenlaw, senior economist, at Morgan Stanley Research. Together with other ongoing economic headwinds—such as slowing global growth and high energy prices—these developments "increase the downside risks to U.S. economic activity," they added.

That expectation, coupled with lingering inflation concerns, will likely prompt the Fed to maintain monetary policy unchanged for the foreseeable future. The Fed's target for the federal funds rate is currently at 2.0%. The central bank has kept rates steady since April 30, 2008. The Federal Open Market Committee (FOMC) meets next on August 5.

[1] Created by the U.S. Congress in the early 20th century, government-sponsored enterprises (GSEs) are financial corporations whose primary goals are to increase lending transparency, lower credit cost and augment credit flow to specific sectors of the economy. As GSEs, Freddie Mac (established in 1970) and Fannie Mae (established in 1938) are independently managed, and operate as publicly traded, shareholder-owned businesses. However, the market has traditionally perceived the U.S. government as the ultimate guarantor of the organizations' underlying portfolios in the event of massive financial distress.

FOR INSTITUTIONAL INVESTORS ONLY AND MAY NOT BE USED WITH THE GENERAL PUBLIC.

Berner and Greenlaw also said that the losses in mortgages experienced to date seemed to be on track with Greenlaw's earlier estimates of US$500 billion in total, with US$100 billion attributable to prime, conforming mortgages.

The economists also downplayed market concerns about the U.S. Treasury credit rating. "[Although] some [market players] are concerned that an explicit guarantee of GSE debt would reduce the U.S. Treasury's credit rating … we do not believe that the U.S. is likely to lose its AAA rating," they said. Even if the federal government were to assume the mortgage debt that is guaranteed by the GSEs, the U.S. debt/GDP ratio—currently at 37%—would rise to 67%. "In contrast, when the rating agencies downgraded Japan's debt in 2001, the country's debt/GDP ratio was 134%, and S&P indicated at the time that they expected it to rise to 165% within five years," Berner and Greenlaw added.

Fixed Income Market Implications

We believe the government has taken a pragmatic approach to bolstering confidence in the two mortgage giants by strengthening its implicit financial guarantee behind the GSEs. Also, it is important to distinguish between the market reaction to the Bear Stearns troubles back in March 2008 and the performance of Freddie Mac and Fannie Mae in the days leading up to the announcement of the government's measures.

As illustrated in *Display 1*, the stocks of the two institutions experienced a massive sell-off last week, but interestingly their credit spread performance tightened, suggesting that investors were not necessarily expecting a senior-debt default by either one of the mortgage agencies.

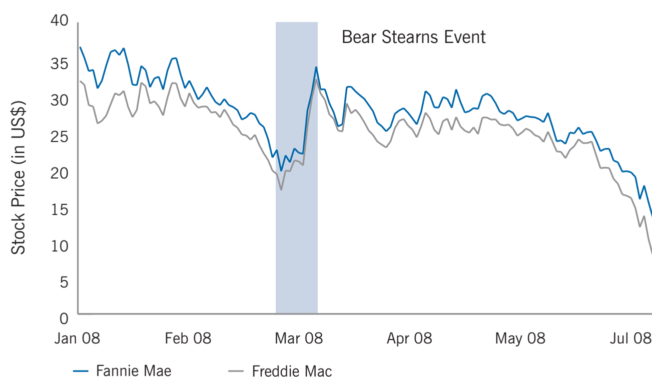
Investors should also keep a close eye on the two mortgage giants' access to money markets and liquidity. Even though the GSEs' short-term debt has been increasing as a percentage of total debt (*Display 2, next page*), the ratio has been in line with historical norms, suggesting that the agencies' access to liquidity remains sound. Freddie Mac's successful auctions on Monday of US$2 billion in three-month discount notes and US$1 billion in six-month discount notes further corroborates this view, and suggests that the government's plan has been initially successful in reassuring lenders of the GSEs' solvency.

Additionally, it is worth noting that the unique structure of the GSEs' business model allows their retained mortgage portfolios to kick off positive cash flows in the interim. "The ability to access internally generated cash flows, along with healthy cash-liquid portfolios and access to short-term money markets, suggests that this is not a liquidity event," said George Goncalves, chief Treasury and agency strategist at Morgan Stanley Research. "These liquidity outlets have been strengthened when combined with the Fed's measure and the Treasury's plan. In aggregate, this plan will likely give investors confidence that there is enough government backing behind the GSEs beyond what is already provided by the capital markets."

Paul O'Brien, a portfolio manager at Morgan Stanley Investment Management's Global Fixed Income team, said that the government's plan is likely to ease concerns about the long-term viability of the two institutions' senior-debt obligations and guaranteed mortgage securities. "We believe that the government will stand behind the senior debt and the guaranteed mortgages," he said. O'Brien added, however, that government support is less clear for the subordinated debt of both institutions, suggesting that investors could still face risk of loss.

