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The Month In Review

June 2005

What's New At Compass?

June has been a busy and exciting month for Compass – we have now surpassed the 25 client milestone!

Other than that, we're gearing up for yet another conference with the Western Secondary Conference here in San Francisco in mid-July. If any of you are attending, please let us know so we can arrange to get together.

New in CompassPoint™!

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

- Bulk Valuation Bid Summary
- Security and AOT Deliveries
- Intra-Coupon Best Execution Enhancements
- Explicit Coupon-Note Rate Definitions
- New Calendar Tool on Cut-Off's for Delivery and Early Delivery Bonus
- Coupon Dependent Rate Adjustors
- Finalization of Alternative Report Grouping

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

Just when you thought rates couldn't go any lower, along comes May. Continuing the drop that began in March, the 10-yr yield has once again slipped below 4.00% and is showing some resilience at these levels. Although Greenspan appears to want higher long-term rates in order to temper possible real estate bubbles in several areas, various safe-haven moves and weaker fundamentals have conspired against him.

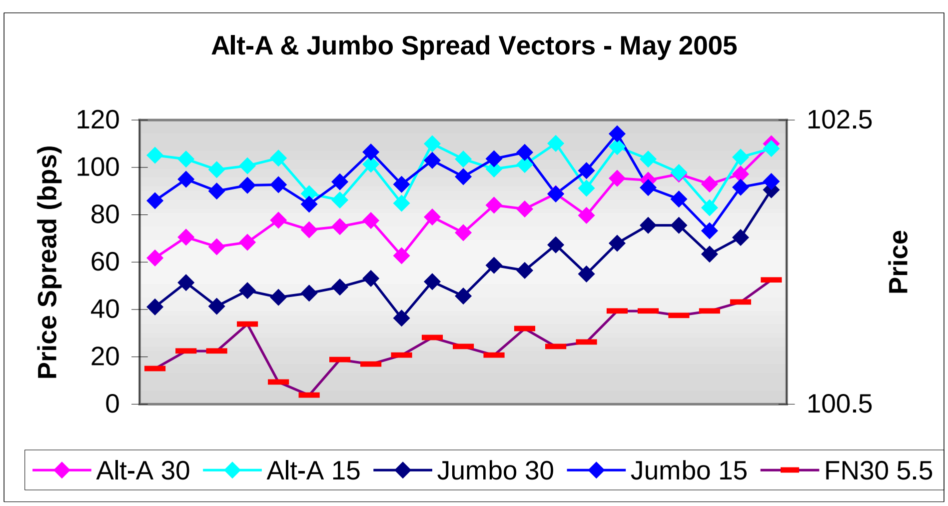
Several factors helped fuel the decline in rates. Early in May, markets were roiled by the news that Standard and Poors downgraded Ford and GM debt to junk level. Soon thereafter, bonds for the two automakers were yielding 800 bps above long-term treasuries, raising concerns for many institutions that rely on investment-grade debt. Rumors of potential problems at various hedge funds added to a flight-to-quality mentality that benefited treasuries and mortgages. Not one to shy away from bold proclamations, Bill Gross at PIMCO (the world's largest bond fund) then said he expects the 10-yr treasury yield to remain within a range of 3.00% to 4.50% for the next 5 years. A rather extreme statement on the surface but given that it came from PIMCO, it was certainly enough to fan the flames a bit more. In early June, dollar-denominated securities got yet another boost when both France and the Netherlands cast resounding "no" votes on the European constitution, a major slap-down for the Euro.

Fundamentals moved mostly in favor of bonds, also. By and large, May production and manufacturing numbers continued the trend of weaker readings vs. the 1st quarter. The Philly Fed survey, Chicago PMI, the ISM index and the industrial production report all showed slowing from the previous month. Much to Greenspan's chagrin, though, housing starts and builder permits were up yet again and home sales readings continued to set new records.

