CREDIT SUISSE

Mortgage Market Focus – Market Watch

MBS Strategy

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Strategy

- **We maintain our tactical short MBS basis recommendation.** Anecdotal evidence points to strong foreign investor demand as the key driver of recent tightening. As noted before, the basis has benefited from flight to quality recently and it should unwind if risky assets rebound.
- **Prepay risk remains concentrated in new vintage 5s and 4.5s, and a 4.50% mortgage rate is needed to trigger it.**
- **We recommend overweighting 15- over 30-year MBS based on attractive risk/reward.** The old story about better convexity in 15s is also the new story. Concerns about the callability of 15-year coupons are more than fully priced in on most 15/30 swaps, in our view. Also, we believe they stand to outperform in sell-offs.

Trade recommendations

- **Buy 15/30 4/4.5 and 5/5.5 swaps at 6+ and -26, respectively.** Hedge ratios of 74% and 83%, respectively.
- **Close out long 4.5 synthetic combo** constructed from a combination of IOS 4.5 and PO 400 vs. FNCL 4.5s. The trade made ¾ points since inception.
- **Hold long FN 4.5/4 swap.** The trade is down ½ tick since inception last week. Factors highlighted in last week's publication remain in place.
- **Hold long new (15/30 5.5/6) swap.** The trade is down 2 ticks since inception. We hold on to the trade given that swap remains cheap adjusted for convexity, curve, and carry.
- **Hold short MBS basis.** The trade is flat since inception on 23 June 2010.
- **Hold sell GN/FN 5.5 swap.** The trade is roughly flat since inception last week.
- **Hold FN 5.5 fly.** The trade has made 3 ticks since inception. Factors highlighted in *Mortgage Market Focus: Trade note* of 30 June 2010 remain in place.
- **Hold IOS 6.5/6 swap.** The trade is down roughly 6.5 ticks since inception. We reiterate our buy recommendation on the swap given attractive levels and significant potential upside based on fundamental valuations.
- **Hold long GN/FN 4.5 swap.** The trade is close to flat since inception. The factors highlighted in the 8 July 2010 *Mortgage Market Focus* remain in place.
- **Hold short GN/FN 6 and 6.5 swaps.** The trades are down 2+ ticks and 13 ticks, respectively. Roll rates on these coupons have rebounded following a seasonal decline in Q1, suggesting that buyout speed increases lie ahead (*July GNMA Spotlight*, 14 July 2010).

Exhibit 1: Current trade recommendations

Actual P&L should be slightly lower as this does not reflect bid/offer spread.

Trade Idea	Start Date	P&L	P&L (ticks)
Buy $100MM DW 5.5s; sell $87MM FN 6s	7-Jul-10	(68,673)	(2)
Buy $100MM FN 4.5s; sell $77MM FN 4s	7-Jul-10	(10,469)	(0)
Sell $100MM GN 5.5s; buy $100MM FN 5.5s	6-Jul-10	15,625	1
Buy $200MM FN 5.5s; sell $100MM FN 5s; sell $100MM FN 6s	30-Jun-10	101,562	3
Long IOS 6.5/6 swap	23-Jun-10	(203,125)	(7)
Short MBS basis (Sell $100MM FN 30-year 4.5s, receive 5-year swaps)	23-Jun-10	3,699	0
Buy $100MM GN 4.5; sell $100MM FN 4.5	2-Jun-10	(3,903)	(0)
Sell $100MM GN 6; buy $100MM FN 6	15-Apr-10	(85,939)	(3)
Sell $100MM GN 6.5; buy $100MM FN 6.5	7-Apr-10	(406,135)	(13)
Total		**(657,358)**	
Total P&L of trades closed YTD		**10,467,856**	

Source: Credit Suisse (US Mortgage Strategy). Note: Pricing date: 14 July 2010.

Overweight 15- over 30-year MBS, buying top (4/4.5), low (5/5.5), and new (5.5/6) swaps

15-year/30-year swaps have underperformed sharply in the recent rally (Exhibit 2). This cheapening reflects lack of sponsorship for 15-year coupons at higher dollar prices, occasional negative carry, and perceived higher negative convexity (call risk) in 15-year coupons compared to their 30-year counterparts. We believe that current valuations overstate the call risk in 15s and recommend buying top and low swaps at 6+ and negative 26 ticks, respectively. We favor hedge ratios of 74% and 83%, respectively.

