Monthly Market Monitor

Monday, October 29, 2007

MMM 10-07

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Current Interest Rates

Closing Results

	10/26/2007 Yield	9/28/2007 Yield	YTD BP Change
Short-term			
Federal Funds Target	4.75%	5.25%	-50
Prime Rate	7.75%	8.25%	-50
Libor (3-mo.)	4.98%	5.23%	-38
3-mo. T-bill	3.94%	3.80%	-106
6-mo. T-bill	4.04%	4.08%	-104
2yr T-note	3.77%	3.98%	-104
Longer-term			
5yr T-note	4.05%	4.24%	-64
10yr T-note	4.40%	4.59%	-30
30yr Bond	4.70%	4.84%	-11

Source: BLOOMBERG L.P. as of 10/29/07 11:15 a.m.

	10/26/2007 Price	9/28/2007 Price	YTD % Change
Washington Mutual, Inc.	$28.58	$35.31	-37.17%
Countrywide Financial Corp.	$17.30	$19.01	-59.25%
Sovereign Bankcorp, Inc.	$14.26	$17.04	-43.84%
ING Groep N.V.	$43.94	$44.31	-0.52%
E*TRADE Financial Corp.	$10.70	$13.05	-52.27%
Hudson City Bancorp, Inc.	$15.52	$15.38	11.82%

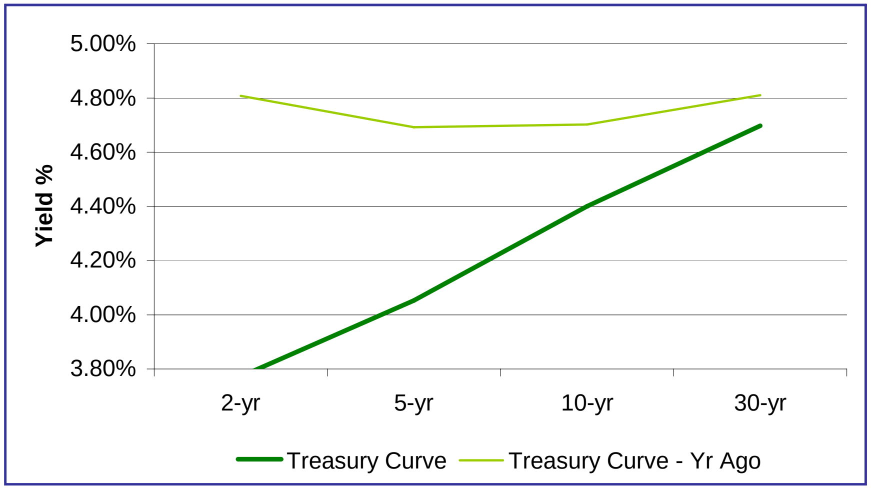
Source: BLOOMBERG L.P. as of 10/29/07 11:15 a.m.

Events

November 20, 2007, OTS 3Q Press Conference – *Tentative*

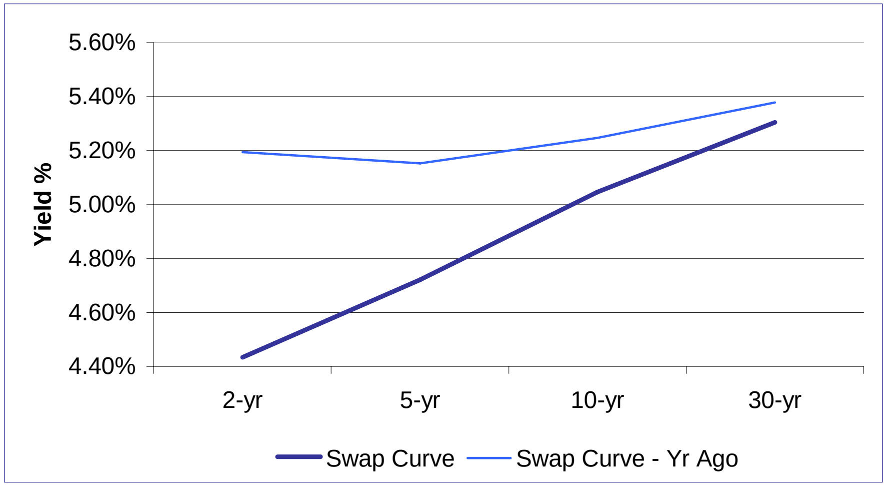
December 3, 2007, OTS National Housing Forum, National Press Club, Washington, DC – *Invitation Only*

TREASURY CURVE (CHART 1)



Source: BLOOMBERG L.P. as of 10/29/07 11:15 a.m.

INTEREST RATE SWAP CURVE (CHART 2)



Source: BLOOMBERG L.P. as of 10/29/07 11:15 a.m.

INTEREST RATE SWAP SPREADS (CHART 3)

Closing Results

	10/26/2007 Spread	9/28/2007 Spread	YTD BP Change
2yr	66	68	30
5yr	66	64	26
10yr	64	63	16
30yr	61	61	10

Source: BLOOMBERG L.P. as of 10/29/07 11:15 a.m.

