900 Larkspur Landing Circle, Suite 285
Larkspur, CA 94939
415-925-2816
www.compass-analytics.com

The Month In Review

August 2005

What's New At Compass?

Compass is continuing to expand and is hiring two new employees this month to join the Compass team!

New in CompassPoint™!

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

- Continued work on AOT best execution, simplification
- Version control consistent with SAS 70 version management and software change controls
- Continued work on Allocation capabilities
- Bulk hedge cost analysis

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 month of July was not a particularly kind one for bonds. Prices for 10-yr treasuries took out one support level after another as stronger economic reports and hints of inflation became visible. The 4.00% 10-yr yield was left in the dust as the volatility seen in June diminished and rates marched higher. As the first week of August ends and the July employment report is behind us, 4.40% appears to be the next line of resistance to challenge the 10-yr yield.

July was filled with economic releases that beat estimates to the upside. Retail sales for June climbed 1.7% and personal income and spending showed solid gains. On the manufacturing side, both factory orders and industrial production showed improvement over the prior month, as did construction spending. Regional activity indexes, including the Philly Fed and NY Empire surveys spiked higher and the July ISM index climbed nearly three points from the June level. Increased strength was also seen in the consumer confidence numbers released in July.

Inflation, as reported in the CPI and PPI releases for June, continued to remain tame, but concern regarding the pace and/or duration of Fed increases gathered steam. As recently as a month or two ago, most analysts considered a Fed Funds rate of 4.00% to be a likely target for this round of tightening. But, with economic strength showing across many sectors, if not in the inflation readings themselves, many Fed watchers began moving up their estimates to the 4.50% range or beyond. The Fed maintained the status quo at the August 9th meeting by increasing Fed Funds by a quarter to 3.50% and continuing their “measured pace” expectation for future increases. But rather than a couple of more .25% increments in store, there is a growing belief that Fed increases may last well into next year.

Adding to a month of strong economic numbers was the July employment report released on August 5th. Non-farm payroll growth climbed to 207,000, coming in higher than the expected 180,000. The June report, originally stated at 146,000 new jobs, was revised to 166,000 and for the second time in two months, May job growth was revised higher. Average hourly earnings growth also accelerated in July and the unemployment rate remained at 5.0%. As may be assumed, the strong employment report sent yields to their highest levels in recent months with the 10-yr treasury pushed up to the 4.40% area.

Although the market gained a bit of a reprieve following the Fed meeting, signs still point to higher rates along the curve. The Fed gave no new indication as to their target, if they have one, for the current tightening but they remain firm in their belief that rates are still accommodative given the pace of economic activity and that more rate increases are coming. Estimates for the year-end 10-yr yield seem to be hovering around 4.75% - 5.00% and it will take quite a bit more selling in the next few months to get there. *– Lindsay Hill*

Topic of the Month: Current Servicing Values

Many industry participants are confused about current mortgage servicing rights (MSR) values because of the published service release premiums (SRP) they observe or receive from the larger whole loan aggregators such as Countrywide, Washington Mutual, Wells, Citi and GMAC. These aggregators offer SRP’s that range from 1.5 points (%) up to 2 points for 25 basis points (bps, or .25%) of servicing value. At the high end, 2% SRP’s translate into 8:1 multiples for servicing value. That multiple stands in stark contrast to multiples observed in the bulk and flow servicing market, which as of late, range from 5-6. Not surprisingly, many industry participants become confused by this substantial difference and believe that either the difference is real or seek answers to explain the difference.

In this month’s Topic of the Month, we seek to provide our insight and explanation to demystify this difference. As we will see, this difference mostly evaporates when you subtract the additional value aggregators earn in their whole loan purchases.

First, consider the **guarantee fees** charged by aggregators. Some aggregators publish the guarantee fee it will charge its originators, others fold it into the price it pays or note rate level adjustments it applies. For the purpose of this example, assume the aggregator pays 1.90 % for .25 FNMA 30 year servicing and charges a guarantee fee of 20 bps to its originator. Further assume that an aggregator’s actual guarantee fee to Fannie or Freddie is 10 bps. That 10 bps of guarantee fee might be worth 4.5:1 when you have to buy down the guarantee fee by that much more (45 bps) or it might be worth 2.75:1 when you have that much less guarantee fee to buy up (27.5 bps). Assuming you buy down half the time and buy up the other half, the guarantee fee advantage might be worth **31 bps** in price to the aggregator.

