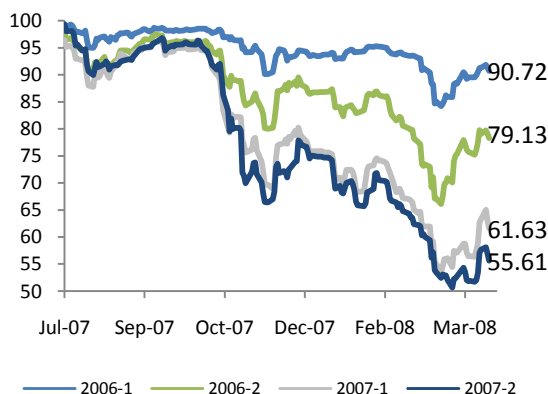


The Week that Was

ABX Commentary

The ABX rally which began slowly in mid-March gathered pace as we moved into April last week. This largely followed similar moves in the broader credit markets as moderately negative economic data was ignored. However sentiment shifted sharply early this week as Itraxx and CDX overshot (CDX traded inside 110bps from a mid-March wide of over 190bps finishing yesterday's close at 123bps). An interesting trend seems to have emerged at the top of the capital structure recently: strong interest in the morning by outright longs and short covers with profit taking and resetting of shorts leading to a weaker close in the afternoon. All the while the dollar price is edging higher until the index is forced lower on negative news. Reporting season kicks off in full next week; poor results would provide enough downward pressure to keep 07-1 in the lows 60s and 06-2 inside 80.

ABX HE AAA Performance



In the News

Rating Agency Actions: MBIA downgraded by Fitch, S&P downgrades Mortgage Insurers, Moody's takes its turn

On Friday last week (5th April), Fitch continued to prove itself to be the most proactive ratings agency by cutting the rating on MBIA's insurance unit to AA from AAA, despite both S&P and Moody's affirming their ratings. Whilst not entirely unexpected (MBIA had asked Fitch to withdraw its rating last month because of continuing disagreements), the downgrade significantly restricts MBIA's ability to write any new business in the near term (Fitch estimates the shortfall in capital required for a AAA rating to be \$3.4-3.8 billion). In addition auditors will require any MBIA-insured positions to be marked down to reflect the lower rating. This can only have a negative impact on the prices of the underlying securities and thrusts the issues surrounding the capital adequacy of the monolines back onto the market's radar.

On the following Tuesday (8th April), S&P downgraded four U.S. mortgage insurers: MGIC PMI, Old Republic and Radian. Only one, Old Republic, succeeded in maintaining a AA- rating on their insurance arm. Given that AA- is the minimum rating required to do business with the Government Sponsored Entities ('GSEs') and S&P's estimate that over 58% of mortgage insurers are now rated below AA-, a review of the future role of mortgage insurers in GSE programs will need to be undertaken. Politically, bailing out the mortgage insurers by reducing the required rating for entry into GSE programs is less desirable than bailing out the homeowner directly through an expansion of

the GSE programs. As such the Frank-Dodd proposals (and rumours of a similar proposal coming directly from the White House) are still expected to be the most likely course of action from Washington.

We also note that Moody's have begun this week to downgrade previously Aaa-rated subprime bonds. This process is in its early stages which makes us wary of coming to any firm conclusions yet but the following table is interesting: to date Moody's does appear to be far more aggressive than S&P and Fitch in downgrading AAA's, downgrading to an average rating of A2. Expect more pressure on the top of the capital structure as the Moody's review process continues.

Previous Rating Aaa	Average Notch Downgraded (assuming the bond is downgraded)
Moody's	5.15
Fitch (1st lien)	4.19
S&P	3.55

IMF- "Collective Failure" may lead to \$1 TRN of Mortgage-Related Losses

The International Monetary Fund released its annual Global Financial Stability Report on Tuesday, forcing markets to refocus ahead for Q1 earnings next week and stopping the recent rally in credit indices in its tracks.

The headline numbers are as follows: a \$565 billion potential aggregate loss related to the U.S. residential mortgage market and a \$945 billion total potential loss when other categories such as commercial real estate, the consumer credit market and corporations are considered. These numbers are roughly 50% ahead of other recent estimates and according to the IMF are the result of a "collective failure" to grasp the degree of leverage taken on by a

whole range of entities including banks, hedge funds, GSEs and of course the monolines.

The report deals extensively with the breakdown in confidence around the valuation of structured finance securities. Some key areas addressed are:

- The role of rating agencies in the structuring and valuation¹ of securities and the adequacy of the models they use;
- The funding model for structured products, and;
- The failure of risk management systems.

WAMU Gets Capital Infusion

Also on the same day, Washington Mutual Inc sold 176 million shares at \$8.75 (a 33% discount to Monday's close) and \$5.5bn in convertible preferred stock raising \$7 billion from a group of investors led by TPG. The capital raising dilutes existing shareholders by half.

The board had rejected a bid by JPMorgan that valued the company at around \$8 a share. While the dilutive impact of the capital raising is a definite negative in the short term for WAMU equity holders, the fact that a name embroiled in subprime lending was able to raise \$7bn in capital and had multiple options in doing so is an encouraging sign for the broader markets.

We have known for some time that private equity has had significant capital sitting on the sidelines. On the whole, they stayed out of the first round of capital raisings as institutions such as Citigroup, Morgan Stanley and Merrill Lynch were forced to look to abroad. The fact that the so-called 'smart money' is beginning to enter the fray (at significantly more attractive levels

¹ Whilst not valuing the security directly, the credit rating assigned by the rating agencies will affect the valuation the security in question.

than last November) is a positive for market confidence.

