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# The Month In Review

## *July 2005*

## What's New At Compass?

We'll be busy at the Western Secondary conference this week and look forward dot seeing some of you there.

## New in CompassPoint™!

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

- Hybrid Arm Hedge Selection Tool
- Expanded Allocation Functionality
- Enhanced Security Delivery User Interface Efficiency

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 June was one of volatility and consolidation for interest rates. The gains that treasuries and mortgages were able to post since March began to top out and resistance and support levels were tested in succession. Early in June, the 10-yr treasury yield slipped back below 4.00% and traders seemed to be hoping for mortgage servicing hedgers to help fuel another leg of the rally. But the additional buying didn't materialize and yields were forced higher. Major support levels for bond prices held during the profit taking but once again, the path of least resistance appeared to be towards marginally higher rates.

There was plenty of variety in the June economic releases to support a volatile and range-bound trade. Core readings for producer and consumer prices remained very tame but consumer confidence numbers improved. The Chicago PM and ISM indexes dropped from the prior month but factory orders and industrial production improved. Initial unemployment claims began the month on the rise but eventually dropped below the level seen at the beginning of the month. The dollar followed suit as the spot index failed to break through support and, subsequently, resistance and may be establishing a trading range of its own.

As was the case in May, Bill Gross at PIMCO was again in the headlines. His statement that he expected the Fed to raise rates a couple more times before beginning to drop Fed Funds by year-end helped push bond prices up from support levels. At the FOMC meeting on June 30, the Fed stayed the course and

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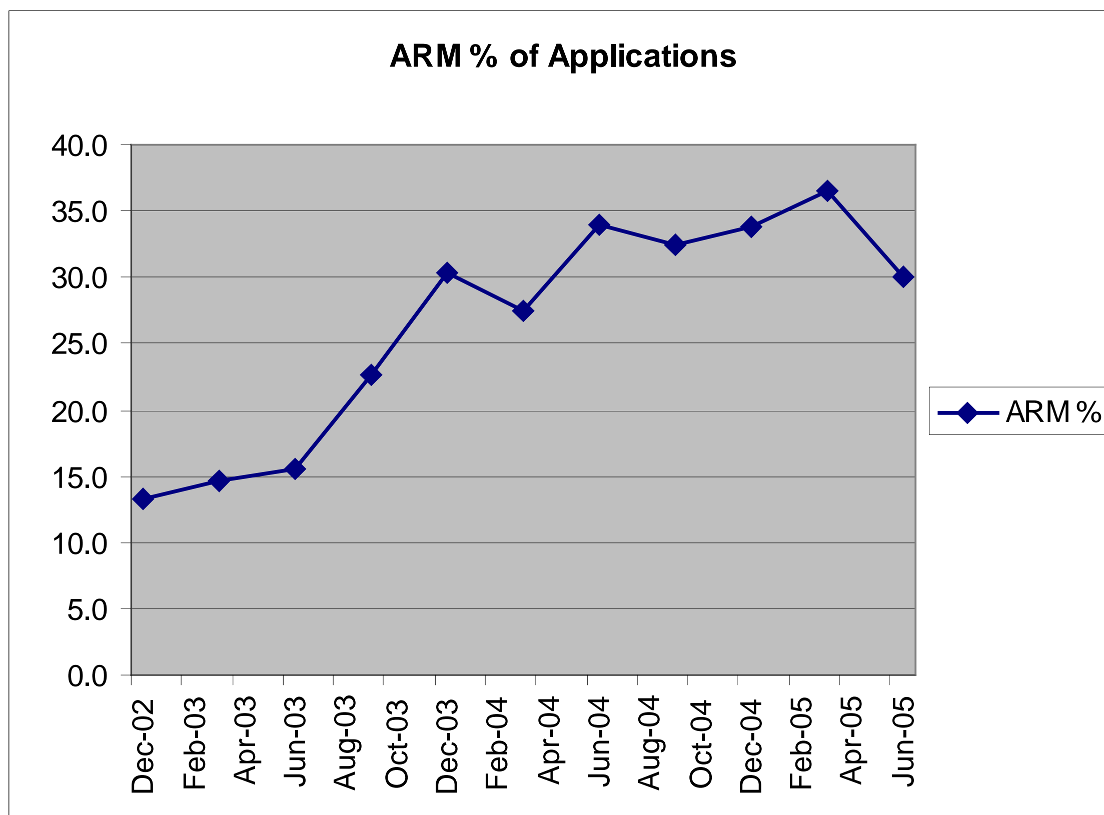
increased the Fed Funds target to 3.25%. But, any hopes for an indication of when the tightening cycle may conclude were shot down. The FOMC statement again pointed to the committee's belief that while long-term inflation remained contained, the economy was on solid footing and current monetary policy remained accommodative.