MARKET COMMENTARY

After the turmoil in the financial markets in August, market participants spent September and October avoiding further risks and sorting through the uncertainty over the financial landscape. The 50 basis point (bp) cut in the target fed funds rate surprised many but had marginal impact on those who suffered from the subprime problems. Problems in the subprime market are deep and likely to persist, if not worsen, in the coming months. While we expect the long-term picture to sort out the problems, one very real concern is ensuring that any government response is balanced and does not further restrict credit.

Asset-Backed Commercial Paper

Funding conditions have improved since August with commercial paper spreads falling from peak levels. Nonetheless, the total cost of funds remains above pre-August rates as risk aversion remains a common practice among money managers. **The asset-backed commercial paper (ABCP) market shrunk considerably with the outstanding balance falling to approximately $899.0 billion from nearly a trillion dollars in August.** Overnight ABCP is trading at approximately 45 bps over the fed funds rate, a significant spread increase over the 12 bps average in the past year. Nonetheless, the trend is moving in the right direction with spreads markedly narrowing from the highs in August. Direct issue 30-day commercial paper continues to enjoy good liquidity, but the rates are also higher by 10 bps than the average over the last twelve months.

Master Liquidity Enhancement Conduit

The announcement of the formation of a "Super SIV" is just a week old, and the investment community will be closely watching to see if the **Master Liquidity Enhancement Conduit (M-LEC)** will actually stem the occurrence of market freezes in the ABCP market. **There are approximately 30 structured investment vehicles or SIVs with roughly $320 billion in assets outstanding.** These entities were created to fund various types of loans, including autos and mortgages, prior to their ultimate sale or securitization. As credit fears erupted in August, the demand for ABCP diminished causing many SIVs to liquidate assets at distressed prices to pay off maturing commercial paper. As noted earlier, liquidity conditions have improved, but there remain fewer buyers of ABCP. To address the potential for another "seizing up" of the ABCP market, three entities, Citigroup Inc., Bank of America Capital Corp., and JPMorgan Chase & Co., have teamed up to create a fund that will serve as a backstop for SIVs that encounter liquidity problems. **M-LEC will be the buyer of last resort for SIVs that may be forced to sell assets. The new fund plans to raise between $80 billion and $100 billion through the issuance of short-term debt securities that will have a layer of protection in the form of junior liens (held by SIVs that sell assets to the conduit) and liquidity backstops provided by the three banks.** Details of the criteria for asset purchases by M-LEC remain uncertain, but reports in the press suggest the conduit will only accept AA rated securities and higher quality loans but no subprime loans. Other banks may join the trio as another source of support for the conduit. While the three banks will provide the liquidity backstop, which is to be considered a contingent liability and therefore, off balance sheet, only one will serve as manager of the fund. The banks will bid for that designation and earn a fee for managing the fund in addition to collecting fees for providing the liquidity facility.

Given the limited information available, **it appears that the creation of M-LEC could enhance investor confidence and improve market liquidity for ABCP**. One of the key questions left to address are the details regarding the credit quality of the assets in the conduit and the rate at which the conduit is able to raise money. Potential investors of the debt issued by M-LEC will closely scrutinize the characteristics of the underlying assets in the conduit to ensure they are not purchasing securities similar to the ABCP issued through the SIVs.

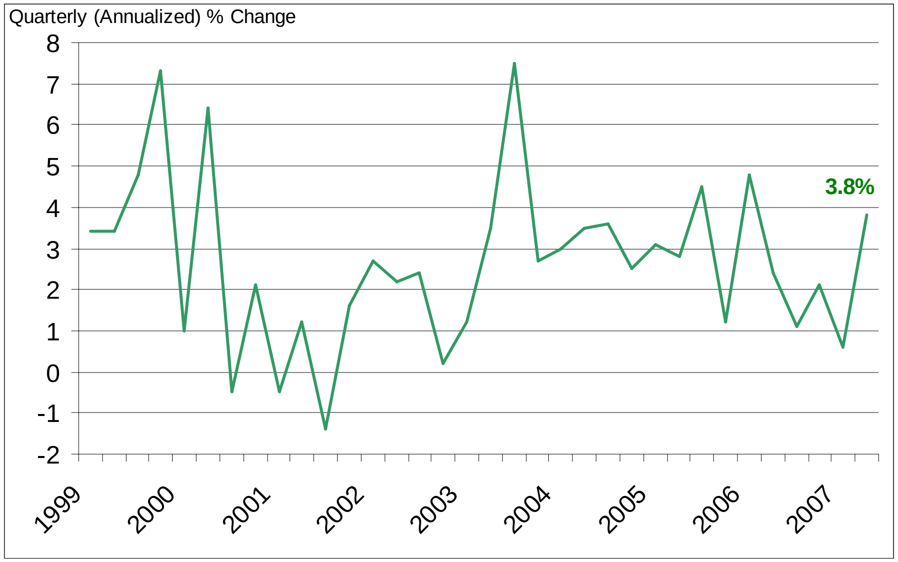
Risk perceptions of the investor community have quelled, but fear of another outbreak remain evident. **Current repo rates for Agency mortgage securities are at one-month LIBOR, or 5.00% plus a 4% haircut.**[1] After a significant decline in September, the Agency repo rate has risen to levels about that in August. The lower rates in September reflected the extreme aversion to non-agency securities by market participants and premium paid for Agency debt. **Repo funding rates for non-Agency mortgage securities have fallen from the September levels to LIBOR +5 bps plus a 10% haircut (versus LIBOR +15 bp), but still vary greatly depending on the characteristics of the collateral.** I expect the liquidity haircuts, of 4% and 10%, to remain at these new elevated levels due to the uncertainty of the full impact of the deterioration in housing conditions and mortgage finance.

