Securitized Products Weekly

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Agency MBS: Market Overview and Relative Value

During the past week, 30-year production coupon MBS have outperformed their Treasury and swap hedges by 3-4 ticks. As the 10-year Treasury rallied 10-12bp and implied volatilities declined over the week following the release of the July employment data last Friday, the overall sentiment in the MBS market had improved substantially and FN 3.0s-4.0s are outperforming Treasuries by another 3-4 ticks today. Annaly reduced its exposure to MBS by $12.8bn in 2Q'13, which brings the cumulative decline in agency MBS holdings of all REITs during the 2Q'13 to $27bn.

Agency MBS: When Will the Market Feel the Taper Impact?

While we believe that there is only 4-5bp upside left from reversal of the MBS spread widening that could be attributed to convexity-related selling during the recent selloff, weak seasonals for home sales starting in October may offset the negative impact of the Fed's tapering for a few months. While most investors agree the gross issuance of agency MBS should be only about $100-110bn per month at current mortgage rate levels, it is interesting that the net issuance of MBS is also likely to be sharply lower over the next few months as home sales show a significant seasonality (almost 30% variation from the Oct-Mar period to the Apr-Sep period).

Agency MBS: July Prepays and Short-term Projections

The aggregate agency prepays declined for the second consecutive month with 30-year Fannie prepays declining by 9% in July. This decline in aggregate speeds was in-line with our expectations but HARP speeds were faster than our projections. The net issuance of agency MBS was $30bn while the total pay-downs on Fed's portfolio were about $22bln in July. We expect aggregate Fannie prepays to drop 18% month-over-month in August because of a continued sharp drop-off in refinance index and the day-count remaining flat. We expect most of this prepay drop to be concentrated in lower coupons with prepays on HARP eligible cohorts remaining fairly stable.

Mortgage Credit

Prices in the non-agency sector remained largely unchanged from the previous week and most supply came from hedge funds and CDO liquidations. We analyze the recent trends in housing and revise our HPA forecast to +10.5% in 2013, +4.5% in 2014 and +3% in 2015. Separately, regarding Eminent Domain, three trustees initiated a lawsuit against the city of Richmond and MRP this week and it appears that the prices being offered are significantly lower than what was stated in MRP's marketing materials.

CMBS: Vornado, Skyline, Rouse

After a slow start to the week, CMBS spreads finished unchanged to marginally tighter, despite continued talk of Fed tapering which caused equities to trade lower. Benchmark GG10 spreads closed 2bp tighter on the week, finishing at 149bp over swaps. This week we continue our coverage of REIT earnings, providing updates on Vornado Realty Trust and Rouse Properties. Notably, Vornado provided commentary on the pending modification of the $678mn Skyline Portfolio loan which is largely in-line with our expectations. Rouse outlined their future financing plans, and we believe they may choose to prepay a subset of CMBS-related loans.

See Disclosure Appendix A-1 for the Analyst Certification and Other Important Disclosures

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Agency MBS: Market Overview and Relative Value

Recent Performance and Market Flows

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During the past week, 30-year production coupon MBS (FN 3.5s and 4.0s) have outperformed their Treasury and swap hedges by 3-4 ticks (Thursday-Thursday closes). As the 10-year Treasury rallied 10-12bp and implied volatilities declined over the week following the release of the July employment data last Friday, the overall sentiment in the MBS market has improved substantially and FN 3.0s-4.0s are outperforming Treasuries by another 3-4 ticks today. Although there is no significant private investor group, other than the Fed, providing a strong demand for agency MBS, the daily purchases of MBS by the Fed are more than enough to offset the daily originator selling. The DW 2.5s/FN 3.0s and the DW 3.0s/FN 3.5s swaps have lost 2-3 ticks over the past week but the 15-year/30-year coupon swaps continue to look quite rich to our models. The GN/FN 3.0s-4.0s swaps have appreciated 3-4 ticks over the week. The Fed was a net buyer of $15.5bn agency MBS over the week ending August 7.

Earlier this week, Annaly (NLY) reported its earnings for 2Q'13 and published a stockholder supplement which gives some useful information about the state of its MBS portfolio after the sharp selloff in rates in 2Q'13. Annaly reduced its exposure to agency MBS by $12.8bn in 2Q'13, which brings the cumulative decline in Annaly's agency MBS portfolio during 1H'13 to $27bn (in terms of face value). However, a portion of the decline in Annaly's portfolio during the 1Q'13 may have occurred more to make room for their purchase of Crexus than because of the decline in MBS dollar prices. As shown in Figure 1, we estimate that the total decline in agency MBS holdings of all mortgage REITs in 2Q'13 was about $27bn (and the total decline in 1H'13 was about $21bn), which is significantly lower than what the market estimated them to be during the recent selloff.

Fig. 1: Agency MBS Holdings of Different Mortgage REITs (in terms of face value, $bn)

		Face Value of Agency MBS ($bn)			Change ($bn)	
		Dec'12	Mar'13	Jun'13	1Q'13	2Q'13
1	NLY	115.2	101.0	88.2	-14.2	-12.8
2	AGNC	91.2	97.7	89.5	6.6	-8.3
3	HTS	22.8	24.0	24.7	1.2	0.7
4	CYS	19.7	19.1	16.8	-0.6	-2.3
5	ARR	17.9	23.2	22.4	5.3	-0.8
6	IVR	13.1	15.2	14.1	2.0	-1.1
7	MFA	6.8	6.7	6.7	-0.1	0.0
8	CMO	13.1	13.1	13.1	0.0	0.0
9	MTGE	5.9	10.1	7.6	4.2	-2.5
10	AMTG	3.3	3.9	N/A	0.6	N/A
11	MITT	3.3	3.4	N/A	0.0	N/A
12	TWO	12.0	13.0	N/A	1.0	N/A
	Total	324.3	330.3		6.0	

Source: Bloomberg, Nomura Securities International Estimates

The aggregate agency prepays declined for the second consecutive month, with 30-year Fannie prepays declining by 9% and 30yr Freddie prepays declining by 7% in July. The decline in aggregate Fannie prepays was in-line with our expectation for a 9% decline, based on a large drop in the refinance index and a slight increase in day-count, but HARP speeds were faster than our projections. The net issuance of agency MBS was $30bn, while the total pay-downs on Fed's portfolio were about $22bln in July. We expect aggregate Fannie prepays to drop 18% month-over-month in August because of a continued sharp drop-off in refinance index and the day-count remaining flat. We expect most of this prepay drop to be concentrated in lower coupons with prepays on HARP eligible cohorts remaining fairly stable.

