Agincourt Capital Management, LLC

INVESTMENT UPDATE

Since taking office, the Trump administration has been dropping hints about its interest in reforming the GSEs (Government Sponsored Enterprises), namely, Fannie Mae and Freddie Mac. These two sister entities, which were put under the conservatorship of the US government in 2008, have long been at the center of housing finance in the United States and are a critical component of the global financial markets. Any talk of reform for Fannie and Freddie is bound to get the attention of both the public and investors.

In this piece, we review a brief history of the GSEs and why they may need to be reformed. We then summarize the content of recent communications from the administration, as well as the challenges that must be considered in contemplating reform of the GSEs. Finally, we review the most likely scenarios for what may transpire and the implications for the US agency mortgage-backed securities (MBS) market.

While the ultimate outcome remains uncertain, the administration has now made it clear on a number of occasions that they are focused on maintaining the government guarantee of agency MBS and are highly attentive to keeping MBS spreads from widening. **Despite two-way risks for the future of the GSEs, we now believe the base case impact to MBS yield spreads will be neutral at worst, with the real possibility that changes to GSE regulations could induce some amount of spread tightening.**

First, the backdrop: There are three US government agencies that pool home mortgage loans into marketable securities: the Government National Mortgage Association (GNMA, or Ginnie Mae), the Federal National Mortgage Association (FNMA, or Fannie Mae), and the Federal Home Loan Mortgage Association (FHLMC, or Freddie Mac). Of the three, GNMA is the only "true" government agency, having been established as a branch of the Department of Housing and Urban Development in 1968. As such, its obligations are provided a "full faith and credit" guarantee by the US Treasury, meaning that GNMA's debentures (as well as its "pass-through" securitized mortgage pools) carry the same guarantee of timely principal and interest payments as Treasury bills, notes, and bonds.

FNMA and FHLMC were not established in the same manner as GNMA, as both were founded as quasi-government organizations, funded by a combination of public equity issuance and publicly-held debentures. Their close association with the US government and their importance to the US housing market meant that there was an assumption of government backing, but from the outset, any guarantees of timely interest and principal payments were more of a "moral obligation," not an explicit guarantee from the federal government.

However, in the immediate wake of the 2007-2008 Global Financial Crisis, both FNMA and FHMLC saw their stock prices collapse as home prices fell at an unprecedented pace, leaving both firms functionally bankrupt. The George W. Bush administration, recognizing the importance of the housing market to the overall health of the US economy, stepped in and placed both Freddie and Fannie under "conservatorship," where they remain to this day. Under this arrangement, while there continues to be no formal guarantee of FNMA and FHLMC obligations, there is a strong assumption among bondholders that principal and interest payments are 'effectively' guaranteed by the federal government.

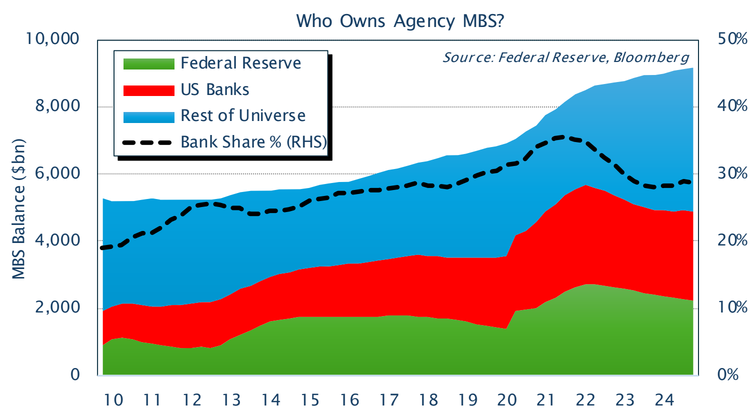
Throughout their existence, the GSEs (along with GNMA) have played a central role in US housing affordability. The very existence of the GSEs, alongside the effective government guarantee on their MBS, enables mortgage lenders to offer loans to a broader array of homebuyers and to do so at lower mortgage rates. After originating a conforming loan, lenders can either sell the loans directly to the GSEs (who then package the loans and sell the mortgage securities) or get the loans guaranteed by the GSEs and then package and sell the securities themselves. These actions free up mortgage lenders' balance sheets so they can continue to make additional mortgage loans to other borrowers, thereby fostering increased homeownership in the US. Additionally, given that end-investors are willing to accept lower yields on FNMA/FHLMC MBS given the securities' implicit credit guarantee (vs. unguaranteed loans), lenders are also therefore able to lend to those homeowners at lower mortgage rates.