We are in the midst of a heavy period of ARM resets in the mortgage market, and the likelihood of further increases in reported delinquency and foreclosure rates is great. The probability of further deterioration in housing conditions remains high, leaving asset prices vulnerable to more declines and credit spreads susceptible to greater widening. The Federal Open Market Committee will meet on October 30-31st, and speculation of another rate cut will lead to continued volatility in the market rates.

[1] LIBOR is the London interbank offering rate. The one-month LIBOR is at 4.792% as of October 26, 2007. The lowest level year over year. The 4% haircut refers to the price discount applied to the market value of the collateral to account for liquidity risk.

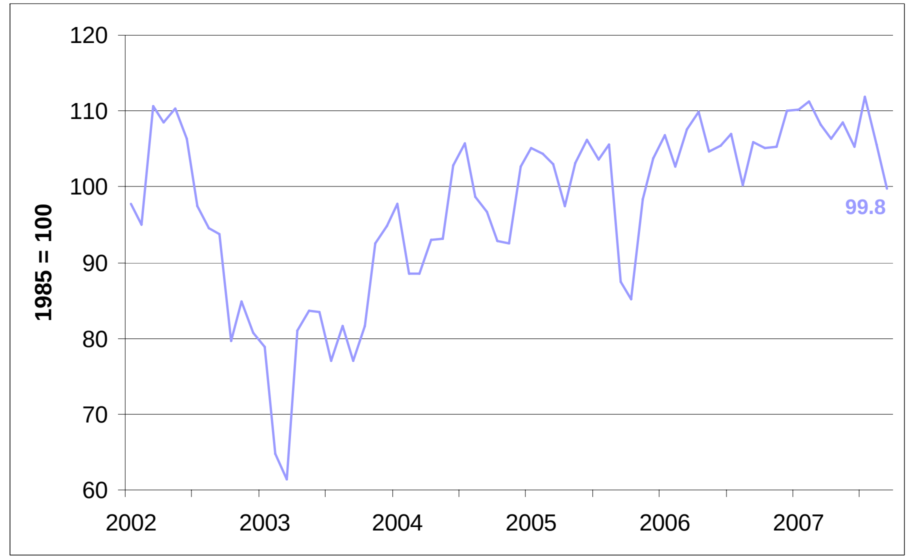
ECONOMIC CONDITIONS

GDP (GROSS DOMESTIC PRODUCT), 2Q AS OF JULY 2007 (CHART 4)



SOURCE: BLOOMBERG L.P.

CONSUMER CONFIDENCE INDEX, AS OF SEPTEMBER 2007 (CHART 5)



SOURCE: THE CONFERENCE BOARD

U.S. GROSS DOMESTIC PRODUCT

The impacts of the demise in the housing market have begun to surface in the overall economy. GDP growth advanced by 3.8% from the second to third quarter and is up 1.9% from a year ago. (Chart 4) While the decline in residential investment continues to depress overall growth by roughly 1.00%, its impact is less evident in consumer spending. Personal consumption grew by 2.9% in the second quarter and is up 3.4% on an annualized basis as of August of this year. Consumer demand for services remains healthy, while purchases of durable goods, such as appliances, are growing at a slower pace. Income growth is also lagging, leaving one to question if consumption can continue at its current pace. A combination of weaker stock prices, slower job growth, limited access to home equity, and tighter credit conditions will challenge households' abilities to shop in the coming months.

