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The Economy

Call it the Vikram Pandit rally.

March began with stocks heading even further into the doldrums, falling over 9% in the first week of trading. The turnaround in share prices can be pinpointed to a single catalyzing event: On March 10th, an internal email from Citigroup CEO Pandit found its way onto newswires. The email stated that the company was profitable in the first two months of 2009, and had passed internal stress tests with flying colors. Stocks responded dramatically, with the S&P 500 gaining over 6% on the day and the KBW Banking Index more than doubling that result, rising 15.6%. Over the following two days, the CEOs of JP Morgan Chase and Bank of America made similar comments regarding their companies. Equity markets never looked back, ending March with substantial gains, led by the banking sector.

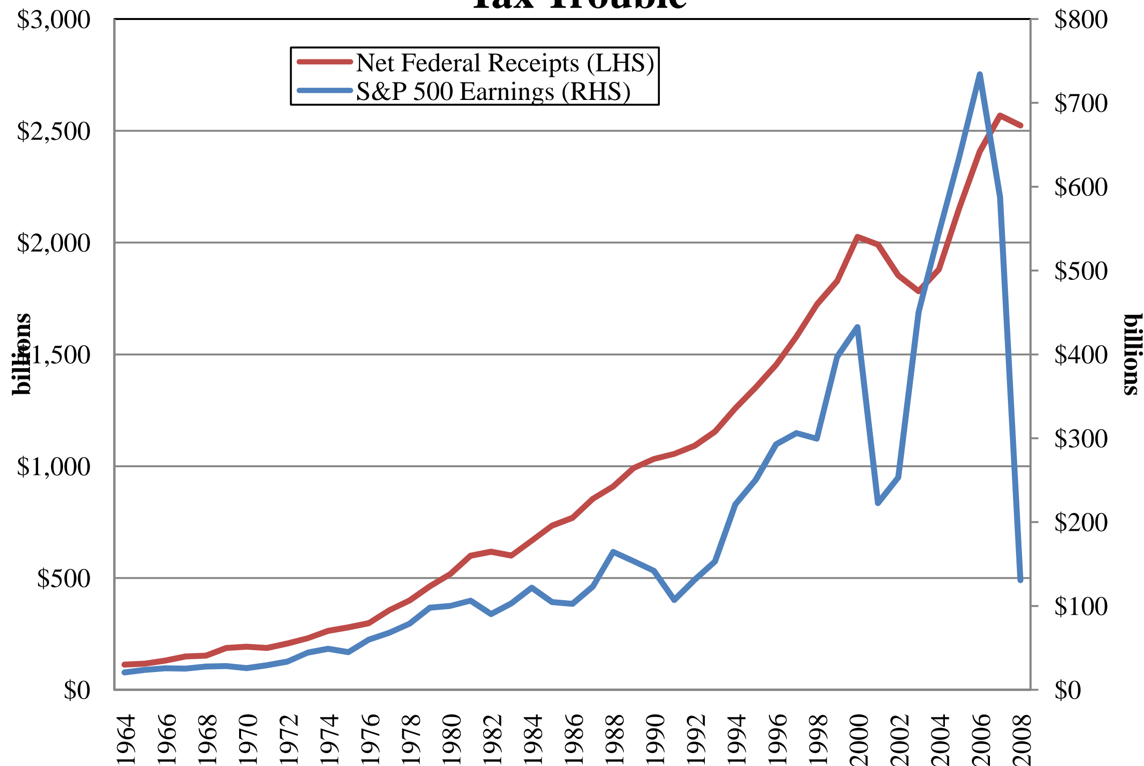
Aiding the move higher in equities was the announcement of Treasury's Public-Private Investment Program (PPIP). This program is designed to address "legacy assets" on bank balance sheets, both loans and securities. Using $75-100 billion of TARP money, along with private capital, the plan will use leverage to get $500 billion in purchasing power (expandable to $1 trillion). Participants will be able to partner with the government to buy these assets from the banks using up to 6-to-1 leverage in the form of non-recourse financing from the Treasury and loans guaranteed by the FDIC. The program has promise. Investors are currently demanding high rates of return to bear the risk of holding these assets, which drives down prices. Adding leverage allows buyers to earn the higher desired ROE even after paying substantially higher prices.

There are still questions about the program. First, private investors will have to be enticed to come along for the ride. Much has been written about the favorable terms available to investors in the PPIP. They are clearly getting a good deal, but there are other risks involved, namely the perceived risk of partnering with the government. With Congress passing laws left and right that reach into the pockets of private enterprise, investors are rightfully nervous about the *upside* of the PPIP. There is some likelihood of public outrage if investors earn *too* high a rate of return with government assistance, and the headline risk is something to consider. Second, the banks themselves will have to be enticed to sell loans and securities into the program, and the recent FASB mark-to-market change suggests that there may be incentives in place not to sell into the program.

