

CDO/CDS Update 10/02/06

I. Commentary

Declining oil prices and optimistic expectations for the upcoming release of third quarter corporate earnings have helped spur the equity markets and tighten the CDX indices. This is all occurring despite the ISM's index of manufacturing activity falling to 52.9 in September (the lowest monthly figure since May 2005), durable goods dropping 0.5% in August and a softer outlook for the U.S. housing market. A weak employment figure later this week could change optimistic market sentiment and reverse some of the past week's gains.

For the most part, credit index spreads in North America were tighter on the week. Since last Friday, the CDX IG series 7 index tightened 1.7 bps to 39.6 bps. For the week, the HVOL index was tighter by 2.9 bps to 83.9 bps and the XO index moved 2.7 bps tighter to 171.2 bps. The CDX HY index rolled to the new Series 7 on September 27 with an initial spread of 322 bps, about 7 bps wider from the series 6 index close of 315 bps. By week-end, HY Series 7 was trading at 324 bps, 2 bps wider than at inception. The best performer on the week was the CDX Emerging Markets index, as spreads narrowed 11.1 bps to 151.1 bps. In Europe, the iTraxx Series 6 was essentially flat on the week, closing at 30.2 bps. The same could be said for the Europe HVOL index which widened just over 0.1 bps to 57.43 bps. The iTraxx Crossover index posted tightening of 2.4 bps to end the week at 286.9 bps.

On October 25, the second version of the CMBX index will launch. One of the changes to the series will be the addition of a BB class, which will provide an alternate exposure to lower-rated CMBS. Last week, the CMBX witnessed marginal spread movement in the AAA to A tranches, while the BBB class tightened 1 bp to 63 bps and the BBB- class compressed 3.75 bps to 103.6 bps. The ABX ended the week with mixed results, as the AAA to A tranches were flat to less than 1 bps wider. Meanwhile, the BBB class widened 9 bps to 155.9 bps and the BBB- tightened 1.2 bps to 270.8 bps.

Rating Agency Regulation: The Credit Rating Agency Reform Act of 2006 (S.3850) was signed into law last Friday. The new law establishes a standardized procedure for a credit rating agency to apply to the SEC for designation as a "nationally recognized statistical rating organization" or NRSRO. The benefit of such a designation is that credit ratings from a NRSRO confer benefits under certain regulations while ratings from a non-NRSRO rating agency do not.

The law creates new section 15E of the Securities Exchange Act of 1934. Under that section, each NRSRO will be required to register with the SEC and to provide updated information periodically. Subsection 15E(g) requires each NRSRO to have procedures for preventing the misuse of non-public information. Subsection 15E(h) requires each NRSRO to have procedures for managing conflicts of interest, including conflicts that arise from charging issuers for ratings. Subsection 15E(i) authorizes the SEC to make rules prohibiting conduct by NRSROs that the SEC deems "unfair, coercive, or abusive."

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One provision, § 15E(i)(1)(B), appears to restrict or prohibit the longstanding practice of "notching." Notching occurs when a rating agency *estimates what rating it would have assigned to a security based on the ratings actually assigned by other rating agencies*. Some rating agencies employ notching as part of their process for rating CDOs. Notching is one of several ways for a rating agency to handle underlying securities that it did not rate. Naturally, the most obvious approach for handling such securities would be to rate them. However, rating agencies have to charge significant fees for doing so and must have access to the relevant information. Notching is an alternative that the rating agencies make available to CDO issuers. It remains to be seen whether the new law will mean the end of notching.

The new law arguably violates the First Amendment as an unconstitutional infringement of freedom of the press. Congress attempted to justify the law with a finding that credit ratings substantially affect interstate commerce. That justification seems weak. Rating agencies publish information and opinions about investment products, just like *The Wall Street Journal*, *The Financial Times*, *Business Week*, *Forbes*, *Fortune*, *Institutional Investor*, and others. The notion of regulating those publications would strike most Americans as preposterous. Just because market participants consider rating agency publications and opinions to be authoritative does not diminish the agencies' status as publishers. Rather, it means that the rating agencies are good at what they do. Accordingly, regulating the rating agencies possibly should be viewed as an unconstitutional encroachment on freedom of the press.

