

CDO/CDS Update 08/07/06

I. Commentary

All eyes will be focused on tomorrow's FOMC meeting, as investors are pricing in about a 20% chance of an interest rate increase. The slim expectation of a rate hike follows Friday's weaker-than-expected July non-farm payrolls figure of 113,000 compared to expectations of 144,000 and an unemployment rate that was 0.2% higher than estimates at 4.8%. In corporate credit, quarterly earnings have been strong with more out-performers than underperformers. However, event risk continues to loom with Ford, Visteon, and HCA all making M&A headlines last week. In addition, British Petroleum's announced closing of the Alaskan Prudhoe Bay field, the largest U.S. oil field (8% of U.S. production), due to pipeline corrosion moved oil to over \$76 a barrel this morning, its largest spike in two weeks.

Credit index spreads in North America and Europe were relatively subdued for the week. The North American investment grade series 6 index tightened 0.3 bp to close at 40.4 and the iTraxx Europe Series 5 index widened 0.1 bps to end the week at 30.7 bps. The NA crossover and high-yield indices were both tighter by just under 3 bps to close at 192.4 and 344.1 bps, respectively. The high volatility index finished the week wider by 0.3 bps to 79.6 bps. The emerging markets index continued to tighten and reached a 3-month low of 138.3 bps, after tightening 4.6 bps during the week. The rest of the major global credit indices traded within a narrow range of less than 2 bps week-over-week. In the on-the-run ABX and CMBX series, the credit curve flattened once again with the BBB and BBB- rated tranches tightening much more than the tranches rated single-A and above.

Despite July unit sales declines of 23% and 34% for GM and Ford, respectively, CDS spreads for the two companies managed to tighten during the week. Higher gasoline prices crippled truck sales and reduced manufacturer incentives resulted in the fourth straight month of declining unit sales for U.S. manufactures. For the first time, Toyota outsold Ford in a one-month period and moved to the number two spot behind GM in U.S. vehicle sales. Also last week, Ford restated its 2Q loss to \$254 million from \$123 million due to increased pension costs from North American head count reductions. However, U.S. auto-manufacturer CDS spreads were tighter following a *Wall Street Journal* report that Ford had hired an M&A specialist to examine the possible sale of its Jaguar division and to evaluate other strategic options. Ford Motor Credit 5-year CDS tightened 40 bps on the week to 394 bps, while GMAC 5-year CDS narrowed 12 bps to 205 bps, a 3-month low. Helping the auto supplier sector was the surge in Visteon Corp. following reports that the company hired Citigroup and JPMorgan to advise it on a sale. Visteon 5-year CDS spreads were 48 bps tighter for the week to close at 518 bps, while the company's stock increased over 28% on the day of the news release.

Toys 'R' Us receives notice of default. On July 26, Toys R Us (TOY) received a notice of default from select bondholders in reference to \$200 million of 8.75% 2021 bonds issued from its TOYS-Delaware subsidiary. The bondholders, who are represented by Mackay Shields LLC, claim that TOY violated a reporting requirement and breached a covenant that mandates the company maintain its ability to secure debt. Although details in the TOY 8-K filing with the SEC were brief, the issue

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seemingly revolves around the recent transfer of assets from the operating company to a subsidiary to finance a \$1.3 billion term loan.¹ According to TOY, the transferred properties were not used to secure debt and the company remains in compliance with its payments and reporting obligations. TOY has also informed the trustee that the notice of default is without merit. In our opinion, MacKay Shields is attempting to create a large enough burden for TOY that it forces the company to buy back the bonds at a premium. Both S&P and Fitch announced that the claim would not lead to any immediate rating action, as the eventual outcome should not have a material effect on the company. TOY CDS spreads were essentially unchanged on the news.

