

The Week that Was

ABX Commentary

Over the past two weeks ABX has staged its strongest positive move since the late November 2007 mini-rally. The rally has been most pronounced at the top of the capital structure with 06-1 AAs and As and 06-2 AAAs and AAs the best performers. There was little on the fundamental front to justify such a dramatic recovery; the positive existing home sales numbers (discussed below) contributed on Easter Monday but it seems the equity market-led turn in sentiment stemming from the Fed-sponsored, JPMorgan-led takeover of Bear Stearns was the chief driver of the move. Whilst the 'fundamental bid' is clearly gaining strength the indices seem to be mainly technically driven with dealers resetting shorts on any negative news

In the News

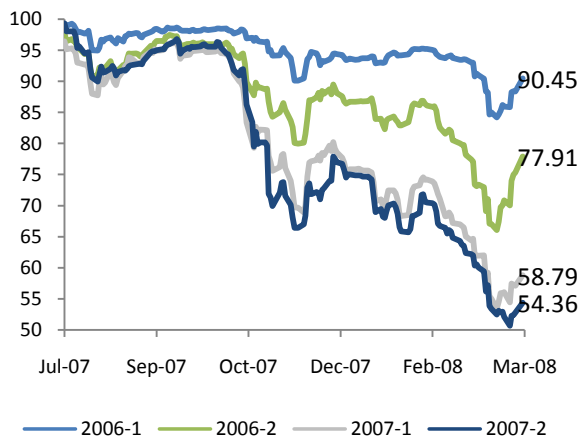
Rating agencies: ratings and model revision

On Thursday Fitch held a conference call to provide an update on U.S. subprime performance. They announced updated 2006 and 2007 vintage loss expectations (of current balance) of 28.1% and 28.0% and provided minimum loss coverage ratios of 2.5x for AAA, 2x for AA and 1.5x for BBB. On this basis Fitch has downgraded roughly 50% of both the 2006 and 2007 vintages.

S&P meanwhile, announced revisions to their subprime loss projection model, raising loss severity to 45% and their loss coverage at the AAA level to 150% of base case losses. S&P's base case loss projections are 19% and 17% for 2006 and 2007 vintages respectively.

This implies Fitch requires the average 2006 AAA to withstand roughly 70% of loss on the current outstanding balance to maintain its rating while S&P requires the average 2006 AAA to withstand only 30% of loss on the current outstanding balance to maintain its rating.

ABX HE AAA Performance



Remit Data

Remittance data was released today and it was far from good but we feel if you look hard enough there are some positives. We summarise the key points below:

- The rate of increase in prepay-adjusted 60+ delinquencies declined by an average of 60 basis points for all indices. This suggests that the 125 basis points of Fed rate cuts announced in January (the effects of which we will only start to see in the current remit reports) may be having an impact on delinquencies.
- While voluntary prepayments slowed, involuntary prepayments began to increase. Thus while total prepayments were down, they were not down by as much as voluntary prepayments. This is a positive for investors up the capital structure, particularly front- and second-pay AAA investors who purchased bonds with the prepay option struck at a [?]10% CPR
- On the downside, loss severity continues to increase for all indices with 06-1, 06-2 and 07-1 indices tracking at or around 50% severity and 07-2 at 58%. We anticipate this number increasing dramatically over the next few months.

The Barney-Dodd Proposal

Congressman Barney Frank and Senator Dodd last week made public a proposal to expand the FHA's ability to refinance loans. With the Fed's recent cuts in the Funds Rate the Hope Now loan modifications plan is less relevant. The Frank-Dodd proposal instead targets home loans on owner occupied properties with borrowers who are at risk of defaulting. The heart of the proposal is the plan for bondholders to forgive debt followed by a

refinancing by writing down the principal on a loan to an 85% CLTV (Cumulative Loan To Value). Effectively the plan calls for the FHA to buy eligible home loans at 85% CLTV's with the bondholder taking the loss at refinance (i.e. \$15 on a \$100 loan with 100% CLTV).

Perhaps counter intuitively, the proposal appears to have merit from the perspective of senior bondholders. It will cap loss severity at roughly 40% for even the very worst loans making any loss of capital for AAA note holders extremely unlikely. However for subordinated classes which are trading at IO values and counting on foreclosure and REO timelines continuing to extend, the Frank-Dodd proposal is bad news.

