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Fixed Income Commentary

Update on the Distressed Residential Whole Loan Sector

General Liquidity

Over the course of the year we have seen liquidity in the distressed whole loan market improve significantly. Year-to-date, approximately $14.1 billion of distressed and or discounted assets have traded. Several large institutions have announced and implemented large orderly sale programs and it appears that more and more institutions are evaluating the sale of distressed residential mortgage loans. Projecting forward, if we combine already announced sale programs, FDIC activities, and build in a continuation of other loan sale activity at volumes already seen this year, we can expect to see a total of $20 – $25 billion of these assets clear the market in 2010.

During the month of June, however, there was a bit of a slowdown in activity. The month started out slowly but activity seemed to pick up toward the middle of the month and finished with approximately $800 million of distressed loan packages out for the bid. The flow of widely distributed pools slowed to the lowest levels seen since February.

During this month there seemed to be more conversations going on between the investment banks and Portfolio managers about valuing and moving distressed assets off of balance sheets. Some of these conversations are already resulting in both widely distributed transactions and quiet "below the radar" transactions. For example, one large institution sold two separate loan packages (each one valued at several hundred million dollars), one publicly and one quietly.

Pricing

Starting in January of 2010, pricing on distressed loan packages increased approximately 5-7 points, peaking around April. Since then we have seen bids back up by a couple of points each month. Specifically, pricing of non-performing loans, which had been as high as the low $50s, is currently in the mid-to-high $40s, with the cover bid being mid $40s. There appears to be a cluster of bidders in this range.

Looking at this in terms of yield, at the beginning of the year packages were trading in the 15% - 18% range. Subsequently the market tightened to a base case return hurdle of 12% - 15%. Current pricing would put us in the 14% -16% area.

The run up in prices reflected the appetite of portfolio managers who had been waiting on the sidelines for distressed product to become available. As pricing tightened, the volume of product brought to market increased. However, ultimately investment managers began to pull away as yields became too low.

This lack of urgency was seen again in June when, despite the lower volume of packages available in the market, pricing continued to soften. It appears most buyers were willing to wait for the market to come to their levels. Another contributing factor to this could have been that many of the most active players in this space have been very busy with settling April and May purchases.

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