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# MONTHLY COMMENTARY

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## Washington Watch

There was some irony in the first week of November 2010, a week in which the Federal Reserve committed to another round of quantitative easing (QE2), this time $600 billion, and the Republicans took control of the House of Representatives and came very close to taking the Senate. The irony is that although the average person probably can't tell you what QE2 is, let alone knows that it is about to happen, it will arguably have a far greater effect on them than the new leadership on Capitol Hill.

We'll talk much more about QE2 in the rest of this monthly commentary, from a number of different perspectives, but we begin with two contextual observations of the Federal Reserve's decision. First, this is not an insignificant decision by Chairman Bernanke and the rest of the voting members of the FOMC. (Except for dissenting Kansas City Fed President Hoenig, who believed that "the risks of additional securities purchases outweighed the benefits.") The prosecution of QE2 will be monitored and adjusted as necessary, but the implication is that the Fed has to be prepared to go bigger if the desired results are still not occurring. It is a slippery slope. Moreover, the monetary policymakers must believe that the probability of continued disinflation, further economic and jobs weakness is great enough to warrant this significant a step, a step without any true precedent or track record of either success or failure. Since the rational mind races to think of the potential downside and unintended consequences of QE2, the only explanation for it is that Bernanke & Co. see something truly dire on the horizon.

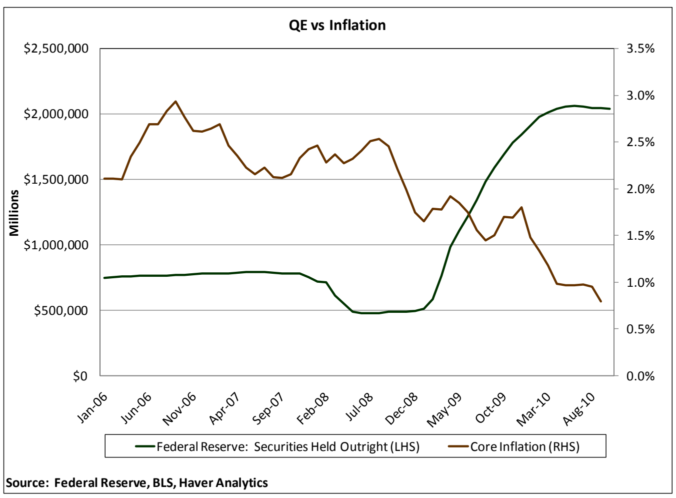
Second, the Federal Reserve (the Fed) is using the bluntest of instruments and the crudest of transmission mechanisms in order to thread a needle of outcomes: It wants inflation expectations to be raised and ratified by long-term interest rates, but it wants to hold down short and intermediate term rates for an extended period of time so as to not impede economic growth. It wants to expand its balance sheet by at least 30% and drive up the prices of financial assets, but it wants CPI inflation to come in just below 2% (and not a bit higher). It wants to stimulate economic growth through the wealth effect of these higher asset prices, on a corporate and household level, but it must go it alone, without the benefit of any fiscal stimulus. It wants to pursue this strategy knowing full well that it is angering the rest of the world and risks devaluing the dollar, but it wants foreign investors to continue to show up at Treasury auctions. Good luck to the Fed and good luck to us all.