Under the terms of conservatorship, the government has maintained tight controls over FNMA and FHLMC. Prior to the financial crisis, these firms were highly profitable, and were far more involved in the secondary market for MBS—buying and selling MBS to enhance their profits. They were also (with disastrous results) involved with the buying and selling of unsecured and unguaranteed derivative securities and subprime loans. Under conservatorship, Fannie and Freddie have had their wings clipped, and largely focus now just on the packaging and selling of their own pass-through MBS. Even so, they are financial juggernauts, and have paid more than $300 billion in dividends to the US government since the financial crisis. Nevertheless, almost from the day they were placed in conservatorship, there have been calls to have FNMA and

FHLMC re-privatized. Chief among these voices for privatization are former shareholders (in particular, certain large hedge funds who bought preferred stock in Fannie and Freddie for pennies on the dollar during the financial crisis) as well as others in the political realm who believe that the government shouldn't be so heavily involved in the US housing industry.

With the arrival of the new administration this year came renewed speculation about the future of the GSEs, as President Trump has a long-standing interest in pursuing reform of the GSEs, dating back to his first administration. Communication from the administration has increased in both frequency and specifics over the past few months, as the potential scope of action for reform of FNMA and FHLMC—at least in the near-term—has become a good bit clearer.

The most recent communications indicate that the administration is considering a partial sale of common equity shares of both FNMA and FHLMC to the public, with some rough parameters on what a transaction could hypothetically look like. The initial figures suggest that a public offering could target raising around $30 billion, or approximately 5% of their combined estimated market value of $500 to $700 billion. In a recent interview, Treasury Secretary Scott Bessent also gave guidance that they plan to choose and announce the investment bank that they'll be partnering with on this process by early October.



The administration has not yet provided much detail beyond these initial figures. However, what they have repeatedly emphasized is their commitment to maintaining the effective government guarantee on FNMA and FHLMC MBS, and to pursuing strategies that keep mortgage rates as low as possible. Taking this message a step further, they have also indicated on several occasions that they are investigating ways to tighten the spread between mortgage rates and Treasury yields.

In our view, these recurrent communications show that the administration is well aware of the issues at stake in approaching any changes to the GSEs. And indeed, the need for a cautious, measured process is vital. The perception of the guarantee is critical to both the credit ratings and bank capital treatment of FNMA and FHLMC MBS—both of which must be sustained to prevent any forced selling by investors who would otherwise have concerns over the creditworthiness of these now-semipublic entities. As the chart on this page shows, US banks own just under $2 trillion of FNMA and FHLMC MBS, with the Federal Reserve holding a comparable amount on its balance sheet.

Turning to the housing market implications, the strained state of US housing affordability is firmly in the political spotlight, reinforcing the concern that any policy changes which cause investors to question the safety of FNMA and FHLMC would drive mortgage rates higher. Failing to maintain the government guarantee while only capitalizing the company with a fraction of the equity they would need to survive a down cycle in the housing market would be disastrous to both the capital markets and the administration's goal of improved home affordability.

Returning to the point of how the administration could lower mortgage rates (and in so doing, tighten MBS spreads)—they have floated a feasible idea on how this could be accomplished. As mentioned above, from the time the GSEs were placed in conservatorship the size of their investment portfolios has been capped. There is a real possibility the administration could consider making a key change to that limitation, by granting the GSEs the ability to grow their investment portfolios and be more involved in the secondary market for MBS. In that way, they would be able to help "police" the trading of MBS, and compress the level of MBS spreads when investor demand wanes, thereby reducing mortgage rates over a full market cycle. This is not without precedent, as it would resemble one of the key roles the GSEs played in the housing market before the financial crisis—a time when their retained portfolios were much larger in size.

Agincourt's interest, as MBS investors, is pretty obvious: The agency MBS market comprises roughly one-quarter of the high-grade US bond market (as measured by the Bloomberg Aggregate Index), and any reforms that impair the perceived creditworthiness of FNMA and FHLMC could have a measurably negative impact on our clients' portfolios. We take some comfort that there are key players in the current administration who seem to fully appreciate the criticality of the effective government guarantee and the impact to mortgage rates, which reduces the tail risk of market disruption. We believe that, in a base case scenario, GSE reform is likely to be neutral at worst for MBS spreads, while a possible easing of the GSE's portfolio limits could induce some amount of spread tightening. On another positive note, the clarification of policy uncertainty may increase demand by banks and overseas buyers for MBS, easing the burden from money managers and providing a modest tailwind to the sector.

The missing piece to this puzzle is what further steps this (and future) administrations will take regarding the GSEs, as they remain in a sort of limbo, even after the current, planned reforms. We will just have to wait for that.