

CDO/CDS Update 9/12/05

I. Commentary

U.S. CDS spreads tightened as the equity market rebounded and CDO-related hedging activities led to protection selling. The 5-year DJ CDX.NA.IG tightened from 53.3 bps to 50.1 bps. The 30-name high-volatility sub-index also finished tighter at 112.0 bps, compared to 119.3 bps in the prior week. The DJ CDX.NA.HY index ended about 18 bps tighter at 362.7 bps. The 5/10-year curve of the CDX index also flattened slightly. Global CDS index spreads also finished tighter.

The investment-grade and emerging market (EM) CDS indices will roll into new maturities on September 20, while the high-yield index will be rolling on October 6, according to Markit. Starting with the next week's roll, the DJ CDX index will have a 35-name "crossover" index,¹ similar to the iTraxx Europe Crossover sub-index. The North American crossover index, called the DJ.CDX.NA.XO, will include credits that are double-B rated by either or both of Moody's and S&P, such as Ford Motor Credit and GMAC. Other names that will be dropped from the current index include Eastman Kodak, Kerr-McGee, Lear, Liberty Media and Maytag. Also, there is a talk of the European crossover index and the Asian ex-Japan index being expanded from 35 to 40 and 30 to 50 credits, respectively.

The base correlations of the CDX.NA.IG Index declined by 3%-7%, with the 0%-3% tranche's base correlation dropping below 10% to 7.3%. Similarly, base correlation of the iTraxx Europe index fell across the board by 4%-9%. As a result, the base correlation curves flattened both in North America and Europe. The 5-year tranche spreads also declined, except for the 0%-3% tranche where the upfront payments moved up slightly. The move was partly related to the increased issuance of leveraged super senior (LSS) tranches.

Also, with the roll date approaching, technical conditions may be developing for the "skew." After the roll, by construction, the new index will likely have much lower spread dispersion than the old series. It means less idiosyncratic risk, as opposed to systematic risk, which would effectively redistribute risk from the equity tranche towards other tranches.

The U.S. speculative-grade default rate rose to 2.4% in August from 2.1% in July, according to Moody's.² Last month, four U.S.-based issuers, Foamex, Foamex Capital, Anchor Glass Container, and Fedders N.A., defaulted for a total of \$1 billion of bonds. In 2005 to date, 18 corporate issuers have defaulted for \$4.5 billion. The *global* default rate also edged up from 1.8% in July to 2.0% in August, but the European default rate remained unchanged at 1.6%. Despite the

¹ *Dow Jones Plans New Credit Index After Ford Downgrades*, Bloomberg news (6 September 2005).

² *Speculative-Grade Default Rate Edges Up to 2.0% in August*, Moody's August Default Report (9 September 2005).

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uncertainty regarding impact of Hurricane Katrina, Moody's forecasts the speculative-grade default rate to rise only moderately over next six to 12 months.

No rating actions have been taken on CRE CDOs in relation to Hurricane Katrina, as the rating agencies scramble to assess the ultimate impact on various structured finance sectors. So far, Fitch has identified 20 CDOs whose collateral pools include CMBS with exposures in the areas affected by the hurricane.³ The largest exposure of 5.7% was found in a deal called SPA CBO, issued in 2000. Fitch also found 18 CMBS deals with exposures to the region exceeding 5%. On the other hand, S&P says 160 U.S. CMBS are likely affected, of which 12 deals may have material exposure to Katrina.⁴

The U.S. CDO issuance is well ahead of last year's pace, according to Moody's.⁵ Through the first half of 2005, the number of rated U.S. CDOs and issuance volume jumped 89% and 109%, respectively, from a year ago. The new issuance accelerated particularly during the second quarter of 2005, with 102 deals issued for an amount of \$41 billion. By deal type, synthetic CDOs now account for about a half in deal count, although by volume they represent about ¼ of all U.S. CDO issuance. While resecuritization CDOs (*i.e.*, structured finance CDOs) accounted for about slightly above one third of the total issuance volume, CLOs made up about 25%.

By collateral backing the deals (including synthetics), structured debt represented 68% of the aggregate collateral pool, followed by corporate bonds (26%) and loans (6%). In contrast, when synthetic deals were excluded, structured debt and loans each accounted for about 45% of the collateral pool. This is because many synthetic deals are now referencing structured finance assets.

Looking forward, Moody's reported that the indicator of relative "arbitrage" gain suggests that high-yield CBOs may stage a comeback, while resecuritization appears to be becoming less attractive. Also, the credit performance of the CDO sector remains favorable with the upgrade-to-downgrade ratio increasing (35% for Q2 vs. 14% for Q1). Given the first half's brisk issuance pace, the rating agency is currently projecting the full-year volume to nearly double from the 2004 level.

S&P assess the effect of concentrations of RMBS in CDOs.⁶ Earlier this year, some market participants have become concerned about the prevalence of high RMBS concentrations in structured finance (SF) CDOs. One advantage of including RMBS in CDOs is their much wider spreads relative to other CDO collateral assets, such as existing CDO, ABS, and CMBS. Moreover, RMBS has shown by far the best credit performance, with an upgrade-to-downgrade ratio of 13.8x over the past year.

The report examined about 40 CDO deals that were issued between the second half of 2004 and early 2005. RMBS accounted for over 50% of the collateral pool in 32 SF CDOs. Moreover, subprime RMBS represented 60-75% of the RMBS collateral in these deals. The shift towards subprime RMBS was motivated by the search for incremental yields around the triple-B level and the increasing supply, which almost tripled between 2002 and 2004.

