

The Week that Was

ABX Commentary

Despite an apparently sharp decline in ABX, there is very little to read in recent moves. Liquidity in the indices has been extremely light with moves in the commercial index, CMBX capturing market interest.



Cash has traded steadily with a number of CDO liquidations and smaller front and second pay lists coming to market.

In the News

GSE Saga Part 3- Is the Final Chapter Nearing?

The GSE reform provisions contained in the Housing Bill which was approved by the Senate in July were meant to reassure the market about the government's commitment to the GSEs. As Treasury Secretary Paulson described, the mere existence of an open-ended commitment from the government would provide a sufficient guarantee to market participants (specifically, buyers of GSE debt) to ensure that the government would never be required to follow through on the commitment.

These days, playing brinkmanship with a skittish market is a dangerous game, even for a respected former head of Goldman Sachs. On suspicions that the appetite for the AAA-rated debt of Fannie Mae and Freddie Mac is drying up, the stock prices of these companies has been pounded. Secretary Paulson, having publicly exhorted both companies to raise more capital, appears to have painted himself into a corner. With the risk of government intervention ever present, investors are reluctant to participate in any stock offering for fear of seeing their positions become worthless should the government choose to effectively nationalise these companies.

This week we saw Freddie Mac place a \$3 billion auction of its debt at unusually wide levels. The five year notes priced at 113 basis points over Treasuries. Last year they were paying inside 50 basis points over Treasuries for a similar issue.

For mortgage investors, the cost of debt for the GSE's is especially relevant as it determines the

mortgage rate that lenders can offer to borrowers. Indeed with the cost of debt for the GSE's increasing, the average 30yr fixed mortgage rate remains elevated at levels above where it was in 2007, before the Fed started cutting rates. In contrast the 10yr Treasury trades around 75 basis lower. Housing affordability, which worsened in the second quarter despite falling house prices is inextricably linked the level of mortgage rates. If the government wants to stop the decline in house prices, they must reduce mortgage rates.

FDIC- the Newest Mortgage Servicer

For the past year Federal Deposit Insurance Corp. Chairwoman Sheila Blair has expounded her views on how to solve the mortgage crisis. With the failure of IndyMac, one of the largest non-agency mortgage servicers in the United States placing a sizeable servicing portfolio into the hands of the FDIC, Bair has a vehicle with which to test her theories.

Upon taking over IndyMac Bair announced a halt on foreclosures until a review of the IndyMac servicing portfolio was completed. On Wednesday the FDIC announced a loan modification program for first lien mortgages on primary where the borrower is seriously delinquent or in default and where the loan is serviced by IndyMac. The modifications will be designed to achieve a 38% debt-to-income ratio ('DTI') through a combination of interest rate reductions, extended amortizations, and principal forbearance. Eligible mortgages will be permanently capped at the current Freddie Mac survey rate for conforming mortgages.

The plan, which appears to target Alt-A borrowers fails to address the key issue of how to deal with stated documentation or so-called

'liar' loans. For loans where the borrower has lied about their income it is unclear whether the DTI adjustment to 38% will apply to the stated income or the actual income. The LA Times has reported that for some loans to achieve a 38% DTI the FDIC may have to extend the loan to 40 years or reduce the interest rate to as low as 3%, less than the current 10 year Treasury rate.

From what we could see the FDIC fails to appease the secondary market. Loan modifications of the sort proposed by the FDIC are likely to wipe out second lien holders. Holders of subordinated tranches of securitisations will also suffer. We await the response of these investor groups.

Rumours Surround Lehman

Lehman Brothers and its Chairman Chief Executive Richard Fuld have not been far from the front pages over the past few months and the past week has been no exception. Lehman's stock is down over 20% since the start of August and over 75% since this time last year. The major talk surrounding Lehman is focussed on the valuation of the \$40 billion-odd of CMBS exposure it has on its balance sheet. Analysts have suggested that Lehman has not sufficiently marked down its CMBS exposures and expect large write-downs for the third quarter.

Earlier this week, reports emerged that Lehman was trying to offload its Neuberger Berman, its asset management business. The market did not respond positively to this rumour, deeming such a sale as 'throwing the baby out with the bath water'.

As recently as Wednesday reports emerged that the Fed had addressed rumours surrounding Lehman Brothers by approaching Credit Suisse

in July to find out whether it had pulled a line of credit to Lehman. Credit Suisse denied that it had even considered such an action.

Thursday brought more Lehman news. The FT reported that Lehman came close to selling a 50% stake in the business to Korea Development Bank this month. It was also speculated that Lehman had held similar talks with China's CITIC Securities. Both talks ended without a deal after parties decided Lehman's price was too high. Late Thursday, Ladenburg Thalman & Co analyst Richard Bove caused a mini-rally in the stock by suggesting that the stock was set for a hostile takeover bid.

We suggest investors watch this news closely. Lehman still has over \$24 billion in residential mortgage exposures and almost \$40 in commercial real estate. The market is demanding resolution to these positions and with quarter end only a week away we expect news sooner rather than later.

Fixed Income Delinquencies Surge in July

Early reports of subprime performance in July indicate that the trend of slowing increases in serious delinquencies may be over. Housing Wire, courtesy of data from Clayton Fixed Income Services, has reported that 60+ delinquencies from the 2006 and 2007 vintages were up 7 and 11%, respectively compared to June. This takes the rate of increase back to pre-summer levels. Loss severities were unsurprisingly reported to have risen as well, up to 48.6% from 46.6% in June.

The data from Clayton's is an advance look at subprime RMBS performance, ahead of remittance data which will be released next week. If remittance data confirms that

performance has deteriorated to the extent suggested by this data, expect some significant downward price pressure.

Macro Picture

US Leading Indicators Worse than Expected

On Thursday, an index of leading indicators of the U.S. economy was released. The index, a composite of 10 factors including jobless claims, manufacturer's new orders, building permits, stock prices, interest rate spreads and consumer expectations fell by 0.7% for the month of July, outpacing consensus estimates of a 0.2% decline.

Jobless Claims Hold Steady

Initial jobless claims remained above 400,000, a level typically associated with a recessionary environment for the 5th consecutive week. The four week average rose to the highest level in seven years. We expect the unemployment rate to continue to rise over the latter part of the year, reaching 6% in 2009 if not before.

Producer Prices Show Inflation Concerns Will Linger

On Tuesday the U.S. producer price index reminded the market how high energy prices were in July. The month on month increase in producer prices of 1.2% compared to an increase of 1.8% in the prior month and was double the level predicted by a Bloomberg survey of economists. Although commodity prices have since declined (oil is off more than

20%), some of the increase in prices experienced by producers in July will be passed on to consumers in the coming months. Even with the decline crude oil prices are still around 30% above where they started the year.

Housing Starts at 17 Year Low

Tuesday also saw new housing starts data for the U.S. This number was expected to be down as a change in New York's building code had led to an inflated number in the previous month. With housing supply still at more than double what is considered 'normal' levels, we can expect this number to remain flat for some time to come.

SCR View

It is becoming increasingly difficult to present a fresh view on a week by week basis. Our view, no doubt well known to all regular readers, is monotonous in its regularity. We see the U.S. economy as heading into recession. The effects of the credit contraction are only beginning to be felt by consumers. Providing liquidity in a market starved of capital can be extremely profitable *if* the capital is deployed appropriately. Subprime, still a dirty word amongst many, is cheap and investors who are prepared to do the work will reap the rewards. Cash bonds with durations of inside 1 year and no risk of any loss of principal can be purchased with discount margins in excess of 300 basis points.

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