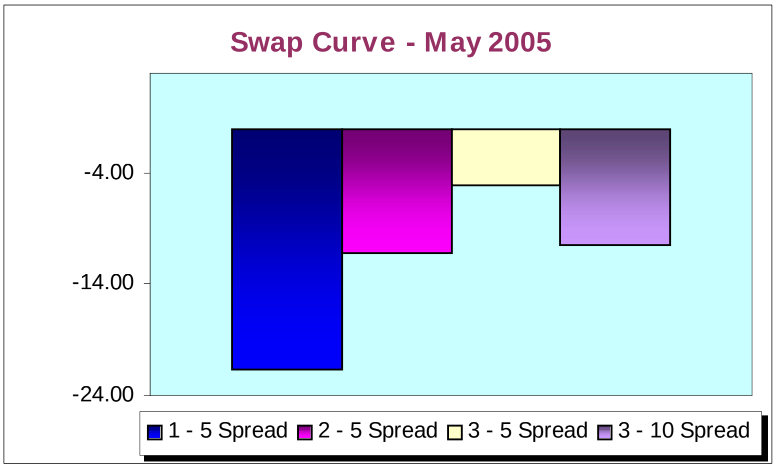
Although the April employment report released in May showed 100k more new jobs than anticipated, the May report released on June 3rd showed about 100k fewer than anticipated. Only 78,000 new jobs made the non-farm payroll report the smallest gain since August of 2003. Bonds quickly sold-off as 10-yr yields approached 3.80% and profit taking took over. But 4.00% provided resistance and continues to do so. Recently, Fed speakers, including Greenspan, outwardly sound somewhat less concerned about long-term rates than was stated a few months ago. With stocks sluggish, oil prices over $50 per barrel and several other issues playing on investors' minds, it suddenly doesn't seem so unreasonable that 10-yr treasuries are yielding 4.00%. *–Lindsay Hill*

Alt A and Jumbo Spreads

May observed greater day over day volatility for Alt-A and Jumbo spreads in which the mode (most frequently observed) change was 9 bps, almost double the daily volatility we have seen in recent months. The stable behavior of spreads in the first week of May is quite surprising given the unexpected sell off on May 6th as the report of a much lower than expected Non Farm Payroll number was released. Spreads moved a mere 2 bps while FN30 5.5's decreased by almost half of a point. This is the third instance in the last few months in which we have seen a lack of reaction in spreads from a significant market move. Compass valued six Alt-A and Jumbo Fixed bulks in April, for which our valuation derived prices within an average of 7 bps from the winning bids. While the range of bids was as wide as 150 bps, similar to what we have observed in the past, we saw one investor win more than 65% of the bids by an average of 23 bps above the cover. *–Vimi Vasudeva*



Hybrid Arm Hedge Analysis



Month Ending May 31 2005	Hedge Performance ED (Bps)	Dwarf (Bps)
3/6 Arm	(22)	(27)
5/6 Arm	(47)	(42)
7/6 Arm	(103)	(95)

There was lots of excitement to start the month of May with news releases that created more volatility in the yield curve. Although May commenced with a flatter curve all around, unexpected news of the Treasury Department considering issuance of the 30-year bond changed the direction of the curve; the steepening was further supported by credit concerns with S&P's downgrade of GM and Ford. Within one day we saw another complete reversal as the non-farm payroll report shocked the market with a 100K higher than expected number, sending swap spreads back near levels at the start of the month and actual swap yields to even higher levels. The curve remained stable until the third week of May where we saw significant flattening at the long end of the curve spiraled by low inflation reads and decreasing long-term rates; the 3-10 spread approached its month low. The month ended on news of the French vote against the EU constitution and sharply declining rates; over 90% of the 2 yr rate's decline in May materialized in those last two days.

Although in the past we have observed a better performance for Eurodollars in a flattening yield curve environment, May's hedge study results were somewhat inconsistent in that the Dwarfs outperformed the Eurodollars in two of the three studies and all studies appeared to realize a loss. As noted on our spread history, this month saw ARM spreads widen out quite a bit while rates dropped across the curve, resulting in ARM prices under performing the hedges and hedge losses. Although not captured in our hedge models, much of the modeled hedge losses were actually mitigated by continued strong demand from bulk buyers where implied spreads were tighter than those derived through our normal spread derivation process.

–Vimi Vasudeva

Production Index

May lock volume was very strong throughout the month due to lower rates. Average volume for the month was 146% of our base volume, with of low of 110% and a high of 221%. The FN30 RNY displayed an average yield of 5.56%, with a range of 5.46% to 5.65%. The Fed's 25 bp rate hike on May 3rd had little effect as yields continued a steady decline from recent highs in March. –*Virgil Caselli*