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## The Month In Review

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*December 2005*

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### What's New At Compass?

Compass welcomes Denise Doerschel as our new Operations Trading Assistant. Denise graduated from Santa Clara University with a degree in Communications and joins us from Wells Fargo where she was a Licensed Banker.

In other news, Compass generated its first agency extracts this month.

### New in CompassPoint™!

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

- Continued Usability and Performance Enhancement on Aggregate Statistic Algorithm
- Finalization of Fannie and Freddie Extracts
- Enhancement to CompassPoint™ Text Output functionality
- Expanded Commitment Detail
- Continued Cash Flow, Credit Enhancement Valuation

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](mailto:rkessel@compass-analytics.com).

### Market Update

The month of November was one of consolidation and volatility for bonds. Climbing to 4.66% early in the month, the 10-year treasury yield eased back during November and for the last couple of weeks has bounced sharply around the 4.50% level. Most economic measures have bounced back from the hurricane-induced slump of a couple of months ago and consumer confidence is on the rebound. The FOMC continued the quarter-point tightening regimen at the November 1<sup>st</sup> meeting, but debate has increased again regarding the likely timing of an end to the current tightening cycle.

Several economic releases from November showed the economy was getting back its pre-Katrina momentum. The mid-month releases of October retail sales and the NY Empire survey came in stronger than expected and industrial production rebounded from a drop in September. The Chicago purchasing managers index also remained strong. Consumer confidence measures, which plummeted following



Katrina, have rebounded strongly over the last two months and with gasoline prices falling sharply, many retailers are predicting a strong holiday season.

The headline inflation measures of producer and consumer prices increased significantly in October, though well below the pace of increases seen in September. While core inflation has remained in check, interest rate markets still have much to be concerned with. Greenspan has continued to prefer the personal consumption expenditure index as a measure of inflation. Personal consumption expenditures can't hide from energy price increases in the same way core inflation readings do. Also, it's not lost on the Fed how well the economy has rebounded from the hurricanes, lending credence to the belief that the overall strength of the economy was and is better than may have previously been assumed.

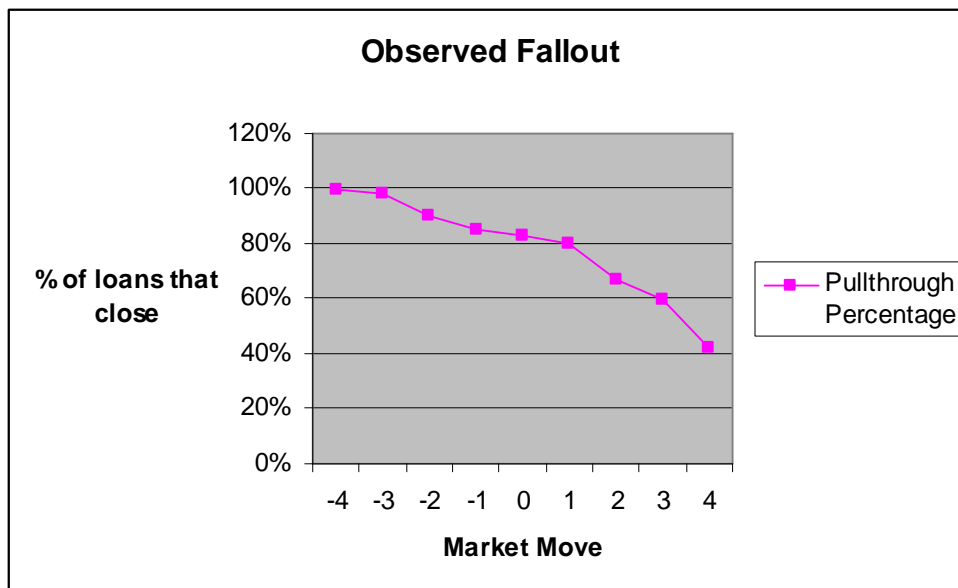
Job growth has also rebounded from the post-hurricane drop. Non-farm payrolls, which showed a decline in September, grew modestly in October and added over 200,000 jobs in November. Average hourly earnings were of some concern in the October report at +0.5%, but the pace dipped back to a more comfortable 0.2% in the November report.

