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Commentary

Market Opinions and Topics of Interest

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What Turns Credit Around?

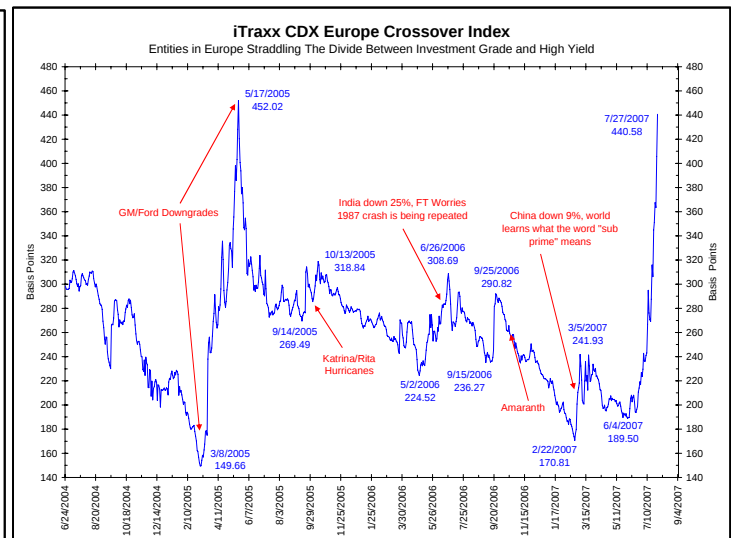
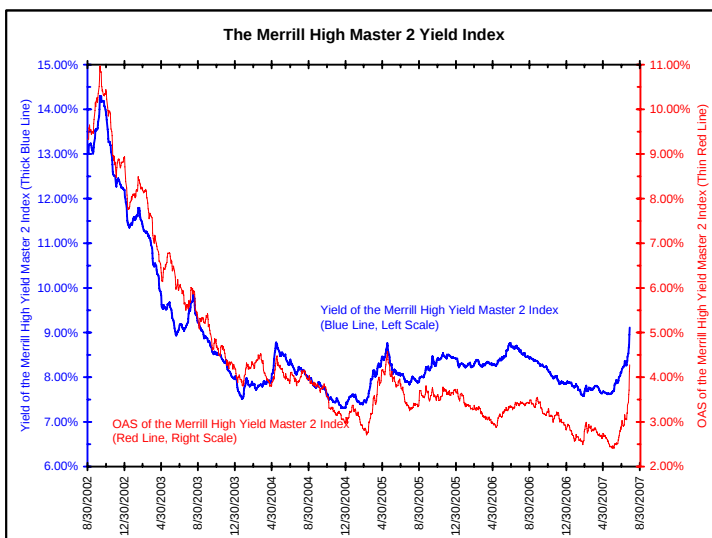
Investors have been buzzing for days, trying to explain the latest losses in the ABX index, which signaled a deepening panic in the mortgage market. Several factors have been at play, including the ratings downgrades. **It also could have been related to mortgage-backed-securities holders' hedging of positions by making bets against the index. Or it could have been because speculators are betting the subprime woes will worsen.** [Our Emphasis] The index isn't a perfect indicator of the health of these securities, because it represents only a narrow slice of the subprime-bond market, and it isn't widely traded. Nevertheless, investors are watching it closely. – [The Wall Street Journal](#), July 18, 2007

Credit is under stress. The big question is how bad is it and what turns it around?

Damage So Far

The chart on the left details the Merrill High Yield Master Index, both its absolute yield (blue line) and its option-adjusted spread, or OAS (red line). This chart goes back to August 2002 to show how much tightening has taken place over the last several years. By this measure, the recent spread widening does not look that ominous.

Change the starting period and perceptions change. The chart to the right shows the popular iTraxx cross-over index, or European credits that straddle the divide between investment-grade and high-yield. This chart begins in June 2004 when this index was first created. By this measure, the spread widening looks worrisome. Only the spread widening in the wake of the GM/Ford downgrade and the “correlation crisis” it created in the market for CDX tranches was worse.



