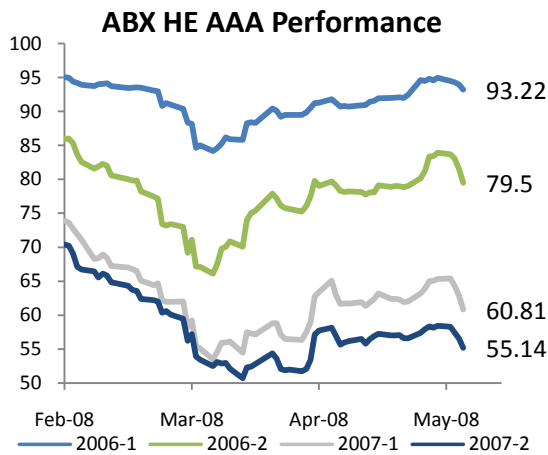


The Week that Was

ABX Commentary

The more seasoned vintages of ABX continued to rally last week as better than expected GDP and employment numbers were released.



Despite these moves, the fate of the bottom of the capital structure appears to have been sealed with only 06-1 single A's pricing in anything but the most remote possibility of principal recovery. This leads us to believe that the rally in AAA (and 06-1 AA) has been largely based on a repricing of the liquidity premium rather than a fundamental repricing of credit risk.

In fact over the past couple of days the rally has abruptly halted, with ABX 06-2 AAA index dropping almost 5 points from its peak. This coincided with the announcement of a new ABX index, the ABX PEN AAA and expectations surrounding intervention in the housing market from Washington. We discuss both further in the 'In the News' Section.

In the News

Rating Agency Actions

The three main agencies were all active over the past week although the volume of downgrades appears to have slowed. S&P downgraded 69 AAA tranches by an average of 5 notches and affirming 254, Fitch only downgraded one tranche while affirming 5 and Moody's downgraded 6 tranches by an average of 8 notches while affirming 23.

S&P also announced that it will not rate any new U.S. RMBS backed by closed-end second liens regardless of credit quality. They reasoned that loan performance has deteriorated to a level where they believe that it does allow for a meaningful analysis of new issuance and securitization. Considering that around 11% of the home equity loans securitized in 2006 were second liens this action has significant implications for the future issuance of subprime ABS. Neither Fitch nor Moody's have made announcements in this area.

ABX PEN AAA Announced

On the 2nd May, Markit announced that a Penultimate AAA sub-index would be added to the existing and future series of ABX.

The index was apparently added based on the results of a dealer poll. It will consist of the penultimate pay AAA notes backed by the same collateral of the last cash flow AAA that is currently in the index.

The key question is where the indices will price. Much information about the current state of the market should be able to be inferred from the initial prices of the new indices. We select two points on which we will focus when the indices launch next week.

One, the 07-1 and 07-2 PEN AAAs will be cheaper shorts than the LCF AAA indices. In recent weeks we have seen a LCF AAA's move towards a price more representative of 'fundamental value' (indeed some pundits claim the index has overshot in this regard). The observed basis between the 07-1/2 PEN AAA and the 07-1/2 LCF AAA versus the intrinsic or modelled basis should provide us with an indication of the strength of the technical short.

Two, with a minimum current credit support of 36.5%, the 06-1 PEN AAA index (of which only 4 bonds are yet to commence paying down with one bond already fully paid down) has in our view extremely remote default risk. With a shorter duration than the LCF AAA, the 06-1 PEN AAA index is a better proxy for the subprime risk premium; the added return investors require to invest in subprime. This proxy is useful in the context of asset allocation decisions providing a benchmark from comparisons across asset classes.

Frank-Dodd, FDIC, FHA Modernization and the Bush Veto

Early last week Barney Frank's FHA Housing and Homeowner Retention Act that would allow the government to guarantee up to \$300 billion in refinancing of distressed residential mortgages passed a key vote in the House of Representatives Financial Services Committee. On the Tuesday President Bush again came out strongly against the bill, threatening to veto the bill if it made it to his desk. Interestingly both Hank Paulson and Ben Bernanke have both

publicly supported key elements of the bill. The House of Representatives passed the bill by a 266-154 vote with some Republicans crossing the floor to the support it. As part of the same package the FHA loan limits were permanently raised to \$729,500 for key high cost areas (the Economic Stimulus Act of 2008 had provided for temporary increases earlier this year).

Bush prefers a solution involving an expansion of existing FHA programs over directly using taxpayer funds. The FHA Modernization Act which in essence aims to make FHA loans accessible to a greater number of borrowers has already been passed by the House of Representatives and is his and many other (although not all) Republican's vehicle of choice.

