Compass Analytics | 900 Larkspur Landing Circle, Suite 285 | Larkspur, CA 94939 | www.compass-analytics.com

The Month In Review

April 2007

What's New?

Compass continues its expansion and is pleased to welcome Dave Bennett to the team as a Junior Account Manager. Bennett joins Compass most recently from Lehman Brothers where he was a Sales Analyst on the Trading, Agency and Derivatives desk. Bennett holds an Economics degree from Princeton University.

New in CompassPoint™!

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

- ¼ Coupon Security Valuation and Best Execution
- Coupon-Based Specified Pool Best Execution
- Loan-Level Prepayment Adjustors as Generalized Adjustor Sets
- Improved Structured Cash Flow Loan Trace
- Deal/Workspace Management
- Screen Navigation Templates
- Optimized Interactive Valuation
- Ongoing SPIRE integration
- IO and PO Tranche Capabilities in Structured Cash Flows
- Filter Builder

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

The rally in bond prices that started in January continued into March but finally started to fade. Fears of a large-scale collapse in the economy, driven in part by the subprime fallout, started to go stale and the knowledge that the Fed was still concerned with the level of inflation began, once again, to drive the discussion.

The FOMC meeting on March 21st appeared to cause some initial confusion in the market. Bond yields dropped as the phrase "additional firming" was removed from the policy statement, leading many to believe that the Fed was adopting a neutral stance regarding the future direction of rates.

Fed Funds futures responded as participants assumed a greater probability of a Fed move to lower rates in the coming months. This hope was likely ill-founded, though, as further examination, and subsequent Fed statements, tended to reiterate the Fed's fear of stubborn inflation.

Finally, the king of monthly economic reports, the non-farm payroll report, described an employment picture that picked-up steam in March. Job creation significantly topped expectations at 180,000 and the unemployment rate dropped 0.1% to 4.4%. Also, as was the case in the previous month's report, prior-month revisions to the upside added to the job-growth picture. While job-growth numbers are still well-south of what may be expected in a strong expansion, they are beginning to look like the type of numbers that will keep the Fed vigilant on inflation.

Many mortgage sectors still face difficulties as investors continue to sort-out the current credit picture. Conduits with a foot-hold in Alt-A best-efforts production are likely seeing increases in production as originators move away from taking risk on some portions of their pipelines. But, at some point, it can be expected that Wall Street mortgage buyers will want to take back market share and their appetite for risk will begin to grow again. Some products may be dead for the foreseeable future but others may ride out the storm and yet other new products will likely be created. March was a painful month for many mortgage companies but eventually the desire for greater spreads will permeate again and the diversity in mortgage products will likely grow anew. *–Lindsay Hill*

Topic of the Month: The Secondary Manager's Guide to the Dark Side of the Cycle

For publication in the May 2007 issue of *Secondary Marketing Executive*

These days, mortgage professionals are asking each other if they ever remember it being this bad in the mortgage industry. Tales of the previous No-Doc craze and spread blowouts are exchanged without making anyone feel any better about the current tough environment. Yes, we all saw it coming, but now that we are in the midst of it, this part of the cycle is really, really dark. Contributing to the industry malaise is the signification uncertainty around how the performance of lower credit quality loans will impact the housing market and how the potential retreat of the housing market may serve to exacerbate defaults, accelerating the vicious cycle. And to top it off, we are looking down the barrel of hundreds of billions in ARM resets over the nest two years, many of which will reset to payment unaffordable to the borrowers, many of whom who will unable to refinance, given the recent tightening of credit standards.

So what is the secondary marketing manager (SMM) supposed to do in this environment – an environment that has already seen credit tightening from the investors and warehouse lenders alike – an environment that has resulted in substantial secondary losses as product has been written or traded down overnight, while warehouse banks have followed suit substantially raising lender cash requirements. The knee jerk reaction for many lenders and SMMs is to stop originating non-agency product all together and to stop hedging most, if now all, of their production. Instead of throwing the baby out with the bathwater, successful SMMs will return to discipline and fundamentals: Know your profit margins, know which products to hedge, know your delivery options and know your markets. For savvy participants, volatility creates opportunity and those who seize opportunities as they are arise, thrive as others flounder. Below are some tips to help SMM through this dark side of the cycle.