Agency MBS: When Will the Market Feel the Impact of Tapering?

Agency MBS spreads appear to be following the trends seen after several major selloffs over the past 10 years, when MBS spreads tightened back to pre-convexity hedging related activity levels within two to three months after the end of selloffs. Production coupon MBS spreads have already tightened by 13-14bp since hitting their recent wides on July 5. While we believe that there is only 4-5bp upside left from reversal of the MBS spread widening that could be attributed to convexity-related selling during the recent selloff, we wonder whether weak seasonals for home sales starting in October will offset the negative impact of the Fed's tapering of its QE3 purchases on MBS spreads for a few months.

Fig. 2: Changes in Dollar Prices of TBAs, 5-year and 10-year Treasuries and Swap Rates

				Changes in Prices and Rates		
	17-May	5-Jul	8-Aug	5/17-7/5	7/5-8/8	Total
FNCL 3.0s	102-17+	94-28+	97-06+	(7-21)	2-10	(5-11)
FNCL 3.5s	105-05+	98-30+	101-02+	(6-07)	2-04	(4-03)
FNCL 4.0s	106-07+	102-03+	104-07+	(4-04)	2-04	(2-00)
5-yr Treasury	0.83%	1.61%	1.36%	88bp	-25bp	63bp
10-yr Treasury	1.95%	2.74%	2.59%	79bp	-15bp	64bp
5-yr Swap	0.99%	1.82%	1.54%	83bp	-28bp	55bp
10-yr Swap	2.09%	2.99%	2.77%	90bp	-22bp	68bp
3mo*10yr Swaption Vol (bp)	71bp	122bp	93bp	51bp	-29bp	22bp
3yr*10yr Swaption Vol (bp)	86bp	106bp	102bp	20bp	-4bp	16bp

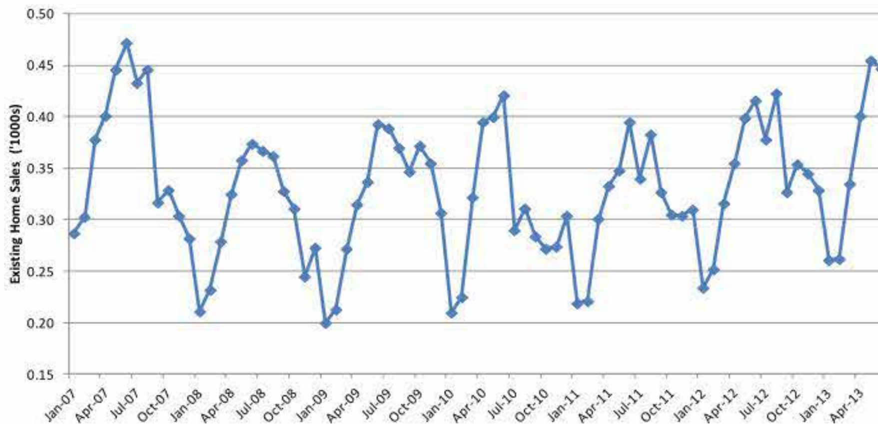
Prices on 5/17 are for June settle, Prices on 7/5 are for July settle; Prices on 8/8 are for Aug settle.

Source: Bloomberg, YieldBook, Nomura Securities International Estimates

Our base case scenario is that the Fed will start tapering its MBS purchase program after the FOMC meeting in September and end its purchase program around the middle of next year. This baseline scenario should lead the Fed to add another $260bn agency MBS (net purchases) before the purchase program actually ends next year. However, just as the Fed starts tapering of its MBS purchases, seasonals for agency MBS issuance are set to improve significantly.

While most investors agree the gross issuance of agency MBS should be only about $100-110bn per month at current mortgage rate levels, it is interesting that the net issuance of MBS is also likely to be sharply lower over the next few months. As shown in Figure 3, home sales show a significant seasonality (almost 30% variation from the Oct-Mar period to the Apr-Sep period) and, as a consequence, the net issuance of agency MBS during this timeframe should be a lot less than we have been seeing recently (of course, over a one-year period, seasonals wash out). Thus, although the annual net issuance of agency MBS is likely to be around $125-150bn over the next year, over the six-month period of Oct'13-Mar'14, it is likely to be around $60-72bn only (annualized rate) or $5-6bn per month. For reference, the net issuance of agency MBS over the first seven months of 2013 was $130bn (or $18.6bn per month). This decline in net issuance of agency MBS should offset the impact of the tapering of the Fed's MBS purchase program and, in combination with the likely lower gross issuance, should offset the negative impact of the tapering of QE3 purchases on MBS spreads for a few months. Essentially, both gross and net issuance of agency MBS should be a lot lower from Oct'13 to Mar'14 than over the past six to seven months.

Fig. 3: Monthly Existing Home Sales (Not Seasonally Adjusted)



Source: Bloomberg, YieldBook, Nomura Securities International Estimates

Below, we summarize some important positive and negative technicals for the MBS basis. .

Positive Factors:

- The Fed is likely to be a net buyer of $260bn agency MBS before the QE 3 program ends (from Aug'13 to June'14) and the risk to this forecast is to the upside – i.e., due to either slower than expected tapering of QE 3 or potential change in the mix of tapering, their net purchases of agency MBS could be higher.
- The short-term direction of rates is likely to be a favorable one for the MBS market. As highlighted by our rates strategists, traditionally, August is a solid month for long-term Treasuries as it is a month where coupons, cashflow and maturing bonds need to get reinvested. (This is due to the six month semi-annual coupons and principal of bonds issued in Feb / Aug cycle, which used to be the old bond auction cycle pre-2008.) In addition, with less corporate bond issuance, typical at the end of the summer, hedging flows could be light as well. Our rates strategists believe that Treasuries are setting up for the traditional seasonal micro-rally in August, which should lead 10-year Treasury to rally to 2.4% into the end of the month.
- Short-term supply technicals are positive because of seasonal factors. As discussed above, just as the Fed starts tapering of its MBS purchases after the September FOMC meeting, the net issuance of agency MBS is also likely to decline due to strong negative seasonals for home sales.
- Overall positioning in the MBS market by leveraged investors like REITs, dealer desks and hedge funds seems to be much better now than in early May and we are likely to see very limited selling from this group even in a continued backup scenario.
- Money managers are close to neutral weight on agency MBS.