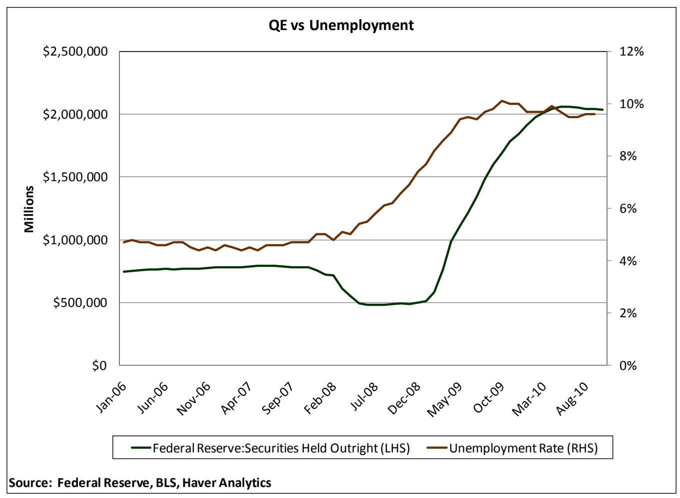
As for the election, it was indeed a strong showing for the Republicans, and they are already lining up their agenda. Unsurprisingly, it will start with taxes and spending (lower and lower, respectively) and moves on from there to re-crafting the Dodd-Frank Act, repealing healthcare and reforming the housing finance system in the United States. We don't presume to be able to handicap the outcome of these or other policy battles. However, the more decisive outcomes in policy after the 2010 election may not be in Washington but at the state level, where the Republicans truly had a historic sweeping victory. According to the National Conference of State Legislatures, Republicans gained over 675 state legislature seats on November 2, the largest gain by either party since 1966, even more than the gains by Democrats in the post-Watergate election of 1974.The GOP now holds about 3,890, or 53%, of total state legislative seats in America, the most seats held by the GOP since 1928, and 54 out of 99 state legislative chambers, its most since 1952. The South has undergone a transformation: In 1990, Republicans didn't hold a single Southern legislative chamber and only 26% of the legislative seats. Today, the GOP controls 18 Southern chambers and 54% of the seats. Alabama and North Carolina state legislatures are under Republican control for the first time since Reconstruction. The country is turning conservative at precisely the same time that legislatures begin the redistricting process. The election to watch for true change on a national level may be 2012. Stay tuned to the state and local levels for advance notice.

# The Economy

All eyes were fixed on the meeting of the Federal Reserve Open Market Committee on November 2 and 3. Expectations of another round of quantitative easing had been elevated ever since Chairman Bernanke's Jackson Hole speech on August 27 and market participants responded by driving the S&P 500 Index up 14.3% and tightening spreads on corporate debt. Economic data released during the month did little to derail the expectation of QE2, as inflation rates remained low and got lower, with headline CPI decelerating to 1.1% year over year and core CPI declining sharply to 0.8%. Jobs data were weak considering that we're supposed to be 15 months into an expansion. October's nonfarm payroll release (which came out after the FOMC statement) featured a stronger than expected establishment survey (151 thousand jobs vs 60 thousand expected), but a weaker household survey (-330 thousand jobs). The unemployment rate rose to 9.644% from 9.579%. These are the two data points that make up the Fed's mandate: to promote maximum employment and stable prices. Various Fed speakers have lamented the stubbornly high unemployment rate, calling it "unacceptable," and characterizing inflation as below the mandated level.

As it turned out, the November 3 FOMC statement was, in the words of poet William Carlos Williams, "the rare occurrence of the expected." Or the nearly expected. The $600 billion in new purchases was slightly larger than the widely expected $500 billion, but the pace of purchases was slightly slower than anticipated. As markets prepare for the implementation of QE2, we should start thinking about how to measure its success. How do we benchmark the Fed's strategy? The most obvious way is to use the two parts of the Fed's mandate: inflation and employment. The graphs below do just that.




If we measure the effectiveness of QE by looking at the Fed's dual mandate, it's very difficult to call round one a success. There is the obvious counterfactual: things could have been worse if nothing had been done. And we also have to take into account that it was done in conjunction with the greatest peacetime fiscal stimulus ever enacted.

Do we know what was accomplished with QE1? It increased asset prices. This isn't exactly part of the mandate, but in Bernanke's *Washington Post* op-ed released the evening of November 3, this seemed to be an important benchmark for the Chairman. As he wrote (emphasis added is ours): "This approach eased financial conditions in the past and, <u>so far, looks to be effective again</u>. <u>Stock prices rose and long-term interest rates fell</u> when investors began to anticipate the most recent action….<u>Lower corporate bond rates</u> will encourage investment. And <u>higher stock prices</u> will boost consumer wealth and help increase confidence, which can also spur spending."

