

CDO/CDS Update 07/11/05

I. Commentary

Issuance of synthetic structured finance (SF) CDOs remains brisk despite the lack of consistency in standardized documentation on ABS CDS. The ISDA has so far published two versions of standardized template for CDS of structured products; one for one-time cash settlement and the other in a pay-as-you-go (PAUG) format. However, the latter is called "Dealer Form," and yet another version, namely for the use by monolines, is expected to be published soon.¹ The disagreement on credit events and settlement procedures resulted in the two varieties of the PAUG template. For now, deals are using tailor-made documentation for synthetic ABS exposures, which may pose some incremental risk. For example, one synthetic ABS-reference deal priced last week, called Pascal CDO, uses a total return swap instead of a CDS to transfer the risk of high-grade structured assets such as RMBS, ABS and CMBS. The deal's triple-A tranche priced at 3mL+43.

CDS spreads finished the week marginally tighter as the stock markets rallied on Friday. The 5-year DJ CDX.NA.IG tightened slightly from 60.0 bps to 58.7 bps. The 30-name high-volatility sub-index also closed a touch tighter at 125.2 bps. The DJ CDX.NA.HY index finished the week about 10 bps tighter at 382.9 bps. The index spreads remained wider than their theoretical levels. Crude oil futures reached the record high close of \$61.28 on Thursday, but finished the week below \$60 as concerns about damages from the Hurricane Dennis subsided. On Thursday, stock prices initially fell sharply and credit spreads gapped wider in the wake of the terror attacks in London. However, both markets quickly recovered after the initial sell-off. The rally continued on Friday after the non-farm payroll for June came out at 146,000, with an upward revision to the May figure to 104,000.

Auto CDS spreads remained wider, lagging to cash bond spreads. Just days after GM announced that its June sales jumped 41% from a year earlier, thanks to the "Employee Discount" promotion, Moody's announced on Thursday that it is considering downgrading GM to junk status. Moody's cited the costly incentive programs, rising demand for fuel-efficient vehicles, and pressure on the U.S. market share as sources of concerns. The market's reaction to the news was generally muted, with the 5-year CDS of GMAC closing the week 10 bps wider at 516 bps. GM's rivals, Ford and DaimlerChrysler, decided to follow suit on employee discount programs, but they are leaving out some of their best-selling models from the promotions. Also, as a result of index rule changes, Ford returned to Lehman's investment-grade bond index, as it is rated investment-grade by two of the three major rating agencies. Ford Motor Credit's 5-year CDS spread finished the week at 433 bps, compared with 406 bps in the prior week.

¹ See, Kim, T., *Moody's Initial Views on the Dealer Form of Confirmation For Pay-As-You-Go Credit Derivatives Transactions*, Moody's special report (21 June 2005).

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Please note: This report now includes base correlation levels for CDS index tranches. (See page 4.)

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The global speculative-grade default rate hit an 8-year low at 1.8% in June 2005, according to Moody's.² The rating agency forecasts that the global default rate will remain around the current level through 2005, but then increase to 3% by 2006Q2. In the U.S., the default rate dropped from 2.6% in the first quarter to 2.1%, also the lowest level since 1997. In June, just one U.S. issuer, Salton, Inc., defaulted for an amount of \$275 million. During 2005Q2, there were just three defaults, all by U.S. issuers, for a total of \$1.4 billion, down from nine defaults for a total of \$1.7 billion in the first quarter of 2005.

The U.S. high-yield market may be at a cusp of the cycle, according to S&P's new report.³ While the downgrades of GM and Ford in May caused little, if any, disruption in the U.S. high-yield market, demand for high-yield bonds may be waning, as net inflows into high-yield mutual funds turned negative during the first half of 2005. U.S. speculative-grade issuance volume through the second quarter of 2005 was \$37 billion, well below the \$57 billion seen during the same period in 2004. S&P expects high-yield issuance to decelerate in 2005 from the fast paces seen in 2003 and 2004 to about \$84 billion, near the 10-year average.

However, the share of low-rated issues ('B-' or lower) reached 47.1% in 2005, the highest level since 1988, with heavy issuance in sectors such as telecommunications, media and entertainment, and consumer products. The rising portion of low-rated issuance tends to cause a spike in defaults in the following years, as seen in defaults peaking in 2001 following the high issuance pace of low-rated bonds during 1997-1999. The average spreads in the U.S. speculative-grade market for non-financial issuers have widened from low 300s in 2004 to 375-475 bps at the end of June 2005. While credit quality of speculative-grade issuers remains relatively stable, S&P also warns that large LBO-related issuance could further dampen the market's appetite for high-yield bonds.

II. Recent Pricing & Pipeline:

Issue	Date	Size (mm)	Collateral Manager	Assets	Lead	Class	Rating	WAL	Spread
Pascal ABS CDO*	7/11	\$1,000.00	State Street Research	HG ABS	RBS				
		864.00				Super Sr.	(not offered)		
		70.00				A	Aaa/AAA/--	6.80	+43/3ML
		44.00				B	Aa2/AA/--	6.80	+55/3ML
		15.00				C	Baa3/BBB-/-	6.80	+290/3ML
		14.50				Sub			
Pioneer Valley Structured Credit I	7/8	\$1,000.00	BAS	CDO	BAS				
						X	Aaa/AAA/--		
						A-1	Aaa/AAA/--	7.30	+30/1ML
						A-2	Aaa/AAA/--	7.30	+46/6ML
						B	Aa2/AA/--	7.30	+59/6ML
						C	A3/A/--	7.30	+155/6ML
						D	--/BBB/--	7.30	+300/6ML
						Sub			
ACA CLO 2005-1	7/8	\$300.00	ACA Management	Loans	BS				
						A-1L	Aaa/AAA/--	7.40	
						X	Aaa/AAA/--	2.90	
						A-2L	Aa2/AA/--	8.20	+42/3ML
						A-3L	A2/A/--	8.20	+75/3ML
						B-1L	Baa2/BBB	8.20	+185/3ML
						B-2L	Ba2/BB/--	8.00	+500/3ML

² *Second Quarter's 1.8% Default Rate Lowest in Eight Years*, Moody's Default Report (7 July 2005).