Recent Widenings

Date = Hi	5/17/2005	10/13/2005	6/26/2006	9/25/2006	3/5/2007	7/27/2007
Wide	452.02	318.84	308.69	290.82	241.93	440.58
Narrow	149.66	269.49	224.52	236.27	170.81	189.50
Difference	302.36	49.35	84.17	54.55	71.12	251.08

The question, therefore, is whether the current widening is going to look like the left-hand chart, the

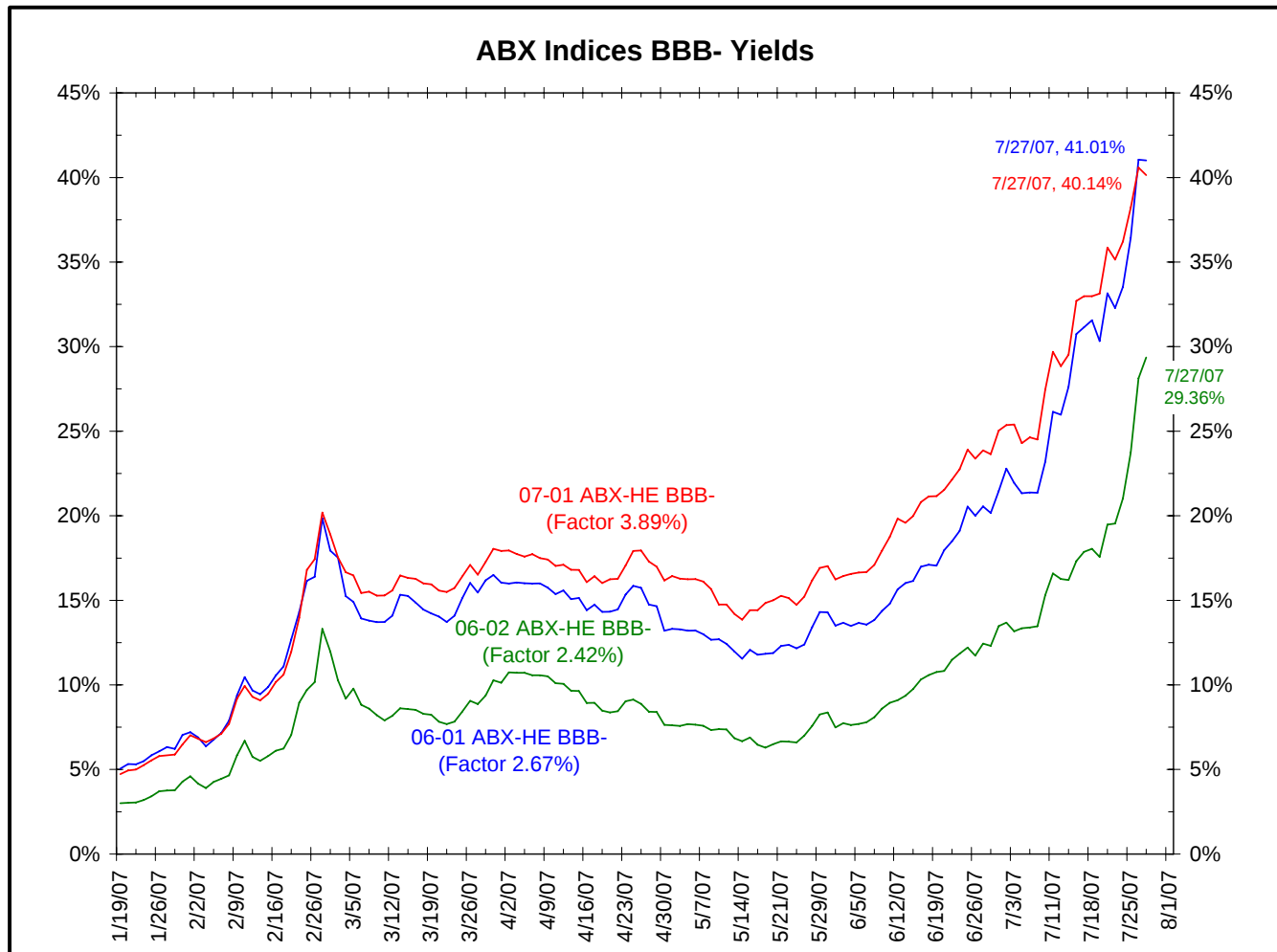
start of a big secular move toward much wider spreads, or the right-hand chart, a cyclical move like

the many seen since 2003. These lasted several weeks and then rebounded back toward the record tights.