Targeting higher asset prices as a policy tool? It is a means to an end. Buying Treasurys is intended to cause investors to bid up other asset classes, which will then lead to—or so the Fed hopes—an increase in investment and spending and overall aggregate demand. It's an interesting strategy (the Bank of Japan has recently said it will bypass the portfolio theory and go right to directly buying certain Japanese equities). The problem with artificially inflating asset prices is that it is simply bringing future returns forward into the current period (much like Cash for Clunkers and the home buyer tax credit brought demand forward). Higher valuations and smaller risk premiums, all else equal, actually increase the amount of risk in the system. The Fed will likely be successful in its asset-price targeting, it remains to be seen if it will be successful at achieving its dual mandate.

## The Treasury/Rates Market

Treasurys had a volatile month in October in the lead-up to the widely anticipated November 3 FOMC meeting. On the month, 2-year Treasurys and 5-year Treasurys were 9 and 13 basis points lower while 10-years and 30-years were 10 and 30 basis points higher, translating to an aggressive steepening of the yield curve. As there were no real standouts in terms of economic releases, the price action in October was more a vote on evolving expectations for QE2. What is clear is that the Fed's commitment to reflate and, implicitly at least, cheapen the dollar, was not a good recipe for the long end of the curve. This was also evidenced by the auction activity for the month: In general each of the Treasury auctions of notes and bonds ($165 billion notional) during the month went reasonably well, with the exception of the 30-year auction which came about 3 basis points cheap to market levels at the 1:00 PM deadline for bid submission.

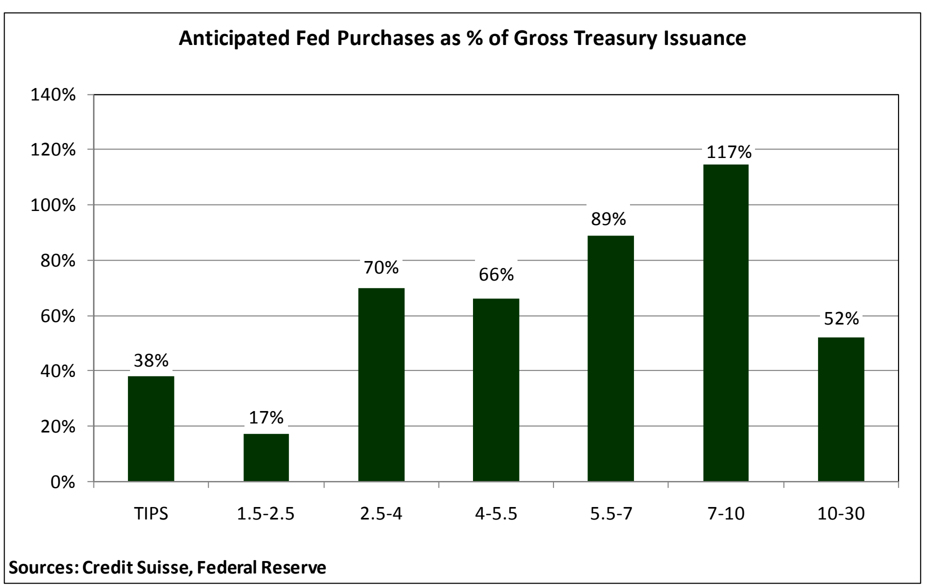
The Federal Reserve's planned purchase of $600 billion longer-term Treasury securities by the end of the second quarter of 2011, coupled with a continued reinvestment of mortgage paydowns, translates to a pace of about $110 billion per month ($80 billion excluding the reinvestment). That pace came in roughly as expected, with some surprise that the program was slated to run for 7+ months, although they did stress some flexibility around the ultimate sum and duration. Perhaps more of a surprise came with the New York Fed's concomitant announcement on the planned maturity distribution of the purchases. The purchases will focus more on 5-year to 10-year maturities, instead of tilting more purchases into the long end, as had been expected by many in the market. Needless to say this decision did not help an already ailing 30-year sector. The following table sets forth the maturity schedule of purchases as released by the New York Fed:

| QE2 Purchase by Maturity/Type | | | | | | | |
|---|---|---|---|---|---|---|---|
| Nominal Coupon Securities by Maturity Range* | | | | | | | |
| $1^{1/2}$-$2^{1/2}$ years | $2^{1/2}$-4 years | 4-$5^{1/2}$ years | $5^{1/2}$-7 years | 10-Jul years | 17-Oct years | 17-30 years | TIPS** $1^{1/2}$-30 years |
| 5% | 20% | 20% | 23% | 23% | 2% | 4% | 3% |

**The on-the-run 7-year note will be considered part of the 5 $^{1/2}$ - to 7-year sector, and the on-the-run 10-year note will be considered part of the 7- to 10- year sector.*

***Tips weights are based on unadjusted par amounts.*

Analysis conducted by Credit Suisse, shown below, represents the purchases as a percent of their anticipated gross issuance. One can see the focus of buying in the middle of the curve, most notably the intent to purchase what amounts to 117% of issuance in the 7-10 year sector. It also shows some neglect for 10-30 year sector.



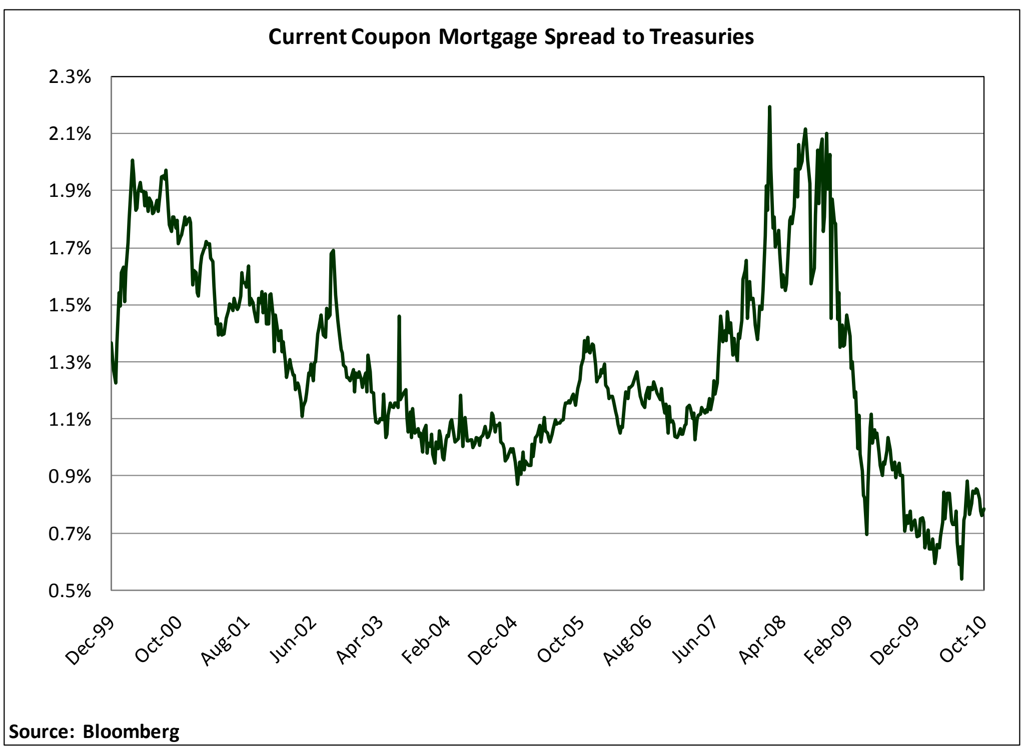
One thing that should be kept in mind is the supply of duration which will occur outside of Treasurys. Most noteworthy is the mortgage sector, where low rates will continue to create a supply of duration as homeowners prepay from higher coupon (shorter duration) mortgages into lower coupon (higher duration) mortgages. Those lower coupon mortgages will have duration that is similar to that of 5.5-10 year Treasurys, which explains the Fed's focus on that maturity sector.