U.S. Regulators Publish Basel II Proposal: Last Monday (9/25/06), banking regulators officially released their proposal for implementing the Basel II risk based capital guidelines in the U.S.¹ The proposal's future is uncertain. Both Congress and various segments of the banking industry have criticized it. Last Tuesday the Senate held hearings at which various witnesses reiterated some of the criticisms.² One criticism is that Basel II creates a competitive imbalance between large banks and small banks in the U.S. A second criticism is that the proposed U.S. implementation could put U.S. banks at a competitive disadvantage relative to foreign banks. A third criticism is that Basel II is just too complicated (you merely need to flip through the proposal to see why). Until the criticisms can be reasonably addressed, it seems unlikely that the final implementation of regulations will be adopted.

Pension reform: FAS No. 158 finalized. On Friday, FASB issued FAS No. 158, *Employers' Accounting for Defined Benefit Pension and other Postretirement Plans*.³ Effective for the fiscal year ending after December 15, 2006 (2007 10-K filings), publicly traded companies will be required to provide the funding status of its benefit plan as a financial statement line item (a footnote will no longer be acceptable) as well as recognize any changes in the balance that occur during the year. The change is aimed to help investors and employees better understand a company's financial position and its ability to meet its future obligations.

The standard will measure the funding status for a company as of the date of that company's fiscal year-end. Pension and OPEB balances will now appear on the balance sheet as "Other Comprehensive Income" under Shareholders Equity. The funded status of a plan will be calculated using the difference between the fair value of plan assets and the projected pension benefit liability. Having to disclose potentially huge liabilities on the balance sheet could cause some companies to breach restrictive covenants or alter dividend policies that are linked to balance sheet ratios. CreditSights notes that almost 85% of S&P 500 companies with pension plans were underfunded with an aggregate unfunded position of \$140 billion at year-end 2005. The expected balance sheet volatility could cause companies to shift their investment allocation to more stable fixed income products. This change in funding would likely lead to more conservative plan rate of return assumptions and consequently reduce reported earnings for companies with large benefit plans.

¹ Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, *Risk-Based Capital Standards: Advanced Capital Adequacy Framework*, 71 Fed. Reg. 55830 (25 Sep 2006) (joint notice of proposed rulemaking)

² See <http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=241>.

³ See <http://www.fasb.org/st/summary/stsum158.shtml>.

II. Recent Pricing & Pipeline

Issue	Date	Size (mm)	Collateral Manager	Assets	Lead	Class	Rating (M/S/F)	WAL	Spread	
Carina CDO Ltd.**	9/29	\$1,500.00	State Street Global Adv	ABS	DBS					
						1,050.00	A-1	Aaa/AAA/-	6.0	Not Offered
						90.00	A-2	Aaa/AAA/-	7.1	+42/L
						75.50	B-1	Aa2/AA/-	7.3	+53/L
						46.50	B-2	Aa3/AA/-	7.5	+62/L
						60.00	C-1	A2/A/-	7.5	+140/L
						19.50	C-2	A3/A/-	7.5	+165/L
						21.00	D-1	Baa1/BBB+/-	7.5	+265/L
						46.50	D-2	Baa2/BBB/-	6.6	+325/L
						16.50	D-3	Baa3/BBB/-	7.5	+390/L
75.00	Eq	-/-	-	-						
Landmark 8	9/29	\$515.875	Aladdin Capital	Loans	DB					
						317.88	A-1	Aaa/AAA/-	7.8	+24/L
						35.50	A-2	Aa1/AAA/-	10.0	+33/L
						36.00	B	Aa2/AA/-	10.0	+36/L
						34.00	C	A2/A/-	10.0	+75/L
						26.00	D	Baa2/BBB/-	10.0	+145/L
						20.00	E	Ba2/BB/-	10.0	+360/L
						46.50	Eq	-/-	-	-
Fort Duquesne CDO 2006-1	9/29	\$1,000.00	Federated Investors	ABS	BAS					
						11.00	A-X	Aaa/AAA/-	4.7	+30/1ML
						450.00	A-1A	Aaa/AAA/-	8.3	-
						400.00	A-1B	Aaa/AAA/-	8.3	-
						100.00	A-2	Aaa/AAA/-	8.4	+43/1ML
						26.50	B	Aa2/AA/-	8.7	+52/1ML
						11.50	C	A2/A/-	9.4	+145/1ML
						5.50	D	Baa2/BBB/-	8.3	+350/1ML
6.50	PS	-/-	-	-						
Hudson HG 2006-1	9/29	\$1,500.00	(static)	ABS	GS					
						12.10	S	Aaa/AAA/-	2.8	Not Offered
						1,275.00	A1	Aaa/AAA/-	5.6	Not Offered
						123.75	A2	Aaa/AAA/-	5.6	+45/1ML
						60.75	B	Aa2/AA/-	6.0	+54/1ML
						20.25	C	A2/A/-	6.2	+130/3ML
						12.75	D	Baa2/BBB/-	4.4	+325/3ML
						7.50	PS	Ba3/-/-	-	-
Duke HD II-S EGAM I: Series 2	9/29	\$1,350.00	Duke Funding	RMBS	CSFB					
						1,212.50	Repo	-/-	-	-
						50.00	A2	Aaa/AAA/AAA	-	+46/1ML
						25.00	B1	Aa1/AA+/AA+	-	+55/1ML
						32.50	B2	Aa3/AA-/AA-	-	+67/1ML
						20.00	C	A2/A/A	-	+145/1ML
						8.75	D	Baa2/BBB/BBB	-	+290/1ML
						2.00	Eq	-/-	-	-
Scorpius CDO*	9/28	\$1,500.00	Strategos Capital Mgmt	ABS	ML					
						975.00	A1	Aaa/AAA/-	6.4	Not Offered
						90.00	A2A	Aaa/AAA/-	5.7	+38/1ML
						90.00	A2B	Aaa/AAA/-	7.0	+45/1ML
						50.00	B	Aa2/AA/-	6.4	+54/1ML
						60.00	C	Aa3/AA/-	6.4	+63/1ML
						22.00	D	A2/A/-	6.4	+140/1ML
						52.00	E	A3/A/-	6.4	+165/1ML
						58.00	F	Baa2/BBB/-	5.3	+325/1ML
						20.00	G	Baa3/BBB/-	5.3	+385/1ML
87.00	Pref	-/-	-	-						

