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The Month In Review

July 2006

New in CompassPoint™!

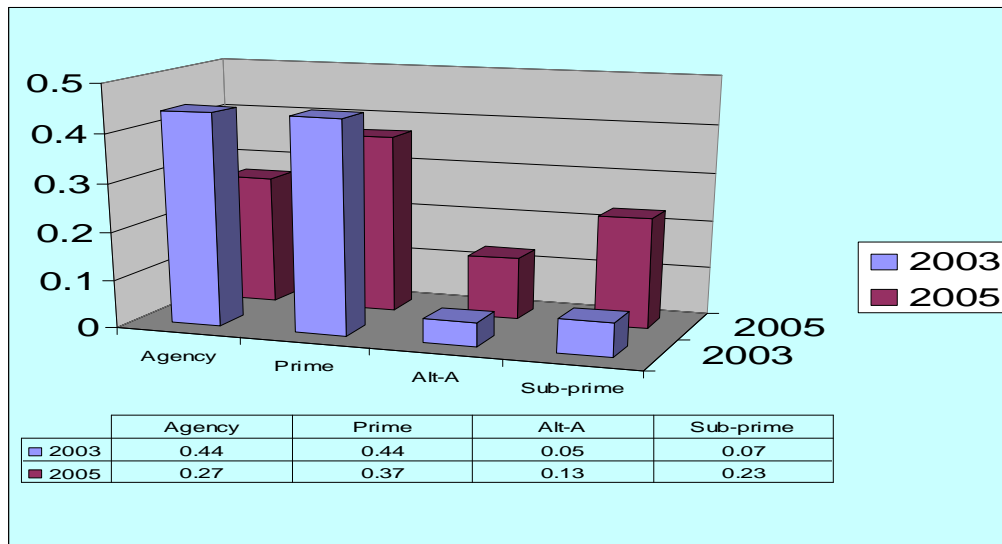
Compass is pleased to report its recent development progress in CompassPoint™, including:

- Addition Data Formatting and Control on Data Stratification Tool
- Hedge Cost and Relative Originator Profitability Reporting and Formatting
- Data Transforms and Audits on Data Mapping/Translation Tool

CompassPoint™ features and capabilities reflect the business needs as defined and requested by its users. For additional information on new features or to submit suggestions and requests, please contact Rob Kessel at 415-925-2812 or e-mail at rkessel@compass-analytics.com.

Topic of the Month - Shrinking A-Credit Production

The mortgage industry has witnessed a dramatic decrease in A-Credit market share over the last several years. As the graph below illustrates, Agency production lost 17 points (or a whopping 38%) and Prime 7 points (or 16%) from 2003 to 2005:



Source: Lehman Brothers, Compass Analytics



How do we explain such market share decline?

- Are Non-Prime rates lower than Prime?
- Are Agency loan limits not keeping pace with housing values?
- Are recent borrowers less creditworthy – investors less risk adverse?
- Is it the interrelation between “affordability” programs and recent HPA (House Price Appreciation)?
- Are Non-Prime loans easier to originate and/or more profitable for lenders and LOs?
- Is it a combination of the above?

First, are Non-Prime rate lower than Prime? No! Although Subprime 2/28 – Alt-A 3/6 rate spreads are at historic lows – lower credit quality still commands higher yields.

Next, when we look at average loan sizes for Alt-A and Subprime production, although average loan amounts have crept up, both averages are still well south of current Agency maximums (SFR 417K).

Next, are recent borrowers simply less creditworthy? In other words, are droves of borrowers buying houses/borrowing money that in previous years would not have had access to loan programs meeting their credit scenario? If that was the case wouldn't we expect to see newer Non-Prime production credit statistics suffer? First blush data belies the hypothesis:

	<u>2003</u>	<u>2005</u>	<u>Change</u>	<u>Creditworthiness</u>
FICO	686	684	-2	Less - Minor
% < 660	35	36	1	Less - Minor
LTV¹	73	76	3	Less
% > 80%	20	16	-4	More ¹
DTI²	37	38	1	Less - Minor
% > 45%	12	9	-3	More ²
Lim/No Docs	33	48	15	Less

1. Does not capture impact of 2nds on CLTV
2. DTI based off of initial payments (including IO, Neg Am)

Source: Lehman Brothers - Includes Jumbo, Alt-A and Subprime

A second look at the same data with special emphasis on affordability programs paints a little different picture.

