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The Month In Review

November 2005

What's New At Compass?

Yesterday, Compass deployed a successful technology upgrade, resulting in greatly expanded broadband capacity for ourselves and our customers.

New in CompassPoint™!

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

- Continued Aggregate Statistic, Data Stratification and Extract Criteria Algorithm Development
- Initial Credit Enhancement Directed Cash Flow Loan Valuations
- Excel, .csv and .txt Mapping Utility
- Expanded Options on Agency Securitization Allocation and Mark-to-Trade Accuracy

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

October was not a particularly kind month for bonds. Notwithstanding a couple of pauses, yields marched higher as inflation fears increased. The 10-yr treasury yield, which sat at about 4.35% on October 7th, climbed its way up to 4.66% for the week ending November 4th. From a technical perspective, beyond 4.64%, resistance to higher yields becomes rather scarce. Talk of a pause or halt in the Fed tightening cycle seems to have disappeared for the moment and talk of a 5.00% Fed Funds rate has begun to circulate.

Economic reports during the month were somewhat mixed, with some measures coming in above expectations and some coming in below. But, there was plenty of data available for the bears to point to keep the pressure on bond prices. Even a drop in crude oil and gasoline prices could not stem the near-constant drift lower for bond prices.

President Bush's announcement of Ben Bernanke as his choice to succeed Greenspan was not unexpected, although the timing maybe was, but the market had to add expectations of a possible Bernanke Fed to changing assumptions regarding the Fed tightening. Fed speakers seemingly sounded more bearish as the month progressed and concerns about the effects of the recent hurricanes faded. Even Dallas Fed president, who has said back in June that he thought the Fed was "in the eighth inning" of the tightening cycle was



quoted as saying that inflation was now at the top-end of the Fed's comfort level and showed no signs of easing.

The October employment report, released on November 4th, showed a smaller-than-expected growth in jobs, but the unemployment rate still dropped to 5.0% and average hourly earnings rose .5%. The increase in average hourly earnings represents an acceleration in wage growth and, one would assume, is well above what the Fed will consider comfortable. Many inflation watchers, in the FOMC or otherwise, believe that core inflation can remain in check until wage inflation begins to accelerate. Thus, any continuation of the strong wage growth seen in the October employment report will not be taken lightly by the bond market.
-Lindsay Hill

Topic of the Month: First and Second Order Effects of a Cooling Housing Market

Yesterday's *Wall Street Journal* reported that the number of purchase contracts signed last month was down 8% nationwide compared to a year ago and down 14% on the West Coast. Other reports have suggested increasing housing inventories and slowing or stagnating house appreciation. Below are some thoughts on how the cooling housing market may impact our business:

- Fewer purchase transactions and cash-out refinance transactions.
- Slower prepayment speeds given lower turnover rate. On a relative basis, this will cause discount agency TBA's to worsen in price (extension risk) and premium TBA's to improve in price.
- Decrease in "speculative" loans and loan products including investor loans, interest only loans, Option ARMs and negatively amortizing loans.
- Potential widening of nonprime spreads. As most nonprime loans are valued at or near securitization value, the rating agencies (e.g. S&P, Moody's) may view certain geographical regions as more risky (greater chance of default), requiring greater credit enhancement (yield) in nonprime securitizations. The question will be what house appreciation scenarios each rating agency already has in place and to what extent those are modified.
- Potential changes to regional default assumptions may also result in changing regional servicing values or SRP adjustments.
- Increased delinquencies may feed back into credit models regarding allowable documentation types, debt-to-income ratios and CTLV.
- More scrutiny on AVM values and appraisal reviews.
- Potential reverse-wealth effect: Many have argued that house appreciation has been behind much of the cash-out refinance activity which has contributed in a non-trivial manner to consumption and economic growth. Freddie Mac recently reported that 72% of its Q3 refinances were cash-out and that extraction through refinance should hit over \$200 billion this year, falling to about \$114 billion in 2006. The previous stock market bust/reverse-wealth effect was mostly offset by the current real estate wealth effect.

At risk of stating the obvious, the extent of the cooling will determine the magnitude of its impact. A current, common assessment is that the cooling will be mild and that factors that contributed to previous housing value busts were more related to regional pockets of economic contraction. – Rob Kessel

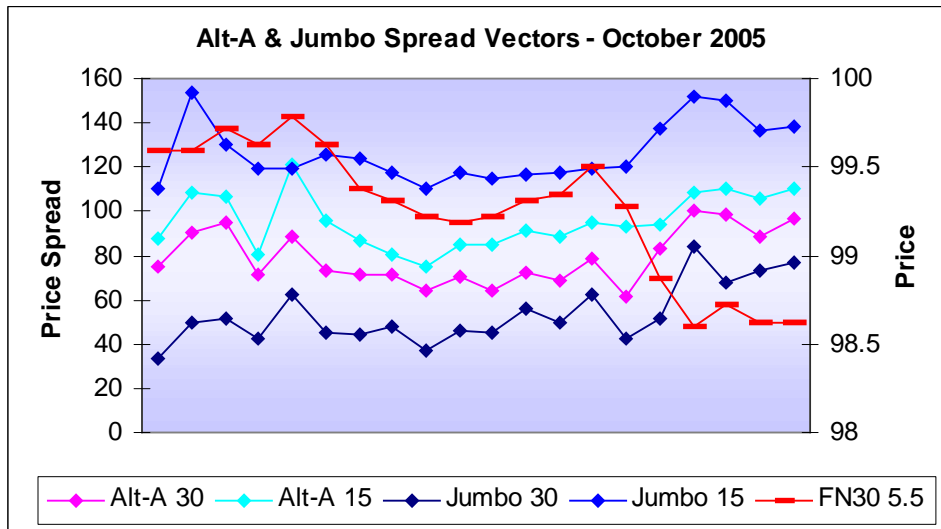
Alt A and Jumbo Spreads

Alt-A and Jumbo spreads remained relatively stable through most of October, despite the volatile beginning and end. Although the market was left unchanged on the second day of the month, spreads widened, most noted in the Jumbo 15 yr spread, which widened 50 bps. Spreads tightened back to first-day levels two days later, only to jump back higher after a market rally on Non-Farm Payroll Day. After that last spike,

