

CDO/CDS Update 03/01/05

I. Commentary

CDO new issuance is accelerating. A few notable trends seem to be forming as activity picked up in recent weeks. First, new issue spreads continue to tighten from the year-end levels, even for mezzanine tranches. For example, single-A tranches of several high-yield CLOs issued in February came out below the 100-bp mark, compared to the year-end level of 100-120 bps. Second, synthetic deals have resumed using certain types of collateral, such as high-yield loans and bonds, which had been mostly absent in 2004. Third, more cash deals now include synthetic features, such as CDS and TRS (total return swaps), in their structures.

Moreover, reflecting bearish views among some market participants, certain new deals allow their managers to take "short" positions. For example, one recently priced deal, called ODIN CDO I, is a managed synthetic CDO with such a feature. The deal's structure allows the collateral manager, AIG Global Investment, to take short positions in credit risk by purchasing credit default swaps (*i.e.*, purchasing protection). The deal's dollar-denominated triple-A tranche priced at 40 bps to 6-month Libor.

U.S. CDS spreads were mostly unchanged last week. Higher oil prices and the weak dollar pushed CDS spreads wider early in the week, but more favorable economic data and synthetic CDO activities resulted in spread tightening by Friday. The 125-name 5-year DJ CDX.NA.IG index closed the week marginally tighter at 44.02 bps. On the other hand, the high-volatility sub-index was virtually unchanged at 89.78 bps. The DJ CDX high-yield CDS index finished the week about 0.5 bps tighter at 301.68 bps.

The auto CDS spreads remained in a tight range ahead of February car sales data, which will be announced this week. The 5-year CDS of Ford Motor Credit and GMAC finished the week 3-4 bps wider at 194 bps and 234 bps, respectively. The spread differential between the two companies remained virtually unchanged at 40 bps.

A recent wave of merger news hit the retail sector last week, as it was reported that Federated Department Stores and May Department Stores were in talks for a possible merger. The CDS spreads of May Department Stores and Federated Department Stores both narrowed by a few basis points on the news, with the 5-year CDS of both companies finishing the week in the mid-30s. Over the weekend, Federated formally announced the details of its \$11-billion bid for May.

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The number of credit events in synthetic CDOs declined in 2004 but recovery rates were also lower, according to Fitch's annual study.¹ Reflecting the drop in global default rates, only 37 credit events in synthetic CDOs were called in 2004. This marks a significant decline from 2003's figure of 118 credit events. By notional amount, this represents just \$93 million in the U.S., less than 25% of the amount a year earlier. However, the study finds that the average recovery rate during 2004 dropped to 20.3%, compared to 45.9% in 2003. The figure was likely affected by the prevalence of Parmalat-related credit events (accounting for 27 out of 37 credit events), which had a lower average recovery rate of 9.2%. The most common credit event was bankruptcy, accounting for 79% of all credit events, followed by restructuring (15%) and failure to pay (6%).

According to the report, 2004 saw two credit events triggered by ABS assets. The first was a "failure to pay interest" credit event, called on a PIK-able subordinate note of an airplane leasing ABS. The other was a "loss" event on mezzanine notes of CMBS, where the lack of sufficient cash flows resulted in a principal write-down that was deemed irreversible. Nearly half (49%) of the synthetic CDOs rated by Fitch in 2004 referenced structured finance assets, up significantly from 21% in 2003. Given the rapid growth of synthetic CDOs that reference ABS and CDOs, Fitch expects that ABS-related credit events will increase in 2005 and that the types of credit events that occur will become more diverse.

II. Recent Pricing & Pipeline:

Issue	Date	Size (mm)	Collateral Manager	Assets	Lead	Class	Rating	WAL	Spread
Kent Funding	2/28	\$1,000.00	Declaration Management	HG ABS	CITG	A1	Aaa/AAA/--	7.70	+53/3ML
						A2	Aa2/AA/--	7.70	+65/3ML
						B	Baa2/BBB/--	7.70	+300/3ML
N-Star CDO II	2/28	\$400.00	NS Advisors	CDO/CRE	CITG	A1	--/AAA/AAA	7.50	+28/1ML
						A2A	--/AA/AA	9.70	+50/1ML
						A2B	--/A/AA	9.70	+50/swp
						B	--/A-/A-	9.90	+85/1ML
						C1A	--/BBB+/BBB+	10.2	+125/1ML
						C1B	--/BBB+/BBB+	10.2	+125/swp
						C2A	--/BBB/BBB	10.9	+155/1ML
						C2B	--/BBB/BBB	10.9	+155/swp
						D	--/BB/BB	11.6	
KKR CLO	2/25	\$1,000.00	KKR Financial	ML	Loans	A1	Aaa/AAA/--	8.20	+27/3ML
						B	Aa2/AA/--	10.5	+45/3ML
						C	A2/A/--	10.8	+80/3ML
						D	Baa2/BBB/--	11.2	+205/3ML
						E	Ba3/BB/--	11.5	+550/3ML
						F	B2/B/--	11.5	+850/3ML
MKP CBO IV	2/24	\$401.00	MKP	ABS	RBS	A1	Aaa/AAA/--	3.70	+30/3ML
						A2	Aaa/AAA/--	6.70	+50/3ML
						B	Aa2/AA/--	7.80	+70/3ML
						C	Baa2/BBB/--	7.10	+290/3ML
Avalon	2/24	\$600.00	Invesco	loans	LB	A1	Aaa/AAA/--	8.50	+27/3ML
						A2	Aaa/AAA/--	8.50	+28/3ML
						B	Aa2/AA/--	10.0	+45/3ML
						C	A2/A/--	10.0	+80/3ML
ODIN CDO I*	2/22		AIG Global	IG corp	JPM	A1U7	--/AAA/--	n.a.	+40/3ML
						B1U5	--/AA/--	n.a.	+80/6ML
						B1U7	--/A/--	n.a.	+90/6ML

