

## Freddie and Fannie . . . the guarantee is now explicit

The government took the final step some had anticipated may be required, taking control of two Government Sponsored Enterprises (GSEs) that are critical components in facilitating a liquid home mortgage market.

Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corporation) were formed as publicly owned enterprises that grew to own or guarantee about half of the \$10+ trillion US mortgage market. The two organizations actively buy mortgages from banks and other financial institutions and primarily repackage them for resale via mortgage-backed securities in which they guarantee the underlying mortgage payments. The GSEs essentially provide a liquid market for financial institutions, buying the mortgages they write, and thus provide increased flexibility to write more mortgage loans than would be possible if they had to be retained on the financial institutions' balance sheets.

The role of the GSEs in providing a readily available source of cash helps to maintain an ample supply of mortgages. A plentiful supply of mortgages is thought to help keep the cost of mortgages low, making home ownership more affordable. The subprime mortgage crisis though has put a tremendous strain on the potentially liability of the GSEs calling into question the adequacy of their capital to make good on their guarantees. With confidence faltering in the creditworthiness of the stressed GSEs, their funding resources (like foreign central bank ownership of their bonds or new issuance of stock) were feared to be losing confidence as well. In order to maintain an active mortgage market in an already stressed US housing market, and to avoid any escalation in the already tumultuous credit market, the US government felt compelled to step in and provide explicit guarantees to those securities issued by Fannie and Freddie. On September 7<sup>th</sup>, the two organizations were placed in conservatorship under the authority of the Federal Housing Finance Agency (FHFA). The action served to diminish virtually all value to the common stock holders of the companies, bad news for some but potentially good news for the broader market and economy.

On the announcement, the broader marketplace greeted the news positively as it substantially eliminates the so-called disaster scenario, where the two entities that had the implicit guarantee of the US government risked defaulting on their obligations. *The guarantee of the US government is now explicit.* World equity markets rallied on the news as did the value of bonds issued by the GSEs.

The government takeover is the latest in a string of attempts to resolve the credit crisis. It follows aggressive cuts in the Fed Funds rate down to 2%, the opening of Federal credit facilities to investment banks (not just commercial banks), the enforcement of naked short selling rules for key financial institutions, and facilitating the sale of troubled Bear Stearns.

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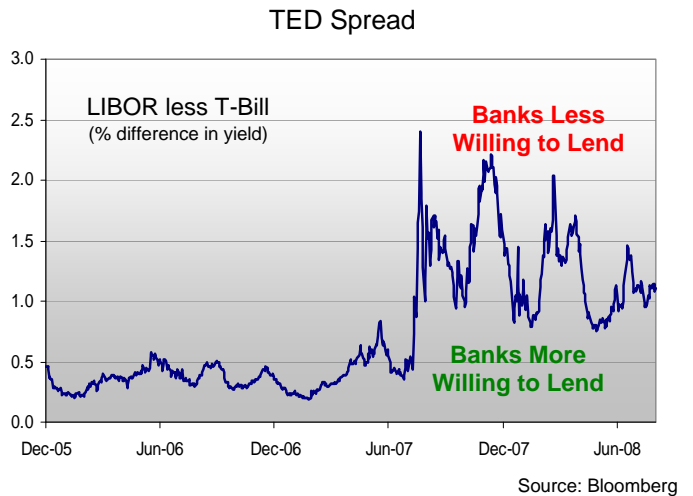
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The credit crisis has proved to be stubbornly persistent and may yet require additional government intervention. Along the way there are numerous indicators to gauge the success of the government's efforts and ultimately the health of the underlying credit market. One such indicator is referred to as the "TED Spread".

### Ted Needs to Improve . . .

The Ted Spread represents the difference between the yield on the US T-bill, a so called riskless asset, compared to the LIBOR rate at which banks lend money to one another (London Interbank Offered Rate). When the spread is high, it suggests a degree of unwillingness for banks to lend to each other, a reflection of their attitude toward making loans in general. In other words, *if banks aren't lending, economic activity slows*. While the decline in the TED Spread from 2.0% is encouraging, a level closer to 0.5% is indicative of a more productive credit market environment.