## The Residential Mortgage Market

October prepayment speeds (November release) for 30-year Fannie Mae mortgage-backed securities (MBS) increased 3% from the previous month from 24.9% to 25.6% Constant Prepayment Rate (CPR), and 30-year Freddie Mac MBS inched up 2% to 29.1 CPR. For Fannie Mae MBS, lower coupons experienced slightly elevated speeds once again with the CPR for Fannie Mae 4% MBS ("Fannie 4s") up to 8.8 CPR from 8.0 CPR, 4.5s coming in at 22.8 CPR from the previous 21 CPR and 5s printing at 30.8 CPR, up from 29.8 CPR. In contrast, higher coupon 6.0s and 6.5s were unchanged from the previous month; this is likely due to credit impaired borrowers being unable to take advantage of lower rates. Prepayment behavior across the Freddie Mac stack was similar to that of Fannie with 4s up 6% to 13.4 CPR, 4.5s up 8% to 26.5 CPR, 5s up 2% to 33.7 CPR, and 6.5s unchanged at 24.7 CPR. This prepayment report provides further proof that there are impediments to typical rate-driven voluntary prepayment activity.

While rumblings of QE2 may have started late summer, it was not until this month that further stimulus became fully priced in for the November 3 FOMC meeting as the 10-year Treasury hit a one-year low in yield of 2.385% on October 21. Looking ahead, MBS investors will need to consider the effect the program on mortgage spreads and prepayment behavior.

First, it is unlikely that QE2, as currently contemplated, will include Agency MBS. Mortgage rates are currently at all-time lows, and buying more Agency MBS fits into the "pushing on a string" vernacular. According to Nomura Securities, the thirty-year Fannie Mae commitment rate (with no points) averaged 3.705% for the month of October, a record low. Moreover, current and future official buying of Agency MBS are unlikely given recent rhetoric from Federal Reserve members regarding their preference of keeping only Treasurys on the Federal Reserve balance sheet. Finally, as illustrated by the below graph, quite unlike in 2008 when the Federal Reserve purchased Agency MBS in the hopes of stabilizing the market and driving in spreads and thus mortgage rates, the spread between the current coupon mortgage and 10-year Treasurys are currently at or near their historic lows. Given this fact, further buying would likely be only marginally effective on spreads.



With respect to QE2's impact on prepayment behavior, MBS investors should look to the context of past prepayment speeds in relation to rates for a clue to future behavior. Before the crisis, the last time the 10-year Treasury was close to the October 29 close of 2.601%, was on June 13, 2003, when it bottomed out at 3.19%: This low rate resulted in 30-year Fannie Mae 6.5 averaging 69.8 CPR over the ensuing five months. When compared to today, with the ten year Treasury yield 51 basis points lower, 30-year Fannie Mae 6.5s have averaged 23.1 CPR over the past five months. This speaks volumes to the negative equity and capacity constraint effects present in the current system, as well as the reduced callability of the mortgage universe. Further tempering speeds are the additional constraints placed upon the origination industry brought about by the recent "robo-signing" debacle. As rates may continue to decline, we will continue to monitor this aspect of the market.