To answer this question, we need to ask why the current spread widening is happening in the first place.

In The Beginning, There Was The ABX

We believe the catalyst and driver of this spread widening was the problems with subprime. The chart below shows the **yield** of the ABX indices rather than the more common price charts (possibly because price is the only way [Markit](#) provides the data to the public on its website).



To be clear, the ABX indices are **not** the price of subprime loans. **They are the price of insuring CDO tranches backed by subprime loans against default.** Too many incorrectly believe these indices to be the actual price of subprime loans. Accordingly, they believe a price of 40, as an example, means that these subprime loans have lost 60% of their value since January.

The ABX indices are structured as bonds so the buyers of protection sell the ABX index, pay an interest rate, or factor (noted in the chart above) and benefit from further declines in prices. The seller of protection buys the ABX index, receives an interest rate factor and benefits from higher prices.

Therefore, the ABX indices are no more the price of a subprime loan than the price of homeowner's insurance for similar homes in similar neighborhoods is a good gauge for the price of your home. **This is a big misconception about these instruments.**

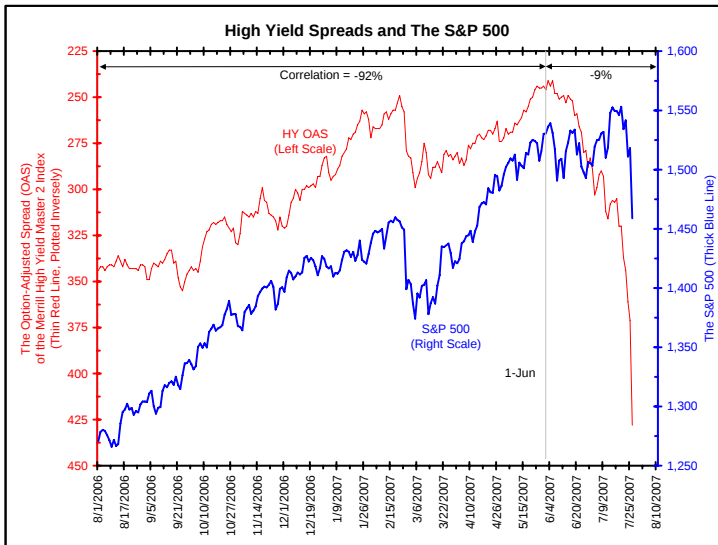
Overpaying For Insurance

Last fall, the price of insuring the BBB- tranches against default (each tranche contains 20 different pools of subprime loans) over the next five years would have cost 3% to 5% of the value of one's portfolio **per year**. On July 26, 2007, that cost rose to 28% to 41% for the 2006-01 and 2007-01 pools, respectively, **per year**. In other words, the price of insuring against default over the next 5 years is

running well over 100%! Of course, if these tranches see 100% defaults in less than 3 years, then the buyers of this protection will have been proven correct.

Is ABX The New S&P 500 For High Yield?

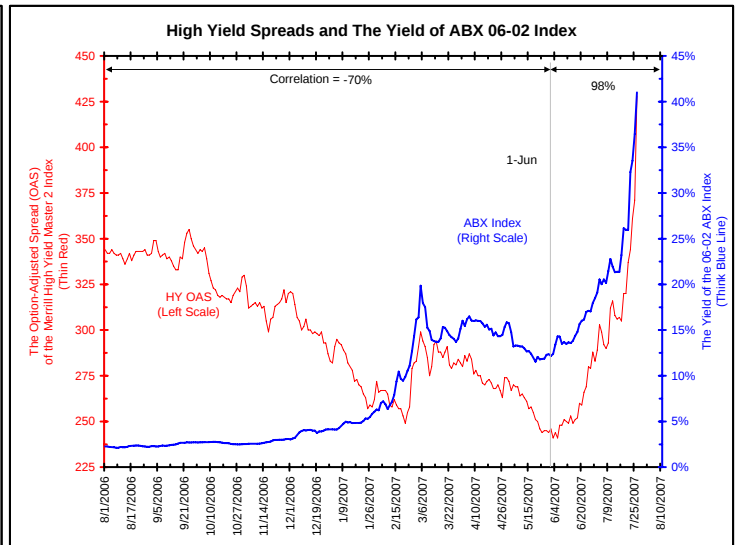
How important is the ABX to the overall market? Consider the following charts.



