

Update on U.S. Fixed Income Market Conditions

I. Review of U.S. Fixed Income Markets in 2006

August 29, 2006

Introduction: The U.S. fixed income market experienced a brisk pace of issuance and moderate growth in aggregate outstandings over the past six months. Rising interest rates for all but the longest maturities have kept total returns at modest levels. Economic fundamentals remain generally favorable, but softening home prices, high energy prices, and geopolitical risk factors somewhat cloud the outlook. Absent an exogenous shock, we expect current trends in issuance and market activity to generally continue over the next six to 12 months. We expect a modest deterioration in both consumer and commercial credit quality, not to a significant degree.

Economics: After notching an impressive 5.6% growth in real GDP in the first quarter, economic activity slowed substantially to a modest 2.5% pace in the second. However, newly available data suggest that real output expanded a bit faster than the "advance" second quarter estimate. In part, this moderation in growth can be traced to the evolution of monetary policy over the past two years as the Federal Reserve has sought to contain inflation pressures amidst high and rising energy costs. Though these policy actions could not prevent the run-up in energy prices from driving up headline inflation, they have largely held the acceleration of other prices in check. Powered by the surge in oil prices, the comprehensive price index for all consumer expenditures has risen 3.3% over the last four quarters, a 15-year high, but the "core" price index consumer expenditures, which nets out the influence of food and energy prices, has risen 2.3%, a slight 0.2% acceleration from its rate when the Fed began tightening in 2004.

Wide monthly (and hence, quarterly) fluctuations in motor vehicle sales, reflecting the on-again, off-again marketing promotions of car manufacturers, accounted for much of the variability in quarterly GDP growth over the past year. For instance, declines in vehicle purchases shaved 1.5% from growth in Q4, 2005 while the rebound from depressed fourth quarter vehicle sales accounted for 0.6% of the first quarter's 5.6% growth.

The slower pace of economic activity in the second quarter, however, reflected a more broadly based slowdown in spending by households. Rising fuel and gasoline costs absorbed a larger share of household income leaving less cash available for "discretionary" purchases. An abrupt cooling of the once over-heated housing market, however, played the biggest role in the second quarter slowdown with the drop in residential investment trimming 0.4% from overall GDP growth in the second quarter.

After fluctuating within a surprisingly narrow range during the first 18 months of steady tightening of monetary policy, long-term interest rates moved sharply higher during the first half of 2006. For instance, the yield on 10-year "constant maturity" U.S. Treasury notes rose from 4.47% in December 2005 to a 4-year high of 5.11% in May and June. This sudden rise in long-term interest rates appeared to reflect largely cyclical forces on real interest rate, which typically emerge a bit earlier in the business cycle but then persist throughout periods of above-trend growth. The U.S. Treasury's

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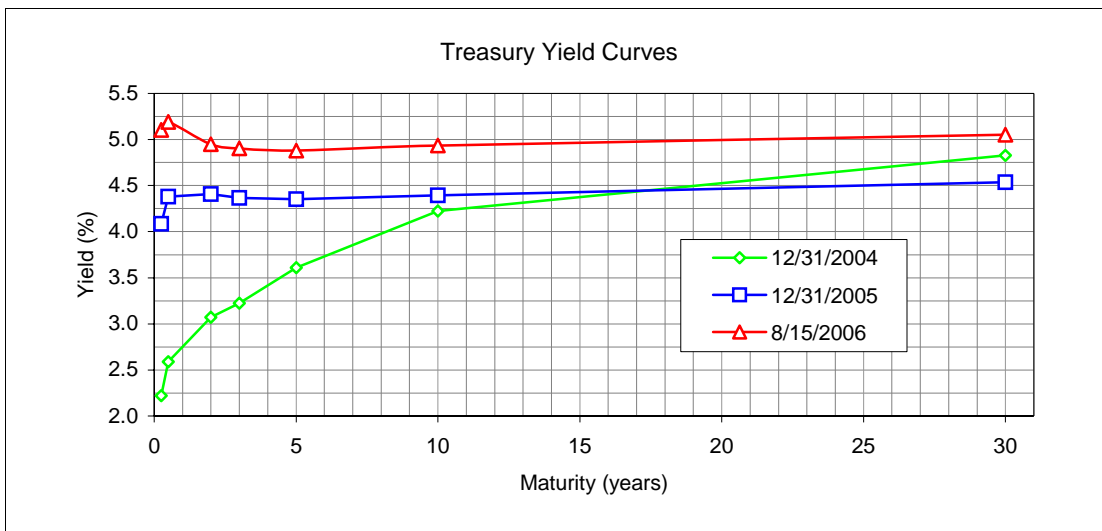
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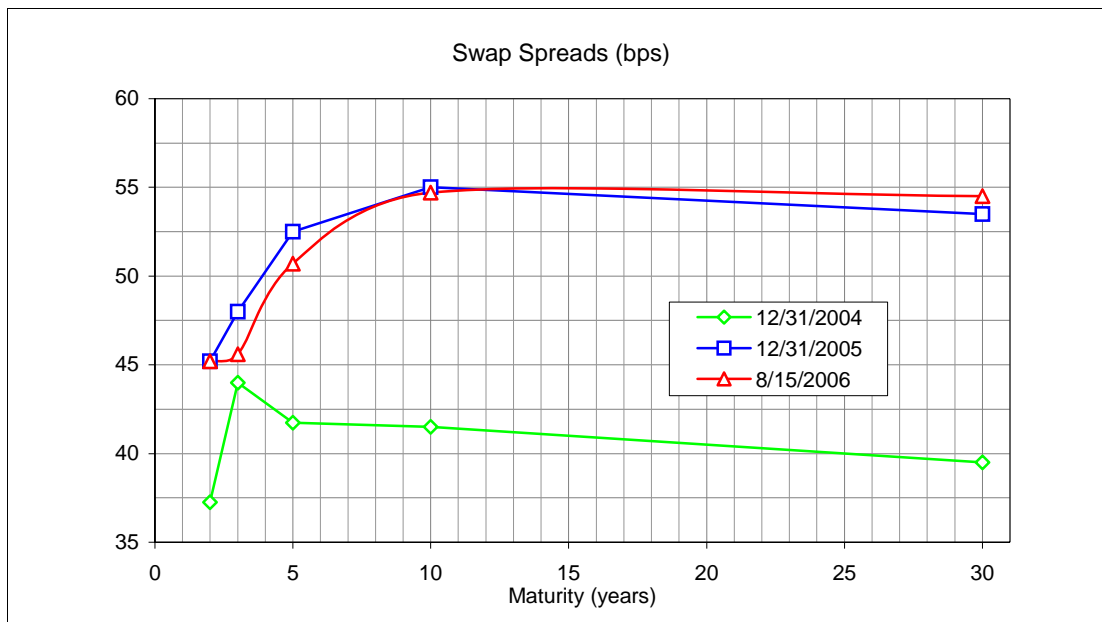
inflation-indexed (real) constant maturity 10-year yield rose from 2.12% in December 2005 to 2.53% in June 2006, accounting for about two-thirds of the rise in nominal interest rates. The remainder can be attributed to an increase in long-term inflation expectations, which nonetheless remained inside a narrow 40-basis point range since the onset of Fed tightening in mid-2004.

Interest Rates: After 17 consecutive 25 basis point interest rate hikes, the Federal Reserve voted nine to one to hold the target funds rate at 5.25% on August 8. However, the Federal Reserve left the door open for further tightening with the following statement, "the Committee judges that some inflation risks remain. The extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information."

