

A Mortgage Bailout?

The Bush Administration proposal to assist homeowners who face mortgage resets violates many principles of free market economics. It involves the government in picking winners and losers and it interferes with private contracts – a cornerstone of freedom. In addition, while it may help some individuals, the economy as a whole is not in need of saving. Fourth quarter growth should come in around 2%, and unlike the conventional wisdom, we foresee robust 3% to 3.5% real GDP growth in 2008. So part of the downside risk the proposal is intended to ameliorate is likely to turn out to be a figment of pessimistic imaginations.

While the proposal may save some homeowners from losing their homes, there is no way the government can save all of them. It can't help everyone. Moreover, in the future, investors (especially foreign ones) may insert a larger risk premium into mortgage products as advance compensation for potential political risk.

Most of the market's attention remains on the bailout properties of the proposal and homeowners who are at risk. But the real impact, and where it may actually have some merit, will be seen in the secondary market for subprime asset-backed mortgage securities, where the market has broken down and bank capital has been compromised.

The homeowner, adjustable-rate-loan side of this equation will take years to sort out, even with the proposal. The investor/asset-backed/bank-capital side is tied in a knot.

Bids, if you can get them, on asset-backed paper are at excessively discounted prices. Uncertainty is one reason, but the "shorts" in this market are squeezing the holders of these securities hoping to force them to sell at ridiculously low prices. As a result, the market is not functioning well.

One way to get it functioning again is to "run the shorts," which means raising the odds that many of the underlying mortgages will be made whole and losses on these bonds will be smaller than once thought. If someone holding a short position all of a sudden becomes fearful that the bonds will rise to 75 cents on the dollar from something like 35 cents on the dollar, they will be much more willing to make a market and book profits. That's what the proposal does: it gets bids back into the market, moves debt prices back toward true fundamental value, and thereby improves capital measures for mortgage debt-holders.

Another consideration is that this process of fixing rates for loans that have been made by multiple firms and split up amongst hundreds of buyers requires agreement among the lenders. This "collusion" may be in the industry's best interest, but it probably needs Treasury Department agreement and oversight to avoid being labeled illegal.

The preference should always be for the federal government to let markets work, allowing them to spontaneously adapt, but as proposals for federal involvement go, history has seen much worse.

| Date/Time (CST) | U.S. Economic Data | Consensus | First Trust | Actual | Previous |
|-----------------|-----------------------------|-------------|---------------------|--------|-------------|
| 12-11 / 9:00 am | Wholesale Trade - Oct | +0.5% | +0.4% | | +1.3% |
| 12-12 / 7:30 am | Import Price Index - Nov | +2.1% | +2.1% | | 1.8% |
| 7:30 am | Export Price Index - Nov | +0.5% | +0.6% | | +0.9% |
| 7:30 am | Trade Balance - Oct | -\$57.4 Bil | -\$56.9 Bil | | -\$56.5 Bil |
| 1:00 pm | Treasury Budget - Nov | -\$80.0 Bil | -\$101.0 Bil | | -\$55.6 Bil |
| 12-13 / 7:30 am | Initial Claims - Dec 8 | 335K | 339K | | 338K |
| 7:30 am | PPI - Nov | +1.6% | +2.1% | | +0.1% |
| 7:30 am | "Core" PPI - Nov | +0.2% | +0.2% | | +0.0% |
| 7:30 am | Retail Sales - Nov | +0.6% | +0.7% | | +0.2% |
| 7:30 am | "Core" Retail Sales - Nov | +0.7% | +1.0% | | +0.2% |
| 9:00 am | Business Inventories - Oct | +0.3% | +0.3% | | +0.4% |
| 12-14 / 7:30 am | CPI - Nov | +0.6% | +0.7% | | +0.3% |
| 7:30 am | "Core" CPI - Nov | +0.2% | +0.2% | | +0.2% |
| 8:15 am | Industrial Production - Nov | +0.1% | +0.2% | | -0.5% |
| 8:15 am | Capacity Utilization - Nov | 81.7% | 81.7% | | 81.7% |