Stability Scores for CDOs. Last week, Fitch announced that it will incorporate stability scores in its ratings for synthetic CDOs that primarily reference corporate portfolios.² A stability score represents the likelihood that the rating of a CDO tranche will remain within a certain rating category after one year. The analysis for stability scores will first simulate one year corporate rating migration rates and then use Fitch's VECOTR to determine the CDO's rating following the migration. The stability rating scale will consist of ST1, ST2, and ST3 scores. ST1 is the highest stability score and represents a theoretical estimate of stability of at least 90%; ST2 implies a stability estimate of 80-90% and ST3 below 80%. At first, stability scores will only be available to AAA rated tranches on a point-in-time basis. Single tier and CDO-squared structures will not be given stability scores. In addition, managed deals will not be evaluated any differently from static deals. The assumption will be that no asset substitutions occur in the upcoming year for managed CDOs. In our view, the introduction of stability scores for synthetic CDOs probably reflects investor dissatisfaction with the stability of ratings in that sector.

Cendant CDS nearly doubles. Cendant CDS spreads nearly doubled last Monday after an extended tender offer to redeem all of the parent company's debt expired with roughly \$63 million of bonds remaining outstanding. The company is undergoing a split that will result in four separately traded entities and will leave all outstanding Cendant debt the obligation of Avis Budget Car Rental. This debt will be structurally subordinated to an expected \$1.0 billion of eight- and 10-year senior unsecured notes and a \$2.375 billion secured credit facility. Moody's responded by downgrading the \$63 million of soon to be subordinate debt to B2 from Baa1 before withdrawing its rating on the company. In March, when the tender offer was first announced, 5-year CDS spreads tightened from a wide of 132 bps to about 52 bps. However, with a somewhat unexpected \$63 million of high yield bonds still outstanding, CDS spreads moved out to 90 bps as of Friday. These non-tendered bonds serve as a possible deliverable obligation for physical settlement CDS and will likely continue to place pressure on Cendant CDS that reference these low-rated legacy bonds.

Fitch releases VECTOR 3.0. Fitch ratings released a beta version of release 3.0 of its VECTOR CDO simulation model market feedback.³ The new model has updated default probabilities, recovery rates and implements Fitch's emerging market's criteria. Overall, VECTOR 3.0 is not expected to result in major rating differences from the 2.2 version, although it does take a more critical view on shorter dated tranches, according to the Fitch. One key modification to the new model is the change in CMBS inter- and intra-industry correlation assumptions. These correlations have been decreased to 75% of their VECTOR 2.2 amount due to the perceived individual characteristics (i.e. property type, geography, etc.) of CMBS deals. Feedback on the proposed changes are due by August 25.

¹ Toys "R" Us, Inc., Current Report on Form 8-K (28 Jul 2006).

² Gambel, R, R. Hrvatin and G Stoye, *Stability Scores for Synthetic CDOs*, Fitch Global Criteria Report (2 August 2006).

³ Vedova, P, L. Jebjerg and L. Carter, *Exposure Draft: Introducing the Fitch VECTOR Default Model Version 3.0*, Fitch Criteria Report (28 July 2006).

