Structured Credit Research LLP

U.S. Residential ABS Research **Volume 2, June, 2008**

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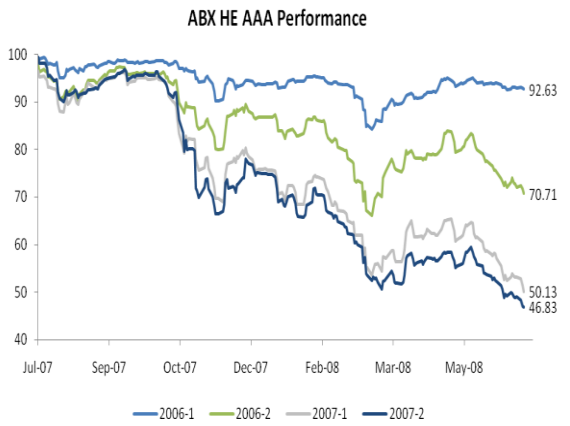
The Week that Was

ABX Commentary

The severe decline in ABX home equity indices discussed in the last newsletter persisted through the whole of June as levels of uncertainty returned to mid-March levels and a deluge of negative data hit the market. New lows have been reached in ABX 07-1 and 07-2, with bid sides on the last cash flow AAAs trading below 50 cents in the dollar translating to spreads over treasuries around 1,000 basis points. The basis between the 06-1 and 06-2 last cash flow AAAs is at all time wides and continues to widen suggesting that only 06-1 AAA's are considered to be free of default risk.



Despite the thin liquidity, fundamentals have played a major role in the recent decline. Concerns about the monolines re-emerging, an abysmal (albeit not entirely unexpected) start to the summer season for home sales, ever increasing fixed mortgage rates, and remit reports which continue to raise more questions than they answer have all combined to drive the market ever lower.

Remittance Reports Released

As per usual the 25th of the month saw the release of remit reports for the subprime universe. Using the ABX indices as a proxy for the broader market we note the following:

- After adjusting for prepayments, 60+ delinquencies increased at a faster rate for 07-1 and 07-2 and a slightly slower rate for 06-1 and 06-2
- For the first time, voluntary prepayments are below 10 CPR for all ABX vintages
- Also for the first time, constant default rates were above 10 for all indices. For 06-1, CDRs contributed to prepayments rates more than CRRs.
- Severities were roughly flat for 06-1, 06-2 and 07-1 but increased further for 07-2

We also note that servicer activity is beginning to manifest itself in two key ways:

- Increased loan modification/partial principal forgiveness
- Reduction in servicer advancing for REO properties. With first lien severities increasing above 85% in the rust belt states of Michigan, Ohio and Indiana, servicers are increasingly reluctant to advance principal and interest.

Moody's- the last cut is always the deepest

Moody's became the last rating agency to strip the two major monoline insurers of their Aaa rating last week. Not to be outdone by Fitch and S&P, Moody's cut MBIA's insurance arm by 5 levels to A2 and cut Ambac's insurance arm to Aa3.

The story around MBIA's cut to A2 is especially intriguing. Recently MBIA had raised $1.1 billion in capital of which $900 million was intended to be downstreamed to its insurance arm, ostensibly to maintain their top credit rating. After the downgrade by S&P, MBIA decided not to downstream the capital and instead keep it at the holding company level. Moody's explicitly stated that this decision contributed to the extent of the downgrade.

Both monolines are now dangerously close to technical default (in other words, the regulator taking control of the insurance arm). The implications of this are severe- it would trigger upwards of $125 billion in swaps which state that if the insurance arm is taken over by the regulator the buyer of protection can immediately demand payment. The regulators have made it clear that their main aim is to protect the municipal bond market. This puts them in a difficult position; placing the monolines into runoff, while desirable from an overall claims paying perspective would trigger immediate payment on the swaps ahead of their municipal obligations.

This situation seems destined to end up in the courts as the insurance regulator tries to protect the municipal bond holder and the holder of the swap contracts tries to enforce their legal rights.

Goldman to Carry Out $7 billion SIV restructure

Goldman Sachs and Deloitte agreed last week to auction some of the assets from a $7 billion structured investment vehicle set up by Cheyne Capital Management. The strategy, the first of its kind relating to SIVs, is that Goldman will sell down some percentage of the SIV to establish a market clearing level. The remainder of the SIV will go into a separate company set up by Goldman at levels established in the auction.

This novel approach to the SIV restructure should provide some much needed price clarity to investors, although any potential conflicts of interest will have to properly considered. Expect to see more restructures come to market over the summer months as banks looks to lighten their exposure to residential credit even further.

Macro Picture

Fed Leaves Rates on Hold but Opens the Door for Future Rises

As expected the FOMC left rates on hold this week. The statement was reasonably evenly balanced with recent hawkish comments by Fed Chairman Ben Bernanke offset by continuing poor credit conditions and a weakening labour market. As in the previous meeting Dallas Fed Richard Fisher dissented, preferred to raise rates.

Supporting the Fed's position was the quarterly GDP number released on Thursday which showed a 1.0% annualised growth rate. Growth is stagnant and with the GDP Price Index at 2.7% inflation fears are justified.

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Case Shiller- Down, But Not by as Much as Last Month

The S&P Case-Shiller index was released this week and showed a year on year decline in U.S. house prices of 15.3%. The monthly decline was only 1.4% in April compared to a 2.2% decline in March. Despite this apparent moderation in decline, we caution against taking this data at face value. The reason is that there is historically a large amount of seasonality in house price data. The summer months tend to exhibit the strongest increases in house prices, becoming more muted in the winter. By this rationale a slowdown in month-on-month declines in winter would be a far stronger sign that an inflexion point has been reached, and the recovery is on the horizon.

Homes Sales Data

Sales of new homes fell by 2.5% in May to an annual pace of 512,000, the lowest level in 17 years. In contrast existing home sales were up 2% month on month but down 15.9% year on year.

Inventory numbers improved slightly; down to 10.8 months from a previous value of 11.2 months. As mentioned with the Case-Shiller numbers we should expect to have an increase in home sales in the summer months. And of course, with increasing default rates we should expect to see a pick-up in existing home sales. We caution though that this does not imply house prices have hit bottom. There is still a long way to go to correct the supply imbalance and with the massive number of homes currently in foreclosure that doesn't look like changing anytime soon.

Consumer Confidence Down Despite Fiscal Policy Aid

The recent set of tax rebates sent to U.S. households throughout May appear to have done little to improve the confidence of American consumers with the Conference Board Consumer Confidence Index hitting a 16 year low of 50.4 down 12% from May. Concern over jobs increased and buying plans for automobiles, houses, appliances and vacations all declined.

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SCR View

Recent moves in the ABX have been sufficiently violent to leave new distressed money entering the subprime space in some distress themselves. Cash remains king and is generally trading cheap to ABX we see the top of the capital structure. We see tremendous value there with option adjusted spreads of over 10% achievable on AAA-rated subprime bonds. Mark to market conscious investors need not shy away from subprime altogether, but rather focus on front paying bonds where prepayments at par should offset declines in the cash price. With the 4th of July approaching, next week should be relatively quiet but expect supply to pick up considerably in mid July.

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