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The Month In Review

March 2006

What's New?

Later this year, Rob Kessel will be teaching two courses at Fannie Mae's Housing Finance Institute. The topics include "Selling Whole Loans to Fannie Mae" and "Managing Your Mortgage Pipeline" on September 26th and 27th in Atlanta, GA and "Selling Whole Loans to Fannie Mae" and "Advanced Topics in Secondary Marketing: Pricing" on November 7th and 8th in Chicago. In a few months, he will also be teaching a course on "The Residential Mortgage Market" at the ABA's Stonier Graduate School of Banking at Georgetown University on June 14th – 16th. If you would like more information on any of these courses, please feel free to contact us.

New in CompassPoint™!

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

- Continued Development in Loan Level Fallout and Hedge Cost Analytics
- Continued Development in Whole Loan and Structured Cash Flow Tools
- Expanded Arm Hedge Selection Report
- Expanded Default/Loss Severity Models

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.

Market Update

Bond yields climbed once again as February drew to a close with Fed expectations, inflation concerns and global bank rates all contributing to the selling pressure. It took a couple of tries for the 10-yr yield to break above 4.60%, but once that level fell, the move higher was pretty swift. What may have appeared to be a psychological resistance level at 4.75% showed little strength and the next likely level traders are eyeing sits at 4.88%.

On the Fed front, futures markets are pointing to the likelihood of at least two more Fed Funds moves that would place the target at 5.00% following the March and May meetings. Even in a flat or slightly inverted yield-curve scenario, it's reasonable to assume that the pressure on the long end of the curve will remain over the next few months.



The economic releases over the past month were a mixed bag but likely still provided the Fed with ample ammunition to justify further rate increases. Among the releases that came in stronger than the previous month's readings were: personal income and spending, leading indicators, the Philly Fed survey and the NY Empire survey. Retail sales for January also saw a strong gain with an increase of 2.3%. January PPI grew .3%, on the heels of a .6% gain in December, and CPI rose .7% following December's .1% decline.

Job growth also rebounded strongly with the February number coming in at 243k. Although the growth number was above consensus expectations, it was tempered somewhat by a drop in manufacturing jobs and an increase in the unemployment rate to 4.8% (following the .2% dip from 4.9% last month). Even so, the market shook-off some initial confusion and traded down once again.

Bond investors have a couple of things to consider before more significant buying occurs. First, with the Fed still in inflation-fighting mode, where are short-term US rates headed and, given the already-flat yield curve, what does that mean for the long end? Second, what are the European and Japanese central banks contemplating as far as rate increases go and where does that leave the value and demand of US bonds? Given that the answers to these questions may still point to higher rates, any rallies in the near term may only be seen as new selling opportunities. *-Lindsay Hill*

Topic of the Month: Hedge Accounting in Post Effectiveness Testing World

A proposed change to Financial Accounting Standards Board (FASB) statement 133 may allow those lenders employing hedge accounting to cease hedge effectiveness testing and value ALL closed, unallocated loans at market. If this change is implemented, volatility should decrease and accuracy increase in reported earnings.

The existing statement requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. An entity that elects to apply hedge accounting is required to establish at the inception of the hedge the method it will use for assessing the effectiveness of the hedging derivative and the measurement approach for determining the ineffective aspect of the hedge. Those methods must be consistent with the entity's approach to managing risk.

In the universe of mortgage banking for firms hedging their pipelines, statement 133 is a ruling by FASB that allows the firm to book gains on closed, unallocated loans where the hedge is proven effective. The statement applies to this portion of the pipeline because these loans are not considered derivatives by FASB. Prior to FASB 133 (and currently for those not employing hedge accounting), loans in this category received Lower of Cost or Market treatment, or LOCOM, which means no gains can be booked.