II. Recent Pricing & Pipeline

| Issue | Date | Size (mm) | Collateral Manager | Assets | Lead | Class | Rating (M/S/F) | WAL | Spread | | | |
|--------------------------------|------|------------|--------------------|----------------|-------|-------------|----------------|----------|----------|--|--|--|
| Shinnecock CLO 2006-1 | 8/4 | \$300.00 | Clinton Group | Loans | MS | | | | | | | |
| | | 198.00 | | | | A-1 Sr | Aaa/AAA/- | 7.9 | +25/3ML | | | |
| | | 22.00 | | | | A-2 Sr | Aa1/AAA/- | 9.7 | +40/3ML | | | |
| | | 24.00 | | | | B Sr | Aa2/AA/- | 10.3 | +48/3ML | | | |
| | | 14.00 | | | | C Mz | A2/A/- | 10.8 | +90/3ML | | | |
| | | 12.00 | | | | D Mz | Baa2/BBB/- | 11.2 | +180/3ML | | | |
| | | 7.50 | | | | E Jr | Ba2/BB/- | 11.4 | +425/3ML | | | |
| | | 22.50 | | | | S/N | -/- | - | - | | | |
| | | | | | | | | | | | | |
| Galaxy VII CLO | 8/4 | \$453.00 | AIG | Loans | MS | | | | | | | |
| | | 270.50 | | | | A1 | Aaa/AAA/- | 8.1 | +25/3ML | | | |
| | | 60.00 | | | | A2 | Aaa/AAA/- | 8.1 | +25/3ML | | | |
| | | 29.50 | | | | B | Aa2/AA/- | 10.4 | +39/3ML | | | |
| | | 26.00 | | | | C | A2/A/- | 10.8 | +67/3ML | | | |
| | | 19.00 | | | | D | Baa2/BBB/- | 11.3 | +145/3ML | | | |
| | | 13.50 | | | | E | Ba2/BB/- | 11.6 | +360/3ML | | | |
| | | 34.50 | | | | Sub | -/- | - | - | | | |
| | | | | | | | | | | | | |
| Denali Cap Crt. Opp. Fund Fin. | 8/4 | \$454.00 | Denali Capital | (market value) | DB | | | | | | | |
| | | 105.00 | | | | A1 | Aaa/AAA/- | - | +31/3ML | | | |
| | | 265.00 | | | | A2 | Aaa/AAA/- | - | +35/3ML | | | |
| | | 17.00 | | | | B1 | Aa2/AA/- | - | +44/3ML | | | |
| | | 17.00 | | | | C1 | A2/A/- | - | +75/3ML | | | |
| | | 50.00 | | | | Com Cap | -/- | - | - | | | |
| | | | | | | | | | | | | |
| Midori CDO Ltd.** | 8/4 | \$506.50 | Lehman Asset Mgmt | Mezz ABS | WS/GS | | | | | | | |
| | | 122.50 | | | | A1 funded | Aaa/AAA/- | 5.3 | +34/3ML | | | |
| | | 202.50 | | | | A1 unfund | Aaa/AAA/- | 6.8 | - | | | |
| | | 6.50 | | | | AX | Aaa/AAA/- | 5.0 | +32/3ML | | | |
| | | 81.50 | | | | A2 | Aaa/AAA/- | 7.0 | +43/3ML | | | |
| | | 28.00 | | | | B | Aa2/AA/- | 7.0 | +48/3ML | | | |
| | | 26.00 | | | | C | A2/A/- | 7.0 | +130/3ML | | | |
| | | 14.00 | | | | D | Baa2/BBB/- | 7.0 | +310/3ML | | | |
| | | 5.50 | | | | E | Ba1/BB+/- | 7.0 | +650/3ML | | | |
| | | 20.00 | | | | Sub | -/- | - | - | | | |
| | | | | | | | | | | | | |
| Gramercy CRE CDO 2006-1 | 8/3 | \$1,000.00 | GKK Mngr | CRE | | | | | | | | |
| | | 500.00 | | | A1 | Aaa/AAA/- | 5.63 | +26/3ML | | | | |
| | | 171.25 | | | A2 | Aaa/AAA/- | 6.35 | +30/3ML | | | | |
| | | 95.00 | | | B | Aa2/AA/- | 7.38 | +37/3ML | | | | |
| | | 33.75 | | | C | A1/A+/- | 7.92 | +52/3ML | | | | |
| | | 20.00 | | | D | A2/A/- | 8.00 | +56/3ML | | | | |
| | | 26.25 | | | E | A3/A/- | 8.00 | +70/3ML | | | | |
| | | 20.00 | | | F | Baa1/BBB+/- | 8.00 | +100/3ML | | | | |
| | | 20.00 | | | G | Baa2/BBB/- | 8.00 | +120/3ML | | | | |
| | | 17.50 | | | H | Baa3/BBB/- | 8.09 | +150/3ML | | | | |
| | | 85.00 | | | PS | -/- | - | - | | | | |
| | | | | | | | | | | | | |
| | | | | | | | | | | | | |

