

## FANNIE AND FREDDIE CRY UNCLE!

Financial markets have been rocked by the recent focus on the precarious financial situation in which the Federal National Mortgage Association (Fannie Mae) and her cousin the Federal Home Loan Mortgage Corporation (Freddie Mac) find themselves. With home prices measured by the Case/Shiller index down 18% year over year, could these two behemoths of global financial markets be about to alter the course of financial markets and U.S. economy for months or years to come? We examine the situation.

### GOVERNMENT ENTITIES WHICH ARE GRANTED THE RIGHT TO ACT AS PRIVATE SECTOR FIRMS

Fannie Mae was created by the FDR administration in 1938 as part of the New Deal to stimulate economic growth coming out of the Depression era. Its mandate was to make housing more affordable to the middle classes by facilitating the financing of homes. Freddie Mac came into existence in 1970 with a similar mission. Both enterprises were eventually transformed into publicly traded corporations in the seventies in response to budget pressures resulting from the Vietnam War and difficult environment of the early 1970s. One needs to focus on the hybrid nature of these two firms to fully realize the place and role they occupy in the American economy and global financial marketplace. They are publicly listed stockholder-owned companies that hold a charter to operate from the Government of the USA, which grants them an *implicit* credit guarantee. Stated otherwise, these two firms are capable of borrowing on equal standing to the world's greatest power, and are exempt from banking regulation and taxes. In essence, their mission is to extend financial intermediaries' mortgage loans by repackaging them into securities to allow banks to lend more, thus enhancing credit availability. Statistics on both entities are mind boggling. Suffice it to say, they currently own or guarantee half of the total U.S. mortgage debt, or over \$5 trillion of outstanding mortgages.

### WHY MARKETS ARE CONCERNED

Investors are rightly concerned about the financial health of Fannie and Freddie because of the role they play in so many parts of the market and the economy. The amount of debt issued by these two entities is equal to the total of Treasury bonds outstanding. As such, millions of investors - ranging from foreign governments to already pressured banks, and from broker-dealers hedge funds to pension funds - own debt securities that could be downgraded in value or rating at any time. The U.S. economy struggles to compose with a serious banking crisis, a \$140 barrel of oil, and a pending slowdown. The worst possible outcome caused by difficulties at these two firms would involve further restrictions on mortgage financing availability. Informed investors are aware that they collectively underwrote 81% of mortgage-backed securities during the first quarter, and that a contraction in credit is the number one cause of recessions in the U.S. The list of concerns is justifiably long. Yet, one item requires special clarification: the media have suggested that should the government intervene in support of F&F - as they have announced their intention to - the U.S. would assume \$5.3 trillion in additional debt. This vastly overstates the risk to taxpayers as it is impossible for 100% of these mortgages to depreciate to zero, and both firms own considerable assets which would become owned by the rescuing entity.

### IS CANADA AT RISK?

Once again Canada is well served by having followed a distinctive policy approach. Canada's banking regulation and competitive landscapes are markedly different. Excessive credit has been much less prevalent in this area. The Canada Housing Trust is responsible for purchasing mortgages from banks and securitizing and reselling them to investors. It is the second largest issuer of debt in the country after the federal government. The resulting security, the Canada Mortgage Bond (CMB), has seen its credit spreads widen over recent months in line with global markets, but certainly not to an extent indicative of stress related to the issuer or underlying mortgages. Canadian mortgages are more often insured (less sub prime), and tend to be paid off faster than in the U.S. Recent measures taken to limit zero-down, 35+ year amortization mortgages indicate a willingness to keep things that way.

### NATCAN WEEKLY MARKER

Worsening difficulties in the U.S. real estate market have inflicted serious wounds on two of its most important players at a time when private sources of lending are contracting. With government support now a given, two issues remain to be solved: the value of the equity in these firms, and the overall availability of mortgage credit in coming months. Equity investments in FNM and FRE are possibly best described as lottery tickets or options. Credit availability will prove a critical factor in charting the course of the economy and markets over the remainder of the year, and into 2009. We will be monitoring the situation very closely.

Michael Quigley, CFA  
Senior vice president, Distribution

## FINANCIAL MARKETS

RETURNS AS AT JULY 11, 2008 (%)	MTD	QTD	YTD	RATES AS AT JULY 11, 2008	
S&P/TSX	-5.20	-5.20	0.48	CAD/USD	1.01
S&P 500	-4.06	-4.06	-13.30	CAD/Euro	1.61
S&P/TSX Small Cap	-5.66	-5.66	-6.02	US Treasuries yield 10-yr/30-yr	3.94/4.52
Russell 2000	-3.09	-3.09	-9.89	GOC bond yield 10-yr/30-yr	3.78/4.09
MSCI EAFE	-5.09	-5.09	-13.13	Fed Fund Rate (target)	2.00
MSCI World	-4.44	-4.44	-12.15		
DEX Universe Bond	0.30	0.30	2.52		

Note: Returns in Canadian dollars, London 4h exchange rates. Source: Datastream, PC Bond, MSCI-Barra, and Bloomberg. PC-Bond, a business unit of TSX Inc. Copyright © TSX Inc. All rights reserved.

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