Traditionally, the 30-year sector has exhibited worse negative convexity than 15s due to the larger loan balances and longer horizons of the underlying borrowers in the former sector. However, in the current restrictive refinancing environment, market concerns about worse negative convexity of cuspy 15-year coupons stem from their superior collateral characteristics. However, we believe these concerns are not borne out by recent empirical data. Steeper prepayment S-curves for 2008 vintage 15-year 4.5 vs. 30-year 5s and 15-year 5s vs. 30-year 5.5s from 2009 speak to worse negative convexity of the 30-year sector even in a restrictive credit environment (Exhibits 3 and 4).

We favor expressing these views on 15s/30s by buying top and low swaps as indicated above. We like the top swap due to the strong credit profile of 30-year 4.5s in absolute terms. In addition, the gap in the credit profile of 30-year 4.5s vs. 15-year 4s is the narrowest among all 15-year/30year coupon swaps (Exhibit 5). For instance, OLTV of 2009 vintage 30-year 4.5s is 68, which is 9 points higher than the OLTV of 2009 vintage 15-year 4s. In comparison, the OLTV difference between 2009 vintage 30-year 5s and 15-year 4.5s is 13 points. FICO scores are within 10 points between 15- and 30-year counterparts.

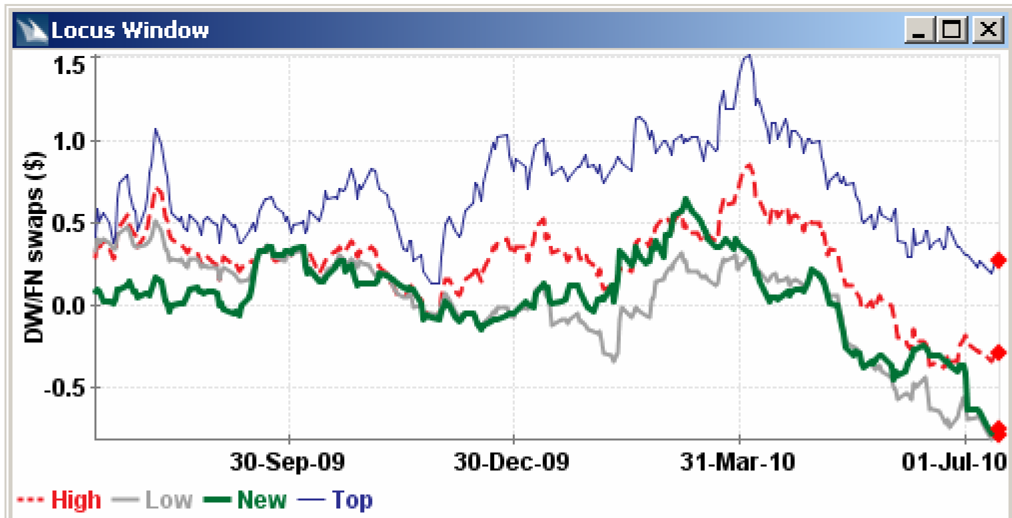
We like the low swap due to burnout in 2008 vintage 15-year 5s (TBA cohort for this coupon), as shown in Exhibit 6. In spite of lower 15-year mortgage rates since Q4:09 as compared to the earlier part of 2009, peak speeds reached during this period have been lower. We anticipate speeds to reach low to mid 30s on this cohort if mortgage rates rally by 25bp-50bp. This should only be marginally higher than the expected speeds of 30-32 CPR on 30-year 5.5s in a similar rally (20 May 2010 *Mortgage Market Focus*).

Finally, a rally in mortgage rates is likely to be associated with a bull flattening in which 15-year primary/secondary spread is likely to widen relative to the 30-year sector. This is observed in the recent rally as well (Exhibit 7). From a prepayment standpoint, it implies that the strike price for the 15-year sector is further out of the money.

We maintain our recommendation to buy new swaps. Factors highlighted in the 8 July 2010 *Mortgage Market Focus* remain in place.