Negative Factors:

- Production coupon MBS spreads have already recovered a major portion of the spread widening that is attributable to convexity related selling during the recent 100+ bp selloff.
- There is limited upside to MBS spreads in a rally scenario (likely 3-5bp spread tightening) versus a significant downside (likely 15-16bp spread widening) in a sharp backup scenario.
- The net issuance of agency MBS is likely to be $150bn and the GSEs are likely to shed $70bn MBS over the next year. Although supply-demand technicals are likely to be positive over the next few months, long-term technicals for the MBS basis look negative (i.e., after the Fed ends the QE 3 program).

- Domestic banks are likely to be a lot less active than before in the agency MBS market due to regulations related to unrealized gains/losses. At the same time, there are no indications that overseas investors will be active buyers of MBS.
- It is not clear who the marginal buyer of MBS will be after the Fed ends the QE 3 program. Money managers still run the risk of substantial redemptions if the rates market sells off again.

From a short-term perspective, the most important determinant of MBS spreads will be the direction of interest rates. If the 10-year Treasury remains below 2.75%, Fed's MBS purchases should overwhelm the net issuance and nominal spreads of production coupon MBS should continue to tighten. Our rates strategists believe that Treasuries are setting up for the traditional seasonal micro-rally in August which should lead the 10-year Treasury to rally to 2.4% into the end of the month. We view this scenario of 10-year Treasury yields as a fairly favorable one to MBS spreads and believe that the combination of sharply lower originator selling along with the reinvestment needs of MBS investors and Fed's MBS purchases will lead spreads to tighten from their current levels. Thus, we continue to recommend a modest overweight on agency MBS, but acknowledge that MBS spreads could widen substantially if the rates market sells off from here.

From a long-term perspective (i.e., after the Fed's purchase program ends), agency MBS spreads are likely to settle down at wider levels than historical averages as long-term supply/demand technicals appear to be weak. As discussed in our prior weekly reports, there is a sharp pickup in the net issuance of agency MBS over the past few months and the GSEs are continuing to reduce their MBS exposure. The organic growth in the MBS market coupled with the reduction in GSE holdings mean the rest of the market may have to absorb up to $220-$250bn agency MBS per year. Although MBS spreads don't look rich, it is not obvious who will be the marginal buyers of agency MBS after the QE 3 program ends.

Relative Value in the Agency Passthrough Market

Figures 4 and 5 show the valuations of the 30-year and 15-year coupon stacks on our models as of yesterday's close (the results from YieldBook models adjusted to reflect our expectations for prepayment speeds). 30-year 2.5s and 4.5s look a lot cheaper than 30-year 3.5s and 4.0s and 15-year 2.5-3.0s look very rich across the 15-year coupon stack.

Fig. 4: Valuations of the 30-year Coupon Stack (as of August 8, 2013)

Security	TBA Assumption (Sep)	Yield	Tsy ZV (bp)	Swap ZV (bp)	Tsy OAS (bp)	LOAS (bp)	Duration	Convexity	1-yr Speed
FNCL 2.5s	2 WALA, 3.20 GWAC, $280 K	3.49%	67	53	49	35	8.3	0.6	1.9
FNCL 3.0s	2 WALA, 3.50 GWAC, $280 K	3.39%	60	47	39	25	7.8	0.1	2.1
FNCL 3.5s	2 WALA, 4.10 GWAC, $280 K	3.37%	70	56	36	22	6.6	-1.0	3.0
FNCL 4.0s	1 WALA, 4.60 GWAC, $280 K	3.18%	84	69	34	19	5.3	-2.3	7.3
FNCL 4.5s	48 WALA, 5.00 GWAC, $250 K	3.00%	101	85	52	36	4.2	-2.2	17.6

Source: YieldBook, Nomura Securities International

Fig. 5: Valuations of the 15-year Coupon Stack (as of August 8, 2013)

Security	TBA Assumption (Sep)	Yield	Tsy ZV (bp)	Swap ZV (bp)	Tsy OAS (bp)	LOAS (bp)	Duration	Convexity	1-yr Speed
FNCI 2.0s	2 WALA, 2.58 GWAC, $260 K	2.52%	40	22	32	14	5.4	0.1	2.6
FNCI 2.5s	2 WALA, 3.00 GWAC, $260 K	2.51%	43	25	31	13	5.1	-0.2	2.8
FNCI 3.0s	2 WALA, 3.45 GWAC, $260 K	2.40%	42	24	23	5	4.4	-0.8	3.7
FNCI 3.5s	24 WALA, 3.95 GWAC, $240 K	2.26%	59	40	37	18	3.5	-1.2	10.1
FNCI 4.0s	48 WALA, 4.45 GWAC, $220 K	2.07%	73	54	54	35	2.7	-1.0	18.2

Source: YieldBook, Nomura Securities International

New Issue Hybrid ARM Valuations

Aggregate Hybrid ARM issuance picked up in July although much of the increase came from Ginnie Mae. GN ARM issuance jumped from around $900mn in June to over $1.8bn in July. The sharpest increase in Conventional ARMs was in the 7/1 sector with issuance increasing from $1.5bn to nearly $1.8bn. The Hybrid ARM sector has generally suffered from a lack of liquidity and weak bank demand. However as investors are increasingly worried about a continued sell off in interest rates, shorter duration assets like Hybrid ARMs could benefit from increased sponsorship.

Figure 6 summarizes the valuation of New Issue 5/1, 7/1 and 10/1 Hybrid ARMs. While Hybrid ARMs offer wider OASs when compared to Conventional 15-year MBS of similar duration and negative convexity, many short duration investors are more interested in nominal spread measures. Across Hybrid ARMs, conventional 15-years offer higher yields than the New Issue 5/1s and 7/1s, with New 5/1s trading at negative Z-spreads. New Issue 10/1s offer marginally higher yields than 15yrs but bank investors may not be interested in a bond that has over 5-year duration.

Fig. 6: Relative Value in the New Issue Hybrid ARM Sector

				Option-adjusted Metrics			Nominal Metrics				
	WAC	TPO %	Price ($)	Eff. Duration	Eff. Convexity	Tsy OAS (bp)	Yield (%)	I-spread (bp)	Z-spread (bp)	1yr CPR (%)	LT CPR (%)
New Issue 10/1	3.20	0	98-10+	5.9	-0.4	45.0	2.74	68	23	5.1	9.8
New Issue 7/1	2.89	58	99-29+	4.6	-0.6	41.0	2.24	71	12	8.5	14.3
New Issue 5/1	2.60	65	100-28+	3.9	-0.9	43.0	1.86	46	-29	14.9	15.6

Source: YieldBook, Nomura Securities International (as of August 8 2013 closes)

Agency MBS: July Prepays and Short-term Projections

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Aggregate prepays declined for the second consecutive month with 30-year Fannie prepays dropping by 9% to 22.5 CPR and 30-year Freddie prepays dropping by 7% to 24.2 CPR. 15-year prepays dropped by 15% across both the agencies. Broadly, prepays were in-line with our expectations based on the increase in mortgage rates and the corresponding decline in refi index. The drop due to these factors overwhelmed the effect of a 2-day increase in day-count. However, higher coupons increased marginally likely due to the impact of the higher day-count.