The May employment report released at the beginning of June helped provide what may be a top to the rally from the March price lows. The June report released on July 8 was neither the 78,000-jobs shocker from May nor the clear-cut rebound in job growth that some expected. June employment growth came in at 146,000 vs. expectations of at least 180,000. But in this case, the weaker than expected growth was balanced in part by upward revisions to both the May and April reports and a drop in the unemployment rate to 5.00%. On the plus side for bonds, average hourly earnings rose by only .2% keeping wage growth contained.

The outlook for bonds remains tough to predict. Rates at the short-end of the curve seem destined to continue the march higher as the Fed appears to have more rate increases in store. Yet long-term treasuries and mortgages must continue to find their own direction. Other than spikes in energy prices, it's difficult to find much in the way of inflation and economic growth has yet to show much consistency. Maybe it's a range trade, defined by volatility near support and resistance levels that we have to look forward to for the next month. – *Lindsay Hill*

## Topic of the Month: A Squeeze Play on ARMs?

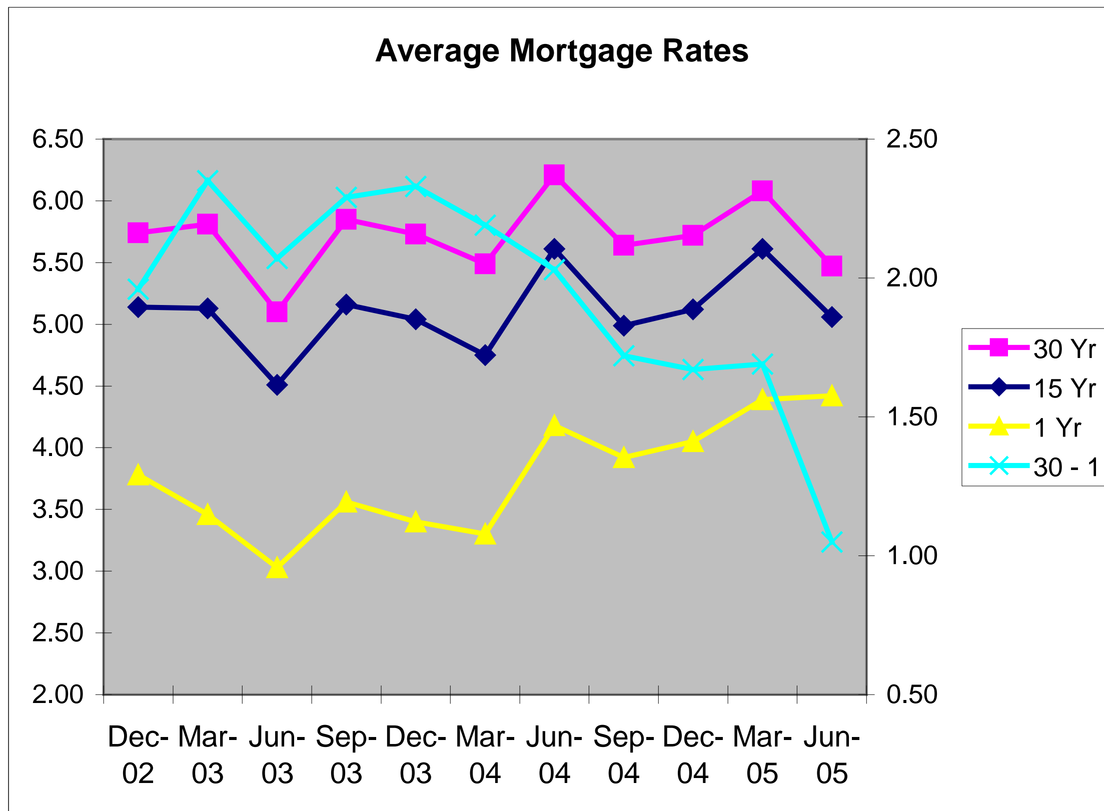
We've all been aware of the growth in popularity of adjustable-rate mortgages (ARMs). As seen in the first chart below, ARMs as a percentage of total loan applications have grown nearly steadily since the beginning of 2003. According the MBAA survey data, ARM volume has grown from less than 15% in December 2002, to over 30% in recent surveys. Only in the last quarter has the popularity seemed to have slipped some. Does the recent slip point to a more pronounced decline in ARM volume in the future?




