

Necessary, but not sufficient

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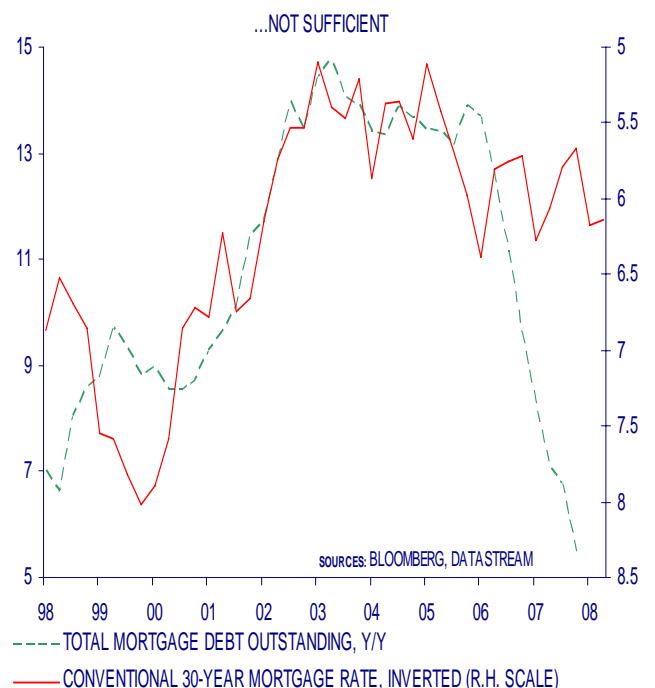
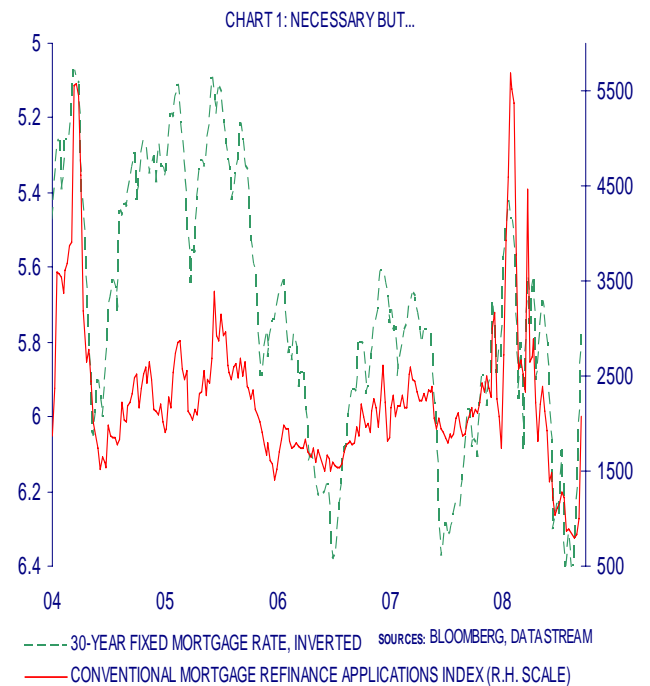
Global markets continue to grapple with the ever-changing financial landscape. The multitude of events and emergence of opinions on them has made it difficult for investors – both professional and personal – to decide where to put their money. In this article we have tried to address some common questions including; what the nationalisation of Fannie Mae and Freddie Mac means for the US, the US government’s reaction to financial institution failures thus far and where do we go from here?

Too big to fail, but too small to help...