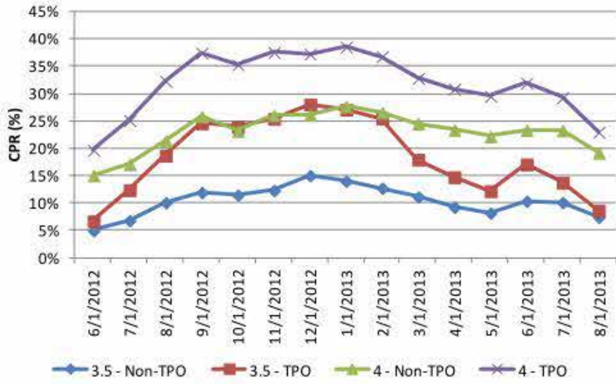
Some interesting trends observed in the recent print include:

- **Lower Coupon Prepays:** Prepays declined sharply on the lower coupons with 2011 FN 3.5s dropping 31% to 13.7 CPR and 2010 FN 4.0s dropping 18% to 20.2 CPR. While TPO and Retail prepays have mostly converged for 3.5s, TPO still continues to prepay around 3-4 CPR faster than Retail in 4.0s.
- **HARP Prepays:** Broadly, prepays on FN 5.5s and higher coupons increased, while those on FN 5.0s declined by 1-3%, with 2008 FN 5.0s coming in at 51.8 CPR (down 3%) and 2008 FN 5.5s at 51.9 CPR (up 1%). Across servicers, prepays continued to decline on Chase loans, while Bank of America/Nationstar Freddie loans are prepaying the fastest.
- **Seasoned Cohorts:** Prepays on seasoned vintages surprised this month. Across most cohorts, prepays were flat to marginally higher despite the backup in mortgage rates, with 2003 FN 5.0s increasing 1% to 37.5 CPR and 2003 FN 5.5s increasing 4% to 35.7 CPR. It appears that the higher day count is keeping these prepays elevated as well. Additionally, at current levels of the 15-year mortgage rate, borrowers may be actively choosing to refinance into a shorter term loan as a means of reducing the overall interest payments.
- **Ginnie Mae:** Aggregate prepays on GN Is increased by 1% to 23.8 CPR, while aggregate prepays on GN IIs declined by 13% to 15.8 CPR. This divergence can be explained by the difference in involuntary prepays across GN I and II. Prepays on lower coupon 2011 and 2012 vintage GN II 3.5s declined around 24%, comparable with that observed for conventional loans. Prepays on the pre-May 2009 Chase cohorts surprised this month, while Wells prepays continued to decline.
- **Fed Paydowns:** Paydowns on the Fed's MBS portfolio are estimated to be around $22bn in July.
- **Issuance:** Gross issuance of agency MBS in July was $145bn while the net issuance was $30bn.

Lower Coupons Prepays

Prepays declined sharply on the lower coupons with 2011 FN 3.5s dropping 31% to 13.7 CPR and 2010 FN 4.0s dropping 18% to 20.2 CPR. Figure 1 shows prepays on Freddie TPO and Retail loans by coupon (3.5s and 4.0s). It is interesting to note that TPO prepays have finally converged with those of Retail for 3.5s, while TPO 4.0s continue to prepay around 3-4 CPR faster than Retail loans. As the incentive declines, it is reasonable to expect that the effect of TPO on prepays diminishes. Similarly, one can expect TPO 4.0s to decline faster than Retail 4.0s over the next few months and eventually converge.

Fig. 1: Aggregate Prepays on FH 3.5s and 4.0s by TPO and Retail

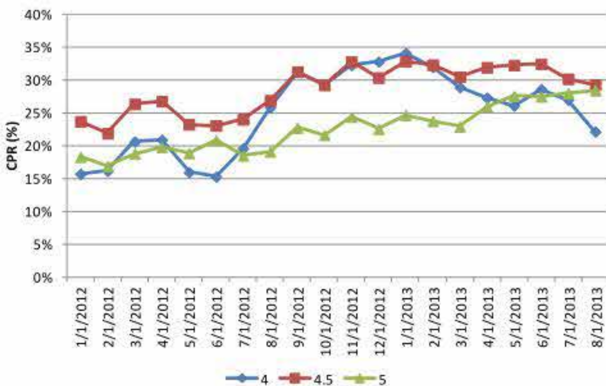


Source: Freddie Mac, Nomura Securities International

Post-HARP Credit-Impaired Cohorts

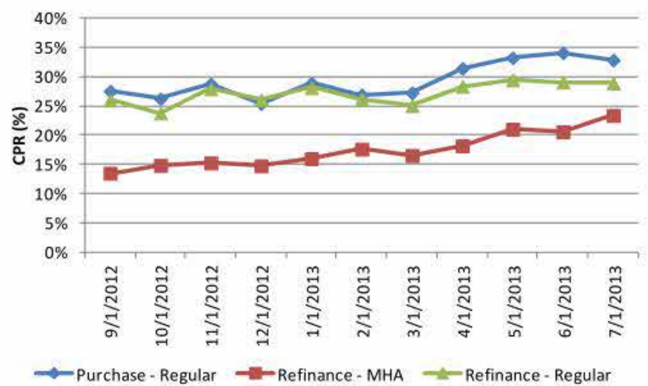
Figure 2 below compares prepays on the 2010 vintage collateral by coupon. While the decline for the 4.0s and 4.5s is not surprising, of specific interest are the 5s of 2010, where prepays were higher by 1.5%. A significant portion of this increase may be attributed to MHA loans, while purchase and regular refinance loans were flat to slightly lower (Figure 3). It is possible that a rapid increase in home prices provided an opportunity for many of the previously locked-out borrowers to refinance. Figure 4 shows that TPO has a greater effect on MHA loans with positive EGSO (Equity Growth Since Origination) than on regular refinance loans, as the MHA borrowers may not be fully aware of the PMI-based refinance opportunities that open up as their LTV drops below 95.