Currently, a typical month end FASB 133 summary shows entries for cash and unrealized gains/losses. Cash items include settled loans and current month payoff gain/loss. Unrealized gain/loss items include gain/loss on pull-through weighted unclosed, unallocated loans, residual hedge, and receivables/payables on yet to settle payoffs, all valued at market. These non-cash items also include closed, unallocated loans, though gains are only valued at market if hedged effectively. Losses are always valued at market and ineffectively hedged loans with gains are valued with a zero gain. Unrealized gains/losses are balance sheet items while their monthly changes flow to the income statement.

To date, in proving hedge effectiveness, many lenders choose a method where assets (loans) must be hedged by like liabilities (i.e. short MBS with similar durations). For those lenders, loans and hedges are deemed like by sharing the same duration characteristics and are placed in a bucket which houses a range of durations (for example, bucket 1 being durations from 0-1.99). Proving correlation between the closed, unallocated loans and the hedge resulting in R-Squared of 80% or above defines an effective hedge.



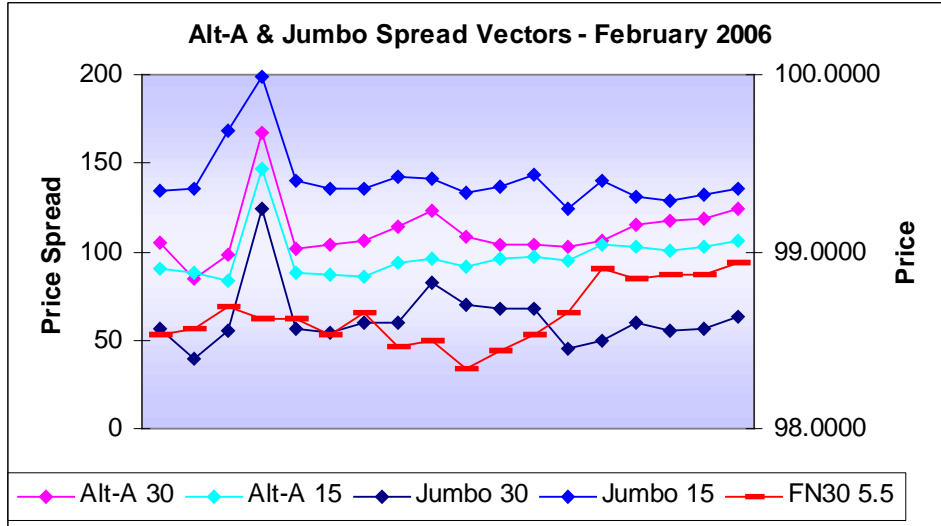
Many mortgage bankers anticipate a proposal currently making its way through FASB to simplify hedge accounting called the “fair value option” which would converge FASB standards with International Accounting Standards (IAS). The proposal would eliminate the requirement that firms demonstrate the effectiveness of the hedge in order to “avoid the time, effort and systems needed to document fair value hedging relationships and demonstrate their effectiveness”. FASB believes this will provide more relevant information than LOCOM treatment. With the proposal, firms could use the fair value option (value loans at market prices) at inception of the commitment and report changes in the fair value of the commitment in earnings. The importance of any changes lie in month, quarter and year end accounting entries, which can improve the financial snapshot of the firm as a result of the ability to book gains that are unavailable with LOCOM treatment.

What does this mean for Mortgage Bankers? With the proposal, gains may be booked on loans which are not effectively hedged, thereby further improving the financial snapshot of firms currently using hedge accounting. Gains may be booked on a wider scope of products for which hedge effectiveness is difficult to prove and therefore may not have been undertaken or were previously booked at LOCOM, such as ARMS. The proposal also opens the door for firms not currently testing the effectiveness of the hedge to use hedge accounting and therefore book gains on the closed, unallocated portion of their pipelines. The only requirement is that the fair value option be applied at inception of the commitment and applied throughout the life of the commitment (until the loan is allocated). Mortgage bankers should embrace this development as it not only reduces balance sheet and earnings volatility, but provides a more accurate view of the firm’s assets and earnings potential. With the passage of this proposal there is no reason for firms to avoid hedge accounting. -*Virgil Caselli*

