

Government programs offer short-term lift, selling opportunities

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More than a trillion dollars and a myriad of federal government programs initiated over the past six months have not significantly aided homeowners, mortgage lending or the mortgage securities market. While the programs have aided consumer credit, the asset-backed securities and commercial mortgage-backed securities markets in the short term, we believe the odds are they are merely delaying the pain of writing off loans that were not sound to begin with.

Beginning with the Troubled Asset Relief Program (TARP) and the bailout of AIG last fall, the federal government has been more active than at any time since the Great Depression in trying to counteract the natural economic forces of financial deleveraging that is part of any recession. Unfortunately, conditions for homeowners and the mortgage market have not really improved. In fact, perhaps it is worse: the Mortgage Bankers Association announced on May 28 that combined mortgage delinquencies and foreclosures rose to a record high of 12 percent in the first quarter of 2009 (their records go back to 1972).

The Term Asset-Backed Securities Loan Facility (TALF), initiated to support the issuance of asset-backed securities (ABS) and consumer credit, has resulted in some success. Bond prices have increased in that market, and the program has been expanded to include commercial mortgage-backed securities. As is the case with residential mortgage programs, however, TALF is not helping the underlying fundamentals that must improve to stabilize the sector over the long term. Delinquencies on credit cards, auto loans and commercial mortgage loans continue to rise rapidly.

Despite these concerns, the programs have created trading activity in the market, albeit temporary, and we are taking advantage of opportunities that will be available over the short term.

MBS: Housing must improve first

Improvement in the mortgage-backed securities (MBS) market must begin with the residential housing market. A \$75 billion housing rescue plan intended to help homeowners avoid foreclosure was outlined in the stimulus package enacted by Congress in February. The plan provides help to homeowners through loan refinancing and loan modification. With home values spiraling downward, many homeowners who would like to refinance at a lower rate can't because they owe more than their house is currently worth. The government's plan is intended to help borrowers refinance into a more affordable mortgage. The loan modification portion helps homeowners who are struggling to make their monthly mortgage payments either because their interest rate has increased (due to an adjustable-rate mortgage) or they have less income, likely due to a job loss or reduced hours, overtime or bonuses. The government's plan offers incentives to encourage mortgage servicers to modify the terms of the loans for borrowers at risk of losing their homes.

However, we expect that the vast majority of homeowners who need help will not benefit from this program. These are homeowners who simply over-borrowed and had too little income for the homes they purchased. The government programs are unlikely to help them, because there is no broad-based assistance to reduce the principal owed on their mortgages. A second group of homeowners

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is in trouble due to a job loss or other temporary problems. They purchased homes they likely could afford and are struggling right now—and many will continue to struggle as high unemployment plagues the economy. The federal programs may help some of these homeowners, but this is a smaller percentage of the overall pool of distressed loans. Indeed, the Treasury Department said the plan will help 7 million to 9 million homeowners restructure or refinance their mortgages to avoid foreclosure, but according to Hope Now, a coalition of mortgage companies, investors and housing counselors, just 518,000 loans had been modified through April.

TARP and PPIP—the Public-Private Investment Program—are two programs intended to more directly help the mortgage securities market. TARP was originally announced as a plan for the government to purchase “troubled” mortgage securities from large financial institutions in hopes that they would then return to their previous lending levels and reopen the credit markets. Instead, most of that money was used to infuse banks with capital. That may have some benefits, but it did not directly improve the MBS market. Likewise, PPIP was designed to help banks sell underperforming loans and securities by giving incentives to private investors. However, the administration of PPIP has caused several problems. Fears that the government will impose compensation limits and other restrictions have discouraged many investors from pursuing this program. Additionally, recent strength in the financial markets and confusion about PPIP’s terms have added questions about whether the program remains of value.

The financial markets have responded with temporary optimism as each new government program was announced. We saw prices rise on securities even as fundamentals continued to deteriorate. Eventually, prices returned to their previous levels. While many non-agency mortgage securities remain very attractive and offer high, long-term yields, prices most likely won’t rise much until house prices stop falling.

Recent Federal Programs

Program	Authorizing Agency
AIG bailout	Treasury
Asset-Backed CP Money Market Liquidity Fund	Federal Reserve
Citi bailout	Treasury
Commercial Paper Funding Facility	Federal Reserve
Emergency Economic Stability Act (TARP)	Congress
FDIC deposit increase	Treasury
Unlimited Foreign Currency Swaps	Federal Reserve
Fannie Mae/Freddie Mac Conservatorship	Treasury
Purchase of Fannie, Freddie debentures and MBS	Federal Reserve
Guarantee Program for Money Market Funds	Treasury
Hope for Homeowners	Congress
Money Market Investor Funding Facility	Federal Reserve
Primary Dealer Credit Facility	Federal Reserve
Temporary Liquidity Guarantee Program	Treasury
Term Asset-Backed Securities Loan Facility	Treasury
Term Auction Facility	Federal Reserve
Term Securities Lending Facility	Federal Reserve
Troubled Asset Relief Program	Treasury

Source: Bank of America, November 2008

ABS and CMBS: TALF is a short-term remedy

The TALF is one government program that has provided a longer-lasting benefit to investors, specifically in the asset-backed securities (ABS) market. New issuance of ABS declined dramatically

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in the fall of 2008, and interest rate spreads on AAA-rated securities versus Treasuries soared, reflecting a high level of risk. The ABS market historically has funded consumer credit—credit cards, auto financing and student loans, for example—and small business loans. The federal government believed that continued disruption of the ABS market could significantly limit the availability of credit to households and small businesses and contribute to further weakening of the economy. The TALF was designed to increase credit availability and support economic activity by encouraging renewed issuance of consumer and small business ABS at more normal prices.

It worked. Since the TALF's terms were released, the yield difference between three-year AAA-rated credit card securities and Treasuries has tightened from more than 600 basis points in December to below 300. It has jump-started consumer lending, and bonds are trading again. It was deemed successful enough that the Federal Reserve Board announced in May that the program would expand to include commercial mortgage-backed securities (CMBS). The CMBS market rallied with that announcement, even though the changes wouldn't become effective until June.

However, the market rallies in ABS and CMBS are not supported by fundamentals. Borrowers continue to fall behind their payments at an alarming rate. According to Moody's Credit Card Monthly Index, for example, the delinquency rate increased 40 percent between March 2008 and March 2009, and the charge-off rate (bills that will likely go uncollected) increased 54 percent. And the commercial mortgage market is not much better. Not only is the number of delinquent loans rising faster than at any time in history, Standard and Poor's is on the brink of changing its rating methodology, which could downgrade most of the CMBS originated in the past three years.

As financing and leverage fell in these markets with the collapse in banks last fall, prices of the bonds sank like a rock. But now, the TALF is once again providing the financing for investors to buy these securities and prices are rising. That has certainly encouraged trading activity, but underlying fundamentals have not improved for most securities. As a result, we have not participated with others in buying heavily in these sectors. This market is, in fact, providing very good selling opportunities. We have sold most of our auto loan holdings and have found very attractive prices for many other securities.

Working through the pain

The government programs are efforts to help individuals and large institutions through a difficult period, but the primary problems—including over-levered consumers and corporations holding assets they could not afford or should not have purchased—are not being resolved. Quite simply, consumers, businesses and the government all have to save more and spend less before we see large-scale improvements in MBS, CMBS and ABS.

While the government's programs can have a material impact on security prices, they tend to generate technical trading opportunities that have mostly been fleeting. We believe the key to success in this type of market is our bottom-up process, which sorts out the difference between stimulus-driven price changes and real, long-term security values.

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