The US mortgage market and Fannie and Freddie

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In many articles written over the years members will note that I have warned many times and strongly of the US Mortgage collapse, at a time when Banks and other financial institutions continued to predict huge profits from this market. I continually forecast that the sub prime mortgage collapse would lead to a US housing crash. This has now happened and caused considerable pain to many people this year; the pain will continue for some time yet, as predicted.

Again, also as predicted Fannie and Freddie are swiftly heading for rough water; last week investors became very nervous. Perhaps they wanted to know whether the Fed would officially nationalize these companies. No one believes the two will disappear, although some government officials may well wish that they would! Furthermore, no one yet knows on what terms they will be saved. Both stocks sold off Friday – with Fannie taking a 27% direct loss, and Freddie hit with a similar 22% loss.

The Fed has let it be known that they stood behind the two back in 1968 – when they were set up in their present form. They were no longer on the government's financial books, but every lender knew they wouldn't be allowed to go broke. So far, Treasury Secretary Hank Paulson has counted on that implicit guarantee – along with a long line of credit – to keep the two going. RIO's comment is that we may see some action soon with investors selling off stock. Hank Paulson may have some convincing to do and come up with some real cash to put on the equity side, otherwise these entities are likely to witness continued volatility and yet further losses.

This is no ant hill! It is more like a volcano and it is about to blow with Fannie and Freddie each in the red for by about $50 billion. In other words together they are about $100 billion short. Judging by yesterday's trading, private investors are in no mood to provide support. But that still leaves an open question: the Fed may be forced to take back Fannie and Freddie (they were publicly owned prior to '68), but at what price? At $10 a share, $2 a share or less? Whatever, it is hard times for these giants!

My comment on the situation is they should face the fact that both companies are effectively insolvent. But the charade that everything's just fine would seem to continue. One reality check may come soon. Fannie has nearly US$120 billion in debt that matures by the end of September. Freddie has US$103 billion in debt. Can the GSEs roll it over? But who is going to buy? The Russians? Central banks? Private equity? Anyone?

If the GSEs cannot fund their operations or roll over their debt, what point is there in having a government sponsored mortgage lender that cannot provide liquidity in the secondary mortgage market? I would again advise members to think what this means for the U.S. housing market when the phrase 'even lower prices' comes to mind.

But what happens if the Treasury steps in now? Frankly, I don't know yet, and whether it will restore any stability to the mortgage market, but I feel strongly that it won't arrest the fall in U.S. home values. It may even precipitate a blow out in the spreads on GSE debt versus Treasuries, forcing the Fed to bring GSE-guaranteed debt onto the taxpayer balance sheet.

In some states the properties have already seen a 25% reduction in market values and no selling. It's a buyers market!! Having predicted all of this before anyone else I am better positioned than most to take advantage of this situation and have already been offered US property at a few cents on the Dollar. I do not yet feel that the risk reward ratios are right, but they may soon be if this fiasco is not solved fast.

About the only thing that members can be reasonably certain of is that the direct assumption of GSE liabilities should be negative for the U.S. Dollar. Even if the Fed reorganizes the companies, liquidates the riskiest assets, and refloats in the form of a public company there remains great uncertainty for two of the largest financial institutions in the country, a situation that markets do not like.

On the other hand, there is always the remote possibility that the appearance of a resolution to the decline and fall of the GSEs will give the stock market a shot in the arm. Irrational rallies are frequent when you are in a permanent state of crisis, as the financial markets now seem to be.

But the stimulus package from last year showed that the government is more than willing to bypass the banks entirely if it needs to. Treasury can simply write cheques to Americans, or, through the wonders of the Internet, make direct deposits into bank accounts. That is how the US stimulus cheques arrived this year, although that probably means the money can be taken away just as quickly and easily as it was given.

Debt is addictive and destructive, which is what makes the behavior of money pushers so morally reprehensible. Mailing cheques to Americans is a direct stimulus. This is a desperate measure. When one is that transparent about so-called "wealth creation" and "economic growth," the nature of the system is exposed for anyone who cares to see. The point is that Markets care! This means it probably will not go on for long until people begin to lose confidence (which happens when you purchasing power is lost quickly). My prediction remains that Dollar-denominated assets should fall, and so should the Dollar. Gold and silver, I would point out, have taken plenty of heavy fire in the last month, but will come out of all this looking like they always do: shiny, durable, and like real money.

But even then, there will likely be another wave of fraud by fiat. Public spending can be ramped up indirectly with an increase in the kind of massive public works that FDR pursued in the 1930s. Perhaps President Obama/McCain had better start working on some new agency acronyms - National Rail System (NRS)? New Manhattan Project For Oil Shale (NMPFOS)? A War To Rebuild America's Infrastructure (WTRAI)?

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