The US Treasury’s bailout of mortgage companies (agencies) Fannie Mae and Freddie Mac was a necessary step toward ending the US housing meltdown and resultant financial market turmoil. Prior to the bailout, the US Federal Reserve had cut its target for the overnight interest rate by a total 3.25% from the peak. At the same time, the US benchmark (30-year fixed) mortgage rate moved to end the month of August higher than when the Fed began to cut rates (Chart 1). The reason for this was that banks simply could not continue to lend due to:

- a rapid fall in the availability of capital to finance mortgage lending; and
- an inability to offset any risk of lending by securitising those mortgages and selling them to investors,

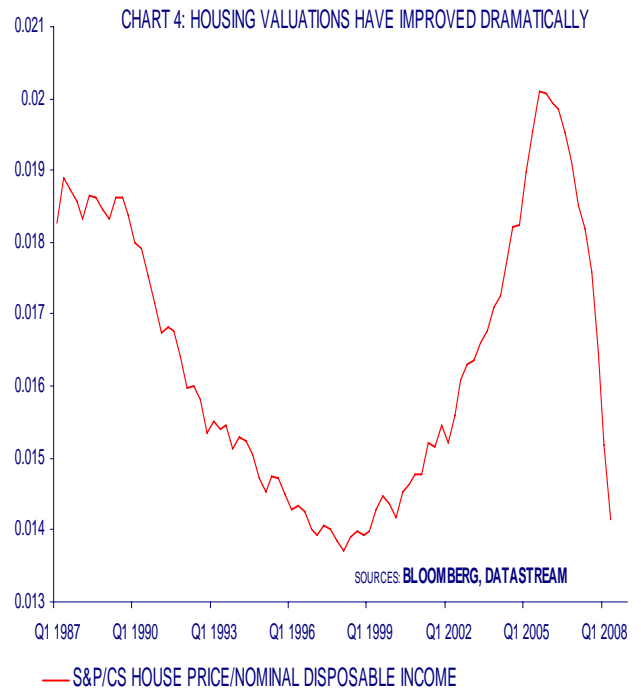
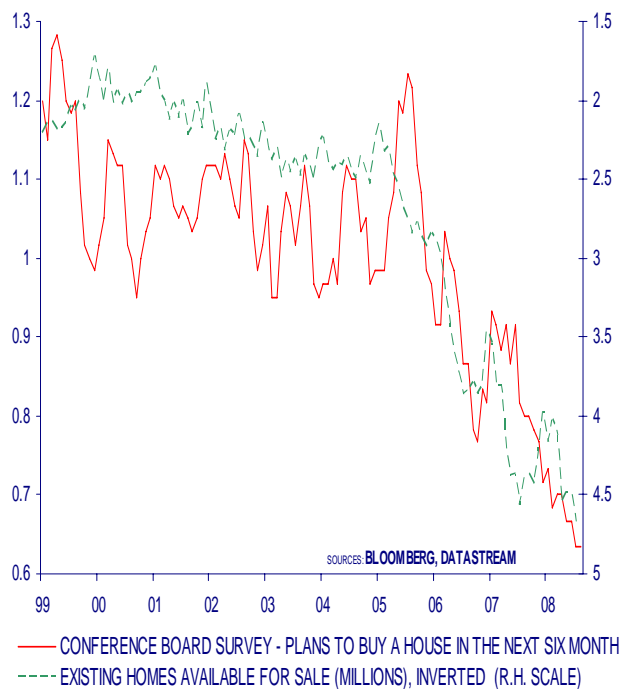
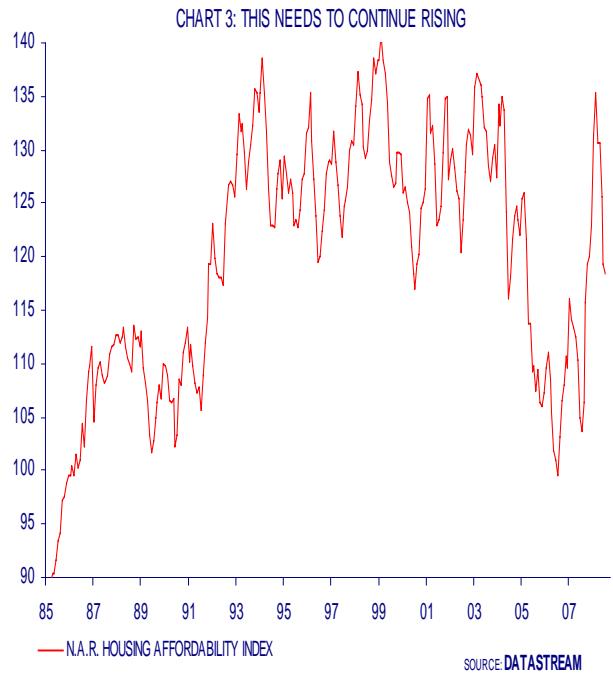
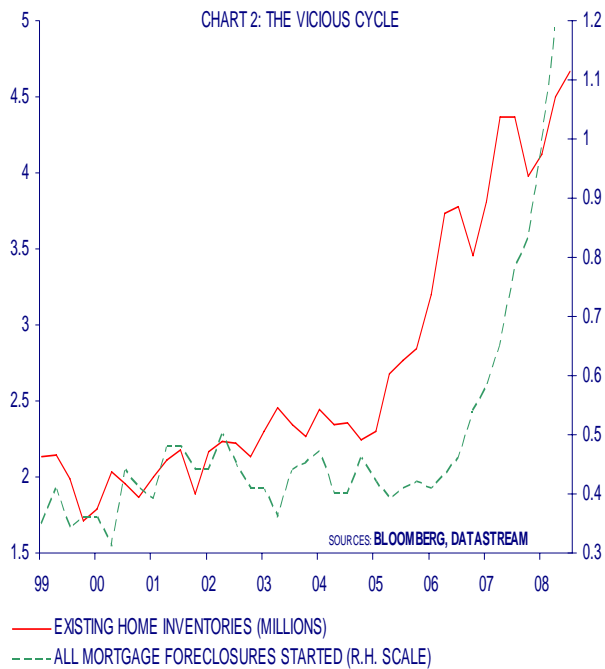
and thus raised their rates to a level high enough to restrict mortgage lending. With house prices plummeting, this was a situation which could not persist. However, the problems go well beyond a lack of availability of mortgage finance.



