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MONTHLY COMMENTARY

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- **The Economy:** *In today's markets, quiet is a relative term*
- **The Mortgage Market:** *Mortgage spreads react to the bailout*
- **The Markets:** *Dollar continues to strengthen; global rates decline*

The Economy

The month of August was quiet in the financial markets, but in the current environment the smart-aleck retort is "Quiet? Compared to what?" Indeed, August held none of the theatrics of August 2007 or February, March and July of 2008, and an exhausted Wall Street seemed to have arranged a truce to enable folks to take some much-needed vacation. Nevertheless, the markets continued to signal lingering uncertainty surrounding Treasury's intentions with regard to Fannie Mae and Freddie Mac (the Agencies). Mortgage spreads continued to grind wider, and the common and preferred shares of the Agencies found little support. Those uncertainties were answered with the decisive action taken on Sunday, September 7, when Treasury Secretary Paulson announced that Fannie Mae and Freddie Mac were being placed under the control of their regulator, the Federal Housing Finance Agency (FHFA). The primary objectives of the plan are to promote market stability, mortgage availability and taxpayer protection. The main points of the takeover are as follows:

- The regulator of the Agencies, the FHFA, was appointed their conservator. Conservatorship is a status in which the Agencies are run as operating companies (unlike receivership, in which companies are dismantled and liquidated). Senior management of the Agencies will be replaced.
- The US Department of Treasury has agreed to purchase as much senior preferred stock in the Agencies as necessary to maintain positive net worth, up to a maximum of $100 billion per company. In exchange for committing to purchase the shares, Treasury will receive warrants to purchase approximately 80% of each company and $1 billion in senior preferred stock.
- The common and preferred stock will continue to be listed on the NYSE, but the FHFA is suspending all dividend payments in order to conserve capital.
- Treasury established a liquidity facility for the Agencies (and the Federal Home Loan Bank) called the GSECF, which will ensure continued funding in the event other funding and liquidity sources become unavailable. This facility expires at the end of 2009.
- Treasury committed to making open market purchase of Agency MBS to further support the mortgage market. This commitment has no pre-determined size and also expires at the end of 2009.
- The Agencies will be allowed to increase the sizes of their retained MBS portfolios through the end of 2009, at which time the portfolios will begin to gradually reduce by 10% per year to an unspecified smaller size.

To us, beyond all the moving parts here and the resulting breathless headlines, there are a couple of major takeaways. First, this plan confirms what we have always said about Agency MBS: Fannie Mae and Freddie Mac have never failed to make good on their guarantee, and in the worst case the government would stand behind that guarantee. To be exact, Fannie Mae's and Freddie Mac's senior debt obligations, including the guarantee of Agency mortgage-backed securities, will continue in their current form with the explicit support of the Treasury's commitments (in fact, their AAA ratings have been affirmed). The subordinated debt will also continue to pay interest. The preferred and common shares, on the other hand, despite the fact that there has been no change in their legal claim, will be significantly diluted. In the short run, the market has responded accordingly, with Agency MBS tightening to Treasuries and the common and preferred trading way down. Most credit spreads tightened on the Monday after the plan was released, while Treasuries were flat.

Second, the conservatorship plan, along with the preferred stock purchase plan, the GSECF, the Agency growth targets and the commitment to purchase MBS in the open market, is an elegant solution to accomplish the Treasury's primary objectives. It will allow for actual cash infusions to only occur on an as-needed basis yet still underpin the funding process of the Agencies. Importantly, it should reduce the possibility that the Agencies would slow down their portfolio growth and support of the mortgage market in order to conserve capital. Third, having the Agencies relatively unfettered in fulfilling their charter (that is, unfettered by such issues as capital adequacy and marking to market) is designed to help increase the amount of capital available to the mortgage finance cycle, but it remains to be seen whether or not the increased appetite of the Agencies and Treasury combined will affect outstanding MBS volumes.

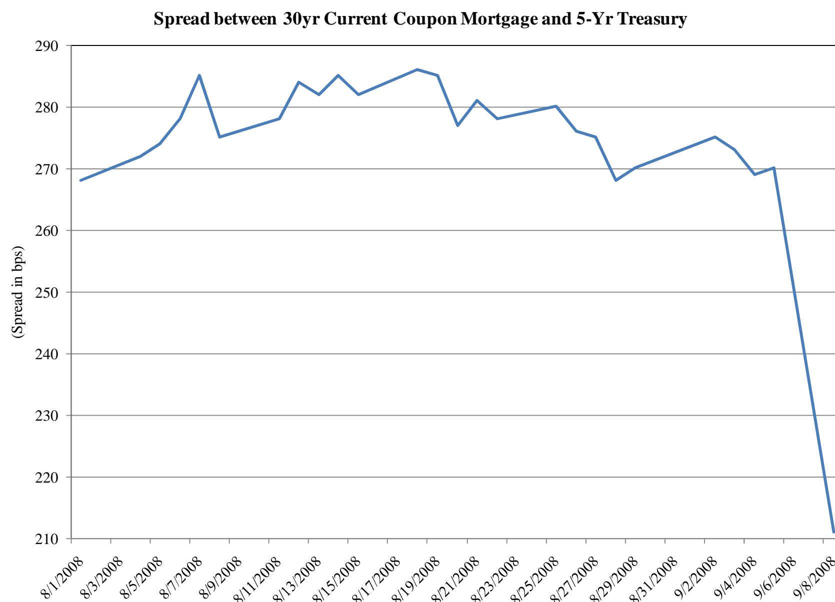
Fourth, it is still too early to tell what the long-term implications are for these actions. For example, will the stepped-up securitization business of the Agencies enable mortgage rates to come down and stay down, and if so will they come down by enough to help ameliorate the decline in the housing market? How will the run-off of the Agencies' portfolios be managed? What will be the knock-on effect to financial institutions that hold the virtually worthless preferred and common stock of the Agencies?