Next, consider the **tax advantage** realized by whole loan aggregators who are permitted to write off the whole servicing release premium at purchase as opposed to amortizing it down as the servicing stream is received (as they would in traditional flow or bulk servicing transactions). Servicing brokers seem to put that value at 5-10% of the servicing value, or using a mid-point of that range and applying it to bulk values of 1.5%, this tax advantage might be worth **11 bps**.

Next, consider the additional **interest float** earned by aggregators through their delivery cut-off schedules. Many aggregators require that whole loans must be received by the aggregator as much as 3 weeks before BMA scheduled settlement date. That compares to the one week required by lenders issuing their own security. Current drop/float value assumptions would put that value at roughly **6.5 bps**.

Finally, consider the **specified pool** opportunity that aggregators enjoy. Free to package loans from a wide lender base (even AOT deliveries are repackaged into different securities), aggregators can put together single-issue specified pools such as low loan balance, low WAC, geographic, quarter coupons, or even weighted FICO pools. This opportunity may be worth as much as **1 bps**.

If we add this all together, we have the following (all in bps):

SRP	189
Lower Gfee	-31
Tax Adv.	-11
Float Income	- 6
Specifieds	- 1

Adjusted SRP: 140 or 5.6 to 1 well within our range of 5-6:1 reported in the bulk market place.

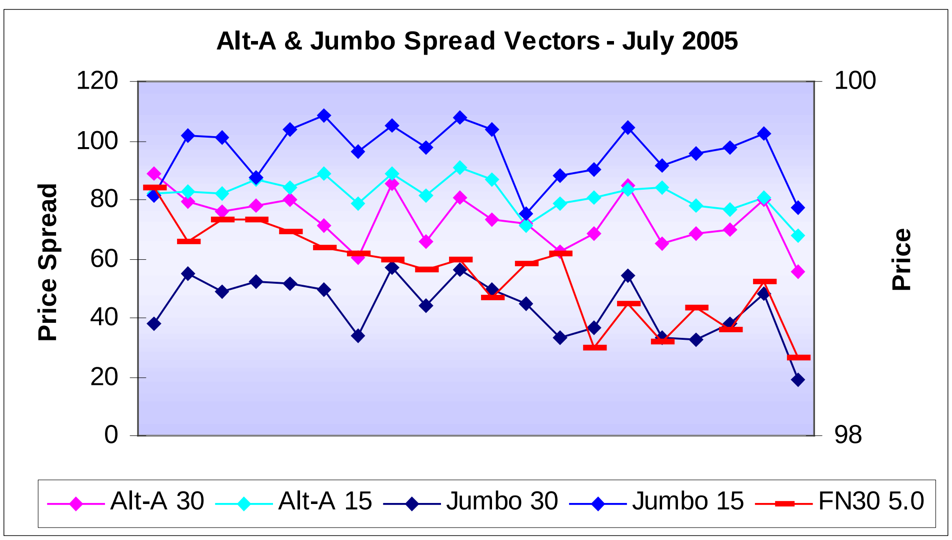
But what about **loan fees** charged by the aggregator? Aggregators still need to QC and purchase the production they acquire as well service their customer base. For the purpose of this analysis, we would regard the lender fees charged and acquisition expenses as mostly a wash. What about the **cost to hedge** servicing? Nearly all industry participants would agree that the hedging of servicing is complicated, risky and possibly expensive. How do we adjust the value of whole loan acquisitions in order to consider the cost of hedging servicing? To this question, we have a two-part answer. The 5-6:1 bulk multiples have already priced in hedge cost assumptions and most aggregators today pass on their cost of hedging the servicing until they acquire it in the form of SRP adjustors that move as par rates move, pushing any decrease/increase in MSR value down to the originator.

Summary: Aggregators pass on a great deal of the value they realize as part of their expertise, scale and size. Although this extra value often takes the form of higher SRP's, we see that for the most part, aggregator MSR valuations are in fact in line with market levels after backing out this additional value aggregators create in their originations.
– Rob Kessel