Fig. 2: Prepays on FH 4.0s, 4.5s and 5.0s of 2010 Vintage



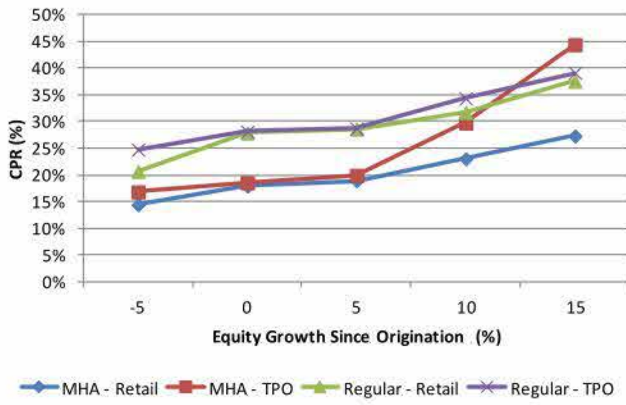
Source: Freddie Mac, Nomura Securities International

Fig. 3: Prepays on FH 5.0s of 2010 Vintage by Loan Purpose



Source: Freddie Mac, Nomura Securities International

Fig. 4: Prepays by EGSO and TPO for Refinance Loans (May-Aug 2013)



Source: Freddie Mac, Nomura Securities International

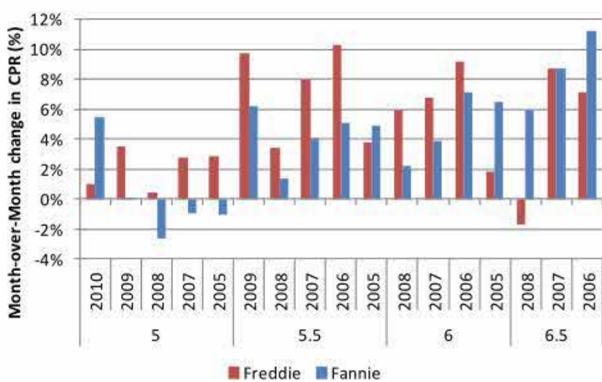
Higher Coupons Prepays

Prepays on higher coupons stood out across the coupon stack as prepays were mostly unchanged to marginally higher compared with the sharp decline witnessed on the lower coupons. Broadly, prepays on FN 5.5s and higher coupons increased, while those on FN 5.0s declined by 1-3%, with 2008 FN 5.0s coming in at 51.8 CPR (down 3%) and 2008 FN 5.5s at 51.9 CPR (up 1%).

Figure 5 shows the month-over-month change in voluntary prepays for 5.0s and higher coupons. While there are some variations across vintages, the change in FN and FH 5.0s was lower compared with that for the 5.5s and higher coupons. We can attribute this difference to the greater rate effect on the lower coupon, which potentially compensated for some of the day count impact. HARP prepays increased across most servicers this month, with Chase prepays actually declining despite the higher day count (Figure 6). This is likely to be the first conclusive sign of burnout in HARP prepays. Also, it is possible that prepays on Fannie transferred collateral slowed this month and we should receive some confirmation in next few days.

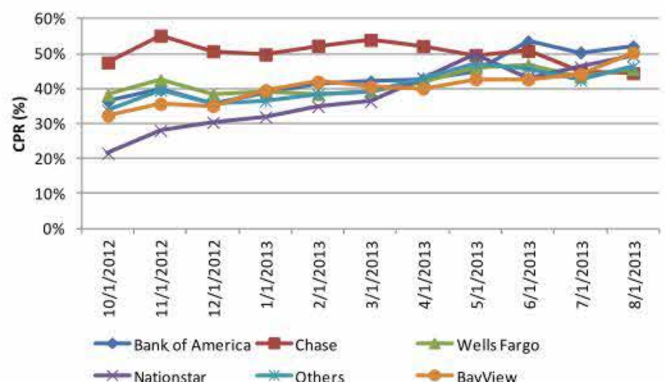
Special servicers like Nationstar and GreenTree are likely to be capacity constrained as they are seeking to find refinancing opportunities in their recently acquired portfolios. The TBW portfolio transferred over to Nationstar this month. The impact of this transfer should be less severe because prepays on TBW loans already witnessed a spike during Mar-Jun 2013 (possibly because Cenlar had tied up with Quicken and some of the better credit borrowers have already been refinanced). However, this transfer should keep capacity tight and delay the onset of any burnout for Nationstar HARP loans.

Fig. 5: Monthly Change in Voluntary Prepays by Cohort



Source: Fannie Mae, Freddie Mac, Nomura Securities International

Fig. 6: Prepays on FH 2006-08 Vintage Loans by Servicer



Source: Fannie Mae, Freddie Mac, Nomura Securities International

Figure 7 below summarizes the voluntary and involuntary prepays across Fannie and Freddie cohorts.

Fig. 7: Voluntary and Involuntary Prepays

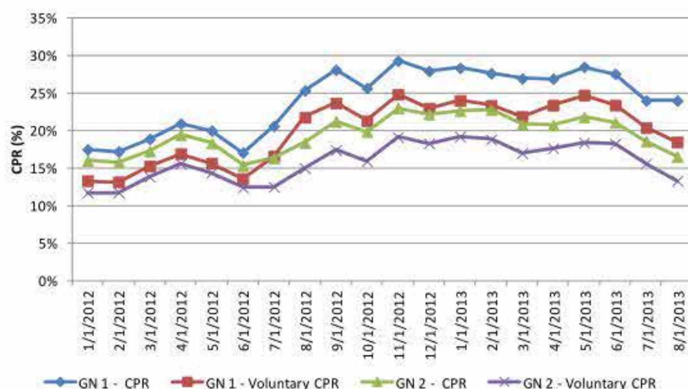
		Freddie				Fannie			
		Voluntary CPR (%)		Involuntary CPR (%)		Voluntary CPR (%)		Involuntary CPR (%)	
Coupon	Vintage	Aug-13	Jul-13	Aug-13	Jul-13	Aug-13	Jul-13	Aug-13	Jul-13
4	2010	22.5	27.3	0.2	0.3	23.0	28.2	0.4	0.4
	2009	31.5	39.3	0.3	0.5	30.2	36.5	0.5	0.6
4.5	2010	29.3	30.2	0.6	0.7	27.9	30.1	0.8	0.8
	2009	34.6	39.0	0.7	0.7	34.1	37.6	1.0	1.0
	2005	40.3	40.3	1.7	2.3	34.3	39.2	3.0	2.7
5	2010	27.5	27.2	1.7	1.6	26.2	24.9	2.1	2.0
	2009	33.7	32.5	1.3	1.4	31.5	31.5	1.8	2.0
	2008	48.5	48.3	3.3	2.7	50.1	51.4	3.3	3.7
	2007	47.5	46.3	4.7	3.6	43.3	43.7	4.2	5.2
	2005	40.7	39.5	2.6	2.8	40.7	41.1	3.1	3.4
5.5	2009	29.4	26.8	2.1	1.9	25.8	24.3	2.4	2.4
	2008	46.6	45.1	4.1	3.3	49.6	49.0	4.2	4.5
	2007	47.8	44.3	4.2	4.3	48.3	46.4	4.8	5.4
	2006	47.7	43.2	4.1	3.8	45.2	43.0	5.0	5.3
	2005	36.1	34.8	3.6	3.6	37.4	35.6	4.7	4.7
6	2008	43.5	41.1	4.1	4.9	45.6	44.6	6.0	5.5
	2007	43.9	41.1	5.3	4.8	44.7	43.1	5.8	6.1
	2006	42.8	39.2	4.8	4.3	43.4	40.5	5.8	5.6
	2005	30.3	29.8	3.8	4.6	32.4	30.5	6.2	6.7
6.5	2008	36.0	36.6	5.0	4.7	41.1	38.7	7.1	8.0
	2007	39.3	36.1	6.8	5.7	38.6	35.5	7.1	7.9
	2006	36.2	33.8	4.7	5.9	38.9	35.0	6.6	7.0