The US housing sector finds itself in a classic 'deflation trap' characterized by rising inventories and falling prices. The situation is compounded by a surging foreclosure rate (+27% y/y in August) (Chart 2) as individuals are unable to make payments on their mortgages for a variety of reasons. Potential homebuyers remain on the sidelines (Chart 2) expecting prices to continue to fall as inventories rise thus reinforcing the 'vicious cycle' which is now in place.

This vicious cycle cannot be allowed to continue if the authorities hope to stabilise both the economy and financial markets. To begin with, housing affordability cannot continue to deteriorate (Chart 3). There are three aspects to affordability:

- House prices
- Cost/availability of finance
- Household disposable income



Market forces have gone a long way to correcting the first of these issues. On most measures, house prices have now reverted to more sustainable long-term levels. House prices-to-cost of rent, house prices-to-employee compensation and house prices-to-disposable income (Chart 4) have now all fallen to pre-bubble levels.

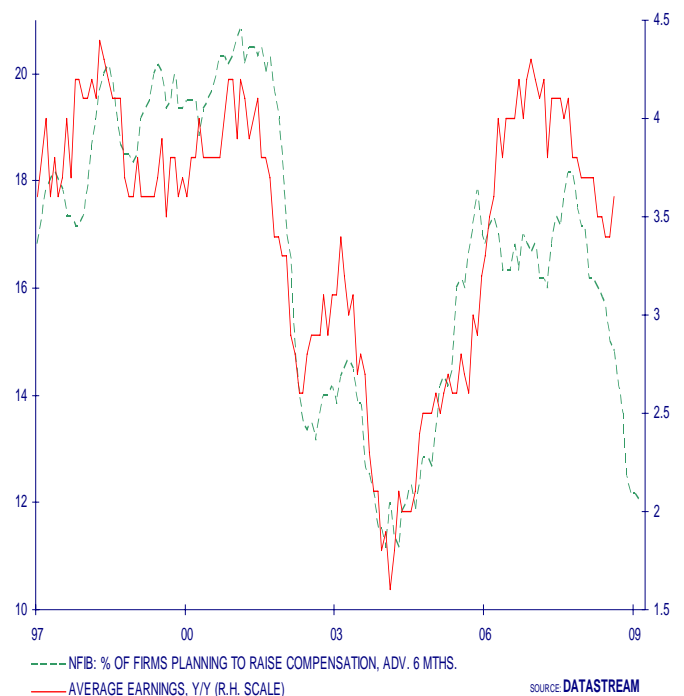
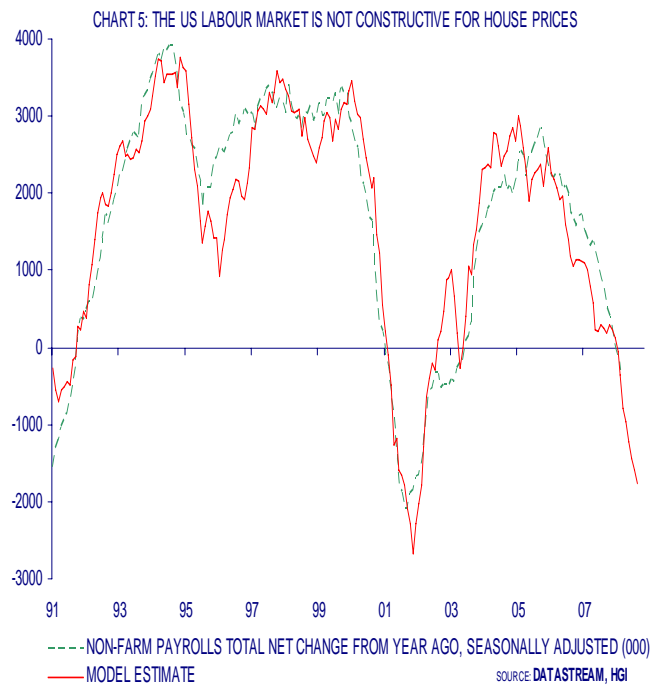
The Treasury's bailing out of Freddie and Fannie combined with what appears to be the imminent creation of a vehicle to purchase banks' distressed assets (more below) goes a long way to bringing down the price of credit and increasing its availability.

However the last, and certainly not least, in the list of problems, from the perspective of affordability, which continues to fester is the deteriorating labour market (Chart 5). The so-called 'shift' of the crisis from Wall Street to Main Street is well in train as the labour market continues to deteriorate and real disposable income growth slides along with it (Chart 5). Our model now calls for the economy to shed monthly non-farm payrolls in the triple digits within a few months. This does not bode well for housing affordability and, frankly, there is not much more the US can do beyond what they've already done on this front.

The Beginning of an End to the crisis?

Financial markets have done a 24 hour about-face following the US government's recent announcement that it is considering the creation of a government funded company which aim would be to acquire banks' troubled assets. Certainly, a vehicle modelled along the lines of a Resolution Trust Corporation (RTC), the government funded corporation which was used to bail out the Savings and Loans crisis of the late 1980's, would go a long way to restoring financial market confidence. Nonetheless, the crisis is multi-faceted and requires a multi-faceted response.