Know Your Profit Margins:

Sound financial planning is always prudent but is particularly crucial during this part of the business cycle. SMMs must begin to face the reality of significantly different production mixes and the impact it will have on the profitability of the firm. Pricing and profit margin policies can not be implemented without regard for overall production volumes. Consider the following simplified, hypothetical example, to put not-so-unrealistic context to the decision many SMMs now face:

Table 1:

ABC Wholesaler – December 2006 – Monthly Production: $100M

Product	Production (M)	Margin[1] (bps):	Gross Revenue
Agency	25	30	$ 75,000
Jumbo Prime	15	30	$ 45,000
Alt-A	35	80	$280,000
Subprime & 2nds	15	100	$150,000
Option Arms	10	100	$100,000
Totals:	100	65 (wtd)	$582,500

1. Margin net of hedge cost and direct commission

Table 2:

ABC Wholesaler – December 2006 – Income

Gross Revenue	G&A, Operations	EBIT
$582,500	$432,500	$150,000

Table 1 reflects a fairly typical production mix for lenders in the late 2006 along with reasonable profit margins net of hedge cost and direct commissions. Table 2 reflects the reasonable operating costs to support $100M in originations. In this example, ABC Wholesaler has pretax profits of $150,000 a month. Now fast forward to Table 3 representing May 2007, where ABC's beleaguered SMM, like many other SMMs, has decided to cease lower credit quality originations and concentrate on agency and higher credit quality production.

Table 3:

ABC Wholesaler – May 2007 – Monthly Production: $ 75M

Product	Production/ Change (M)	Margin[1] / Change (bps):	Gross Revenue
Agency	35 (+10)	22 (-8)	$ 77,000
Jumbo Prime	20 (+5)	20 (-10)	$ 40,000
Alt-A	15 (-20)	65 (-15)	$ 97,500
Subprime & 2nds	0 (-15)	100 (N/A)	$ 0
Option Arms	5 (-5)	80 (-20)	$ 40,000

Totals:	75 (-25)	34 (-31) (wtd)	$254,500

1. Margin net of hedge cost and direct commission

Table 4:
ABC Wholesaler – May 2007 – Income

Gross Revenue	G&A, Operations	EBIT
$254,500	$346,000	-$ 91,500

Table 3 represents ABC's May 2007 production which reflects a 25% decline in origination volume but more relevant, a nearly 50% decline in weighted profit margin and a 56% decline in gross revenues. Like many lenders, ABC tightened credit standards, stopped subprime and 2nd production while facing tighter margins in higher credit quality loans as more lenders chased fewer loans. Despite the painful 20% reduction in operating costs reflected in Table 4, ABC has now swung from a gain of $150,000 to a loss of $91,500.

Beyond providing a realistic scenario facing many lenders today, Table 1-4 highlights additional key distinctions. In Tables 1 and 3, the profit margin is simply provided as a given. Its simple presentation belies the challenge associated with measuring and defining profit margin net of hedge cost, particularly for non-agency product. This challenge underscores the absolute necessity of having accurate day of lock and ongoing valuations for pipelines as well as accurate hedge cost determination. Without accurate profit margins, SMMs may make misinformed decisions on ratesheet pricing and staffing decisions. No less benign are the implicit assumptions for June 2007 and after. Can current margins and production levels be maintained? Will credit standards tighten further? What can de done to improve margins? The first key recommendation for SMMs is to be vigilant regarding assumed and actual profit margins and to actively and realistically model prospective volume and profit margin assumptions.