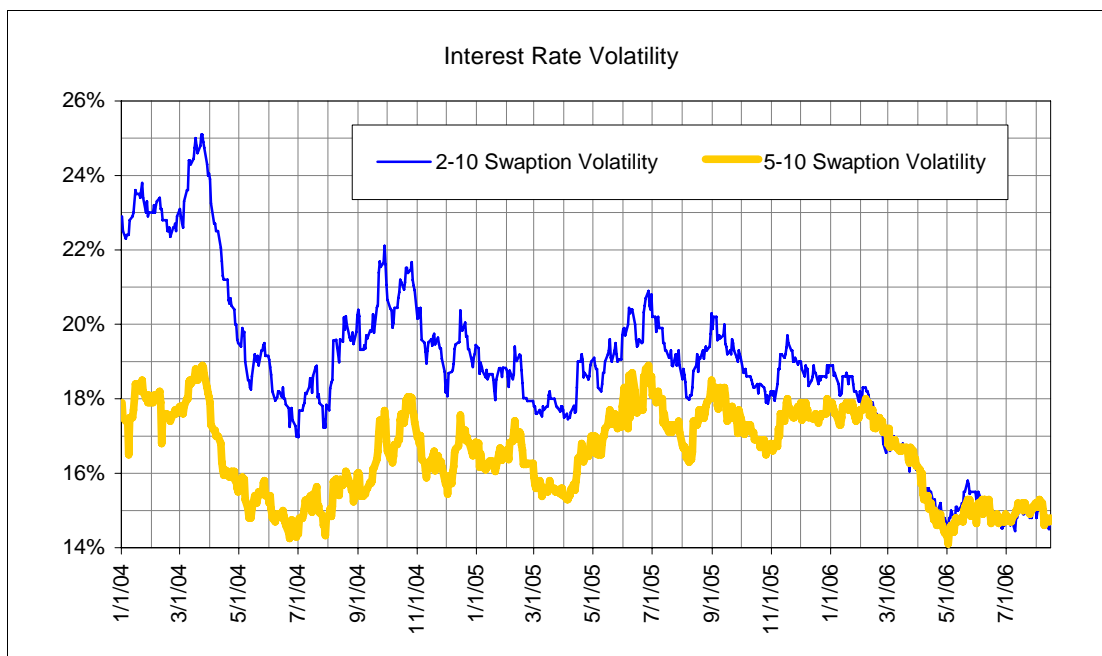


Source: Bloomberg IYC 6

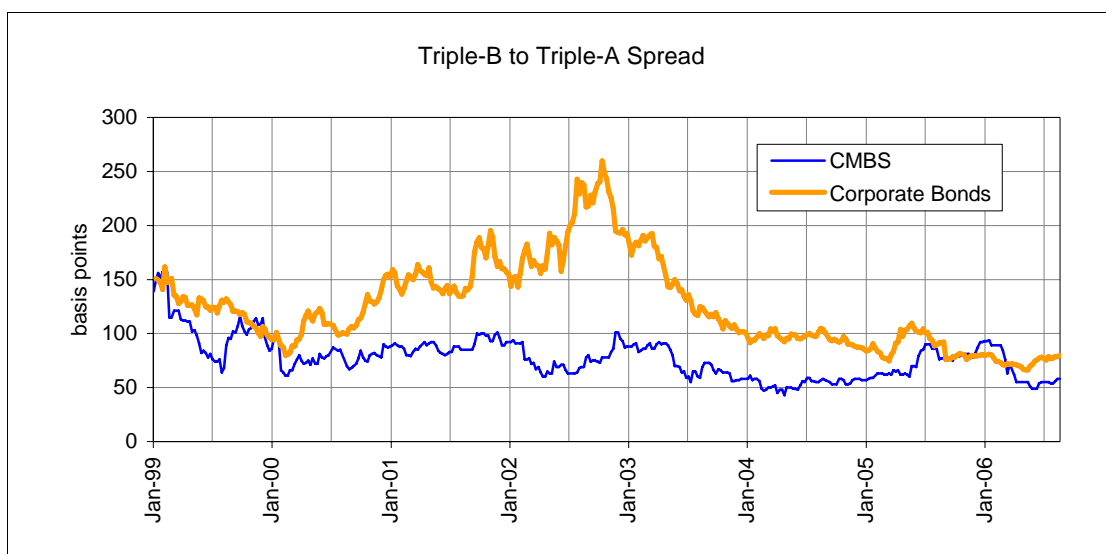
Since the beginning of the year, interest rates are higher, but the shape of the yield curve is unchanged. In fact, yields on benchmark Treasuries from 2 years to 30 years to maturity are all higher by 51 to 54 basis points. Meanwhile, swap spreads are modestly tighter in the 2-year to 10-year area of the curve, but slightly wider in the 30-year. The widening in 30-year swap spreads came on the heels of the new 30-year Treasury issue in February, the first 30-year bond the US Treasury issued for five years.



Implied interest rate volatility declined sharply in the second quarter of 2006, and has been range-bound at relatively low levels in the third quarter. In spite of the uncertain interest rate environment, as future moves by the Federal Reserve are far less certain than at any point since the Fed began tightening in 2004, implied volatility has not yet increased significantly. Consequently, financial instruments which are sensitive to volatility, such as mortgages, have performed well so far in 2006.



Spreads: Spreads in most structured finance sectors of the U.S. fixed income market have tightened thus far in 2006. The increasing popularity of derivative products on ABS and CMBS deals such as single-tranche credit default swaps, CDS indices, and synthetic CDOs has provided investors with greater means for leveraging their portfolios. For example, the seller of protection on the CDS of a triple-B rated tranche in a home equity deal is able to achieve a payoff similar to owning the underlying bond, but the seller of protection only has to provide a fraction of the capital that the owner of the bond would have to provide. Consequently, the risk appetite of the investment community has grown and pushed spreads tighter.



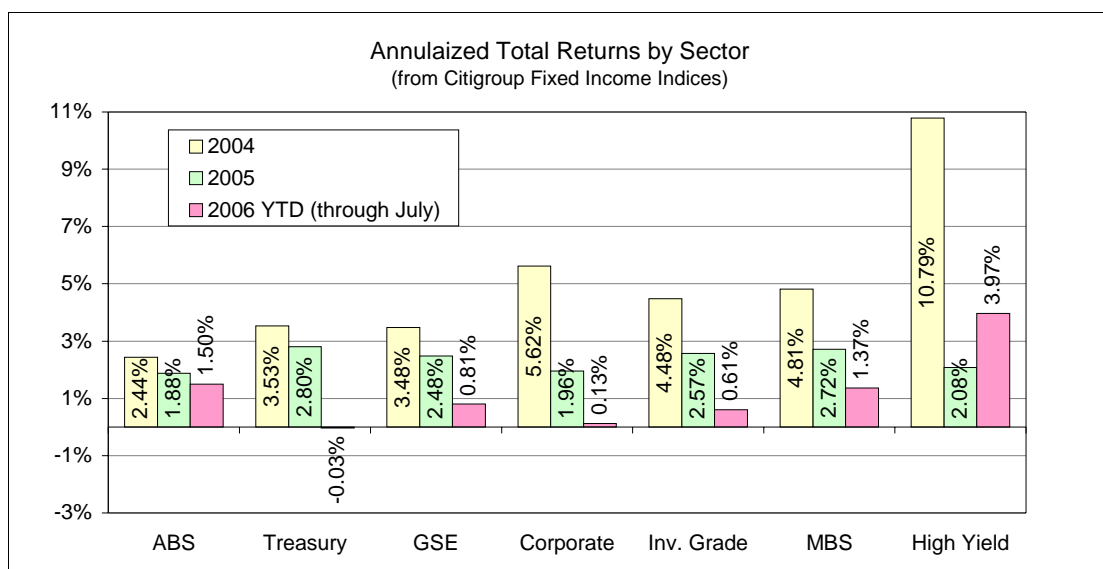
Source: Bloomberg LISPBBB <index>, LISPAAA1 <index>, LUCI3BSS <index>, LUCI3ASS <index>

One of the results of increased demand from synthetic products has been a compression in the credit curve, as the chart above illustrates. While fundamentally tight credit spreads seem hard to justify, we do not anticipate that CDO demand will abate in the short-term, therefore we expect the credit spread tightness to persist.

Since the start of 2006, triple-A CMBS spread are tighter by 6 basis points in the 30% enhancement tranche and 12 basis points in the AJ tranche. Triple-B spreads are 42 basis points tighter this year while triple-B minus spreads are tighter by a whopping 75 basis points, a 40% decline. In triple-A home equity, spreads are 5 to 10 basis points tighter depending on the average life of the tranche. Meanwhile, triple-B home equity spreads are 15-20 basis points tighter on fixed-rate deals and 40 basis points tighter on adjustable-rate deals. Other ABS sectors such as credit cards, student loans, and prime auto loans are also tighter by roughly 3-10 basis points in investment-grade tranches.

In the corporate sector, spreads are marginally wider as credit fundamentals have weakened slightly and LBO risk persists. According to the LUCI index of liquid corporate bonds, corporate spreads are 3 basis points wider overall. Triple-A rated corporate spreads are 1 basis point wider, double-A spreads are 6 basis points wider, and triple-B spreads are 3 basis points wider. Within corporate sectors, gaming & lodging and healthcare spreads are 40 and 15 basis points wider, respectively. On a positive note, investment-grade manufacturing spreads are 35 basis points tighter as a recent rally in non-investment grade rated auto makers has pushed spreads in across the industry.

Total Returns: For the first seven months of 2006 total returns in most fixed income sectors have been modestly positive, according to the Citigroup family of fixed income indices. Only the Treasury sector has reported a negative total return over this period, meanwhile all spread products have outperformed Treasuries. The ABS and MBS sectors have outperformed other investment-grade sectors and the high yield sector has produced the best overall total return.



Source: Bloomberg SBACAAB <index>, SBGT <index>, SBGS <index>, SBBIG <index>, SBCRP <index>, SBMT <index>, SBHYMI <index>

Credit Quality: Corporate: Performance of U.S. corporate credit is at historically strong levels. S&P reports that the 12-month trailing speculative-grade default fell to 1.57% in July 2006, a new nine-year low. For the second quarter of the year, Moody's *upgrade to downgrade ratio* (the rate of positive to negative rating changes) was 1.6, the highest ratio since mid-2005. Moody's also highlighted utilities, airlines, and banking as specific industries that experienced improving credit quality, while the automotive and building materials industries showed weakening credit quality.

