CUMBERLAND ADVISORS

About Paulson's Statement

July 13, 2008, 9:00 pm

Excerpts from Treasury Secretary Paulson's Statement About Fannie and Freddie with inserts of Cumberland's Observations.

Treasury Secretary Paulson. "In recent days, I have consulted with the Federal Reserve, OFHEO, the SEC, Congressional leaders of both parties and with the two companies to develop a three-part plan for immediate action. The President has asked me to work with Congress to act on this plan immediately."

Cumberland comment: Everybody has bought into this plan (politically) whether they want to or not. This is no longer about "if" but about "how soon" and "how much."

Paulson: "First, as a liquidity backstop, the plan includes a temporary increase in the line of credit the GSEs have with Treasury. Treasury would determine the terms and conditions for accessing the line of credit and the amount to be drawn."

Cumberland comment: Paulson wants a full discretion as to "how much." He must have Congressional approval to increase this line of credit. He may get it but he may also get a limit as to the amount and the timing. Congress would be more protective of the federal taxpayer if it puts a cap on this line of credit rather than vest discretion without limits. And Congress would better protect the taxpayer by oversight. Remember that it was the Congress and the government agencies that got us deeply into this mess. What makes anyone believe they can be trusted with full discretion and without any limitations?

Paulson: "Second, to ensure the GSEs have access to sufficient capital to continue to serve their mission, the plan includes temporary authority for Treasury to purchase equity in either of the two GSEs if needed."

Cumberland: Okay, taxpayer, you are about to become a shareholder in F&F with your voting rights in the hands of the Bush Administration. Are you ready for that one? There are many ways the government can honor the "implied" guarantee of the federal government on F&F debt. No where is the shareholder granted an implied bailout. Treasury does not need to buy equity. It does not need to dilute existing shareholders. Under current market conditions, if it does not dilute them, it gives the existing shareholders a subsidy from the rest of the taxpayers who will have to pay it. An alternative is for Treasury to buy subordinated debt or preferred stock (convertible or non-convertible). Congress can modify this one quickly and place the taxpayer in a more senior position to the existing shareholders. We expect a policy fight over this one.

Paulson: "Use of either the line of credit or the equity investment would carry terms and conditions necessary to protect the taxpayer. "

Cumberland: The line of credit expansion is a partial fulfillment of the implied federal guarantee. It reassures markets and improves the liquidity necessary for the functioning of markets in F&F mortgage related debt. It requires Congressional Authorization which is why the Federal Reserve has agreed to "backstop" F&F after the existing $2.25 billion credit line is exhausted. F&F now have Discount Window access to all the liquidity they need to operate. F&F debt markets will like these provisions. A rally in their prices and decline in their yields is expected.

Paulson: "Third, to protect the financial system from systemic risk going forward, the plan strengthens the GSE regulatory reform legislation currently moving through Congress by giving the Federal Reserve a consultative role in the new GSE regulator's process for setting capital requirements and other prudential standards."

Cumberland: It is the proper role of the Federal Reserve to deal with systemic risk. In fact the Fed cannot apply monetary policy without a functioning system. But here we see a vast expansion of the role of the central bank. This is worrisome. The last year of turmoil has dramatically changed the role of the central bank. And it has caused the Fed to alter its balance sheet in ways never previously seen. See Cumberland's website, www.cumber.com, for the tracking of the Fed's balance sheet changes.

All of this has been done without thoughtful deliberation and has occurred in response to crisis. We do not know what seeds of future turmoil are being planted now by this policy making apparatus. We are not sure of any of the measures of outcome. Congress will give this power to the Fed because it does not want to take on any responsibility itself. The Fed has been a credible institution and thus is available for this role. But readers must remember that the Fed is a creature created by the Congress and that this Congress has held Fed Governor appointees hostage.

We are proceeding into dangerous and uncharted waters. We can only hope that the radar is turned on and the lookout is peering into the murky water for mines and rocks. But financial markets cannot operate on hope. We expect this proposal to cause more questioning of American resolve after it is examined by foreigners.

We believe that Congress is going to pass this legislation rapidly. It will probably be law before the August recess.

Stock markets may have a positive initial reaction from a deeply oversold position. F&F debt will rally and the entire spectrum of financial asset classes will be relieved because they will see the federal government extending its commitment to the implied federal guarantee with deeds and not just words. Once this rally is over, the markets will have to confront the economic realties of our housing/energy/food/election-uncertainty/economic slowdown/pressured-consumer/large deficit/weak dollar situation.

David R. Kotok, Chairman and Chief Investment Officer, email: david.kotok@cumber.com

This article was distributed on July 13, 2008 via email to our subscribers.
Sign up at www.cumber.com to receive Cumberland Advisors' commentary emails.