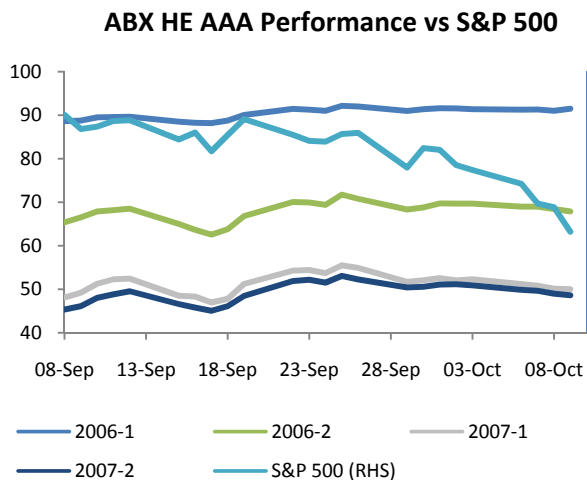


The Week that Was

ABX Commentary

The past month has certainly been historic for the broader financial markets but what has kept our attention has been the outperformance of ABX AAA's versus other risky asset classes. This reinforces our position that sub-prime MBS has found a bottom.

As the chart below shows the AAA index has outperformed equities. It has also outperformed corporate credit (Itraxx 5y CDS – 60 basis points wider over the same period), leveraged loans (LCDX dollar price down over 10 points) and commodities (crude oil down \$20).



With the Troubled Asset Relief Program expected to focus on the sub-prime and Alt A segments of the mortgage market we expect very little positive price action in ABX until buying gets underway.

In the News

Lehman Brothers Demise leads to Interbank Lending Crisis

Since Lehman Brothers filed for bankruptcy the broader financial markets have gone through a crisis of confidence.

The downfall of Lehman led to a severe blockage in interbank lending markets. Lehman's bankruptcy led to a number of money-market funds 'breaking the buck', leaving investors with a likely return of less than one dollar for every dollar invested. This was just the second time in history a money market fund has broken the buck and led to unprecedented levels of fear in the money markets as investors sought a safe haven for assets they had previously considered secure. The U.S. government quickly moved to guarantee the money market funds with a \$50 billion backstop but the damage had been done.

The results were a dramatic pullback in the market for commercial paper as money market funds moved their funds out of commercial paper and into U.S. Treasuries. In the last week of September the market for commercial paper fell almost \$95 billion to \$1.6 trillion, dropping over \$300 billion over a five week period to October 15. In addition, the market for longer-dated CP dried up as companies were forced to finance themselves at far shorter maturities.

At the same time, global Central Banks were providing short term liquidity to banks unable to fund themselves in the interbank market. This had an adverse effect as banks stopped lending to each other and LIBOR spiked. The

flood to Treasuries by money managers and unwillingness of banks to lend to each other pushed the TED spread (the difference between 3month LIBOR and the yield on 3mth T-Bills and a commonly used fear gauge) to a wide of over 450 basis points. Around the Bear Stearns bankruptcy, the TED Spread had been a little over 200 basis points and in 2007 averaged less than 100 basis points.

Although specific global interventions by world governments have led to a slight reduction in the TED spread it still remains elevated to previous highs.

Troubled Asset Relief Program Gets Some Revisions

While the Troubled Asset Relief Program, more commonly known as TARP was eventually passed by both the Senate and the House, its form was widely criticised from both sides and financial community. Worries over how long it would take to be implemented along with outstanding questions as to whether TARP was the right course of action led to extreme levels of uncertainty across financial markets. With short term lending becoming increasingly costly and the stock of non-financials starting to come under pressure, it took government intervention outside of TARP to restore some semblance of calm to the market.

The first positive action came from Gordon Brown, Prime Minister of the United Kingdom. He announced that the British government would invest £37 billion in three of the UK's major 'high street' banks. The investment would see the UK government take majority control of two, RBS and HBOS, giving them the power to half dividends and bonuses to senior executives.

He also announced plans to guarantee interbank lending.

Following the UK's lead, European leaders announced that they would guarantee bank lending for up to five years. They also gave permission for governments to buy preferred shares in banks and committed to recapitalising banks in distress.

Subsequent to the intervention in the UK, Treasury Secretary Paulson, Federal Reserve Chairman Bernanke and FDIC Chairwoman Bair announced that 9 U.S. banks would be accepting (it has been widely circulated that the banks were forced to accept) a \$125 billion bailout. The plan will involve the government spending about half the initial \$250 billion approved by the government on preferred shares of Citigroup, JP Morgan Chase, Bank of America, Goldman Sachs, Morgan Stanley, State Street and Bank of New York Mellon.