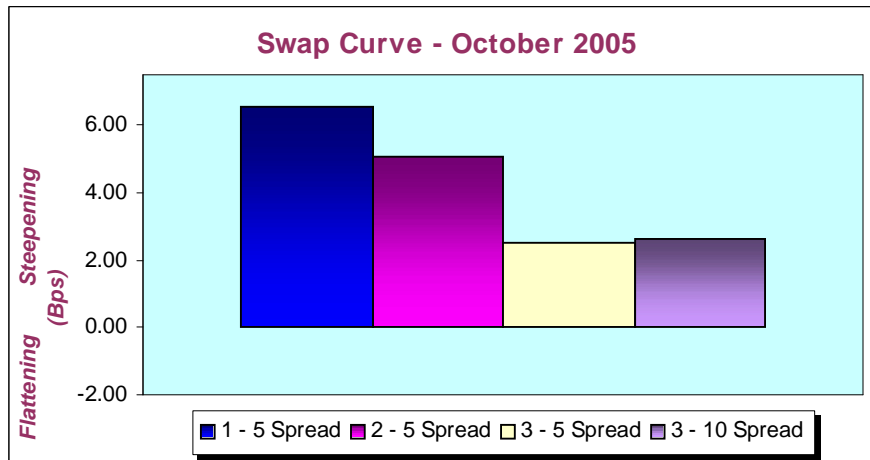


the MBS market, as well as spreads, remained very stable mid-month, in which the average daily change was 2 bps. The market took a turn for the worse the last week of October with the nomination of new Fed Chairman Bernanke, perceived as an inflation hawk. The market sold-off day after day, as much as 40 bps on FN30 5.5's on one day alone. Interestingly spreads increased, although not anywhere near the magnitude of change seen in the market, as can be seen in the graph below.

Compass valued thirteen Alt-A and Jumbo Fixed bulks in October, for which our valuation derived prices with a mode of 8 bps. The range of investor bids increased back to an average of 92 bps, and one particular investor won 1/3 of the bulks this month. *—Vimi Vasudeva*



Hybrid Arm Hedge Analysis



Month Ending Oct 31 2005	Hedge Performance	
	ED (Bps)	Dwarf (Bps)
3/6 Arm	30	20
5/6 Arm	55	35
7/6 Arm	60	37

October began with a strong ISM Manufacturing Index, which sent the market down 22 bps and swap spreads wider, though the ISM Services Index relieved some inflation worries on Wednesday. Friday’s NFP release showed a loss of 35K jobs against an estimated loss of 150K, though the market was uncertain of Hurricane Katrina’s true impact on the jobs situation. The market finished nearly flat for the week and swap spreads widened an average of 2 bps.

A short market week followed with no economic news until Thursday, though the market sank 40 bps as Fed officials, including Greenspan, were speaking on economic conditions and inflation early in the week. The market drifted lower as the news releases began on Thursday, including a significantly higher than expected CPI reading. The market fell off 56 bps through the week and the swap curve steepened overall, the 1-5 by 6 bps and the 3-10 by 5 bps.

A very quiet week of economic data followed with the only meaningful release being PPI, which came in at 1.9% vs. an expected 1.1%, one of the biggest 1 month spikes on record, though the market shrugged it off. The week’s most substantial gain came Friday as Hurricane Wilma strengthened in the Caribbean and sparked a flight to safety. The market, with its only weekly gain in October, added 28 bps. The swap curve flattened overall as the 5 and 10-year swap yields each fell over 9 bps. The 1-5 swap spread led the way, decreasing 8 bps, while the rest of the curve tightened an average of 4 bps.

October’s final week began with the nomination of Ben Bernanke as Chairman Greenspan’s successor. Bernanke’s hawkishness towards inflation was the question of the week, which weighed on the market



quite heavily in another relatively light week for economic releases. A strong GDP number on Friday had little impact on MBS prices. The market declined 88 bps and swap spreads widened overall once again, the 1-5 portion by 6 bps and the remainder of the curve by an average of 2 bps.

As seen in the graph above, the swap curve steepened throughout as the market dropped 118 bps in the month of October, with the front end of the curve widening most significantly. The 5 and 10-year swap yields gained 28 bps each over the course of the month while the 1, 2 and 3-year swaps gained an average of 24 bps.

The Eurodollar Future hedge outperformed the Dwarf hedge by an average of 17 bps with all hedges in positive territory. The 5/6 and 7/6 hedges showed the greatest gains with the front end of the curve steepening as it did. – *Virgil Caselli*

Production Index

Production in October fell off slightly following September's rebound. Average volume for the month was 118% of our base volume ranging from a high of 164% to a low of 59%. Yields on the FN30 RNY continued to increase throughout the month as a replacement for Chairman Alan Greenspan was selected and Fed language indicated further rate hikes were on the horizon. The average yield on the FN30 RNY was 5.98% ranging from a low of 5.84% on the first day of the month to a high of 6.13% on the 31st. -*Bob Gundel*