	<u>2003</u>	<u>2005</u>	<u>Chg</u> <u>Pts</u>	<u>Chg</u> <u>%</u>
Simultaneous 2nds	6	27	21	350
Interest Only	16	34	18	112
Negative Amort.	1	26	25	2500
Investor	10	15	5	50
ARMs	21	48	27	129
2/10 Slope (bps)	230	20	-210	

Source: Lehman Brothers



When we look at affordability programs, e.g. Simultaneous Seconds, Interest Only, Negative Amortization, Option ARMs, ARMs in general, and 40-year loans, we see that these types of programs have indeed grown dramatically. Simultaneous 2nds do point to a worsening in credit as LTV statistics above do not consider CLTV credit impact. Interest Only and Neg-Am loan programs promote front-end affordability at the expense of payment resets at a later date. Investor loans reflect a loan production by-product of favorable HPA and ARMs and have more than doubled market share even though the yield curve flattened 210 bps during the same period! So these loan features, more widely available and/or marketed in Non-Prime loan products have exploded in market share and contributed significantly to Prime/Non-Prime market share shifts. The question remains to what extent the popularity of affordability programs and current Prime/Non-Prime market shares are dependent on HPA assumptions.

Finally, one additional explanation provides some understanding to market share shifts - profit margins. Despite sharp contraction in profit margins from 2003 to 2005 across Agency, Prime, Alt-A and Subprime loan production, Agency/Prime profit margins were and remain 1/3 of Alt-A/Subprime profit margins.
-Rob Kessel

Market Update

Increasing inflation fears and confusion as to the strength of the economy highlighted the month of June. Although economic data showed some weakness was creeping into the economy, back-to-back 0.3% gains in May's core PPI and CPI tipped bond prices into a nine-day losing streak, the longest such streak in over 20 years. The bond markets used the inflation concerns to push yields higher across the board until the entire curve was huddled around the 5.25% mark, which was the expected, new Fed Funds target following the FOMC's June 29th meeting. As rates increased, Fed Funds futures trading for August showed that expectations for another Fed increase, to 5.50% following the August meeting, had also increased. As the June 29th meeting approached, the August contract had priced-in an 80% chance of an additional increase and many economists began speaking of a 6.00% Fed Funds rate by year-end.

The Fed continues to be in a bit of a quandary given that several economic measures are showing signs of weakening and while the Fed needs to maintain its inflation-fighting credentials, it doesn't want to send the economy into recession. Apparently, one of the trickiest decisions for the Fed to nail is to know when to stop.

The Fed announcement on the 29th was pretty much inline with recent statements and carried forward a theme used by Greenspan late in his tenure: essentially, that there was no specific, pre-determined Fed Funds target and that each month's economic data would determine further moves. Suddenly, an 80% probability of an August increase seemed a little drastic given two weak job-growth reports, among other things, and more than a month of upcoming data before the next meeting. Rates started to fall once again and the curve moved back into an inverted stance.

In the week following the June Fed meeting, the June non-farm payrolls number again posted weak headline with job growth a rather anemic 121,000. Bond prices improved further on the news but were constrained somewhat by a spike in average hourly earnings and a stubborn employment rate that remained at a low 4.6% despite three months of relatively weak job growth.