On Thursday the 16th October, the Swiss National Bank put 6 billion francs into UBS. They will also provide loans of up to \$54 billion to back a fund to which will hold risky assets sourced from the balance sheet of UBS, including around \$31 billion in US dollar denominated assets comprising sub-prime and Alt A securities.

In essence world governments have said they will underwrite for any new share issues that banks undertake in the near future. This action, while diluting common shareholders, at least provides reassurance that the banking sector is a going concern for the near future. This is a good thing and equity markets responded positively, at least initially (more on this later).

By guaranteeing interbank lending the governments of the developed world are intending to free up credit markets. With this

goal in mind the ECB lent banks over \$170 billion for 7 days at 2.28%. One week LIBOR is currently 3.82%. Clearly banks are incentivised to borrow from the ECB and lend in the interbank market. But to who? The Central Banks are flooding markets with liquidity so there is no reason why a bank would choose to borrow in the interbank market. This is keeping LIBOR rates artificially high.

It remains to be seen whether these measures will bring down lending rates and stimulate the interbank market as is their intent.

Volatility- VIX Breaking New Ground

In the midst of the uncertainty around future regulation across global financial markets and growing recessionary concerns, world equity markets crashed last week in a big way.

The Dow closed down 18% for the week ending the 10th of October at 8451. It traded as low as 7,885, the first it had dropped below 8,000 since March of 2003. It is currently over 35% off its peak experienced in October of 2007. The statistics for the S&P 500 and all the globals tell a similar story. VIX reached an intraday peak of 76.94 (NB. On Thursday VIX reached 80), almost 70% higher than the previous peak in 1998 (data since 1990).

The drop in the equity market was driven by fears that a number of banks in both Europe and the United States were facing imminent bankruptcy and concerns that hedge funds were facing unprecedented redemption requests and are being forced to offload any risky positions. Compounding this were suspicions that in order to avoid the damage suffered by hedge funds who had their assets frozen by Lehman's bankruptcy, a number of large hedge funds had 'hedged' their exposure to the default of their prime broker by buying CDS or selling the stock

short. As the drops in the stock market became more precipitous, retail investors began to take notice and started selling risk.

The overwhelmingly negative sentiment was offset somewhat by government intervention on the previous Monday and Tuesday. Indeed the rally was one of the strongest in history with the Dow up over 11% on Monday.

Despite the relief rally fundamentals are remain extremely poor. Some terrible data points were released on Wednesday causing sentiment to again sour with the drop in the S&P 500 being the worst single day move since 1987.

Mortgage Rates Rise Again

We believed the placement of Fannie Mae and Freddie Mac into conservatorship would see mortgage rates come down and mortgage affordability improve. Since August that has been the case with the yield on Fannie Mae 5.5% dropping below 6% in mid-August and reaching a low of 5.2% in early September. Since then they have risen and currently are hovering around the 6% mark. This is in spite of a 50 basis point cut in the Federal Reserve Target Rate. The move in mortgage rates has largely reflected the increase in the 10 year T-bond yield which has risen on recession fears.

This is an issue that needs addressing. As we have said previously, in order for the U.S. housing market to find a bottom, mortgage rates need to come down.

But in what is a piece of positive news coming from the GSE, the agencies announced on the 11th of October that have been directed to start purchasing \$40 billion a month of underperforming mortgages. The purchases,

part of the Hope for Homeowners Act which commenced at the start of October, will be largely directed at sub-prime and Alt-A mortgages. However we remain sceptical. Purchasing \$240 billion of poorly performing mortgages each hardly seems like a good idea for two institutions already saddled with bad mortgages.

\$350 billion of Alt-A Paper on Watch for Downgrade

On Wednesday last week S&P placed over \$350 billion in original face value (roughly \$280 billion in current face value) of Alt-A securities from 2006 and 2007 on CreditWatch with negative implications. In total 5,536 classes of 456 securitisations were placed on review.

The move comes as a result of an increase in loss severity assumptions for Alt-A fixed and long reset hybrids. S&P increased their loss severity assumption from 35% to 40%, highlighting increased carrying costs for properties in inventory, foreclosure costs and further declines in home sales. They also noted persistent rises in the level of delinquencies among Alt-A mortgage loans.

We have long held the view that any credibility the rating agencies had in their assessment of U.S. non-agency RMBS has long been extinguished. Nevertheless these potential downgrades will have a price impact as some holders of Alt-A paper are ratings constrained. At times of scarcity in capital the impact of a downgrade is far greater.

Macro Picture

With all the events of the past weeks it would be easy to forget that a number of significant data points were released these past two weeks.

US Employment

Initial jobless claims have been above 450,000 for the past 6 weeks with the four week moving average over 480,000 well above the pre-September single week peak for the year. The monthly change in Nonfarm Payrolls has been negative for the entirety of 2008 and doubled from August. The drop in payrolls has been nowhere near as precipitous as the declines of the early part of the decade but they show no signs of slowing.

