

**CIOVACCO**  
CAPITAL MANAGEMENT

**A Sad Day for U.S. Taxpayers**  
**Monday, July 14, 2008**

*“Treasury Secretary Hank Paulson swatted back reports of government nationalization of Fannie and Freddie, which would mean making explicit what, has long been an implicit taxpayer guarantee of their liabilities. This would instantly add \$5 trillion in liabilities to the federal balance sheet, doubling the U.S. public debt burden and putting America’s AAA credit rating at risk. This is a nightmare scenario for taxpayers.”*

**Wall Street Journal, Saturday, July 12, 2008** (prior to Sunday’s announcements)

Think about the long-term implications of the statement above, which references a doubling of the already off the charts U.S. debt burden and a mention of America possibly losing our AAA credit rating. While yesterday’s government intervention into the Fannie and Freddie (GSEs) situation may be good for traders and short-term market conditions, it is most definitely bad news for the long-term outlook for the United States and U.S. investors.

While our government is claiming to let Fannie and Freddie “operate in their current form”, the facts are this is another example of interference with the free market system. Mr. Paulson wants the ability to take an “equity stake” in the GSEs if needed. Taking an equity stake is a form of nationalization. Taking an equity stake means using taxpayer money to buy newly issued shares of Fannie and Freddie. The key is newly issued shares. Newly issued shares are bad news for stockholders in Fannie and Freddie. Why? Because newly issued shares dilute the value of existing shares.

*“But if the companies try to raise massive sums of new capital by issuing stock, they will severely dilute the ownership of their current shareholders - that’s a big reason the stocks have nosedived.”*

**Los Angeles Times, July 10, 2008**

Assume for illustrative purposes that Fannie had one million shares of common stock outstanding. Assume the government invests our money into one million newly created shares. As an existing shareholder, the book value of your shares gets cut by 50% instantly.

*“As part of the plan (to help Fannie & Freddie), the administration will also call on Congress to raise the national debt limit, people briefed on the plan said.”*

**New York Times, July 14, 2008**

Pushing aside today's initial reaction and taking a long-term perspective:

- This is bad news for the taxpayer because we have now been saddled with even more debt.
- This is bad news for interest rates since increased indebtedness and a threat to America's AAA credit rating will mean higher rates in the long run and lower prices for current holders of U.S. Treasury bonds.
- Higher rates are bad for anyone with a mortgage, credit card debt, a home equity loan, a margin account, etc.
- Higher rates also increase the government's debt burden via higher interest payments on outstanding debt.
- This is bad news for the U.S. dollar for all the reasons above.
- This is bad news for oil prices since a weaker dollar helps drive up all commodity prices.
- This is good news for gold prices in the long run for all the reasons above.

While today will see traders fuel a dead cat bounce in many financial stocks and stocks in general, it is one day in what is a firmly entrenched downtrend. Housing inventories remain high, which means we are not near a bottom in terms of the decline in home values. This without question means more write-offs and more trouble ahead for financial institutions and a continuation of the credit crisis. This may mark the start of a short-term rally, but skepticism based on the facts remains prudent for now.



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