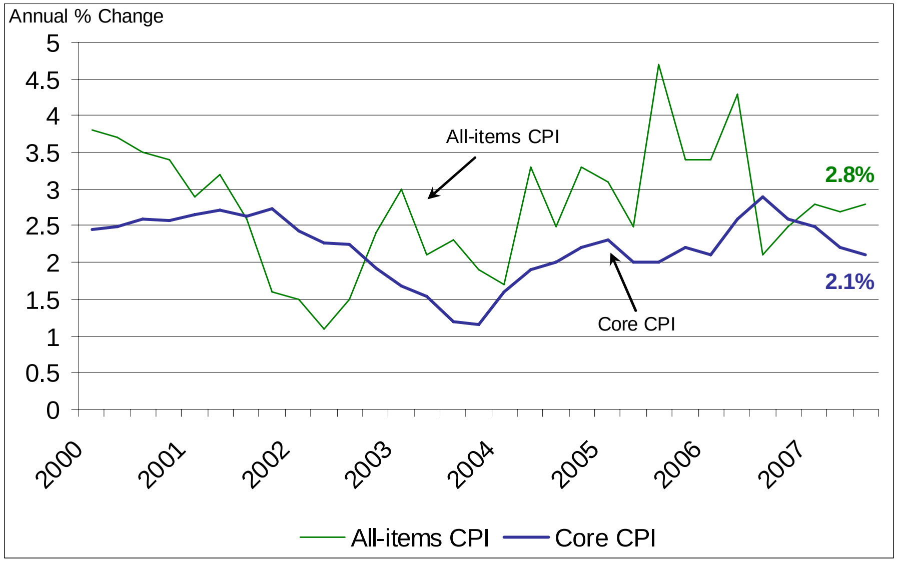
While there are many surveys of consumer confidence, we have chosen to use the Conference Board's index due to the breadth of the survey sample. The index has fallen from a four-year high of 111.9 in July 2007 to 99.8 in September of this year. (Chart 5) The expectations index was also down more than 4% in September as survey respondents expressed less confidence in the ability to obtain a job. Consumer confidence has been an incidental indicator of demand the past five years, as the availability of home equity, strong income growth and stock market gains have allowed consumer spending growth to outpace that of income. However, the absence of these factors is likely to lead to a deterioration of consumer confidence and ultimately impact the desire to spend. Add to the confluence of factors, the potential for a decline in home values, and one can easily conclude that the consumer may tighten their wallet and actually begin saving again. A drop in spending and its overall impact on U.S. economic growth may be substantial as personal consumption expenditures contributed 1.00% to second quarter GDP and more than 2.50% in the first quarter.

Inflation

Price inflation measures eased modestly in the August, but food and energy prices continued their ascent and led to a considerable increase in the overall CPI during the month. (Chart 6) Food prices rose by 4.5% from a year ago, while energy costs were 5.3% for the same period. Oil import prices soared in September, with a year-over-year advance of 20.1%, which may put upward pressure on gasoline prices once again. Nonetheless, the majority of the cost of goods sold is labor, and wage gains appear to have stalled after a healthy growth spurt earlier in the year.

Forecasters are likely to portray a descent holiday shopping season, but the outlook for 2008 is very uncertain. Optimists are counting on relief for the housing market and lower interest rates (aided by a Fed rate cut), while others remain tentative about the prospect of a housing recovery. Third quarter corporate earnings may foretell the challenges ahead for an economy that must deal with an overhang of housing supply, softer commercial real estate conditions and slow growth in payrolls. The impact of these factors on the consumer psyche will likely determine the pace of economic output over the next six months.

CPI (CONSUMER PRICE INDEX) 3Q, AS OF SEPTEMBER 2007 (CHART 6)



SOURCE: THE BUREAU OF ECONOMIC ANALYSIS

HOUSING

The news on U.S. housing conditions worsened in the past month as delinquencies, foreclosures and home inventories all rose to at least 5-year highs. The question of whether the worst is yet to come appears to have been answered, as financial firms report substantial credit losses and reduced financing business due to the slowdown in the housing industry.

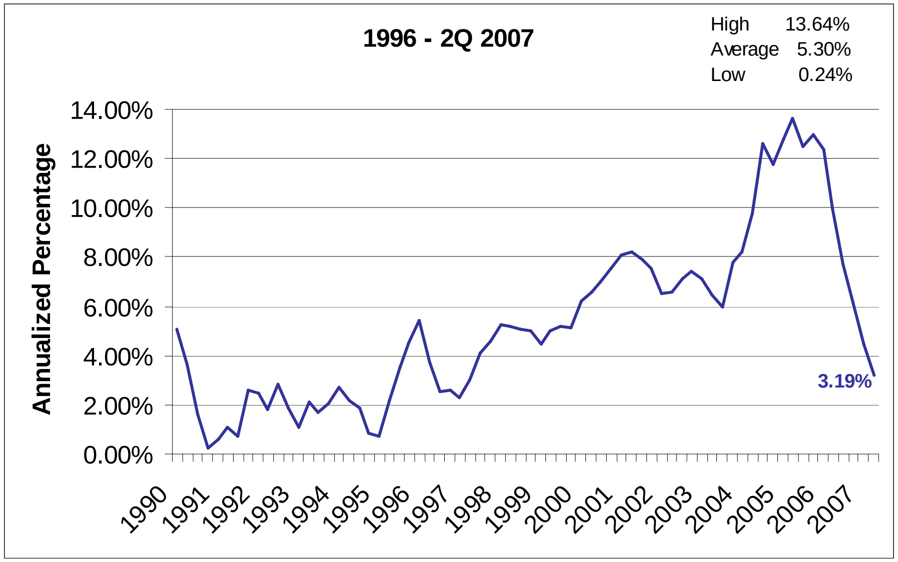
In place of a narrative on housing conditions, I have included a recap of some of the events that occurred in housing finance the past two months (Chart 7). Charts 8-19 provide information on sales volume, and delinquency and foreclosure data for the months of July and August (the most current information available).

