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By Lynn Adler Reuters.com

PAULSON PLAN SWEEPS FANNIE, FREDDIE DEBT TIGHTER

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NEW YORK (Reuters)

A U.S. Treasury plan to freeze payments for subprime mortgage holders fired up demand for Fannie Mae and Freddie Mac mortgage and agency debt on Friday, as it assuaged fears of massive loan defaults and helped erase steep yield premiums racked up in last week's panic selling.

"The market was so pessimistic about the prospect of mortgage credit in general that good news of this magnitude was definitely a huge shot in the arm," said Lance Pan, credit research director at Capital Advisors Group in Newton, Massachusetts.

Fannie Mae and Freddie Mac agency debenture spreads ended 1 to 6 basis points tighter on Friday, ending one of the biggest weeks of premium swings in several years.

The market last week had a huge swing in the other direction, on heightened fears of the damage wrought by mortgage losses. Freddie Mac last week reported a $2 billion third-quarter loss, but this week helped restore market confidence by selling $6 billion in preferred shares to shore up its capital.

The spread moves of the past two weeks were last seen on a similar scale during the summer of 2003, said Nancy Vanden Houten, agency analyst at Stone & McCarthy Research Associates.

"At that time rates were starting to rise and major mortgage hedging needs, including by the GSEs and perhaps primarily by the GSEs, caused spreads to be extremely volatile for a few weeks," she said.

The Paulson plan, expectations that the Federal Reserve will soon cut interest rates again, and tightening swap spreads all propelled agency and mortgage-backed securities to outperform Treasuries this week.

Credit fears pushed some short-term agency yield premiums to record highs last week as investors fled to Treasuries for safety. This pattern was unwound this week.

"Clearly all mortgage credit markets are reacting to the Paulson announcement with the banks ... in which apparently they are going to freeze a large number, if not all, subprime adjustable-rate mortgages at current rates for a period of time to prevent the scheduled resets," said Art Frank, director and head of agency MBS research at Deutsche Bank.

"There are going to be fewer defaults than we expected a day ago," he added.

Treasury Secretary Henry Paulson discussed the plan at a meeting with top banking regulators and industry representatives on Thursday, and details could be announced as soon as next week, sources familiar with the meeting told Reuters. For details see [ID:nN30421799].

In an example of the immense swings over the past two weeks, two-year agency notes that were issued by Fannie Mae just two weeks ago at a 65 basis-point spread last week leaped to about 85 basis points -- a record for that maturity. By late Friday, the widening was more than recouped and the spread had been slashed to about 60 basis points.

Agency spreads barely budge 1 or 2 basis points in more typical trading, and swings of triple or quadruple that amount have become the norm of the past few volatile weeks.

In MBS, Fannie Mae 5-1/2 percent 30-year mortgage-backed securities prices rose 4/32 for a yield of 5.446 while 10-year Treasuries declined 8/32 to yield 3.962 percent.

The 1.484 percentage point yield difference is down from 1.547 late Thursday, and from 1.68 point on Monday, according to Reuters data.

RBS Greenwich Capital analysts wrote that the mortgage basis has gone through "massive gyrations over the past few weeks," tightening more than 20/32 to Treasuries this week.

Despite this rally, a number of negatives linger, the firm said. Among them are looming rating agency revisions of bond insurers, as downgrades could hurt credit markets including MBS; high net agency MBS issuance and the fact that Fannie Mae and Freddie Mac have limited room under their portfolio caps to increase their MBS holdings.

(editing by Leslie Adler)

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