Issue	Date	Size (mm)	Collateral Manager	Assets	Lead	Class	Rating (M/S/F)	WAL	Spread
Longride ABS CDO I	9/28	\$500.00	D.B.Zwirn & Co.	ABS	ML				
		\$200.00				A1A	Aaa/AAA/-	5.9	Not Offered
		\$150.00				A1B	Aaa/AAA/-	5.9	+30/3ML
		55.00				A2	Aaa/AAA/-	6.1	+45/3ML
		27.00				B	Aa2/AA/-	6.1	+52/3ML
		20.00				C	A2/A/-	6.1	+130/3ML
		12.00				D	Baa2/BBB/-	5.8	+315/3ML
		12.00				E	Baa3/BBB/-	5.8	+385/3ML
		8.00				F	Ba1/BB+/-	5.8	+625/3ML
		16.00				PS	-/-	-	-
Kent Funding II	9/28	\$1,300.00	Declaration Mgmt & Research	ABS	ML				
		\$780.00				A1	Aaa/AAA/-	6.6	+16/1ML
		\$325.00				A2	Aaa/AAA/-	6.6	+35/1ML
		\$113.00				A3	Aaa/AAA/-	6.9	+45/3ML
		\$55.00				B	Aa2/AA/-	6.9	+51/3ML
		\$10.00				C	A2/A/-	6.9	+130/3ML
		\$11.00				D	Baa2/BBB/-	6.8	+310/3ML
		\$9.00				Pref	-/-	-	-
Istana HG ABS CDO I*	9/28	\$1,000.00	ST Asset Mgmt	ABS	ML				
		600.00				A1	Aaa/AAA/-	4.6	+16/1ML
		250.00				A2	Aaa/AAA/-	5.5	+35/1ML
		50.00				A3	Aaa/AAA/-	5.6	+38/3ML
		50.00				A4	Aaa/AAA/-	5.6	+45/3ML
		21.50				B	Aa2/AA/-	5.6	+51/3ML
		13.00				C	A2/A/-	5.6	+130/3ML
		7.50				D	Baa2/BBB/-	5.6	+310/3ML
		2.55				E	Ba1/BB+/-	4.6	+600/3ML
		5.45				Pref	-/-	-	-
Non-profit Pref Funding (STEP)	9/28	\$416.00	Cohen Muni Cap	-	ML				
		90.00				A1	Aaa/-/AAA	9.1	+55/MMD
		230.00				A2	Aaa/-/AAA	9.1	+61/MMD
		16.50				B	Aa2/-/IAA	9.9	+80/MMD
		22.00				C	A2/-/IA	9.9	+105/MMD
		14.00				D	Baa2/-/BBB	9.9	+150/MMD
44.00	E	-/-	-	-					
Grand Avenue CDO II	9/28	\$1,500.00	TCW Asset Mgmt	ABS	WS/ Fortis				
		1,128.00				A-1A	Aaa/AAA/-	6.5	-
		150.00				A-1B	Aaa/AAA/-	6.7	-
		42.00				A-2	Aaa/AAA/-	6.7	-
		61.50				A-3	Aaa/AAA/-	6.7	+42/3ML
		66.00				B	Aa2/AA/-	6.7	+53/3ML
		18.00				C	A3/A/-	6.7	+140/3ML
		18.00				D	Baa2/BBB/-	6.7	+300/3ML
		16.50				PS	-/-	-	-
		IMAC CDO 2006-1*				9/28	\$300.00	Ivy Asset	CDOs
75.00	A1		Aaa/AAA/-	5.4	+25/3ML				
110.00	A2		Aaa/AAA/-	6.0	+45/3ML				
16.00	B		Aaa/AAA/-	6.1	+55/3ML				
35.00	C		Aa2/AA/-	6.1	+64/3ML				
5.50	D		Aa3/AA/-	6.1	+75/3ML				
20.00	E		A2/A/-	6.1	+160/3ML				
20.00	F		Baa2/BBB/-	5.3	+365/3ML				
3.50	G		Baa3/BBB/-	5.3	+460/3ML				
15.00	PS		-/-	-	-				

