The Financial Tsunami: The Next Big Wave is Breaking Fannie Mae, Freddie Mac and US Mortgage Debt

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The announcement by US Treasury Secretary Henry Paulson together with Federal Reserve chief Bernanke, that the US Government will bailout the two largest guarantors of housing mortgage debt—the Fannie Mae and Freddie Mac—far from calming financial markets, has confirmed what we have said repeatedly in this space: The Financial Tsunami which began in August 2007 in the relatively small "sub-prime" high risk US mortgage securitization market, far from being over, is only gathering momentum. As with the Tsunami which devastated Asia in wave after terrifying wave in December 2004, the financial Tsunami we are witnessing is a low-amplitude, long-wave phenomenon of trillions of dollars of financial securities being unwound, defaulted on, dumped on the market. But the scale of the latest wave to hit, the collapse of confidence in the two Government-Sponsored Entities, Freddie Mac and Fannie Mae, is a harbinger of worse to come in what will be the most devastating financial and economic catastrophe in United States history. The impact will be felt globally.

The Royal Bank of Scotland, one of the largest financial institutions in the EU has warned its clients "A very nasty period is soon to be upon us—be prepared." They expect the S&P-500 index of US stocks, one of the broadest stock indices in Wall Street used by hedge funds, banks, pension funds could lose almost 23% by September as in their term, "all the chickens come home to roost" from the excesses of the US-led securitization revolution that took hold after the dot.com bubble burst and Greenspan lowered US interest rates to levels not sustained since the 1930's Great Depression.

This all will be seen in history as the disastrous Alan Greenspan "Revolution in Finance,"—the experiment in Asset Backed Securitization, a mad attempt to bundle risk in loans, "securitize" them in new bonds, insure them via specialized insurers called "monoline" insurers (they only insured financial risks in bonds), rate them thereby via Moody's and S&P as AAA, highest grade. All that was done so that pension funds and banks around the world would assume they were high quality debt paying even higher interest than safe US Government bonds. Fed in Panic Mode

While he is getting praise in the financial media for his "innovative" and quick reactions to the un-raveling crisis, Fed chairman Ben Bernanke in reality is in a panic mode with little short of hyperinflationary tools at hand to deal with the crisis. Yet, his room to act is increasingly bound by the soaring asset price inflation in food and oil which is pushing consumer price inflation to new highs even by the doctored "core inflation" model of the Fed.

If Bernanke continues to act to provide unlimited liquidity to prevent a banking system collapse, he risks destroying the US corporate and Treasury bond market and with it the dollar. If Bernanke acts to save the heart of the US capital market—its bond market—by raising interest rates, its only anti-inflation weapon, it will only trigger the next even more devastating round in Tsunami shock waves.The real significance of the Fannie Mae bailout

The US government passed the law creating Fannie Mae in 1938 during the Great Depression as part of President Franklin D. Roosevelt's New Deal. It was intended to be a private entity but "government sponsored" that would enable Americans to finance buying of homes, as part of an economic recovery attempt. Freddie Mac was formed by Congress in 1970, to help revive the home loan market. Congress started the companies to promote home buying and their charters give the Treasury the authority to extend a $2.25 billion credit line.

The problems in the privately-owned Government "Sponsored" Entities or GSEs as they are technically known, is that Congress tried to fudge on whether they were subject to US Government guarantee in event of a financial crisis as the present. Before now, it always appeared a manageable problem.

No more.

The United States economy is in the early phase of its worst housing price collapse since the 1930's. No end is in sight. Fannie Mae and Freddie Mac, as private stock companies, have gone to excesses in leveraging their risk, most as many private banks did. The financial market bought the bonds of Fannie Mae and Freddie Mac because they bet that the two were "Too Big To Fail," i.e. that in a crisis the Government, that is the US taxpayer, would be forced to step in and bail them out.

The two, Fannie Mae and Freddie Mac, either own or guarantee about half of the $12 trillion in outstanding US home mortgage loans, or about $6 trillion. To put that number into perspective, the entire 27 member states of the European Union in 2006 had an annual GDP of slightly more than $12 trillion, so $6 trillion would be half the GDP of the combined European Union economies, and almost three times the GDP of the Federal Republic of Germany.

In addition to their home mortgage loans, Fannie Mae has another $831 in outstanding corporate bonds and Freddie Mac has $644 billion in corporate bonds.

Freddie Mac owes $5.2 billion more than its assets today are worth meaning under current US "fair value" accounting rules, it is insolvent. Fair value of Fannie Mae assets has dropped 66% to $12 billion and may as well go negative next quarter. As the home prices continue to fall across America, and corporate bankruptcies spread, the size of the negative values of the two will explode.

On July 14, symbolically the anniversary of Bastille Day, US Treasury Secretary Paulson, former chairman of the powerful Wall Street investment bank Goldman Sachs, stood on the steps of the US Treasury building in Washington, a clear attempt to add psychological gravitas, and announced that the Bush Administration would submit a bill proposal to Congress to make taxpayer guarantee of Freddie Mac and Fannie Mae explicit. In effect, in the present crisis it will mean nationalization of the $6 trillion agencies.

The bailout by Paulson was accompanied by a statement by Bernanke that the Fed stood ready to pump unlimited liquidity into the two companies.

The Federal Reserve is rapidly becoming the world's largest financial garbage dump as for months it has agreed to accept banks' Asset Backed Securities including sub-prime real estate bonds as collateral in return for US Treasury bond purchases. Now it agrees to add potentially $6 trillion in GSE real estate debt to that.

However, the disaster in the two private companies was obvious as far back as 2003 when grave accounting abuses in the two companies were made public. In 2003 then President of the St. Louis Federal Reserve, William Poole publicly called for the US Government to cut its implied guarantee of Freddie Mac and Fannie Mae claiming then that the two lacked capital to weather severe financial crisis. Poole, whose warnings were dismissed by then Fed Chairman Greenspan, called repeatedly in 2006 and again in 2007 for Congress to repeal their charters and avoid the predictable taxpayer cost of a huge bailout

As financial investors warn the Paulson bailout is not a bailout of the US economy but a direct bailout of his Wall Street financial cronies. What until recently had been the largest bank in terms of loans outstanding, Citigroup in New York, has been forced to raise billions in capital from Sovereign Wealth Funds in Saudi Arabia and elsewhere to remain in business. In its May announcement, Citigroup's new Chairman Vikram Pandit announced plans to reduce the bank's $2.2 billion balance sheet of liabilities. However, he never mentioned an added $1.1 trillion in Citigroup "off balance sheet" liabilities which include some of the highest risk deals in the US real estate and securitization era it so strongly backed. The Financial Accounting Standards Board in Connecticut, the official body defining bank accounting rules is demanding tighter disclosure standards. Analysts fear Citigroup could face devastating new losses as a result with value of liabilities exceeding the bank's $90 billion market value. In December 2006 prior to the onset of the Tsunami crisis, Citigroup had a market value of more than $270 billion.

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