

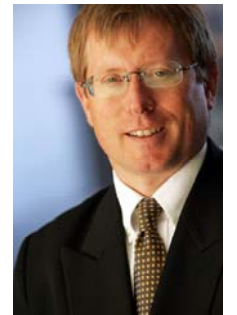
A moving of the deck chairs

As the world began to pack up for Christmas 2009, the US government quietly announced a further capital injection for the fundamentally troubled Freddie Mac and Fannie Mae mortgage 'banks'. These quasi government institutions (which are more formally Government Sponsored Enterprises or 'GSEs') had suffered extremely severely during the global financial crisis, in part as a natural result of their huge exposure to the US housing market but also as a result of their massive trading, borrowing and other 'financial engineering' operations that also struggled during the crisis. Not surprisingly, the majority of the world's press – and even, it seems, the armies of financial bloggers – largely missed this event, presumably having better things to do on Christmas Eve than report on such seemingly arcane transactions but this does not diminish the significance of the event. At first, we took this state-initiated recapitalisation effort simply as a politically inconvenient confirmation of just how expensive the bailout of the GSEs was in reality and also an implied admission that many, if not the majority, of total assets of the GSEs were still notionally being held off balance sheet and financially under water.

The buyer of last resort has changed

Over recent weeks, however, we have been obliged to alter our initial reading of the situation in that it does appear that the Obama Administration did not just merely recapitalise the troubled GSEs, so that they could continue

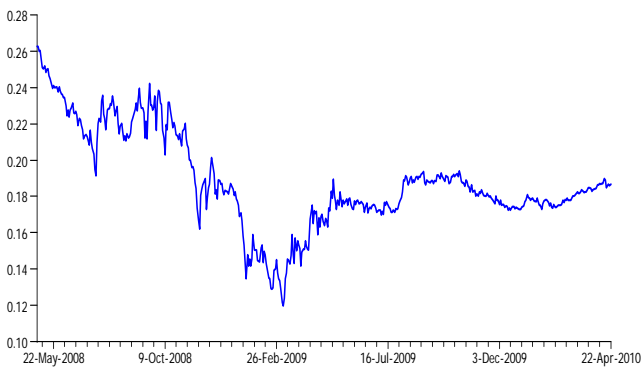
to carry their existing assets, the Treasury also provided them with the wherewithal to expand their assets further, which they have done over the last few weeks. Specifically, press reports and public notices issued by these institutions



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confirm that the GSEs have returned as substantial buyers of what might be described as deeply compromised housing debt-related securities from banks, hedge funds and other investors. What makes the story perhaps even more intriguing is that the GSEs apparently expanded their activities in this direction just at the moment that the Federal Reserve, the US central bank, announced that it would no longer be buying mortgage backed securities (MBS) itself, following a decision to wind down that part of its quantitative easing policy (QEP). In effect, one government department, namely the central bank, has stopped supporting the mortgage markets but another department – the GSEs – appear to have simply taken over the support role, although their actions have been rather less high profile. In summary, it seems that the GSEs are buying the MBS that the Federal Reserve is no longer buying under its QEP – no wonder the world's financial press has largely missed this particular piece of alphabet soup but, once again, this should not detract from its importance.

USA: Financial Sector Share Prices Recover
S&P Financials Relative to All Equity Prices



For the commercial banks and other investors who have until now been effectively trapped in their now largely unwanted boom-era mortgage-related investments, the appearance of the GSEs as substantial and perhaps even more aggressive buyers of mortgage securities than was the Federal Reserve in 2009 must have seemed like the arrival of a white knight that has allowed them to exit these once troublesome positions, presumably at relatively attractive prices. Indeed, this new government facility would seem to offer some explanation for the US financial sector's recent buoyancy: they have been allowed to escape from some of the persistent hangover of the global financial crisis.

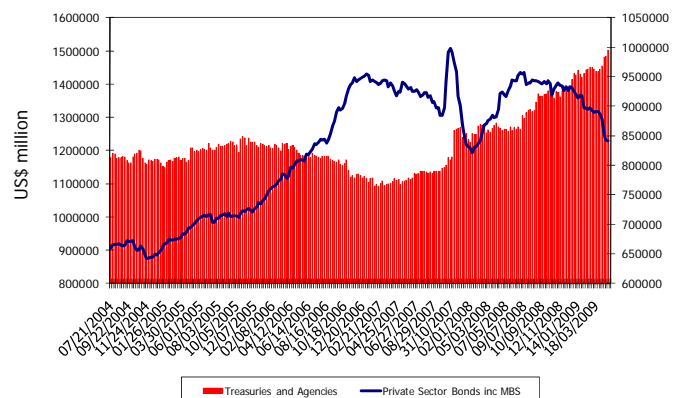
A white knight for MBS?

