

## The Week that Was

### ABX Commentary

Since our last issue 2 weeks ago, ABX has reversed its downward trend and now sits between 3 and 6 points above the lows for the last cash flow ('LCF') AAA. The penultimate AAA has made a similar move with the basis between the it and the corresponding LCF index remaining steady at around 20 points for 06-2, around 7 points for 07-2 and 06-1 and around 15 points for the 07-1 index. 06-1 AAs and As and 06-2 AAs joined in the rally too, albeit to a lesser extent.



The move has been sentiment driven and based largely on two factors: a decline in the price of crude oil (and the subsequent rally in equity markets) and the July remittance data which was positively received by the market. The rally in ABX has taken place amidst very thin liquidity with volumes on a couple of days coming in at less than \$100 million. In contrast, cash bonds have largely lagged the rally against a backdrop of increasing supply.

### In the News

#### *Merrill Offloads CDOs to Lone Star... Or Does it*

Last week in a similar deal to the Blackstone and UBS deal from May, Merrill Lynch announced that it had entered into an agreement with private equity firm Lone Star to sell some super senior positions in ABS CDOs. The notional exchanged was \$30.6 billion for which Lone Star paid just \$6.7 billion, or roughly 22 cents in the dollar. As at 30 June, Merrill had valued these CDO's at over \$11 billion. Consequently Merrill have taken a \$4.4 billion write-down on the CDO positions they have sold to Lone Star and an associated \$1.3 billion write-down on other CDO exposures. Seventy-five percent of the \$6.7 billion purchase price will be funded by a loan from Merrill Lynch with the first loss piece retained by Lone Star. From our perspective Merrill has sold off the equity tranche of a CDO of super senior tranches of CDOs and retained the senior tranche. This used to be called a CDO-squared but we can understand why it has not been referred to as such. We note that if the combined value of the CDO's drops below 75% of the \$6.7 billion sale price (or roughly \$5 billion) then Merrill will be in the first loss position, meaning they have hardly put all their problems behind them as some market pundits suggested. Given that the value of the positions apparently dropped by close to 40% in the month of July, a 25% move hardly seems unlikely.

In addition (or consequently) Merrill announced a sale of \$8.5 billion of common stock. The market interpreted the capital raising and the sale of the CDOs positively, with the stock

rallying the on the day of the announcement despite a greater than 35% dilution of existing shareholders. Merrill closed at \$28.33 on Tuesday, up from a low of \$24.33 prior to announcing the share issue.

### *The GSE Saga- Part 2*

On Tuesday the New York Times published an article on Freddie Mac's CEO Richard Syron. The article suggested that Syron had ignored warnings from key personnel including the former Chief Risk Officer, David Andrukonis, that the firm was buying bad loans which "would likely pose an enormous financial and reputational risk to the company and the country".

The next day Freddie Mac announced a second quarter net loss of \$821 million, compared with the \$272 million predicted by a Bloomberg survey of 9 analysts. Fannie Mae is due to report on the 8<sup>th</sup> of August. Syron reiterated Freddie Mac's commitment to raise another \$5.5 billion of new capital. Both Fannie Mae and Freddie Mac were down around 10% soon after the announcement of Freddie's results.

### *AIG Scares the Market*

The second quarter loss of \$5.36 billion reported by insurer American International Group ('AIG') announced after the close on Wednesday is surely not an example of a company 'putting the worst behind it.' After announcing a 3<sup>rd</sup> consecutive quarterly loss which well exceeded analyst forecasts AIG traded down around 18%, its worst performance in over 25 years. AIG holds \$23.6 billion in U.S. subprime RMBS which it had

written down to around \$16.3 billion by the end of Q2. 94% of its subprime exposure is in the 2005-2007 vintages. Given the performance of ABX in July it's fair to say that there are more write-downs to come.

### *Rating Agency Watch*

On July 30 S&P released a report detailing revisions to its loss assumptions for U.S. RMBS. For 2006 vintage subprime they increased their loss severity assumption to 50%, up from 45%. This resulted in lifetime loss projections of 23% and 27% as a percentage of original balance for the 2006 and 2007 vintages respectively (previously these were 19% and 23%).

Given the change in assumptions it was not surprising to see S&P being very active in downgrading subprime bonds in late July. On the 29<sup>th</sup> July they either put on negative watch or downgraded 212 bonds of which 88 were originally rated AAA (of which all were put on negative watch).

Given 1<sup>st</sup> lien loss severity is already greater than 50% this adjustment seems way behind the curve. Expect S&P to downgrade more AAA subprime bonds as they continue to adjust their assumptions.

### *Remit Reports*

July remittance reports were released a little over a week ago. We noted the following:

- Prepay adjusted, 60+ delinquencies slowed for the 06-1 and 06-2 ABX indices

- Voluntary prepayment rates slowed across all ABX vintages. We found an even more dramatic slowdown when we considered the entire 2006 vintage and not just ABX.
- Monthly default rates increased across all ABX indices. The increase was most dramatic for the 06-2 index.
- Loss severity on ABX was up by 1-2% across all indices except the 07-2 index where it was down by a similar amount.
- Credit enhancement at the AAA level remained steady across all the ABX indices, increasing only slightly for 06-2, 07-1 and 07-2 and declining for 06-1 (albeit only slightly from a very high level).

## Macro Picture

### *RPX and Case-Shiller Showing Slowing Declines in House Prices*

On the 29<sup>th</sup> of July the S&P/Case Shiller composite index was released for the month of May. It showed a slowing in the decline in house prices with a month on month move of only -1% compared to -1.3% in the price month. This implied an annual depreciation number of 15.78%, slightly better than the 16% decline predicted by a Bloomberg survey of economists.