To help answer that question, it's important to look at the factors that helped lead to the growth in ARM volume over the last couple of years. One major factor in determining whether borrowers are relatively attracted to ARMs is the comparative level of rates available for different borrowing terms. If ARM rates are relatively low compared to fixed rate products, it can be assumed that ARMs will gain market share of total applications. Generally speaking, a flattening yield curve environment, like the one we've been in since the Fed began raising the Fed Funds rate, makes ARMs less attractive in relation to fixed rate products. The flattening curve describes one where short-term rates, like those backing ARM products are rising in relation to long-term rates, like those backing fixed-rate products.

Oddly enough though, over the last couple of years, ARMs have gained volume percentage in an environment where they were becoming relatively more expensive based on average rates. As seen in the MBAA survey information below, average 1-yr ARM rates have increased in relation to 15-yr and 30-yr fixed-rate mortgages. The spread between 30-yr fixed and 1-yr ARM rates (light-blue line on the chart below) dropped sharply from 2.35% in March 2003 to only 1.05% last month. In the same timeframe, the

average 30-yr rate has fallen over 30 basis points while the average 1-yr rate has increased by nearly 100 basis points.




Then, if it's not the relative attractiveness of ARM rates on the whole, what other factors may help explain the increase in market share? The answer may lie in the new ARM products that have become available. The advent of products like monthly option ARMs have given borrowers new ways to get into properties cheaper and keep monthly payments low. In addition to buyers of primary homes, this loan program has been beneficial to the growing number of short-term real estate investors and property "flippers". The low start rates for some of the new ARM programs are providing attractiveness, as is the ability to pay an interest-only or even a neg-am payment.

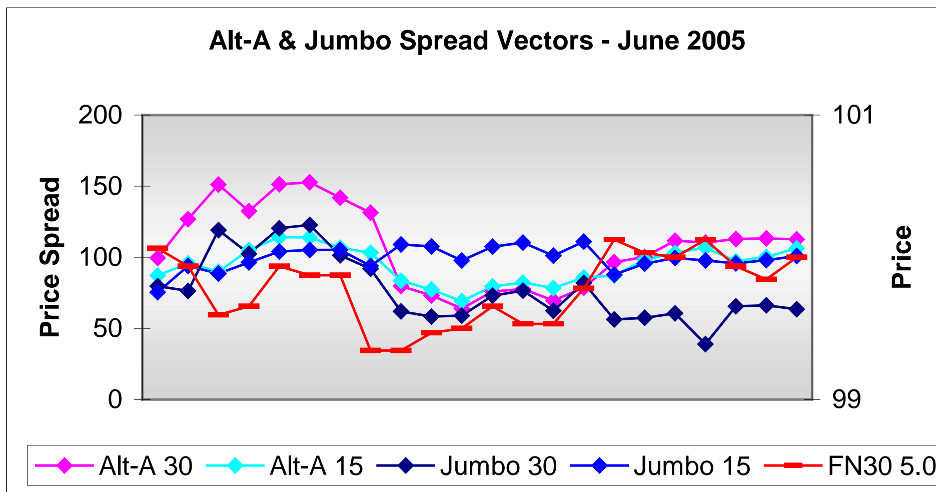
Given that it's reasonable to expect further Fed tightening and, quite possibly, further curve flattening, it's also reasonable to expect ARM volume percentages to decline. But with property prices high, the desire of borrowers to lower their start rates and monthly payments provides some counter-balance. It seems likely that the drop in ARM production relative to fixed-rate production will not occur at the quite the pace that it has increased over the last couple years. – *Lindsay Hill*

