630-322-7756
www.ftportfolios.com

First Trust

Sep 8, 2008

Monday Morning Outlook

Brian S. Wesbury - Chief Economist
Robert Stein, CFA - Senior Economist

Mark-to-Market Now Mark-to-Taxpayer

Less than six months after the federal government interceded to prevent the collapse of Bear Stearns, it has now seized control of both Fannie Mae and Freddie Mac.

Although we are not thrilled with some details of the Treasury Department's plan, something had to be done. The ultimate fate of the GSEs (Fannie and Freddie) increased uncertainty much like an approaching storm. Would they have to suddenly dump their massive portfolios of mortgages? Would they cease securitizing mortgages, throwing the mortgage market into further turmoil?

For the mortgage security marketplace these questions were huge. The mortgage market has been in disarray, spreads increased and prices were held artificially low, even for conforming, and performing, conventional mortgages. To top it off, reduced prices, because of "mark to market" accounting rules, led to pressure on capital requirements, which in turn increased the odds of a liquidation of huge mortgage portfolios. This "vicious circle," of falling bond prices, impaired capital, falling prices and impaired capital threatened to turn a trickle of failed financial institutions into a flood.

Some institutions have the ability to hold assets to maturity and do not have to mark to market these assets. Others, such as hedge funds, cannot avoid marking every month. And if leverage is involved, even an entity that wants to hold to maturity may be forced to liquidate. And once a fire sale price is established it forces even lower marks across the financial landscape. Mark to market accounting pushes earnings up artificially in the good times and pulls earnings artificially lower in the bad times.

It is important to realize that most of the losses booked by financial firms are not the result of a recession or other serious economic downturn. Instead they are the result of truly dumb lending standards, an excessive use of leverage encouraged by a Federal Reserve policy of extremely low interest rates, the implied government backing of the GSE's which allowed them to get too big, and pro-cyclical mark to market accounting rules.

With the government now serving as a backstop, mortgage bond prices should firm and begin to be priced at a fair market value which reflects the true performance of the underlying credits.

Backstopping the GSEs with public funds and a detailed plan resolves a great uncertainty hanging over the mortgage market. As a result, we think the actions taken this weekend will help add liquidity to the mortgage market and help end the vicious cycle of mark to market mayhem; a necessary step for a financial recovery.

Our biggest concern that is still unresolved: several years from now, will the government allow the GSEs to grow too big all over again? We hope not and are relieved that the GSEs are now out of the lobbying business.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-08 / 2:00 pm	Consumer Credit – Jul	$8.5 Bil	**$5.7 Bil**		$14.3 Bil
9-09 / 9:00 am	Wholesale Trade - Jul	0.7%	**N/A**		+2.8%
9-11 / 7:30 am	Int'l Trade Balance - Jul	-$58.0 Bil	**-$57.4 Bil**		-$56.8 Bil
7:30 am	Import Prices - Aug	-1.8%	**-0.8%**		+1.7%
7:30 am	Export Prices - Aug	0.4%	**+1.2%**		+1.4%
7:30 am	Initial Claims - Sep 6	440K	**443K**		444K
1:00 pm	Treasury Budget - Aug	-$105.0 Bil	**-$115.0 Bil**		-$102.8 Bil
9-12 / 7:30 am	Retail Sales - Aug	+0.3%	**+1.1%**		-0.1%
7:30 am	"Core" Retail Sales - Aug	-0.2%	**-0.4%**		+0.4%
7:30 am	PPI - Aug	-0.5%	**-0.9%**		+1.2%
7:30 am	"Core" PPI - Aug	+0.2%	**+0.1%**		+0.7%
7:30 am	Business Inventories - Jul	+0.5%	**+0.5%**		+0.7%
8:45 am	U. Mich. Consumer Sentiment	64.0	**64.0**		63.0