Goldman Sachs Global Markets Research

First thoughts on the market impact of the Treasury's GSE plan

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1. Overview of market impact
As aired in the press late on Friday, Freddie Mac and Fannie Mae have been placed into conservatorship, with direct oversight from the Federal Housing Finance Agency. The Treasury has become a direct shareholder in the GSEs, and is initiating a temporary plan to buy new MBS originated by the GSEs. The move is consistent with the US Administration?s main aim to secure financial stability first, in the spirit of the Bear Stearns bailout in March and the declaration of the unusual and exigent circumstances by the Federal Reserve Board.

While our views will likely evolve over the next day or two, we offer below our first quick thoughts across asset markets from across our macro strategy groups ahead of the market open. The US Economics group has just released a note covering the action and its economic impact in more detail. In summary, we view the policy announcement as very positive both from reducing systemic risk and the economic tail risk of deeper housing credit contraction. It should be particularly beneficial for high-quality spread products, which we expect to tighten in the coming sessions, and ? at least in the near-term ? for financial stocks and broader equity risk. In FX, there are conflicting cross-currents, but we see it ultimately as more likely to be dollar-positive and to provide a lift to risky EM and carry crosses.

We do not think these fiscal policy initiatives alter the profile for Fed rates over the coming quarters and continue to expect policy rates to be kept on hold at 2%. However, to the extent that these policies support the recovery in housing, they may affect expectations of a faster normalization in the 3-5 year horizon. As such, we expect 5-year Treasuries to underperform on the curve from a rich level. Unlike in March, when investors re-rated financial risks against the backdrop of a stronger economy, the front end of the curve is likely to remain better pegged. Any sell-off in rates markets is likely to be mostly led by the intermediate part of the yield curve. Although the increase in the federal deficit is likely to be relatively small (we are expecting an increase of around 0.5 percent a year over the next few years relative to the baseline), US Treasury securities are likely to remain cheap to OIS.

Of course, the economic context of a severely impaired housing market and damage financial system has not changed, nor the new dynamic of significant non-US slowing. And questions are likely to be asked about what happens after the end of 2009 when Treasury authority is currently planned to end and a planned gradual contraction in GSE assets to begin. By this time, however, the housing market is likely to have stabilised. And we see the policies announced today as a further confirmation of a bipartisan resolve to try new measures if fresh problems emerge.

2. The policy announcement: capital injection, liquidity backstop, MBS purchases
The authorities plan is centred around two mutually reinforcing initiatives, one acting on the liability side of the ledger of the GSEs and the other on the asset side. In order to underpin the capital structure, the Treasury is injecting capital into the GSE s in the form of preferred shares, senior to existing shareholders. Moreover, the Treasury is establishing a secured lending facility under the authority is was granted by congress in July. With fresh equity capital and a liquidity backstop, the financial viability of the GSEs should be secured.

The announced agreements entail that the GSEs will growth their balance sheet moderately through the end of 2009) when the housing market will presumably have stabilized, and then shrink it from 2010 onwards by 10% per annum. The effective expansion of the GSE assets will in reality be larger, since the Treasury plan also includes buying new mortgage-backed securities (MBS) originated by the GSEs, another highly significant development. In our view this represents an important offset to the contraction in the private sectors balance sheet. As such it reduces the chances of a bigger contraction in domestic demand.

3. The impact on fixed income: Fed still on hold, 5-years vulnerable, agencies and credit tighter
The expansion of fiscal policy comes in the context of a dire economic background. We remain of the view that Fed policy rates will remain at 2 percent in the coming quarters. With tail risks to the economy reduced and greater chances of stabilization in housing, however, the market could revisit the probability of a faster normalization of Fed policy further down the line. We are of the view that 5-year Treasuries will underperform on the curve, from already stretched levels according to our GS-Curve analysis.

Agency paper has underperformed Treasuries in recent months. Benchmark 5yr Fannie Mae agencies, for instance, are trading close to 100bp above corresponding maturity Treasureis, 15-20bp tighter than their March 14 wides. We think a compression is likely, which in turn should prove beneficial for swap spreads and high quality credit product.

Further down the credit ladder in corporate credit proper, spreads should also rally tighter on this news, as systemic risk fears and hedging demand from investors with mortgage exposures have been among the primary factors responsible for elevated spread levels. The decompression trade put out by our Credit Strategy team on Friday (long risk in the 3-100 tranche of IG, and short the CDX high-yield index) is particularly well-positioned to benefit from these developments.

4. The impact on FX: more likely USD-positive
With respect to the Dollar, there are three main channels through which this may impact the Dollar.

First, the action will have a fiscal impact and is likely to see increased Treasury issuance. Although this is not a money supply issue as such, as it is not the Federal Reserve which is injecting capital, the fiscal deterioration is a Dollar negative from a twin deficit perspective. Second, the action will have a growth impact, or at a minimum an impact of the risk of tail events in terms of growth outcomes. This positive impact on the growth outlook is Dollar positive, particularly if it makes events in terms of growth outcomes. This positive impact on the growth outlook is Dollar positive, particularly if it makes Fed easing less likely. Third, the action will have an impact on the flow situation through foreign investment in agency bonds. Uncertainty about the safety of agency debt has arguably reduced foreign demand for agency bonds in recent months. How important this has been for the Dollar depends on the degree to which foreign investors have substituted from Agencies into Treasury securities. But on the margin, the actions taken today should keep this foreign flow coming in and remain Dollar supportive.

All in all, if we add up the different channels we get to a net positive Dollar impact, though we would not expect the impact to be dramatic. If it prompts a more meaningful turn in sentiment towards the US financial sector, it could constitute a fresh Dollar positive influence. With respect to Global FX more broadly, the measures could have an impact on 'risky assets' and carry trades, particularly coming after a sizeable deleveraging phase where carry trades have suffered significantly. This could be relevant for cross yen (GBP/JPY and AUD/JPY) and it also could help key EM currencies like BRL, TRY and ZAR.

5. The impact on equities: a bounce on domestic/financial-related areas

At the top line, from the Equity Trading Strategies side, we see the GSE package as a clear short-term positive for equity index risk broadly, as markets respond to the reduction in both systemic tail risks and the potential deepening of the credit crunch. While the last few months of equity pressure have been more about economic than systemic risk, we think stocks could bounce quite vigorously in the short-term, even if many of the underlying headwinds remain.

Beyond GSE equity itself, the financial sector on average should be a clear beneficiary. Institutions with significant preferred GSE holdings may be at some risk, though the plan is friendlier to them than it might have been and preferred stock has clearly incorporated a significant dilution risk already. For the broader sector, the benefits to MBS and agencies from the package and the reduced risk of a sharper credit contraction spiral are likely to outweigh this, especially for those with significant conforming mortgage assets. To the extent that some overseas banks have suffered from perceived concerns about their GSE debt holdings, they too may see relief.

Under the index, the news is also a significant marginal positive to areas *directly* related to housing, as it keeps the GSE balance expansion intact. We have argued recently that these areas (homebuilders) have looked more attractive ? this news reinforces that view. It also makes us happy to stay on the sidelines in consumer-related areas for now. The impact on the broader global cyclical areas, where we have been most negative and which have seen sustained pressure, is more complex. A market rally may provide some relief here, but we think the positives here are much murkier than for domestic-facing areas and would be tempted to fade bounces in this area. We also maintain a preference for domestic-facing cyclicals against foreign-exposed ones in the US market (we are currently short our Wavefront Foreign Growth basket). The GSE package reinforces that view, particularly if we are right that it ends up USD-positive, and may add to the recent pressure on long energy/short financial positioning.

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