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Washington Watch

The next voice to be heard in the debate on the future of housing finance in the United States will be that of the Treasury Department, which is slated to release its report on the subject sometime this month. Given the sensitive political and economic nature of the topic, the complexity of the problem and the current tenuousness of the housing market, we imagine that Treasury's contribution will be not so much a shout, more like a polite throat-clearing.

Mortgage-Backed Securities (MBS) investors are an important constituency in the housing finance debate, because since the advent of securitization it is the MBS investor—in particular the Agency MBS investor both here and around the world—who has provided the majority of the capital to the $11 trillion US residential mortgage market. Roughly 70% of American residential mortgages are pooled and held in securitized form by investors of all kinds. When various constituencies discuss how the market will look under the wide range of future potential housing finance paradigms, the MBS investor needs to be at the table, because we are the ones who will price out the MBS relative to competing opportunities in the market, which ultimately drives the pricing of primary mortgage rates.

The core of the debate over housing finance reform is the government's role in the mortgage market. Right now, that role is significant, largely through the credit guarantee that is wrapped around Agency MBS. Fannie Mae and Freddie Mac, of course, are the most prolific providers of this guarantee (although Ginnie Mae is catching up thanks to the credit crisis), because most of the borrowers in the United States are of the conforming variety. The discussion over the government's role is often conflated with the history, performance and expense-to-taxpayers of Fannie and Freddie. We can all agree that Fannie and Freddie as business models were seriously flawed—private companies with a public charter, poor incentives for management, excess leverage for their book of credit risk, and so forth—and they are rightly being effigized for it. The former operating models of Fannie and Freddie, particularly their retained portfolios, will likely not survive this exercise (although the effective government backing of their MBS will).

But is government involvement necessary for the housing finance system in the United States? The short answer is no, but this is a complex issue without any short answers. Again, it all comes down to price. There would be consequences to a housing finance system that had no government involvement and, depending on how different the new system is from the current one, these consequences could be significant. In other words, if mortgage rates and house prices were not an issue, the government would never have been involved in housing finance in the first place.

To argue, however, that the US mortgage market doesn't need government involvement because other countries without a Fannie/Freddie/Ginnie model have similar home-ownership rates and manageable mortgage costs misses some very significant points. First, the mortgage capital stack in the US is unique. Whereas securitization is the largest capital formation tool in housing credit in the US, in Europe bank balance sheets and covered bonds fund most mortgages. Not only isn't there anywhere near enough bank capital in the US to supplant securitization, it is difficult to conceive that the universe of "rates" buyers will become mortgage credit buyers or move over to covered bonds (which default to the issuing bank's credit ratings), at least not at the same price levels and in the same size.

Second, the government guarantee is such a powerful advantage for US homeowners looking to buy or refinance a primary residence. The current housing finance system, certainly the one that prevailed until underwriting standards started to slip around 2004, is the most efficient credit delivery system in the world. Securitization allows borrowers of similar creditworthiness using similar mortgage products to receive the benefits of scale in pricing, and the government guarantee to make timely payments of interest and principal scales the process even further. The to-be-announced market is the window through which much of this scale occurs; it levels the playing field for smaller loan originators and community banks and enables lenders to offer longer rate-locks for borrowers. It is what makes possible the very popular 30-year fixed-rate mortgage with a down payment that is manageable for a wide swath of creditworthy borrowers (20%, with or without primary mortgage insurance for a conforming borrower), but also maintains other underwriting standards as well.

Third, and we say this only half in jest, anyone who suggests that a money-center bank, European or otherwise, is not a government-sponsored enterprise hasn't been reading the papers lately.

Aside from all this, and perhaps most importantly, the price and availability of credit and the value of our housing stock matter a great deal to current and prospective homeowners, the vast majority of whom pay their mortgages on time, take pride in their homes, form the basis of solid communities in America and have already seen their home values fall 25% or more. If one were to ask them to chime in on this issue, our guess is they would want to maintain the best aspects of the current system.