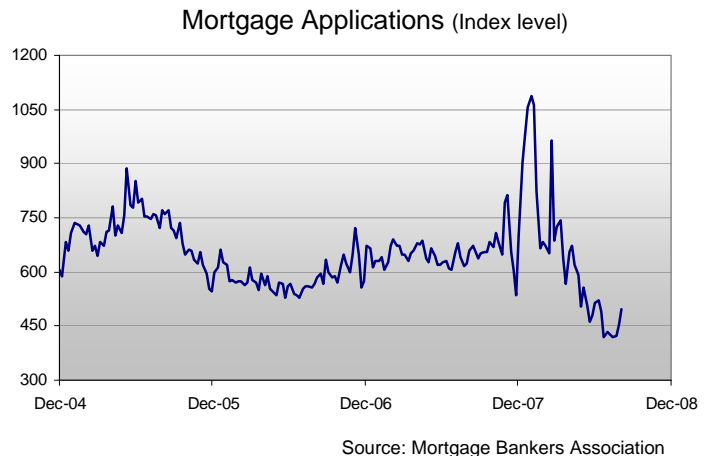


The Ted Spread did not change much from its 100+ basis point position in the days after the GSE takeover, seemingly a confirmation that there are no quick fixes to the credit crisis. On the other hand, it has not reverted to previous extremes, and the declining trend in peak levels is positive.

### . . . So Does the Housing Market

Without ample and affordable mortgages facilitated by Freddie and Fannie, the housing market would have an even greater struggle recovering from its turmoil. Freddie and Fannie have been distracted from their regular business trying to shore up their capital base and stave off the eventual government intervention. With the GSEs operating in something other than an extreme crisis management environment, perhaps the supply of mortgages and level of rates will be more conducive to overall lending activity and the housing market.

Signs to watch in the weeks and months ahead will be the trend in mortgage applications and mortgage rates. In recent weeks the mortgage application trend has bounced somewhat higher, but remains at a 7-year low.



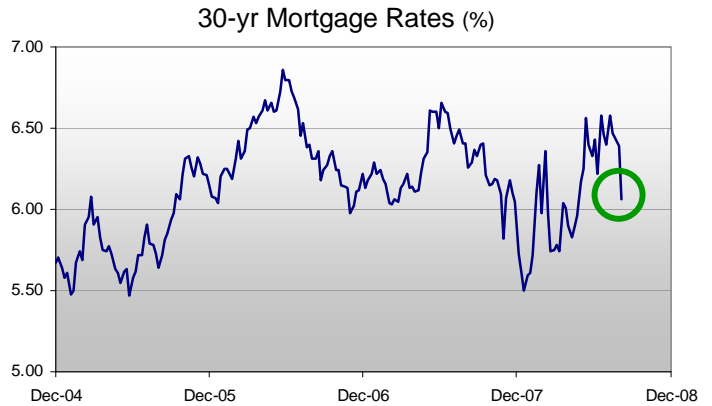


Interest rates on mortgages have eased from their one-year high of 6.58% on a 30-year fixed loan down to 6.06% according to the Mortgage Bankers Association for the week ending August 29<sup>th</sup>, prior to the GSE takeover. If the government control of Freddie and Fannie have a further easing affect, perhaps rates could approach the more stimulating level of 5.5% hit briefly earlier in the year.

### Stock Investors Take Heed

As the government confronts the ongoing threats to the credit markets, committed stock market investors should take comfort in acknowledging the historic tendencies for the equity market to act as a leading indicator, anticipating the future environment. So when indicators like the Ted Spread finally revert to more normal levels, or housing activity begins to turn, the stock market may have responded positively well in advance.

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Source: Mortgage Bankers Association