| Issue | Date | Size (mm) | Collateral Manager | Assets | Lead | Class | Rating (M/S/F) | WAL | Spread |
|-----------------------|------|------------|--------------------|----------------|---------|----------|----------------|-------|-------------|
| G-Force 2006-1 | 8/3 | \$881.00 | GFAM | CRE | BS | | | | |
| | | 57.20 | | | | A1 | Aaa/AAA/AAA | 3.50 | +24/Sw |
| | | 74.60 | | | | A2 | Aaa/AAA/AAA | 6.19 | +31/Sw |
| | | 135.20 | | | | A3 | Aaa/AAA/AAA | 7.54 | +38/Sw |
| | | 203.00 | | | | SSFL | Aaa/AAA/AAA | - | Not Offered |
| | | 67.00 | | | | JRFL | Aaa/AAA/AAA | - | Not Offered |
| | | 42.90 | | | | B | Aa1/AA+/AA+ | 9.35 | +43/Sw |
| | | 18.70 | | | | C | Aa2/AA/AA | 9.48 | +46/Sw |
| | | 31.90 | | | | D | A2/A+/A+ | - | Not Offered |
| | | 28.60 | | | | E | -/A/A | - | Not Offered |
| | | 12.10 | | | | F | -/A-/A- | - | Not Offered |
| | | 22.00 | | | | G | -/BBB+/BBB+ | 10.15 | +135/Sw |
| | | 16.50 | | | | H | -/BBB/BBB | 10.35 | +175/Sw |
| | | 22.00 | | | | J | -/BBB-/BBB- | 10.77 | +245/Sw |
| 59.20 | K-P | - | - | Retained | | | | | |
| 89.40 | Pref | - | - | Retained | | | | | |
| GoldenTree Crdt. Opp. | 8/3 | \$650.00 | GTAM | (market value) | JPM | | | | |
| | | 100.00 | | | | A-6 | Aaa/AAA/- | | +31/3ML |
| | | 300.00 | | | | A-7 | Aaa/AAA/- | | +35/3ML |
| | | 60.00 | | | | B | Aa2/AA/- | | +43/3ML |
| | | 55.00 | | | | C2 | A2/A/- | | +73/3ML |
| | | 5.00 | | | | C3 | A2/A/- | | Fx 6.192% |
| 130.00 | D | -/BBB/- | | +137/3ML | | | | | |
| De Meer MM CLO 2006-1 | 8/3 | \$410.00 | LaSalle | Loans | WS/ ABN | | | | |
| | | 193.20 | | | | A1 | Aaa/AAA/AAA | 2.36 | +12/3ML |
| | | 82.80 | | | | A2 | Aaa/AAA/AAA | 4.53 | +25/3ML |
| | | 10.80 | | | | B | Aa2/AA/AA | 3.20 | +40/3ML |
| | | 34.00 | | | | C | A2/A/A | 3.20 | +60/3ML |
| | | 18.80 | | | | D | Baa2/BBB/BBB | 3.20 | +125/3ML |
| | | 22.40 | | | | E | Ba2/BB/BB | 3.20 | - |
| | | 47.52 | | | | IN | -/-/- | - | - |
| ACA Aquarius 2006-1** | 8/1 | \$2,000.00 | ACA Mgmt | Mezz ABS | UBS | | | | |
| | | 1,266.00 | | | | SS | Aaa/AAA/- | 6.74 | - |
| | | 255.00 | | | | A1 | Aaa/AAA/- | 6.77 | +43/3ML |
| | | 177.00 | | | | A2 | Aa2/AA/- | 6.77 | +53/3ML |
| | | 80.00 | | | | A3 | A2/A/- | 6.77 | +155/3ML |
| | | 17.50 | | | | B1 | Baa1/BBB+/- | 6.77 | +260/3ML |
| | | 74.50 | | | | B2 | Baa2/BBB/- | 6.77 | +325/3ML |
| | | 20.00 | | | | B3 | Baa3/BBB/- | 6.77 | +370/3ML |
| | | 110.00 | | | | PS | -/-/- | - | Not Offered |
| | | | | | | | | | |
| Buckingham III CDO | 8/1 | \$1,500.00 | Deerfield | RMBS | BC | | | | |
| | | 1350.00 | | | | A / ABCP | P-1/A-1+/- | - | - |
| | | 67.50 | | | | B | Aaa/AAA/- | 7.5 | +42/1ML |
| | | 37.50 | | | | C | Aa2/AA/- | 7.5 | +50/1ML |
| | | 21.00 | | | | D | A2/A/- | 7.5 | +125/1ML |
| | | 13.50 | | | | E | Baa2/BBB/- | 7.5 | +325/1ML |
| | | 10.50 | | | | IN | -/-/- | - | - |
| | | | | | | | | | |