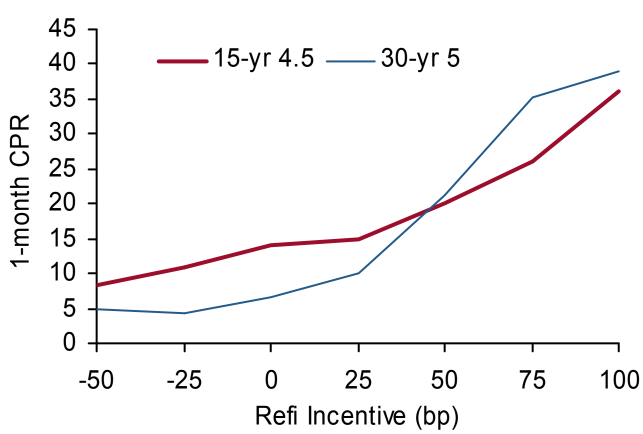
Exhibit 2: 15/30 swaps have cheapened significantly in the recent rally

12 month history



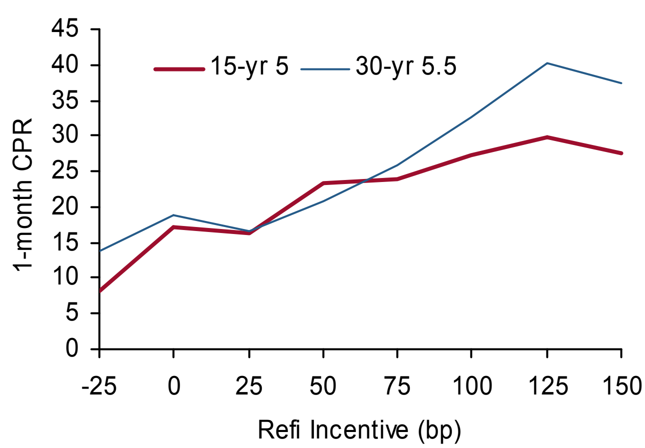
Source: Credit Suisse (US Mortgage Strategy)

Exhibit 3: Prepayment S-curves for 2008 vintage 15-year 4.5s versus 30-year 5s during 2009



Source: Credit Suisse (US Mortgage Strategy)

Exhibit 4: Prepayment S-curves for 2008 vintage 15-year 5s versus 30-year 5.5s during 2009



Source: Credit Suisse (US Mortgage Strategy)

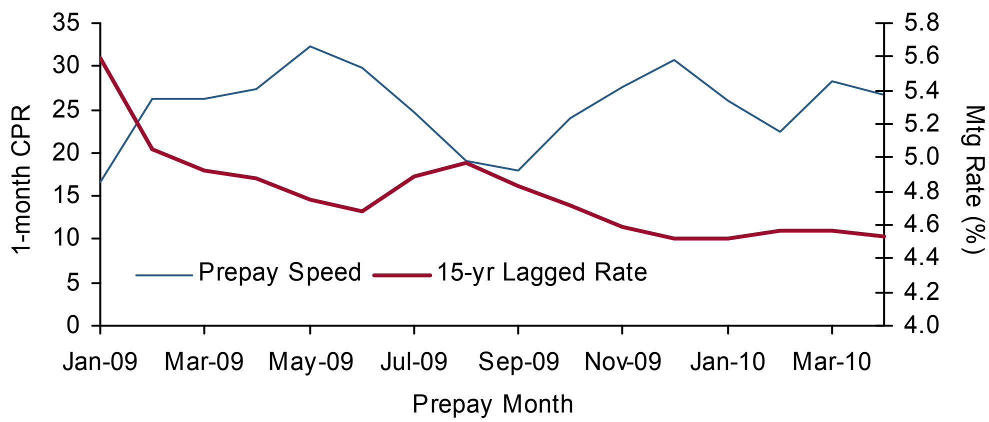
Exhibit 5: Collateral characteristics of selected 15-year and 30-year cohorts