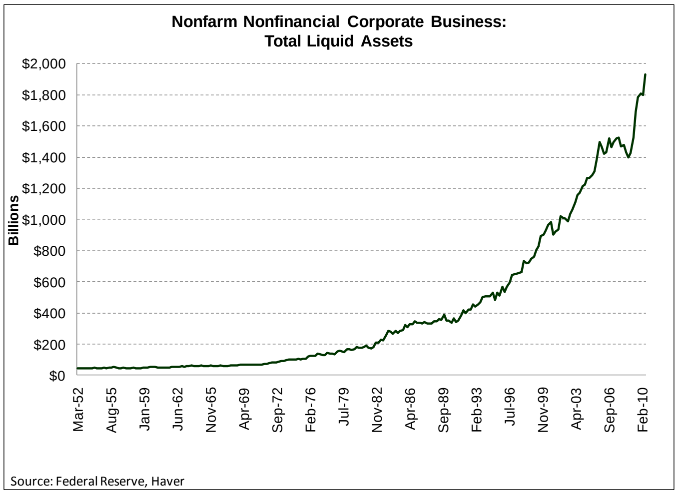
The message from the bond market is loud and clear: We are prepared to fund our neighbors' homes, in size and at relatively attractive rates, particularly if there is a government wrap involved. Yes, protect the taxpayers by guaranteeing only soundly underwritten mortgages and charging appropriate guarantee fees, and allow for a vibrant and competitive private-label market by carefully defining the conforming box, implementing sensible risk retention rules and setting risk-priced guarantee fees. If policymakers, however, resolve to have no government involvement at all, the bond market will price it out for you, but the likely outcome is a residential mortgage market that is smaller, more expensive, and less liquid.

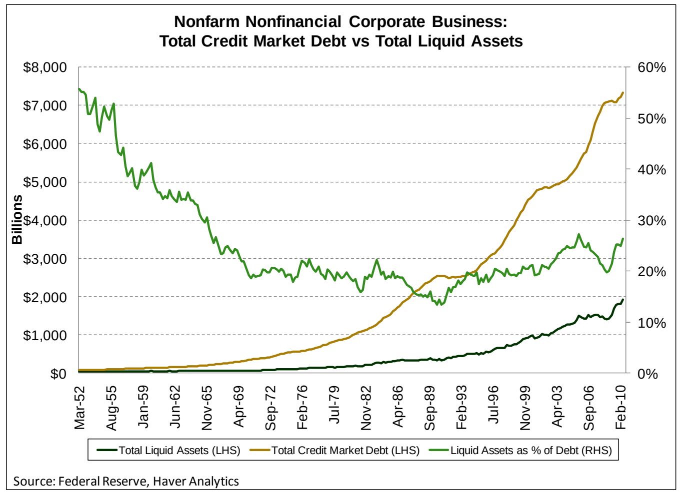
The Economy

In last month's commentary, we asked readers to submit fresh alternatives for "choppy" or "uneven" to describe the economy. The winning submission, bimarian, means "of or related to two seas." (Thank you, RAM!) In the first part of the year, as the Federal Reserve's initial foray into quantitative easing came to a close, fresh signs of economic stagnation began to emerge. Initial jobless claims stopped their decline and began to rise through the summer. GDP growth slowed from 5% at the end of 2009 to just 1.7% in the middle of 2010. Nonfarm payroll growth peaked early in the year and then declined to disappointing, though still positive levels. The unemployment rate remained stubbornly above 9.5%. Equity markets peaked around the time that the Fed was winding down its first round of quantitative easing (QE1) and subsequently suffered a correction of about 15%. During the same time period, the 10-year Treasury yield peaked out near 4% before making its way below 2.5%.

The Fed's Jackson Hole summit at the end of August marked the sea change. Chairman Bernanke's speech soothed markets by hinting at another round of quantitative easing (QE2), but what really got things going was his *Washington Post* op-ed the following day. Not long after, the FOMC made good on the hint, initiating a $600 billion Treasury purchase program. From that speech to the end of the year, the S&P gained over 20% and the 10-year yield moved almost 100 basis points (bps) higher from its lows. Following the Fed's script, the incoming economic data began to show signs of life. Initial jobless claims began to trend down again, breaking below the 400,000 mark once during December. Various manufacturing surveys, durable goods orders, and retail sales perked up. Some of the credit for this bounceback goes to the fiscal authorities as well, thanks to the stimulative tax deal that will go into effect in 2011. Improvement in the economy isn't without blemish—including the ongoing weakness in housing and jobs (see today's employment release)—but it has been noticeable.