While there may be questions about the execution of PPIP, no one is questioning the government's purposefulness. If some aspects of the PPIP are not working, we have every confidence that those problems will be fixed. The defining moment of clarity on this front came on March 18 when the Federal Open Market Committee (FOMC) committed the Federal Reserve to "employ all available tools to promote economic recovery and to preserve price stability." The statement outlined new tools, including an expansion of the Term Asset-Backed Securities Loan Facility (TALF), a commitment to expand its 2009 purchases of Agency MBS from $500 billion to $1.25 trillion and a doubling of its 2009 purchases of Agency debt to $200 billion. The FOMC also resolved to purchase up to $300 billion in longer-term Treasuries "to help improve conditions in private credit markets."

The PPIP, the expansion of the Fed's balance sheet and the new and improved TALF should have a positive effect on markets, although the ultimate extent of that effect is unknown. Thus far the Fed's purchases of Agency MBS have had an impact on primary mortgage rates and the secondary market for Agency MBS. (Thus far the Fed has bought some $270 billion in Agency MBS.) Since the Fed first announced the program on November 25, 2008, the Freddie Mac 30-year mortgage commitment rate has fallen from over 6% to below 5%, and the yield on the current coupon has fallen from over 5% to under 4%.

While the Fed, Treasury and the FDIC are doing their part to solve financial market credit issues, there are still other fish to fry. With S&P 500 earnings taking a sharp turn the worse, and unemployment rising, expect tax receipts to slow down considerably.



According to the Wall Street Journal, there are at least 10 states considering increasing their sales or income taxes: Arizona, Connecticut, Delaware, Illinois, Massachusetts, Minnesota, New Jersey, Oregon, Washington and Wisconsin. California and New York have already put theirs in place. What the stimulus gives, higher taxes will take away.

The Residential Mortgage Market

February prepayment speeds (March release), increased from 17 CPR to 23 CPR, or 39% month-over-month, which was slightly quicker than most dealer estimates. Looking ahead, most dealers are estimating a similar pick-up in speeds beginning in April or May at the earliest with future prepayment dynamics driven by both mortgage rate movements and more aggressive policy innovations.

As we have discussed before, the crest of the current refinancing activity should be below that of 2003 primarily due to four distinct differences between the current environment and that of 2003. In no particular order, the first distinct difference is the ability of the borrower to take cash out when they refinance. Under the new refinancing programs implemented by the GSEs, cash out refinancings are strictly prohibited. Second, affordability products are virtually non-existent in the current environment. Barclays Capital estimates that during the height of the housing market, 2003 through 2006, 30-65% of all mortgage origination was non-Agency loans. Borrowers refinanced into option ARMs, hybrids, interest-only, and low/no documentation loans during this time period, all of which are ineligible for purchase under the current government buying programs. Third, originators are still operating under capacity constraints as a result of downsizing and warehousing limits.

Fourth, despite the fact that the current LTV requirement has essentially been increased to 105% for Fannie Mae and Freddie Mac loans under the housing affordability plan, a substantial portion of borrowers are still over this threshold. As the table below demonstrates, a large number of all loans originated in the 2003 to 2008 period are either not fully documented, have second liens, or have pushed their current LTV above 105% due to home price depreciation. For the 2006 and 2007 vintages, over a third of those borrowers have all three of those characteristics. This is a sizable block of borrowers who will likely be unable to refinance.

Vintage	I. % Current LTV > 105%	II. % Not Fully Documented	III. % with 2nd lien	I, II & III combined
2003	1.1	16.6	7.7	23.0
2004	2.2	10.6	12.1	22.6
2005	5.8	9.3	13.5	26.1
2006	8.7	14.6	16.6	34.7
2007	11.5	13.6	17.4	37.0
2008	4.9	8.4	11.8	23.6
source: Barclays Capital				

The Commercial Mortgage Market

The continuing credit crisis and recession continue to wreak havoc on commercial real estate. The sector saw its first trophy property, the 1.7 million-square-foot John Hancock Tower, become a foreclosure action headline. In 2006, the property was sold for $1.3 billion to Broadway Partners, who financed the acquisition with a combination of a mortgage loan and mezzanine debt. Broadway defaulted on the mezzanine debt in January 2009. The property was sold at a foreclosure auction to a partnership between Normandy Real Estate Partners and Five Mile Capital Partners for $20.1 million for the mezzanine debt and the assumption of the first mortgage of $640.5 million (which had been securitized). As we forewarned our readers in our November 2008 Commentary to 'Stay tuned' on cap rates, based upon this repricing the Hancock Tower's cap rate rose from 3.80% at acquisition to 6.76% today. Some of the facts surrounding this transaction are still being unearthed, but the trend is indisputable.

