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METWEST

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# Fixed Income Research:

## Weekly RMBS Market Update

### Agency Updates

**Agency Spread Basis:** Since the buyout announcement, several investment banks have turned from underweight or negative to neutral on the current coupon mortgage basis (the spread between current mortgage coupon and treasury rates). Most had expected the basis to widen by 20-30 basis points once the MBS purchase program ended on March 31. But the tradable MBS outstanding, which was already reduced by Fed purchases, will be further reduced by up to $200 billion in the next 2-3 months through the buyouts. Plus, the GSEs will continue to take out another $15 billion in MBS as part of ongoing buyouts every month. In addition, some investors will want to reinvest the paydowns they receive from buyouts, and they will be forced to go down in coupon, further supporting the current coupon basis. So, the decrease in supply of MBS and possible increase in demand for MBS means that the basis may not widen as previously expected.

**IOS – New Product:** Agency mortgage IOS (Interest Only Synthetic) indices are expected to be launched on March 12. IOS is a synthetic total return swap index referencing the interest component of agency mortgage pools, which provides investors with synthetic exposure to the interest flows of agency MBS, an alternative to cash IO instruments that is hitherto unavailable. Three IOS indices are expected to launch based on the Fannie Mae 30-year 4%, 4.5% and 5% pools issued in 2009. An IOS contract is structured to synthetically replicate the economic value of owning IO agency mortgage assets financed at Libor.

Servicers and hedge funds will be natural participants in this product. Total return investors with the freedom to own derivative assets could also play major roles in this market.

**Fed MBS Purchases:** The Fed purchased $11 billion of agency MBS during the week ending February 17 bringing the total to $1,195 billion. $55 billion remains to be purchased in about 6 weeks remaining untill March 31, 2010. The Fed is not expected to extend this program beyond March 31. The Fed has purchased most of the 2009 agency MBS issuance and now holds 20% of all agency MBS outstanding.

**MBA Delinquencies:** As per the Mortgage Bankers Association (MBA) Q4 2009 National Delinquency Survey, the non-seasonally adjusted delinquency rate increased 50bp to 10.44% from 9.94% in Q3 2009. Although delinquencies are still rising, the pace has slowed from the previous quarter when delinquencies increased by more than a point.

### Non-Agency Updates:

**HAMP Update:** The Home Affordable Modification Program (HAMP) showed a significant pickup in permanent modifications (116,000 in January versus 66,000 in December, both cumulative), with another 76,000 pending, requiring only the borrower's signature.

However, eligibility criteria may be a limiting factor in reaching the Treasury's goal of 3-4 million modifications. 6% of HAMP trials have been rejected so far. According to Treasury guidelines, these rejected loans must now be evaluated for the short sale or deed-in-lieu option before initiating foreclosure proceedings and eventual REO liquidation. An increasing number of rejected HAMP trials, therefore, could imply more short sales and higher CDRs on non-agency deals. For non-agency deals, this could foreshadow increased short sale completions, as well as higher default rates

**Non-Agency Cash Markets:** The trade volume was relatively light in the holiday shortened week. The non-agency market saw $1.4 billion in bids and the subprime market saw another $1.0 billion. Prices stood firm at the previous week levels.

## Barclays' Cash Prices

| | 19 Feb | 12 Feb | 5 Feb | 11 Dec | 6 Nov | 30 Oct | 25 Sep | 28 Aug |
|---|---|---|---|---|---|---|---|---|
| Jumbo SS Fixed AAA | 83 | 83 | 84 | 84 | 83 | 85 | 82 | 80 |
| Jumbo SS ARM AAA | 73 | 73 | 72 | 73 | 71 | 74 | 72 | 67 |
| Alt-A Fix SS AAA | 69 | 69 | 70 | 71 | 72 | 75 | 74 | 65 |
| Alt-A ARM SS AAA | 59 | 59 | 60 | 57 | 56 | 60 | 58 | 52 |
| Option ARM SS AAA | 53 | 53 | 53 | 49 | 51 | 53 | 49 | 45 |

| | 24 Jul | 26 Jun | 29 May | 1 May | 3 Apr | 13 Mar | 6 Mar | 27 Feb |
|---|---|---|---|---|---|---|---|---|
| Jumbo SS Fixed AAA | 81 | 75 | 80 | 79 | 72 | 65 | 60 | 71 |
| Jumbo SS ARM AAA | 65 | 60 | 63 | | | | | |
| Alt-A Fix SS AAA | 63 | 56 | 58 | 58 | 50 | 43 | 43 | 47 |
| Alt-A ARM SS AAA | 50 | 47 | 48 | 44 | 45 | 38 | 40 | 41 |
| Option ARM SS AAA | 46 | 40 | 37 | 36 | 36 | 33 | 34 | 40 |

ABX prices staged a small rally last week. All ABX pAAAs and AAAs, except one, rose by 0.6 to 1.1 point last week. 2006-1 pAAA rose by 0.18.

| | 07-2 | 07-1 | 06-2 | 06-1 |
|---|---|---|---|---|
| pAAA | 38.5 | 43.3 | 73.3 | 88.1 |
| AAA | 35.2 | 35.2 | 47.7 | 82.5 |
| AA | 4.7 | 4.0 | 12.8 | 36.1 |
| A | 4.4 | 3.4 | 5.1 | 12.6 |
| BBB | 3.3 | 3.4 | 6.1 | 4.5 |
| BBB- | 3.3 | 3.4 | 5.6 | 4.6 |
| Cum Loss | 16.46% | 15.45% | 14.83% | 10.60% |
| 60+ Delinq | 52.1% | 53.3% | 50.5% | 45.2% |

## Market Indicators

**New Home Starts:** New home starts for January rose 2.8% to a 591,000 seasonally-adjusted, annualized pace, exceeding street expectations of 580,000. For all of 2009, builders broke ground on 554,500 houses, the fewest since records began in 1959. The annual rate was down 39% from 905,500 in 2008, the second-lowest level on record. The report also showed building permits in January decreased 4.9% to a 621,000 pace from a 653,000 rate in December. Permits were forecast to fall 5.1% to a 620,000 rate. Homebuilder confidence increased in February, according to the National Association of Home Builders Housing Market Index. The index rose from 15 to17 in February, a larger increase than predicted by street analysts.

Part of the increase in January housing starts may have been due to warmer weather in January compared to December. But rising foreclosure levels and high unemployment levels remain as obstacles to a sustained housing recovery.

**Discount Rate:** Late Thursday afternoon, the Federal Reserve Board voted to increase the discount rate by 25bps, to 0.75%, effective February 19, 2010. Chairman Bernanke had previously telegraphed this move in last week's testimony, as well as in the recent minutes of the January 26-27 FOMC meeting minutes. The Board has stressed that the hike should not be interpreted as any sign of impending tightening in monetary policy. The 2-10 year treasury curve initially flattened by 7bps, only to re-steepen a few days later. We believe that the Fed will keep rates low for an extended period of time, providing a landscape for numerous carry trade structures.



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