Source: Fannie Mae, Freddie Mac, Nomura Securities International

Ginnie Mae

Aggregate prepays on GN Is increased by 1% to 23.8 CPR, while aggregate prepays on GN IIs declined by 13% to 15.8 CPR. This divergence can be attributed to involuntary prepays as GN I voluntary prepays declined by around 9%, which is line with the decline in conventional (Figure 8). Prepays on lower coupon 2011 and 2012 vintage GN II 3.5s declined around 24%, again comparable with that observed for conventional loans. Prepays on the pre-May 2009 cohorts also declined this month across most issuers, after accounting for buyouts as discussed below.

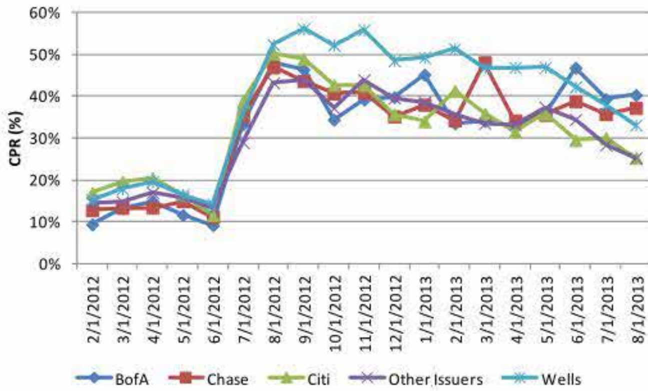
Fig. 8: Aggregate and Voluntary Prepays for GN 1 and GN 2 Cohorts



Source: Ginnie Mae, Nomura Securities International

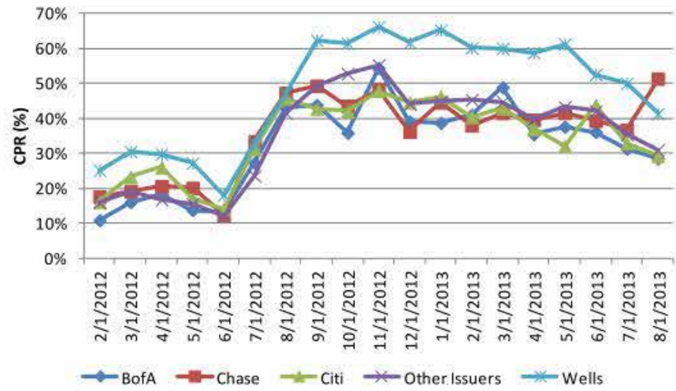
Prepays on the pre-May 2009 vintage Wells loans continued the decline that we have been highlighting over the past few months[1]. The biggest surprise this month was the sharp jump in 5.0s and higher Chase loans. This increase does not appear to be due to buyouts. For instance, in 2008 GN I 5.0s, Wells FHA prepays declined by around 17%, while Chase FHA prepays increased 40%. There is some uncertainty around factors driving the sharp increase in Chase prepays for 2008 and prior vintages. Until we receive further information, we assume that this spike will reverse the following month.

Fig. 9: Prepays on Jan-May 2009 GN I 4.5s FHA Loans by Issuer



Source: Ginnie Mae, Nomura Securities International

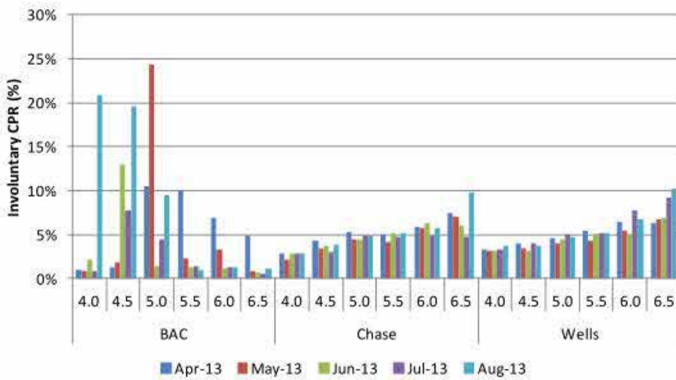
Fig. 10: Prepays on 2008 GN I 5.0s FHA Loans by Issuer



Source: Ginnie Mae, Nomura Securities International

Involuntary Prepays: This month, Bank of America bought out loans from lower coupons (4.0s, 4.5s and 5.0s), while Chase buyouts picked up in 6.5s this month.

Fig. 11: Involuntary Prepays on GN 1 Loans by Issuer



Source: Ginnie Mae, Nomura Securities International

Short-term Projections

We expect aggregate Fannie prepays in August to drop 18% month-over-month because of a continued sharp drop-off in refinance index and the day-count remaining flat. We expect most of this prepay drop to be concentrated in lower coupons with prepays on HARP eligible cohorts to be fairly stable. Figures 12-14 show our cohort-level projections.