Macro Picture

U.S Unemployment

The end of last week saw U.S. employment numbers released. Payrolls were down by 80k, more than the 50k drop forecast and more than the 76k from last month. Unemployment rose to 5.1% up from 4.8% in February and a low of 4.4% in March of last year. Initial jobless claims were up by less than forecast for the week ending April 5 but continuing claims to the end of March were higher at 2.94 million people.

Pending Home Sales

The National Association of Realtors' index of signed purchase agreements on previously owned homes declined by 1.9% to 84.6. Compared to last year the measure is down 21%. The decline was led by a 5.5% decline in the South and a 3.7% decline in the Midwest with rises taking place in the Northeast (by 3.2%) and in the West (2.1%).

Consumer Borrowing

Consumer borrowing rose in February but by less than forecast, increasing \$5.2bn to a total \$2.54tn. A Bloomberg survey had forecast a \$5.9bn increase in consumer borrowing. The main decline was seen in non-revolving debt, such as auto loans, which rose by less than \$500m in February after a \$4.7bn increase in January and a \$3.2bn increase in the month before.

FOMC Minutes

Minutes from the March 18 U.S. Federal Reserve meeting were released this week and pointed to an increasingly bearish FOMC. Two

issues in particular point to the overall bearish sentiment of participants:

- Several members of the committee expressed concern that *“falling house prices and stresses in financial markets could lead to a more severe and protracted downturn in activity than currently anticipated”*.
- Evidence that an *“adverse feedback loop”* was underway was considered by the committee. An adverse feedback loop is where a lack of credit causes a decline on economic outlook which in turn causes a contraction in credit. The fact that this may already be underway is concerning.

University of Michigan Confidence Index

The Reuters/University of Michigan index of consumer sentiment decreased to 63.2 on Friday (11th April), well below 69, the level previously forecast by a Bloomberg survey of economists. The reading, the worst in over 25 years reflects the concerns of U.S. consumers around higher food and energy costs, recent job losses and what many economists are predicting to be the most severe correction in the U.S. housing market since the Great Depression. Economists had previously predicted that consumer spending, which accounts for more than two-thirds of the U.S. economy would grow at 0.5% this year, the smallest gain since 1991.

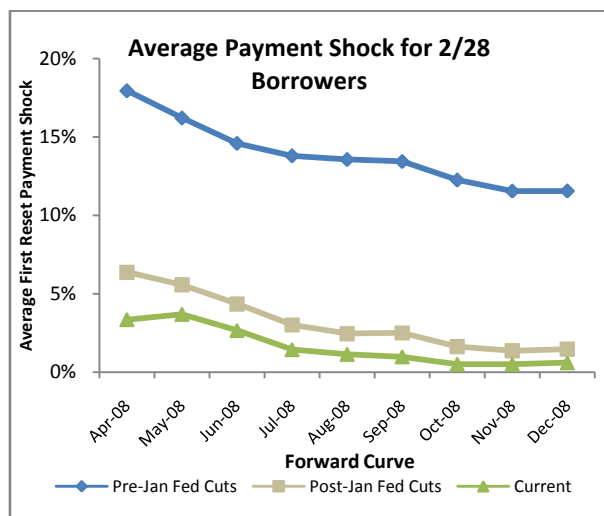
Quant Corner

We asked our quants two questions this week:

1. What is the monthly payment shock we can expect based on the recent movements in the forward curve for a 2/28 loan resetting this year?; and

- If there is a reduction in the payment shock, do we expect it to result significantly better performance from borrowers?

The chart below shows that the monthly payment shock resulting from the first reset of 2/28 loans has been virtually eliminated.



With this in mind our quants then prepared the following table. They compared the roll rates for loans resetting in December to roll rates for loans resetting in March in June of 2008 over the past three months. If the payment shock is to have any benefit, we should expect to see the roll rates for the December resets to be significantly higher than that for the March, 2008 and June 2008 resets, as was the case historically. Considering the universe of borrowers who were current² in the 6 months leading up to December 2007 we find:

Reset Date	Status for the 3 months post Dec 2007	
	Current/Prepaid	Defaulted
Dec-07	85%	15%
Mar-08	89%	11%
Jun-08	90%	10%

We see that the reset shock prior to the Fed rate cuts caused only a marginal decline in performance relative to loans which did not experience a rate reset in December. So although the Fed rate cuts have made a significant impact on the monthly payment shock, we can expect only a small benefit in terms of performance.

SCR View

An interesting week thus far with not a lot of economic data but a lot of price-relevant news coming to market. Despite the recent respite from the price declines of early March, the rally in ABX is unlikely to continue with anywhere near the same impetus. Granted, the government has demonstrated its clear commitment to supporting the financial markets and there are early signs that real money investors may be re-entering the market but these points do not justify the change in sentiment alone. Moody's is now actively and aggressively downgrading at the top of the capital structure, house price declines show no sign of slowing, consumer confidence is at quarter century lows and unemployment is on the rise. Moody's latest actions demonstrate that ratings volatility will persist even up the capital structure. Investors who do not want to be in a situation where they buy AAA and end up holding BBB a week later should focus on front pay AAAs, or last cashflows with significant enhancement that have already been affirmed by Fitch.

² Current is defined as less than 60 days delinquent. Defaulted is defined as 60+ days delinquent.

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