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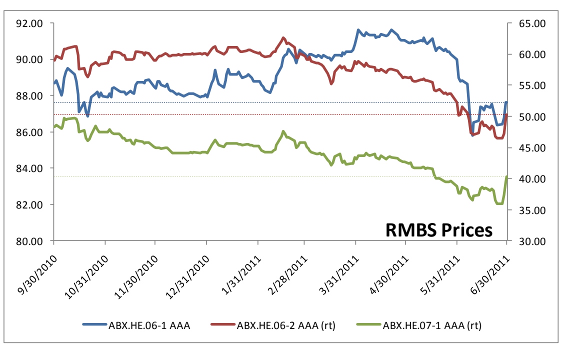
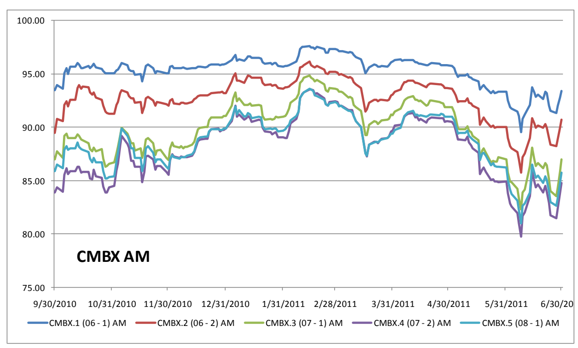
Securitized Products: Technical Sell-off, Fundamental Opportunity

Market recovery interrupted by de-risk trade

In our 2010 year-in-review, we pointed out that strong sector technicals and a renewed appetite for risk had fueled a rally, irrespective of concerns around underlying fundamentals. Today we find ourselves in almost the opposite environment. Fundamentals are largely in line with our firm view (for example, we've been bearish on real estate for some time). Yet weak sector technicals and a global de-risking has led to a repricing that has brought prices on many Securitized Products back to the levels of Fall 2010.





For patient investors, we see an attractive entry point. At the height of the rally, we wrote that careful asset selection and deft reallocation into different RMBS and ABS subsectors was necessary. At today's prices, the opportunity set has expanded and once again we find good value in on-the-run securitized products. Securitized products remain an asset class that provides uniquely powerful downside protection while also offering returns hundreds of basis points wide to alternatives --- even after applying conservative credit assumptions. The volatility in the macro environment is challenging, and weak securitized product technicals are likely to continue to subdue any rallies in the near term. That said, we believe securitized products offer cheap cash flows and will appreciate from here, if not always in a straight line.

Supply/demand technicals have been unfavorable

Renewed concerns about the fragility of the U.S. economic recovery, paired with weakness in the Euro-zone has weighed on asset prices generally. In securitized products, a number of events have added supply and reduced demand in recent months. Perhaps foremost was the government's plan to sell the RMBS it acquired in the bailout of AIG (ie the "Maiden Lane" bid list). The Federal Reserve had been selling portions of its ~$18 billion Maiden Lane II portfolio in waves, after rejecting a bid from AIG itself in March. While initially successful, it became increasingly clear that the extra volume was pushing prices lower, and the Fed retreated (at the end of June they indicated they were suspending the auctions for now). Adding to that selling pressure was an announcement in late May by Belgium-based Dexia that it planned to shrink its balance sheet by 35 percent and take a charge of $5.1 billion for the anticipated sale of its U.S. residential mortgage-backed securities portfolio. Several other European banks have also been discussing selling due to increased capital requirements on distressed assets.

Overlaying this new supply were drags on demand. Dealers have become increasingly cautious about the size of their positions, especially to protect their balance sheet at quarter-ends. Increased capital requirements also play into the diminished role of the street in holding inventory. Lastly, the popularity of CMBX (an index that tracks 25 tranches of CMBS bonds) as a hedge for a wide variety of risk assets has skewed the technicals in that market. Because CMBX is quite liquid, it has become a popular tool for investors to express a negative view on the economy. In a down market, this phenomenon often means that CMBX (or, for that matter, ABX, the index that tracks a groups of subprime mortgage tranches) will trade much wider than the cash market. Eventually, however, investors will exploit the basis between the two, bringing cash CMBS bonds down with the CMBX itself.

