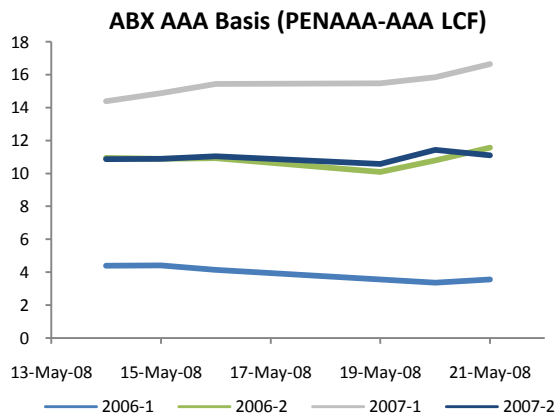


## The Week that Was

### ABX Commentary

The last week marked the first week of trading for the PENAAA index. As the below chart shows the basis to the LCF AAA traded within a fairly tight range albeit with some sizeable intraday volatility in the first two days. The 06-1 PEN AAA index has traded around a 98 handle, which translates to a discount margin of around 250 basis points on a one year weighted average life. As mentioned last week this represents the best proxy of the subprime risk premium to date, and is significantly wider than other AAA rated ABS.



### In the News

#### *UBS Sells Subprime to Blackrock, Raises \$15 billion*

On Thursday UBS announced plans to sell US\$15.1 billion in shares at a 31% discount to the closing share price the day previous close. This takes the total capital raised by financial institutions worldwide to almost \$270 billion (source: Bloomberg).

On Wednesday UBS announced that it gave an \$11.25 billion loan to Blackrock to complete the sale of \$15 billion in subprime and Alt-A US residential mortgage backed bonds. The notional on the bonds was \$22 billion. Further details on the loan have not been released but the fact that UBS is willing to sell assets at a 30% discount to face and provide 3 times leverage on the remaining value of the assets is compelling. From Blackrock's perspective, the deal looks like a no-brainer. At a 30% discount to face, we estimate the unlevered asset yield to be 10-15%. With leverage the yield could go from anywhere between 30-50%. And these assets would have been originally rated AAA.

The sale of these assets by UBS gives two important insights:

1. Investment banks may be more desperate to get rid of subprime than we initially thought. The strategy of placing these assets in the 'hold-to-maturity' bucket may no longer be palatable to shareholders. Pressure from them could see a flood of previously tightly held bonds come to market.

2. Liquidity is king. As demonstrated by Blackrock on more than one occasion, there are tremendous opportunities for the liquid, well capitalised investor.

*Dodd, Shelby Achieve Bipartisan Support on Housing Relief Package*

On Tuesday, the U.S. Senate approved a housing relief package by a landslide vote of 19-2. The measure, similar to one proposed by House Financial Services Committee Chairman Barney Frank, is due in large part to the efforts of Senator Christopher Dodd who worked with Republican Senator Richard Shelby to build a bipartisan consensus. The President had earlier issued a veto threat against the Frank plan labelling it a taxpayer funded bailout of housing speculators. Such resistance is not expected this time due to the support from Republicans in the Senate and the different structure which calls for the expansion of the FHA's mortgage insurance program to be funded by a GSE-sponsored affordable housing fund rather than directly by the taxpayer.

We see this plan as being highly beneficial for Class A noteholders and bad for subordinate classes. Mass refinancing at some discount to face value will quickly erase any credit enhancement in a deal and lead to faster prepayments for the AAA noteholder than currently forecast. Despite this, we remain sceptical about implementation and the economic incentive of the servicer to participate in this plan.

*More Servicers Turning to REO Auctions*

In a worrying trend, Fitch reported Monday that with the rapid accumulation in REO inventories servicers are turning to REO auctions as an alternative approach to disposing of properties.

Fitch's report stated that as of Monday, 60% of servicers had used auctions to liquidate REO holdings. From the perspective of the bondholder the problem with this approach is that auction REO liquidations have a markedly higher loss severity than non-auction REO liquidations. Based on a survey of 9 servicers which employ REO auctions as a means for disposing of property, loss severities were on average 15% higher than non-auction REOs. Of course, REO-auctions tend to take place in the most distressed areas but their rapidly increasing use has serious implications for loss severity estimates.

*Oil- \$135 a barrel*

Spot crude oil prices briefly touched \$135/barrel this week up 7% on the week and over 40% on the year. Airlines the world over are raising prices in response with the consumer expected to bear the brunt of the rise through increased fuel and food costs. These rises are likely to have a greater impact on the subprime borrower than the average worker in the United States for two reasons:

1. On the whole they live outside major metropolitan areas. They must travel larger distances to go to their place of employment and as such rely on cheap gasoline to make the effort worthwhile.
2. A larger proportion of the income of the subprime borrower goes to food. The prime borrower has room to cut back

on restaurants, and other forms of discretionary spending. The subprime borrower does not enjoy the same luxury.

