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The Month In Review

May 2005

What's New At Compass?

It was great to see many of you here in San Francisco last week at the Secondary Conference and look forward to seeing those of you we missed in the near future.

We also wanted to share, for those of you who have not attended a recent FNMA Mortgage Banking course, Rob Kessel is teaching his 3rd of three sessions this week, this time in New Orleans. Topics include a range of subjects from Best Efforts to Mandatory transitions to more complicated sessions around hedging, managing fallout risk, interest rate risk and pipeline risk management solutions. Feel free to call Rob Kessel at 415-925-2812, or email at rkessel@compass-analytics.com if you would like more information.

New in CompassPoint™!

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

- Enhanced Fallout Analysis and Automation
- Allocation Extract Mapping Utility
- Enhanced Loan and Hedge Grouping Tools
- Improved Hedge Bucketing Reporting

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

Bonds again spent most of the last month surprising nearly everyone. Beginning at the end of March, 10-yr yields sharply reversed course and dropped back into the range that had contained them from September until well into February. Volatility increased as yields once again dropped, but bond prices have been able to maintain support levels and demand seems fairly firm at the recent levels.

Towards the end of March, as yields finally climbed out of the multi-month range, bonds appeared quite oversold and the technical picture pointed to at least a small rebound in prices. Add to the technical improvement a weaker than expected employment report on April 1st and bond prices started heading higher once again. Momentum towards higher prices continued to build as crude oil prices fell from their early April highs of \$58.00 to test the \$50.00 mark by mid-month. The drop in energy prices is a blessing



and a curse for bonds but with inflation fears running high, the drop was seen as a positive for bonds. Conversely, stocks were not able to gain ground on the news given Wall Street's sudden parade of analysts predicting slower economic growth in the second half of the year.

Other economic reports began showing the weakness that many on Wall Street were predicting. March retail sales came in at about half of the consensus estimate and consumer confidence numbers were slipping. Inflation measures, including PPI and CPI showed strength and a possible up-tick in pricing power, but this led more to bond volatility rather than a solid reverse back to lower prices.

The Fed continued the tightening cycle, as expected, by raising the Fed Funds target to 3.00%. The accompanying statement left little for the market to grab on to with the language looking much like it has through most of the cycle. It took the treasury, or someone at the treasury, to rile things up a bit. On May 4th, in a statement that surprised and worried bond traders, the treasury said that it was considering new auctions for 30-yr bonds. Yields at the 30-yr end quickly jumped and, to a much lesser extent, so did 10-yr mortgage yields. But again, the market absorbed the news rather quickly and, except for some losses on the 30-, prices were mostly unchanged by the end of the day.

To add to another volatile week in a volatile month, the April employment report released on May 6th showed strength across the board. Job growth came in at 274k, about 100k more than expected and over 90k in jobs were added across the previous two months. Average hourly earnings and the average work week also showed strength. Bonds took a hit on the strong report, but not enough at this point to change the tone of the market back to bearish. Stocks continue to have problems and with stocks moving sideways at best, it looks as though bonds might once again start moving sideways, too.

Topic of the Month: *Renegotiations: The Good, the Bad, and the Ugly*

There may be nothing more painful and draining in secondary marketing departments than dealing with lock renegotiations. Especially in the wholesale arena, renegotiations on existing locks can cause headaches and cost money. Regretfully, the intention of this article is not to impart wisdom on how to best deal with aggressive, me-first brokers, but rather to describe the effects and ways to value various types of renegotiations.

Broadly speaking, lock renegotiations take place whenever changes in the terms of the lock affect the value of the loan in the market. Renegotiations can either be favorable to the lender or, more likely, unfavorable to the lender and typical categories of renegotiations may include: lock extensions, note rate and discount point changes, and program changes. Below are examples of each of these categories and ways to value the G(L) effects of the changes.

Lock Extensions

Given the cost-of-carry assumptions built into mortgage pricing in the secondary market, extending an existing lock lowers the value of the loan, other things equal. The cost-of-carry can easily be seen in the fact that an August MBS of a given coupon is priced below a July MBS of the same coupon. On the cash delivery side, the same effect is displayed where 60-day commitments generally have lower prices for a given loan than do 30-day commitments.

