

CDO/CDS Update 05/15/06

I. Commentary

Synthetic replication of cash CDOs is becoming the latest technological advancement, amid tight collateral spreads and strong demand for CDO paper. Synthetic CDOs-squared all but disappeared last year, after the major turmoil in the correlation market hurt deal economics and made investors skeptical about the high leverage employed in these structures. However, market participants began to explore ways to "piggy back" on managed cash CDOs by referencing them in a synthetic deal.

In the past, CDOs-squared were either (1) re-securitization of existing cash CDOs, or (2) synthetic deals referencing a portfolio of hypothetically-constructed corporate CDO tranches. The new breed of CDOs-squared, in contrast, synthetically replicates a portfolio of cash CDOs. For example, Stanton Vintage CDO, currently in the pipeline, uses a total return swap (TRS) to replicate the cash flow of a portfolio of CDO tranches. The reference portfolio, managed by UNIQA, will include at least 50 CDOs. Another deal in the pipeline, called TCW Visage, also uses a TRS referencing a portfolio of ABS CDO tranches from the 2003-2006 vintages.

The older CDOs-squared used the CDS template designed for corporate credits, while some of the recent deals use TRS that closely mimic the cash flow of the underlying CDOs. While the so-called pay-as-you-go (PAUG) template has become the standard for synthetic risk transfer of structured finance securities, the PAUG template for CDOs is still in the works.¹ Furthermore, new synthetic CDOs-squared include both ABS CDOs and CLOs for sector diversification. For example, the reference portfolio of Tricadia CDO 5, priced last week, consists of CLOs (75%) and ABS CDOs (25%).²

CDS spreads continued to move wider in North America and Emerging Market. The 5-year DJ CDX.NA.IG Series 6 index widened 3.0 bps to 38.8 bps. The CDX XO index and the CDX HY index also finished the week 4.8 bps and 11.4 bps wider, respectively. The emerging market (EM) index also gapped wider to close at 155.1 bps, as the rising U.S. Treasury yields pushed Emerging Market spreads by 12.3 bps on Friday alone. In Europe, spread widening was much more subdued, with the iTraxx Europe index widening by just 0.7 bps to 28.8 bps. Since the current series of the North American and European indices reached the tightest levels on May 2, they have widened about 10%. In contrast, the Asian and the Japanese indices continued to *tighten*, finishing the week 1.1-2.8 bps tighter.

Earlier in the week, research firm CreditSights Inc. raised GM, Ford, and American Axle to "overweight," pushing the auto companies' spreads to the tightest levels in weeks. CreditSights was

¹ *Trading Template May Send CDO Shorts Soaring*, Securitization News (10 March 2006).

² This deal uses 85 CDS, instead of TRS, each referencing a CDO tranche.

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optimistic about Delphi reaching an agreement with its union on labor contracts. On Wednesday, GM restated its first-quarter results, which swung to a profit of \$445 million from a loss of \$323 million. GM also stressed that resolving the Delphi situation is a "critical" near-term priority. GMAC's 5-year CDS tightened by 21 bps to 314 bps, below the levels reached immediately after GM agreed to sell a majority stake of GMAC in early April. Ford Motor Credit moved closed 15 bps tighter on the week at 505 bps.

Most index tranches also moved slightly wider last week, particularly in Europe and in the longer maturities. In North America, in contrast, tranche spreads were little changed in the senior part of the capital structure. Since March, the base correlation curves in Europe have flattened across the maturities, as base correlations moved up in the junior tranches while declining in the senior tranches (*i.e.*, the senior tranches underperforming the junior tranches).

Global default rates crept down in April, according to Moody's.³ Dana Credit Corporation, a unit of Dana Corporation that defaulted in March, was the only issuer to default in April.⁴ The U.S. speculative-grade default rate edged down from 2.3% in March to 2.2% in April. The European default rate remained 0% for the third month, as no issuers have defaulted over the past 14 months. The volume-weighted default rates in the U.S., however, remained considerably higher than the issuer-weighted default rate at 4.7% in April.

