

Market Update

Overview

Financial markets continue to operate in an extremely stressed environment, with a constant flow of negative news and many economies in recession. Economic indicators continue to be weak and unemployment continues to rise.

Governments and central banks around the globe have attempted to aid financial system by aggressively cutting interest rates and announcing substantial fiscal stimulus packages. In the US the Troubled Asset Relief Program (TARP) was passed allowing the Treasury to purchase up to \$700bn in assets. This was quickly followed by the Term Asset-Backed Securities Loan Facility (TALF) which aimed at making \$200bn in loans to oil the market for securities backed by loans to small businesses and consumers. In addition, the Fed plans to buy up to \$500bn in agency mortgage-backed securities, and up to \$100bn in agency debt. The Fed has also introduced policies tantamount to quantitative easing by announcing the potential for the direct purchase of long dated treasuries. More recently the Homeowner Affordability and Stability Plan has been passed, with the aim of (i) providing low cost refinancing for 4 to 5 million responsible homeowners, (ii) allocating \$75bn to reach 3 to 4 million homeowners who are struggling to afford their mortgage repayments and (iii) supporting lowering mortgage rates by strengthening confidence in Fannie Mae and Freddie Mac.

In Europe we have seen multiple bank bailouts for financial institutions including Hypo Real Estate, Fortis, Dexia, ING, UBS, HBOS, RBS and Lloyds as well as numerous institutions in smaller European states, guarantees on bank deposits, and aggressive interest rate cuts by the ECB and BoE. More recently the UK has announced a state insurance programme allowing UK financial institutions avail of state guarantees on risky assets, in an attempt to revive lending by helping banks set aside illiquid assets. Already RBS has availed of state guarantees on £325bn of assets and Lloyds has contributed £260bn of assets – both institutions are state controlled after two bailouts.

ABS Markets

The ABS market continues to struggle against the backdrop of broader economic issues. Asset prices continue to be weak (particularly for US exposures) as the rating agencies review their rating methodologies leading to severe downgrades for some US assets, and less severe downgrades for European exposures.

US ABS

US RMBS continues to be a weak performer with delinquencies and foreclosures increasing month on month. In particular the US Alt-A RMBS sector has come under the spotlight recently with both Moody's and S&P revising their loss assumptions due to the difficult economic environment and weak performance. This has led to downgrades by super senior bonds by Moody's from Aaa to Caa and lower in many cases.

Other sectors such as credit cards, CMBS and student loans are also experiencing some stress.

European ABS

Volumes in European ABS continue to be light with the traditionally large players paralysed. The performance of almost all ABS sectors continues to deteriorate leading to downgrades - mostly at the junior level.

In particular CMBS and Spanish RMBS are experiencing downgrades frequently at the most senior level. In the case of CMBS this is largely driven by LTV triggers being breached and increased refinancing risk. In the case of Spanish RMBS this is largely due to higher than expected arrears and losses and falling property prices.

Market Outlook

A market rise in US household savings rates is anticipated. In the longer run, this will be welcome helping correct an excess of household indebtedness,

Market Update

one of the main causes of the recent crisis. However in the more immediate future the contraction in consumer spending is likely to exacerbate economic contraction.

The ECB is likely to continue with further rate cuts and continue flooding the banking system with funds, in effect “quantitative easing”, in order to boost the Eurozone economy. These measures will increase greatly if deflation becomes a real threat to the Eurozone.

We remain cautious in the short term and expect continued debt reduction to weigh heavily on the general economy.