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Fixed Income Commentary

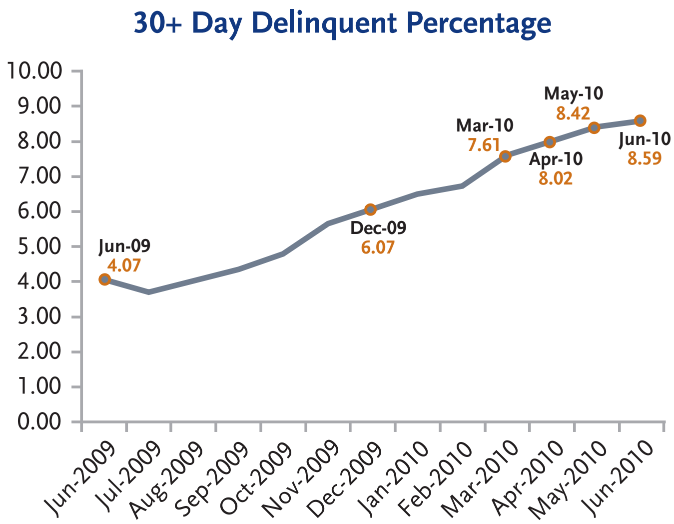
CMBS 2Q10 Review and Outlook

The second quarter was marked by a couple of firsts for the commercial mortgage-backed securities (CMBS) market this year. The market saw its first true multi-borrower, new-issue conduit transaction since 2008 and the first sign that special servicers will start liquidating the mounting number of loans that are becoming delinquent and moving into special servicing.

During May, the CMBS market lost 1.67%, its first month of negative performance and relative underperformance to the Barclays Capital Aggregate Index since February 2009. The market had recorded 14 consecutive months of positive performance and was up 45% since the lows of March 2009. The performance in May was in large part correlated with the global macroeconomic fears and continued sovereign risk of Europe that have pervaded the broader markets. However, over the course of the entire second quarter, the CMBS portion of the Barclays Aggregate returned 2.62% and is now up 12.12% year-to-date (YTD).

The major positive news during the quarter was the pricing of two multi-borrower CMBS transactions. The first transaction was brought by RBS in April and was very well received by the investor market. The underwriting standards of the CMBS 2.0 era (lower leverage; in-place cash flows; well-performing properties) led the deal to be oversubscribed, and the AAA's with 22% Credit Enhancement (CE) priced at 90 basis points (bps) over Swaps. The second deal, JP Morgan Chase Commercial 2010-C1, had more difficulty pricing as it had higher leverage and less credit enhancement than the first RBS deal. Nonetheless, the AAA tranche (with 15% CE) still ended up pricing at 140 bps over swaps and the general market consensus was that the deal's diverse pool of loans and new underwriting standards allowed it to price competitively despite the lower credit enhancement. If the number of multi-borrower, new-issue transactions continues to increase, it could provide a well-needed additional avenue of financing for the tremendous amount of loans maturing over the next couple of years.

Another positive development in the CRE deleveraging process during the second quarter was servicers' willingness to begin liquidating loans out of its special servicing pipeline. According to Realpoint, $1.24 billion worth of loans were liquidated during April and May, and the pace of liquidations has jumped dramatically. YTD through May, there have been $2.6 billion of loans liquidated, surpassing the $2.2 billion of loans that were liquidated for all of 2009. The largest special servicer, LNR Partners, recently sold off a $1 billion portfolio of loans, and if anything, the increase in the number of transactions will provide pricing clarity for a market that has had a limited number of transactions since the beginning of 2008. That being said, there is approximately $700 billion outstanding in the securities market and at the current pace of $6+ billion liquidations per year, it would take 14+ years to liquidate the current pool of loans in special servicing ($87 billion). Thus, the CRE market has a long way to go in its deleveraging process.



Source: Trepp

As of June 2010, the percentage of loans 30+ days delinquent is 8.59% (according to Trepp), which is more than double the delinquency rate of 4.07% of a year ago. The majority of loans in CMBS transactions have reported their 2009 year-end financials with cash flows reported down 5-10% on average from 2008. This decrease in cash flow will continue to put pressure on borrowers' ability to pay their mortgages and will continue to lead to maturity as well as term defaults. Moreover, severities on loans that have liquidated have remained on average above 60% and it appears that any aggressive buyers of pools of commercial mortgages have been limited to trophy properties in the top primary markets, while the bid for properties in secondary markets remains extremely distressed.

On the synthetic side, the CMBX market has remained quite volatile, showing large correlation with the broader equity markets as fast-money investors have dominated the market. Over the second quarter, the CMBX 07-2 AAA's were up 1.60%; underperforming cash CMBS as transaction volume remained quite low. The mezzanine part of the capital structure, meanwhile, vastly outperformed the market, as the CMBX 07-2 AJ's were up 12.87% over the last quarter.

Historical CMBS Relative Value Snapshot: Yield Spreads to Swap Curve

	Description	12/31/2009	3/31/2010	6/30/2010
CMBX 07-2 AAA	30% Super Senior	+318	+282	+260
CMBX 07-2 AJ	12-20% Attachment Points	+1,140	+1,270	+1,074
CMBX 06-1 AAA	30% Super Senior	+157	+136	+157
CMBX 06-1 AJ	12-20% Attachment Points	+603	+554	+545
GSMS 2007-GG10 A4	Last Cash Flow Benchmark 30% Super Senior	+500	+394	+375

Source: Markit, TCW/MetWest