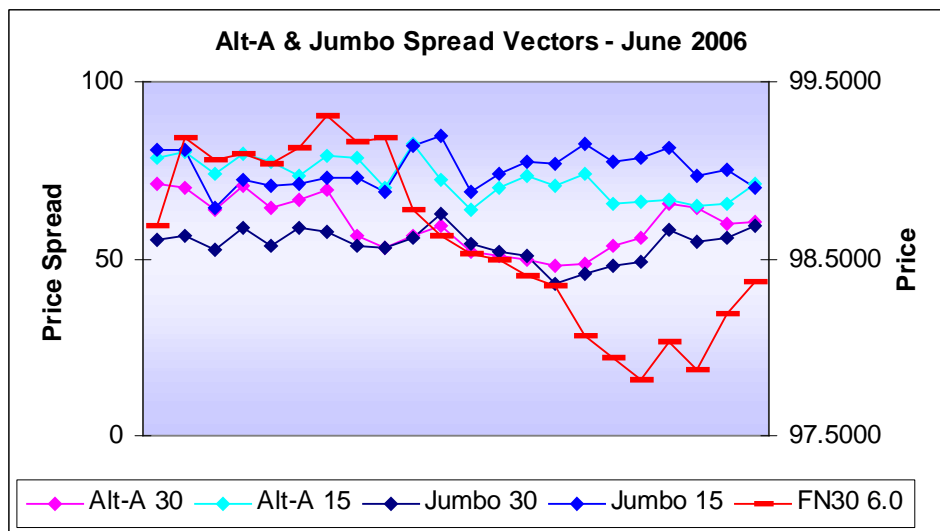
True to the Fed's suggestion, the market remains focused on current economic data although the tone seems fairly positive with dips in prices usually met with buying over the last week. But, much is still left to decide, with a slowing economy at odds with a pick-up in core inflation. The next month may become more volatile as each report pushes the conversation to one side or the other. -Lindsay Hill



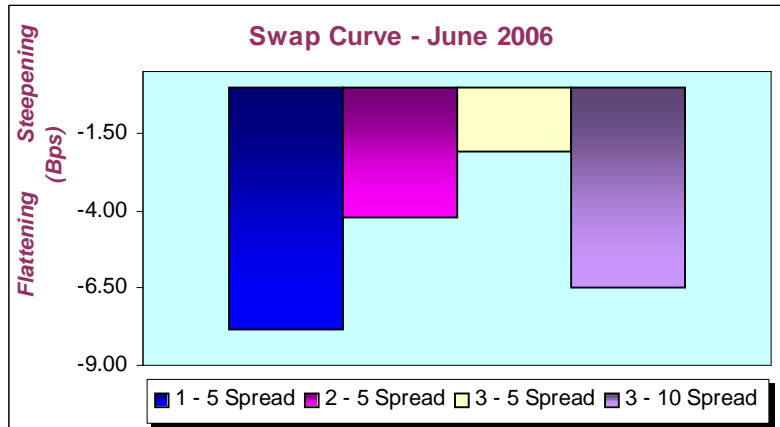
Alt A and Jumbo Spreads

Alt-A and Jumbo spreads moved in a tight range in June, which is interesting given the extreme volatility in the MBS market. FN30 6.0's traded within a 150 basis point range with 9 consecutive days of declining prices. The only significant reaction in spreads occurred on the first day of the sell-off, inspired by higher than expected PPI and CPI reports. FN30 6.0's dropped 40 bps while spreads increased across the board, most noted in the 15 year spreads increasing 13 bps. Both spreads returned to the lower levels seen in the preceding days, and remained within a 3 bp range through the rest of the month. We observed an interesting shift in June in that like-term Alt-A and Jumbo spreads approached similar levels, whereas in the past we have seen the Alt-A spread quite a bit wider than the Jumbo. Such a convergence suggests that investors are starting to perceive and value both products in a similar fashion.