The proposal is the most encouraging to date as it shows that legislators are beginning to comprehend the negative equity problem in the U.S. housing market. However we have three key concerns:

1. Will it be too little too late? We are concerned that this proposal will take too long to successfully implement. By the time the proposal is approved and gets underway most 2006 subprime borrowers who are going to default on their mortgage will have defaulted and entered the foreclosure process. This mitigates the benefits of reduced loss severity through a loss forgiving refinance.
2. Will the FHA be prepared to underwrite all the eligible loans? And if they go into a GNMA program, who will buy them?
3. How do you get junior bondholders to agree to a plan which if carried out on the scale proposed, would effectively default their bonds?

Recent Action by the Fed

The Fed has been increasingly active in the capital markets over the month of March. On the 11th, the Fed announced a plan to lend \$200 billion in Treasuries at weekly auctions in return for debt including AAA-rated mortgage-backed securities sold by the GSEs and banks. On the following weekend the Fed cut the discount rate on direct loans to banks to only 25bps above the main rate (historically this has been 100bps) and extended the window from 30 to 90 days (remember as recently as December this was overnight). They also for the first time in their history lent to the primary dealers (Goldman, Lehman and Morgan Stanley all have stated publicly that they are 'testing' the facility) with their Primary Dealer Credit Facility overnight lending program. In addition they provided \$30 billion in capital to assist JPMorgan finance Bear Stearns' less liquid assets. Then on the 18th the Fed cut its main lending rate 75bps to 2.25%, moving the direct rate to 2.5%. Over the Easter weekend, news emerged that the Fed has effectively assumed the \$30 billion portfolio of less liquid assets mentioned above and has engaged BlackRock as manager. Quite a couple of weeks, indeed.

Chase Stays In the Game

Coming off the back of Merrill Lynch's decision earlier this month to close their entire subprime origination arm First Franklin, Chase, the corresponding arm of JPMorgan has made an unspecified number of cuts in their subprime lending group.

Despite these cuts, they have reasserted their commitment to originating subprime mortgages, albeit at far more stringent levels. This has positive implications for investors who are prepared to carry out the loan level analysis on mortgage pools to find creditworthy borrowers.

Fannie, Freddie Get Back Into the Game

Last week OFHEO reduced the amount of surplus capital Fannie Mae and Freddie Mac were required to hold from 30% to 20%. Whilst some market pundits were hoping for more, this reduction will allow the two GSEs to pump around \$200 billion into the mortgage market, a not insignificant amount. However the credibility of the move is questionable given the fact that both are thinly capitalised with around \$7 billion each in surplus capital (after the reduction to 20%). UBS analysts have recently estimated that, net of writedowns, Freddie and Fannie could be sitting on as much as \$30 and \$15.5 billion of writedowns respectively in Q1 2008.

Indeed, on Tuesday Fannie Mae announced that it had further tightened its underwriting policy, boosting by 5% the required size of down payments or borrower equity on new lending.

Macro Picture

Case-Shiller

U.S. house price depreciation continued to accelerate as the S&P/Case-Shiller index dropped 10.7% through January, 2008 vs. a 9% decline through December. This outpaced the median forecast of a 10.5% drop. The worst performing MSAs continue to be Miami, Las Vegas and Phoenix. Interestingly, the rate of price decrease slowed in a number of states, most notably, New York. OFHEO said prices fell 1.1% in January, much faster than the 0.6% drop in December.

Existing and New Home Sales Data

Sales of existing homes rose in February, their first rise in seven months, increasing 2.9% month-on-month, compared to -0.4% in January. At current prices inventories also

declined to 9.6 months from 10.2 months in January.

On the other hand, sales of new homes fell by 1.8% to a 13-year low. The decline was broadly in line with forecasts.

The contrast between the new and existing sales numbers highlights the dire state of the U.S. housing market. Existing home sales are increasing as foreclosed properties are sold at heavy discounts while the housing construction market remains dormant.

Consumer Confidence or Lack Thereof

U.S. consumer confidence fell more than forecast in March, down to 64.5 from a revised 76.4 in February. The outlook for the economy fell to a 34 year low with the gauge of expectations for the next 6 months at 47.9. These numbers suggest the recent contraction in consumer spending will continue and confirms that the United States, if not already there, is moving ever closer to a recession.

SCR View

News and data has been coming thick and fast over the past few weeks with the Fed continuing to break new ground in the way it seeks to communicate with market participants. While we caution that the last of the mark-to-market volatility may not be behind us, we suspect that we are reaching an inflexion point with mortgage delinquencies. Despite the fact that loss severities will undoubtedly get far worse before they get better we continue to gain comfort at the top of the capital structure as credit enhancement continues to build. Investors with concerns about ratings volatility should stay at the AAA level and focus on bonds which have already been affirmed by Fitch.

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