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The Month In Review

September 2005

What's New At Compass?

Summer has quickly come to an end and we are gearing up for yet another conference. This time we'll look forward to seeing many of you in Orlando towards the end of October for the National MBA.

New in CompassPoint™!

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

- Aggregate Statistic Solving Algorithms
- Expanded Commitment Detail and Workflow
- Enhanced Extract Mapping and LOS Integration
- Trade Level Tolerance and Expanded User Interface
- Expanded Day 1 Profit Tools

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

Regardless of what happened prior to the end of August, the past month, and possibly several more months, was defined by Hurricane Katrina. Relative certainty in several areas, including the likely pace of Fed rate increases, was severely compromised. Improving economic conditions and increased inflation fears had pushed rates higher through July and early August with the 10-year yield climbing to 4.40%. Prices then staged a corrective move higher in mid-August, but it was the hurricane aftermath that forced the 10-year yield back down near its recent lows and moved short-term yields even more sharply lower.

Economic reports released in August were somewhat less strong on the whole than those released in July. Durable goods orders, factory orders and the Chicago PMI were among reports that came in below the previous month's readings. Consumer sentiment numbers also dropped as higher energy prices damped confidence in the economy. Although much of the data weakened from the prior month, several releases, including the Philly Fed survey and the ISM index, remained above the base levels and still pointed to growth in their respective measures.



The PPI and CPI releases in August showed the effects of higher energy prices with the overall numbers rising sharply. Fortunately for bonds, core rates remained tame in the short-term but the market, as well as the Fed, is showing concern that core inflation will eventually succumb to higher energy prices. Fed speak throughout the month, even following the hurricane, mostly focused on inflation fears. Concerns about the potential effect on 3rd-quarter GDP took a decided back seat. Bonds rallied as scenes from Katrina unfolded and the devastation was shown to be greater than anticipated. The yield curve steepened in the rally as short-term rates dropped faster than long-term rates, reflecting the initial expectation of a slowing in the pace of Fed increases. But, with the Fed reiterating their concern about possible core inflation acceleration, the curve flattened somewhat as prices began to slip from the post-hurricane rally.

The August employment report, released on September 2nd, showed a decline in job growth from the previous month. But, the report came in within consensus estimates for job growth and the unemployment rate fell to 4.9%. Many jobs will have been wiped away by Katrina, at least in the intermediate term, but some employment sectors will show regional spikes in activity as reconstruction begins.

Basically, like several other economic reports, the August employment report is thought of as "pre-Katrina" and the full effect on employment from the storm is yet to be known. Suffice to say that the Fed is still on inflation watch and interest rates are going to struggle against upward pressure as long as the Fed sees inflation as the primary concern. -Lindsay Hill

Topic of the Month: Challenges in Pricing Non-Conforming Loans

Many lenders employ successful delivery strategies with non-conforming loans (Fixed and Adjustable Alt-A & Jumbo A) that entail hedging and selling closed loans in bulk packages (greater than \$3M). Such lenders are often able to realize substantial execution improvement over Best Efforts delivery strategies. Unlike conforming mandatory pricing, no transparent pricing exists for bulk mandatory non-conforming loan sales. Consequently, many lenders simply take the best Best Efforts pricing and then add some of their anticipated mandatory bulk execution improvement, i.e. they sweeten their price to their originators by some or all of their expected profits. Other lenders gradually ease off on price adjustments as they gain a comfort level that bulk execution results in less negative price adjustments. The challenge lies in accurately valuing this portion of the pipeline.

Lenders who price off of Best Efforts pricing must be cautious as bulk mandatory/best-effort spreads move around on a daily basis and in some cases, an investor's Best Efforts pricing may actually be better than mandatory bulk execution. Given the lack of transparent pricing for these products, how should lenders address these challenges?

Most risk management services, such as Compass, provide lenders with a New Lock report comparing the lender's secondary cost (rate sheet cost + expected profit margin) to a current economic value derived by market pricing on the day of the lock plus any feature adjustments. The first day mark compared to the secondary cost is equal to the estimated marketing gain; the purpose of hedging is to maintain the expected profit margin. If a loan is locked at a loss on day one, there is no hedge strategy that can be employed to mitigate this loss, unless the hedge is not working as intended. Conversely, when a loan is locked in-the-money, it is probable that the gain will be greater than the corresponding hedge cost. This gain, however, would only be realized if the loan actually closed, which is less likely given the ability of borrowers to shop around. A lock that is in-the-money has a higher chance of falling out, which is a cost that one must consider.