With Greenspan still taking most opportunities to emphasize his inflation concerns, even stating that a "neutral" Fed Funds rate may not be the current target, the market should be prepared for at least a few more quarter-point increases. Given that Bernanke told Congress during his confirmation hearings that he doesn't intend to make any significant changes to Greenspan's approach to monetary policy, Greenspan's continued push towards higher rates is likely to continue somewhat beyond his tenure as chairman. With further increases in short-term rates likely and the yield curve already so flat, the recent consolidation around 4.50% in the 10-year yield may just be a pause on the way to higher rates. *-Lindsay Hill*

### **Topic of the Month: Thoughts, Parameters, and Considerations when Measuring Fallout Risk**

One of the biggest risks Lenders incur when granting loan locks is Fallout Risk. Changes in interest rates not only affect the value of a Lender's pipeline but also have a direct influence on the percentage of loans that will close. By observing and measuring Historical Fallout in a variety of market scenarios, Lender's can create models in order to predict the percentage of loans in their pipeline that will close and adjust their hedging strategy accordingly. Additionally, by analyzing Fallout at the loan level, Lender's may discover ways to adjust the dynamics of their pipelines in an effort to reduce fallout and maximize profits.

There are three scenarios that can occur following a rate lock: rates increase; rates decrease; or rates stay unchanged. In the event that interest rates increase following a loan lock, Borrowers are more likely to accept the terms of the lock and thus a higher percentage of loans in the pipeline will close. In the event that interest rates decline during the lock period, Borrowers are more likely to look elsewhere for a better rate causing a lower percentage of loans to close. In the final scenario rates stay unchanged following the lock date and an average number of loans in the pipeline close. The Graph below illustrates a sample of Observed Fallout.



Following the date the loan was locked, if prices fall and rates rise, a higher percentage of loans should close all other things equal. This increase in closed loans occurs at an inopportune time since the value of the loans closing in this scenario will be valued less than they were at the time the lock was granted. This illustrates how Fallout Risk in a rising rate environment magnifies the Interest Rate Risk that Lender's accept when granting rate locks and emphasizes the importance of a strong hedging policy. By observing historical fallout, Lender's can anticipate increased volume in a rising rate environment and allow for an increase in the amount of hedge. As the value of the mortgage pipeline declines in this example, the short position of hedging instruments should increase in value and help to offset the pipeline's losses, protecting the Lender's profit margin.

Conversely, when prices increase and rates decline, the percentage of loans that close should decrease all other things equal. Although the loans in the pipeline that do close are valued higher than they were at the time the rate locks were granted, the decrease in volume means less opportunity to generate a profit. By measuring historical fallout, Lender's can anticipate the percentage of loans that will close and adjust the amount of hedge accordingly. For example, let's assume that the Lender Pairs-Off hedges at the same time loans are sold. In this scenario, although the Lender may make a profit on his/her loan sales above and beyond their initial margin, they will incur a Pair-Off Cost when buying back their short hedging instruments at higher prices. Having too much coverage on in this scenario would eat into a Lender's profit margin (on reduced volume) again illustrating the importance of measuring Fallout.

In the final scenario, rates are unchanged following the date the lock was granted. Without any influence from changing rates, an average number of loans in the pipeline should close, with the value of the loans being unchanged from the lock date. Again, as an example, let's assume the hedges are Paired-Off at the time of loan sale. Since the value of the hedge is relatively unchanged in this scenario as well, the Lender can expect to make the profit margin on the loan and simply incur a transaction cost on the hedge based on the Bid/Ask spread of the hedging instrument in question.

There are many different factors to consider when measuring observed fallout at the loan level. Loan type, origination source, purpose, stage, lock length, and lock type can all factor into a Borrower's sensitivity to