#### *Freddie and Fannie Portfolios Expand*

At the end of the week, Fannie Mae and Freddie Mac both released statements detailing the growth of their portfolios since their capital requirements were loosened. Freddie said its portfolio grew at an annual rate of 42% in April, expanding by around \$25 billion. Fannie's portfolio grew at a slightly slower rate; only 9.8% annualised, expanding by around \$5.5 billion. Fannie also announced that the conventional single-family serious delinquency rate (serious delinquencies are defined as a borrower who has missed three or more consecutive monthly payments) rose 5 basis points in March to 1.10%.

#### **Macro Picture**

##### *U.S. Home Prices*

House prices fell 3.1% in the first quarter from a year earlier, according a report by the Office of Federal Housing Enterprise Oversight, released Thursday. Purchase only prices fell an average of 1.7% from the fourth quarter of 2007 (California and Nevada each down over 8%) with the all-transactions index, which includes appraisals for refinancings, down 0.2%. Some market pundits took the smaller than expected decline in the all transactions index as a positive sign that the decline in house prices was nearing its end. At SCR we prefer to focus on the purchase only index which paints a different picture. Refinancings are based on appraised home valuations which in turn are based on home sales data. With purchase only prices plunging, we expect the all transactions index to follow.

##### *Initial Jobless Claims Down on the Week*

Initial jobless claims fell last week by 9,000 to 365,000. Economists had forecast claims would rise to 373,000. The four week moving average rose by 5,000 to 372,250.

Anecdotally, however, the unemployment rate looks certain to rise in the coming months; financial institutions are continuing to announce job cuts (as part of the JPM/Bear deal, around 10,000 employees from both sides are expected to be cut), retailers are preparing for slowing sales growth and oil price dependent institutions such as airlines are beginning to announce their own measures.

##### *MBA Mortgage Applications*

Mortgage applications were down again last week with the Max national mortgage

applications index down 2.1% and the MBA mortgage applications index down 7.8%. The MBA purchase index slid 6.9% to the second-lowest level in five years. This is concerning because despite increasingly attractive affordability levels for both first time and repeat buyers (home affordability for first time buyers is the highest since the mid 1990s), these potential borrowers remain on the sidelines.

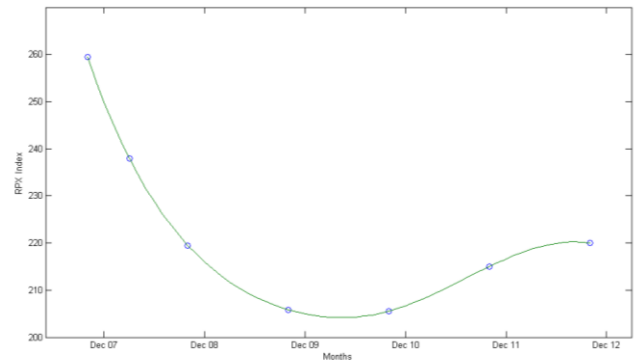
*Fed Minutes from April*

The U.S. Federal Reserve released minutes from their April 29-30 meeting this week. The minutes indicated that a further economic contraction won't be enough to spur further rate cuts despite forecasting only 0.3-1.2% in growth for the year. The reason for the hawkish tone is the fine balance between the growth concerns and increasing fears for inflation. As highlighted by Paul Volcker, ex-Chairman of the Fed, there is some resemblance to the current state of the economy in the inflationary environment of the 1970s.

**Quant Corner**

It is fair to say that the subprime market is in somewhat of an impasse. Delinquencies have shown no signs of slowing and severities are just beginning to ramp up as servicers look to start reducing their liquidation backlogs. Investors are busily looking for a sign that we are approaching bottom in order to gain some comfort in extrapolating trends to generate forecasts of prepayments, defaults and severities. One major uncertainty is where we are in terms of house price depreciation. There are many conflicting views with some observers claiming we are in the early years of a Japan-like decades long slump in house prices and others claiming that affordability levels indicate we are nearer to the end of the slump than the beginning.

The RPX.CP28 forward curve index for house prices across 25 major metropolitan statistical areas provides an indication of the market consensus on where we are in the slump. In the chart below our quants have mapped the forward points on a cubic spline to give us a sense of the market view on where the inflexion point in house price depreciation is. From the below chart it appears we should expect to say the rate of acceleration in house price depreciation slow in the latter half of this year.



### SCR View

News continues to be negative. Despite this equity markets have been extraordinarily resilient, with the S&P 500 touching 1425, a level not seen since early January. We on the other hand maintain a bearish view on the U.S. economy. In the subprime space negative fundamentals have been priced in for some time and opportunities continue to present themselves for the cash investor in what remains a highly illiquid market.

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