A new S&P report confirms that new managers are flooding the CDO market.⁵ Based on the S&P-rated structured finance (SF) CDOs and CLOs issued between 2004 and 2005, a total of 28 new managers entered the CDO market for the first time.⁶ Also, there were 10 managers where existing CDO teams started a new firm, and 15 managers who entered a *new CDO sub-sector* (either SF CDOs or CLOs). Further, four European managers newly entered the U.S. structured finance CDO market over the same period.

According to the report, the top motive for asset managers entering the CDO business was the desire to earn management fees and to own equity in the booming business. Hedge funds, in particular, entered the CDO management business to diversify their income and leverage on their credit expertise. Existing managers also sought diversification across collateral types by advancing into another CDO sub-sector.

Further, the report highlights the barriers to entry into the CDO market. These barriers include: (1) financing, (2) experienced staff, (3) ability to source collateral, (4) track record, and (5) system and technology, among others. S&P reports that the ability to source collateral remains a high entry barrier, as demand for collateral assets is so strong. Interestingly, however, new managers do not seem to be concerned about the lack of track record, as they are often not able to refer to their track records from previous firms for legal reasons. Market participants have recently voiced their concern about the lack of tiering among collateral managers, who can enter the CDO business without adequate analytical infrastructure and good track records.⁷

³ *Corporate Default Rates Hold Steady in April*, Moody's April Default Report (4 May 2006).

⁴ Dana Credit entered into a forbearance agreement with more than 70% of its senior note holders to suspend payments on its 6.93%, 7.18%, and 7.03% senior notes, a total amount of \$275 million.

⁵ *CDO Spotlight: New CDO Market Managers Are Undeterred by High Barriers to Entry*, S&P research (9 May 2006).

⁶ The report defined a new manager as: (1) one that is new to the CDO market, or, (2) a new firm/team of professionals from existing CDO managers.

⁷ See, for example; *Nomura CDS/CDO Update*, Nomura Fixed Income Research (3 April 2006).