To determine the cost of a lock extension, one needs to compute a daily value for the drop in market price and then multiply that value by the number of days in the extension. For example, if the price to the market drops .25% for each 30 calendar days and the requested extension is 10 days, then the cost of the extension is approximately $(.25\% \times 10/30 = 8.33$ basis points). This would represent a loss in value on the loan. But, in the case where a fee is charged for extensions – let's say .125% for each 10 days – the renegotiation



may actually work in favor of the lender because the amount charged for the extension more than covers the estimated loss in value on the loan.

Since delivery periods are often stratified (a loan ready for delivery in 50 days may be priced at 60 days) actual drops in value for short extensions may not be priced on a daily basis to the market. But it still makes sense for the lender to calculate an estimated daily value, both for ease of renegotiation tracking and to help build extension fee policies.

Note Rate and Discount Point Changes

Changes to the rate/term structure are often what's thought of when the term "renegotiation" comes up in relation to rate locks; borrowers or brokers that intend to close within their original lock period but want to take advantage of improving prices. Simple changes in discount points or rebates are easy enough to value by taking the difference in the new points vs. the original points. Changes in note rate require converting the note rate changes to price values. To convert the rate change, the duration of the product/note rates are used. By taking the average duration (duration defined as the expected price move for a given change in rate) across the two note rates, an estimated change in value can be calculated. For example, if a loan is changing from a note rate of 5.750% to a note rate of 5.500% (and the durations for those note rates are 4.50 and 5.00, respectively, then the estimated change in value = $((5.00 + 4.50) / 2) \times (5.500 - 5.750) = (1.1875)$. Thus, the loan lost approximately 119 basis points in value, plus or minus any change in the discount points collected.

Program Changes

Program changes may or may not fall under the category of renegotiation depending on whether the value of the loan changes in relation to any changes in discount points. For example, a loan that moves from a 30-yr to a 15-yr note is usually not considered a renegotiation if the lock is still within its original lock period and the new pricing is based on pricing from the original lock date. In any case, calculating the value change for a program change is not as easy as valuing extensions and rate/point changes and often requires manually checking the prices of the old and new products and their changes from initial lock through change date.

Renegotiations and Fallout

Renegotiations affect not only the value of the loans in question but also the overall fallout assumptions of the pipeline. To some, fallout may be thought of as that percentage of loans locks that do not close. But, more accurately, fallout is that percentage of loan locks that do not close or that close at a lower-value structure than what was committed to at the time of the original lock.

In calculating estimated fallout percentages for a pipeline, it's unreasonable to consider any loan that has had an unfavorable renegotiation to have fallen out, but some threshold should be established to determine which closed loans did not close at their original terms. A benchmark of .250% to .375% in value change provides a good point to stratify the closed loans. Those loans with negative value changes below the threshold are considered to have closed at their original terms and those with larger negative value changes are considered to have fallen out and relocked at new terms. This information can be very useful, not only to establish pipeline fallout assumptions but also to monitor relative performance among different production channels or individual production sources.

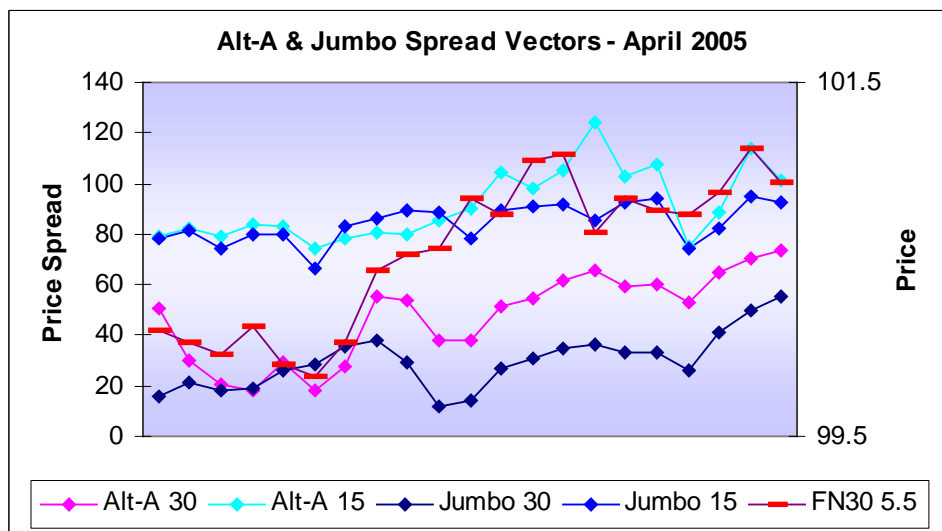
Now, if we can just find some wisdom on dealing with aggressive, me-first brokers.