## The Commercial Mortgage Market

For the past 12 months, activity in the commercial mortgage-backed securities (CMBS) market has been slowly building momentum. Although the market initially gained traction in 2009 with the issuance of three single-borrower transactions, investors were cautiously awaiting the return of the CMBS conduit product. This product in particular had reflected all that had gone wrong with commercial real estate finance: asset over-leveraging, complicated structures, lax rating agency oversight, etc. Since RBS agented the first multi-borrower, multi-property transaction in March 2010 (previously discussed in our May 2010 Commentary), the market has seen five additional CMBS conduit transactions priced with one currently in the market. This month we'll review the new conduit issuance, sometimes referred to as 'CMBS 2.0' and compare it to "legacy" CMBS of 2005-2007 vintage.

The following table outlines the salient characteristics of the CMBS conduit transactions priced to date.

| | Size ($MM) | | # of Loans | Pool debt service coverage | Pool LTV | Retail | Office | Industrial |
|---|---|---|---|---|---|---|---|---|
| JPMCC 2010-C1 | $ | 716.0 | 36 | 1.64 | 62% | 71% | 12% | 12% |
| GSMS 201-C1 | $ | 788.0 | 23 | 1.88 | 54% | 78% | 10% | 8% |
| JPMCC 2010-C2 | $ | 1,101.0 | 30 | 1.66 | 60% | 67% | 17% | 10% |
| COMM 2010-C1 | $ | 857.0 | 42 | 1.71 | 59% | 43% | 29% | 2% |
| WFCM 2010-C1 | $ | 736.0 | 37 | 2.01 | 58% | 31% | 29% | 13% |
| average | $ | 839.6 | 33.6 | 1.78 | 59% | 59% | 19% | 9% |
| Source: Bloomberg, Trepp | | | | | | | | |

The first observation is that CMBS 2.0 has a lower average loan count of 33.6 as compared to the legacy CMBS issuance that contained hundreds of loans. Not only are the pools more decipherable due to fewer loans but investors are given more time to perform their due diligence (during the "go-go days" investment grade investors were given perhaps two to three days to review hundreds of loans). Also, a smaller loan count creates smaller pools versus the legacy pools that averaged $2 billion with some pools topping $7 billion. While legacy pools reflected debt service coverage and LTVs similar to CMBS 2.0, those ratios included a significant component of pro forma underwriting. Today, debt service coverage is calculated off in-place income with nearly all of the loans containing amortization from day one and reserves being funded for capital expenditures. Even so, rating agencies have assigned slightly higher subordination level to the AAA bonds of 17-18%, much better than the 11-13% attachment points for the legacy CMBS. Finally, the new transactions contain fewer tranches, generally two AAAs supported by five to eight tranches beneath them compared to legacy transactions which had up to 29 tranches.

Regarding the asset classes shown in Table 1, retail, office and industrial securitized loans currently comprise 59%, 19% and 9%, respectively, of the CMBS 2.0 pools, higher than the legacy composition of 30%, 30% and 4%, respectively. More retail is being financed in the CMBS market because portfolio lenders have basically red lined all retail other than 'fortress malls.' Hotels would also typically comprise about 10% of securitized assets, but CMBS investors today have frowned on those assets as well. Finally, multifamily loans historically comprised 20% of securitized loans; however, the Agencies dominate the multi-family finance segment today with low rates and generous leverage.

Drilling a bit deeper into the collateral, one of our favorite tests for loan viability is the amount of leverage placed on an asset, or the 'loan per unit.' In the table below, we note that the 2010 vintage has substantially less leverage than 2006-2007 and matches up fairly well with the amounts noted for transactions securitized during 2002-2003.