The chart to the left compares the option-adjusted spread (OAS) of the Merrill High Yield Master 2 Index (red line) and the S&P 500 (blue line). From the start of the chart (August 1, 2006) to June 1 (essentially the start of the current period of credit market stress), the stock market and high yield spreads were 90+% correlated. Since June 1, this correlation has disappeared to a near-random 9%.

The chart to the right overlays the same option-adjusted spread (OAS) of the Merrill High Yield Master 2 Index (red line) and the ABX 06-02 BBB-yield (blue line, also the blue line shown on the previous page). The correlation has been an almost perfect 98% since June 1.

The correlation with stocks has been replaced by a correlation to the ABX indices. **We believe this chart confirms what everyone believes – that the ABX, as a measure of the subprime market, has replaced the stock market as the major influence**



on the high yield market. As goes ABX, so goes high yield

Implied Home Price Outlook

So with every jiggle in the ABX, the high yield market follows. This begs the question, what do the ABX numbers say about the state of the subprime housing market? In order to answer this question, we will employ J.P. Morgan's ABX fair value model for this discussion (detailed in their [July 20 conference call](#)).

The first table on the next page shows what kind of housing market is implied by current ABX prices. The second table shows what level of defaults correspond to the housing market scenario implied by ABX prices. Highlighted in red is the scenario implied by yesterday's closing prices. Note, the tables do **not** include the recent 07-02 series as it only started trading earlier this month.

ABX Prices And What Housing Scenario They Imply

Based on J.P. Morgan's ABX Fair Value Model

			Housing Price Scenarios									
			First Year	-10%	-10%	-10%	-10%	-6%	-6%	-3%	-3%	0%
			Yrs 2 to 5	-5%	-3%	-1.5%	0%	-3%	0%	-3%	0%	0%
			Total Decline	-27%	-20%	-15%	-10%	-17%	-6%	-14%	-3%	0%
Current Price 27-Jul			After Yr 5	3%	3%	3%	3%	3%	3%	-3%	3%	3%
2006-01	AA	93.60	98.79	100.86	100.81	100.80	100.79	100.76	100.70	100.77	100.76	100.76
	A	76.28	42.23	78.19	93.66	93.75	101.48	101.80	101.63	101.59	101.37	101.37
	BBB	63.31	12.09	15.38	19.92	30.13	58.48	81.02	74.41	94.73	98.66	99.44
	BBB-	57.06	12.19	13.88	16.93	17.46	33.78	56.89	46.57	82.47	87.88	88.58
2006-02	AA	89.22	55.80	86.81	95.04	97.20	100.54	100.51	100.48	100.47	100.45	100.45
	A	64.56	11.02	15.80	34.68	46.44	77.06	91.69	92.09	98.75	101.97	101.96
	BBB	47.33	7.27	7.80	8.11	8.18	15.21	19.38	22.53	43.89	58.41	59.00
	BBB-	39.94	7.67	8.11	8.41	8.42	15.03	16.10	16.75	22.87	36.10	36.95
2007-01	AA	79.73	12.49	45.44	82.04	94.37	100.69	100.62	100.59	100.56	100.53	100.53
	A	53.67	8.32	9.11	10.49	12.86	47.50	71.06	69.23	102.03	103.72	103.68
	BBB	39.65	8.28	8.63	9.02	9.05	11.30	12.35	14.28	34.87	48.36	49.67
	BBB-	38.03	9.46	9.83	10.19	10.20	12.30	13.06	15.25	18.23	35.66	37.38

