Comment on the US Nationalization of Freddie and Fannie

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Members will already know that the US government has bailed out troubled home loan giants Freddie Mac and Fannie Mae, who together guarantee or own about half of the $12 trillion US mortgage market. Both Freddie and Fannie have no direct UK equivalent, because rather than lending directly to borrowers, as is the practice in the UK, they provide funds to almost all US mortgage lenders.

Indeed American treasury sources are reported to have said that if the deteriorating situation had been allowed to continue for even a further fortnight, a financial meltdown at Freddie and Fannie was on the cards. Hence the decision to effectively nationalize the two companies.

In terms of restoring global confidence this may have some bearing, although it will not be good for the US Dollar because the liabilities involved are so huge. Furthermore, while the value of the Dollar slid when the news broke, the price of gold rose. Equity holders of Freddie and Fannie will receive nothing from the rescue, but the confidence of credit holders will be bolstered by the knowledge that their debts are now guaranteed by the US government.

The story is breathtaking, the biggest US nationalization in history. Freddie and Fannie finance 3 out of 4 new mortgages in the USA. Now, the mortgage industry depends neither on willing buyers and sellers nor on willing lenders and borrowers but on the U.S. government.

The notion of taxpayers bailing out the mortgage finance industry is ridiculous; taxpayers cannot even finance existing federal obligations. This year, for example, there will be a shortfall of a half trillion dollars. I would forecast that, over time, these institutions will have to confess losses, take write-downs; and raise new, dilutive capital. Many will be taken over by the FDIC, which again wipes out shareholders!

<u>My comments</u>

When many Americans think of debt and deficits, their immediate reaction is to blame the war in Iraq, or defense spending. Some people think that the US can solve the financial problems by stopping fraud, waste and abuse, or by reversing the Bush tax cuts. **Unfortunately, the United States could do all three of these things and still would not come close to solving the nation's fiscal challenges.** The U.S. already has $11 trillion in fiscal liabilities, including public debt. To this amount is to be added the current unfunded obligations for Social Security benefits of about $7 trillion and one could also take into account Medicare's unfunded promise of $34 trillion.

As I have reminded you periodically, I forecast these GSE shortcomings back in 2002. I pointed out the dangers because the growth of these GSEs was far outpacing that of the mortgage market. This is one time I am unhappy to have unfortunately predicted correctly.

The smart money is selling into this rally. Why? Because it is a bear market!

The smart money is looking for safety, but seems to think it is better off in US Treasuries than in gold, which makes me think that it is not so smart as it thinks! We estimate that the credit of the world's biggest debtor will prove less sure than they believe. The debts and financial obligations of the U.S. government continue to rise many times faster than the growth of the economy. Under the Bush administration, they have gone up faster than ever before in the history of the USA. We doubt that they will go up any more slowly if Obama is elected. Eventually, the United States will be recognized for what it is – a sub prime borrower!

As to how much exactly this will add to the debts, we cannot say yet. No one knows. When the question was put to the man who should know, Hank Paulson, he replied: "We didn't sit there and figure this out with a calculator."

Apparently, taking control of Mac and Mae was considered a matter of national financial security, something you could not put a price tag on. But it is safe to guarantee that the cost will be enormous. Sooner or later, someone is bound to undertake some serious calculation.

Lehman Bros shares plunged to their lowest level in almost ten years last week, falling 45%. They reported a quarterly loss of $4 billion – their worst since going public, and second consecutive loss. Another one bites the dust!!! And this time there is no bailout.

RIO's comment is that to spite this 'multi-prong' plan, which includes moving the firm's commercial real estate assets into its own separate entity and reducing its residential real estate holdings by half, fears in the marketplace have not been quelled. **Just as predicted in the "Ten Year of Success issue" of RIO News page 53/54 we are now in phase 6 of the disaster as the US banking system is now indeed crippled by bad loans.** Can you remember the knockout punch delivered by the Savings & Loans crisis in the 1980s? This is bigger. More than 2,500 banks, thrift organizations, credit unions and mortgage companies wrote a combined $1.5 trillion in sub prime loans during the peak of the boom.

When George Bush Snr threw $150 billion at the S&Ls, it helped spark a three-year recession. What will happen as Washington tries to defuse a multi trillion Dollar time bomb?

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