The question before the house is the sustainability of the recent growth trends. Where will the next dollar of GDP growth come from? The great hope in 2011 is that corporations are going to take over the spending yoke from the government. As the graph on the left below shows, as of September 2010, nonfinancial corporations had over $1.9 trillion of liquid assets (i.e., cash) on their balance sheets, a new record. The issue is that cash is now 26% of total credit market debt outstanding, slightly below the 2005 peak of 27%, and well below levels of the 1950s and 1960s.





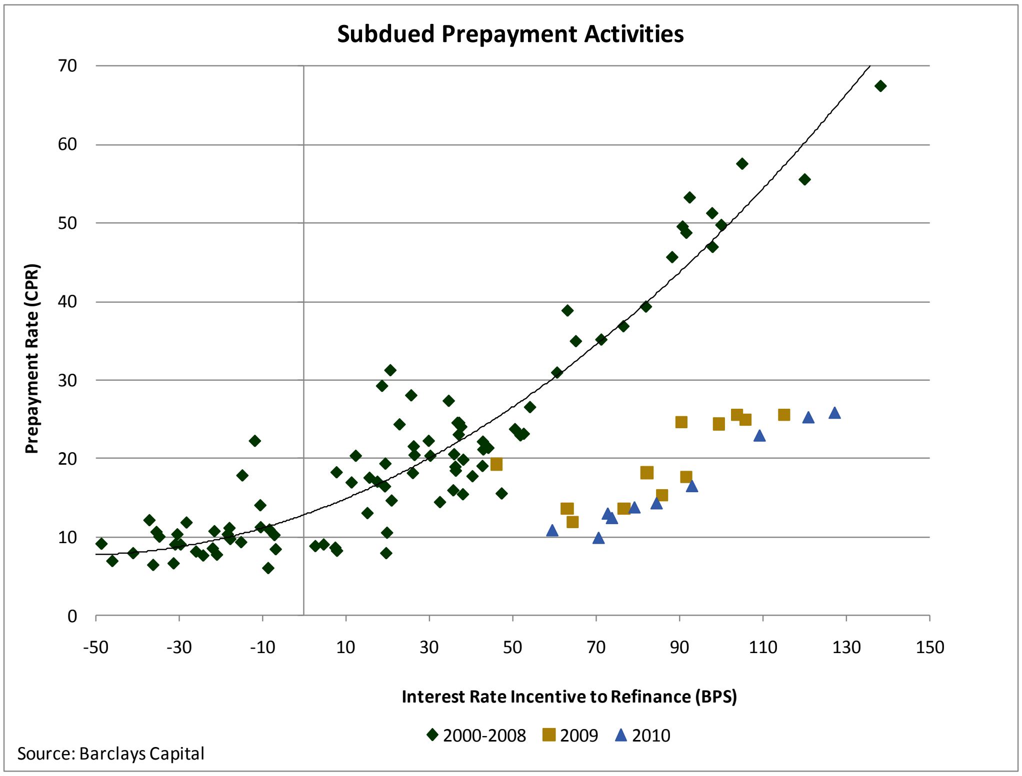
In 2011, we expect the tug-of-war between sectors that have the willingness and ability to expand their debt and invest their cash like the federal government and corporate credits (see below) and those that don't, like municipal borrowers, financial companies and households, to continue in bimarian fashion.

The Residential Mortgage Market

Prepayment speeds in December (January release) for 30-year Fannie Mae MBS slowed 5% from the prior month, in line with dealer expectations. Fannie Mae reported a drop of 4.4% in Constant Prepayment Rate (CPR) to 25.8 CPR. Lower coupons fell the most, with speeds on 30-year 4s and 4.5s down 10% to 10.1% and 22.9 CPR respectively. Similarly, aggregate speeds on Freddie Mac 30-year MBS declined 6.5% to 29 CPR. Looking ahead, speeds are likely to continue to decline on the implementation of increased Fannie/Freddie guarantee fees, seasonality and the recent backup in Treasury rates.

