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Of Maes and Macs: From Ridiculous to Sublime

MARKETS AT A GLANCE

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We'd like to begin this article with a trip down memory lane. As our readers know, we've been one of the very few on the street who saw today's financial mess coming a mile away. We furthermore long believed that two of the key catalysts of this financial mess would be Fannie Mae and Freddie Mac. They are so-called *Government Sponsored Enterprises*, companies set up by government yet allowed to operate as private corporations – a disastrous combination chock-full of moral hazard and systemic risks. It is no secret that Fannie and Freddie use (and risk) the capital of the government/taxpayers in order to maximize their business, profits, and management compensation. As such, over the past decade they have morphed into behemoths, having a hand in fully half of the $10 trillion US mortgage market, and indubitably aiding and abetting not only the US housing bubble but also the global credit bubble. It could be argued, and has been by astute analysts, that through their issuance of derivatives and reams of mortgage backed securities (that have implicit government guarantees), Fannie and Freddie provided more liquidity to the financial markets over the past five years than even the Federal Reserve did with its easy money policies.

Unfortunately, with the subsequent implosion of the housing and credit bubbles, Fannie and Freddie were disasters waiting to happen. Today it's there for all to see, with a massive bailout of some sort in the works. However, the stage was set long ago. This is what we wrote a while back in one of our articles, aptly titled *Surviving a Meltdown:*

"The derivatives balloon, the housing bubble, the carry trade, Fannie Mae and Freddie Mac – all have the potential to blow up, cascading into a market meltdown and potentially a financial crisis of gargantuan proportions." [1]

This we wrote *four years ago*. Here's another quote from a different article of ours shortly thereafter:

"Of prime concern are the activities of the Government Sponsored Enterprises (GSE's): Fannie Mae and Freddie Mac. In every sense of the phrase, these entities function as **leveraged hedge funds**, with trillions of dollars at stake. Barely a day goes by without an article in the financial press discussing the systemic risk these companies pose." [2]

Our message hasn't changed since then. More recently, in our *Dead Men Walking* article in November of last year, we enumerated Fannie and Freddie as being firmly on the corporate equivalent of Death Row. Like many other financial companies who partook too deeply in the lending mania, these companies are now in deep trouble, their only salvation being a last minute reprieve from the government in the form of a taxpayer sponsored bailout. In hindsight, what we wrote eight months ago proved to be quite prescient:

"Some would argue that the sheer size of the GSE's, the major banks, and most of the investment banks make them too big to fail. The government would likely have no choice but to bail them out. Perhaps so. But what will the value of the stocks be in that scenario? Probably a lot lower than they are now." [3]

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[1] "Surviving a Meltdown", *Markets At A Glance*, May 2004.
[2] "Does Paper Really Cover Rock?", *Markets At A Glance*, June 2004.
[3] "Surreality Check… Dead Men Walking", *Markets At A Glance*, November 2007.

We'll let the facts speak for themselves. Back at the start of November, the share prices of Fannie and Freddie were both north of $50. Now, as I write this sentence, their share prices are a shadow of their former selves, at $13 and $8, respectively. With the prospect of a government bailout, they are indeed "a lot lower", just as we predicted. By mid-July, in the space of only one week, the two stocks had fallen a breathtaking (or heartstopping if you're an unfortunate shareholder) **60%!** It was relentless carnage. We believe they will ultimately be worth closer to zero. Implicit guarantee or not, there is no consolation for shareholders. Nor will there be any for US taxpayers, the government deficit, or the US dollar. It's just bad news all around. Although we may appear prescient, it was all highly predictable.

Unfortunately, prescience is one thing that the people in authority **don't** have. We're talking about the people who are responsible for this mess and who are now, in a leap of illogic, the ones in charge of cleaning it up using the same easy money policies that created the mess in the first place. Greenspan, Bernanke, Paulson, Dodd, the SEC, the banking regulators. Here's a word to the wise: You would do very well as an investor ***never*** to listen to their musings. They are politicians parading as economists. As such, they have an agenda and are woefully lacking in objectivity. At every turn they will massage the message to what the public and the markets want to hear, invariably promoting the rosy outlook and dismissing as unlikely anything bleak even if it stares them in the face. Their proclamations have been like clockwork: always trying to sooth the markets just when the worst is about to happen. Investors should ignore what they have to say, or even better, do the exact opposite.

Let's take a few examples as cases in point. Last year Ben Bernanke infamously proclaimed that the unfolding subprime crisis was contained. Oh how wrong he was! A few years ago when ARM rates were at historic lows, never to return to those levels again, Alan Greenspan recommended that adjustable-rate mortgages as opposed to fixed rate mortgages were the way to go for homebuyers. Dead wrong once again. Recently, Treasury Secretary Henry Paulson proclaimed that 99% of banks, including Fannie and Freddie who have a mere 1.6% of capital supporting over $5 trillion of mortgages and mortgage guarantees, are well capitalized. That was also a load of malarkey. This week, the Bush administration is proposing a rescue plan for Fannie and Freddie, claiming a ridiculously low potential cost of $25 billion, or only half of one percent of their mortgage exposure in a still declining housing market. More bull. Even more ridiculously, the proposal is claiming that there is a greater than 50% chance that not even a dime of taxpayer money would be used! We're willing to wager that the true odds are a virtual certainty, and that the cost of the rescue will be multiples of their bogus projections. When all is said and done, we believe the government through deficits, or more likely the Fed through money printing, will need to rescue the failed financial system to the tune of trillions.

Of course, nobody wants to speak the truth these days lest it erode confidence in the financial system. Public knowledge of the truth is tantamount to a self-fulfilling prophecy. But confidence needs to be earned, not proclaimed. Although it is true that a sound financial system, at its foundation, is all about confidence, the best way to instill confidence is to have clean accounting books, free of irregularities, reported in a timely and regular manner, and aptly regulated with regards to the above. These have been conspicuous in their absence, especially in regards to the largest GSE, Fannie Mae. For the banking system as a whole, confidence requires engaging in sound lending practices, avoiding undue risks, requiring downpayment and adequate collateral, maintaining sufficient capital ratios, and once again, fair but firm regulation. On all these points the financial system has failed miserably. Now it has come to the point where we must rely on government bailouts to keep the system intact. Is this supposed to re-instill confidence in the financial system? We think not. Furthermore, promises of stronger regulation going forward are tantamount to closing the barn door after the horses have already escaped.

We'd like to conclude this article with the most bogus claim yet made by someone in authority: the one made by Greenspan that he (and central bankers in general) are unable to identify a bubble as it is occurring, and using this as an excuse for their failure to squelch it. What hogwash! Even we, with far fewer resources than the Fed, clearly saw the housing bubble and the lending mania. How can there not be a bubble when people were able to

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procure mortgages with no downpayment, no documentation, inflated appraisals, being able to borrow greater than 100% of a home's value, with negative amortization of interest and, last but not least, where the ability of a borrower to pay just didn't seem to matter. It was a bubble through and through. We find it most perplexing how nobody in a position of authority was willing to identify it for what it was. The Fed, in fact, continued to maintain an ultra-easy monetary policy while these shenanigans were going on, and the regulators and legislators continued to turn a blind eye in spite of evidence of mounting systemic risks. Now the same people are being relied on to solve the problem they didn't even see coming. The same people who, through bad decisions, bad advice, and inaction, caused the problem in the first place. From the ridiculous to the sublime…

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