Know which Products to Hedge:
Before the SMM can determine profit margins for any products in applicable markets, he or she must know what each product's secondary market execution will be. On a product-by-product basis, SMMs must continually decide and reevaluate which products will be hedged and how the products will be delivered. For example, if the price that a single loan will fetch for a best efforts delivery is a net (of hedge cost) 25 bps less than the mandatory delivery, that difference in execution will greatly impact how competitive the SMM is for that product, which will in turn impact attainable profit margins. Notwithstanding, the pressure to improve pricing and profit margins, SMMs must consider interest rate risk, basis risk (the risk that your hedge doesn't track your loan prices) and fallout risk (the risk of under or overestimating how many unclosed loans will become closed loans). On non-agency loans, SMMs must also consider spread or credit risk, the mostly unhedgeable risk that mortgage spreads (additional yield required for riskier products) widen (demand for more spread) causing prices to decline and/or that investors will simple refuse to buy the product. The decision paradigm as to what products to hedge remains the same as it was before 2007: evaluate the opportunity (best execution delivery versus best-efforts price), characterize the risks (interest rate, basis, fallout, credit/spread), decide if the value proposition sufficiently exceeds the expected risks, and continually reevaluate the decision.

Successful SMMs will avoid categorical decisions to stop hedging all products. In this environment, risk is not restricted to hedge risks, but company profitability and viability. Risk/return decisions must be made in the context of how such decisions will impact pricing, production levels and resultant revenues. Return to Table 3 to see what losing 25 bps in execution might do to the realistic recognition of targeted profit margins. Successful SMMs will pick and choose which product they hedge by evaluating each risk/return profile and continually reevaluating their decision. As an example, higher credit quality Alt-A and Jumbo fixed and Arms may represent sufficiently minor spread risk that it makes sense for many SMMs to continue to hedge that product with the expectation that the growing dearth of such product in the mandatory market may result in lager mandatory/best-efforts spreads in the future. For some SMMs, moving all product to best-efforts, even conforming agency product, may simply not be an option, given how tight margins are in their marketplace, i.e., it could actually introduce far greater profitability or cash flow risk. Finally, the decision to hedge certain products does not end once the lock is accepted. Many nimble SMMs minimized losses during the recent credit tightening by quickly selling affected unclosed loans on a best-efforts basis as investors announced underwriting changes.

Know Your Delivery Options:

Beyond determining the actual execution price of a loan or group of loans may fetch, delivery methods can also mitigate losses in many cases. Addressing the former, SMMs must evaluate their delivery options in determining what their best execution price would be by product type. For agency-released production, that may include AOT, bulk and single loan sales. For non-agency released production, best execution delivery may be single loan or bulk sales. As an example, if delivering mandatory Alt-A loans in bulks resulted in 25 bps on average better execution than single loan mandatory sales, that execution price would determine how competitive and with what margin the SMM can approach each market for that collateral.

With respect to troubled loans, enterprising SMMs will consider all viable options in selling recently abandoned credit profiles. One common strategy includes securing additional documentation or other investor requirements from borrowers. In many cases, SMMs can improve their execution prices by several points. Other SMMs are exploring Lender MI when possible. Lender MI can reduce the potential loss of lower credit product sufficiently to make the product more attractive to investors. Some SMMs have negotiated delivery pricing without EPD indemnification. Many SMMs are keeping bulk delivery execution in place on higher credit quality collateral yet performing whole loan best execution when the bulk bids come back – just to make sure they are not being arbitraged by traders fighting for their own gains in this volatility. On conforming product, lenders can profit by revisiting assignment of trade agreements and having that execution in place to compare against bulk bid execution. Successful SMMs continue to test delivery options, network for ideas and continue discussions with investors.

Know Your Markets:

In parallel to establishing which products are hedged and in what ways they are delivered, knowing and understanding the markets in which one originates, i.e., the applicable products and acceptable profit margins can make a successful or unsuccessful SMM. SMMs must be familiar with current production and anticipate changes in future production given changing investor and lender credit standards. SMMs must then actively iterate and freshen targeted profit margins to validate competitiveness and resultant production in each marketplace. Successful SMMs must synchronize projections with reliable production feedback and model and present meaningful production estimates and sensitivity to competitiveness of pricing. In addition to understanding each market's favored product set and acceptable pricing, successful SMMs must be knowledgeable about their competitors in those markets. It is in this environment that expanding production resources can dramatically influence an originator's performance. Successful SMMs who made a point of keeping tabs and developing relationships with competing production resources are now first in line to pick up production resources as competitors close or inappropriately scale back productions. Survey 100 lenders today and at least 20 are growing for this reason alone. To summarize, how well the SMM knows the market knows its marketplace is directly proportionate to the accuracy of his or her Table 3 forecasts.