Residential MBS: In spite of signs of a slowing housing market, the U.S. residential mortgage-backed securities (MBS) sector continues to display strong credit performance. According to Moody's, in the first half of 2006 only 14 ratings in 12 deals have been downgraded, while 46 ratings in 10 deals were upgraded in the U.S. residential MBS sector. The downgrades were a result of poor underlying loan performance. For the 12 month period ending June 2006, Moody's reports that the RMBS downgrade rate declined to 0.5% from 0.9% at year-end. Downgrades averaged 3.3 notches in this period, declining from 4.8 notches per downgrade at the end of 2005.

ABS: Credit performance in the major ABS sectors was mixed in the first half of 2006. In total, 153 ratings in 93 deals were upgraded and 153 ratings in 84 deals were downgraded according to Moody's. However, the home equity sector dominated the downgrades with 79% of the total, while home equity only accounted for 18% of upgrades. On the positive side, auto loan deals accounted for nearly half of all upgrades in the first half of 2006. As a whole, ABS credit performance is stronger than historical levels as Moody's reports that the overall downgrade rate of 1.8% is below its 10-year average of 5.4%.

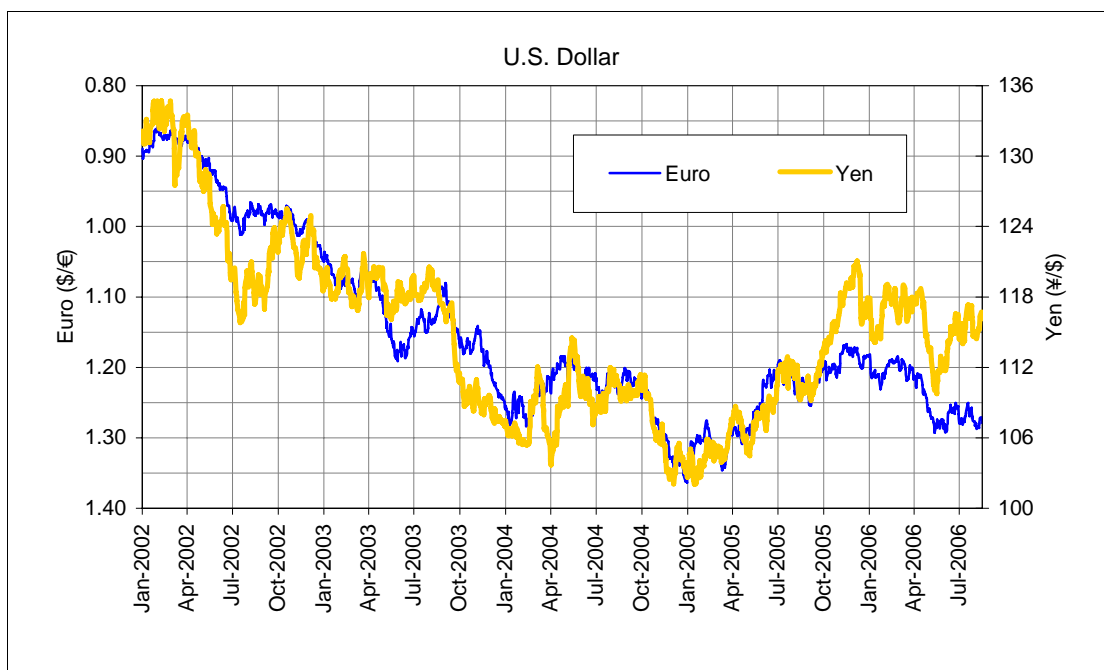
CDOs: CDO credit quality remained mixed, but has improved in the first half of 2006. Moody's upgraded 50 tranches in 27 deals and they downgraded 52 tranches in 35 deals during this period. This *downgrade-to-upgrade ratio* of 1.0 is a major improvement from the 10-year historical average of 15, yet downgrades still outnumbered upgrades. Furthermore, average notches per downgrade declined from 4.5 at 2005 year-end to 3.4 at the end of the first half of 2006. Moody's calculates that 31% of CDO downgrades were in high-yield CBOs and 27% were in synthetic arbitrage CDOs. High-yield CBOs also accounted for 46% of CDO upgrades.

Fitch's US structured finance (SF) CDO performance update for 2006 stated that upgrades for new SF CDOs are primarily the result of amortization through prepayments or structural features that allocate excess spread to mezzanine tranches. In SF CDOs rated from 2003 through 2005, 48 tranches were upgraded while only one tranche was downgraded. The positive rating performance is attributed to higher concentrations of MBS and home equity ABS in those vintages and the collateral's stable performance.

Compared to Fitch's previous Structured Finance (SF) CDO performance update in 2003, the market has a much higher concentration of MBS and home equity ABS exposure in new SF CDOs. When comparing 2000 and 2005 vintages, the average exposure to sub-prime mortgage ABS has increased from 25.7% to 58.6%. Mean exposure to MBS (i.e., backed by prime-quality mortgage loans) has also increased from just 4.5% of the 2000 vintage to 23% of the 2005 vintage. Manufactured housing has witnessed a significant decline with 2005 vintage exposure of less than 0.5%, down from 18% in 2000. ABS and CMBS average exposure is also down to just 2.5% and 6.7% in 2005 from 20% and 22.1%, respectively, in the 2000 vintage. Although recent SF CDOs have performed relatively well, the high concentration of RMBS collateral could make the sector vulnerable to losses in the event of a long-term downturn in the housing market.

MBS: Credit performance in CMBS was nearly flawless as upgrades outnumbered downgrades 475 to 33 in the first half of 2006 according to Moody's. Nearly all downgrades in CMBS were a result of losses related to specially serviced loans. Moody's reported that the upgrade rate for the 12-month period ending June 2006 reached an all-time high of 19.2%. Meanwhile, "core" delinquencies (60+90+foreclosure+REO) in CMBS conduit deals continued their decline from 0.66% at year-end to 0.43% based on Trepp data.

Currencies: After a strong year in 2005, the US dollar has been weaker thus far in 2006. The dollar has weakened 7.9% relative to the Euro, 10.0% relative to the pound sterling, 6.8% relative to the Swiss franc, and 4.0% relative to the Canadian dollar. Against the yen, the dollar has appreciated, but only by 1.4%.



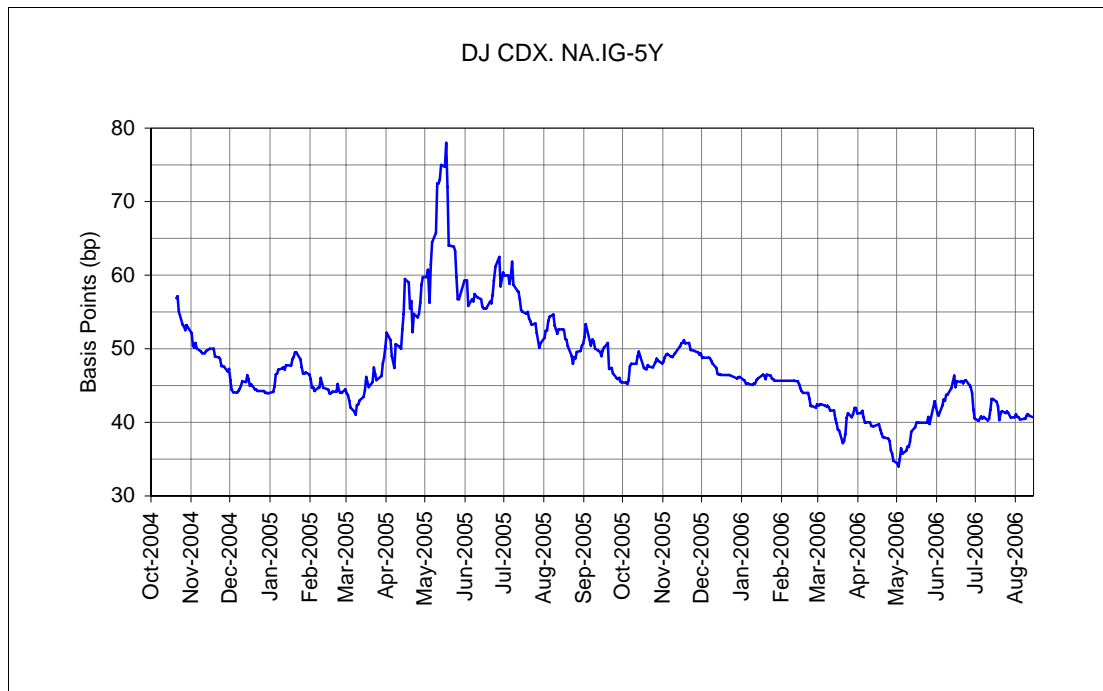
Source: Bloomberg EUR <crncy>, JPY <crncy>

Credit Default Swaps & Structured Credit Products: Based on anecdotal evidence, the total notional amount outstanding for credit derivatives, including credit default swaps (CDS) and baskets, index, and portfolio products has grown to \$20 to \$21 trillion from \$17.1 trillion at year-end.