The news articles, analyst reports, rumours and speculation about the potential structure of the government funded entity focus on 'the purchase/funding of banks' troubled assets' Though this is a necessary step in the reparation of financial markets, such a vehicle alone does not address the underlying problem: distressed borrowers who cannot make payments on their mortgages. It seems somewhat perverse that the government would agree to buy up assets whose income stream continues to



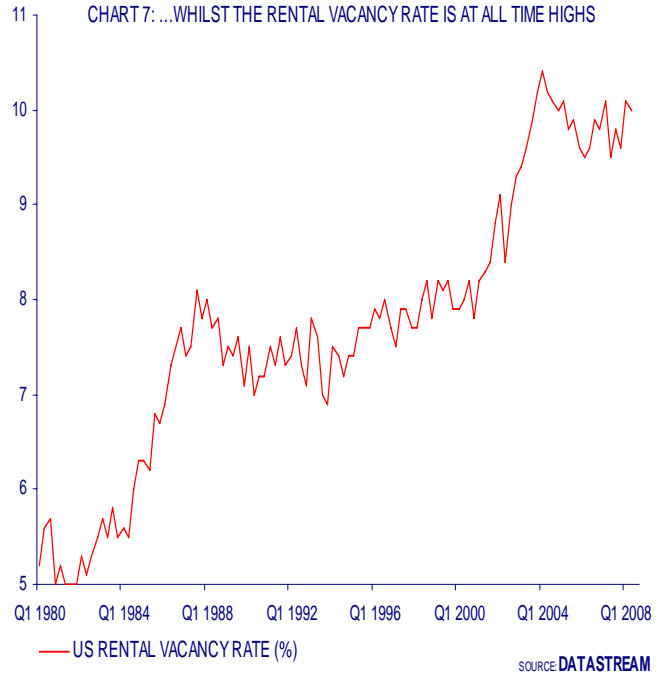
deteriorate. Thus, it is likely that the 'ultimate' structure of RTC 2 would:

- Shore up banks' balance sheets by acquiring impaired assets
- Directly fund the distressed parts of the US housing market

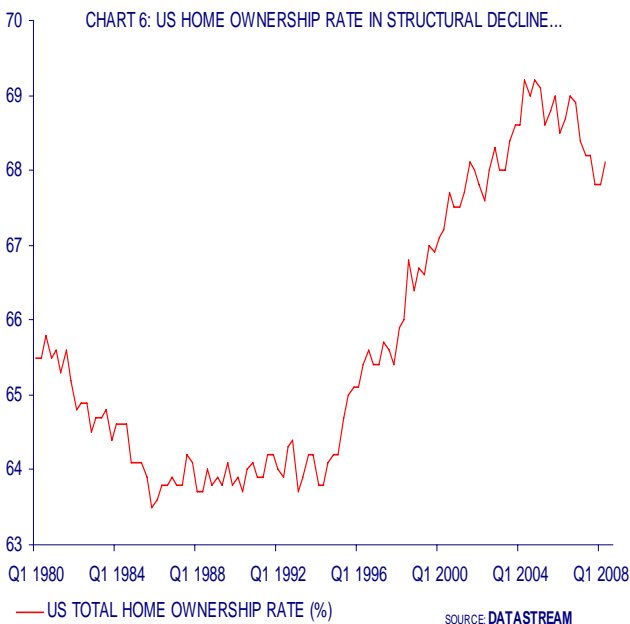
Finally, as with the original RTC, the vehicle must be properly funded. It took the US government several attempts and numerous pieces of legislation before the original RTC was sufficiently capitalised and properly staffed. The announcement, expected this weekend, may only be the beginning of what will be a multi-year process. Thus, there could be significant financial market volatility in the months ahead as investors struggle to assess the impact of RTC 2.

US housing has a longer-term problem

The US housing sector faces additional structural headwinds. In the intervening time period between the bursting of the technology bubble in 2000 and the bursting of the US housing bubble in 2007, the extreme loosening of lending standards led to a massive residential building boom as homebuilders extrapolated the trend into infinity. The US has seen its home ownership rate rise to artificially high levels and has now entered a period of structural decline (Chart 6). At the same time, rental vacancies are already at all-time highs (Chart 7). The problem is that there are just too many houses in the US and not enough people to live in them. Charts 6 and 7 further explicate why any government sponsored 'bailout' must target the housing sector in addition to banks' troubled assets.



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