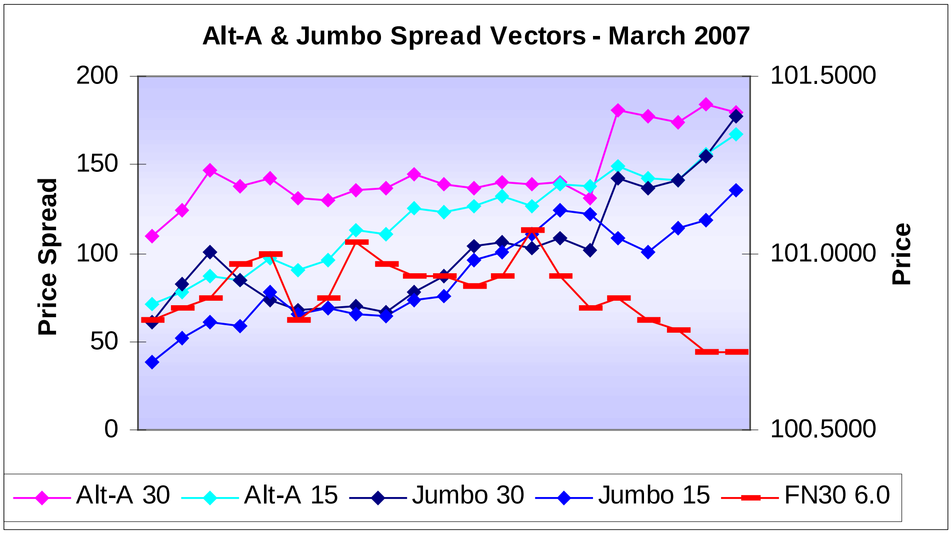
Summary:

Like any crisis, participants often benefit by returning to the fundamental. Many lenders will not survive this part of the cycle. Some lenders will prudently decide to exit gracefully and others will flame out. Many lenders will improve their market share and future prospects through this part of the cycle. Those that follow the fundamental analysis and strategies laid out above will improve their chances of successful navigating this period and emerge from the dark side. *–Rob Kessel*

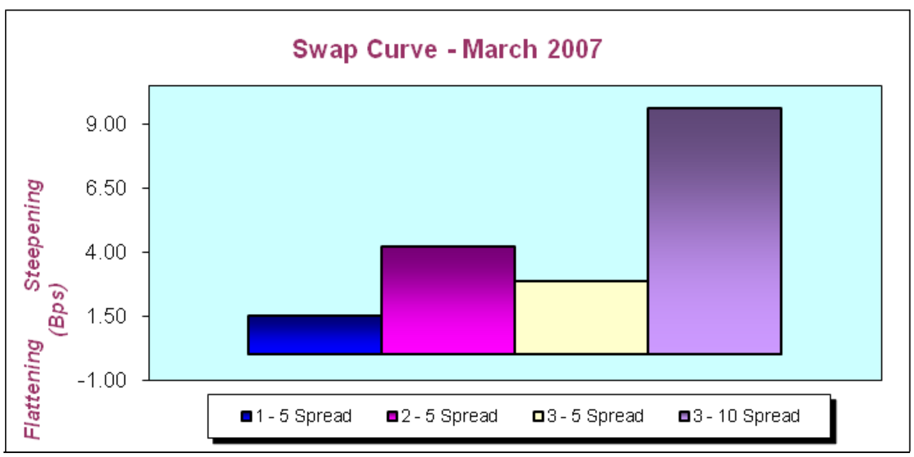
Alt A and Jumbo Spreads

The MBS market was relatively stable through the month of March, with an average (mode) daily change of 1 tick. The largest move of the month occurred on the release of the February employment report, which was in line with expectations. A revision upwards to the prior month, however, caused the market to sell off and FN30 6.0's ended down 6 ticks on the day. Unlike most months, Alt-A and Jumbo spreads did not react to the market move. Similar to MBS behavior, spreads also had a moderate daily change in March, at an average (mode) of 2 bps. Although the daily change was moderate, spreads continued to climb and ended significantly higher by the end of the month. Spreads increased an average of 85 bps, most likely a continuation of the turmoil in the subprime market spilling into the Alt-A world.