In June, ISDA released three new documentation templates. The first template addressed credit default swaps on collateralized debt obligations (CDS on CDOs). This template is similar to the Dealer Form template for CDS on ABS with pay-as-you-go (PAUG) settlement. The CDS on CDOs template, like the Dealer Form, tackles implied write-downs. Implied write-downs occur when collateral deterioration causes a deal to become under-collateralized. ISDA also revised its template for credit derivatives transactions on ABS with cash or physical settlement. This template permits delivery of a total return swap for settlement. The revised form, which does not include a PAUG

feature, is more common in Europe than in the U.S. Lastly, ISDA released a template for CDS on syndicated loans, as these transactions have become more common. ISDA teamed up with the Loan Syndication and Trading Association (LSTA) to develop a template to be used with the LSTA's Physical Settlement Terms rider. The Syndicated Loan Credit Default Swap template was created primarily for U.S. transactions, where syndicated secured loans are the reference and deliverable obligation.

Since the last Dow Jones CDX.NA.IG roll to the Series 6 index in March, spreads are currently trading at around the same price of 38 bps. During that span however, spreads had moved to a wide of 47 bps on inflation fears and rising commodity prices. An overall solid earnings season, investor demand, and optimism regarding restructurings for the US auto industry have helped to compress credit spreads over the past few months.



Source: Markit.com

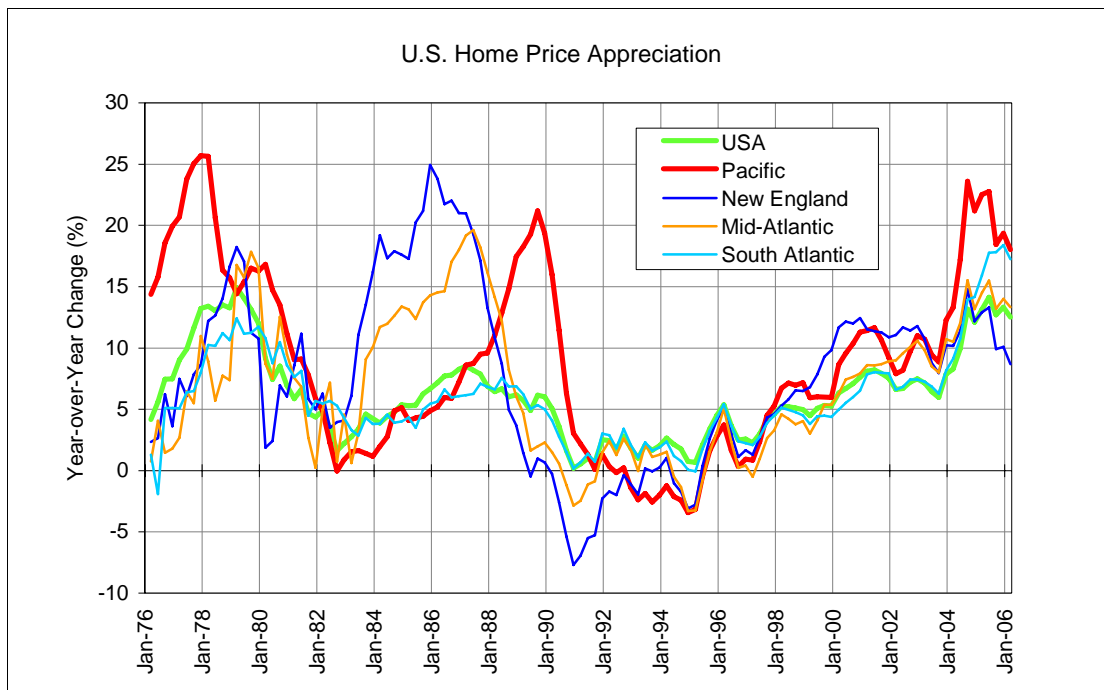
II. Outlook for U.S. Fixed Income Markets in 2006/2007

Major Themes: We perceive three key drivers for U.S. Fixed Income markets over the next six to eighteen months: (1) uncertainty about interest rates (2) home prices (3) energy prices.

Interest Rate Uncertainty: Three distinct possibilities exist for the future direction of the Fed Funds rate, yet none appears improbable. By mid-2007, the Fed could continue tightening, have begun easing, or still remain on hold. With uncertainty about how the Fed will react, we expect the market will overreact to the release of new economic data, thus increasing the volatility of interest rates. Currently, the market is pricing in very little chance of future rate hikes and the market expects the Fed to start easing in the beginning of 2007. However, several Fed Governors have warned that further hikes may be needed to curtail inflation. Therefore, for the first time since the Fed began raises rates in 2004, the future direction of the next Fed move is uncertain. We conclude that this will lead to more violent swings in rates and higher implied interest rate volatility.

Home Prices: After nearly a decade of strong home price appreciation, there are signs of a possible "bubble" in the U.S. residential real estate market, especially in some particularly inflated parts of the country. Years of low interest rates and the continued use of "affordability" products, such as interest-only mortgages and negative amortization loans may have inflated prices and fueled overbuilding. Recently, home price appreciation has started to slow as illustrated in the chart below.

Additionally, evidence is starting to mount that the real estate markets are weakening more quickly than most real estate professionals have anticipated. For instance, the value of the S&P homebuilder index is down 32.5% thus far in 2006. Also, the number of months' supply of homes for sale has shot up from 5.1 months at year-end to 7.3 months in July.

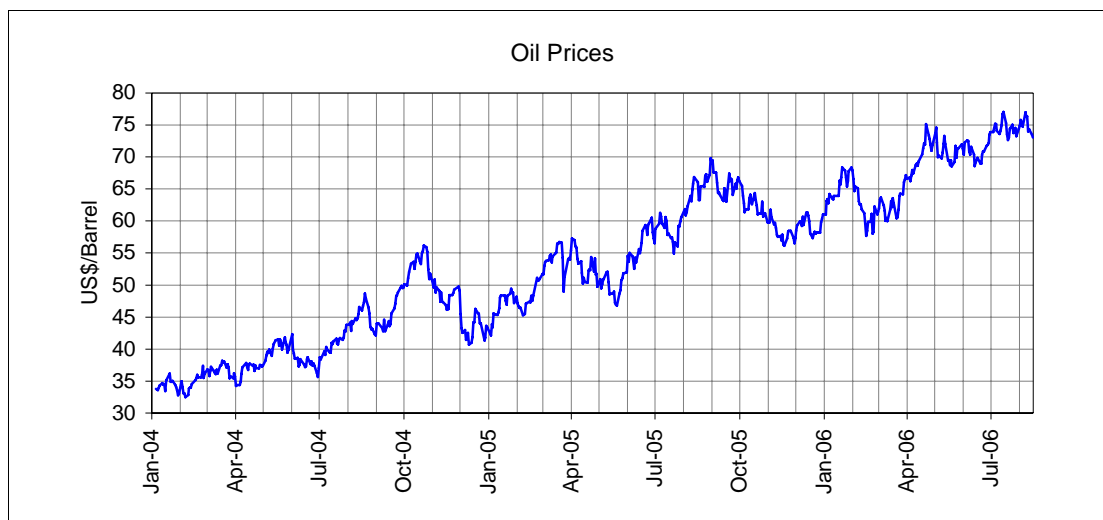


Source: Office of Federal Housing Enterprise Oversight, Bloomberg (HPI)

We continue to expect that nationwide residential real estate prices will be close to flat or slightly negative or a prolonged period of time. However, we anticipate that certain parts of the country such as Florida and parts of Arizona and Nevada could experience more severe declines.¹

Energy Prices: Our final theme is gauging the long-term impact of higher energy prices. We expect geopolitical uncertainty to continue driving a high risk premium in oil and gas prices. Several recent events such as the conflict in Lebanon, Iran's nuclear ambitions, and aviation terrorism highlight the vulnerability of the Middle East's energy supply. Energy prices have been steadily rising since 2004, yet the impact on the economy so far has been relatively benign. However, we believe that the longer energy prices remain inflated the greater and more severe the impact will be on inflation, consumer spending, and consumer credit quality.

¹ Losses on a residential mortgage loan should occur only when two conditions exist at the same time: (1) the borrower becomes unable to meet his monthly payment obligations and (2) the value of the property securing the loan is less than the amount necessary cover interest, principal, and related expenses. Thus, even if home prices decline significantly, losses on mortgage loans need not increase proportionately if borrowers continue to be able to afford their monthly payments. If home prices decline, losses on mortgage loans would become more sensitive to conditions in the labor market because borrowers who lose their jobs would be more likely to default on their loans. Over a somewhat longer-term horizon, losses on mortgage loans would become increasingly sensitive to interest rates as borrowers on adjustable-rate loans potentially face the impact of rising rates.



Source: Bloomberg USCRWTIC <index>

Economy: Growth seems likely to continue at a slower pace in the second half of 2006 and into 2007. Indeed, we forecast that real GDP growth will fluctuate in a narrow band averaging about 2.8% over the next six quarters, roughly one-half of one percentage point slower than the average rate of expansion during the past 60 years.

More generally, several key developments throughout the first half of 2006 are likely to remain the defining characteristics of the outlook for the next year or more. In particular, a robust expansion of capital spending and a steady improvement in the U.S. trade balance are expected to counteract a moderation in consumer spending and continuing declines in residential investment. The resulting forecast of slightly below-trend growth reflects a presumption that slower growth in household spending will encourage caution over capital spending and also slow economic growth abroad to prevent a more rapid improvement in the trade accounts. Recent reports suggest that the housing and real estate sector have become considerably more fragile, a development that has increased the downside risks to the overall economic outlook.