The gain or loss of a lock on day one is a key factor in determining the pull-through of the loan, which ultimately affects hedge effectiveness. Consider the example below, in which we have \$10M worth of locks. In scenario



A, we have locks that appear to be 2 points in-the-money, and a pull-through factor of 75%. In scenario B, we have locks that are at-the-money and a pull-through factor of 85%. In this example, the market sells off from the day of lock and is 1 point worse on the day that the loan is allocated. Presumably, we lose on the sale of the loan, but because MBS prices have now dropped, we have profited from the hedge. However, due to the disconnect in the pricing in Scenario A, we have been under covered in the market sell-off and do not realize as much of a hedge gain as we do in Scenario B.

	Amount	MTM Price	Secondary Cost	Pull-Through
A) ITM	10,000,000	102	100	0.75
B) ATM	10,000,000	100	100	0.85

When reconciling Day 1 pricing, one may assume that the ideal result when comparing the economic valuation to the actual secondary cost would be for no or little mismatch to exist. This perception must be balanced versus the various objectives of reporting on Day 1 pricing, and the complexities involved in valuing non-conforming products, as discussed above. Lenders may choose to price products to cash pricing and a standard set of adjustments to avoid large discrepancies in Day 1 price reporting. This method, however, may not necessarily depict the true economic value of the loan, specifically for lenders who sell such products in mandatory bulk packages. With this in mind, lenders may choose to sacrifice a “clean” New Lock report for a more accurate picture of what the aggregate pipeline would be worth if sold bulk mandatory.

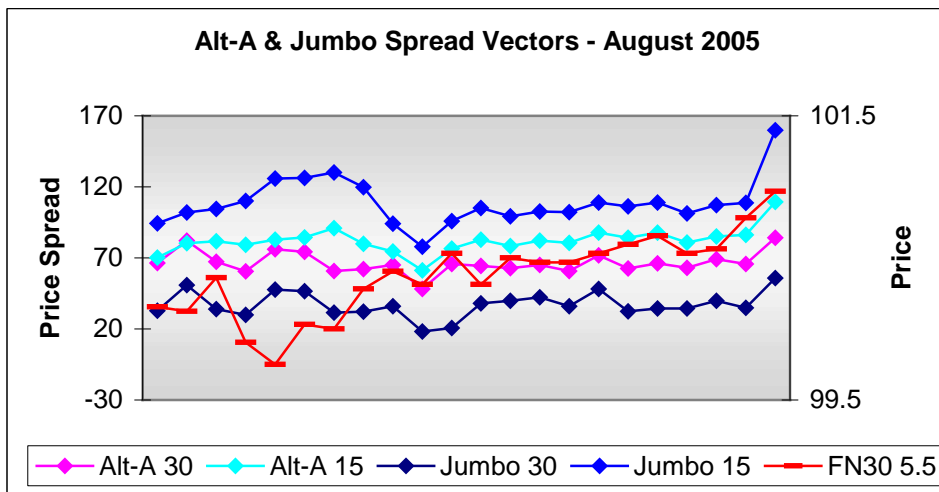
Despite the challenges in achieving a perfect G/L match on a New Lock report, monitoring Day 1 pricing on a loan level basis provides for the opportunity to discover potential issues associated with certain products. A specific program that is continuously locked in or out-of-the-money should be a red flag, particularly if the difference is not compensated for at the time of allocation. In addition to product profitability, analyzing Day 1 pricing aids in determining originator profitability, which can lead to more profitable production strategies. Determining the most accurate valuation method is not only critical to effective reporting and profitability analysis, but the in or out-of-the-moneyness of a lock affects its pull-through percentage, corresponding hedge ratios, and ultimately the hedge cost of the lock. – *Vimi Vasudeva*

