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•**The Economy:** *Bernanke pulls a Volcker*
•**The Mortgage Market:** *The Refi Index spikes, but will prepayment speeds?*
•**The Markets:** *Yields fell, stocks fell, gold continued its surge*

The Economy

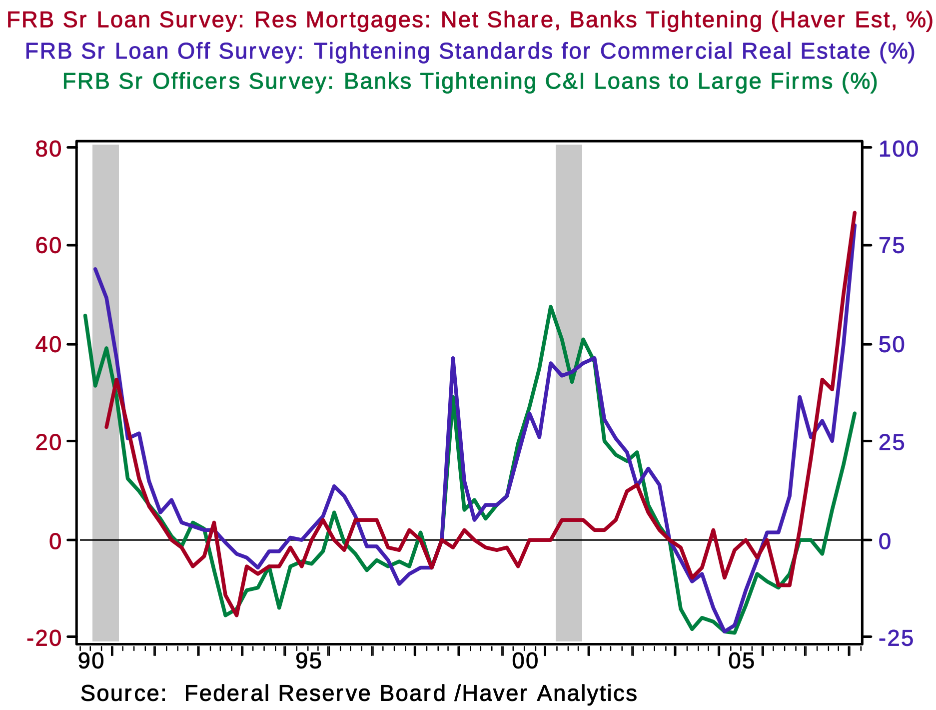
In the month of January, the Ben Bernanke-led Federal Reserve lowered the Federal Funds target rate 125 basis points in just eight days. It was an extraordinary amount of easing in that short of a time frame, bigger than what followed the 1987 stock market crash, the LTCM crisis, and 9/11. To us, this was perhaps the most decisive action taken by the Fed since Paul Volcker's famous "Saturday Night Massacre" press conference on Saturday October 6, 1979, in which he laid out the monetary policy reform that would end the inflationary mindset in the US.

In retrospect, Volcker's decision was the right, albeit painful, thing to do—and a victory for Monetarism over Keynesianism—but at the time the jury was still out. Interest rates soared, bond prices plunged, stocks tanked, and hearings were convened. Testifying before the Congressional Joint Economic Committee on November 5, 1979, none other than Volcker's successor, Alan Greenspan, explained the rationale to uncomprehending Congressmen: "We are here…to evaluate the moves of Chairman Volcker and his colleagues last month, implying that some alternate policies were feasible at that time. However, given the state of the world financial markets, had the Fed not opted to initiate a sharp interest rate increase in this country, the market would have done it for us."

We don't know how history will judge the decisions of Chairman Bernanke and his colleagues. But we would borrow Mr. Greenspan's testimony from 29 years ago and adapt it for today: Had the Fed not opted to initiate a sharp interest rate reduction in this country, the market would have done it for us. The persistent and deepening inversion between the Fed Funds rate and the 2-year Treasury, the gapping of LIBOR to Fed Funds, and the extreme volatility of global stock markets are but a few indications that the market was already ahead of the Fed.