These cyclical pressures on real rates have begun to recede as the current and prospective pace of economic activity has slowed. In addition, concerns about inflation have remained largely centered on the relatively near term outlook. Reflecting the continuing confidence that monetary policies will successfully keep inflation pressures contained, the inflation premium in long-term rates has begun to retreat, albeit slowly. The economic outlook, featuring slightly below trend growth and a rough balancing of growth in the most interest sensitive sectors (robust capital spending and weak housing investment), should limit cyclical pressures on real interest rates. With inflation held in check, long-term rates seem most likely to fluctuate within the relatively narrow range of the past year throughout the forecast horizon. A persistent pattern of low inflation and below-trend growth, however, signals an overly restrictive monetary policy. Consequently, our forecast envisions a shift in monetary policy during the first half of 2006 toward unwinding some of the most recent policy moves as policymakers seek to restore a "neutral" setting for the federal funds rate. The recent inversion of the yield curve suggests the markets already anticipate such a development.

Nomura U.S. Economic Forecast									
	Actual				Forecast		Act.	Forecast	
	2005		2006				2005	2006	2007
	Q3	Q4	Q1	Q2	Q3	Q4			
Interest Rates (Constant Maturity Yields)	Quarterly Averages						Annual Averages		
Fed Funds Target	3.75	4.25	4.75	5.25	5.25	5.25	3.21	4.97	5.15
3-Month Bills	3.43	3.91	4.50	4.83	5.04	5.01	3.21	4.84	4.79
2-Year Treasuries	3.95	4.36	4.60	4.99	4.98	4.82	3.85	4.85	4.60
10-Year Treasuries	4.21	4.49	4.57	5.07	4.93	4.82	4.29	4.85	4.66
Mortgage Rates*	5.76	6.22	6.21	6.60	6.58	6.43	5.87	6.45	6.18
Growth & Inflation	Annualized Growth (%)						Q4/Q4 (% change)		
GDP (Qtr/Qtr)	4.2	1.8	5.6	2.5	2.5	2.9	3.2	3.5	2.8
Final Sales (Qtr/Qtr)	4.4	-0.3	5.6	2.1	2.4	2.8	3.2	2.7	2.9
CPI (Qtr/Qtr)	5.1	3.2	2.2	5.0	4.2	3.1	3.7	3.6	2.3
"Core" CPI (Qtr/Qtr)	1.6	2.4	2.4	3.5	2.8	2.6	2.1	2.8	2.4
Federal Budget (b\$, FY)							-319	-255	-350

Source: Nomura Securities Int'l

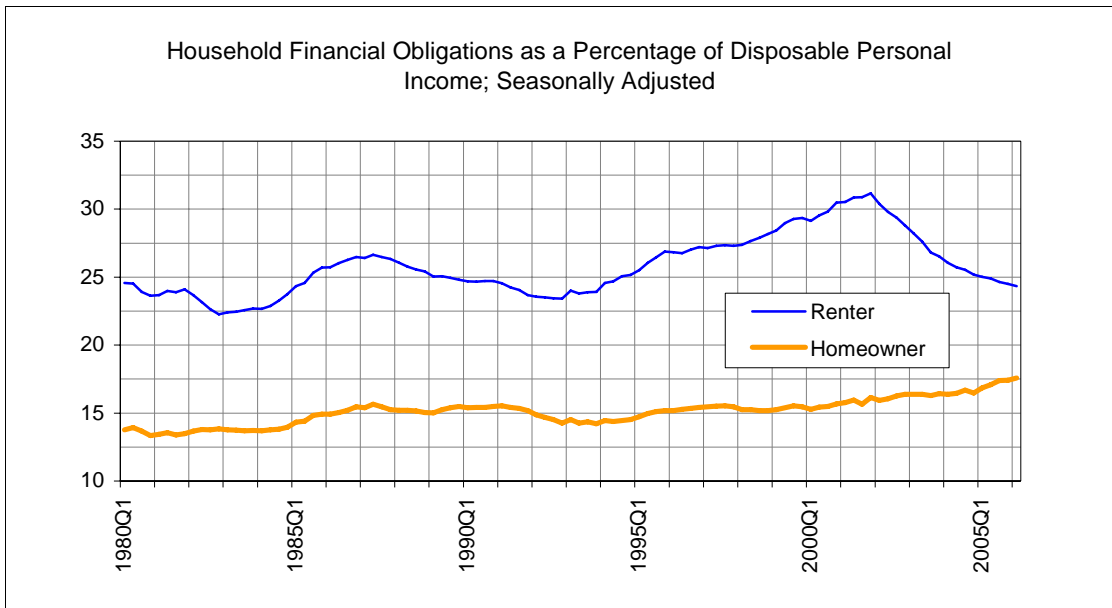
Credit: Corporate Bonds: We expect LBO candidates, energy prices, and yield curve flatness to continue to be on the forefront of investor minds for the rest of 2006. Consequently, we expect defaults to rise and credit quality to deteriorate heading into 2007. However, coming off of historically low default rates and solid credit fundamentals, from a historical perspective, credit quality will likely remain healthy overall.

According to S&P, the global corporate speculative-grade default rate increased slightly to 1.13% in June from 1.09% in May. Although the global speculative grade default rate is still below its long-term (1981-2005) average of 4.66%, it is expected to trend slightly upward in 2006 from its near all-time low. The U.S. spec-grade default rate was 1.72% for the month and, according to S&P's forecast model, is expected to reach 2.5% by year-end and 3.6% by July of next year.

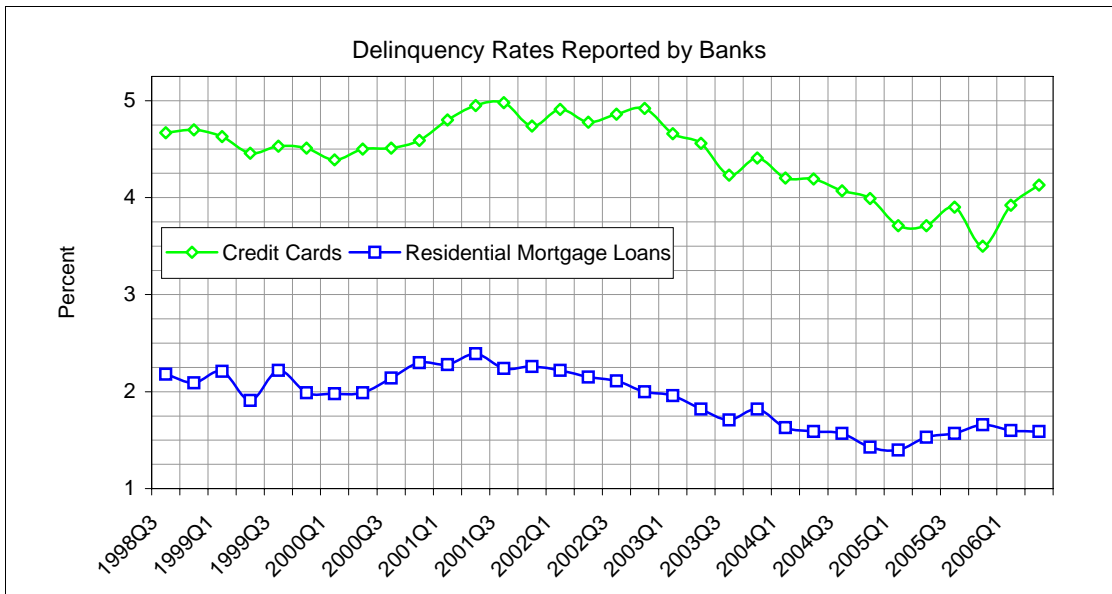
Overall, we expect corporate spreads to widen as we progress through the year. The conflict in the Middle-East, equity market volatility, and the growing list of LBO candidates (as buyout firms more frequently team-up to raise large amounts of capital) should increase event risk and place pressure on spreads. Despite corporate spreads currently residing near 12-month wide levels, spread pickup remains scarce and may continue to force investors either further down the credit curve or into more volatile sectors for excess yield. With spreads expected to weaken we would recommend investors look to up-in-quality trades. In our opinion, the 125 bps spread pick-up from BB-rated to BBB-rated corporate spreads does not adequately compensate investors, especially when considering that the crossover trade yielded over 175 bps at the start of the year.

Consumer Credit: We expect consumer credit quality to weaken somewhat over the next 12 months as softer home prices, higher energy prices, and a higher interest rate environment affect a growing number of consumers. Accordingly, we expect delinquency and loss rates to rise, but to generally stay within their historical ranges.²

² Overall, we still perceive asymmetric uncertainty around our base case expectation for credit. We still believe that there is greater potential for movement on the downside than on the upside. The strong credit performance of residential mortgage loans and other consumer receivables primarily reflects the favorable combination of three conditions: (1) low unemployment, (2) low interest rates, and (3) strong home price appreciation. There is potential for significant performance deterioration if anything disturbs the delicate balance of circumstances.