As of July 2010 factor date

FN 30-year coupons	Vintage	WAC (%)	Avg. Loan Size ($K)	Age	Orig LTV	FICO	Curr Bal ($MM)
4.5	2009	4.95	228	13	68	763	274,644
5.0	2009	5.43	193	12	74	747	72,485
	2008	5.65	216	26	73	745	61,740
5.5	2009	5.95	152	12	75	724	9,106
	2008	6.03	193	26	76	736	89,872
FN 15-year coupons							
4.0	2009	4.49	170	12	59	766	51,886
4.5	2009	4.89	143	12	61	756	22,804
	2008	5.06	159	27	61	753	14,815
5.0	2009	5.48	103	13	65	731	1,416
	2008	5.55	129	25	62	744	11,105

Source: Credit Suisse (US Mortgage Strategy)

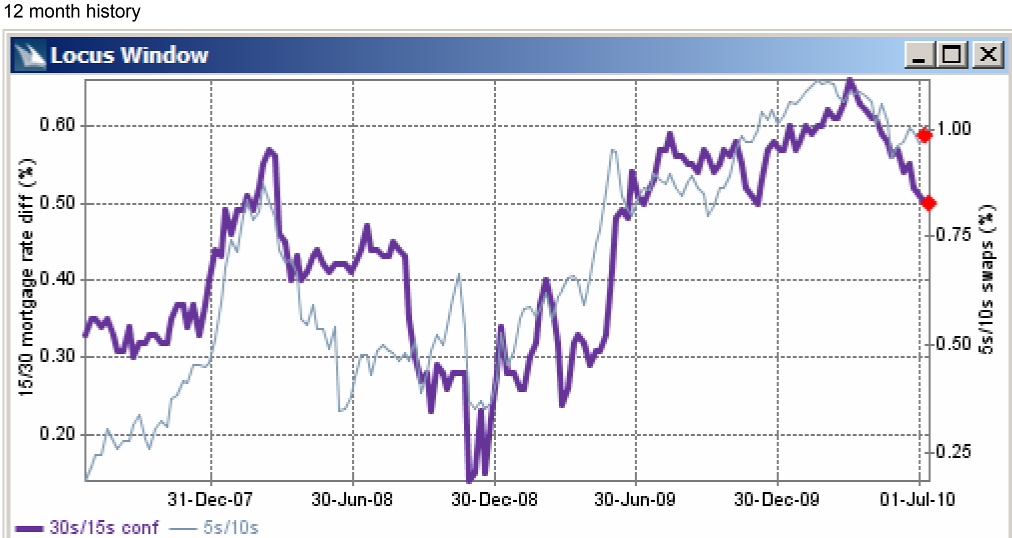
Exhibit 6: 2008 vintage 15-year 5s show signs of burnout



Source: Credit Suisse (US Mortgage Strategy)

Exhibit 7: 15-year mortgage rates could lag 30-year rates in a bull flattening rally

12 month history



Source: Credit Suisse (US Mortgage Strategy)

Reiterate buy IOS 6.5/6 swap – "Macro hedge" strategies to sell these could actually backfire

We reiterate that the IOS 6.5/6 swap offers compelling valuations, in our view. The swap has cheapened around 6+ ticks since we initially recommended it. It has underperformed due to strong technicals. However, the swap is fundamentally cheap, in our view, and offers significant potential upside as we estimate its fair value to be at least $1-09 and more realistically up to 2 points.

We downplay arguments recommending selling IOS 6.5s versus lower coupons as a "macro hedge" against a potential government-induced prepay spike. Far from being a hedge, such strategies may actually backfire in many scenarios. First, we note that all government steps so far have provided ample notice. Market participants have then had the opportunity to hedge or in some cases take a contrary view. It is difficult to imagine anything different going forward. Second, any concrete measures to improve the refinanceability of 6.5s would benefit the better credit quality 6s and 5.5s more, in our view. A removal of LLPA would have a minimal effect as we pointed out in *Mortgage Market Focus – Market Watch*, 1 April 2010. Similarly, any steps to remove non-quantitative barriers are potentially easier to remove for better credit borrowers underlying 6s and 5.5s.

Below we restate the case for buying IOS 6.5/6.

