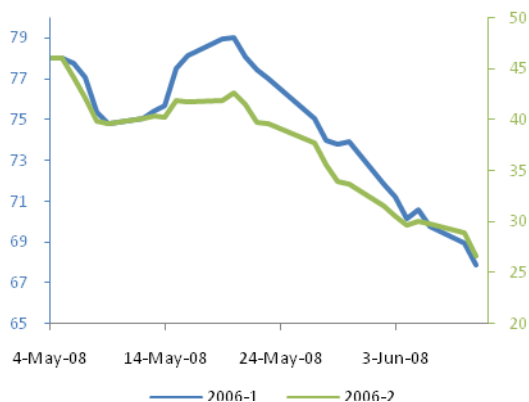


The Week that Was

ABX Commentary

The last two weeks have seen an abrupt repricing of risk across all parts of the capital structure in ABX. The move, which saw prices drop beyond levels seen in the mid-March selloff that accompanied the downfall of Bear Stearns, has been particularly pronounced in 06-1 and 06-2 AA's and 07-1 and 07-2 last cash flow AAs.

ABX HE AA Performance



Since early May ABX 06-2 AAs have dropped over 40% and now appear to be heading closer to an IO valuation. The basis between the 06-2 LCF AAA and the 06-2 AA is approaching 50 points, an all time high across all vintages. RPX has joined the fray and is now pricing a cumulative peak to trough decline in house prices across the United States of 29%. A little over a week ago, the market was pricing in a 25.5% decline.

On a technical front, the sleeping giant that is dealer hedging has awoken again. On the back of some negative fundamental data the Street has aggressively looked to reset hedges while the heightened volatility has kept long term players on the sidelines. In the coming sections we outline the fundamental factors that precipitated and then contributed to the decline.

In the News

Mortgage Rates Remain Elevated as Bernanke gets increasingly hawkish

On June 9, Ben Bernanke remarked that risks of a substantial downturn appear to have diminished over the past month whilst emphasising that the Fed will 'strongly resist an erosion of longer-term inflation expectations.'

These comments were felt especially strongly in the subprime universe as 3 month LIBOR increased by 10bps putting increasing pressure on adjustable rate mortgages. Average rates on 30yr fixed rate mortgages which reflect inflation expectations more than the current Fed Funds rate have echoed Bernanke's concerns for the past month, rising from 5.8% to around 6.20%. The climb in long term rates makes it increasingly difficult for existing borrowers to refinance and for new borrowers to enter the market despite increasingly attractive affordability levels.

SEC Plans to Recommend that Rating Agencies Amend the Ratings Scale for ABS

This week plans by the SEC to propose a new ratings scale for asset-backed securities were leaked in a Bloomberg article entitled, 'Asset-Backed Market Depreciates in SEC 'Scarlet Letter' Drive.

The proposal would give the agencies two choices: one, to publish a report on how they came up on each rating and how it could go wrong and two, to add a designation to differentiate an asset-backed bond from a corporate bond. The second choice was by far the most controversial with possible regulatory implications judged to have a strongly negative impact on demand for AAA rated ABS.

Whether calling a AAA-rated asset-backed security AAA.sf makes any difference to the regulators is anyone's guess. If it does make a difference then the financial sector, already undercapitalised, will become even more deficient thus further impairing their ability to stimulate an already stagnant U.S. economy.

Lehman Q2 Loss of \$2.8 billion Proves the Street is Not Yet Out of the Woods

Having avoided booking a loss since they went public in 1994, Lehman delivered a Q2 loss that exceeded already bearish analyst forecasts by around 3 times. The \$2.8 billion loss was driven by hedges on the bank's portfolio of mortgage-related assets and leveraged loans which lost money.

Despite concerns about Lehman's overall leverage ratio the company had remained profitable through Q4 2007 and Q1 2008 while its competitors recorded sizeable losses.