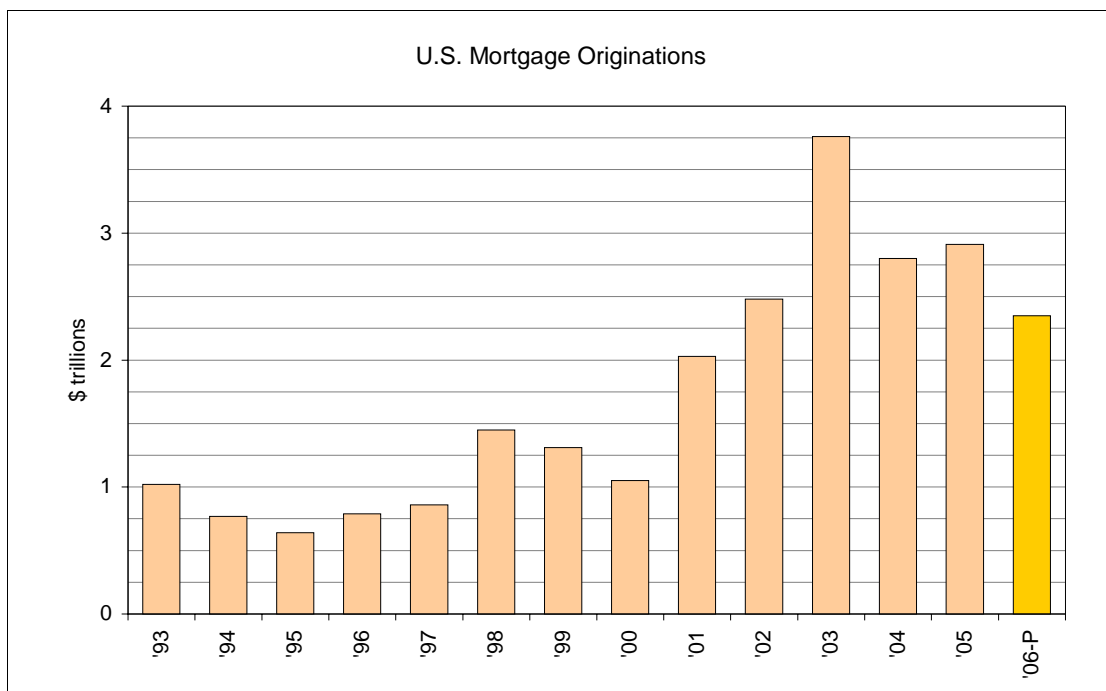


Source: Federal Reserve <<http://www.federalreserve.gov/releases/housedebt/default.htm>>.



Source: Federal Reserve, Bloomberg USDECRED <index>, USDERESI <index>

Mortgage Originations: For the first half of 2006, mortgage originations totaled \$1.22 trillion, significantly below the pace of 2005, which totaled \$2.9 trillion. For the full year, we project mortgage originations will total \$2.35 trillion. Higher interest rates and a softening housing market will likely continue to reduce residential mortgage loan originations for the remainder of 2006.



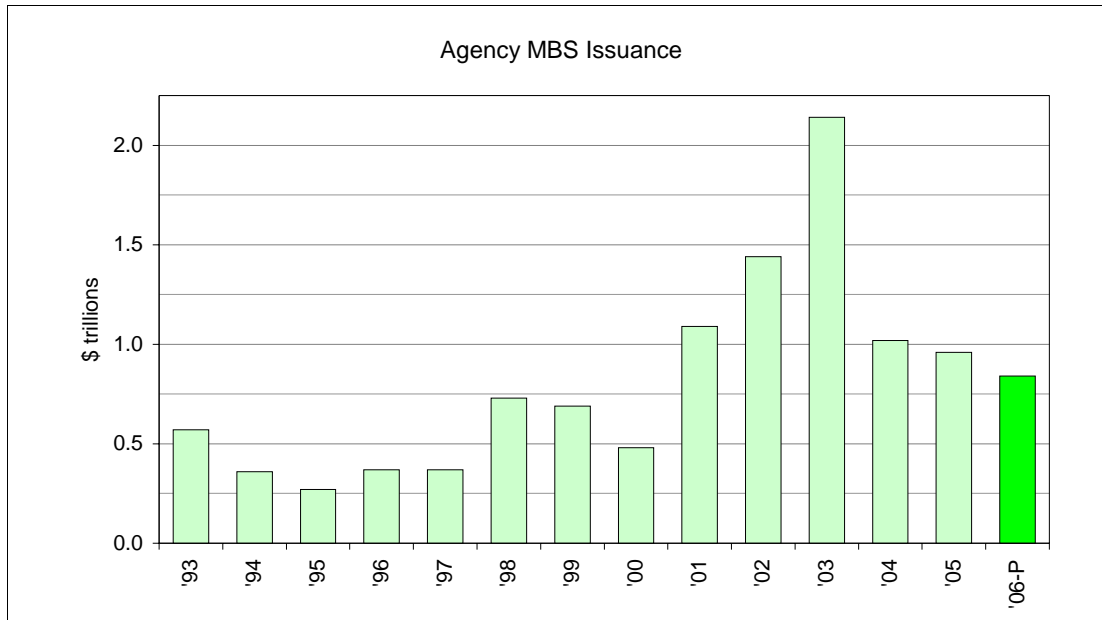
Sources: Nomura Securities International, Inside Mortgage Finance

Issuance: New issue activity for the U.S. fixed income market should be lower compared to 2005. In particular both Agency and non-Agency MBS issuance as well as Agency debentures are expected to be lower for the year. Meanwhile, home equity ABS, Corporate and CDO issuance are all expected to be up compared to 2005. Finally, in CMBS and Agency CMOs, issuance should be relatively unchanged.

Issuance by Sector (\$ billions)			
Category	2004	2005	2006 Projected
Agency Debt	950.0	669.0	600
Agency MBS	1,019.0	959.7	840
Agency CMOs	318.5	295.2	295
Inv. Grade Corp.	510.0	540.5	615
Non-agency MBS	864.2	1,191.3	1,100
ABS	626.0	696.0	720
CMBS	93.0	169.2	170
CDOs (rated US vol.)	90.0	162.0	190

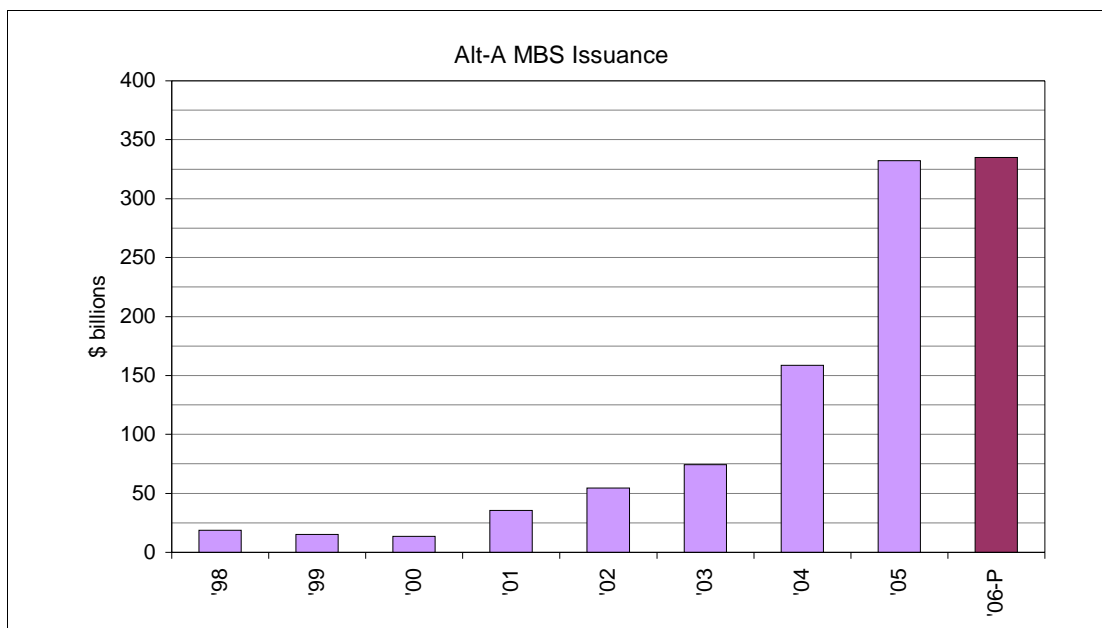
Sources: Nomura Securities International, Asset Backed Alert, Commercial Mortgage Alert, Asset Securitization Report, Inside Mortgage Finance, Moody's, Federal Reserve

Agency MBS: We currently expect agency mortgage issuance in 2006 to total \$840 billion, the lowest level since 2000. \$439 billion was issued in the first half of 2006, well below the pace of the last three years.



