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- **The Mortgage Market:** *Prepays come in more slowly with weak housing and more regulation*
- **The Economy:** *Big sentiment shift on little change in data*
- **The Markets:** *Bonds cry a river of tears as expectations adjust for Fed ease*

The Mortgage Market

Prepayment speeds in April (May release) were relatively unchanged from March, slightly slower than dealer expectations. Despite late May's rally in rates and seasonality starting to come into play, refinancing activity failed to flare up mainly due to a two business day decrease and a softening housing market. The average Constant Prepayment Rate on 30yr Fannie Mae pass-throughs is now at 11.8%, which is flat compared to the beginning of the year and slower than earlier projected. Looking ahead to May, we can expect speeds to remain fairly flat to a small 5% increase as seasonality starts to come more into play as the warmer months are approaching.

Adjustable-rate mortgages (ARMs) typically prepay faster than fixed-rate mortgages. Prepayment speeds for adustables increased 4% to 5% over last month mainly in the shorter 3/1 hybrid space (these are bonds with a fixed coupon for 3 years that adjust every year thereafter). These speeds were nonetheless slower than expected. One factor that may be potentially affecting prepayment speeds on adjustable-rate mortgages, especially non-traditional products like Interest Only (IO) or option ARMs, is a set of new underwriting requirements being put forth by the Office of the Comptroller of the Currency (OCC). Going forward, borrowers will have to qualify based upon the fully indexed amortized payment for non-traditional ARMs, which will add an additional constraint for the IO borrowers to refinance.

As borrowers who are close to reset on their adjustable rate mortgages look to refinance into fixed rate mortgages, the tighter underwriting standards brought forth by the OCC could lead to spreads tightening on ARM products. Since our last commentary we have seen a substantial tightening of spreads on ARM products: for instance, on generic Fannie Mae 6% 5/1 hybrid ARMs spreads to Treasurys have narrowed from 95 basis points to 75 basis points. While some of this tightening is likely due to the overall backup in rates since then (as Treasuries sell off, spreads will tighten due to the lower likelihood of borrowers exercising the "call option" to refinance), we expect that some of it is due to the new OCC rules. As research analysts at Credit Suisse said, "Tightening in underwriting standards, limiting supply and improving collateral quality" are all "positives" for ARMs.