Lehman avoided any substantial capital raisings through the first quarter but after the \$3.7 billion of writedowns for Q2 it has sought to raise \$6 billion through an issue of \$4 billion of common stock and \$2 billion of converting preferred stock. The stock closed at \$23.75 on the 11th June, approximately 15% below the issue price of the common stock and 25% below the close a week ago.

The loss suffered by Lehman highlights the danger of hedging risk against the certainty of selling risk. The equity market has sent a clear signal to the financial sector; they will no longer tolerate further writedowns in mortgage-related assets. We expect to see additional supply hit the subprime market and thus further downward pressure on asset prices.¹

Macro Picture

U.S. Unemployment Rises to 5.5%

Last week saw a half point rise in the U.S. unemployment rate to 5.5%, the largest in over 20 years. The rise was driven by an increase in the size of the labour pool as young people entered a job market which experienced the fifth consecutive month of decline in payrolls. Last week claims initial claims rose again, higher than forecast to 384,000, up 25,000 on the previous week.

While the Fed indicated that they had already incorporated forecasts for rising unemployment

¹ On June 12, Lehman CFO Erin Callan was replaced by co-chief accounting officer Ian Lowitt. President Joseph Gregory will step down to be replaced by global head of equities, Herbert McDade

into its projections, it is doubtful they forecast such a dramatic rise. However Bernanke's hawkish statements last week (see In the News section) suggest that despite the rise, the Fed will not look to cut rates again this year.

The rise in unemployment, particularly given that it is driven by youth unemployment, will slow any potential recovery in the housing market. The rate of entry of new borrowers into the housing market will be somewhat constrained until there is the employment market for school and college leavers improves.

U.S. Trade Gap Widens

Supporting Ben Bernanke's recent hawkish comments was the widening in the U.S. trade deficit. The deficit grew 7.8% to \$60.9 billion which meant that increased exports driven by weakness in the dollar were not sufficient to offset the rising cost of fuel prices. After eliminating the impact of prices, the deficit was \$46.9 billion, the lowest since August of 2003.

Pending Sales of Existing Homes

With the pace of foreclosures increasing and the inventory of unsold existing homes at an all time high, it was not a question of would sales of existing homes increase but rather when. In perhaps the first sign of an inflexion point in house price declines, sales of existing homes were up 6.3% in April.

Of course the increase was coming off all time lows. In April, the number of existing home sales was 4.8 million annualised which is the worst since records began in 1999. How pending home sales perform through the

summer months will provide some colour on whether new buyers are beginning to see value. A sharp increase could be a sign that house prices have hit their lows and provide a basis for any subsequent rally.

Retail Sales Up As Consumers Spend their Tax Rebates

The tax rebates provided by the Bush Administration's stimulus plan appear to have been quickly spent by consumers if the advance retail sales numbers are anything to go by. Sales were up by 1% in May, double the amount forecast by a Bloomberg survey and 2.5 times the April number. The sales numbers show that the resilient American consumer continues to spend. In the short term this is good news for the growth prospects of the American economy but we are still yet to be convinced that the increase in retail sales and by extension consumer spending will be sustained; something that will be necessary if the United States is to avoid a recession.

SCR View

Despite the volatility in the ABX and RPX indices we adopt a selective long on high grade subprime cash bonds. We see the repricing at bottom of the capital structure as a rational response to increasing rates of default (as opposed to just higher levels of delinquencies).

Our long is tempered by two caveats: one, that the threat of hawkish monetary policy putting further pressure on resettable mortgages, and two, regulatory reform distinguishing between AAA corporate and AAA structured credit. We expect the impact of a Federal Reserve seemingly once again focussed on inflation to be offset by a more proactive government but are wary of a Republican victory come November. Regulatory intervention is hard to gauge but we feel that natural buyers of AAA credit risk remain and cannot be satiated by corporate AAA's and sovereigns alone. We note that with the downgrade of MBIA and Ambac much of the municipal bond market can no longer command a AAA rating so there remains a question as to from where the supply of highly rated paper will originate.

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