³ *Vazza, D., et al, U.S. High Yield Outlook: A Delicate Sense of Equanimity*, S&P Global Fixed Income Research (7 July 2005).

Issue	Date	Size (mm)	Collateral Manager	Assets	Lead	Class	Rating	WAL	Spread
Abacus 05-3*	7/6	\$2,000.00	GC (static)	ABS	GS				
		1200.00				Super Sr.	-	-	-
		100.00				A-1	Aaa/AAA/-	-	+55/1ML
		120.00				A-2	Aaa/AAA/-	-	+65/1ML
		260.00				B	Aa2/AAA/-	-	+85/1ML
		40.00				C	Aa3/AA-	-	+100/1ML
		100.00				D	-	-	+175/1ML
		60.00				E	Baa2/BBB/-	-	+350/1ML
		75.00				F	Ba2/BBB/-	-	+800/1ML
		45.00				G	-	-	+1500/1ML

New Pipeline	Size (mm)	Collateral Man.	Assets	Lead
Delta CDO II*	\$2,000.00	Wharton AM	ABS	DBS
Bishopsgate*	TBA	Stanfield	HY corp	CAL
LCM CLO IV	\$307.00	Lyon Capital Management	Loans	ML
Halcyon 2005-1*	\$15.75/€66.88	HRE (Hypo Real Estate Bank)	CMBS	Hypo
Harch II	\$449.50	Harch Capital	Loans	GS
Hylime 2005-1	\$400.00	NY Life Inv. Mgt.	Loans	GS
Babson CLO 2005-II	\$500.00	Babson Capital	Loans	CITG
Soloso CDO 2005	\$500.00	-	TruPS	BS/SunTr
Fortress Credit Funding CLO	\$1,000.00	Drawbridge Special Opp. Advisors	Loans	CITG

* denotes synthetic. Source: MCM, IFR, Bloomberg

III. CDS Spreads

Name	5Y CDS (7/8)	Week Ago (7/1)	Credit Rating (M/S/F)	5Y CDS Index	Mid (7/8)	Week Ago (7/1)	Change
Fannie Mae	18	19	Aaa/AAA/AAA	CDX.NA.IG 4	58.69	59.98	-1.29
Boeing	20	20	A3/A/A+	CDX.NA.IG 4 HVOL	125.22	127.92	-2.70
IBM	25	25	A1/A+/AA-	CDX.NA.HY 4	382.87	392.21	-9.34
GE Capital	29	29	Aaa/AAA/--	iTraxx Europe	40.11	39.75	+0.36
Deere & Co	29	30	A3/A-/A	iTraxx CJ Japan	26.32	25.84	+0.48
McDonalds	30	30	A2/A/A	iTraxx Asia ex-Japan	49.13	49.82	-0.69
Walt Disney	30	30	Baa1/A-/BBB+	iTraxx Australia	33.25	34.23	-0.98
SBC Communications	33	31	A2/A/A+				
AIG	34	34	Aa2/AA/AA				
Duke Energy	35	35	Baa1/BBB/BBB+				
Alcoa	36	34	A2/A-/A				
Dow Chemical	36	36	A3/A-/A-				
Time Warner	40	40	Baa1/BBB+/BBB+				
CIT Group	45	46	A2/A/A				
AT&T	46	47	Ba1/BB+/BB+				
Computer Associates	71	73	Ba1/BBB-/BBB-				
Albertsons	77	78	Baa2/BBB-/BBB				
Viacom	77	78	A3/BBB+/A-				
Altria Group	116	118	Baa2/BBB+/BBB				
Ford Motor Credit	433	407	Baa2/BB+/BBB				
GMAC	516	506	Baa2/BB/BB+				

Source: Markit and Bloomberg

IV. CDS Index Tranche Indicative Spreads & Base Correlation

ITraxx Europe Series 3						
	July 8		July 1		Weekly change	
Overall index spread	39.3 bps		39.8 bps		-.5 bps	
	Spread	Correlation	Spread	Correlation	Spread	Correlation
0%-3% (upfront payment + running spread = 500 bps)	27%	16.1%	28%	15.5%	-1.1%	+ .6%
3%-6%	82 bps	31.2%	88 bps	30.1%	- 6.2 bps	+ 1.1%
6%-9%	32 bps	41.1%	33 bps	39.9%	- .4 bps	+ 1.2%
9%-12%	18 bps	48.8%	19 bps	47.5%	- 1.0 bps	+ 1.3%
12%-22%	12 bps	66.6%	14 bps	64.0%	- 2.3 bps	+ 2.6%
CDX.NA.IG Series 4						
	July 8		July 1		Weekly change	
Overall index spread	59.5 bps		60.0 bps		- .5 bps	
	Spread	Correlation	Spread	Correlation	Spread	Correlation
0%-3% (upfront payment + running spread = 500 bps)	47%	12.0%	48%	11.3%	-0.8%	+ .7%
3%-7%	136 bps	34.3%	142 bps	33.2%	- 5.7 bps	+ 1.1%
7%-10%	43 bps	45.1%	43 bps	44.0%	+ .6 bps	+ 1.1%
10%-15%	23 bps	58.2%	26 bps	56.9%	- 2.0 bps	+ 1.3%
15%-30%	16 bps	80.8%	16 bps	79.8%	+ .2 bps	+ 1.0%

Source: Nomura

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