900 Larkspur Landing Circle, Suite 285
Larkspur, CA 94939
415-925-2816
www.compass-analytics.com

The Month In Review

October 2005

What's New At Compass?

As Compass continues its growth, we are pleased to welcome Kevin Mapel as our new Trading Assistant. Kevin graduated from Vanderbilt University with a degree in Civil Engineering. He started his career working as an Investment Banking Analyst at Bear Stearns and has spent the last two years at Corrpro Companies as a Corrosion Engineer.

Other than that, we look forward to seeing you at the National MBA in Orlando!

New in CompassPoint™!

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

- Continued Commitment Detail and Reporting
- Enhanced Trade Allocation
- Trade and Transaction Level AOT, Delivery Instructions and Trade Ticket Reporting
- Continue Hedge Cost/Performance Analytics

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

Entering the month of September on the heels of Hurricane Katrina, bonds quickly priced out the probability of further rate hikes by the Fed. The 10-yr yield dropped to 3.98% on the grim pictures from the gulf. But even as Hurricane Rita loomed a few weeks later, bond prices pushed lower as the overall economic effects of the double-whammy appeared to be less severe than originally assumed. With or without the hurricanes, the fear of core inflation acceleration turned yields higher.

Most of the economic reports released in September described conditions in August (i.e., pre-Katrina) and many showed weakening vs. the prior month. The Philly Fed survey and the NY Empire survey showed significant dips in activity and industrial production growth was nearly flat. Following the recent trend, consumer confidence measures dipped further as higher energy prices affected the outlook. Leading economic indicators also fell in August following a drop in July. Personal income dipped slightly in August and personal spending fell 0.5%.

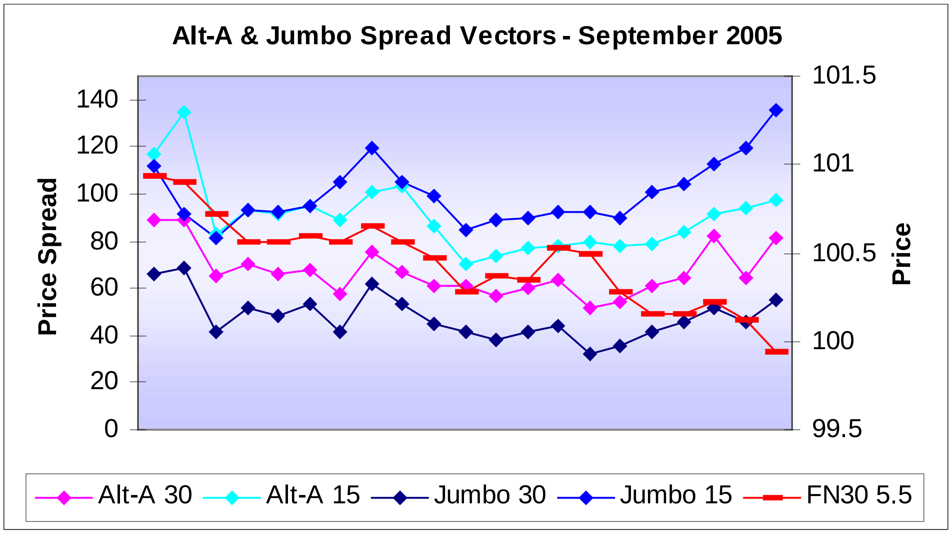
Although economic activity slowed in many sectors, price pressures appeared to build. Energy prices have been on the rise for several months, but until recently it appeared that core inflation would continue to escape the pressure and the flattening of the yield curve during the current tightening cycle projected this belief. It seems unlikely that core inflation can forever defy the pressure of higher energy prices and fairly strong underlying economic growth. While still fairly tame, core inflation has continued to creep slowly higher and the Fed has made it clear, even in the wake of Katrina and Rita, that inflation remains their primary concern. What no one wants to see is a stagflation scenario where weak growth is accompanied by increasing inflation.

The September employment report showed better job growth, when adjusted for hurricane-related losses, than expected. The consensus expectation was for a loss of approximately 150,000 jobs, but only 35,000 were lost overall. The prior month's job growth was revised upwards, also. To balance the job growth somewhat, the unemployment rate increased from 4.9% to 5.1% and average hourly earnings increased only 0.2%. But, the job growth was sufficient to keep upward pressure on interest rates.

