

The Week that Was

**ABX Commentary**

Our commentary on the ABX index is becoming decidedly repetitive. Over the past two months the last cash flow AAA index has found new negative momentum pushing prices below the levels reached in the mid-March Bear Stearns selloff.



Even in the face of rallying equity markets and better than expected results for a number of key financials, ABX has continued to weaken. At this point we are sceptical that any significant outright longs have entered this market and suggest that the shorts and relative value players continue to dominate. We further believe it will take a sustained benign period for long players to enter the market after being burned so many times before.

*Cheyne SIV Liquidation Takes Place*

Late last week the subprime market gained some additional data points when the liquidation of the Cheyne SIV took place. We believe the novel structure of the liquidation, described below, contributed to the slightly cheap prices we saw in the subprime space.

Firstly, the collateral was placed in into one of eight buckets: ABS CDOs, CRE CDOs, CLOs, Balance Sheet CDOs, CMBS, wrapped ABS, non-prime RMBS and prime RMBS. Next, Dealers were required to submit bids for a bucket, not individual line items meaning they had to take the bad with the good. Bids had to be good for greater than 24 hours which was significant given the liquidation took place at the height of the concerns around the GSE's (see below), and could be subject to significant scaling on a pro-rata basis.

This process established a price on the subprime bucket. From there, dealers have to determine what the bucket price implies for individual line items. Based on the bucket price we expect to see some dealers forced to mark down their existing inventory.

With another liquidation list coming in late July and an increasing number of BWICs coming to market, month-end marks will be under some pressure.

### *The GSE Saga*

The past month has been a memorable one for Fannie Mae and Freddie Mac, the two quasi-government agencies charged with providing much needed liquidity to the U.S. mortgage market.

In early July, the Fannie and Freddie plunged on concerns that neither had enough capital to weather the housing crisis.

The stocks were heavily and publicly shorted leading to a five day slump where they were down 60%. The move put into question the agencies' ability to 1) raise additional equity capital if required, and 2) issue debt into the capital markets. 5yr Fannie debt traded close to 100 basis points over U.S. Treasuries with 1 year CDS on Fannie sub debt peaking at over 300 basis points, up from inside 100 only a month ago.

With a \$3 billion sale of short term debt scheduled to take place on the morning of July 14, Treasury Secretary Hank Paulson requested authority to buy equity stakes in the two companies and increase the government's credit line. The sale went through well but doubts persist about the solvency of Fannie and Freddie, and indeed the plan suggested by Paulson.

Given how widely Fannie and Freddie debt is held we share the view that it is unlikely that the government will allow the two agencies to fail. If anything, the quasi-government guarantee is more explicit than ever before. However it is not clear how a government-controlled entity will act in this market. Earlier this year, both Fannie and Freddie spoke publicly about their role in providing liquidity to the mortgage market. More recently the tone of their statements has changed. On July 11

Freddie Mac released a statement on their capital position. One option they highlighted for managing their capital was to not replace the run-off in their retained portfolio, effectively reducing the amount of credit available to borrowers.

Where the GSE's will end up is anyone's guess right now. Some increased role for the government appears inevitable but the exact form and implications of this are speculation at this point. It is unclear whether a government controlled Fannie and Freddie will be more or less aggressive in providing liquidity to the mortgage market.<sup>1</sup>

### *IndyMac is No More*

The largest bank failure in the last quarter century took place on the 11<sup>th</sup> July when IndyMac was taken over by the Federal Deposit Insurance Corporation. FDIC, which will guarantee IndyMac's bank deposits, has assumed that it will take a \$4-8 billion hit.

The failure of IndyMac was precipitated by the release of a letter by Senator Charles Schumer which expressed concerns about the bank's ongoing viability. This led to depositors withdrawing more than \$1.3 billion from their accounts and caused the liquidity crisis which forced the Office of Thrift Supervision to take action.

