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Market Facts

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How Will Foreigners React to Fannie Mae's Problems?

The law of supply and demand, simple to understand and taught universally in Economics 101, is misconstrued constantly. Such may be the case with Fannie Mae and the market for agency securities.

When the Office of Federal Housing Enterprise Oversight (OFHEO) announced last week that Fannie Mae applied accounting methods that did not comply with generally accepted accounting principles (GAAP) in certain derivatives transactions and hedging activities, questions arose as to how this would affect the agency market.

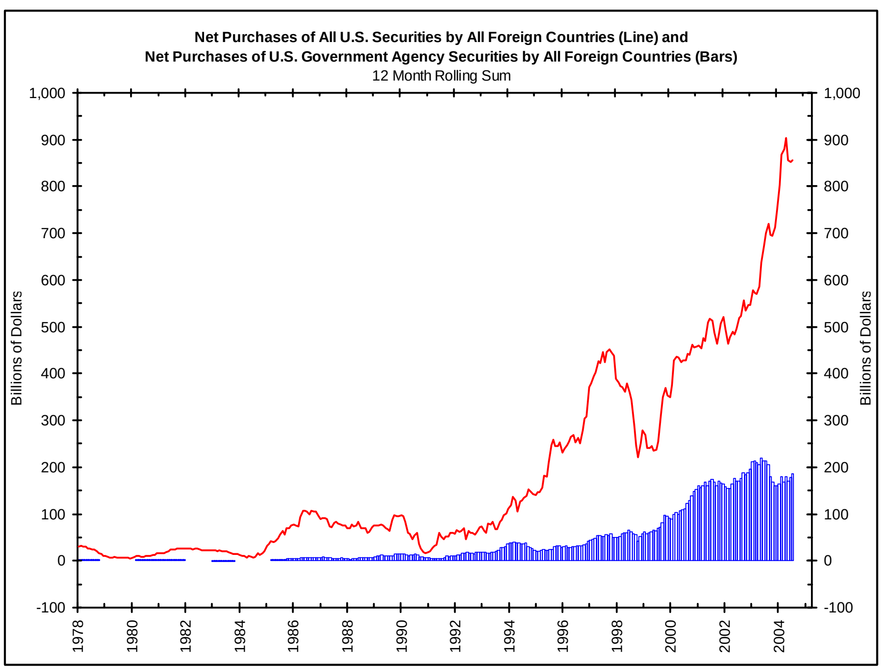
Many investors quickly assumed that, as a result of OFHEO's latest announcement, Fannie Mae would be forced to either reduce or slow the growth of their mortgage portfolio. This seems likely, and would in turn mean that Fannie would issue fewer agencies. The assumption then made was that the price of agencies would increase as a result of lower supply. This may not necessarily be the case.

The supply of a good represents only half the equation in determining its price. All else being equal, lower supply does raise prices. However, Fannie Mae's latest accounting problems should also affect the demand for their agencies among one of the fastest-growing groups of buyers – foreigners.

Foreign Demand

Over the past few years, foreigners have been one of the fastest-growing groups of buyers of U.S. securities. As the red line in the chart below shows, All Foreign Countries' net purchases of All U.S. Securities (Treasuries, Corporates, Agencies, and Equities) rose from $428 billion in July 2000 to $855 billion in July 2004 (latest data), almost doubling in that four-year period.