How long will the conservatorship last? What will be the ultimate disposition of Fannie and Freddie? These questions will hopefully be answered in the fullness of time, but one thing of which we are fairly certain is that the outlook for the US economy hasn't really changed because of the plan to take over the Agencies. Perhaps the mortgage credit crunch will begin to ease, but it probably will have little effect on the vast overhang of homes for sale in the country. Otherwise, the economy continues to flash weakness. The Fed's latest "Beige Book", which sets forth anecdotal economic information from the 12 Federal Reserve Bank districts, reported that "the pace of economic activity has been slow," and that "[c]onsumer spending was reported to be slow in most Districts, with purchasing concentrated on necessary items and retrenchment in discretionary spending." The Mortgage Bankers Association released its quarterly survey on mortgage credit and reported that the total delinquency rate (6.41%), the rate of foreclosure starts (1.08%) and the percentage of loans in the process of foreclosure (2.75%) set new records. The latest employment data continued the trend of losses, with non-farm payrolls declining 84,000 in August, bringing the average monthly job loss to 76,000 during 2008. The unemployment rate rose from 5.7% to 6.1%. According to Northern Trust economists, with this jump the unemployment rate has now risen 1.3% in just six months, the worst six month period since the recession of 1981-82. The Federal Open Market Committee next meets on September 16, 2008, to deliberate monetary policy. It is unlikely that the Fed will opt to change rates at the meeting. If anything, we agree with the President of the Federal Reserve Bank of Boston, Eric Rosengren, who said that the relatively low Federal Funds rate does not mean that monetary policy is necessarily accommodative. "[T]he reductions in the Federal Funds rate have done little but offset some of the tightening occurring in the marketplace in response to the credit crunch conditions. Thus one can argue that much of the easing in monetary policy to date has merely offset the tightening in credit conditions created by the financial turmoil that began last summer."

The Mortgage Market

Prepayment speeds in July speeds (August release) continued to surprise to the slow side despite lowered dealer expectations. The largest discrepancies between expectations and reality continue to be in newer vintages and higher coupons, suggesting the slower speeds are being driven by home price depreciation and tighter underwriting guidelines. For example, speeds on 30-year FNMA 6s originated in 2006 and 2007 came in 20% to 25% slower than dealer expectations, whereas 30-year FNMA 5s originated during the same time period were closer to 5% to 15% slower than expectations. Looking ahead, in the autumn seasonal downturn speeds typically fall 10% to 15%, however given the slight slide in mortgage rates we have seen recently (6.4% as of August 29 from 6.63% as of July 30 on 30-year conventional fixed-rate) most dealers are calling for more modest declines of 5% to 10%.

Despite the tremendous liquidity measures aimed at adding stability to the mortgage market, and the overall financial system, Agency mortgage backed securities still gapped wider throughout the first half of August, later tightening in towards the end of the month. Spreads widened on concerns over the solvency, and ultimately the future, of Fannie and Freddie and rumors that a major Wall Street institution was on the verge of collapse. However, with the historic announcement on September 7th concerning Fannie Mae and Freddie Mac, spreads dramatically and immediately tightened in. On the first trading day post the announcement agency MBS spreads tightened in by 60 basis points versus Treasuries of similar duration as investors clamored for the product. Rates on 30-year conventional fixed-rate mortgages dropped below 6%. We will continue to monitor the market for signs of improved technicals and fundamentals. The graph below shows the nominal spread of the 30-year current coupon mortgage to Treasuries throughout the month of August and the beginning of September.



Source: UBS

The Markets

In August, gold and oil continue to slip, and the dollar continued to strengthen. Global rates were lower as market concern over economic weakness began to trump fears of inflation. Stocks were flat. Refinancing activity continued to decline.

	8/31/2008	7/31/2008	8/31/2007	MOM % change	YOY % change
Fed Funds	2.00%	2.00%	5.25%	0.0%	-61.9%
2-year US Treasury	2.371%	2.512%	4.136%	-5.6%	-42.7%
10-year US Treasury	3.813%	3.948%	4.531%	-3.4%	-15.8%
10-year JGB	1.415%	1.539%	1.613%	-8.1%	-12.3%
10-year euro	4.176%	4.355%	4.242%	-4.1%	-1.6%
10-year UK Gilt	4.480%	4.806%	5.036%	-6.8%	-11.0%
10-year Canada Treasury	3.534%	3.701%	4.425%	-4.5%	-20.1%
30 yr conventional mortgage	6.053%	6.280%	6.375%	-3.6%	-5.1%
Dollar Index	77.38	73.23	80.79	5.7%	-4.2%
Japanese Yen	108.78	107.98	115.92	0.7%	-6.2%
S&P 500	1282.83	1267.38	1473.99	1.2%	-13.0%
Nasdaq Composite	2367.52	2325.55	2596.36	1.8%	-8.8%
Gold $/oz (nearby contract)	$831.20	$913.90	$675.80	-9.0%	23.0%
Oil $/bbl (nearby contract)	$115.46	$124.08	$74.04	-6.9%	55.9%
MBA Refi Index (month end)	1059.7	1074.4	1770.2	-1.4%	-40.1%

Source: Bloomberg; Japanese Yen quote is the London feed

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