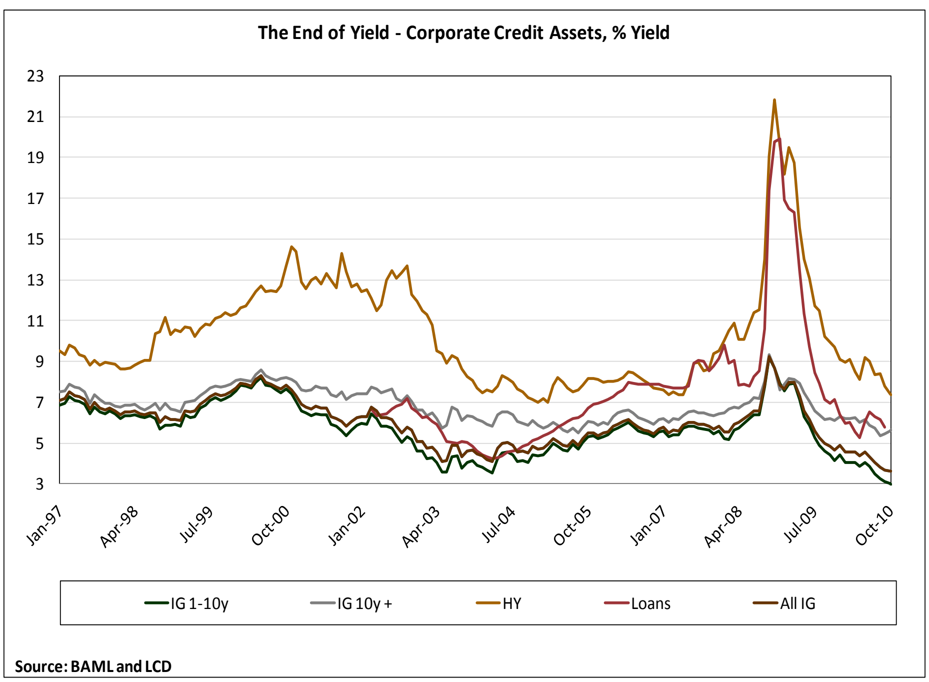
| | Debt per square foot | | |
|---|---|---|---|
| Vintage | Retail | Office | Industrial |
| 2010 | $ 109.72 | $ 81.43 | $ 25.37 |
| 2006/2007 | $ 134.50 | $ 149.83 | $ 38.22 |
| 2002/2003 | $ 98.50 | $ 91.00 | $ 37.26 |
| Source: Bloomberg, Trepp | | | |

Finally, the assets in CMBS 2.0 comprising the majority of the pools have historically been relative outperformers from a credit perspective. The CMBS conduit apparatus has apparently been listening to participants. For the investment grade bond buyers, these transactions almost reflect a 'Back to Future" feeling given their size and collateral characteristics. Time will tell how these assets perform, but at least investors have a better risk profile to assess.

## The Corporate Credit Market

The official launch of QE2 is not only fueling continued momentum in corporate credit assets, it is also driving a high-pitched debate on its risks and rewards. For us, we can identify several fundamental positive impacts of QE2 on the corporate sector. These include a meaningful reduction in the average cost of capital, a 9th inning opportunity for overleveraged firms to fix broken capital structures, positive currency translation from a depreciating dollar, and the potential appreciation of distressed assets still sitting on bank balance sheets.

These are all good things. Yet, one result of QE2 is depressed yields. Additional exposure to the asset class requires a leap of faith associated with entering uncharted waters and timing the inevitable empirical truism that asset bubbles tend to end badly. The look-back, however, is impressive. Who would have thought back in January that investment grade credit would generate 14% annualized returns for 2010? All those smart-or-lucky investors who have been flooding dollars into long-only fixed income funds have enjoyed the net worth impact. The challenge now is yield: very simply, low yields foreshadow more downside price risk to a fixed income asset's future price path. The chart below gives historical context to the effect of QE2 on today's yields.



October performance provides good context on asset behavior under QE2. The investment grade market was anchored around its low yield of roughly 3.60%. Index total returns for the month at 0.21% (2.50% annualized) reflect that while average yields fell 9 basis points, the yield on the 10-year-plus sector rose 13 basis points. The yield reach trade was most evident in the stellar performance of high yield: overall yields fell 55 basis points, with the yields on the lowest quality triple-C tier dropping 100 basis points.