Sources: Inside MBS & ABS

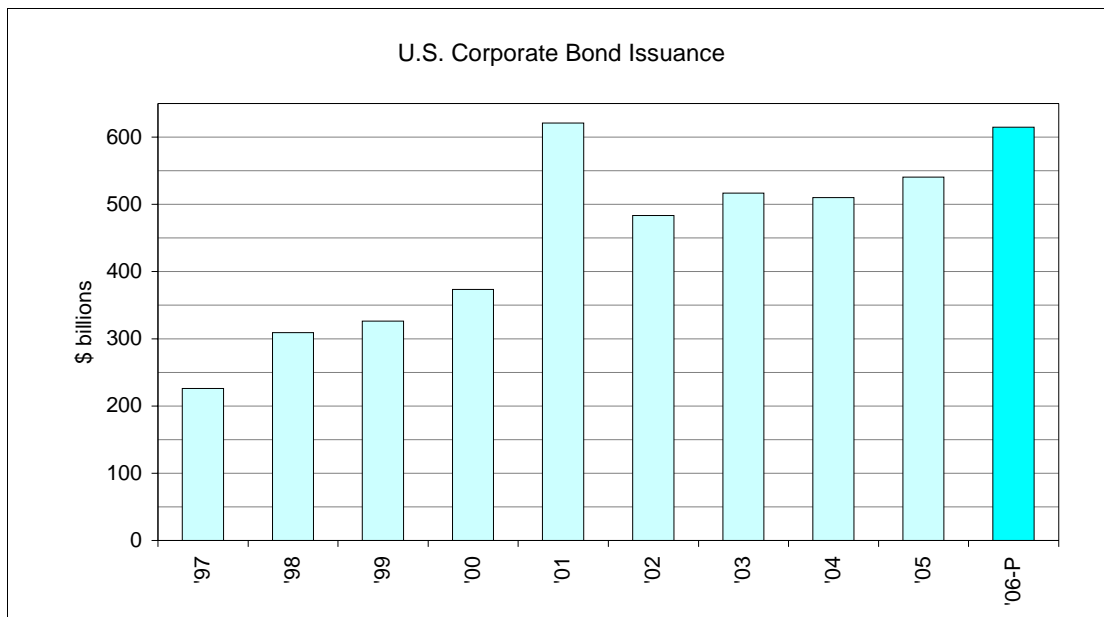
Non-agency MBS (jumbo and alt-A): After a record year in 2005 in which \$1.2 trillion in new paper was issued, non-agency MBS issuance continues to be robust in 2006, with \$659 billion issued in the first seven months of the year. We are projecting full-year 2006 non-agency issuance to drop slightly to \$1.1 trillion. Within the alt-A segment of non-agency MBS, we expect issuance will be slightly above last year's total of \$332 billion.



Source: Inside MBS & ABS

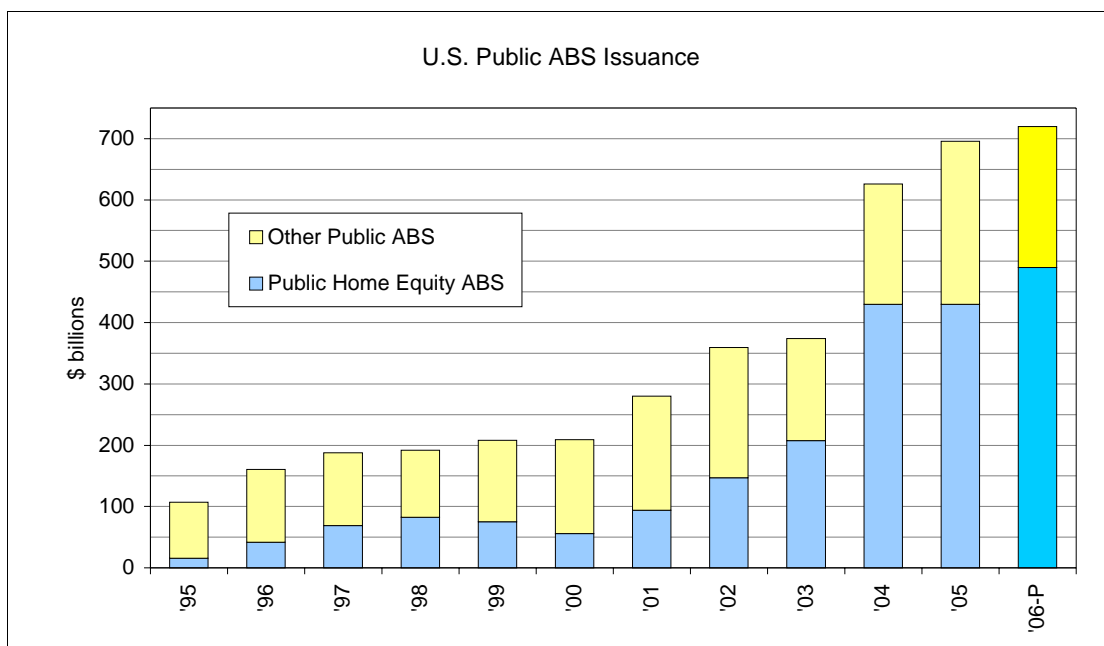
Corporate Bonds: Total U.S. corporate bond issuance continues to surge, reaching \$421.4 billion for the first half of 2006. Volume is up 17.3% from the \$359.4 billion issued for the same period last year, according to the BMA. Investment grade issuance totaled \$384.5 billion for the first half of 2006, up 20.6% year-over-year. Primary activity was virtually flat from the first quarter to the second quarter. Increased M&A activity and capital spending have steadily fueled issuance ahead of 2005's

pace. This differs from the previous trend where the refinancing of maturing debt was the main reason for corporate issuance. We expect shareholder friendly initiatives and acquisitions to continue throughout the year. For the full-year we would expect investment grade issuance to approach \$700 billion, up from \$633 billion of primary activity in 2005.



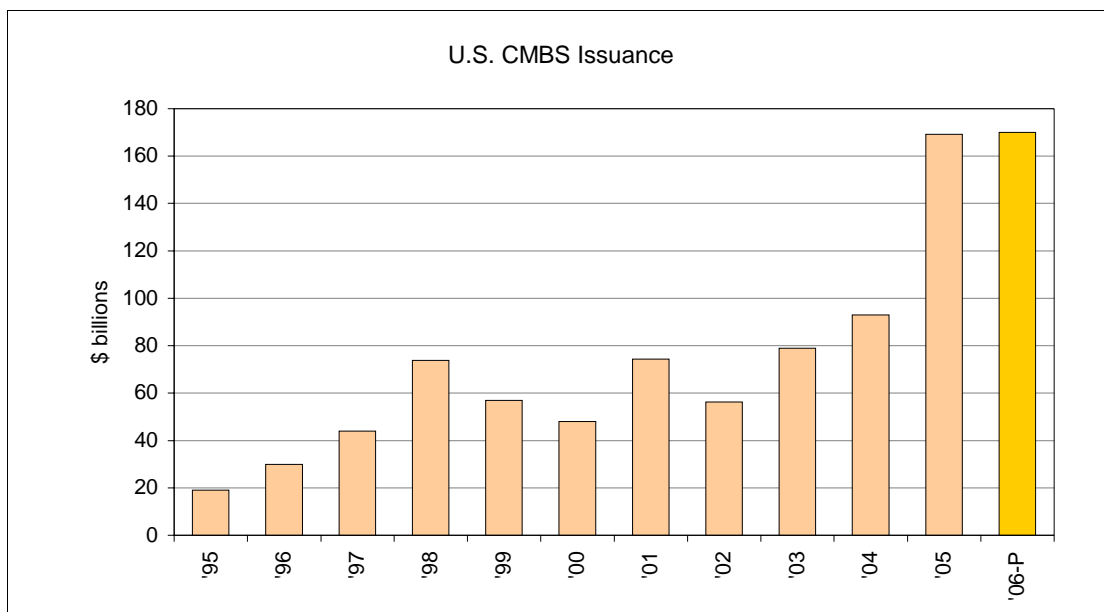
Sources: Nomura Securities International, Thomson Financial, MCM

ABS: We expect ABS issuance to be \$720 billion in 2006, including \$490 billion in home ABS issuance. ABS issuance currently stands at \$471 billion, a pace slightly greater than 2005. However, the increase is fully attributable to the home equity sector as all other sectors combined are lagging last year's pace. Thus far in 2006, \$320 billion in home equity paper has been issued, roughly 75% of total for 2005 with more than four months remaining on the year.