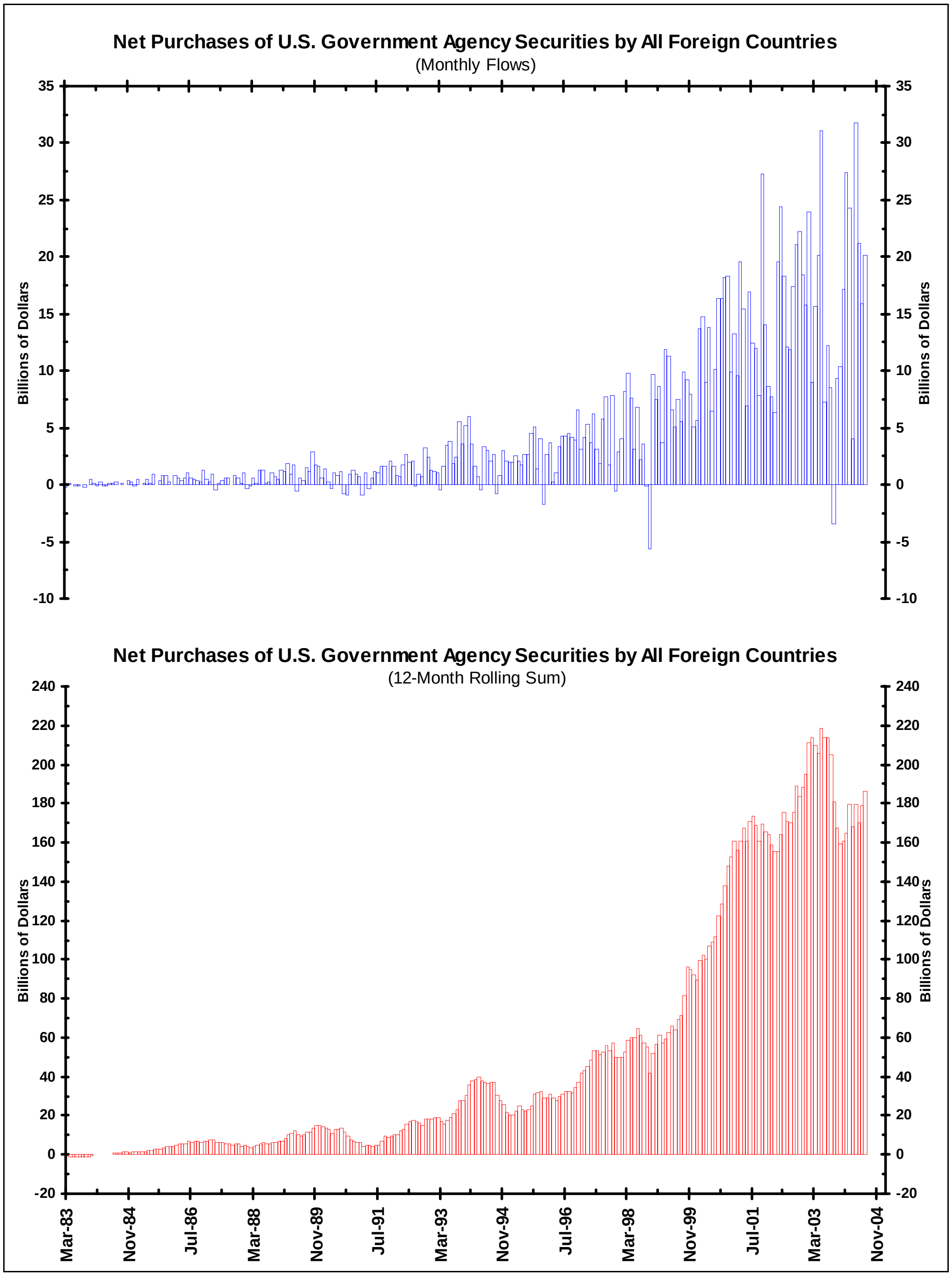
A similar but slower pace of buying can be seen in All Foreign Countries' net purchases of U.S. Government Agency Securities. This is shown as the blue bars in the chart below, and is further broken down on the chart on the next page.



The chart below examines Foreign net purchases of U.S. Government Agency Securities in more detail. The monthly net purchases are shown in the top panel, while the 12-month rolling sum is shown in the bottom panel.

What does this chart tell us about any possible impact Fannie's accounting issues might have on foreign demand of U.S. Government Agency Securities? Luckily, we have a recent precedent for this type of occurrence.