IOS 6 and IOS 6.5 are backed by the 2008 FN 6 cohort and the 2006-07 FN 6.5 cohort, respectively. However, pools belonging to the above cohorts with more than 10% of the balance coming from previous vintages are excluded. This exclusion has caused IOS 6 to be somewhat better than its benchmark cohort from a credit standpoint because of the removal of pools with a larger than 10% share from 2007 or earlier origination years. In contrast, IOS 6.5 is relatively weaker than its benchmark from a credit perspective because of the exclusion of relatively better pools with higher shares from 2005 or earlier years. Consequently, historical data show a small basis in IOS vs. cohort speeds, which is more pronounced for IOS 6 (Exhibit 8). However, most of the difference between IOS 6 vs. cohort speeds goes away if April prints are excluded (buyout month for FN 6).

Exhibit 8: Speed differences between IOS 6.5 and 6 speeds versus cohorts are small

Period	IOS 6.5	Cohort	IOS 6	Cohort
1m	26.5	25.9	27.7	27.9
3m	48.7	28.4	41.4	44.5
6m	37.0	47.1	34.8	36.7
12m	27.8	35.9	29.9	30.6

Source: Credit Suisse (US Mortgage Strategy)

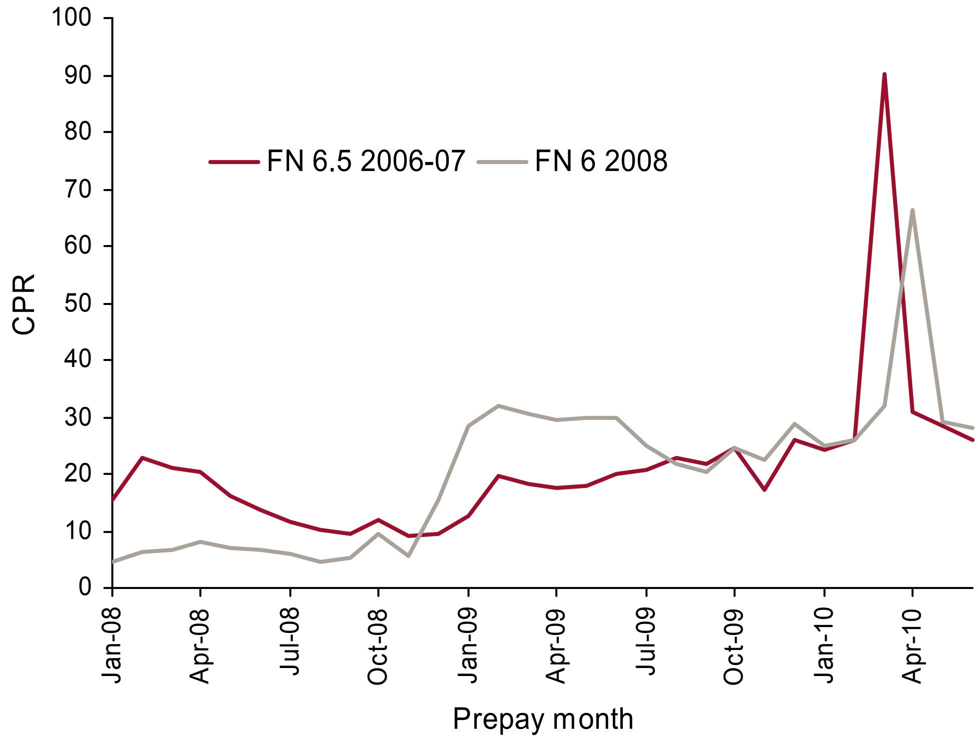
Excluding the buyout months, the 2008 FN 6 cohort has historically prepaid faster than the 2006-07 FN 6.5 cohort. It also showed significantly worse negative convexity than the 2006-07 6.5 cohort during the refi wave of 2009 (Exhibit 9). IOS 6 speeds could rise further above 6.5s as roll rates on the 2006-07 FN 6.5 cohort decline because of credit burnout, in contrast to a ramping up in the 2008 6 cohort. Additionally, IOS 6.5s benefit from the stable speed profile of the 2006 vintage 6.5s (Exhibit 10). IOS 6.5s could benefit further if the 2007 vintage starts tracking the 2006 vintage.