Conditions in the housing market continue to deteriorate in the areas of new construction, new and existing home sales and housing finance. Contributing to the malaise is higher mortgage rates and tighter credit conditions as lenders, saddled with loans on balance sheets, have fewer funds to lend and less desire to extend credit to non-prime borrowers. The result is likely to be a prolonged correction in the housing market with downward pressure on home values and rising inventories. The impact on loan performance is evident in this month's data which likely foretells the future.

SUPPLY/DEMAND DYNAMICS IN HOUSING, SEPTEMBER 2007 (CHART 8)

SOURCE: NATIONAL ASSOCIATION OF REALTORS

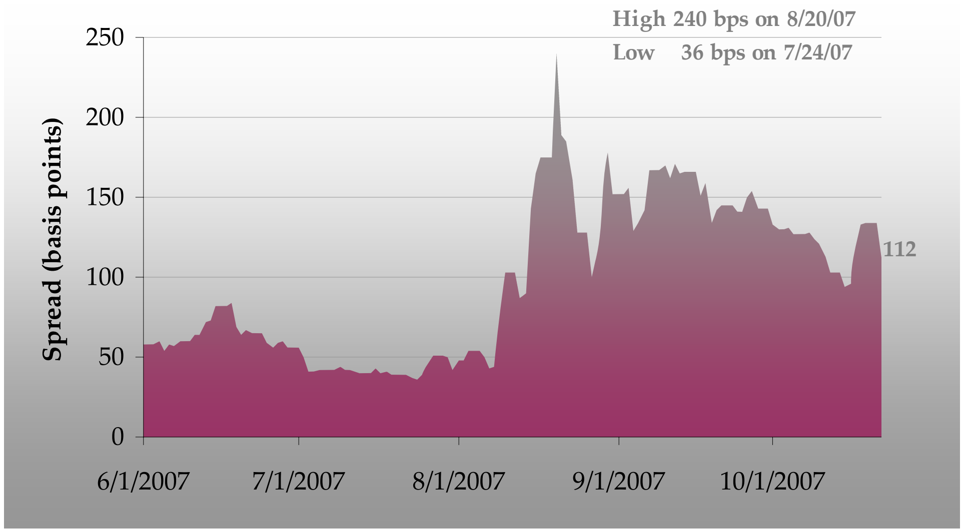
NATIONAL HOME PRICE APPRECIATION QUARTERLY – ANNUALIZED (CHART 9)



SOURCE: OFFICE OF FEDERAL HOUSING ENTERPRISES OVERSIGHT (OFHEO)

Chronology of the Mortgage Malaise & a look at the spread between 3-month T-bills vs. 3-month LIBOR (Chart 7)

As credit fears climbed during the summer months, so did the demand for U.S. Treasury bills. Concerns over bank exposure to subprime loans constrained inter-bank lending causing LIBOR to rise while short term Treasury yields fell. The result is illustrated in the chart below which portrays the critical nature of the credit squeeze cause by the mortgage malaise.



Source: Bloomberg L.P.

June 2007
- Bear Stearns halts redemption and begins liquidating $3 billion subprime assets from its hedge funds.
- Moody's cuts ratings on $5 billion bonds backed by subprime loans.

July 2007
- American Home Mortgage Investment Cop. losses access to bank lines of credit and is unable to fund loans.
- Spreads current coupon on Agency MBS widen to the highest level since August 2003.
- Swaps spreads widen to the highest level since February 2002.

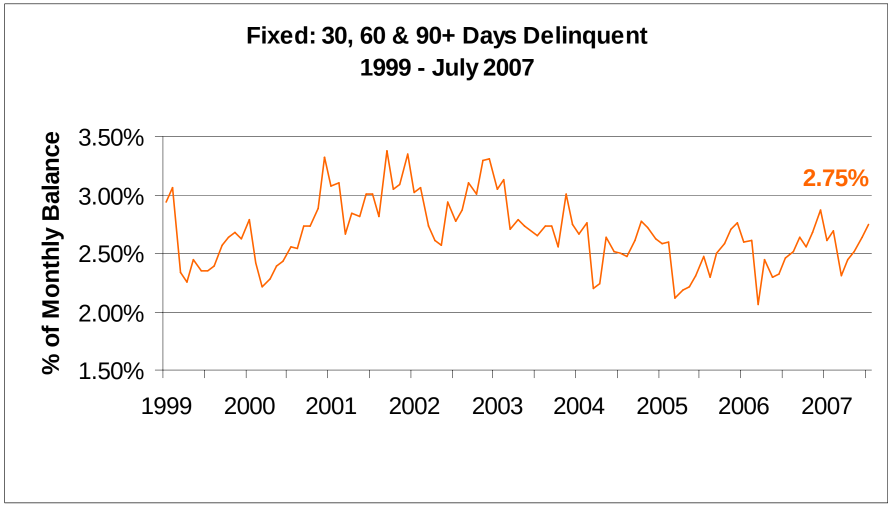
August 2007
- Federal Reserve reduces the discount rate by 50 bps and increases the term of discount window borrowings.
- Spread between 3-month LIBOR and 3-month T-Bill widens from a low of 35 bps in July to a high of 240 on August 20, 2007.
- Countrywide Financial draws on its entire $11.4 billion line of credit after asset-backed commercial paper market shuts down.
- 5-yr Interest rate swap spreads widen to year-to-date high of 78 bps.