Measured by the spread between the yield on the current coupon mortgage and the yield on the 10-year Treasury, 2010 was a relatively stable year for Agency MBS. The year ended with a spread of 83 bps, only 12 bps higher from where it began the year, with a wide of 99 bps (December 1) and a narrow of 54 bps (July 30). This relative stability occurred despite some rather significant uncertainties that sprung up throughout the year, including the effects of large scale buyout programs of delinquent loans by the Agencies, the low level of interest rates, the end of QE1 and the start of QE2, and general macroeconomic challenges.

According to Barclays Capital's *Outlook 2011*, the market expects continued muted prepayment behavior in 2011 "due to diminished borrower responsiveness to rates, incrementally tighter underwriting and persistent origination capacity issues." The graph below puts 2010 prepayment behavior in historical perspective. Despite a 130 bps rate incentive for refinancing in the mortgage universe, the aggregate prepayment speed during 2009 and 2010 was only 25 CPR, or roughly a third of the historical norm at similar levels of rate incentive in the prior decade. Clearly the current mortgage stack is demonstrating signs of substantial "burn-out," or unresponsiveness to rates. Burn-out, coupled with tighter underwriting standards, is a likely recipe for relatively tame prepayment speeds in 2011, all other things being equal.



The Commercial Mortgage Market

"Alive! It's alive!" Gene Wilder exclaimed in *Young Frankenstein*. The same could be said about the commercial real estate market as 2010 came to a close. Lending rose both in the public and private markets, investment banks initiated new conduit lending programs and the velocity of transactions in both financing and sales increased steadily if somewhat slowly.

Commercial mortgage-backed securities (CMBS) issuance for 2010 came to approximately $12 billion, at a pace of execution that started slowly and clearly accelerated as year-end approached. Issuers were rewarded as AAA spreads rallied to 135 bps at year end from 190 bps during the spring. At the lower end of the investment-grade spectrum, BBB spreads hovered around the +420 bps level during the year.

With such momentum in mind, industry veterans are forecasting 2011 CMBS issuance to total anywhere from $35 to $50 billion. Most expect investment banks to team up with other specialty finance lenders and securitize mortgages as soon as practical.

Structurally, there were some improvements to 2010 CMBS transactions. Credit enhancement went back to 2002 and 2003 levels of 18% to the AAA class, a welcome relief from the aggressive levels for 2006 and 2008 vintages. We anticipate some pressure to subordination levels in 2011 as originators compete for product.

We estimate that approximately $300 billion of commercial mortgages will mature during 2011. Nearly 70% of that amount is attributable to the banks and thrifts and another 20% to CMBS and the balance to life insurance companies. Banks' balance sheets have been mending and as a result they have an increased desire to add commercial real estate loans to their portfolios. That activity, coupled with a resurgent CMBS market and better life company allocations, should result in sufficient funds for those projects which are financeable, although we may see more "amend, extend and pretend" programs for over-levered commercial real estate.

The Corporate Credit Market

The corporate credit markets have started 2011 with excellent follow-through momentum from a stellar 2010. Fundamentally, the sector continues to benefit from micro-oriented themes of balance sheet deleveraging, liquidity management, declining default rates and minimal corporate risk taking. Last month, an additional positive catalyst came in the form of a macro surprise: the wholesale extension of the Bush tax cuts. Current valuations present a double-edged sword for credit investors. While higher valuations are a manifestation of "good times," they also imply that 2011 will be a more challenging year than its predecessor.

The Fed's effort to inflate financial asset prices was broadly successful last year. The table below shows the degree that risk taking was rewarded across the investment spectrum. Even the rates sector, the worst performer, beat cash by several hundred basis points. In high grade corporates, the unexpected drop in Treasury rates together with tighter spreads pushed returns towards the double-digit threshold. Relative to other high quality fixed income segments, the sector benefited from its high interest rate sensitivity (duration is 25% higher than the broad index). In high yield, the investor preference for BB credit risk played out in returns as it outperformed single-Bs. Leveraged loans underperformed their high yield counterparts due to their lack of rate duration. Further down the capital structure, equity finally beat its fixed income counterparts on the return front, despite resilient flow trends in favor of bonds.