To again echo Greenspan, were there alternate, feasible policies to consider? Let us consider the information that Mr. Bernanke had at his disposal as he convened both the inter-meeting FOMC video conference call over the Martin Luther King, Jr. holiday weekend and the regularly scheduled meeting on January 29/30. The housing market continued its downward trend, as housing starts and the pace and prices of existing and new home sales fell; the job market weakened, as jobless claims moved up, the unemployment rate jumped from 4.7% to 5%, and payroll growth dropped to virtually nothing; retail sales, an important barometer of the health of the US consumer, declined 0.4% in December and, ex-gasoline, grew an anemic 1.9% in the fourth quarter vs. 4.4% in the third quarter; and overall GDP growth stalled in the fourth quarter to 0.6% according to the preliminary estimate, the lowest growth since 2002.

Perhaps the most important piece of information that the Fed knew as they deliberated over that eight-day period was the January 2008 Loan Officer Opinion Survey on Bank Lending Practices. Released on February 4 but, we believe, likely available in draft form at the FOMC's meeting on January 29/30, the Survey paints a picture of a credit crunch as financial institutions reported tightening their lending standards for a broad range of loan types over the prior three months. The graph below shows that for commercial and industrial (C&I) loans, a third of respondents reported tightening standards. An astonishing 80% of respondents said they have tightened standards for commercial real estate loans, the highest fraction since the survey began in 1990. Lending conditions for prime, sub-prime and non-traditional residential mortgage loans continues to tighten (even though the Survey breaks them out, our graph below has created a single time series), including 55% of prime lenders. And although it's a relatively short time series, it's clear to see that recessions (the gray bars) usually accompany tighter lending conditions. Thus, the irony of today's massive monetary accommodation is that it is underway in the middle of a massive credit contraction.



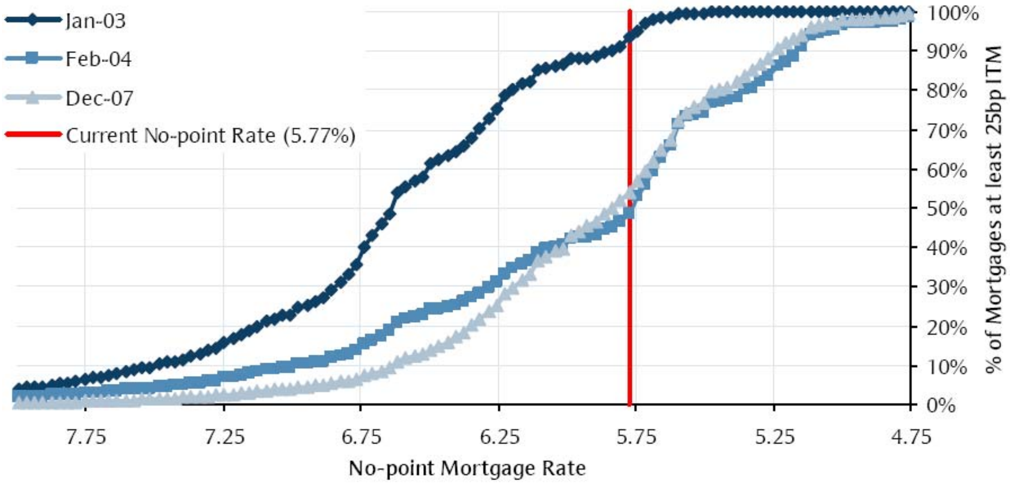
Trying to get ahead of the curve—the markets, the economy, credit—the Fed is clearly brushing aside inflationary concerns and moving economic growth to the fore. Explaining their inter-meeting 75 basis point ease, the FOMC explained that it "took this action in view of a weakening of the economic outlook and increasing downside risks to growth. While strains in short-term funding markets have eased somewhat, broader financial market conditions have continued to deteriorate and credit has tightened further for some businesses and households. Moreover, incoming information indicates a deepening of the housing contraction as well as some softening in labor markets."

To get back to our earlier question, we believe that the Fed had no feasible alternate tools because it doesn't actually have that many tools at its disposal. To do nothing would have risked market and structural problems, and quibbling about the amount and the speed of the Fed ease is missing the point about economic conditions today. The events of last month reminded us of William McChesney Martin, Jr., Chairman of the Fed for five presidents from 1951 to 1970, who used to tell people, "I'm not an economist." It turns out that January 2008 was the month when Ben Bernanke stopped being an economist and started being a risk manager.