September 2007
- The Federal Reserve cuts the target fed funds rate by 50 basis points.
- U.K. Treasury guarantees deposits at Northern Rock Plc. After the lender encounters cash short falls and bank run ensues.
- Net Bank is put into receivership with the FDIC.

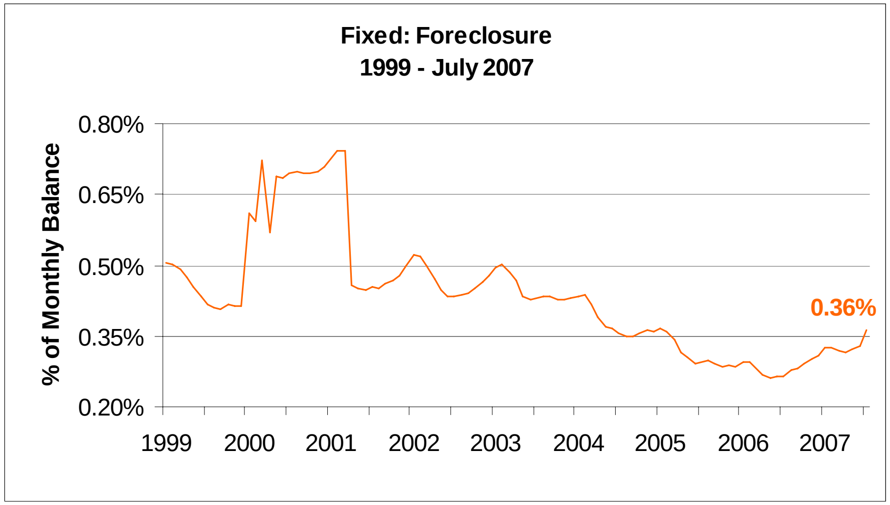
October 2007
- Miami Valley Bank of Ohio is closed down.
- Bank of America Corp., JPMorgan Chase and Citigroup agree to set up the Master Liquidity Enhancement Conduit (M-LEC), a new fund to provide liquidity to the asset-backed commercial paper market.

National Delinquency & Foreclosure Rates: Fixed & ARM Loans

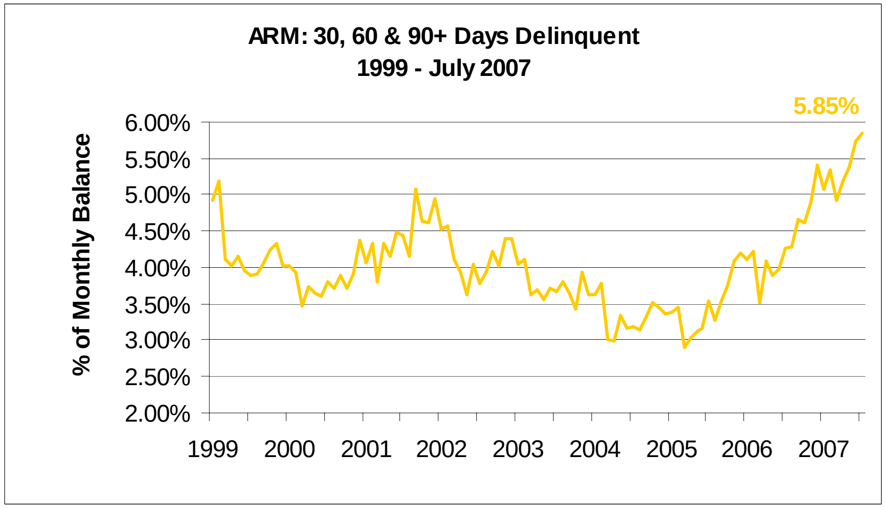
(chart 10)



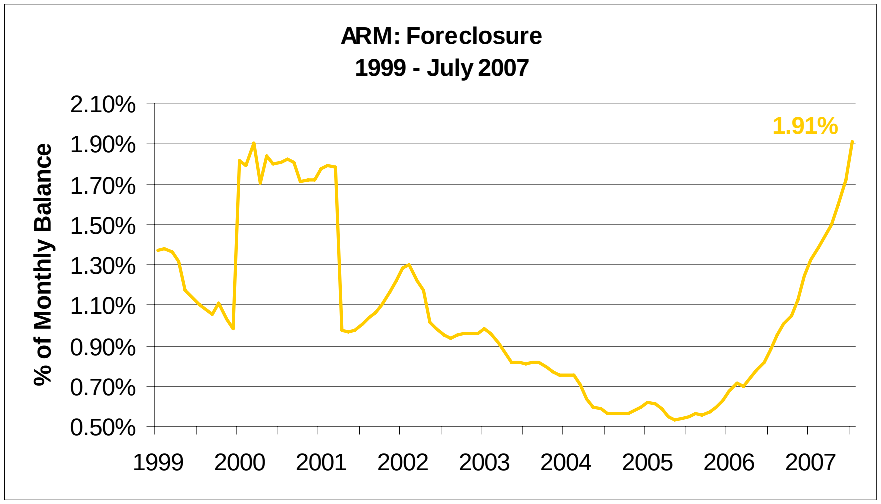
(chart 11)