2010 Returns and "Starting Yields" for 2011

		Return			Yield*		Spreads**	
Broad Sector	**Sub Sector**	**2008**	**2009**	**2010**	**Yr Ago**	**Current**	**Yr Ago**	**Current**
Rates	US Treasury Current 10yr	20.1%	-9.7%	7.9%	3.8%	3.3%	-17	-13
	Agency MBS	8.3%	5.8%	5.7%	3.7%	3.5%	14	39
High Grade	US Corporates	-6.8%	19.8%	9.5%	4.9%	4.1%	190	163
	US Corporate BBB	-11.1%	31.4%	10.9%	4.7%	3.9%	169	148
High Yield	US High Yield (Cash Pay)	-26.2%	56.3%	15.2%	9.0%	7.6%	628	505
	US High Yield BB	-19.2%	45.2%	14.9%	7.6%	6.4%	473	384
	US High Yield B	-27.9%	47.6%	14.0%	8.6%	7.7%	597	512
	US High Yield CCC	-38.2%	94.1%	19.0%	12.4%	10.7%	990	844
Leveraged Loans	S&P/LCD All Loans	-29.1%	51.6%	10.1%	6.4%	5.4%	L+614	L+517
Equity	Standard and Poor's 500	-38.5%	23.5%	12.8%	7.1%	4.9%	NA	NA
	Russell 2000	-34.8%	25.2%	25.3%	7.7%	5.2%	NA	NA

* Effective yield for fixed fncome sectors and estimated earnings yield for equity. ** Option-adjusted spreads, in bps
Sources: Bloomberg, BAML, and LCD.

From a yield perspective, bonds are less competitive with equities than a year ago. Consider that the forward earnings yield of the S&P 500 is 7.73%; this compares to a 4.21% yield for high grade bonds. Indeed, one of this year's biggest investment challenges for fixed income investors is managing low base yields but still "wide" spreads. The effect of the conundrum is clearly playing out in one way already: record flows into loan funds. Low yields and rising stocks could very well mark the reversal of the investor flows into fixed income. More immediately, January has commenced with very strong demand as evidenced by the healthy appetite for the new issue calendar.

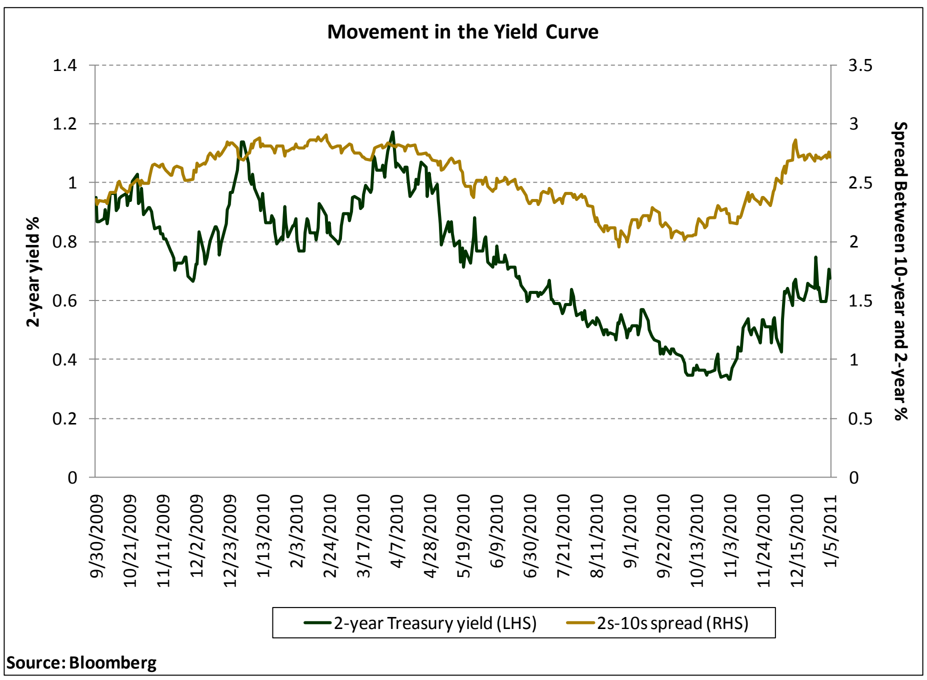
From a fundamental perspective, the corporate credit cycle is playing out more normally than other cycles. It is not overwhelmed by secular forces nor is it still plagued by post-bubble chronic retrenchment. Most recently, the credit profiles of firms in deep cyclical sectors like autos, specialty retail, and gaming have turned and are widely expected to have positive credit rating momentum going forward. Likewise, the leading indicators of defaults— distressed price ratios, easing of lending conditions, negative real short-term rates — are underpinning 2011 consensus forecasts for corporate defaults in the 2% range. So in the words of baseball great Yogi Berra, 2011 "is déjà vu all over again": With corporate balance sheets in improved condition, the risk to credit performance would have to come from large-scale macro factors—like changing interest rates, sovereign woes (both here and in Europe), and that random tail event that is not yet on anyone's radar.