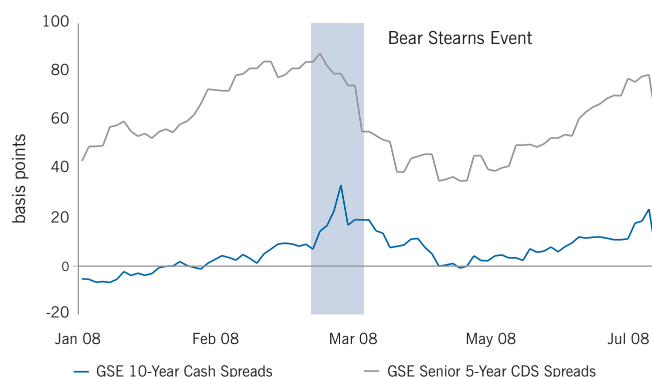
O'Brien also said that the government's plan could alleviate pressure on the overall financial system. "That's a significant positive not just for the mortgage agencies, but for financial institutions and for the financial markets more generally," he said. Moreover, providing the two agencies with access to fresh capital could allow them to expand their mortgage lending to the U.S. economy.

Display 1: While GSE stocks fell last week...



Source: Bloomberg

...their credit spreads tightened



Source: Bloomberg

Equity Market Implications

On the equity front, we believe that the Treasury plan, if approved by Congress, may leave the door open for a future nationalization. "So far, it doesn't look like the government is planning to nationalize either one of the mortgage agencies," said Abhijit Chakrabortti, chief U.S. equity strategist at Morgan Stanley Research. "My impression is that they want to avoid bringing Freddie's and Fannie's US$5 trillion debt obligations into the government's books."

Chakrabortti added that, as it stands, the government plan provides enough breathing room for the two institutions. "This gives room for the government to respond as things evolve," he said. The Morgan Stanley equity strategist also said that, in the long run, the government's main goal should be to improve the GSEs' lending capabilities.

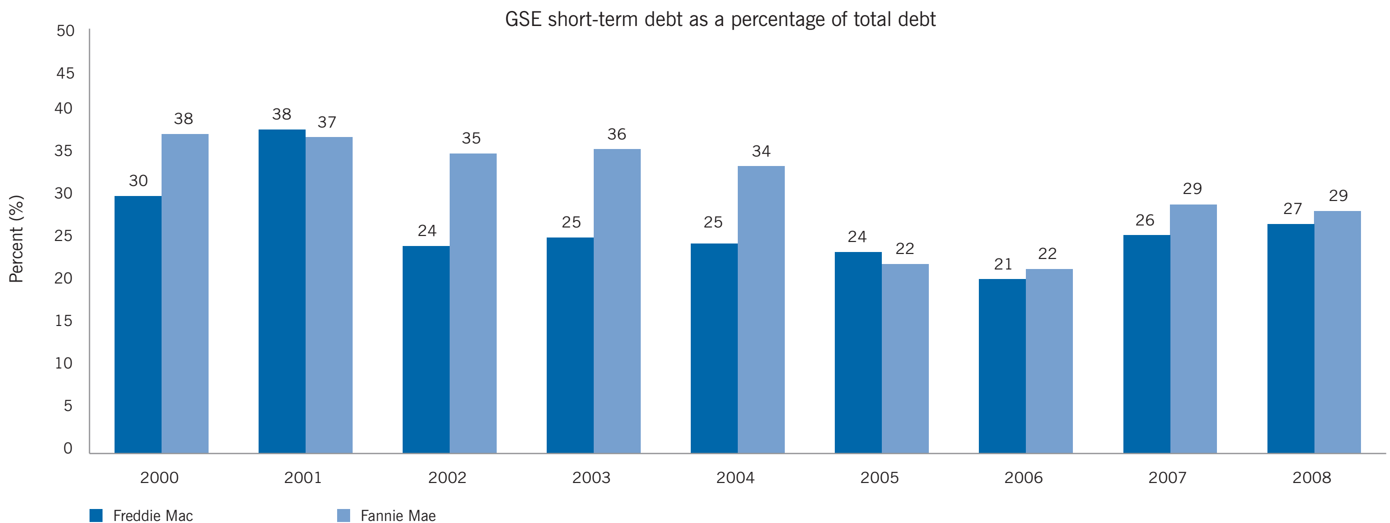
Lingering Risks

Despite the overall positive sentiment about the government's proposed plan, we still see meaningful risks in the current situation.

First and foremost, there are political risks. "The plan still needs to be approved by Congress and signed by President Bush. So we need to keep a close eye on any developments that could translate into opposition to the plan," said O'Brien.

Further, economic and credit market risks are still present. "The U.S. economy is weak, the housing sector is under significant stress, and we still don't know for sure the ultimate size or scope of the credit problems affecting the mortgage agencies," O'Brien said, adding that "the U.S. economy is still going through a period of macroeconomic and financial distress."

Display 2: Maintaining access to money market liquidity is key



Source: Fannie Mae, Freddie Mac and Morgan Stanley

The opinions referenced above are those of Richard Berner, David Greenlaw, George Goncalves, Paul O'Brien and Abhijit Chakrabortti as of July 15, 2008, and are subject to change at any time due to changes in market or economic conditions and may not actually come to pass. The comments should not be construed as a recommendation of individual holdings and/or market sectors, and do not contend to address the financial objectives, situation or specific needs of any individual investor. They are intended to be an illustration of broader themes.

© 2008 Morgan Stanley

Morgan Stanley

IU08-03928I-T07/08 5815454_CH_INST_V01_078