We do not foresee any dramatic near-term improvements in Securitized Products technicals, at least for the remainder of the summer. There is currently no obvious new source of demand. Supply will continue to leak out, whether it be Maiden Lane or Dexia or any number of large banks that are sitting on large pools of securitized assets. In all likelihood, improvements in prices will be met with the reappearance of these sellers, muting rallies in the short run.

CMBX indices plummet, CMBS bonds capitulate, even as CRE property values stabilize

Initially, cash CMBS bonds held value as the CMBX index sold off. Over time, the gap closed and cash bonds fell. Again, all of this was without a real change in real estate fundamentals, as evidenced by flat to rising commercial real estate indices.

Commercial Real Estate Prices	Decline Since Peak	Change from Recession Low
National – multifamily	-31.0	+14.1
National – industrial	-40.1	0.0
National – office	-35.0	+ 1.9
National – retail	-33.5	+ 9.4
Top 10 MSA's – multifamily	-29.9	+ 9.5
Top 10 MSA's – industrial	-33.0	+ 6.6
Top 10 MSA's – office	-13.3	+40.0
Top 10 MSA's – retail	-30.2	+10.5

Source: Moody's

Rising markets lift all bonds --- but falling markets discriminate, and so it is with CMBS and Commercial real estate ("CRE"). While CMBS AJ's are down as much as 15 points, the "dupers" are off only 2 points.[1] Meanwhile credit fundamentals are mostly sideways, with delinquencies range bound in the 9-10% range and special servicing holding at 13% of the collateral universe.

As CMBS prices have faltered, the bond-by-bond divergence has been striking. The premiums for better vintages, better structural protection, and better dollar prices had narrowed in the rally, but in this downturn, asset selection within CMBS has been key to performance. We favor the protection offered by the AM classes, though for better (older) vintages, we also invest in AJ classes.

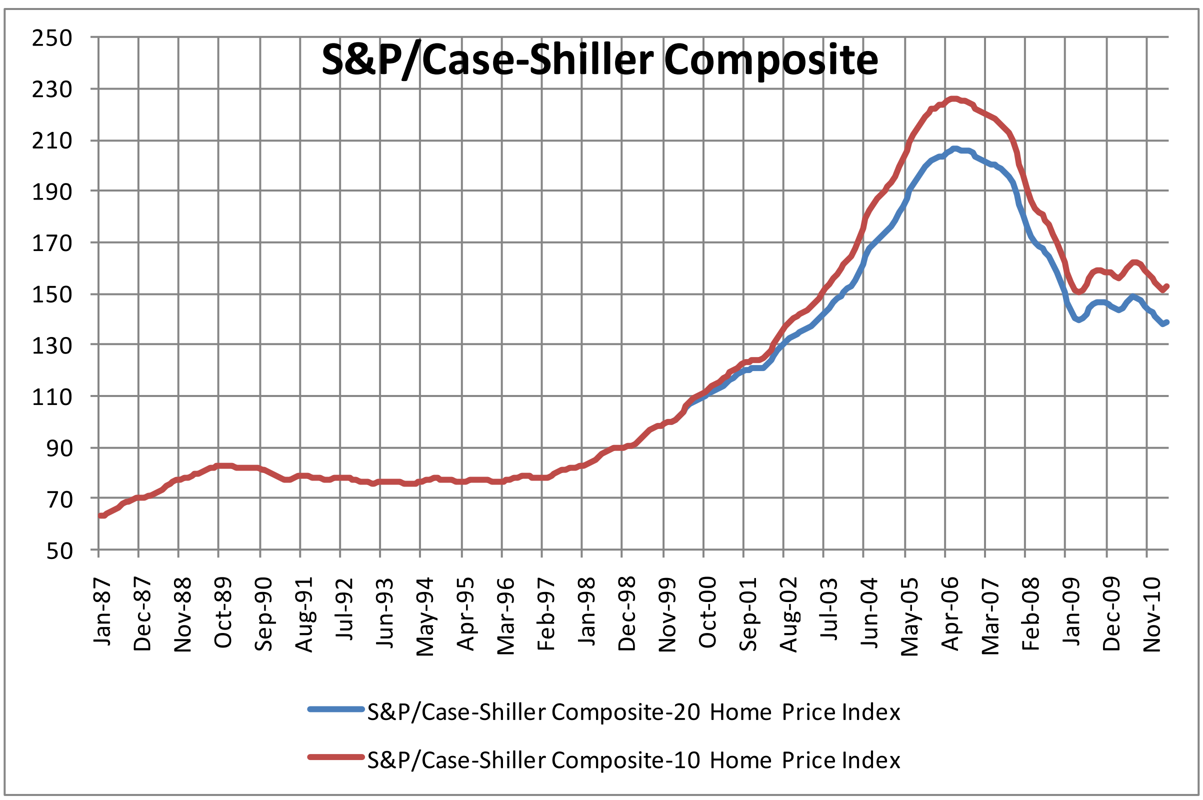
As for the underlying assets, the commercial real estate (CRE), major metro areas and better class properties are doing well. After falling as much as 50% from the peak, most are off their lows. By contrast, weaker, tertiary markets and lesser quality property, especially retail, continue to suffer.