The Mortgage Market

December speeds (January release) came in 12% faster in both the 30-year fixed-rate and hybrid ARM sectors, which was slightly faster than expectations. The largest increase was concentrated in the recent vintages that have fresh documentation and are therefore easier to process. In January, we can expect speeds on more seasoned paper to start picking up as borrowers from 2005 and earlier start to take advantage of December's rally. Looking ahead we can expect modest (10%) increases for the next several months, but dealers are still predicting slow speeds throughout 2008-2009. Bear Stearns is calling this period the "floor" from which all future prepayments models will be calibrated.

With the tremendous rally in Treasuries since our last commentary, and the corresponding decrease in mortgage rates, prepayments are on the mind of every MBS investor. Citigroup analysts have calculated that at today's current mortgage rates, approximately 45% of the mortgage universe is refinanceable, while with a 50 basis point drop in mortgage rates, 80% of the universe would become refinanceable. Barclays analysts put the same question to the test, and also compared the current mortgage universe to past markets. As the graph below illustrates, Barclays is a little higher and calculates that about 50% of the current mortgage universe is at least 25 basis points "in the money" at the current mortgage rate (with no points), and therefore marginally refinanceable. This is about the same as the universe in 2004, but well below the historic high levels experienced during the refi wave of 2003. Similar to Citigroup's conclusion, a 100 basis point decline in mortgage rates would make virtually the entire universe refinanceable.



Interestingly, even though the MBA Refinancing Index has jumped in recent weeks (it hit 5103.6 on January 25, the highest since July 2003), it has been suggested that the recent spike is a reflection of single borrowers putting in multiple applications for refinancing—recall that the Refi Index measures applications, not closings. It remains to be seen whether this surge translates into faster refinancing activity. As we have discussed in prior commentaries, there are three elements that would tend to depress refinancing activity: 1) Worsening credit trends: Foreclosure, default and delinquency rates are rising; 2) Home price depreciation: As home prices depreciate, loan-to-value ratios will only increase. So as already leveraged borrowers become even more levered they will have fewer and fewer options to refinance; and 3) Credit availability. As the graph at the top of the commentary shows, banks are tightening their standards today, whereas in 2003/2004 the lending spigots were wide open.

The Markets

In January, the Fed eased another 125 basis points. The dollar weakened, bond yields and mortgage rates fell, and refinancing applications jumped. Stocks were down. Gold continues its strong rally.

	1/31/2008	12/31/2007	1/31/2007	MOM % change	YOY % change
Fed Funds	3.00%	4.25%	5.25%	-29.4%	-42.9%
2-year US Treasury	2.097%	3.051%	4.921%	-31.3%	-57.4%
10-year US Treasury	3.595%	4.025%	4.810%	-10.7%	-25.3%
10-year JGB	1.452%	1.510%	1.704%	-3.8%	-14.8%
10-year euro	3.930%	4.331%	4.100%	-9.3%	-4.1%
10-year UK Gilt	4.477%	4.508%	4.976%	-0.7%	-10.0%
10-year Canada Treasury	3.878%	3.990%	4.177%	-2.8%	-7.2%
30 yr conventional mortgage	5.408%	5.921%	6.299%	-8.7%	-14.1%
Dollar Index	75.18	76.70	84.60	-2.0%	-11.1%
Japanese Yen	106.44	111.79	120.91	-4.8%	-12.0%
S&P 500	1378.55	1468.36	1438.24	-6.1%	-4.2%
Nasdaq Composite	2389.86	2652.28	2463.93	-9.9%	-3.0%
Gold $/oz (nearby contract)	$922.70	$838.00	$652.00	10.1%	41.5%
Oil $/bbl (nearby contract)	$91.75	$95.98	$58.14	-4.4%	57.8%
MBA Refi Index (month end)	5103.6	1620.9	1940.2	214.9%	163.0%

Source: Bloomberg; Japanese Yen quote is the London feed

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