As at March 31 2008, IndyMac had \$32 billion in assets of which \$5.3 billion was AAA-rated non agency securities. What the FDIC plans to do

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<sup>1</sup> Paulson's rescue plan is expected to go to the House of Representatives on Thursday.

with these securities could have significant implications for pricing in the non agency sector.

### Results Watch

Late last week the financial sector rallied on a number of positive earnings surprises from some key names in the market. The below table shows the earnings, estimated earnings and 7 day returns of those to recently announce 2<sup>nd</sup> quarter results

Banks	Net Earnings/(Loss)	Bloomberg Survey	7-day Equity Return (thru 22/7)
Citigroup	\$(2.5) bio	\$(3.67) bio	43%
JPM	\$2 bio	\$1.5 bio	32%
Wells Fargo	\$1.75 bio	£1.65 bio	48%
Wachovia	\$(8.9) bio	\$(2.0) bio	85%
Bank of America	\$3.4 bio	\$2.5 bio	75%
Washington Mutual	\$(3.3) bio	\$(1.2) bio	80%
Broker Dealers			
Merrill	\$(4.65) bio	\$(1.56) bio	38%

American Express also announced Q2 results after the close on Monday. On the back of increasing levels of unrecoverable loans, profit from continuing operations declined to \$655 million, less than the \$968 million predicted by a Bloomberg survey of analysts.

Investors have responded positively to the results with banking stocks performing well over the past week, up around 40%. However we caution against the optimism. Wachovia and WAMU's results indicate that losses are spreading from subprime into Option ARM loans. American Express underperformed expectations against a backdrop of rising levels of uncollectible debt and worsening performance amongst even top tier borrowers.

### Macro Picture

#### OFHEO Better Than Expected

The OFHEO house price data for May was released on Tuesday and showed only a 0.3% decline in house prices. This is much less than the 0.8% decline suggested by Bloomberg survey of economists and the 0.8% decline in April. The May number makes the year on year decline -4.8%.

While we caution against drawing inferences from the absolute value of the move, the fact that it represents a substantially smaller number than the previous month is somewhat encouraging.

#### Inflation Showing No Signs of Slowing

The month on month CPI number for June was 1.1%, up from 0.6% in May and up 5% over the past year, the most since 1991. The increase in June was driven by increases in food and fuel expenses on the back of the rises in oil prices. With oil moderating at below \$130/barrel the pressure on consumers, and indeed the Fed, is growing.

### *June Housing Starts Up*

Housing starts retreated from their lows in June, reaching levels not seen since last year. The implications of this are both positive and negative, but in our view, largely negative. An increase in housing starts stimulates growth in employment and the broader economy. However with such a massive oversupply of housing in the United States, building more houses will not aid the pricing correction which is already underway but rather will exacerbate it.

### *Mortgage Rates at 6 year High*

The Bankrate average 30yr fixed mortgage rate has been on a tear recently reaching 6.50%, a level not seen since early 2002. The RPX Dec 2010 forward close currently implies a 29% drop in nationwide HPI, up from a 24% decline at the start of July. This does reflect the higher than expected CPI numbers for June but we note that the rate has continued to increase even in the face of a moderating oil price.

Current mortgage rates are a key determinant of housing affordability. Until they decrease and credit becomes available to new borrowers entering the market we cannot see a bottom in nationwide house prices.

### **SCR View**

The market has continued to re-price dramatically over the past month. ABX is considerably weaker, dealers have been forced to mark down inventory and there has been a significant pick up in the supply of bonds. Levels are extremely attractive and with capital so scarce opportunistic investors will find cheap paper. The one caveat to this is the supply equation. With bank balance sheets severely constrained banks will be looking to release capital intensive assets and have zero capacity for adding potentially capital intensive assets like AAA-rated subprime bonds. Recent auctions will help buyers and sellers find realistic levels and this will have to take place quickly because banks are in no position to bridge the gap.

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