## Alt A and Jumbo Spreads

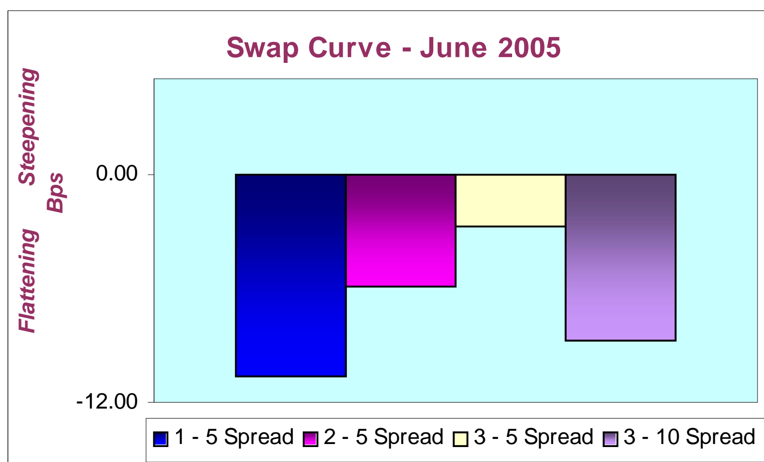
In May's article, we commented on the lack of reaction in Alt-A and Jumbo spreads from significant market moves; ironically, every significant market move in June spiraled a non-trivial reaction in spreads. The reactions were inconsistent, however, with spreads both increasing and decreasing on instances of a market sell-off. The first big news of the month was the much lower than expected Non-Farm Payroll

number. The market failed to rally as profit taking kicked in, and FN30 5.0's fell 35 bps, while 30 yr spreads increased by 40 bps. Greenspan's words two days later nearly reversed the sell-off; FN30 5.0's increased by over ¼ point yet this time spreads followed direction and increased as well. Another Greenspan induced sell-off in the second week observed both market price and spread decreases of ½ point. Although the second half of June provided for a less volatile environment, the ambiguity in spread behavior continued. On two consecutive days in which the market rallied over ¼ point, spreads increased on the first, then decreased on the second to levels lower than observed before the rally.

Compass valued three Alt-A and Jumbo Fixed bulks in June, for which our valuation derived prices within an average of 20 bps from the winning bids. The range of bids was as wide as 100 bps; the cover was consistently 20 bps back and a different investor won each bid. Also consistent was that one particular investor was the lowest bid for all three bulks. *–Vimi Vasudeva*




## Hybrid Arm Hedge Analysis



| Month Ending June 30 2005 | Hedge Performance ED (Bps) | Dwarf (Bps) |
|---|---|---|
| 3/6 Arm | (15) | (23) |
| 5/6 Arm | (5) | (14) |
| 7/6 Arm | (2) | (12) |

