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FNMA and FHLMC in the Headlines AAM's Perspective

Amidst all of the reports in the marketplace, it is of value to take a step back and apply some objectivity to the situation at hand regarding the US government sponsored agencies - the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC). Financial institutions require the confidence of the markets in order to have the capital and liquidity to operate on a leveraged basis. Because of the implicit backing of the US government and the vital role that the housing agencies play in financing the US housing industry, we do not believe the agencies will face a liquidity crisis. FNMA and FHLMC are essentially the only lenders in the housing market today, and this makes their survival critical to our economy. While this could change at any point in the future, both Federal Reserve Chairman Bernanke and Treasury Secretary Paulson are battle-tested and highly competent. We believe that this should mitigate any significant price deterioration in agency notes and mortgage backed securities, although we expect significant volatility as this situation works its way through.

We understand that the lack of capital for the housing agencies must be addressed. FNMA has followed through with its capital raising earlier this year while FHLMC recently announced its intention to raise capital but is waiting until later this quarter to raise it. Expectations are that both companies will need to raise significantly more capital. The big question is how capital will be raised. It is difficult to predict whether this will take the form of a private market solution in the form of selling additional stock and massively diluting equity owners or a federal government bailout. Regardless, the capital raising process will lead to significant volatility and potentially unlimited downside for stock and preferred holders of FNMA and FHLMC, but not the investors of FNMA and FHLMC notes and mortgaged backed securities, as exemplified by today's prices. Our view is that the government will try to orchestrate a solution that involves a greater backing while leaving the agencies as private companies. This will be a difficult path with a nationalization of the housing agencies as the ultimate fallback.

While the housing agencies have grabbed the headlines this week, we are closely monitoring all credits within the financial space. Liquidity is minimal in the corporate debt markets, and this is especially the case for regional banks. These are challenging markets with unprecedented volatility across all financial markets. We will continue to keep you apprised and as always, welcome your questions.

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