[1] Section titled 'Update on GNMA Prepays', published on 31 May 2013

Fig. 12: Prepay Projections for 30yr FN

Coupon	Vintage	Bal ($mm)	WAC	WAM	WALA	WACLS	FICO	LTV	1-Mo Actual		1-Mo Projection	
									Jun	Jul	Aug	Sep
3.0	2012	151,301	3.59	347	10	267,020	769	71	6.8	5.5	4.5	4.0
3.5	2012	195,166	4.01	342	14	239,985	759	74	13.4	9.8	6.0	5.0
3.5	2011	33,513	4.03	333	22	243,646	771	70	19.7	13.7	8.0	7.0
3.5	2010	13,728	4.12	320	33	229,039	772	70	22.8	18.1	12.0	10.0
4.0	2012	62,413	4.47	339	15	200,009	738	79	15.4	13.3	9.0	8.0
4.0	2011	73,968	4.47	330	25	224,094	759	74	24.6	20.2	14.0	12.0
4.0	2010	64,500	4.49	319	34	223,662	764	72	28.5	23.3	17.0	15.0
4.0	2009	42,348	4.55	300	50	208,916	765	67	36.9	30.5	22.0	19.0
4.5	2012	7,086	4.96	338	17	169,182	725	81	16.1	14.3	10.0	9.0
4.5	2011	62,344	4.93	327	26	203,833	748	76	25.5	23.2	18.0	16.0
4.5	2010	63,273	4.94	315	38	214,782	753	74	30.7	28.5	23.0	21.0
4.5	2009	91,581	4.93	302	49	206,125	757	71	38.2	34.8	27.0	24.0
4.5	2003	6,576	5.07	228	120	135,948	731	69	37.0	36.8	32.0	29.0
5.0	2011	19,827	5.37	327	27	191,819	729	81	23.5	23.1	20.0	19.0
5.0	2010	34,754	5.36	314	39	204,908	734	79	26.4	27.9	24.0	22.5
5.0	2009	28,260	5.42	305	48	190,812	740	76	32.9	32.8	28.0	26.0
5.0	2008	11,992	5.66	289	63	186,749	735	73	53.2	51.8	46.0	43.0
5.0	2005	21,423	5.64	254	97	158,334	723	71	43.2	42.6	38.0	35.0
5.0	2004	12,509	5.55	238	110	143,872	722	72	38.7	37.9	33.0	31.0
5.0	2003	28,885	5.50	226	120	127,998	720	70	37.1	37.5	33.0	31.0
5.5	2008	20,028	6.04	290	63	179,202	728	75	51.3	51.8	49.0	46.0
5.5	2007	18,693	6.14	278	74	176,908	719	73	49.4	50.8	48.5	45.0
5.5	2006	9,086	6.16	266	86	168,361	718	72	46.0	48.0	45.5	43.0
5.5	2005	21,542	5.98	253	97	142,851	711	73	38.6	40.4	38.5	36.0
5.5	2004	17,737	5.94	240	109	133,245	712	73	36.0	37.9	36.0	34.0
5.5	2003	30,344	5.94	225	122	117,895	714	72	34.2	35.6	34.0	32.0
6.0	2008	11,475	6.54	290	62	163,412	714	78	47.7	48.8	46.5	44.0
6.0	2007	25,307	6.57	280	73	161,468	707	77	46.6	48.0	45.5	43.0
6.0	2006	19,482	6.56	266	85	152,081	708	75	43.9	46.7	44.5	42.0
6.0	2005	6,230	6.50	255	96	121,835	700	78	35.0	36.5	34.5	33.0
6.0	2004	7,737	6.44	239	110	114,017	699	78	32.3	32.5	31.0	32.0
6.0	2003	6,472	6.49	226	122	105,161	702	75	30.2	31.1	29.5	28.0
6.5	2007	7,587	7.06	280	73	135,479	692	81	40.4	42.8	40.5	38.5
6.5	2006	8,798	7.02	266	85	127,480	697	79	39.5	42.9	41.0	38.5
									Mortgage Rate		4.30	4.37

Source: Fannie Mae, Nomura Securities International

Fig. 13: Prepay Projections for 15yr FN

Coupon	Vintage	Bal ($mm)	WAC	WAM	WALA	WACLS	FICO	LTV	1-Mo Actual		1-Mo Projection	
									Jun	Jul	Aug	Sep
2.5	2012	76,108	3.00	166	11	218,891	770	64	11.5	7.5	4.5	4.0
3.0	2012	44,986	3.45	162	15	184,041	762	65	15.2	11.5	8.0	7.0
3.0	2011	27,569	3.45	154	22	188,297	770	63	21.4	15.9	11.0	10.0
3.0	2010	3,473	3.58	142	33	160,354	773	62	21.5	18.5	15.0	13.5
3.5	2012	7,448	3.97	159	16	135,046	749	67	13.3	13.9	11.5	10.5
3.5	2011	26,335	3.91	149	26	162,672	762	64	23.3	21.0	17.5	16.0
3.5	2010	21,093	3.92	141	34	156,720	769	62	27.3	24.2	20.0	18.0
4.0	2011	13,183	4.37	148	27	140,905	753	64	25.9	24.6	22.0	20.0
4.0	2010	17,047	4.41	136	38	136,178	759	63	31.3	30.0	27.0	25.0
4.0	2009	13,927	4.48	124	49	124,582	761	60	34.4	33.7	31.0	29.0
4.0	2003	3,592	4.55	55	120	53,314	742	59	22.2	24.3	22.0	20.5
4.5	2010	4,334	4.85	135	39	118,998	744	66	28.1	29.6	28.0	26.0
4.5	2009	6,666	4.89	125	49	111,937	748	63	31.1	32.6	31.0	29.0
4.5	2008	2,652	5.06	110	64	108,775	744	61	39.2	37.6	35.5	33.0
4.5	2004	3,510	4.97	64	111	62,993	732	59	24.0	24.2	22.5	21.0
4.5	2003	12,000	4.96	54	121	49,496	736	59	22.2	23.4	22.0	21.0
5.0	2008	2,569	5.57	111	63	94,365	734	62	34.5	36.2	34.0	32.0
5.0	2005	2,691	5.49	77	97	70,516	728	60	25.2	24.8	23.0	21.0
5.0	2004	2,785	5.43	66	109	58,632	721	61	20.2	22.2	21.0	20.0
5.0	2003	7,962	5.45	53	122	44,419	727	60	21.0	21.9	21.0	20.0
									Mortgage Rate		3.35	3.40