The main concern for the growing concentration of RMBS in CDO collateral pools is the growth of so-called "affordability" products, such as 40-year mortgages, interest-only loans and certain adjustable-rate mortgages (ARMs), but particularly option ARMs. These borrowers tend to have lower income, and these new products are likely to experience more severe payment shocks when the principal becomes due and/or the interest rate switches to variable.

³ Kabahar A. and R. Gambel, *CDOs of CMBS May Feel Gust from Katrina*, CDOpinions (6 September 2005).

⁴ *Hurricane Katrina Could Affect \$2.5 Billion In U.S. CMBS Collateral*, S&P structured finance surveillance (9 September 2005).

⁵ According to the presentation at *Moody's 5th Annual CDO Investor Briefing*, New York, September 7, 2005.

⁶ Kiggundu-Bentham, M., et al., *Is The Fortune for Structured Finance CDOs Tied To RMBS Performance For Better Or Worse?*, S&P CDO Spotlight (7 September 2005).

Given the higher risk associated with these affordability products, S&P identifies three core skills necessary for the managers of SF CDOs: (1) close relationships with underwriters/originators, (2) the infrastructure for monitoring/analyzing, and (3) the knowledge of the servicer market. However, the strong RMBS market has so far led to collateral-related *upgrades* in 10 SF CDOs with high concentrations (60%+) in RMBS.

II. Recent Pricing & Pipeline:

New Pipeline	Size (mm)	Collateral Man.	Assets	Lead
Sentinel CLO	\$1,000.00	Lehman Bros. Asset Management	ABS	LB
Lafayette Square	\$600.00	Blackstone Group	Loans	CITG
Ayresome CDO- I	\$400.00	General Re-New England Asset management	Mezz ABS	LB
Taberna Preferred Funding III	\$779.00	Taberna Capital Management	REIT TruPs	ML
Symphony CLO- I	\$400.00	Symphony Asset	Loans	CITG
KLIO III Funding	\$4,000.00	Bear Stearns	ABS	CITG
FMC Real Estate CDO 2005-1	\$467.00	Five Mile Capital	REIT CDO	DBS
Duane Street	\$350.00	D/A Capital	Loans	MS

* denotes synthetic. Source: MCM, IFR, Bloomberg

III. CDS Spreads

Name	5Y CDS (9/9)	Week Ago (9/2)	Credit Rating (M/S/F)	5Y CDS Index	Mid (9/9)	Week Ago (9/2)	Change
Fannie Mae	14	15	Aaa/AAA/AAA	CDX.NA.IG 4	50.05	53.34	-3.29
Boeing	18	18	A3/A/A+	CDX.NA.IG 4 HVOL	111.98	119.27	-7.29
IBM	20	20	A1/A+/AA-	CDX.NA.HY 4	362.72	380.83	-18.11
Deere & Co	21	22	A3/A-/A	iTraxx Europe	35.86	37.22	-1.36
GE Capital	23	23	Aaa/AAA/--	iTraxx Europe HVOL	65.77	69.89	-4.12
Alcoa	25	26	A2/A-/A	iTraxx Europe X-over	277.57	290.04	-12.47
AIG	27	27	Aa2/AA/AA	iTraxx CJ Japan	23.00	23.31	-0.31
Dow Chemical	28	30	A3/A-/A-	iTraxx Asia ex-Japan	46.25	47.94	-1.69
SBC Communications	33	33	A2/A/A+	iTraxx Australia	28.63	29.08	-0.45
Walt Disney	34	34	Baa1/A-/BBB+				
McDonalds	34	36	A2/A/A				
Duke Energy	35	34	Baa1/BBB/BBB+				
CIT Group	37	37	A2/A/A				
AT&T	40	40	Ba1/BB+/BB+				
Viacom	49	51	A3/BBB+/BBB+				
Time Warner	54	56	Baa1/BBB+/BBB+				
Computer Associates	69	67	Ba1/BBB-/BBB-				
Altria Group	107	109	Baa2/BBB+/BBB				
Albertsons	263	213	Baa2/BBB-/BBB				
Ford Motor Credit	421	437	Baa3/BB+/BBB-				
GMAC	467	474	Ba1/BB/BB+				

Source: Markit and Bloomberg

IV. CDS Index Tranche Indicative Spreads & Base Correlation

iTraxx Europe Series 3						
	September 9		September 2		Weekly change	
Overall index spread	35.8 bps		37.5 bps		- 1.8 bps	
	Spread	Correlation	Spread	Correlation	Spread	Correlation
0%-3% (upfront payment + running spread = 500 bps)	26%	11.7%	26%	15.3%	+ 0.5%	- 3.6%
3%-6%	77 bps	23.3%	90 bps	28.0%	- 13.1 bps	- 4.7%
6%-9%	26 bps	31.3%	28 bps	37.3%	- 1.7 bps	- 6.0%
9%-12%	14 bps	37.7%	16 bps	44.6%	- 1.9 bps	- 6.9%
12%-22%	8 bps	52.9%	10 bps	61.6%	- 1.6 bps	- 8.7%
CDX.NA.IG Series 4						
	September 9		September 2		Weekly change	
Overall index spread	50.3 bps		53.5 bps		- 3.3 bps	
	Spread	Correlation	Spread	Correlation	Spread	Correlation
0%-3% (upfront payment + running spread = 500 bps)	43%	7.3%	43%	10.5%	+ .2%	- 3.2%
3%-7%	115 bps	22.9%	140 bps	27.5%	- 24.7 bps	- 4.6%
7%-10%	29 bps	31.1%	38 bps	36.5%	- 9.2 bps	- 5.4%
10%-15%	17 bps	41.1%	23 bps	47.3%	- 6.2 bps	- 6.1%
15%-30%	8 bps	61.7%	11 bps	68.9%	- 3.3 bps	- 7.2%

Source: Nomura

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