Issue	Date	Size (mm)	Collateral Manager	Assets	Lead	Class	Rating (M/S/F)	WAL	Spread
JER CRE CDO 2006-2	9/27	\$1,200.00	J.E. Robert Co.	CRE	GS/MS				
						A-FL	Aaa/AAA/AAA	8.19	+33/L
						B-FL	Aa2/AA/AA	9.41	+50/L
						C-FL	A1/A+/AA-	9.74	+65/L
						C-FX	A1/A+/AA-	9.74	+65/Sw
						D-FL	A2/A/A+	9.86	+75/L
						D-FX	A2/A/A+	9.86	+75/Sw
						E-FL	A3/A-/A-	9.97	+85/L
						E-FX	A3/A-/A-	9.97	+85/Sw
						F-FL	Baa1/BBB+/BBB+	10.02	+150/L
						G-FL	Baa2/BBB/BBB-	10.02	+200/L
						H-FL	Baa2/BBB/-	10.02	+250/L
Rockville CDO I**	9/27	\$1,200.00	Petra Cap Mgmt	RMBS	ML				
						A1	Aaa/AAA/-	5.3	+21/1ML
						A2	Aaa/AAA/-	6.2	+27/1ML
						A3	Aaa/AAA/-	6.2	+44/3ML
						B	Aa2/AA/-	6.2	+50/3ML
						C	Aa3/AA/-	6.2	+61/3ML
						D	A3/A/-	6.2	+135/3ML
						PS	-/-	-	-
Pampelonne CDO I*	9/27	\$1,250.00	Vertical Capital	ABS	BarCap				
						S Snr	-/-	-	-
						A-1	Aaa/AAA/-	8.0	+40/3ML
						A-2	Aaa/AAA/-	8.0	+44/3ML
						B	Aa2/AA/-	8.0	+50/3ML
						C	A2/A/-	8.0	+140/3ML
						D	Baa2/BBB/-	8.0	+335/3ML
						E	Ba1/BB+/-	8.0	+650/3ML
Inc Nts	-/-	-	-						
Halcyon Loan Inv – I	9/26	\$400.00	Halcyon Loan Inv	Loans	CITG				
						A-1A	Aaa/AAA/-	-	+25/3ML
						A-1B	Aa1/AAA/-	-	+34/3ML
						A-2	Aa2/AA/-	-	+38/3ML
						B	A2/A/-	-	+69/3ML
						C	Baa2/BBB/-	-	+145/3ML
						D	Ba2/BB/-	-	+350/3ML
						Inc Nts	-/-	-	-

New Pipeline	Size (mm)	Collateral Man.	Assets	Lead
Sorrento 2006-1*	\$67.40	(static)	ABS	CS
Harbourview CLO 2006-1	\$400.00	Harbourview Asset Mgmt	Loans	CS

* denotes synthetic; ** denotes hybrid deals.