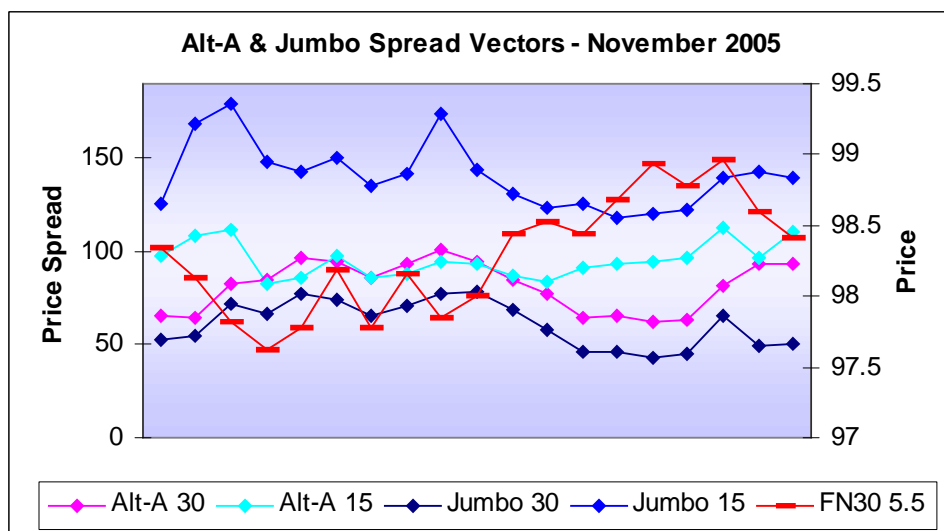


interest rate moves. Additionally the skills of the Loan Officer and even the geographic location of the loan can factor into the probability of a loan to close. By monitoring Historical Fallout through a variety of market scenarios, Lender's can incorporate the findings into their hedging strategy in an effort to create more effective hedges. As described above, Pullthrough rates can directly influence profits, so Lenders often find valuable information in looking at Pullthrough across a number of dimensions, including Pullthrough by originator. -Bob Gundel

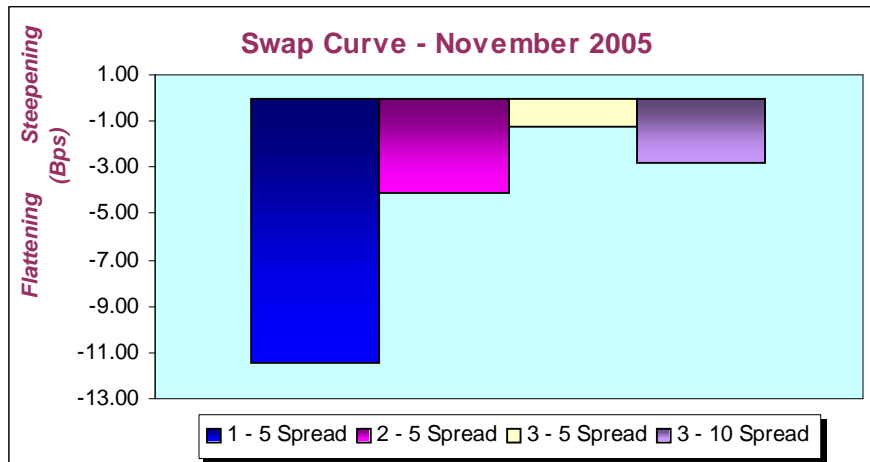
### Alt A and Jumbo Spreads

Given the volatility in the MBS market in November, it is surprising that Alt-A and Jumbo spreads remained as stable as they did. The month started out with a market under pressure, as several news releases pushed MBS prices lower. The first week absorbed another Fed rate hike, a 3<sup>rd</sup> quarter productivity number well above expectations, and a lower than expected Non-Farm Payroll number which failed to spiral a market rally. As the market continued to fall day after day, spreads moved moderately, with the exception of the Jumbo 15-year spread which experienced more volatility, as can be seen in the graph below. The market was extremely volatile the following week as MBS prices bounced around within a 40 bp range. Although in the past we have seen dramatic reactions in spreads with a moving market, spreads did not move more than 10 bps during the unstable market week. This unexpected behavior continued to the end of the month, at which point spreads returned to levels close to those at the beginning of the month.

Compass valued thirteen Alt-A and Jumbo Fixed bulks in November, a quarter of which our valuation was within 3 bps of the winning bids. The range of investor bids was quite wide at an average of 92 bps, with one bulk seeing a range as high as 215 bps. The most competitive investor in October won an even greater share, 50%, of bids in November. - Vimi Vasudeva



### Hybrid Arm Hedge Analysis



Month Ending	Hedge Performance	
	ED (Bps)	Dwarf (Bps)
11/30/05		
3/6 Arm	4	4
5/6 Arm	20	22
7/6 Arm	16	18