Fed Cuts Rates

After unanimously choosing to hold rates steady in September the Fed cut its target rate by 50 basis points to 1.50% in early October as inflationary concerns rapidly died to be replaced by even stronger concerns about growth. The cut was part of a coordinated response from the Federal Reserve and other Central Banks. Alongside the Federal Reserve the ECB, Bank of England, Sweden's Riksbank, and Bank of Canada all made rate cuts, each of a half a percent. China cut its benchmark rate by 0.27% and prior to the coordinated cuts the Reserve Bank of Australia cut its target rate by 100 basis points.

The statement by the Fed noted that inflationary pressures had started to moderate. It highlighted that *the recent intensification of*

the financial crisis has augmented the downside risks of growth.

Retail Sales

Advance retail sales numbers were announced for September on the 15th of October. Outpacing negative expectations of a 0.7% monthly drop the actual decline was 1.2%, the worst number since June of 2004. This was the third consecutive month of decline in retail sales which is the first time on record (since 1992) this has occurred. Any doubts that the United States is not in recession should surely be extinguished by this number.

Mortgage Applications Down

Despite MBA mortgage applications numbers suggesting weekly increases over the last two weeks, we assert that if multiple applications are excluded application rates continue to decline over 55% off the January peak.

theMax mortgage applications index which excludes repeated applications showed a 13.1% decline in applications for the week ended October 17.

Notwithstanding the decline in mortgage applications in October, pending home sales for August were up 7.4%. We see this as an inevitable by-product of the ever-increasing foreclosure and REO pipeline which must at some point be cleared.

Production and Manufacturing Declines

While undoubtedly due in part to Hurricane Ike and strikes at Boeing, industrial production was down by 2.8% in September. This exceeded economist estimates of a 0.8% and was the biggest drop since December of 1974.

The Philadelphia Fed's general economic index fell to its lowest level in 18 years. The reading of -37.5 was 28.5 less than the level predicted by a Bloomberg survey of economists. A negative reading reflects contraction. Yesterday the New York Fed reported its Empire index of manufacturing had fallen to 24.6, the lowest level since it began in 2001.

CPI Unchanged in September

Depending on which way you look at it the one bright piece of economic data to come out over the past two week's was inflation. Reflecting a decline in oil prices, consumer price inflation was flat in September, less than the 0.1% predicted by a Bloomberg survey of economists. For the first time in two years, prices have not increased for two consecutive months. We say depending on which way you look at it because the slowdown in CPI, while obviously reflective of price stability, is indicative of a slowing economy. What the decline in inflation does do is give the Fed scope to cut interest rates further to stimulate growth.

US Housing Starts Drop to 26 Year Low

On Friday it was announced that housing starts on all residential properties across the United States dropped to the lowest level in 26 years. Economists had predicted a monthly drop of

2.5% to 872,000; instead the drop was almost 9%.

Building permits also fell, down 8% to 786,000, more than the 1.6% drop that had been forecast. This is the lowest level in 27 years.

When we consider that the population of the United States has increased by roughly 30% over the last 25 years these numbers become even worse. But the slowdown is necessary. Construction of new homes would accelerate the downward path of house prices as they add new supply to an already more than satiated market. Notwithstanding the fact that this data points to an exceptionally severe recession in the U.S. housing industry, the slowing rate of housing starts and building permits are positives for sub-prime investors.

SCR View

Perhaps surprisingly given the events of the last month, we have not changed our view on the sub-prime mortgage market. The past few weeks have impacted us on the periphery with mortgage rates increasing as a result of recessionary fears and the recapitalisation plans for banks hopefully freeing up credit for potential homebuyers. We see the various negative and positive outcomes and offsetting each other and leaving our position broadly unchanged. The likelihood of a recession is ever stronger but we see this as largely priced into the sub-prime mortgage market.

A number of lists came to market over the past week as hedge funds and money managers were forced to offload risky illiquid positions to fund redemptions, meet margin calls or re-allocate to Treasuries. Those investors with cash took advantage of the illiquidity by sourcing paper at very cheap levels.

With government intervention soon to commence with the Hope for Homeowners Act and TARP, we see potential for a rally in sub-prime in early November. Interestingly, investors who put money to work in high grade sub-prime bonds through July or August would not have suffered material losses in cash or ABX.

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

General Line: +44 20 7976 3650

Judith Sciamma

Partner

Ph: +44 20 7976 3671

Email: jsciamma@challengergroup.co.uk

Pete Robinson

ABS Analyst

Ph: +44 20 7976 3673

Email: probinson@challengergroup.co.uk

Mike Chacos

Managing Partner

Ph: +44 20 7976 3670

Email: mchacos@challengergroup.co.uk