Source: MCM, IFR, Bloomberg

III. Spreads

Index Constituent	29-Sep	Week Ago	Moody's Rating	S&P's Rating	5Y CDS Index	29-Sep	Last week	Change
Fannie Mae	7	7	Aaa	AAA	CDX.NA.IG 7	39.62	41.30	-1.68
Boeing	13	13	A2	A	CDX.NA.IG HVOL 7	83.93	86.82	-2.89
IBM	18	18	A1	A+	CDX.NA.XO 7	171.20	173.92	-2.72
Deere & Co	17	17	A3	A-	CDX.NA.HY 7	324.37	322*	+2.37
GE Capital	13	12	Aaa	AAA	CDX.EM 6	151.08	162.22	-11.14
AIG	10	10	Aa2	AA	iTraxx Europe 6	30.20	30.38	-0.18
Dow Chemical	20	21	A3	A-	iTraxx Europe HVOL 6	57.43	57.25	+0.18
Alcoa	19	19	A2	A-	iTraxx Europe X-over 6	286.88	289.25	-2.37
CIT Group	27	27	A2	A	iTraxx CJ Japan 6	24.82	25.13	-0.31
Duke Power Co	23	23	A3	BBB	iTraxx Asia ex-Japan 6	61.56	61.66	-0.10
McDonalds	16	14	A2	A	iTraxx Australia 6	31.25	33.25	-2.00
Walt Disney	17	18	A3	A-	iTraxx SDI-75 3	35.15	34.89	+0.26
Viacom	59	59	Baa3	BBB	CDX IG 7 Widest	29-Sep		
Time Warner	45	47	Baa2	BBB+ /*-	RadioShack Corp	126		
Xerox Corp	89	97	Ba1	BB+	Starwood Hotels & Resorts ¹	126		
Altria Group	39	34	Baa2 /*+	BBB	Toll Bros Inc	122		
Tyson Foods	112	116	Ba2	BB+	EXPEDIA INC	117		
Ford Motor Credit	370	390	B3	B	Sabre Hldgs Corp	111		
GMAC	171	187	Ba1 /*-	BB /*	CDX IG 7 Tightest	29-Sep		
Carrefour	15	15	A2	A	Fed Natl Mtg Assn	7		
AXA	13	12	A2	A	Wells Fargo & Co	8		
AKZO Nobel N V	26	27	A3	A-	Wal Mart Stores Inc	10		
Suez	13	11	A2 /*+	A- /*+	Amern Intl Gp Inc	10		
GUS PLC	42	40	Baa1 /*-	BBB+ /*-	Target Corp	12		
Cadbury Schweppes PLC	35	36	Baa2	BBB	iTraxx Europe Widest	29-Sep		
Renault	45	42	Baa1	BBB+	ITV Plc	111		
Brit Telecom PLC	44	46	Baa1	BBB+	Glencore Intl AG	108		
Lafarge	42	38	Baa2	BBB	Valeo	89		
Deutsche Telekom AG	44	49	A3	A-	Telecom Italia SpA	75		
METRO AG	33	33	Baa2	BBB	GKN Hldgs plc	75		
France Telecom	36	38	A3	A-	iTraxx Europe Tightest	29-Sep		
Telecom Italia SpA	75	83	Baa2	BBB+ /*-	Royal Bk Scotland plc	6		
Volkswagen AG	28	27	A3	A-	ABN AMRO Bk N V	7		
DaimlerChrysler AG	64	68	Baa1 /*-	BBB	Barclays Bk plc	7		
Telenor ASA	31	31	A2e	BBB+	SAN PAOLO IMI S p A	9		
Koninklijke Ahold N V	123	129	Ba1	BB	Bca Intesa SpA	9		

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

* The CDX.NA HY 7 spread for last week is actually as of Sept. 27, the date the new series began trading

Source: Markit and Bloomberg

ABX.HE Index (as of September 29, 2006)				
	Price	Weekly change (bps)	Spread* (bps)	Coupon (bps)
ABX.HE.AAA.06-2	100.09	-	8.90	11
ABX.HE.AA.06-2	100.09	+ 0.26	14.49	17
ABX.HE.A.06-2	99.75	+ 0.64	51.55	44
ABX.HE.BBB.06-2	99.28	+ 8.98	155.91	133
ABX.HE.BBB-.06-2	99.12	- 1.23	270.83	242
CMBX.NA Index (as of September 29, 2006)				
	Spread	Weekly change (bps)	Coupon (bps)	
CMBX.NA.AAA.06-1	6.76	+ 0.19	10	
CMBX.NA.AA.06-1	16.51	- 0.16	25	
CMBX.NA.A.06-1	25.98	- 0.58	35	
CMBX.NA.BBB.06-1	63.00	- 1.00	76	
CMBX.NA.BBB-.06-1	103.56	- 3.75	134	

Source: Markit * assuming 35% CPR.

Source: Nomura Securities International

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