

Market Update

Overview

Recent commodity price falls and mixed economic data including US Q2 GDP surprising on the upside have contributed to a relatively calm period for global markets since our last update in mid June. However short term funding rates have not improved and we remain concerned about the consequences of further funding stress for the financial sector.

Although spreads have drifted wider, corporate CDS volatility has fallen to its lowest level of the last year. ABS prices have continued to fall reaching a low point for 2008, as continued portfolio liquidations, CDO unwinds and SIV restructurings take their toll on the market.

The importance of Fannie Mae and Freddie Mac to the operation of the US mortgage market led to the US authorities making their implicit support explicit as concerns developed about their capital adequacy. Concerns about the adequacy of Lehman's capital have replaced concerns about its funding position. Settlements of legal disputes and reinsurance activities at MBIA, Syncora and FGIC have provided a glimmer of hope for the monoline sector.

US ABS

Problems facing the US RMBS market are well documented. Arrears and foreclosures continue to increase month on month. Weak performance first seen in the subprime space has filtered through to the Alt A and Prime RMBS sectors. Furthermore prepayment rates continue to fall as borrowers' ability to refinance is largely closed off. In addition property prices in the US continue to fall leading to increased REO buckets and higher loss severities. We expect to see further rating pressure on this sector. However SIV restructurings have put severe pressure on this sector from a price perspective and careful selection could lead to significant returns over the medium term.

US Consumer ABS transactions also show signs of weakening as inflation, falling house prices and falling consumer confidence takes its toll.

European ABS

Spreads have continued to widen against the backdrop of very light flow in the street. Particularly hard hit are Spanish RMBS where general economic weakness persists and the continued reliance from Spanish banks on ECB funding. CMBS also remain a concern due to falling commercial property values and refinance risk.

Recent comments from ECB council member Mersch that the ECB was considering tightening the rules on eligible collateral, specifically that collateral taken by the ECB must also be traded in the market to ensure price accuracy should increase the cost of funding for several European Banks. Most concern following these comments has focused on the impact on Spanish Banks. The ECB will announce their revisions in the Autumn and are likely to encourage banks to increase the balance of term debt in their funding mix. New issue supply pressure from bank unsecured debt is likely to push ABS prices wider.

Market Outlook

We expect ABS prices to continue to deteriorate as risk aversion and CDO liquidations persist. Any change in the ECB's collateralised funding arrangements with European banks is likely to have a sharply negative effect on asset prices.

Cumulative bank write downs since the start of the credit crisis now exceed \$510bn. Banks have raised more than \$350bn of new capital and we expect the deleveraging / new capital raising trend to continue.

We continue to recommend a cautious stance and although attractive opportunities exist, investors must have the capacity to tolerate potentially severe market volatility.