Compass's valuation of the Alt-A and Jumbo Fixed bulks in March derived prices within a 30 bp average range from the winning bids. There was no notable pattern in investor performance this month. -*Vimi Vasudeva*



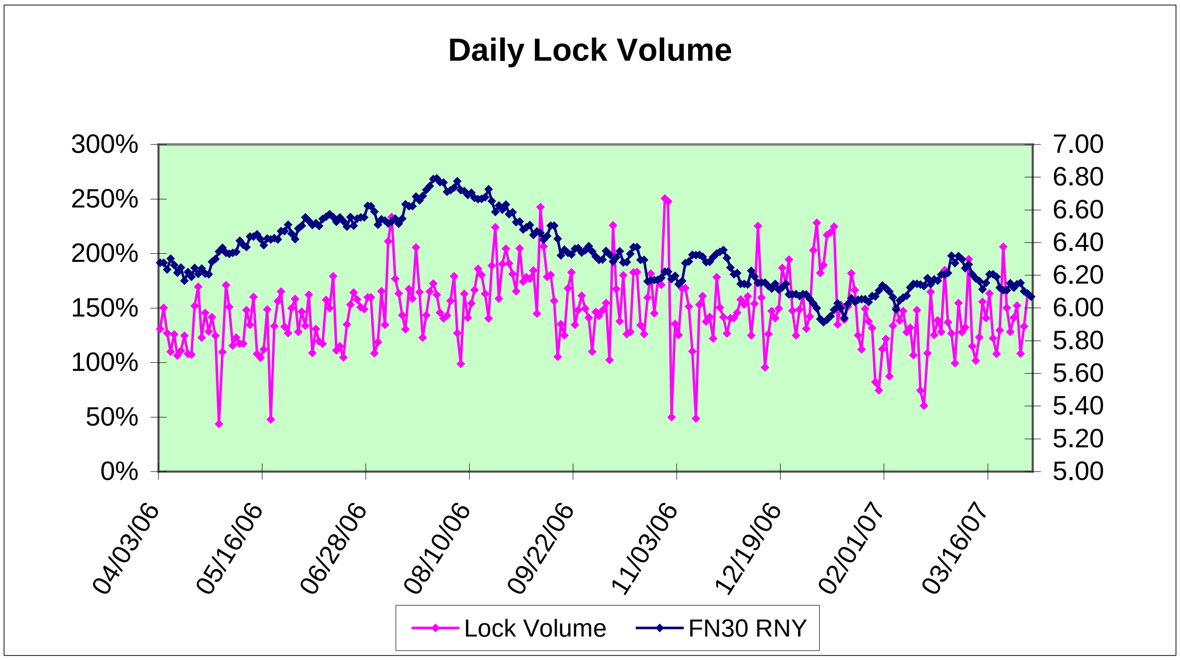
Swap Curve Analysis



Swap yields were mixed and volatile throughout March, especially in short term maturities. Investors interpreted the Fed's policy announcement as a shift toward a neutral bias, which increased speculation of a rate cut later this year, pushing more sensitive short term rates lower.

Yields began to rise again as the Fed reasserted its stance against inflation and strong economic numbers filtered in. March ended with 2 year swap yield down about 3 bps versus an 8 bp gain in the 10 year yield, with the remainder of the curve relatively flat. The 1-10 swap spread finished the month inverted by about 4 bps. The 2-10 Treasury yield spread moved to a positive slope following the Fed announcement and remained positive through month end. *–Virgil Caselli*

Production Index



Production in March increased slightly while rates again traded in a tight range, with the average yield decreasing 11bps from February. Average volume for the month was 145% of our base volume (vs. 140% in February) ranging from a low of 117% to a high of 243%. The average yield on the FN30 RNY was 6.05% (vs. 6.16% in February) ranging from a low of 6.00% to a high of 6.12%. *–Bob Gundel*