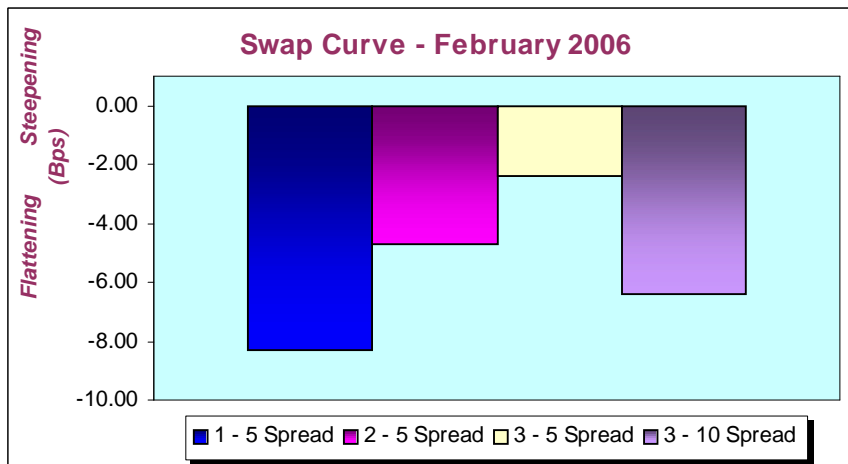
Alt A and Jumbo Spreads

The first week of February, characterized by a volatile spread environment, certainly did not set a precedent for the rest of the month. The week finished with the release of the January Non-Farm Payroll data, which came in much lower than expected and triggered a volatile MBS day, but a light reaction in Alt-A and Jumbo spreads. The moderate reaction was surprising given the pattern we have seen in previous months in which we have observed a significant jump in spreads on NFP day. There appeared to be a one day lag in spreads, as the following day all spreads dramatically widened, as much as 69 bps for both of the 30 year spreads, only to return to previous day levels the very next day. Although we saw several ups and downs in the MBS market, spreads remained stable throughout February with an average daily change of less than 4 bps.

Compass valued ten Alt-A and Jumbo Fixed bulks, for which our valuation derived prices within a 29 bp average range from the winning bids. The range of investor bids remained wide at an average of 144 bps, with the largest variance at 207 bps. There appeared to be no notable pattern in investor performance in February, as no investor won more than two bulks throughout the month, and covers were spread among several investors. – *Vimi Vasudeva*



Hybrid Arm Hedge Analysis



Month Ending	Hedge Performance	
	ED (Bps)	Dwarf (Bps)
Dec 30 2005		
3/6 Arm	(23)	(29)
5/6 Arm	(28)	(39)
7/6 Arm	(29)	(41)

With little surprise, February began with the Fed Funds rate 25 bps higher as Greenspan passed the torch to Ben Bernanke. Though the Fed's move on the last day of January had little impact on the market, an abundance of strong economic data, including a 0.2% drop in the Unemployment Rate, had the market increasing bets on two additional rates hikes by May 10 as opposed to one. Overall, the MBS market lost



15 bps and swap spreads were flatter with the 3-10 spread tightening by about 6 bps, while the remainder of the curve was marginally tighter.