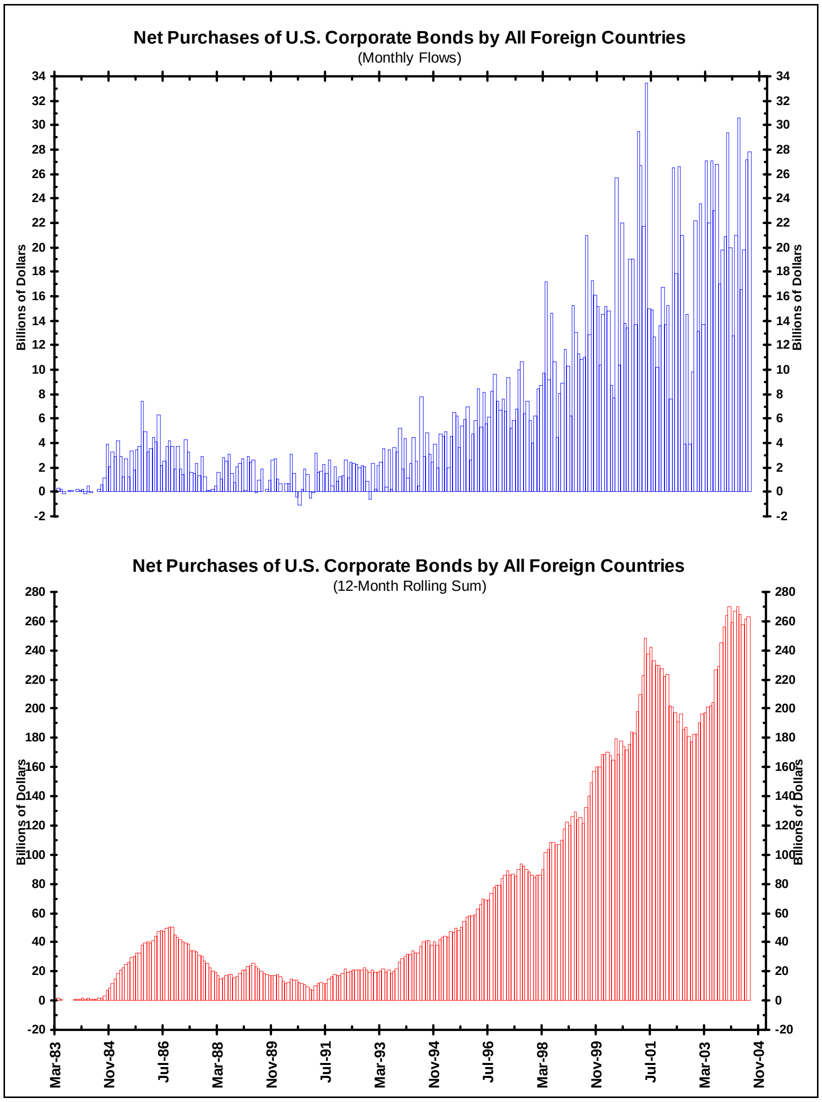
On June 9, 2003, Freddie Mac disclosed similar accounting problems. The bottom panel of the chart below depicts how net purchases of agencies by All Foreign countries peaked at the end of May 2003. One could argue that Freddie's accounting problem diminished foreign demand for agency securities. If so, we would expect Fannie Mae's recent occurrence to have a similar effect.



Where Is the Money Going?

The chart below depicts the net purchases of U.S. Corporate Bonds by All Foreign Countries. The top panel illustrates the monthly flows, while the bottom panel shows the 12-month sum of net purchases. Note the recent spike in net purchases on the bottom panel. Foreigners' net purchases actually had a short-term bottom near the end of 2002. A resurgence in demand occurred shortly after that.

It is possible this resurgence in foreign demand for U.S. Corporates could be due to the aversion foreigners have had towards U.S. Agencies since the Freddie Mac problems in June 2003. Rather than investing in agencies while Freddie was under fire, foreigners may have simply shifted their investments to a similar security deemed less risky, U.S. Corporates.



Conclusion

Because of Fannie Mae's recent accounting problems, they may be forced to slow the growth of their mortgage portfolio. This would mean they would be issuing fewer agency securities and, in turn, would push agency spreads tighter.

While this argument seems to make sense at first glance, it is only taking into account half of the law of supply and demand. Demand would have to remain constant in order for lower supply to drive agency spreads tighter.

Foreigners may have already turned away from agencies since Freddie Mac disclosed similar accounting problems in June 2003. Since then, foreigners have been buying fewer agencies and more corporate bonds. The newest problems at Fannie Mae could exacerbate this trend.

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