Fundamentally, earnings have ranged from mixed to respectable; the mortgage putback imbroglio has had only a muted and short-lived effect on bank spreads; and the furious pace of high yield new issuance for the past several months remains dominated by liability management trades. Specifically, the use of proceeds of two-thirds of gross supply has been to refinance existing debt, with continued bond-for-loan take-outs dominating.

One of the more micro-level repercussions of QE2 is the effect it is having on the shape of the "back-end" or longer-dated maturities in the yield curve. The 10/30 Treasury curve has steepened to a record of 157 basis points, and the same phenomenon is observed in the corporate market. The Treasury and investment grade corporate (IG) are the "back-end" of the U.S. debt market. In the former, 14% (or $834 billion, excluding T-bills) of the market is 10-plus years, and in the later, 24% (or $842 billion in market value) is 10-plus years. Another way to put it is as follows: At a yield of 3.59%, 10-plus year Treasury bonds account for 36% of the index's yield and 14% of the risk, while at a yield of 5.60%, 10-plus year IG corporate bonds account for 37% of the index's yield and 24% of the risk.

By these measures, back-end pricing for investment-grade corporates is less extreme than for Treasurys, suggesting that thirty-year bond yields have more of a pricing floor than their shorter-dated cousins (because of the disproportionate contribution of risk and reward). Typically, when the 10/30 treasury curve steepens, the corporate 10/30 spread curve flattens helping longer corporates outperform on an excess return basis. Herein lies the case for long-end corporate bonds. However, while the 5.60% yield may seem relatively compelling, at a record 12-½ year effective duration it may be just another reach.

## The Markets

October looks like a month of front-running QE2. The short end of the yield curve rallied and the long end didn't. Stocks rose and corporate yields fell. The dollar declined, which helped gold and oil.

| | 10/31/2010 | 9/30/2010 | 10/31/2009 | MOM % change | YOY % change |
|---|---|---|---|---|---|
| **Federal Reserve Funds** | 0.25% | 0.25% | 0.25% | 0.0% | 0.0% |
| **2-year US Treasury** | 0.340% | 0.426% | 0.893% | -20.2% | -61.9% |
| **10-year US Treasury** | 2.601% | 2.512% | 3.385% | 3.5% | -23.2% |
| **10-year JGB** | 0.939% | 0.940% | 1.415% | -0.1% | -33.6% |
| **10-year euro** | 2.518% | 2.275% | 3.231% | 10.7% | -22.1% |
| **10-year UK Gilt** | 3.076% | 2.950% | 3.619% | 4.3% | -15.0% |
| **10-year Canada Treasury** | 2.810% | 2.758% | 3.423% | 1.9% | -17.9% |
| **30 yr conventional mortgage** | 3.787% | 3.749% | 4.708% | 1.0% | -19.6% |
| **Barclays US Corporate** | 3.59% | 3.63% | 4.86% | -1.1% | -26.1% |
| **Dollar Index** | 77.27 | 78.72 | 76.30 | -1.8% | 1.3% |
| **Japanese Yen** | 80.4 | 83.46 | 90.09 | -3.7% | -10.8% |
| **S&P 500** | 1183.26 | 1141.20 | 1036.19 | 3.7% | 14.2% |
| **Nasdaq Composite** | 2507.41 | 2368.62 | 2045.11 | 5.9% | 22.6% |
| **Gold $/oz (nearby contract)** | $1,357.60 | $1,307.80 | $1,040.40 | 3.8% | 30.5% |
| **Oil $/bbl (nearby contract)** | $81.43 | $79.97 | $77.00 | 1.8% | 5.8% |
| **MBA Refi Index (month end)** | 4626.10 | 4288.30 | 2693.70 | 7.9% | 71.7% |

Source: Bloomberg; Japanese Yen quote is the London feed

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