The Treasury/Rates Market

Treasurys had a very poor month in December, after a similarly woeful November. The intermediate part of the curve was the underperformer as 5-year, 7-year, and 10-year Treasurys all sold off roughly 50 bps, while the 2-year only sold off 11 bps and the 30-year sold off 23 bps. The initial catalyst for the sell-off was a general sense of increased optimism due to improving economic data, but the sentiment accelerated with the tax compromise from Washington—which raised concerns over a deteriorating fiscal picture, a stronger near-term growth outlook and a sidelined Fed. The sharp pace of the sell-off made it clear that many investors were caught offsides after the QE2 decision by the Fed combined with typical year-end forces (balance sheet reduction and closing the books on 2010). Another factor in the price action was the pace of flows out of bond funds, both actual and prospective: while many of the flows to-date have been from municipal bond funds, the market is alert to the possibility that retail investors will see their poor end-of-year returns in bond funds and sell in order to chase strong equity returns.

December saw $165 billion of new supply in nominal notes and bonds from the Treasury, same as last month. The auctions results were mixed, most notably a strong 7-year and 30-year auction and a poor 5-year auction. In addition, during the month the Fed purchased $100 billion in nominal Treasurys as part of its QE2 purchase program.

The macro landscape today is looking quite a bit like that of a year ago, with accommodative monetary and fiscal policies and a resulting upturn in economic prospects, as well as questions regarding sustainability, from both a fiscal and a long term growth trajectory standpoint. In this environment, market participants put current relative and absolute yields in context in order to guide their future expectations, for example the differences between different futures contracts, forwards rates versus spot rates, and yields at different points on the yield curve. In the graph below, we see that the spread between the yield on the 2-year Treasury and the 10-year Treasury, a measure of the steepness of the yield curve, is about as wide (or steep) as it was a year ago, while the 2-year yield is lower. The question gets begged: Will the Treasury curve steepen or flatten? And from which end? Stay tuned….



The Markets

With QE2 underway, certain asset prices rose—such as gold, oil and equities—while the yield curve steepened. The Mortgage Bankers Association Refi Index dropped with the rise in mortgage rates.

	12/31/2010	11/30/2010	12/31/2009	MOM % change	YOY % change
Federal Reserve Funds	0.25%	0.25%	0.25%	0.0%	0.0%
2-year US Treasury	0.597%	0.457%	1.139%	30.6%	-47.6%
10-year US Treasury	3.295%	2.799%	3.839%	17.7%	-14.2%
10-year JGB	1.128%	1.194%	1.295%	-5.5%	-12.9%
10-year euro	2.963%	2.670%	3.387%	11.0%	-12.5%
10-year UK Gilt	3.396%	3.225%	4.015%	5.3%	-15.4%
10-year Canada Treasury	3.122%	3.061%	3.613%	2.0%	-13.6%
30 yr conventional mortgage	4.512%	4.096%	4.895%	10.2%	-7.8%
Barclays US Corporate	4.03%	3.79%	4.74%	6.3%	-15.0%
Dollar Index	79.03	81.20	77.86	-2.7%	1.5%
Japanese Yen	81.12	83.61	93.14	-3.0%	-12.9%
S&P 500	1257.64	1180.55	1115.10	6.5%	12.8%
Nasdaq Composite	2652.87	2498.23	2269.15	6.2%	16.9%
Gold $/oz (nearby contract)	$1,421.40	$1,385.00	$1,096.20	2.6%	29.7%
Oil $/bbl (nearby contract)	$91.38	$84.11	$79.36	8.6%	15.1%
MBA Refi Index (month end)	2115.40	2974.40	2008.90	-28.9%	5.3%

Source: Bloomberg; Japanese Yen quote is the London feed

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