II. Recent Pricing & Pipeline:

Issue	Date	Size (mm)	Collateral Manager	Assets	Lead	Class	Rating	WAL	Spread	
IXIS ABS CDO 2**	5/12	\$506.50	IXIS Securities	ABS	BAS					
		100.00				A-1 Funded	Aaa/AAA/-	5.3	-/3ML	
		225.00				A-2 Unfunded	Aaa/AAA/-	6.8	-/-	
		6.50				A-X	Aaa/AAA/-	4.2	+40/3ML	
		85.00				A-2	Aaa/AAA/-	7.0	+45/3ML	
		30.00				B	Aa2/AA/-	7.0	+52/3ML	
		21.00				C	Aa2/A/-	7.0	+145/3ML	
		15.00				D	Baa2/BBB/-	7.0	+325/3ML	
		4.00				E	Ba1/BB+/-	7.0	+625/3ML	
20.00	Sub notes	-/-	7.0	-/-						
C-BASS CBO XVI	5/12	\$400.00	C-Bass Investment Mgmt	Mezz ABS	BAS					
		314.80				A	Aaa/AAA/AAA	4.1	+25/3ML	
		22.50				B	Aa2/AA/AA	7.0	+45/3ML	
		26.50				C	A2/A/A	7.0	+115/3ML	
		9.50				D	Baa2/BBB/BBB	6.5	+280/3ML	
		26.70				E,PS	-/-	-	-/-	
Rosedale CLO	5/10	\$250.00	Princeton Advisory Group	Loans	DKW					
		60.00				A-1S	Aaa/AAA/-	6.6	+25/3ML	
		106.00				A-1A	Aaa/AAA/-	6.8	+27/3ML	
		8.50				A-1J	Aa1/AAA/-	8.8	+41/3ML	
		22.00				B	Aa2/AA/-	9.4	+47/3ML	
		15.50				C	A2/A/-	10	+80/3ML	
		12.50				D	Baa2/BBB/-	10.6	+175/3ML	
		9.00				E	Ba2/BB/-	-	-/-	
		16.50				Pref.	-/-	-	-/-	
Vitesse CLO 2006	5/10	\$600.00	TCW Advisors	Loans	BS					
		374.00				A1L	Aaa/AAA/-	7.7	+25/3ML	
		80.00				A1LR	Aaa/AAA/-	7.7	-	
		28.00				A2L	A2/AA/-	8.2	+38/3ML	
		41.00				A3L	A2/A/-	8.2	+67/3ML	
		25.00				B1L	Baa3/BBB/-	8.2	+180/3ML	
		17.00				B2L	Ba/BB/-	8.2	+425/3ML	
		55-56				P/S	-/-	-	-/-	
Tricadia CDO 2006-5*	5/09	\$400.00	Tricadia Mgmt	CDO	CDO	MS				
		200.00					A	Aaa/AAA/-	7.3	-/3ML
		55.00					B	Aa1/AAA/-	8.0	+60/3ML
		56.00					C	A2/AA/-	8.7	+75/3ML
		22.50					D	A2/A/-	8.8	+175/3ML
		18.25					E	Baa2/BBB/-	8.8	+375/3ML
		20.25					F	Ba2/BB/-	7.9	+600/3ML
		28.00					Sub Notes	-/-	-	-/-
Montauk Point II CDO	5/09	\$500.00	Fortis Investments	Mezz SF	UBS					
		340.00				A1S	Aaa/AAA/-		+42/3ML	
		34.25				A1J	Aaa/AAA/-		+53/3ML	
		50.00				A2	Aa2/AA/-		+59/3ML	
		15.00				A3	Aa3/AA/-		+145/3ML	
		15.50				A4	A2/A/-		+320/3ML	
		20.50				B	Baa2/BBB/-		+650/3ML	
		5.00				B	Ba2/BB/-		-/-	
		19.75				PS				
New Pipeline		Size (mm)	Collateral Man.	Assets	Lead					
BlueMountain CLO II		\$400.00	BlueMountain Capital Mgmt	Loans	MS					
TCW Visage CDO I*		\$402.00	TCWAM	ABS CDO	CSFB					
UNIQA Stanton Vintage CDO*		\$400.00	UNIQA	ABS CDO	CSFB					
Taberna Pref Funding VI		\$723.00	Taberna Capital	REIT TruPs	ML					
Diogenes CDO II		\$400.00	State Street Global Advisors	ABS/Corp	DBS					
Baldwin ABS CDO*		\$1,000.00	GSC Partners	ABS	MS					