November began with the Fed unanimously voting to add 25 bps to the Fed Funds Rate and no notable change in the accompanying policy statement. Friday's NFP release showed a gain of 56K jobs versus an estimated gain of 100K, though mixed data throughout the week plagued the market and gave rise to inflation fears. The MBS market finished off 84 bps for the week and swap spreads widened slightly. A short, though volatile market week followed. Treasury auctions went generally well with a strong indirect bid for the 10 year while oil prices dipped below \$58 per barrel on rising inventories. Thursday's news revealed a record trade deficit and lower import and export prices. The market gained 53 bps through the week and the swap curve flattened overall, with the 1-5 and 2-5 portions leading the tightening, at about 9 and 5 bps, respectively. The following week brought inflation and housing numbers that were relatively benign. While most of the numbers through the week were in line with estimates, Core PPI checked in at -0.3%, well below the forecast 0.2%. The market added 28 bps in another volatile week. The 1-5 swap spread tightened 5 bps, while the remainder of the curve was close to unchanged, though the long end did widen slightly. Thanksgiving week began with a rally on speculation ahead of the FOMC minutes, which signaled that inflation is well contained, helping the market gain 50 bps through Tuesday. The market lost then regained 15 bps in thin trading Wednesday and Friday to finish up 50 bps for the week. The front end of the curve flattened as the 5 year swap yield fell more than the 1 and 2 year yields while the long end widened as the 10 year yield decline did not keep pace with the fall in shorter maturity yields. On the final Monday of November, the 2-5 portion of the Treasury curve inverted, though yields started climbing after Tuesday's strong Consumer Confidence number induced a 38 bps sell off.

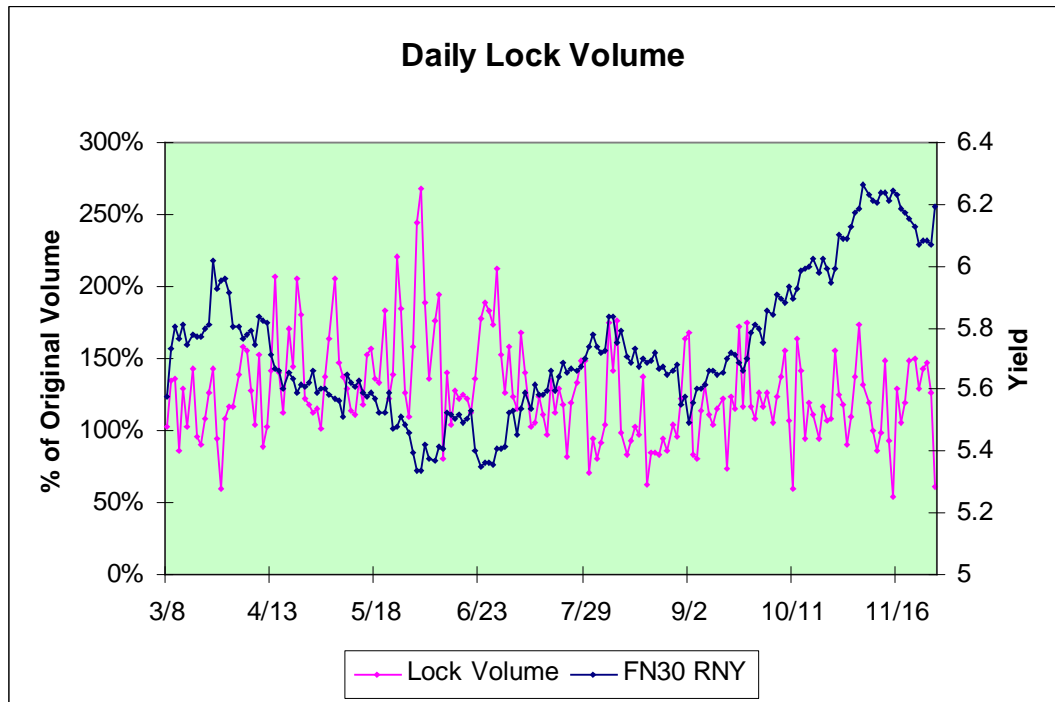


As seen in the graph, the swap curve flattened throughout in a volatile month, though the market gained only 9 bps, with the 1-5 portion of the curve tightening more than 11 bps. The 1-year LIBOR yield was up 10 bps while the 5 and 10-year swap yields were down about 1 and 2 bps, respectively.

The Dwarf hedge marginally outperformed the Eurodollar Future hedge by an average of about 1 bp with all hedges in positive territory. The 5/6 and 7/6 hedges showed the greatest gains. –Virgil Caselli

### Production Index

Production in November stayed relatively unchanged following October's decline. Average volume for the month was 120% of our base volume ranging from a high of 173% to a low of 55%. Yields on the FN30 RNY remained in a tight range with a low of 6.06% and a high of 6.26% with an average yield of 6.18%.



***Happy Holidays and all the best for a Healthy and Prosperous New Year!***