¹ Miller, D., et al., *Credit Events in Global Synthetic CDOs: Year-End 2004 Update*, Fitch special report (28 February 2005).

Jupiter High Grade CDO II	2/22	\$989.00	Maxim Advisory (static)	RMBS /ABS/CDO	ML	A1	Aaa/AAA/AAA	6.00	+27/3ML
						A2	Aaa/AAA/AAA	6.20	+50/3ML
						B	Aa2/AA/AA	6.20	+73/3ML
						C1A	Baa2/BBB/BBB	5.60	+295/3ML
						C1B	Baa2/BBB/BBB	8.00	fx. 7.265%
Palmer Square	2/18	\$755.00	Princeton Advisors	ABS	DKW	A1A	Aaa/AAA/--	n.a.	+20/3ML
						A2A	Aaa/AAA/--	n.a.	+30/3ML
						B1	Aa2/AA/--	n.a.	+75/3ML
						C1	A2/A/--	n.a.	+125/3ML
						D1	Baa2/BBB/--	n.a.	+300/3ML
Stack I*	2/18	\$252.00	TCW	ABS	DBS	A2	--/AAA/AAA	4.30	+29/1ML
						B	--/AA/AA	4.30	+58/1ML
						C	--/A/A	4.30	+118/1ML
						D	--/BBB/BBB	4.30	+260/1ML
Belem CDO*	2/16	\$ 20.00	IXIS	corp	IXIS	A2	Aaa/--/--	n.a.	+39/3ML
Babson CLO	2/15	\$799.00	Babson	loans	CITG	A1-rev	Aaa/AAA/--	n.a.	+32/3ML
						A1-B1	Aaa/AAA/--	n.a.	+29/3ML
						A2	Aa2/AA/--	n.a.	+50/3ML
						B1	A2/A/--	n.a.	+80/3ML
						C1	Baa/BBB/--	n.a.	+195/3ML

New Pipeline	Size (mm)	Collateral Man.	Assets	Lead
Light Point CLO	\$334.50	Light Point	loans	WS
Fort Sheridan ABS CDO	\$1,000.00	Vanderbilt Capital	HG SF	ML/Descap
Landmark CLO V	\$300.00	Aladdin Capital	loans	BS

* denotes synthetic. Source: MCM, Asset Securitization Report, Bloomberg

III. CDS Spreads

Name	5Y CDS (2/25)	Week Ago (2/18)	Credit Rating (M/S/F)	DJ CDX.NA. Series	Mid (2/25)	Week Ago (2/18)	Change
IBM	16	17	A1/A+/AA-	CDX.NA.IG.5Y	44.02	44.18	-0.16
McDonalds	17	17	A2/A/A	US HVOL 5 Y	89.78	89.68	+0.10
Fannie Mae	19	19	Aaa/AAA/AAA	CDX.NA.HY	301.68	302.27	-0.59
American International Group	19	20	Aaa/AAA/AAA				
GE Capital	20	22	Aaa/AAA/--				
Deere & Co	22	21	A3/A-/A				
Alcoa	22	23	A2/A-/A				
Dow Chemical	23	23	A3/A-/A-				
Boeing	22	23	A3/A/A+				
Duke Energy	25	25	Baa1/BBB/A-				
Walt Disney	25	25	Baa1/BBB+/BBB+				
CIT Group	28	29	A2/A/A				
SBC Communications	31	31	A2/A/A+				
Viacom	35	33	A3/A-/A-				
Time Warner	38	37	Baa1/BBB+/BBB+				
Albertsons	38	40	Baa2/BBB/BBB				
AT&T	45	45	Ba1/BB+/BB+				
Computer Associates	53	54	Ba1/BBB-/BBB-				
Altria Group	83	84	Baa2/BBB+/BBB				
Ford Motor Credit	194	190	A3/BBB-/BBB+				
GMAC	234	231	Baa1/BBB-/BBB				

Source: Markit and Bloomberg

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