| New Pipeline | Size (mm) | Collateral Man. | Assets | Lead |
|----------------------------------|-----------|------------------------|----------|---------|
| Octagon-X | \$450.00 | Octagon Credit | Loans | WS/Bear |
| MSC 2006-SRR1* | \$620.00 | (static) | CMBS | MS |
| Apidos CDO IV | \$300.00 | Apidos Collateral Mgmt | - | MS |
| GSC ABS CDO 2006-4* | \$750.00 | GSC Partners | Mezz ABS | UBS |
| BlackRock Senior Income Series 3 | \$308.90 | BlackRock Fin'l Mgmt | Loans | ML |

* denotes synthetic; ** denotes hybrid deals.

Source: MCM, IFR, Bloomberg

III. Spreads

| Index Constituent | 4-Aug | Week Ago | Moody's Rating | S&P's Rating |
|-----------------------|-------|----------|----------------|--------------|
| Fannie Mae | 7 | 7 | Aaa | AAA |
| Boeing | 14 | 14 | A2 | A |
| IBM | 19 | 19 | A1 | A+ |
| Deere & Co | 21 | 21 | A3 | A- |
| GE Capital | 14 | 15 | Aaa | AAA |
| AIG | 14 | 14 | Aa2 | AA |
| Dow Chemical | 23 | 21 | A3 | A- |
| Alcoa | 21 | 21 | A2 | A- |
| CIT Group | 27 | 28 | A2 | A |
| Duke Energy | 27 | 27 | A3 | BBB |
| McDonalds | 14 | 15 | A2 | A |
| Walt Disney | 19 | 19 | A3 | A- |
| Viacom | 64 | 61 | Baa3 | BBB |
| Time Warner | 51 | 49 | Baa2 | BBB+ /*- |
| Computer Associates | 127 | 139 | Ba1 | BB |
| Altria Group | 34 | 36 | Baa2 /*+ | BBB |
| Tyson Foods | 111 | 110 | Ba1 | BBB- |
| Ford Motor Credit | 394 | 428 | B2 | B+ |
| GMAC | 205 | 215 | Ba1 /*- | BB /* |
| Carrefour | 17 | 17 | A2 | A |
| AXA | 18 | 18 | A2 | A |
| AKZO Nobel N V | 25 | 22 | A3 | A- |
| Suez | 19 | 19 | A2 /*+ | A- /*+ |
| GUS PLC | 34 | 46 | Baa1 /*- | BBB+ /*- |
| Cadbury Schweppes PLC | 34 | 35 | Baa2 | BBB |
| Renault | 39 | 43 | Baa1 | BBB+ |
| Brit Telecom PLC | 49 | 51 | Baa1 | BBB+ |
| Lafarge | 42 | 45 | Baa2 | BBB |
| Deutsche Telekom AG | 41 | 42 | A3 | A- |
| METRO AG | 36 | 37 | Baa2 | BBB |
| France Telecom | 35 | 36 | A3 | A- |
| Telecom Italia SpA | 54 | 56 | Baa2 | BBB+ |
| Volkswagen AG | 26 | 28 | A3 | A- |
| DaimlerChrysler AG | 53 | 57 | A3 | BBB |
| VNU | 509 | 505 | Caa1 | CCC+ |
| Koninklijke Ahold N V | 132 | 142 | Ba1 | BB |