* denotes synthetic; ** denotes hybrid. Source: MCM, IFR, Bloomberg

III. CDS Spreads

Index Constituent	15-May	Week Ago	Moody's Rating	S&P's Rating	5Y CDS Index	15-May	Week Ago	Change
Fannie Mae	8	8	Aaa	AAA	CDX.NA.IG 6	38.75	35.75	+3.00
Boeing	13	14	A2	A	CDX.NA.IG 6 HVOL	74.75	67.11	+7.64
IBM	13	12	A1	A+	CDX.NA.IG XOVER	161.16	156.38	+4.78
Deere & Co	20	19	A3	A-	CDX.NA.HY 6	304.25	292.83	+11.42
GE Capital	14	13	Aaa	AAA	CDX.EM 5	155.12	138.46	+16.66
AIG	17	17	Aa2	AA	iTraxx Europe 5	28.80	28.07	+0.73
Dow Chemical	21	20	A3	A-	iTraxx Europe HVOL	50.90	48.96	+1.94
Alcoa	16	15	A2	A-	iTraxx Europe X-over	234.61	235.52	-0.91
CIT Group	20	19	A2	A	iTraxx CJ Japan 5	27.16	28.21	-1.05
Duke Energy	24	24	A3	BBB	iTraxx Asia ex-Japan	50.66	53.50	-2.84
McDonalds	16	16	A2	A	iTraxx Australia	27.28	27.29	-0.01
Walt Disney	18	18	A3	A-	iTraxx SDI-75 2	38.25	38.50	-0.25
Viacom	41	40	Baa3	BBB	CDX Widest 15-May			
Time Warner	40	37	Baa2	BBB+	Jones Apparel Gp Inc	153		
Computer Associates	65	62	Ba1	BBB-	SUPERVALU INC	152		
Altria Group	50	51	Baa2	BBB	RadioShack Corp	115		
Tyson Foods	98	108	Baa3 /*-	BBB	Tyson Foods Inc	109		
Ford Motor Credit	488	502	Ba3	BB-	Wendys Intl Inc	109		
GMAC	298	320	Ba1 /*-	BB /*	CDX Tightest 15-May			
Carrefour	16	16	A2	A	Wal Mart Stores Inc	9		
AXA	14	15	A2	A	Fed Natl Mtg Assn	9		
AKZO Nobel N V	26	24	A3	A-	Target Corp	11		
Suez	18	17	A2 /*+	A- /*+	Wells Fargo & Co	12		
GUS PLC	43	42	Baa1 /*-	BBB+ /*-	Bristol Myers Squibb C	14		
PLC	26	25	Baa2	BBB	iTraxx Widest 15-May			
Renault	27	26	Baa1	BBB+	Portugal Telecom Intl	115		
Brit Telecom PLC	46	45	Baa1	A-	Glencore Intl AG	93		
Lafarge	33	32	Baa2	BBB	THOMSON	76		
Deutsche Telekom AG	37	35	A3	A-	Degussa AG	72		
METRO AG	32	32	Baa2	BBB	ITV Plc	71		
France Telecom	37	35	A3	A-	iTraxx Tightest 15-May			
Telecom Italia SpA	49	45	Baa2	BBB+	ABN AMRO Bk N V	6		
Volkswagen AG	27	25	A3	A-	Royal Bk Scotland plc	7		
DaimlerChrysler AG	55	52	A3	BBB	Nestle S A	7		
VNU	176	179	Ba1 /*-	BBB- /*-	Barclays Bk plc	8		
Koninklijke Ahold N V	116	116	Ba1	BB	Bco Bilbao Vizcaya Ar	9		

Single-name CDS spreads are on a "XR" basis (without restructuring) for North America.

Source: Markit and Bloomberg

ABX.HE Index (as of May 12, 2006)				
Index	Price	Weekly change	Spread* (bps)	Coupon (bps)
ABX.HE.AAA.06-1	100.31	+ 0.00	10	18
ABX.HE.AA.06-1	100.52	+ 0.02	17	32
ABX.HE.A.06-1	100.51	+ 0.09	38	54
ABX.HE.BBB.06-1	101.02	+ 0.02	121	154
ABX.HE.BBB-.06-1	101.93	- 0.08	203	267
CMBX.NA Index (as of May 12, 2006)				
Index	Spread	Weekly change	Coupon (bps)	
CMBX.NA.AAA.06-1	6.47	+ 0.31	10	
CMBX.NA.AA.06-1	17.00	- 0.12	25	
CMBX.NA.A.06-1	26.94	+ 0.13	35	
CMBX.NA.BBB.06-1	65.00	- 0.12	76	
CMBX.NA.BBB-.06-1	111.75	- 2.00	134	

Source: Markit * assuming 35% CPR.