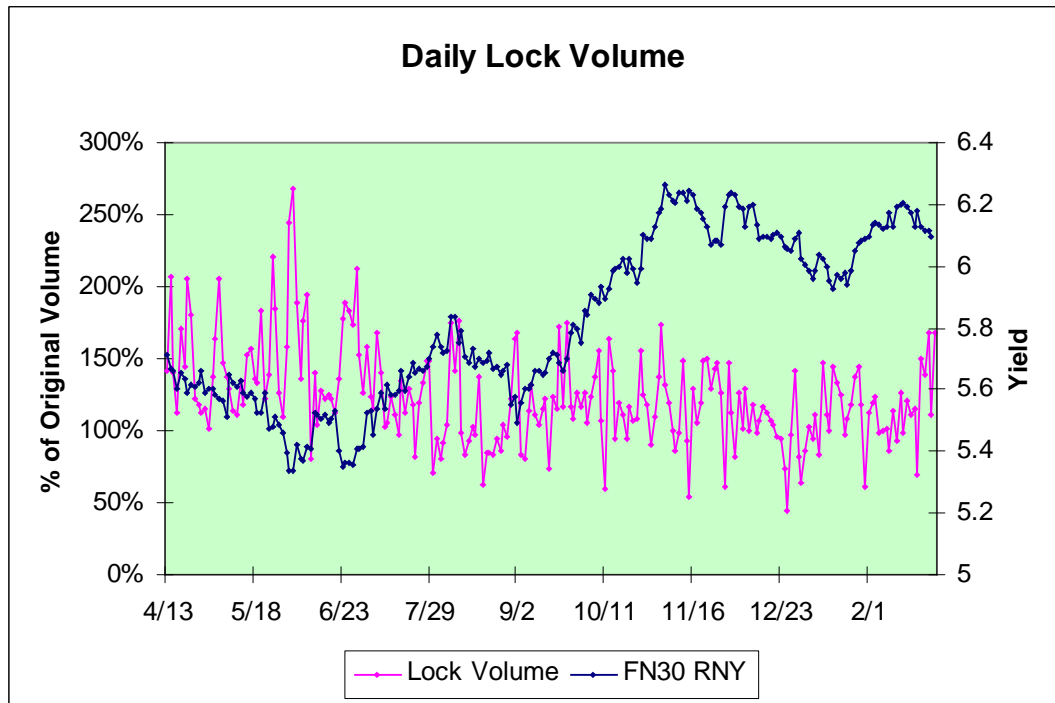
The second week of February saw mostly second tier data releases with the significant event being the return of the 30 Year Treasury Bond. The Long Bond saw strong demand and finished the week yielding 4.55%, below the 10 year and 2 year yields. Despite strong demand for the 30-yr, the market lost 21 bps and swap yields were higher. The 1-5 portion of the curve was slightly wider while the remainder of the curve was tighter, though the most significant move was only 2 bps tighter by the 3-10 portion.

The following week Ben Bernanke testified before Congressional Banking and Finance committees and echoed the policies of his predecessor. His appearance led to small market gains Wednesday and Thursday. A strong Core PPI number did not take a toll on the market on a short Friday as the University of Michigan sentiment index was weaker than expected, leading to a 28 bp gain. Though the swap curve flattened overall, spreads were little changed until Friday, when they tightened an average of 2 bps. The 1-5 portion led the flattening, tighter by about 3 bps for the week.

A holiday-shortened week began with a strong Leading Indicators reading which led to a 15 bps loss for the market. Wednesday's CPI release jumped on a surge in energy prices, though Core CPI was in line with expectations and gave the market a reason to rally 25 bps. The release of the Jan. 31 Fed minutes revealed nothing new. Swap spreads were close to unchanged early in the week and tightened Thursday and Friday across the curve to finish the week slightly tighter. The 2-10 Treasury spread inverted further to finish the week at -16 bps. As the transition into March began, yields continued pushing higher and swap spreads began to move wider.

As seen in the graph, the swap curve flattened overall last month, with the 1-5 and 3-10 portions leading the way. The 1-yr LIBOR yield gained 17 bps and short term yield gains outpaced long term yield gains. At February month end, the Eurodollar Future hedge outperformed the Dwarf hedge by an average of 10 bps with the 3/6 EDF hedge showing the best performance. The 7/6 EDF hedge outperformed by the widest margin and all hedges finished the month in negative territory. *-Virgil Caselli*

Production Index



Production in February continued January's upward trend with average volume for the month at 117% of our base volume (vs. 110% in January) ranging from a high of 169% to a low of 70%. Again, yields on the FN30 RNY traded in a tight range with a low of 6.10% and a high of 6.20% with the average yield for the month at 6.15%. -Bob Gundel