ABX Prices And What Level Of Defaults They Imply

Based on J.P. Morgan's ABX Fair Value Model

Current Price 27-Jul			Housing Price Scenarios										
			First Year	-10%	-10%	-10%	-10%	-6%	-6%	-3%	-3%	0%	0%
			Yrs 2 to 5	-5%	-3%	-1.5%	0%	-3%	0%	-3%	0%	0%	0%
			Total Decline	-27%	-20%	-15%	-10%	-17%	-6%	-14%	-3%	0%	0%
			After Yr 5	3%	3%	3%	3%	3%	3%	-3%	3%	0%	3%
Bond Write Downs													
2006-01	AA	93.60	3%	0%	0%	0%	0%	0%	0%	0%	0%	0%	
	A	76.28	70%	29%	10%	10%	1%	0%	0%	0%	0%	0%	
	BBB	63.31	98%	96%	94%	84%	57%	31%	40%	15%	9%	8%	
	BBB-	57.06	98%	97%	95%	95%	81%	61%	71%	34%	27%	26%	
2006-02	AA	89.22	53%	17%	7%	4%	0%	0%	0%	0%	0%	0%	
	A	64.56	98%	94%	76%	64%	30%	12%	12%	4%	0%	0%	
	BBB	47.33	100%	100%	100%	100%	95%	93%	92%	70%	56%	55%	
	BBB-	39.94	100%	100%	100%	100%	96%	95%	97%	92%	81%	80%	
2007-01	AA	79.73	100%	66%	24%	9%	0%	0%	0%	0%	0%	0%	
	A	53.67	100%	100%	100%	98%	65%	39%	43%	3%	0%	0%	
	BBB	39.65	100%	100%	100%	100%	100%	100%	100%	81%	72%	70%	
	BBB-	38.03	100%	100%	100%	100%	100%	100%	100%	99%	87%	84%	
Total Collateral Loss (% Original Balance)													
2006-01			13.84%	11.86%	10.48%	9.99%	8.82%	8.01%	7.96%	7.06%	6.64%	6.60%	
2006-02			19.37%	16.71%	14.81%	14.15%	12.34%	11.23%	10.99%	9.80%	9.13%	9.07%	
2007-01			23.92%	20.33%	17.58%	16.61%	14.59%	13.13%	13.14%	11.32%	10.48%	10.38%	
Total Collateral Loss (% June Balance)													
2006-01			22.69%	19.29%	16.97%	16.13%	14.10%	12.71%	12.63%	11.09%	10.39%	10.30%	
2006-02			26.67%	22.89%	20.23%	19.31%	16.72%	15.14%	14.81%	13.13%	12.18%	12.10%	
2007-01			27.68%	23.52%	20.32%	19.20%	16.86%	15.16%	15.17%	13.07%	12.09%	11.97%	

Source: [J.P. Morgan](#)

A few observations:

- There is no consistency in the pricing among tranches. The AA and A tranches are pricing a housing disaster on par with the Great Depression (down more than 27% over the next 5 years) while the BBB- tranches are pricing in a flat housing market. Such inconsistencies suggest irrational pricing.
- A lot of commentators have called lower-rated BBB and BBB- tranches "toxic waste." The ABX market agrees as some of the current prices imply bond writedowns of over 80% for the BBB- tranches.
- Many are over-reading the price movements of the ABX indices. In the lower-rated tranches of BBB and BBB-, a move of 3-to-5 points does little to change the implied outlook for housing and writedowns. This, however, does not

prevent high yield from reacting to a small jiggle in these indices as a major "repricing of risk."

It must also be mentioned that these ABX indices are protection against defaults of the subprime mortgages of the underlying pools (each has 20 pools). It is assumed that these pools are of similar composition to the U.S. subprime housing market. They are not. They are heavily weighted to California and Florida.

	2007-01	2006-02	2006-01	U.S. Average
Concentrations At Origination				
CA	24%	29%	30%	10.4%
FL	11%	11%	9%	6.6%
Total	35%	40%	39%	17.0%

	2007-01	2006-02	2006-01	U.S. Average
Current Concentrations				
CA	24%	29%	32%	10.4%
FL	12%	11%	9%	6.6%
Total	36%	40%	41%	17.0%

Source: [J.P. Morgan](#)

Also, keep in mind that the housing declines implied in the tables above are for the homes that make up the underlying pools, not necessarily the entire country, or even the entire subprime housing market. That said, if subprime home prices in the underlying pools collapse, largely California and Florida, we believe the overall U.S. median home, composite Case-Shiller housing index and/or OFHEO Home price indices decline hard as well.

What Causes More Pain, Further Declines or A Rally?

Wall Street's rumor mill is working overtime trying to determine who has blown up given the plunge in the ABX index. This is not surprising as we have all been trained to expect the markets to get worse (spreads widen) until someone says they are "out of business." At that point the selling stops and the markets rebound.