Compass's valuation of the Alt-A and Jumbo Fixed bulks in May derived prices within an 18 bp average range from the winning bids. There was no notable pattern in investor performance, as the highest bids and covers came from several investors. The spread between investor bids continued to decrease resulting in an average range of 115 bps, down 50 bps from the average range at the beginning of the year. -Vimi Vasudeva



Hybrid Arm Hedge Analysis



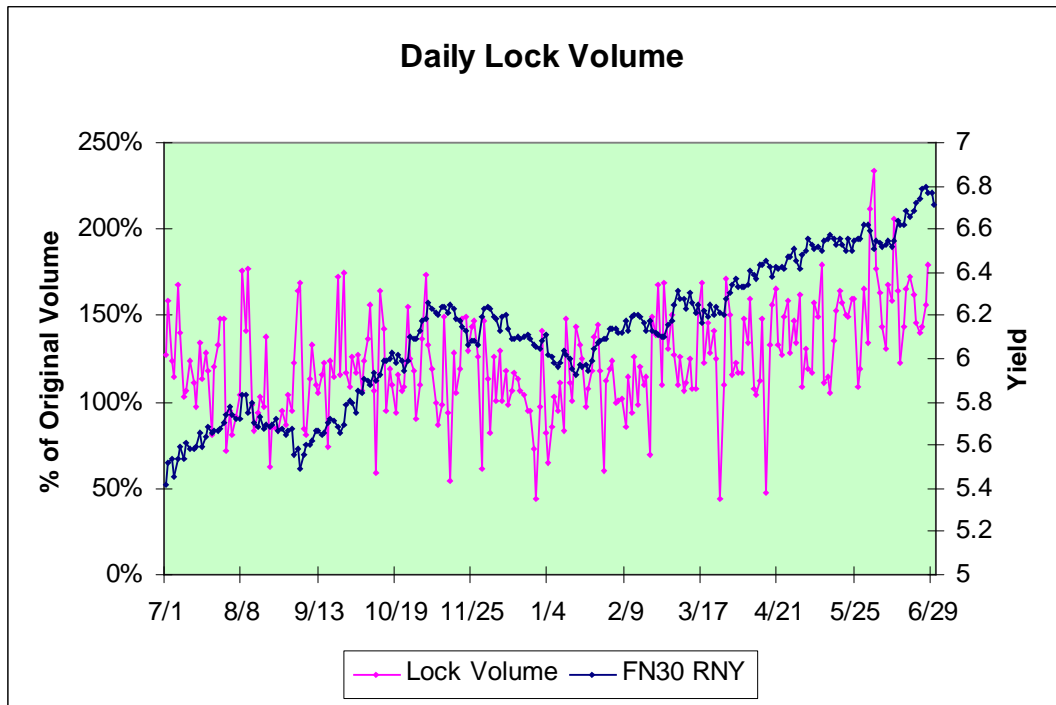
June saw yields pushing higher as the market was agitated by inflation concerns throughout the month. At the end of June the Fed, as predicted, raised the Fed funds rate by 25 bps for the 17th consecutive time. The policy statement indicated inflation risks still exist and future decisions would remain reliant on incoming economic data. The market lost 38 bps over the course of the month and the one-year LIBOR, which gained 18 bps, led swap yields higher, although the 10-year swap yield gained only 6 bps. With short-term swap yield gains outpacing gains in long-term yields, the swap curve flattened throughout last month. By month end, the swap curve was slightly inverted through the 5-year.

At June month end, the EDF hedge had outperformed the Dwarf hedge in all three studies, though all studies finished in negative territory. -Virgil Caselli

Month Ending	Hedge Performance	
	ED (Bps)	Dwarf (Bps)
June 30, 2006		
3/6 Arm	(33)	(38)
5/6 Arm	(22)	(31)
7/6 Arm	(22)	(31)



Production Index



As observed over the last several months, production in June continued to trend upward despite increasing rates. Average volume for the month was 163% of our base volume (vs. 138% in May) ranging from a low of 123% to a high of 233%. The average yield on the FN30 RNY was 6.64% (vs. 6.53% in May) ranging from a low of 6.51% to a high of 6.79%. -Bob Gundel