Swap curve spreads exhibited a great deal of volatility in June, starting with the shocking 100K lower than expected Non-Farm Payroll number. Although such data would typically spiral a rally, the market actually sold off on profit taking and swap spreads increased all across the curve. The steepening was most noted in the front end, where the 1-5 spread increased 7 bps day over day. The abrupt steepening did not hold, however, and the following week the curve insistently flattened. The flattening was prompted by Greenspan's lack of explanation to the low yield "conundrum" and sustained with more “measured pace” language throughout the week. The belly of the curve flattened most aggressively, where the 3-10 spread tightened 8 bps for the week. Characterized by weaker than expected economic numbers, the following week observed a curve reversal. The curve steepened, and swap spreads at the front end approached month highs. Curve behavior remained relatively stable for a few days, until long-term rates significantly dropped on talk of the Fed continuing to increase short-term rates. The curve flattened aggressively, once more noted at the front end, where the 1-5 spread decreased by 5 bps on the first day, followed by another 7 bp decrease the next. Although the curve began to steepen in the last few days of June, the announcement of the 25bp rate hike from the Fed on June 30$^{th}$ erased any signs of steepening and propelled swap spreads across the curve to month lows.

Akin to what we have observed in the past in a flattening yield curve environment, the Eurodollar Future hedge outperformed the Dwarf hedge in the month of June. The EDFs outperformed in all hedge scenarios by an average of 9 bps. – *Vimi Vasudeva*

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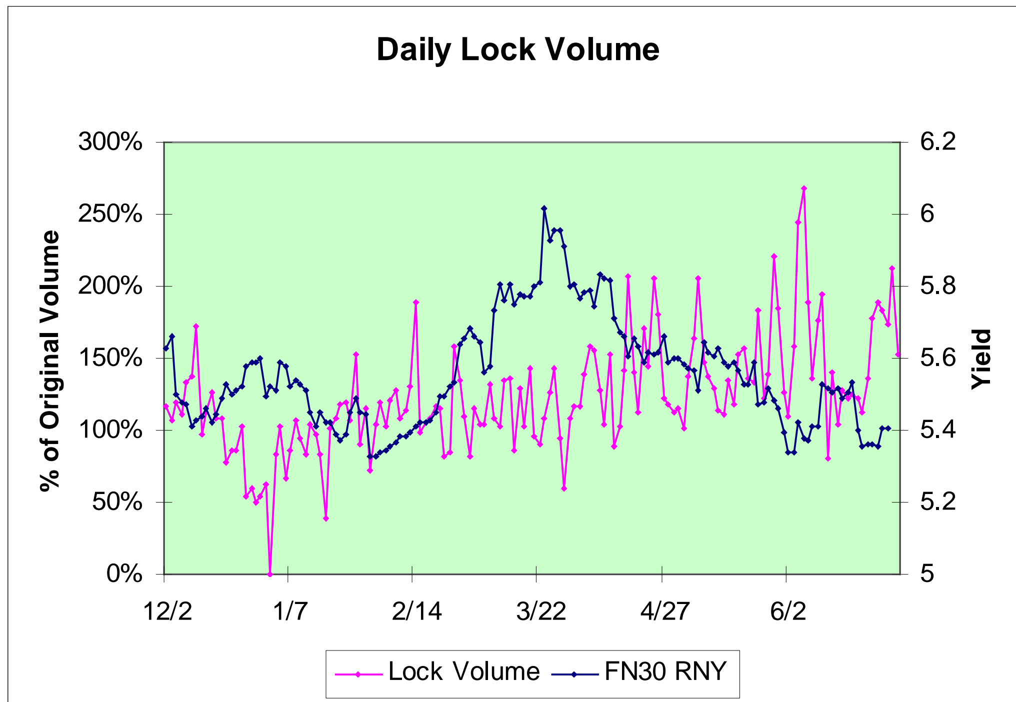
## Production Index

Much like May, June lock volume was very strong throughout the month on lower rates. Average volume for the month was 160% of our base volume, with a low of 81% and a high of 268%. The FN30 RNY displayed an average yield of 5.42%, the lowest average since the month of February, and a range of 5.34% to 5.53%, down from May's range, as rates continued their decline. On the last day of June, the Fed hiked the Fed Funds Rate yet again to 3.25%. – *Virgil Caselli*

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