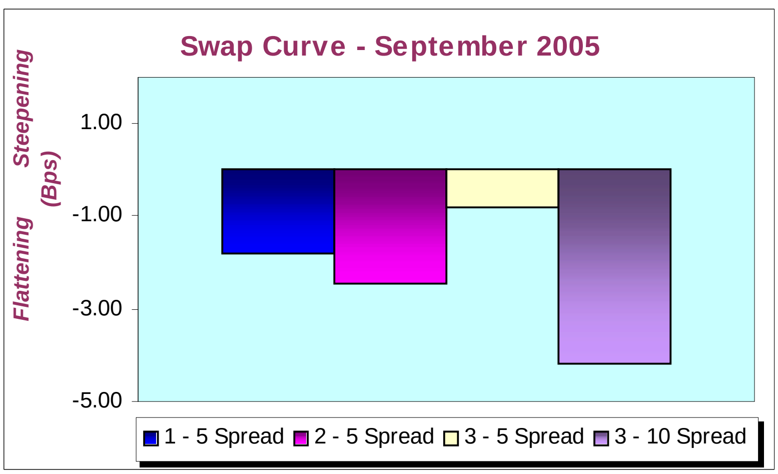
As of October 12th, the 10-yr yield is pushing hard on resistance levels around 4.45%. With the Fed still firmly in the tightening mode, at least through year-end, higher rates appear likely and a steeper yield curve may also be part of the equation. –*Lindsay Hill*

Alt A and Jumbo Spreads

There was no rest for the market after the Labor Day weekend, as the market sold off on a stronger than expected ISM Service Index report and a drop in oil prices. FN30 5.5's dropped almost ¼ point and Alt-A and Jumbo spreads tightened as much as 55 bps in the Alt-A 15 yr spread. The MBS market, as well as spreads, remained very stable the following few days, until volatility picked up with several economic indicators released. The market fell nearly another ¼ point on a much lower than expected Michigan Consumer Sentiment number; 15 year spreads tightened more aggressively than 30 years. As can be seen in the graph below, there were several ups and downs in the market, accompanied by a trivial reaction in spreads. The day-over-day change averaged 5 bps in the last half of the month, with the largest move on the last day. The release of a stronger than expected Chicago PMI number caused the market to sell-off, and spreads shot up in the other direction, approaching levels seen at the beginning of the month. Compass valued seventeen Alt-A and Jumbo Fixed bulks in September, for which our valuation derived prices with a mode of 1 bp. The range of investor bids noticeably decreased this past month with an average of 80 bps compared to a typical range greater than 100 bps. – *Vimi Vasudeva*



Hybrid Arm Hedge Analysis



Month Ending Sep 30 2005	Hedge Performance ED (Bps)	Dwarf (Bps)
3/6 Arm	(20)	(35)
5/6 Arm	2	(23)
7/6 Arm	11	(16)

The first week of September, as is generally the case every month, included the Non Farm Payroll number. The release turned into a non-event and a quiet day in the MBS market, as it was not significantly askew from expectations and preceded the Labor Day weekend. The market held its gains for the week as focus remained on the impact of Hurricane Katrina early in the month, which pushed oil prices up, short term yields down and swap spreads wider.

We moved into the short week with a strong ISM Manufacturing Index and falling oil prices, pushing yields higher. Though there was no significant news, other than falling oil prices as refineries came back on line, the market gave up 31 bps over the course of the week. The swap curve flattened overall, with the 2-5 portion tightening 4 bps and the other portions by an average of 3 bps.

The slide in oil prices continued into the following week and the core PPI number remained unchanged in the first significant news of the week, helping the market on Tuesday to its only gain of the week. Conflicting reads on inflation, including core CPI and manufacturing surveys, sent the market down Thursday and Friday ahead of the Fed's rate decision the following week. The market lost another 31 bps through the week and the swap curve steepened overall, the 3-10 by 4 bps and the rest of the curve by an average of 2 bps.

Though some had predicted, that the Fed would pause its rate hike cycle as a result of Katrina and surging energy prices, this was not to be the case. The Fed routinely tacked another 25 bps to the Fed Funds Rate. As Hurricane Rita lost strength late in the week, previous gains were lost. A volatile market finished unchanged for the week, though the swap curve flattened overall, with the 3-10 and 1-5 portions of the curve tightening 6 bps and 5 bps, respectively.

The final week of September began with a two day Fed speaking engagement including Greenspan and other officials, who remarked on mortgage banking and the U.S. economy. The week finished with a strong Chicago-NAPM number, igniting inflation fears and sending the market down for a loss of 34 bps for the week. Swap spreads tightened overall once again, the 3-5 and 2-5 portions by 6 bps and 4 bps, respectively.

As seen in the graph, the swap curve flattened throughout in the month of September, though the only notable flattening occurred in the 3-10 portion of the curve, which tightened over 4 bps. The remaining portions of the curve tightened an average of 1.5 bps. The 1 through 3 year yields increased an average of 38 bps, outpacing the ten year yield which increased 33 bps.

Given the flattening in the long end of the curve, it is not surprising the 5/6 and 7/6 hedge studies were in positive territory. In the flattening curve environment, the Eurodollar Future hedge outperformed the Dwarf hedge by an average of 22 bps. –*Virgil Caselli*

Production Index

Production in September rebounded after declines in the two months prior. Average volume for the month was 122% of our base volume, with a range from 75% to 175%. Though yields on the FN30 RNY, averaging 5.67%, climbed quite steadily throughout the month, production remained solid. Yields hit a low of 5.49% early in the month with Katrina's impact and settled on the last day of September at a month high of 5.85%. *–Virgil Caselli*