



OVERVIEW

- Just when we thought we had “seen it all,” the financial market crisis hit another previously overlooked sector: Government Sponsored Entities (GSEs). More specifically, the crisis impacted Fannie Mae and Freddie Mac, the two giant mortgage companies that provide liquidity to the U.S. mortgage market by buying mortgages from local lenders and selling the repackaged assets back to the market.
- The trouble started when analysts looked into the companies’ assets and predicted growing losses as a result of rising mortgage defaults. At issue was Fannie Mae’s and Freddie Mac’s strategy of transforming themselves into private companies, growing earnings and revenue sources, with corresponding salaries and bonuses for their executives.
- Unfortunately, despite their extensive housing finance expertise, Fannie Mae and Freddie Mac made the same mistakes that have plagued banks and brokers and accumulated too many, now worthless, assets. This resulted in a Federal Government bailout that included an increased credit line from the Treasury Department and the potential for a direct, Government-funded equity injection.
- This landscape contributed to stock markets experiencing a volatile July, extending losses in the first two weeks of the month, due to Freddie and Fannie’s troubles, before staging a tentative rebound in the latter half. The major U.S. stock indices ended the month unchanged or slightly higher, while Treasury yields moved higher in July on persistent inflation pressures and signs of better economic news.
- Fixed income credit markets saw more spread widening in July with High Yield markets significantly underperforming other credit asset classes.
- Finally, the U.S. dollar had a mixed month, weakening generally against other Developed Market currencies, but posting broadly positive gains compared to Emerging Markets.

ECONOMY

- While markets took another tumble in July, data on the current state of the U.S. economy continues to rebut forecasts of an imminent recession. The tax rebate checks helped consumers through the most recent period of record gas prices, business investment perked up again in the second quarter, and there is gradually mounting evidence of stabilizing housing demand.
- The debate between the “bulls” and “bears” now rages about the sustainability of the current growth pickup. What happens in the second half of 2008 when the economic stimulus package fades?
- In our opinion, the answer depends largely on the price of oil. The most recent decline in oil and gas prices is encouraging, but insufficient. Oil prices need to fall towards \$100 by the end of the year to offset the impact of fading tax rebates. In fact, a 25% decline in oil and gasoline prices would add back as much to household wallets as the tax rebate program did over the summer.
- On the other hand, if oil prices stay around \$125, the economy might be able to plot along between 0% and 1% growth. However, if prices rise back to \$145 and beyond, a recession could be inescapable.

- There is also more tentative good news on the housing side. Home builders have cut back new construction sufficiently so that even the current, admittedly very weak sales levels are reducing the inventory of unsold homes. Additionally, the pace of decline in sales is about matching the decline in inventories, so the widely followed ratio between the two has not improved much.
- House prices are still falling, but the pace of decline is slowing, suggesting current sales can be sustained with increasingly fewer price concessions. Credit availability remains the biggest obstacle for a broader housing rebound.
- Mortgage rates have also increased notably in recent weeks. Freddie Mac’s 30-year fixed mortgage rate is trading about 30 basis points above their 2007 average, and the difference between mortgage rates and Treasury yields is showing the widest gap in 7½ years, suggesting affordability is deteriorating again.

POLICY

- The Federal Reserve has been steering a steady course through the recent, difficult times. It took the central bank a few months to comprehend the scale of the problem, but, since last December, the bank has fully embraced the severity of the crisis and earned top grades for the innovative tools it developed to deal with the liquidity crisis.
- The increase in inflation pressures has complicated the Fed’s strategy, but with the help of more expansionary fiscal policy, growth is less of an issue right now, and the focus has shifted to addressing the inflation risks.
- Headline consumer price inflation accelerated to a 17-year high 4.9% in June, and within the producer sector inflation is running at an even faster 9% pace. We continue to believe that the consensus within the Federal Open Market Committee (FOMC) will slowly shift towards a rate increase by the end of the year.
- In the meantime, the Federal Reserve remains very active providing liquidity support for the still stressed U.S. banking system and extending its new lending faculties into the next year.
- During the recent Fannie Mae and Freddie Mac crisis, the bank once again broadened its lending facilities to include the two mortgage companies in order to ease investor concerns over the GSEs’ ability to raise funds in capital markets.

INVESTMENT OUTLOOK

- As before, we are maintaining a cautious stance in both our equity and fixed income strategies. The downside risks to our baseline outlook of a moderate rebound in growth over the summer remain significant evidenced by the latest reports on more write-offs among U.S. banks and brokers.
- Clearly, the de-leveraging of the financial system is not over, and the housing market has not turned around yet. At the same time, the threat of entrenched inflation is leading to shifts in monetary policies around the world and will eventually trigger a series of rate increases here=.
- What would change our attitude towards risk now? Further declines in the price of oil, more convincing evidence of a bottom in the housing market, and evidence that banks are getting closer to the end of massive asset write-downs.



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