So why haven't any blow-ups occurred to-date aside from the original, two-month-old Bear Stearns hedge fund stories? Let us quote two recent stories.

The ABX index is the only liquidity that currently exists to hedge or reduce risk" in the markets for subprime mortgage bonds and collateralized debt obligations [our emphasis], said Carl Bell, who helps manage \$63 billion in fixed-income assets as head of the structured-credit team at Putnam Investments in Boston. – [Bloomberg](#), July 17, 2007

And,

Mr. Cioffi's 30-day plan was a last-ditch effort to salvage his fund, which he has run since August and is geared to sophisticated investors. ... The fund bet a popular index that tracks subprime mortgages, the ABX, would fall. Late last year and early this year, those moves bore good returns, says a person familiar with the matter. Then the tide began to turn. After reaching a low of 62 late in February, amid rising numbers of defaults and delinquencies in the subprime market, the ABX unexpectedly recovered in the months that followed, reaching 72 in mid-May. It has since gone back down to 61. This led to losses for Mr. Cioffi. [our emphasis]

During April, the leveraged fund began falling sharply. Its **bearish** [our emphasis] bets on subprime securities had created paper losses, and some investors were getting antsy and asking to redeem their cash, says a person familiar with the matter. – [The Wall Street Journal](#), June 16, 2007

Conclusion

As the quotes immediately above say, the ABX indices are the only game in town. Everyone knows this and they are all flocking to these instruments to

protect themselves against a fall in illiquid CDO tranches backed by subprime mortgages. It is also a near-universal belief subprime problems will continue. This mentality is encouraging the continued buying of protection against default (selling the ABX indices). Consequently, these indices are now grotesquely overpriced when looking at what type of housing declines they imply. Massive overpricing in default insurance is not unusual and it was a **rally** from a similar overpriced state in the ABX indices in April, a perceived **recovery** in subprime market, that led to the highest profile blow up this cycle - the Bear Stearns hedge funds (see quote above). **Let us repeat, while the markets are worried sick about the situation in subprime, it was a recovery in this market that caused the most pain to-date.**

We are concerned this scenario might repeat as so few fear it. **It is our sense, as no data exists, that most players are hedged, if not over-hedged, in ABX indices as well as CDS/CDX high yield instruments. They are not suffering as spreads widen.** Consider the following:

Now Germany's largest bank [Deutsche Bank] is poised to reap a bonanza of at least \$270 million and as much as \$540 million from a strategy that enabled its traders to sell subprime mortgage loans with derivatives contracts that appreciated as the U.S. housing market suffered its worst slump in 16 years. ... Deutsche Bank traders, led by Greg Lippmann, sold ABX index contracts, providing 200 million euros (\$272 million) of revenue in the first quarter and possibly another 200 million euros in the past quarter, assuming the position wasn't changed, said Kinner Lakhani, the top-rated banking analyst at ABN Amro Holding NV in London. – [Bloomberg](#), July 30, 2007

In fact, some are actually hoping for more widening. Too few, we fear, see the default protection they bought as massively overpriced and a big risk when a recovery ensues.

This is why Wall Street is scratching its head over the "missing blow-ups" to date. If they grotesquely overpaid for default insurance, then further spread widening is the winning side of the trade. However, the smallest recovery or ray of hope in such a market can lead to a massive short squeeze in these default protection instruments. **Restated, a rally in subprime is the biggest risk right now.**

Add to this the misunderstanding of what the ABX indices are (price of default insurance for CDO tranches backed by subprime loans) and are not (the actual price of subprime loans) and we can see how this misunderstanding of the ABX indices is causing such an emotional reaction in all markets and why the ABX indices have replaced the U.S.

stock market as the biggest influence on the high yield market.