[1] At new issue, AAA-rated CMBS bonds were further tranched into three classes -- the "super duper AAA" (aka "dupers"), the mezzanine AAA (the AM) and the junior AAA (the AJ). Post crisis, most of these bonds are no longer AAA-rated. Though some AM classes may be as high as AA today, many AJ classes are now BBB-rated, for example.

But whereas a year ago almost all markets and all property types were suffering from declining revenue, today revenues are stable to rising for Multi-family, Hotel and Industrial properties and many Office properties. Even in Retail, more than half the metros now have stable revenues. Cap rates are approaching their 10-yr average (+350bp over the 10-yr), settling in at +385bp after ballooning from +150 to +500bp. As commercial real estate remains pegged to an economic recovery -- and with a lag at that -- we still favor the top of the capital structure (i.e. senior bonds rated AAA at issue), and choose stronger vintages. Given the sell off, today's CMBS risk-adjusted returns have become very attractive, even without general economic recovery.

<u>We'd rather our double-dips in ice cream…</u>

… but we're not surprised by the one in housing prices. The housing market officially recorded a "double dip" in March of this year when the Case Shiller 20-city index fell below its 2009 nadir. April eked out a month-over-month gain of 0.7% in the 20-city index, simply a reflection of seasonality (the index almost always rises m-o-m in April). In some of the markets that are most troubled (and prominent in RMBS collateral), even the spring selling season could not provide a price boost (prices fell m-o-m in Miami, Tampa and Las Vegas, for example).



We have had a more bearish view on residential real estate than the market for over a year, and have been telling clients to expect a double dip to register this spring. Accordingly we recommended a more defensive position – using vintage, structure, or asset type to protect against further home price declines. Nonetheless, some market participants appear to have been taken by surprise. Many have only now revised downward their outlook for home prices once the newly negative data was released. This market recalibration makes some of the RMBS we had traded out of in the beginning of the first quarter worth revisiting today.

It is a fair question as to whether this latest "dip" reflects a new trend, or whether pro-housing government policy had merely temporarily masked the downward trend established in 2009. We think it is the latter. By pulling demand forward with homebuyer tax credits, and pushing supply out with modifications, the administration created the appearance of stabilization in housing. The distinction is important – there is nothing "new" that has caused a double-dip. The fact is that the necessary correction in housing has not yet run its course.

