The Centurion Counselor

First Quarter 2010

UNDERVALUED SECTORS
(CONSIDER!)
- TECHNOLOGY
- CONSUMER DEFENSIVE
- MEDICAL DEVICES
- MEDICAL DIAGNOSTICS

OVERVALUED SECTORS
(AVOID!)
- JUNK BONDS
- EMERGING MARKETS
- LONG TERM TREASURIES
- REITS

WE ARE FROM THE GOVERNMENT AND WE ARE HERE TO HELP!

Recently the inspector general of the TARP program issued a report, stating frankly the “Home Loan Affordable Modification Program (HAMP) (maybe it should have been called hemp) is a joke.”

A year into the program, although more than a million trial modifications have been initiated, the number of permanent modifications thus far, 168,708, has been, even according to Treasury, “disappointing,” says the report. “The program will not be a long-term success if large amounts of borrowers simply re-default and end up facing foreclosure anyway.” Then the Office of the Comptroller of the Currency delivers this startling statistic: **51.5% of delinquent borrowers who’ve gotten loan modifications defaulted again after only nine months.**

One big reason is most of the modification agreements don’t reduce the borrower’s principal. In fact, in many cases, the principal grows. The report notes that "HAMP allows principal reduction, but it is not typically implemented in practice,” and until it is, the incidence of “strategic default” will likely grow.

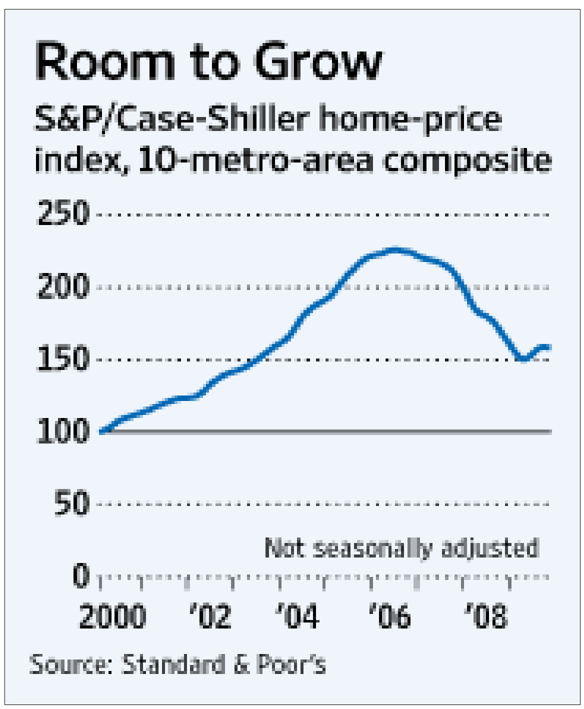
The obvious solution, at least in the eyes of Washington, is more government help. Having failed to help underwater homeowners who are delinquent, they now propose to help underwater homeowners who are still current with their payments.

The highlights…

- Borrowers who’ve lost their jobs can make sharply reduced payments -- or in some cases, no payments at all -- for up to six months

- Banks will now be given an incentive to reduce principal… courtesy of you, the taxpayer. The government will use $14 billion of TARP money to cover their losses. A chunk of this money will be used to help clear home equity loans and HELOCs. In a foreclosure, those are second in line behind the primary lien holder, and, on an underwater home, are frequently worthless
- Borrowers taking advantage of the program would refinance into a loan backed by the Federal Housing Administration. So the banks might book a loss (covered at least in part by the TARP money), but they'll shuffle the risk of foreclosure onto the FHA -- which faces rising losses on the loans it backs already.

Will this new program work better than HAMP? Probably not, but in Washington it is always better to rearrange the deck chairs and declare victory.



TAXPAYER SUPPORTED HEDGE FUND

Unless one was to read deep into the pages of financial papers, it would have been easy to miss the recently announced losses of Fannie Mae and Freddie Mac, bringing their total loss since the fall of 2008 to $126 billion. It barely registered as news, although taxpayers are on the hook for the bad debt of these government-sponsored enterprises.

It has not been unusual for politicians of both parties to take shots at the support given to the publicly owned financial sector. Let's take a closer look at the facts: $465 billion of direct capital, $285 billion of loan guarantees, and insurance of $418 billion of assets. To listen to Washington it is money down the drain. As of early April 2010, $175 billion has been returned, the loan guarantees look much safer, and the insurance program, mainly for Citigroup, has been terminated. Even the poster child for financial excess, AIG, may be able to fully pay off the government if the housing market doesn't deteriorate further.

But the chances are slim to none that Fannie or Freddie will be able to pay back the funds. It is highly likely that taxpayers will lose well over $200 billion -- and it may well pass $300 billion. When the history of the crisis is all written, these two institutions will turn out to be the most costly of the financial sector -- worse than AIG, Citigroup or Bank of America/ Merrill Lynch combined.

So where is the outrage?

It's not the pay packages. Compensation at Fannie and Freddie was right up there with other financial firms. For example, in 2006 and 2007, as housing conditions were weakening and the crisis started, the CEO salaries of Fannie were $14.4 and $12.2 million, and Freddie were $15.5 million and $19.8 million.

The answer may lay in the ways of Washington. On one side, the conservatives argue that Fannie and Freddie were ground zero of the subprime crisis, having been arms of the Clinton-Bush era push toward affordable housing for all. On the other side, liberals say the noise over Fannie/Freddie is a bid to divert blame from the supposed true causes, deregulation and the excesses of Wall Street. There is probably a little truth to both views. But these arguments are beside the point: Fannie Mae and Freddie Mac are where they are because they were run as a large hedge funds.

They operated under the following formula; we put in $1, you lend us $25. Then we will invest this $26 in bank-originated pools of mortgages that are not easy to sell and face significant long-term risks. We'll try to hedge that risk, but our models have such uncertainty that our hedges might not work. In case that is not risky enough they put 15 percent of the funds in subprime mortgages with borrowers unable to pay in a recession or a severe housing downturn.

This is a description of a $1.5 trillion hedge-fund, the business model of Fannie Mae and Freddie Mac. It has become a disaster for taxpayers. And unlike the banks or AIG, these risks were out in the open. Analysts have been pounding their fists on the table for years about them, so we have no one to blame but ourselves.

What to do now? The answers are not easy, because slowly but surely, the public has become hooked on a government drug. Washington now makes or backs 75% of all new home mortgages in America. A sudden withdrawal from the market would cause interest rates to rise and result in a tremendous drop in home prices. Because of their size and importance to the mortgage market, Fannie and Freddie should continue their mortgage-guarantee and securitization programs, but be split up into numerous smaller companies with the explicit government backing withdrawn over a period of 10 to 15 years. This would allow the market time to adjust without having a too big to fail quasi-government lender.