Of course, if Freddie, Fannie and indeed the other GSEs are now re-expanding their balance sheets, they must also be obtaining funding from some source. Although the official data is not yet available, it seems that the GSEs are funding their acquisitions with what might be described as *ersatz* Treasury Bonds – in effect they are being allowed to borrow under a US government guarantee that allows their debt (known as Agency Bonds) to be rated as though it were “Uncle Sam’s”. Adding to the puzzle is the fact that some of the biggest buyers of US Treasuries over recent weeks have been US commercial banks, although we doubt that they have been the only significant domestic buyers of late.

For the commercial banks, this particular deal must seem very attractive since they are being allowed to offload their troubled holdings of mortgage securities at presumably beneficial prices to the GSEs institutions that in turn then fund their purchases of these compromised securities by selling ‘triple A’ Treasury bonds to the very banks that they are buying the troubled assets from.

One should not underestimate the importance of this event. The commercial banks are being allowed to offload loss-making securities, which were implicitly sapping their capital, onto the balance sheet of the government and to take on instead higher grade profitable securities (since the yield offered by US Treasuries is significantly higher than the banks’ notional cost of funds). Moreover, many of these banks, particularly in the realm of investment banks, can then use their newly acquired Treasury bonds as collateral in complex ‘repo borrowing’ and other bubble-era style transactions. To coin a phrase, the latest actions of the GSEs are implicitly both re-capitalising and re-collateralising the once troubled banking system with a hugely beneficial impact on the banks’ profits and hence their ability to supply credit.

USA: Banks' Securities Holdings



Unfortunately, it does not appear that the banks are using their new found ability to lend to increase the availability of credit to either households or small companies in a meaningful way; although we can perhaps suggest that they have at least stopped reducing their supply of credit to these sectors. Instead, the banks appear to have stepped up their provision of credit to the financial sectors - virtually all of our clients in the 'leveraged space' have noted that the prime brokers are now offering them substantial credit lines once again and currency market sources are also talking of a return of carry trade interest in markets (whereby investors borrow in low interest currencies such as the Japanese Yen and use the funds to acquire positions in higher yielding currencies, such as the NZD and AUD), a situation that is usually indicative of a return of 'leverage' to the financial system.

Arbitrage opportunities don't go begging

This report has been loaded with acronyms and talk of convoluted 'asset swaps' between the government and the financial system that appear to have gone on behind the scenes. What these transactions imply is that, despite the recent events in Greece (whose problems are simply intractable and can only be solved by either the country's default on its debts and / or its exit from the Euro) and the apparently tightening regulatory environment, the US and hence the global financial system is once again entering a new period of balance sheet expansion that, although different in detail to the situation that persisted in the mid 2000s, is in character remarkably similar.

For financial markets, we suspect that this state of affairs is generally positive for bond, equity, commodity and currency markets, despite the apparent fundamental contradiction offered by the thought of rising commodity prices (and hence inflationary pressures) and rising bond prices (usually the product of low

inflation or deflation). For New Zealand, the prospect of a return of the Yen carry trade brings with it the prospect of further gains in the NZD (although we suspect that it may still lag the AUD) and potentially some downward pressure on debt yields and even longer term mortgage rates.

A strong Kiwi still on the horizon

At a fundamental level, we remain concerned by the health of the global economy – the US and UK consumer recoveries appear only transitory feints to us and the economic situation in Europe is clearly deteriorating following the predictable travails of the Mediterranean economies (as we have noted in these pages before, the demise of Europe's "PIGS" economies offers a clear reason for Australia and New Zealand to resist any attempt at an Antipodean currency union). The emerging market economies are of course notably stronger than the OECD economies but despite this seemingly positive development, global trade and savings imbalances remain and these can be expected to haunt financial markets for the next few years. Despite these fears and worries, the global tide of liquidity seems to be rising for now and this may yet lift all the 'boats in the financial harbour', regardless of their fundamentals. Of course, as Warren Buffet has noted, when the tide ebbs away, we will find out just who is swimming naked (as Greece was doing) but we will probably have to wait for either tighter US monetary conditions or greater levels of financial regulation for this period of revelation.

Andrew Hunt
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London

See over for upcoming Tyndall presentations:

Andrew's 2010 New Zealand presentation dates:

Winter Series

| | | |
|-----------------|--------|--|
| 6 August | 7.15am | Auckland, breakfast The Auckland Club |
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| | 12.30pm | Wellington, Lunch The Intercontinental |
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| 24 August | 2.00pm | Queenstown |
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| 26 August | | Convention Centre Christchurch |
| Workplace Savings Forum | | |

Other Tyndall Manager Presentations:

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| Week of 14th June | Calvin Ho from JP Morgan Alternative Asset Management will be in NZ. Dates/Venues TBA. |
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For further details of presentations, please contact enquiries@tyndall.co.nz