The administration is considering, once again, initiatives to stimulate the housing market. The disproportionate share of housing losses in politically important markets like Florida and Ohio, and even Nevada, may be behind the renewed interest in housing stimulus. Generally, we believe that policy should treat the symptoms (the weak economy) and not the cause (real estate). But with the economy not responding so well to medicine, it's very possible the government tries to spur housing demand again. Our favorite proposal (and one we suggested several years ago) is to make it more attractive for ***investors*** to buy residential real estate. If we cannot increase the homeownership rate (and we can't, without easy credit), then by definition the investor ownership rate will rise. Investors are already an important part of the housing market, representing nearly 1 in 4 sales nationwide and double that in some markets. Why not, via GSE lending policy or tax policy, make it more attractive for investors to be landlords?

Of course, many continue to fear that the government might implement new policies geared toward reducing foreclosures via loan modifications. Especially if they announce a program to help investors (the "haves") buy homes, it might only seem politically "fair" to also help underwater borrowers (the "have-nots"). We would not expect anything radical (read: meaningful). The main thrust of the programs to date has been to make sure that, *when loan modifications are an economic alternative to foreclosure*, that those modifications do in fact happen. To help ensure that as many of these economic modifications as possible were done, the government created a modification framework, and provided incentives to help reduce the frictional costs for the various parties involved. For the administration to do much more than this would be both costly and controversial. To protect our investments from the risk of unanticipated policy changes, we continue to stress our RMBS, especially by assuming very long timelines for resolution of problem loans.

We are finally seeing some credit burnout in mortgage pools. For example, in ABX the 60+ cohort (which includes all loans 60 or more days past due, foreclosures and REOs) peaked in November 2010 and is down about 16%. Similarly, in agency mortgages the 60+ cohort peaked in February 2010 and is down more than 20%.

The recently announced agreement by Bank of America to pay $8.5 billion to settle claims by a group of RMBS investors awaits court approval. The investors allege that the securitized mortgage loans did not comply with the issuer's representations and hence should be bought back. If approved, the bank will make payments to the trust equaling approximately 10% of projected losses for each securitization. Now that one such suit has been successful, they may proliferate, with JP Morgan, Citigroup and Wells Fargo as likely viable targets. To be conservative, we generally ascribe a small value to any future windfalls, given the probability of fruition, the timing, and the magnitude of the settlement. However, we are also closely examining how these payments are distributed to the various RMBS classes, which in some cases is counterintuitive and may have significant pricing implications.

Meanwhile, the states' attorneys general have yet to reach an agreement with the banks to settle state and federal claims over mortgage-servicing and foreclosure problems. Best estimates are a $20-25 billion hit to the banking industry. None of the settlement would be borne by RMBS trusts. Separately, the "Helping Responsible Homeowners Act" was introduced. The bill would allow Fannie Mae's and Freddie Mac's "underwater" borrowers to refinance, even though the mortgage loan exceeds the value of the home. Of course, this impacts only agency mortgages, but to the extent it is stimulative and may also prevent foreclosures, the bill would be a boon to the broad housing market.

Conclusion

The recent price declines in securitized products have been some of the most dramatic since 2008, which presents an opportunity rather than a harbinger. Unlike 2008, when short sellers were shorting par bonds, we are post-apocalypse and the bubble has already burst. Unlike 2008, downgrades are in the past and not on the horizon. Unlike the exuberance of 2008, broad sentiment is much more cautious and pessimistic. Unlike 2008, default risk of U.S. financial institutions is off the table. For RMBS and CMBS today, cash flow projections are not much different than they were six months ago. But the prices of those cash flows are cheaper. That won't change overnight, but we do believe it will change. Many factors may coalesce to keep securitized products cheap, but we expect these asset prices to march back up over time.

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