The 60-plus day delinquency rate is also rapidly accelerating for CMBS and stands at 1.21%, an increase of 79 basis points over the last six months. This compares to an increase of only 6 basis points for the preceding six-month period. Fueling the delinquency rate are not only borrowers that cannot make their monthly payments, but also a sizable amount of maturing loans that are not refinanced. These loans, referred to as balloon defaults, continue to remit their monthly payments and are extended at the discretion of the transaction's special servicer. Unfortunately, the loans that are being extended are exposing a fissure in the CMBS framework: Are the special servicers acting in a fiduciary manner to the trust that will result in a maximization of principal and interest received for loans that are extended?

The AAA investors, or the senior certificate holders, trade return for surety of repayment. The ratings also imply that payments will be made on a timely basis. This position is in contrast to the first loss investor, who has no expectations as to the timeliness of the recovery of his investment. Rather, he is only concerned with the amount of the investment recovered since he does expect loans to default and losses to be realized. And since his purchase is made at a discount to par value, maintaining the stream of cash flows from an underlying mortgage is beneficial to his bond investment.

This conflict is manifested in the return expectations for the so-called Super Duper AAA bonds. Not to get too bogged down in detail, but we want to illustrate what we mean with a real life example. We selected the AAA-rated A2 class of BSCMS 2005-PWR 10 securities. This class is currently priced at 94-03 to yield 9.38% with a three month principal repayment window ending December 2010. The bonds carry a current pay cash coupon of 5.27%; therefore, approximately 400 basis point of the yield expectation is the accretion of the discounted purchase price to par. Given that the security has the benefit of 30% credit enhancement and that the origination of the underlying mortgage loans in the pool was 2005, a slightly better year for underwriting than the more notorious vintages of 2006-2008, the AAA investor will feel relatively secure regarding the opportunity to recognize the 9.38% yield. However, if all loans are extended by the special servicer for 12 months beyond their stated maturity, the yield drops to 7.89%; at a 36-month extension, the yield is 6.84%. While the present credit environment poses challenges, AAA investors would prefer to see a current monthly pay mortgage, originated prior to 2006, go through the refinance mill. Special servicers believe that more proceeds can be realized once the crisis passes. (Let us be clear: This bond is not in default or in the hands of a special servicer. It was chosen purely for illustrative purposes.)

Presently, the American Special Servicers Association is lobbying the U.S. Treasury to change REMIC rules to give special servicers more flexibility to deal with problem loans. The special servicers would like the ability to extend loans more easily and

to permit a property in workout to be transferred to a new buyer, who could also assume the mortgage. Senior CMBS investors, on the other hand, believe that their seniority and their relative size and exposure in the structure should enable them to dictate a resolution that is more beneficial to them. Efforts to strike a compromise between a consortium of 15 of the biggest senior CMBS investors and special servicers have broken down. Senior CMBS investors are considering forming their own lobbying team. Unsurprisingly, it looks like the only party who will maximize proceeds from this situation is the lawyers.

The Markets

Markets treaded water in March, but stocks showed signs of life with news of new policy programs and a commitment by policymakers to not sit idly by. Another weak jobs report helped bonds. Interestingly, gold fell even as the dollar weakened.

	3/31/2009	2/28/2009	2/29/2008	MOM % change	YOY % change
Fed Funds	0.25%	0.25%	2.25%	0.0%	-88.9%
2-year US Treasury	0.800%	0.974%	1.586%	-17.9%	-49.6%
10-year US Treasury	2.665%	3.015%	3.411%	-11.6%	-21.9%
10-year JGB	1.353%	1.280%	1.284%	5.7%	5.4%
10-year euro	2.994%	3.112%	3.899%	-3.8%	-23.2%
10-year UK Gilt	3.166%	3.623%	4.348%	-12.6%	-27.2%
10-year Canada Treasury	2.782%	3.131%	3.440%	-11.1%	-19.1%
30 yr conventional mortgage	4.307%	4.759%	5.587%	-9.5%	-22.9%
Dollar Index	85.43	88.01	71.80	-2.9%	19.0%
Japanese Yen	99.35	97.96	99.86	1.4%	-0.5%
S&P 500	797.87	735.09	1322.7	8.5%	-39.7%
Nasdaq Composite	1528.59	1377.84	2279.10	10.9%	-32.9%
Gold $/oz (nearby contract)	$922.60	$942.50	$916.20	-2.1%	0.7%
Oil $/bbl (nearby contract)	$49.66	$44.76	$101.58	10.9%	-51.1%
MBA Refi Index (month end)	3063.4	3906.3	2636.0	-21.6%	16.2%

Source: Bloomberg; Japanese Yen quote is the London feed

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