Late April the FDIC unveiled its own solution to the housing malaise; the Home Ownership Preservation (HOP) Loan Proposal. It proposes that the Treasury loan distressed borrowers \$50 billion to pay down a portion (up to 20%) of principal on their mortgages which would then allow the borrower to refinance into a traditional fixed rate mortgage. The government loan would have no payments for the first 5 years and then amortize at below interest rates thereafter.

The key to each of the plans is not getting the legislation passed but the implementation. As we have discussed previously, the Hope Now Alliance which garnered so much publicity in late 2007 and early 2008 has been an abject failure. Even if they were sufficiently resourced (and capitalised) to do so, servicers have no upside in aggressively implementing plans which maximises returns for one set of investors at the expense of another.

Fannie Mae Posts Loss But Will Raise Capital

Fannie Mae posted a \$2.2 billion loss over the first quarter. The number, \$2.57 a share, was far worse than the \$0.64 anticipated by a Bloomberg survey of 12 analysts. They also announced a plan to raise up to \$6 billion in capital as well as cutting their dividend to \$0.25 (it had previously been cut to \$0.35 from \$0.50) starting with a \$4.5 billion issue in common and convertible preferred shares. The converts will pay a coupon of 8.75% and pay a conversion premium of 18-22%. The common stock was priced at \$27.50 a share.

Separately, OFHEO announced that they were lowering surplus capital requirements to 15% from 20% (it was 30% prior to the mid-March reduction). The stock rallied on the news, up 8% on the day. It has since traded down with the broader market and is now flat on the week.

The whole concept of raising capital to effectively lever into the worst housing market since the Great Depression seems counterintuitive. Despite this, if the GSEs can successfully put this capital to work then subprime mortgage investors, particularly those at the top of the capital structure, should benefit.

Macro Picture

U.S. Consumer Debt Rises

U.S. consumer borrowing increased by \$15 billion in March, more than double the amount forecast by a Bloomberg survey of economists. With household spending growing at the slowest rate since the 2001 recession, consumer borrowing in the first quarter at the highest level since the first three quarters of

2001 and the home price ATM cashed out, the outlook is not at all positive for consumers and by implication the broader economy.

U.S. Pending Homes Sales Fall

The index of pending resales fell 1% in March as falling home prices and an inability to access credit discouraged potential buyers. With 30 year fixed mortgage rates remaining stubbornly around 5.8% even as the Fed Funds rate has dropped to only 2%, the accessibility of mortgage credit is unlikely to improve in the near term.

MBA Mortgage Applications

The Mortgage Bankers Association reported a 15.6% increase in mortgage applications this week. Interestingly several market sources have reported that the mortgage market's other key applications index, theMax Mortgage Applications Index, actually declined on the week. The difference between the two indices: theMax does not include multiple applications from the same address. It appears that distressed borrowers are making multiple applications to refinance in the hopes that one will be accepted. We take this as a sign of the desperation of borrowers rather than a sign that mortgage markets are functioning as they should.

US Unemployment: Better than Expected

The U.S. shed fewer jobs than expected in April with the unemployment rate falling to 5%. This is less than the previous month, and 2 basis points less than the number forecast by a Bloomberg survey of economists. Despite the strength in the unemployment rate, a decline in the average number of hours worked and only a small increase in the hourly wage meant that

the weekly earnings were down by \$1.45, the biggest drop in two years.

U.S. Not in a Recession... Yet

The term 'grocession' has been bandied about by economists recently. It describes a stagnated economy where real GDP hovers around 0% for an extended period of time. This term appears apt for the current state of the U.S. economy where first quarter growth of 0.6% (annualised) was driven by a sharp increase in inventories and not increases in fixed investment by companies or consumer spending.

The Fed's Last Cut. For Now

As expected the Fed cut its target rate 25 basis points to 2% last week. As with the last cut the FOMC vote was not unanimous with two members preferring no cut at all. The statement had a more hawkish tone warning that 'some indicators of inflation expectations have risen in recent months' and dropping a remark about the 'downside risks' to the economy. With the stance of the Fed equally weighted between downside risks to growth and inflationary pressure and barring a severe contraction in the economy, no cuts are expected for at least the next few meetings.

SCR View

Despite the recent run-up in prices on last cash flow AAAs we remain consistent in our view on the U.S. subprime mortgage market. Fundamentals are poor at best and the outlook for the U.S. economy is worst. We remain focussed on the top of the capital structure, preferring to take advantage of the embedded optionality surrounding the various government programs whilst remaining wary of potential rating agency actions.

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