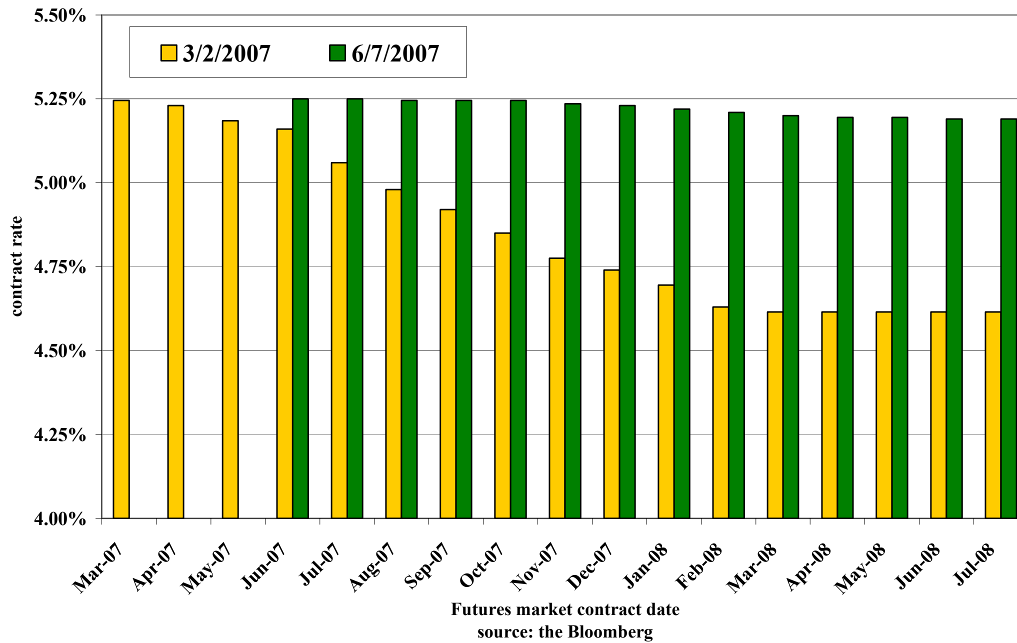
The Economy

If anything, the data released during May was more of the same mixed data we have had for several months—slowing economic growth, subsiding inflationary pressures, no definitive trends other than the continued weakness in the housing sector. According to the S&P/Case-Shiller index of home prices in 20 US metropolitan areas, values fell 1.36% year-over-year, as supply of unsold homes continues to outstrip demand. Existing home sales dropped precipitously in the month as prices moved only slightly down, while new home sales were flat as prices dropped precipitously. Clearly the homebuilders are holding a fire sale to clear away inventory, while homeowners who are selling their houses haven't dropped prices sufficiently. Pending sales of existing homes have fallen to their lowest level since the last recession. US GDP in the first quarter, previously estimated to have grown 0.8%, was revised downward to 0.6%. The Federal Reserve's favorite measure of consumer price inflation, the core personal consumption expenditure (PCE) price index, rose a less than expected 0.1% month-to-month change, which brought year-over-year inflation by this measure to 2.0%. Fed policymakers in the past have said that they would be comfortable with prices rising within a 1% to 2% comfort zone. Retail sales were generally weak, as big US retailers reported lower same store sales. The relative bright spots in the economic picture in the month were jobs and manufacturing. US job growth was slightly higher than expected, as 157,000 non-farm jobs were added in the month. Adding jobs during the month were service industries, including banking, insurance, restaurants and retailers. The unemployment rate stayed at 4.5%. Manufacturing activity as measured by the Institute for Supply Management's factory index rose to 55, the highest since April 2006.

In the minutes to the FOMC meeting on May 9 (released on May 31), members acknowledged that economic growth had slowed, largely due to the weakness in housing, and that it would likely stay at below long-run potential, and they also acknowledged that inflation was turning more favorable. There was a thread of puzzlement in the minutes related to the irreconcilable fact of slowing growth with a relatively strong job market. They suggested that it "could partly reflect measurement issues." Nevertheless, "the apparent tightness of the labor market remained a significant source of upside risk to inflation."

The Fed's stubbornness in holding the Funds rate at 5.25% at its May 9 meeting, the hawkish rhetoric on inflation that continued forcefully throughout the month, along with other possible factors, contributed to a marked shift in sentiment in the market.

During the month, the 2-year Treasury yield rose 32 basis points, from 4.59% to 4.91%, and the 10-year Treasury rose 27 basis points in yield, from 4.62% to 4.89%. As we write this commentary, the market has sold off even further, with the 2-year at 5% and the 10-year at 5.10%. The Fed Funds futures market has adjusted its expectations for future Fed activity. In the beginning of March the market was projecting two eases by year-end; today the market is pricing in virtually no chance of an ease, or a hike. The Fed has successfully maneuvered the market into a position of having no clear opinion on what the next step will be.



To us, the main thing that has changed since March is sentiment. While the housing recession may be taking somewhat longer to evolve than investors perhaps initially expected, it is nevertheless playing out as predicted: Weaker growth, slowing consumption, ebbing inflation, deteriorating credit performance.

The Markets

In May, global interest rates rose, the dollar strengthened, oil and gold remained elevated. Stocks charged ahead.

	5/31/2007	4/30/2007	5/31/2006	MOM % change	YOY % change
Fed Funds	5.25%	5.25%	5.00%	0.0%	5.0%
2-year US Treasury	4.912%	4.595%	5.037%	6.9%	-2.5%
10-year US Treasury	4.890%	4.624%	5.121%	5.8%	-4.5%
10-year JGB	1.753%	1.660%	1.840%	5.6%	-4.7%
10-year euro	4.422%	4.154%	3.982%	6.5%	11.0%
10-year UK Gilt	5.255%	5.043%	4.591%	4.2%	14.5%
10-year Canada Treasury	4.490%	4.154%	4.445%	8.1%	1.0%
30 yr conventional mortgage	6.37%	6.15%	6.57%	3.6%	-3.0%
Dollar Index	82.30	81.45	84.72	1.0%	-2.9%
Japanese Yen	121.81	119.38	112.37	2.0%	8.4%
S&P 500	1530.62	1482.37	1270.09	3.3%	20.5%
Nasdaq Composite	2604.52	2525.09	2178.88	3.1%	19.5%
Gold $/oz (nearby contract)	$661.00	$683.50	$642.50	-3.3%	2.9%
Oil $/bbl (nearby contract)	$64.01	$65.71	$71.29	-2.6%	-10.2%
MBA Refi Index (month end)	1874.6	2015.8	1409.0	-7.0%	33.0%

Source: Bloomberg; Japanese Yen quote is the London feed

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