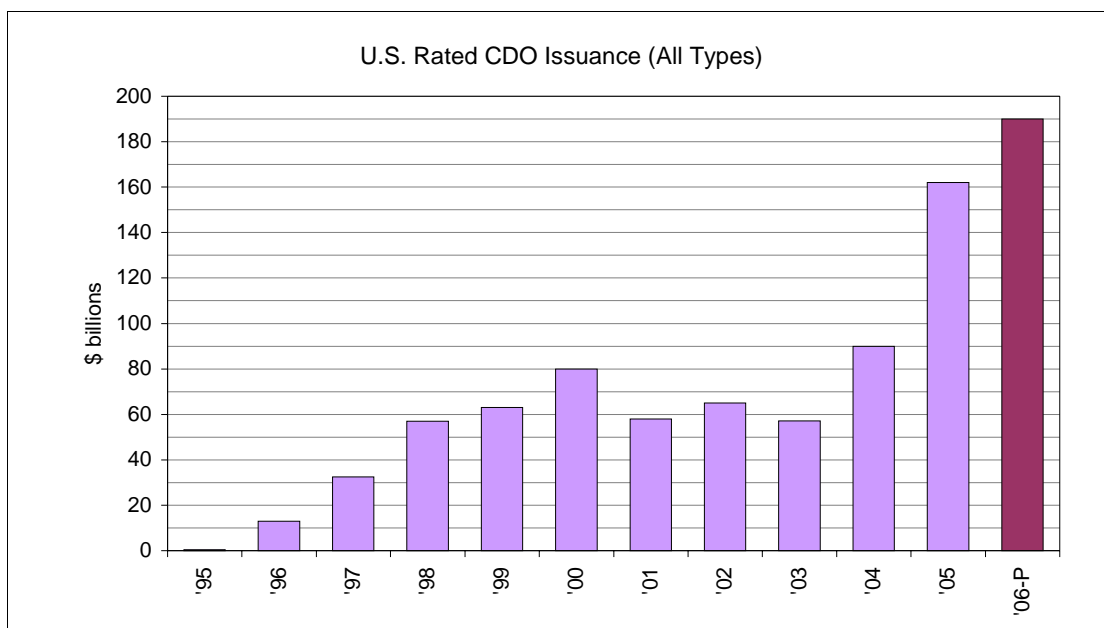
Sources: Moody's, Bloomberg IABS, Asset Securitization Report, Bond Market Association

CMBS: CMBS issuance in the first half of 2006 was \$90.6 billion, a pace even greater than 2005's record level in which the first half totaled \$71.7 billion. For the full year we project issuance will be \$170 billion, only slightly greater than 2005, as issuance slows a bit in the second half of the year.



Sources: Commercial Mortgage Alert, Inside MBS & ABS

CDOs: According to Moody's, U.S. rated CDO/CLO supply increased by 97% in the first half of 2006 compared to the first six-months of 2005. While the growth rate is high, the trend follows a 2005 YOY growth rate of 65% and a 2004 growth rate of 47%. We anticipate strong investor demand to continue to fuel CDO issuance. For the full-year, we expect U.S.-rated CDO issuance to outpace 2005's result of \$162 billion. We would expect 2006 U.S.-rated CDO issuance to total around \$190 billion, up about 17% from last year's total.



Source: Moody's

Credit Default Swaps and Structured Credit Products: The credit derivatives market continues to be one of the fastest growing segments of the overall fixed income market, as evidence suggests that the market is now greater than \$20 trillion and has doubled in the last 18 months. However, it remains uncertain whether the ABX and CMBX, both introduced earlier this year, will sustain a strong following as additional newer series are released.

ABCP: After pausing to work through accounting issues from 2002 through 2004, U.S. ABCP programs expanded aggressively in 2005 and continuing into 2006. The amount of asset-backed

commercial paper outstanding grew from \$855 billion at the end of 2005 to \$950 billion currently and will probably surpass \$1 trillion by year-end.

U.S. Dollar: Higher interest rates from the European Central Bank and Bank of Japan while the Federal Reserve remains on hold will continue to put pressure on the dollar. Nonetheless, we expect the U.S. dollar to weaken only modestly against the major currencies throughout the remainder of this year.

Accounting, Legal and Regulatory Developments:

Fraud: NCFE Healthcare Securitizations: The U.S. Department of Justice obtained indictments against seven former executives of National Century Financial Enterprises (NCFE).³ The company issued over \$3 billion of healthcare receivable-backed ABS that subsequently defaulted resulting in huge losses for investors.

CDS Litigation: Federal courts recently issued decisions in two cases that affect CDS. First, in *Deutsche Bank v. Ambac*, the District Court for the Southern District of New York ruled that the protection seller under a CDS was excused from its obligation to pay following the bankruptcy of the reference entity because the protection buyer had failed to deliver the reference obligation within the timeframes specified in the contract.⁴ Second, in *Aon Financial Products v. Société Générale*, the same District Court interpreted a CDS in a way that conflicts with the views of most market participants.⁵ In the *Aon* case, the court ruled that a protection seller was required to make protection payments even though a credit event (arguably) had not occurred and the conditions to settlement had not been satisfied. The protection seller is appealing the decision and ISDA is submitting a "friend of the court" in support of the protection seller's position.

FNMA Examination: In May, the Office of Federal Housing Enterprise Oversight (OFHEO) released its sharply critical report on Fannie Mae.⁶ OFHEO found that Fannie Mae had improperly manipulated its accounting to achieve earnings targets and to maximize executive bonuses. Additionally, the OFHEO found that Fannie Mae had a corporate culture that promoted a false façade and that concealed the company's flaws. Alongside OFHEO's investigation of Fannie Mae, the SEC conducted its own. On May 23, Fannie Mae settled jointly with OFHEO and the SEC by agreeing to pay a penalty of \$400 million.

Rating Agency Regulation: Legislation to regulate the rating agencies moved forward significantly over the past few months. On July 12 the House of Representatives passed the Credit Rating Agency Duopoly Relief Act of 2006 (HR 2990). As passed by the House, the bill would replace the current system in which the SEC grants NRSRO designation to a handful of rating agencies with one in which any rating agency could achieve the designation simply by registering and meeting a few basic eligibility requirements. The bill also would impose substantive regulation on the credit rating industry. In particular, it would eliminate or discourage notching⁷ and unsolicited ratings.⁸ Eliminating

³ U.S. Department of Justice, *Seven National Century Financial Enterprises Executives Indicted in \$3 Billion Securities Fraud Scheme*, press release (22 May 2006) (http://www.usdoj.gov/opa/pr/2006/May/06_crm_316.html).

⁴ *Deutsche Bank v. Ambac Credit Products*, No. 04 Civ. 5594 (DLC) (SDNY 6 Jul 2006).

⁵ *Aon Financial Products v. Société Générale*, 2005 WL 427535 (SDNY 22 Feb 2006) (the case is on appeal the U.S. Court of Appeals for the Second Circuit, No. 06-1080-CV).

⁶ Office of Federal Housing Enterprise Oversight, *REPORT ON THE SPECIAL EXAMINATION OF FANNIE MAE* (May 2006) <<http://www.ofheo.gov/media/pdf/FNMSPECIALEXAM.PDF>>.

⁷ 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*.

The rating agencies employ notching as part of their process for rating CDOs. In the context of rating a CDO, 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 their CDO issuers.

unsolicited ratings arguably would be unwise. When they were more prevalent, unsolicited ratings were how the rating agencies challenged each other and pointed out each other's analytic mistakes. Unsolicited ratings served an important quality control function for the credit rating industry as a whole. In our view, eliminating unsolicited ratings likely would reduce rather than improve the reliability of rating agency ratings. In early August, the Senate Banking Committee reportedly passed a version of the legislation, but it has not yet cleared the full Senate.

Risk-Based Capital: Implementation of the Basel II⁹ advanced capital adequacy framework in the U.S. appears to have hit some stumbling blocks. In April, the Federal Reserve released a draft of a 448-page joint notice of proposed rulemaking.¹⁰ However, market participants are still waiting for the formal release of the proposal. Several large banks, including Citigroup and JP Morgan Chase, apparently reacted to the draft, complaining to the Fed that the advanced framework is too complicated. In January, U.S. regulators had predicted that they would release a notice of proposed rulemaking for the U.S implementation of Basel II during the second quarter of the year. They also predicted that they would release a notice of proposed rulemaking on the so-called "Basel IA"¹¹ alternative shortly afterwards. So far, neither has been released.

Off-Balance Sheet Accounting: The Financial Accounting Standards Board (FASB) decided in July to expand the scope of its deliberations on amendments to FAS 140.¹² Accordingly, a new amendment to FAS 140 is unlikely before 2007Q2.

Securities Disclosure: The capital markets appear to have adapted smoothly to the SECs "offering reform" regulations that became effective last December. The markets also have adapted to Regulation AB, which governs disclosures on ABS and MBS and which became effective on January 1. Contrary to some alarmist predictions, the new regulations have not disrupted the markets.

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⁸ Credit Rating Agency Duopoly Relief Act of 2006, H.R. 2990, 109th Cong. § 4 (2006) (creating § 15E(i) of the Securities Exchange Act of 1934); H.R. Rep. 109-546 at 21 (2006).

⁹ Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards, A Revised Framework* (updated November 2005) <<http://www.bis.org/publ/bcbs128.htm>>.

¹⁰ <<http://www.federalreserve.gov/generalinfo/basel2/draftnpr/NPR/>>

¹¹ Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of Thrift Supervision, *Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Domestic Capital Modifications*, 70 Fed. Reg. 61068 (20 Oct 2005) <<http://www.federalreserve.gov/boarddocs/press/bcreg/2005/20051020/attachment.pdf>>.

¹² Financial Accounting Standards Board [hereinafter "FASB"], Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (Sep 2000) <<http://www.fasb.org/st/>>. FAS 140 is the key accounting standard that controls whether a securitization counts as a "sale" for accounting purposes. If so, the company effecting the transaction can remove the assets (and their associated liabilities) from its balance sheet.

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