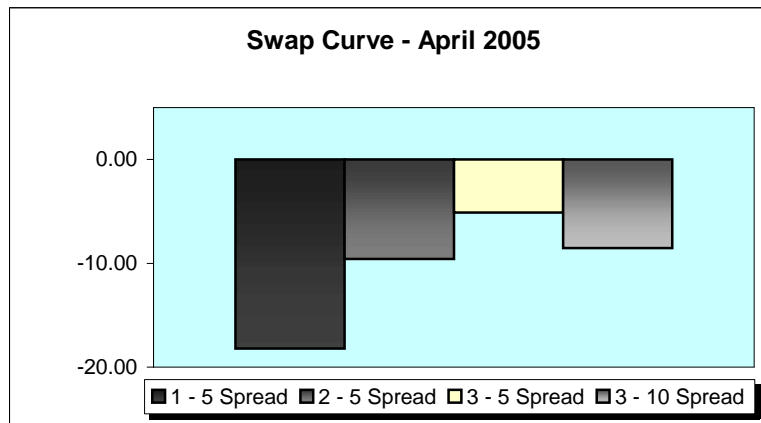
Alt A and Jumbo Spreads

Alt-A and Jumbo spreads in the first half of April mimicked March, in that they remained stable throughout the first half of the month until another FOMC announcement shook things up. The market rallied the second week of April as the minutes of the FOMC meeting diminished concerns about the Fed taking a more aggressive stance; FN30 5.5's increased by almost half of a point. Akin to what we saw last month with such a big market move, but dissimilar to what we usually observe in such an instance, spreads only moved moderately, with the exception of the Alt-A 30-yr spread, which widened 30 bps. As can be seen in the graph below, spreads exhibited more volatility after the rate hike, compared to the first half of the month in which spreads moved by an average of 5 bps day over day.

Compass valued over five Alt-A and Jumbo Fixed bulk bids in April, for which our valuation derived prices as close as 3 bps from the winning bids. We saw more occurrences this month where winning bids were almost 1 point higher than the cover, something we have not seen in recent months.



Hybrid Arm Hedge Analysis



Month Ending	Hedge Performance	
	ED (Bps)	Dwarf (Bps)
Apr 29 2005		
3/6 Arm	(1)	1
5/6 Arm	6	15
7/6 Arm	(22)	(13)

At the risk of overusing the word that seems to be patented by Mr. Greenspan, the "conundrum" in April seemed to drive the volatility behind the yield curve. Although the month began relatively quiet, we saw two instances throughout which sparked significant moves in the curve. The curve flattened dramatically in the second week of April when the minutes of the FOMC meeting diminished concerns about the Fed taking a more aggressive stance. The entire curve flattened, most noted at the front end in which the 1-5 spread flattened as much as 7 bps. The data in the last week of April showed alternating concerns about slower than expected economic growth and stronger than anticipated inflation, creating volatility in the short end of the curve, with a wavering 2-yr swap and increasing 3-month Libor. Ultimately, the month ended with an overall flatter curve; swap spreads flattened more aggressively than observed in recent months and decreased by more than 50% from 6 months ago.

Although in the past we have observed a better performance for Eurodollars in a flattening yield curve environment, April's hedge study results were somewhat inconsistent in that the Dwarfs outperformed the Eurodollars. The results for the month-end can perhaps be attributed to the volatility in the short end of the curve in the last week of April.



Production Index

April lock volume was strong throughout the month, save one day that coincided with the high yield of the month. Average volume for the month was 138% of our base volume, with a high of 208%. The FN30 RNY displayed an average yield of 5.69%, with a range of 5.59% to 5.83%. Yields remained well below March highs as inflation worries subsided. Mid-month, yields began to fall towards the low end of the range as the market rallied.