(chart 12)

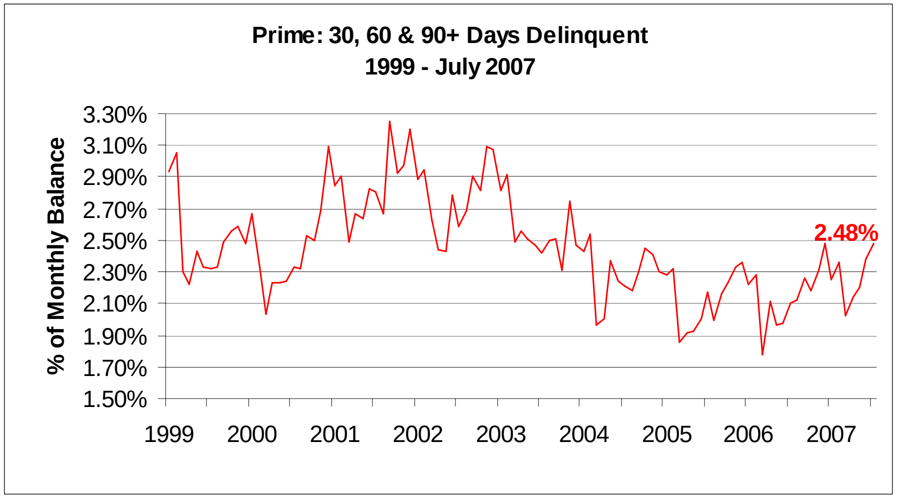


(chart 13)

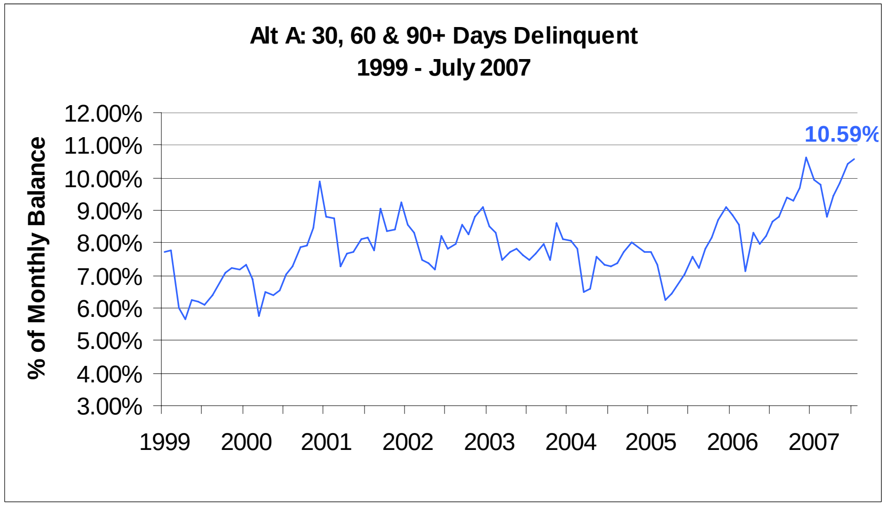


NATIONAL DELINQUENCY RATES: PRIME, ALT-A & SUBPRIME LOANS

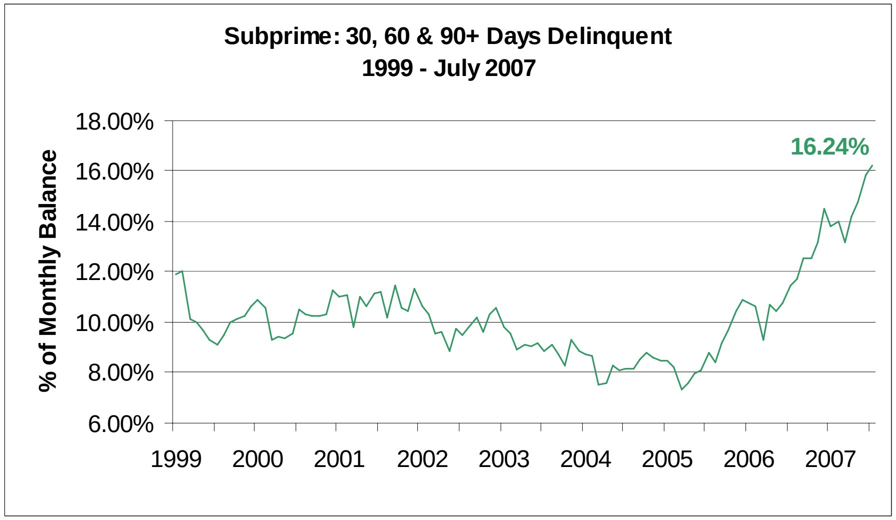
(CHART 14)



(CHART 15)