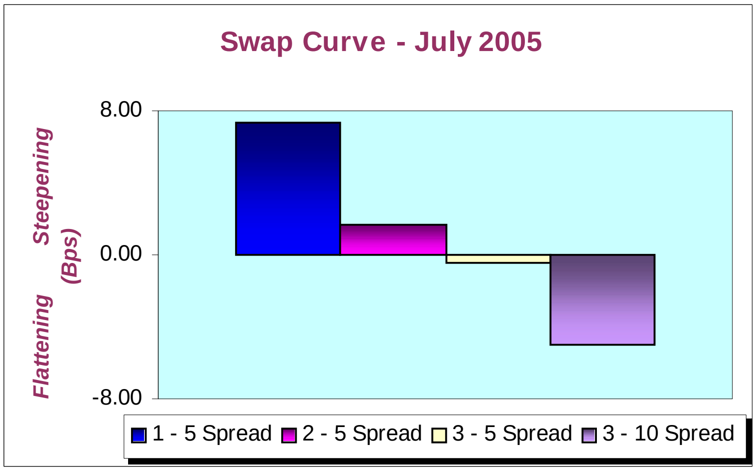
Alt A and Jumbo Spreads

Alt-A and Jumbo Spread volatility increased in July, in which the mode (most frequently observed) change was 10 bps day-over-day for Alt-A 30 spreads. The month started out with another lower than expected Non-Farm Payroll number and a déjà vu reaction as the market failed to rally and FN30 5.0's fell 30 bps. There was a mixed response from spreads, in which Jumbo spreads increased 20 bps, and Alt-A spreads moved marginally. The sell-off set the tone for the first half of the month, in which the market continued a downward trend, and spreads moved unexpectedly in both directions. The market finally found support ahead of Greenspan's two-day testimony in the middle of the month and the market rallied almost ¼ point; 15 Year spreads plummeted, particularly the Jumbo 15 spread, which decreased almost 30 bps. The next big market move, spiraled by the news of China's currency revaluation, sent the market into a frenzy; FN30 5's collapsed over ½ point while spreads interestingly showed no reaction. The market, along with spreads, remained volatile through the end of the month at which point the market observed the second ½ point sell-off in July. Although the previous sell-off caused spreads to widen, this instance provided for a different reaction in spreads, which tanked ¼ point.

Compass valued ten Alt-A and Jumbo Fixed bulks in July, for which our valuation derived prices within an average of 27 bps from the winning bids. The range of investor bids was as wide as 150 bps; 100 bps being the average range. The variance between the highs and lows seemed to be less for bulk packages consisting of both Alt-A and Jumbo products, in contrast to packages containing just one of the two products. This distinction goes beyond supporting that investors have a different appetite for Alt-A and Jumbo packages in general, suggesting perhaps, that investor preferences between the two products could influence their bid depending on the structure of the package. – *Vimi Vasudeva*



Hybrid Arm Hedge Analysis



Month Ending July 29 2005	Hedge Performance ED (Bps)	Dwarf (Bps)
3/6 Arm	2	0
5/6 Arm	12	9
7/6 Arm	17	14

The market had no pity for those still recovering from the long holiday weekend as it continued to sell-off from the first day of the month. FN30 5.0's fell almost 70 bps in the first two business days and the curve steepened, most prevalent in the front end where the 1-5 spread widened by 9 bps. The three-day sell-off was unable to sustain itself as oil approached new highs above $61 a barrel; the curve flattened and continued to do so until the end of the week. The release of June's Non-Farm Payroll report, which came in 50K below expectations, caused a similar market reaction to the previous month. The market sold off on data including upward revisions to the April and May NFP numbers, and profit taking kicked in; swap spreads modestly steepened.

A barrage of economic data, which surprisingly had no real effect on swap spreads, characterized the following week. The mixed bag of news allowed for swap spreads to remain relatively stable until the following week when the market sold off. Although no economic data accompanied the first sell-off, the 30 Yr Swap Yield increased 7 bps day-over-day, increasing swap spreads across the curve. The second significant market move of the week was brought about by China's revaluation of the Yuan, which shocked the market and caused panicked selling. Yields skyrocketed and swap spreads at the front – mid part of the curve approached month highs; the 1-5 spread widened 8 bps from the previous day.

The last week of July observed a volatile market, surprising given the series of economic numbers that were close to expectations. Also surprising is that swap spreads remained nearly unchanged, not moving more than one bp in either direction. The market sold off on the last day of the month on a much stronger than expected Chicago PMI number and swap spreads widened. As can be seen in the graph above, July ended with a steeper curve in the front end and a flatter curve in the belly.

The Eurodollar Future hedge outperformed the Dwarf hedge in all hedge studies in July. Given that the front end of the curve steepened, it is not surprising that the EDFs outperformed by a marginal 2 bps in the 3/6 study, and both hedges nearly broke even. The greater positive performance in the 5/6 and 7/6 studies is what we would expect given their relationship to the belly of the curve, which flattened for the month of July. – *Vimi Vasudeva*

Production Index

July production fell off from very strong performances in May and June. Average volume for the month was 125% of our base volume, with a low of 82% and a high of 167%. The FN30 RNY displayed an average yield of 5.60%. Instigated by China's revaluation of the yuan later in the month, yields began a push towards levels not seen since early April, settling at a high just above 5.70%, on the final day of July.
– *Virgil Caselli*