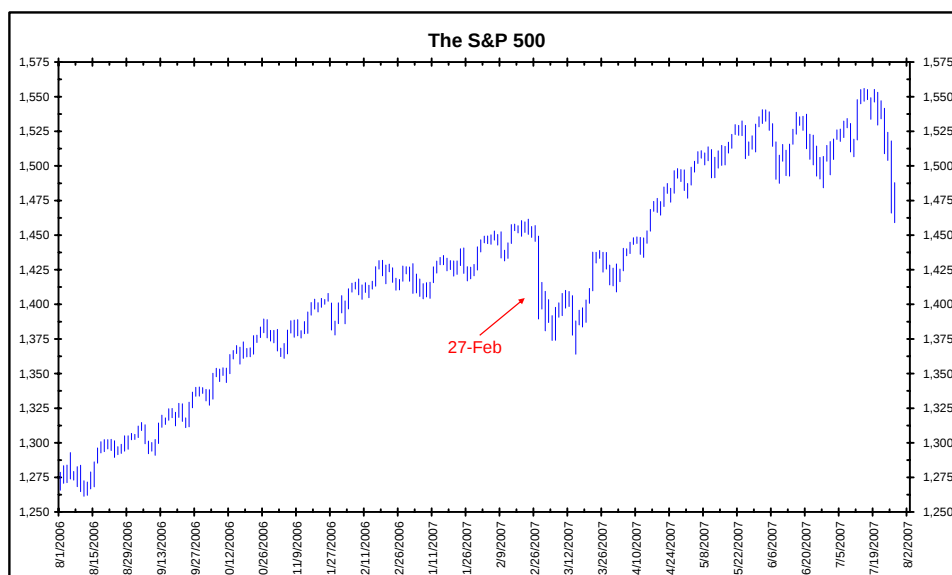
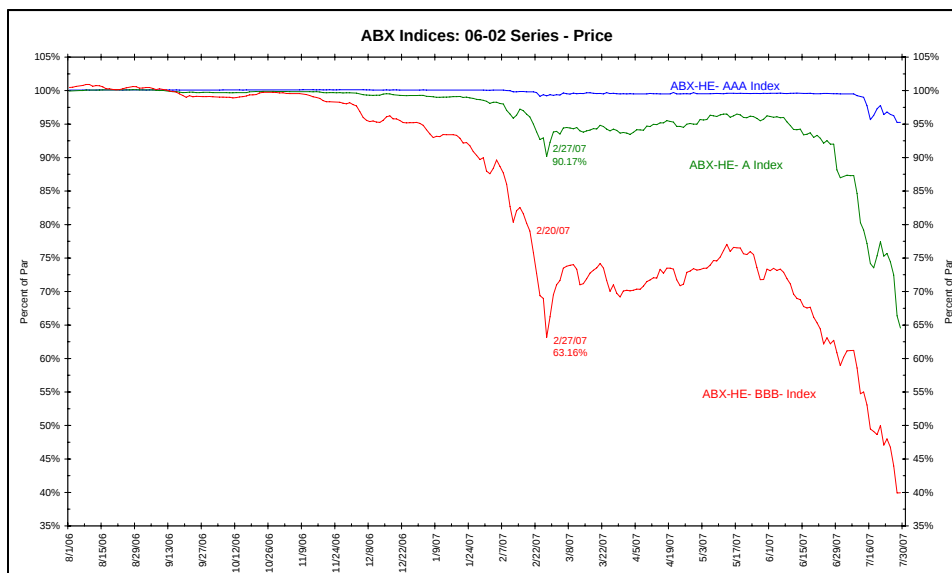
The Last ABX Rally

The first chart below shows the **price** of the 06-02 ABX indices. These indices bottomed on February 27. The second chart below shows the S&P 500 over the same period. Noticed that the stock market plunged on February 27 and continued lower for the next few weeks. So, the start of a decline in stocks marked the **end** of the decline in the ABX indices.

We would argue that when the stock market plunged, it was an admission that subprime was having a problem which until that moment was being ignored. Once the problem was recognized, the ABX index had a relief rally. Given the overpriced status of the ABX indices, that relief rally turned into a squeeze that killed the Bear Stearns hedge funds.

Last week stocks plunged again on recognition that high-yield has a problem and the buy-out boom is at risk. Could this stock market plunge give ABX investors another reason for a relief rally? If so, given the greatly overpriced nature of these indices, could this relief rally turn into a vertical rise and a big reaction in high-yield spreads? Such a rise would be perceived as a signal that the credit stress is over and ironically this same move could cause the greatest pain amongst hedge funds.

It has been said that history does not repeat but it does rhyme. Since few are linking the stock market in this matter, such a rhyme as we suggest is not expected. This is why it might be worthy of consideration.



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