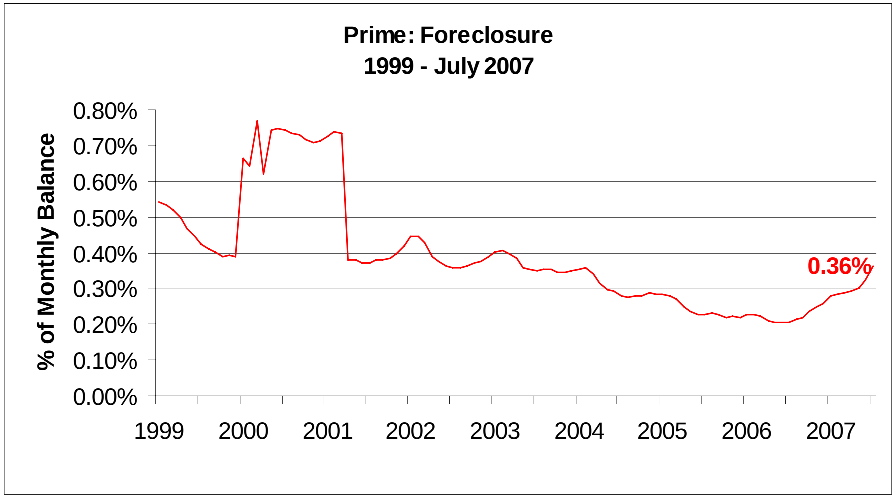


(CHART 16)

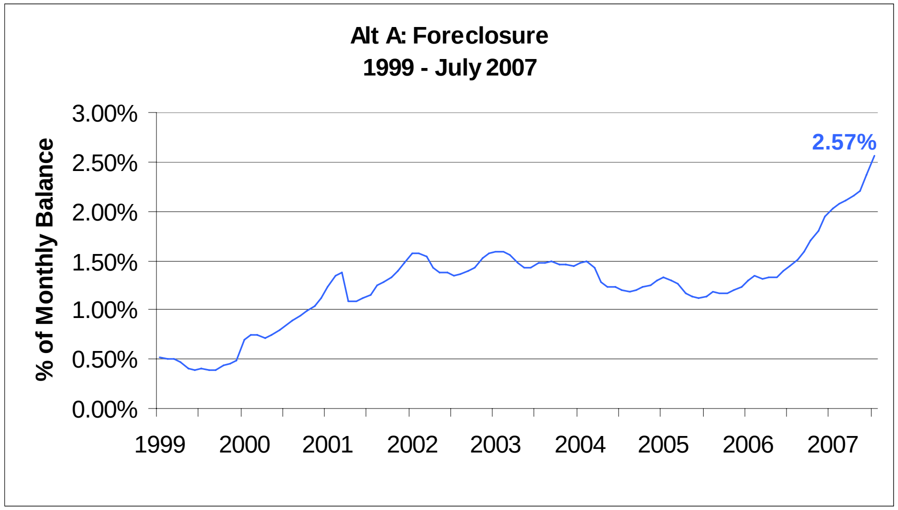


NATIONAL FORECLOSURE RATES: PRIME, ALT-A & SUBPRIME LOANS

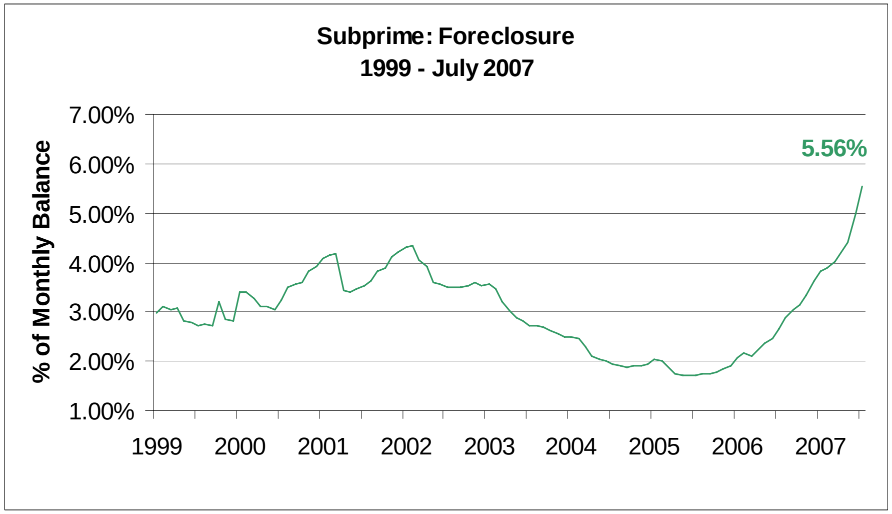
(CHART 17)



(CHART 18)



(CHART 19)



SOURCE: CHARTS 10-19 LOANPERFORMANCE, A SUBSIDIARY OF FIRST AMERICAN REAL ESTATE SOLUTIONS (FARES)
NOTE: ALT A IS DEFINED AS ORIGINAL CREDIT SCORE 620-659 AND LTV AT ORIGINATION > 80%.
ALL VARIATIONS OF DOCUMENTATION ARE INCLUDED. DATA FOLLOWS THE MBA DEFINITION OF DELINQUENCY.

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