Two days later RPX printed its May numbers, down 15.60% for the year. Immediately prior to the announcement the Dec 08 futures had traded at a level implying an 18.3% decline. Currently the same contract is implying an 18% cumulative decline.

### *Unemployment and Payrolls*

On the 1<sup>st</sup> of August two key employment statistics for the United States were released. The first was the U.S. unemployment rate for July which was worse than expected, increasing 0.2% to 5.7%, the highest since March of 2004. The second was the change in Nonfarm Payrolls which came in at -51,000. This was better than the 75,000 decline expected by a Bloomberg survey of economists and equal to June's decline. Earlier in the week an ADP payroll report surprisingly suggested that 9,000 jobs had been added to the economy.

Anecdotally there has been much made of recent job cuts at high profile companies such as Starbucks and UAL. A New York Times article reported that the number of Americans who have seen their full time jobs changed to part time has increased to more than 3.7 million; the largest figure since the government began tracking this statistic over 50 years ago.

Initial jobless claims announced Thursday rose 7,000 to 455,000 to a 6 year high. Continuing claims were 3.311 million, a 4 year high. All signs are pointing towards a weakening labour market.

### *U.S. GDP Announced*

Despite the gloomy macroeconomic environment the U.S. economy continues to stave off recession, experiencing annualised growth of 1.9% for the second quarter.

This figure was well in excess of the 0.9% from the first quarter. It must be noted that the temporary boost from tax rebates helped, as

did the exceptionally strong export numbers which reduced the U.S. trade deficit to its lowest level in 7 years. The number was slightly lower than the 2.3% expected by a Bloomberg survey of economists.

With weakness spreading across global markets the strength in U.S. exports may not be sustainable. With domestic spending slowing it seems there is little to keep the United States out of a recession.

#### *FOMC Leaves Rates on Hold*

On Tuesday the Fed announced to no surprise that they had left rates on hold. The accompanying statement removed the word 'diminished' from a comment about the downside risks to growth whilst continuing to caution that price increases are of "significant concern". The market interpreted the slight change in tone as implying rates will be on hold for the remainder of the year. Again Richard Fisher of the Dallas Fed dissented, preferring to raise rates.

#### **SCR View**

In contrast to the broader U.S. economy the subprime market has had a positive couple of weeks. For starters there is definite evidence that the rate of increase in 60+ delinquencies is slowing, the rate of decline in house prices looks like it may (and we stress may) be slowing, and the Hope for Homeowners act has passed all of its political hurdles. While we caution that the macroeconomic picture is bleak, specific developments in the subprime market have established a support level for subprime bonds. Cash has lagged the rally in

ABX and with good supply up the capital structure there are opportunities to pick up decent bonds with plenty of support at heavily discounted prices.

### Research Disclaimer

The information and opinions in this presentation were prepared by **Structured Credit Research LLP** or one of its affiliates (collectively "SCR"). The information herein is believed by SCR to be reliable and has been obtained from public sources believed to be reliable, notwithstanding SCR makes no representation or warranty as to the accuracy or completeness of any of the information contained herein (except where such information relates directly to SCR). This presentation is not exclusive to any recipient and SCR may undertake business in respect of any of the concepts represented by this presentation with other parties other than a particular recipient. SCR may also undertake business which is inconsistent with the trading suggestions made in this presentation.

Opinions, estimates and projections in this presentation constitute the current judgment of the author as of the date of this presentation. They do not necessarily reflect the opinions of SCR and are subject to change without notice. Neither SCR nor the author have any obligation to update, modify or amend this presentation or to otherwise notify a reader thereof in the event that any matter stated herein, or any opinion, projection, forecast or estimate set forth herein, changes or subsequently becomes inaccurate. Prices and availability of financial instruments also are subject to change without notice. This presentation is provided for informational purposes only. It is not to be construed as an offer to buy or sell or to participate in any particular trading strategy in any jurisdiction. The financial instruments discussed in this presentation may not be suitable for all investors and investors must make their own investment decisions using their own independent advisors as they believe necessary and based upon their specific financial situations and investment objectives. If a financial instrument is denominated in a currency other than an investor's currency, a change in exchange rates may adversely affect the price or value of, or the income derived from, the financial instrument, and such investor effectively assumes currency risk. In addition, income from an investment may fluctuate and the price or value of financial instruments described in this presentation, either directly or indirectly, may rise or fall. A large fall in the price of one or more of the financial instrument described herein if purchased by an investor could result in the loss of all monies. Furthermore, past performance is not necessarily indicative of future results.

This presentation may not be reproduced, distributed or published by any person for any purpose without SCR's prior written consent. Please cite source when quoting.

### Structured Credit Research LLP

[www.structuredcreditresearch.com](http://www.structuredcreditresearch.com)

**General Line:** +44 20 7976 3650

#### Judith Sciamma

Partner

Ph: +44 20 7976 3671

Email: [jsciamma@challengergroup.co.uk](mailto:jsciamma@challengergroup.co.uk)

#### Pete Robinson

ABS Analyst

Ph: +44 20 7976 3673

Email: [probinson@challengergroup.co.uk](mailto:probinson@challengergroup.co.uk)

#### Dominic Wynniatt-Husey

Partner

Ph: +44 20 7976 3672

Email: [dwhusey@challengergroup.co.uk](mailto:dwhusey@challengergroup.co.uk)

#### Mike Chacos

Managing Partner

Ph: +44 20 7976 3670

Email: [mchacos@challengergroup.co.uk](mailto:mchacos@challengergroup.co.uk)