

# MEMORANDUM

To: **Wurts & Associates Clients**  
From: **Eric Petroff, CFA, Director of Research**  
Date: **July 25, 2008**  
Re: **Fannie, Freddie, and Financials**

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Financial markets continued their rapid evolution with recent news regarding Fannie Mae, Freddie Mac, and the nation's major banks. Housing data continues to weaken and inflationary pressures are rising, making investors even more uncertain as to what the future holds. Over the short term, uncertainty is very much the case. Over the long term however, the government is doing us the favor of laying out a very clear path to economic recovery. So rest assured recent events are actually good news for those of us serving as Fiduciaries for long term assets.

Earnings announcements in the banking sector have been generally poor, with some results being worse than expected. Bank of America leads the pack with a 41% drop in profits over the last year to produce earnings of \$3.4 billion for the most recent quarter. This is on top of \$8.6 billion in trading losses and plans to cut 7,500 jobs. Citigroup followed with a \$2.5 billion quarterly loss. Washington Mutual posted a slightly higher \$3.3 billion loss and is setting aside reserves of about \$8 billion for future loan related losses. The biggest hit to investor confidence though was Wachovia's \$8.9 billion loss, whereas the market expected only a \$2.8 billion loss the day before. Wachovia also announced 11,000 job cuts and set aside \$11 billion for credit losses, nearly triple their expectation from a year ago.

Though banking losses may seem appalling at first glance, there is very good news to be found here. Just think back to the days of Enron and WorldCom, and investors' realization that accounting practices were in need of revision. We saw huge write offs across the board for publicly traded companies to account for poor bookkeeping. Thereafter reported earnings strongly rebounded. In fact, we are now coming off historically high profit margins. So the good news here is the banks will work through these losses as quickly as possible, and investors and money managers will generally shy away from these holdings for various emotional and business related reasons. This of course will dramatically increase prospective returns through lower valuations, and is something we shouldn't forget about as the dust settles in this industry.

We are also seeing tremendous concern regarding Fannie Mae and Freddie Mac. These institutions collectively oversee about \$5 trillion in mortgage debt, of which 30% is held by foreigners. The magnitude of dollars involved has drawn the attention of US Treasury Secretary Paulson and Congress. Recently Paulson said housing was at the "heart of our nation's economy" and that continued operations of Fannie and Freddie are "central to the speed with which we emerge from this housing correction." These are true statements and we should take solace in

knowing the government is wisely acknowledging this problem. This is why the House of Representatives passed legislation to provide “unlimited” loans to Fannie and Freddie, and allow the government to purchase equity stakes as necessary to support these entities.

The need for government intervention is of course bad news. However, the government’s intent to throw unlimited cash at the problem offers us a rare vision of the future. When you examine the mosaic of recent government actions to lower the Fed Funds rate, swap mortgage backed bonds for Treasuries, regularly auction credit, and offer Fannie and Freddie unlimited loans, one can draw a clear conclusion. That is the government has chosen to inflate our way out of current economic woes through higher money supply.

Though runaway inflation should be avoided at all costs, controlled inflation is not necessarily such a bad thing given the circumstances. By allowing inflation to run at higher than previously expected rates, the government is essentially eroding away the real value of outstanding debt. And we all know that too much debt is central to our economic problems. This of course erodes wealth for the lenders, but helps the borrowers tremendously. When you consider that foreigners hold nearly 60% of US Treasuries, or are lenders, such a course of action doesn’t seem like such a bad idea.

The Fed released its Beige book report this week and noted that consumer spending was reported as sluggish and slowing in all districts and that domestic manufacturing was declining. So the economy is clearly in need of growth in consumer spending, and bolstering home values is the first best step to making that happen. The Fed also reported that overall pricing pressures are elevated or rising as the weaker dollar is already importing inflation into our economy through raw materials.

So the takeaway from all this for Fiduciaries is to recognize that inflation is likely to rise for the time being, from both domestic and international sources. This is good news for pension plans with fixed liabilities, assuming they gain exposure to inflation protected assets such as TIPs and real assets. This is not such good news for endowments and foundations that rely upon real returns, but these institutions can access inflation protecting assets as well.

The other good news is we can reasonably expect a bottoming of consumer and investor sentiment in the near term, which is historically followed by strong upswings in capital markets. Just think when was the last time the US Treasury Secretary felt it necessary to publicly state that “no one has or will lose a penny of insured deposits.” Again, we should thank our government for signaling a bottoming in sentiment. Such times are a rare sight indeed.

To conclude, we encourage our clients to focus their attentions where they will be most productive. This means not focusing on the past, but instead towards the future and how to best design broad investment policy exposures to accommodate trends in capital markets.