IV. CDS Index Tranche Indicative Spreads & Base Correlation

iTraxx Europe Series 5 (5 years)						
	12-May		5-May		Change	
Overall index spread	29.0 bps		28.0 bps		+ 1.0 bps	
	Spread	Correlation	Spread	Correlation	Spread	Correlation
0%-3%	19%	9.8%	19%	9.4%	+ .9%	+ .4%
3%-6%	53 bps	20.0%	48 bps	19.4%	+ 5.0 bps	+ .6%
6%-9%	15 bps	27.3%	14 bps	26.5%	+ 1.3 bps	+ .9%
9%-12%	7 bps	33.5%	6 bps	32.4%	+ .6 bps	+ 1.1%
12%-22%	4 bps	49.1%	2 bps	48.9%	+ 1.4 bps	+ .2%
CDX.NA.IG Series 6 (5 years)						
	12-May		5-May		Change	
Overall index spread	38.5 bps		37.0 bps		+ 1.5 bps	
	Spread	Correlation	Spread	Correlation	Spread	Correlation
0%-3%	28%	9.8%	27%	10.1%	+ 1.0%	- .3%
3%-7%	78 bps	24.3%	75 bps	24.5%	+ 3.5 bps	- .2%
7%-10%	18 bps	32.5%	18 bps	32.6%	+ .5 bps	- .1%
10%-15%	9 bps	43.4%	8 bps	43.7%	+ 1.0 bps	- .3%
15%-30%	6 bps	65.0%	6 bps	64.9%	+ 0.0 bps	+ .0%
iTraxx Europe Series 5 (7 years)						
	12-May		5-May		Change	
Overall index spread	39.0 bps		37.8 bps		+ 1.3 bps	
	Spread	Correlation	Spread	Correlation	Spread	Correlation
0%-3%	37%	7.5%	35%	7.8%	+ 2.3%	- .3%
3%-6%	154 bps	17.6%	136 bps	18.1%	+ 18.0 bps	- .5%
6%-9%	44 bps	25.4%	38 bps	26.0%	+ 5.5 bps	- .6%
9%-12%	22 bps	31.7%	20 bps	32.4%	+ 2.5 bps	- .6%
12%-22%	8 bps	49.5%	7 bps	50.1%	+ .8 bps	- .6%
CDX.NA.IG Series 6 (7 years)						
	12-May		5-May		Change	
Overall index spread	48.5 bps		46.5 bps		+ 2.0 bps	
	Spread	Correlation	Spread	Correlation	Spread	Correlation
0%-3%	45%	6.6%	44%	6.3%	+ .4%	+ .3%
3%-7%	215 bps	18.3%	206 bps	17.9%	+ 9.5 bps	+ .3%
7%-10%	38 bps	26.7%	36 bps	26.2%	+ 1.5 bps	+ .5%
10%-15%	18 bps	38.0%	18 bps	37.2%	+ .5 bps	+ .7%
15%-30%	8 bps	62.9%	8 bps	61.4%	+ 0.0 bps	+ 1.5%
iTraxx Europe Series 5 (10 years)						
	12-May		5-May		Change	
Overall index spread	49.5 bps		49.0 bps		+ .5 bps	
	Spread	Correlation	Spread	Correlation	Spread	Correlation
0%-3%	48%	8.9%	46%	9.4%	+ 1.8%	- .5%
3%-6%	500 bps	10.3%	468 bps	10.8%	+ 32.0 bps	- .5%
6%-9%	102 bps	17.9%	92 bps	18.5%	+ 10.5 bps	- .6%
9%-12%	47 bps	24.3%	45 bps	24.7%	+ 2.0 bps	- .4%
12%-22%	19 bps	41.1%	18 bps	41.6%	+ 1.5 bps	- .5%
CDX.NA.IG Series 6 (10 years)						
	12-May		5-May		Change	
Overall index spread	60.5 bps		59.0 bps		+ 1.5 bps	
	Spread	Correlation	Spread	Correlation	Spread	Correlation
0%-3%	52%	7.4%	52%	7.4%	+ .4%	+ .0%
3%-7%	540 bps	11.0%	540 bps	10.3%	+ 0.0 bps	+ .7%
7%-10%	102 bps	18.9%	96 bps	18.0%	+ 6.0 bps	+ .8%
10%-15%	48 bps	29.0%	44 bps	28.2%	+ 4.0 bps	+ .8%
15%-30%	14 bps	54.7%	15 bps	51.9%	- 1.0 bps	+ 2.8%

Source: Nomura

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