| 5Y CDS Index | 4-Aug | Week Ago | Change |
|-----------------------------|--------------|----------|--------|
| CDX.NA.IG 6 | 40.41 | 40.67 | -0.26 |
| CDX.NA.IG 6 HVOL | 79.64 | 79.33 | +0.31 |
| CDX.NA.IG XOVER | 192.44 | 195.33 | -2.89 |
| CDX.NA.HY 6 | 344.07 | 346.80 | -2.73 |
| CDX.EM 5 | 138.29 | 142.87 | -4.58 |
| iTraxx Europe 5 | 30.72 | 30.59 | +0.13 |
| iTraxx Europe HVOL | 56.87 | 56.91 | -0.04 |
| iTraxx Europe X-over | 270.93 | 269.38 | +1.55 |
| iTraxx CJ Japan 5 | 28.00 | 28.08 | -0.08 |
| iTraxx Asia ex-Japan | 58.25 | 58.25 | +0.00 |
| iTraxx Australia | 28.12 | 28.34 | -0.22 |
| iTraxx SDI-75 2 | 38.06 | 38.75 | -0.69 |
| CDX Widest | 4-Aug | | |
| SUPERVALU INC | 198 | | |
| Jones Apparel Gp Inc | 155 | | |
| RadioShack Corp | 134 | | |
| Wendys Intl Inc | 125 | | |
| Tribune Co | 122 | | |
| CDX Tightest | 4-Aug | | |
| Fed Natl Mtg Assn | 7 | | |
| Wells Fargo & Co | 9 | | |
| Wal Mart Stores Inc | 11 | | |
| Target Corp | 12 | | |
| Bristol Myers Squibb Co | 13 | | |
| iTraxx Widest | 4-Aug | | |
| Portugal Telecom Intl Fin B | 180 | | |
| ITV Plc | 128 | | |
| Degussa AG | 114 | | |
| Glencore Intl AG | 104 | | |
| Valeo | 76 | | |
| iTraxx Tightest | 4-Aug | | |
| Nestle S A | 6 | | |
| ABN AMRO Bk N V | 7 | | |
| Royal Bk Scotland plc | 7 | | |
| Barclays Bk plc | 9 | | |
| SAN PAOLO IMI S p A | 9 | | |

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

Source: Markit and Bloomberg

| ABX.HE Index (as of August 4, 2006) | | | | |
|--------------------------------------|--------|---------------------|---------------|--------------|
| | Price | Weekly change (bps) | Spread* (bps) | Coupon (bps) |
| ABX.HE.AAA.06-2 | 100.09 | 0.00 | 8.90 | 11 |
| ABX.HE.AA.06-2 | 100.09 | -0.01 | 14.58 | 17 |
| ABX.HE.A.06-2 | 100.01 | -3.21 | 43.71 | 44 |
| ABX.HE.BBB.06-2 | 100.28 | -7.38 | 124.39 | 133 |
| ABX.HE.BBB-.06-2 | 100.70 | -5.71 | 219.91 | 242 |
| CMBX.NA Index (as of August 4, 2006) | | | | |
| | Spread | Weekly change (bps) | Coupon (bps) | |
| CMBX.NA.AAA.06-1 | 6.28 | -0.22 | 10 | |
| CMBX.NA.AA.06-1 | 17.81 | -0.05 | 25 | |
| CMBX.NA.A.06-1 | 28.38 | 0.17 | 35 | |
| CMBX.NA.BBB.06-1 | 64.00 | -1.00 | 76 | |
| CMBX.NA.BBB-.06-1 | 107.62 | -5.24 | 134 | |

Source: Markit * assuming 35% CPR.

Source: Nomura Securities International

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