Alt A and Jumbo Spreads

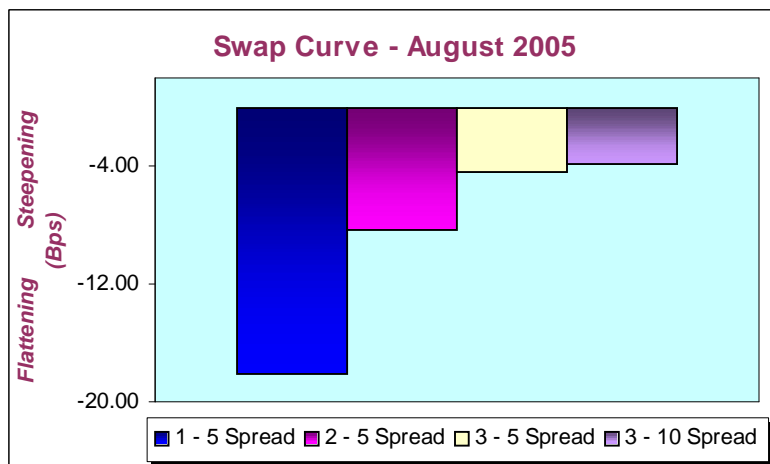
Alt-A and Jumbo Spreads exhibited quite a bit of volatility in the first half of August, unable to stabilize until mid-month. The first significant market move was prompted by official news of the Treasury reissuing the 30-year bond. FN30 5.5's rallied ¼ point, followed by an interesting reaction in spreads in which 30 yr spreads tightened almost 20 bps, while 15 yr spreads moderately widened. Breaking the pattern of the last few months, the July Non-Farm Payroll number actually came in above expectations. Although a moderate deviation, upward revisions to the May and June numbers provided for a market sell-off. The reaction in spreads was somewhat surprising, as the largest change was 6 bps in the Alt-A 30 spread as FN30 5.5's tanked almost ½ point. As can be seen in the graph below, two similar instances followed shortly thereafter, in which a significant market move failed to spiral a reaction in spreads. The first ¼ point rally was instigated by the release of the FOMC minutes, which were less hawkish than some had expected, and the second by a much lower than expected retail sales number. Spreads barely changed, and remained very stable until the end of the month, at which point the effects of Hurricane Katrina priced into the market. On the last day of the month, the MBS market rallied, and for the first time all month, we saw a considerable reaction in spreads.



Compass valued fifteen Alt-A and Jumbo Fixed bulks in August, for which our valuation derived prices within an average of 20 bps from the winning bids. The range of investor bids was as wide as 157 bps; 100 bps being the average range. The cover behind the winning bids appeared to be further back than observed in recent months, with a mode (most frequently observed) cover back by 25 bps. – *Vimi Vasudeva*



Hybrid Arm Hedge Analysis



Month Ending	Hedge Performance	
	ED (Bps)	Dwarf (Bps)
July 29 2005		
3/6 Arm	-7	-2
5/6 Arm	-19	-8
7/6 Arm	-41	-27



August started with a strong ISM Manufacturing report which sent the market down 4 ticks. Mid-week, the Treasury officially announced the widely expected return of the 30-year bond. A strong Non-Farm Payroll report on Friday, which came in well ahead of expectations, gave the market reason to sell off, with FN30 5.5's finishing the week down 37 bps. The swap curve steepened, though marginally, with the 1-5 spread widening 4 bps, and the remaining portions 1 bp or less. We moved into the next week with no news, although the market lost 20 bps with Treasury auctions and a Fed meeting looming. The Fed raised rates 25 bps and the policy statement was benign, igniting a rally in the MBS market with FN30 5.5's closing up over a ¼ point. Soft economic data and rising oil prices sustained the rally through the end of the week as 65 bps were tacked on from Monday's low. The swap curve flattened about 11 bps in the 1-5 portion and tightened throughout. A week of volatility set in with a rally on the core CPI number and sell off the following day as a result of core PPI. The market rallied again on Thursday, albeit for no apparent fundamental reasons, as jobless claims and leading indicators were in line with expectations. Though the swap curve flattened, it was nearly unchanged for the week as no portion tightened more than ½ bp. The following week had been quiet with no surprises and mostly second tier economic data releases until Friday, when Mr. Greenspan took center stage from Wyoming. The Fed Chairman expressed that rising asset prices and abundant liquidity are increasingly considered in policy decisions. The market had been drifting upward for the week until Friday, when FN30 5.5's lost 13 bps. The curve flattened, with the front-end and the long-end each tightening about 4.5 bps. In the final days of August, Hurricane Katrina battered the Gulf Coast and sent oil prices soaring through the \$70 per barrel mark. The Ten Year Treasury briefly dipped below 4% amid a rally set off by the storm's chaos. The swap curve in this period began to steepen as short-term rates dropped more rapidly than long-term rates.

As seen in the graph, we flattened throughout the curve in the month of August and most significantly in the front end. The 1-5 spread tightened 18 bps as the 5-year swap yield fell considerably more than the 1-year. The Dwarf hedge outperformed the Eurodollar Future hedge in all studies in August, though all hedges performed negatively. Given the sharp flattening in the front end, it is not surprising the 3/6 Arm hedges fared better than the 5/6 and 7/6 hedges. – *Virgil Caselli*



Production Index

Production in August fell off from July, which is the second consecutive month of decline. Average volume for the month was 102% of our base volume, the lowest average we have seen for some time. The FN30 RNY displayed an average yield of 5.713% and fell late in the month as Hurricane Katrina induced a rally. On August 31st, yields settled at 5.552%, the low for the month. – *Virgil Caselli*