In a double-dip risk scenario, the 2008 FN 6 cohort is likely to experience as much if not more deterioration in credit performance than the 2006-07 cohorts because of a lower degree of credit burnout.

It is important to note that June prepays were 1.2CPR slower on IOS 6.5s than 6s. However, we conservatively estimate the fair value of the IOS 6.5/6 swap at $1-09, assuming IOS 6.5 and IOS 6 prepay on top of each other. Our estimate is based on equal yield analysis and assigns no value to the better convexity of IOS 6.5. If IOS 6.5 speeds are 1-2 CPR slower than IOS 6, as anticipated, we estimate the fair value of the swap is 2+ points higher (Exhibit 11).

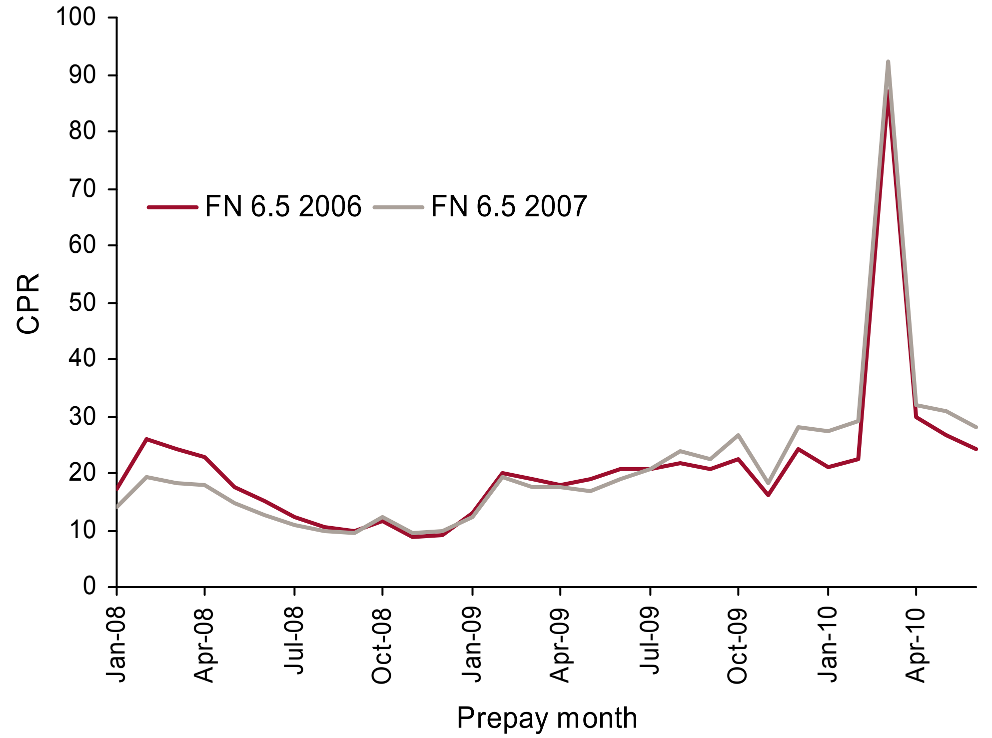
A government-policy-induced spike in prepayments is a perceived risk to this trade. However, we believe that the impact on 6.5s and 6s should be comparable in such a scenario.

Exhibit 9: Speed comparison between 2008 vintage FN 6s and 2006-07 vintage FN 6.5s



Source: Credit Suisse (US Mortgage Strategy)

Exhibit 10: Prepay speeds on 2006 vintage 6.5s have been 4 CPR slower (on average) than on 2007 vintage 6.5s since the beginning of H2:09



Source: Credit Suisse (US Mortgage Strategy)

Exhibit 11: 2006 estimated fair value pay up for IOS 6.5 over IOS 6

(ticks)

Speed Diff (IOS 6 - IOS 6.5)	LT Speed of IOS 6.5 30	28	25
-3	-0-133	-0-121	-0-102
-2	0-033	0-042	0-055
-1	0-21+	0-220	0-225
0	1-091	1-091	1-091
1	1-307	1-300	1-291
2	2-222	2-206	2-187
3	3-156	3-136	3-105

Source: Credit Suisse (US Mortgage Strategy)

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