Source: Fannie Mae, Nomura Securities International

Fig. 14: Prepay Projections for 30yr GN Is

									1-Mo Actual		1-Mo Projection	
Coupon	Vintage	Bal ($mm)	WAC	WAM	WALA	WAOLS	AOCS	OLTV	Jun	Jul	Aug	Sep
3.0	2012	17,662	3.50	347	11	197,535	713	95	7.0	5.3	4.0	3.5
3.5	2012	24,505	4.00	342	15	189,657	701	94	15.4	11.9	8.0	7.0
3.5	2011	9,282	4.00	335	22	201,340	712	95	17.1	14.4	11.0	10.0
4.0	2011	20,140	4.50	331	26	179,031	704	95	22.4	22.4	17.0	16.0
4.0	2010	24,786	4.50	322	34	203,298	709	94	20.0	24.5	15.0	14.0
4.0	Jun-Dec 2009	5,887	4.50	306	49	194,991	649	94	26.5	27.9	19.0	18.0
4.5	2011	8,020	5.00	330	27	155,460	686	94	22.6	23.9	19.0	18.0
4.5	2010	34,678	5.00	317	39	185,227	700	94	26.5	29.6	21.0	20.0
4.5	Jun-Dec 2009	34,389	5.00	308	47	191,469	635	94	28.1	28.7	24.0	23.0
4.5	Jan-May 2009	18,451	5.00	303	52	179,830	657	94	39.7	37.6	32.0	31.0
5.0	2010	9,403	5.50	316	40	147,151	671	93	21.3	23.9	18.0	17.0
5.0	Jun-Dec 2009	24,394	5.50	308	47	164,595	639	94	25.6	23.9	20.0	19.0
5.0	Jan-May 2009	13,380	5.50	302	53	159,902	626	94	33.5	31.5	28.0	27.0
5.0	2008	4,038	5.50	292	62	166,595	648	93	38.1	38.4	35.0	34.0
5.0	2003	4,967	5.50	225	121	120,534	673	96	26.3	26.7	24.0	23.0
5.5	2008	9,451	6.00	293	61	151,989	620	93	35.2	38.4	35.0	34.0
5.5	2003	5,673	6.00	223	122	112,332	667	95	25.4	27.9	25.0	24.0
6.0	2008	7,622	6.50	294	60	137,766	609	93	31.4	34.3	31.0	30.0
									Mortgage Rate		4.30	4.37

Source: Ginnie Mae, Nomura Securities International

Mortgage Credit

Market Color

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There was a pickup in activity this week in the non-agency market. In subprime most supply came from CDO liquidations and legacy sellers. The bonds that traded were mostly clean, stable profile bonds and there was strong interest from money managers. In addition, a moderate volume of R&W bonds traded this week in this sector. In option ARMs, supply came mostly from hedge funds and buyers were a mix of hedge funds and money managers.

Prices were higher by approximately ½ point from the previous week. There was a pickup in activity in Alt-A sector as well with supply coming in from a mix of both hedge funds and money managers. Spread levels were in line with last week and most demand came from hedge funds.

Dealer inventories declined by around $200mn this week, according to TRACE data (as shown in the Appendix). BWIC volumes were $1.2bn in subprime, $150mn in option ARMs, $1.1bn in Alt-A and $300mn in Prime.

Over the past few weeks, the technical environment for the non-agency market has improved meaningfully. As rates have shown some signs of stability, there has been a renewed interest in the sector, particularly from money managers looking to increase their allocation to the sector. In addition, supply has dropped meaningfully and is expected to be relatively low in the near term. We retain our overweight recommendation on the non-agency sector given the attractive spreads and the favorable technical environment. Figure 1 shows recommended positioning by sector.

Fig. 1: Recommended positioning

Servicer tiering	Prefer Nationstar, SPS, Wells
Buy subprime bonds with R&W upside, specifically from DB/JP/Bear/LB shelves	Greater structural leverage to putback-related cashflows in subprime, expect increased probability of settlements and individual loan putbacks as other settlement proceedings draw closer to completion
Buy subprime non-IG bonds that are expected to be money good	Market has been saturated with these bonds recently. These bonds are very attractively priced versus IG bonds and other comparable assets, and expect them to tighten in the medium term.
Buy POA SSNRs with higher enhancement	Attractive spreads, greater carry and more stable yield profile from higher CE
Buy floaters off clean Alt-A fixed collateral	Attractive spreads in base case scenario with potential upside from prepay pickup from slightly underwater borrowers as housing continues to improve. High WACs resulting in less sensitivity to higher rates, and floating coupon resulting in less duration

Source: Nomura

Mortgage Litigation

R&W litigation: This week AMI filed an amicus brief on the statute of limitations was filed in a R&W case (FHFA vs. Greenpoint Mortgage) over LXS 2006-GP2. According to the brief, the statute of limitations should start running from the time when the sponsor/seller refuses to buy back the loans with R&W breaches. According to the PSA, a cause of action may arise against Greenpoint when there is a discovery of a R&W breach and failure to cure such breach. The brief also stated that in other cases, loan-level repurchases have continued to occur even after six years after the issuance date.

Securities fraud: This week Royal Park Investments sued Deutsche Bank over misrepresentations made in over $535mn of securities it purchased from the bank.

Separately, Allstate discontinued a securities fraud lawsuit against Goldman Sachs over fraudulent representations and warranties in over $123mn securities it had purchased from the bank, possibly due to a settlement.

The Department of Justice and SEC filed a civil lawsuit against Bank of America over securities fraud involving the $835mn BOAMS 2008-A deal. The complaint alleged that a significant percentage of loans were originated through the wholesale channel, a fact that was not disclosed to the buyers, the Federal Home Loan Bank of San Francisco and Wachovia. Bank of America also decided not to perform any due diligence on the loans underlying the deal as such reviews on previous deals had identified more than 40% of the loans to breach BoA's underwriting guidelines, causing them to be removed from those deals.

Additionally, JP Morgan disclosed in its recent 10-Q filing that it may be the subject of a similar lawsuit over securities sold from 2005 to 2007. In May, the Justice Department had preliminary concluded that the bank had violated civil securities laws over subprime and Alt-A bonds issued by the bank.

News

Mortgage Delinquencies declines: According to the latest MBA national delinquency survey, delinquencies continued to fall nationwide and dropped to 6.96% which is the lowest since mid-2008. Foreclosure inventory also declined to 3.3% compared with 4.4% last year. However, the rate of new foreclosures in New York hit an all-time high and foreclosure rate in judicial states was three times the foreclosure rate in non-judicial states (5.59% vs. 1.86%)

PPIP report: According to the latest PPIP quarterly report, all the nine funds have been wound down, having distributed all the proceeds and repaid all Treasury equity and debt. The Treasury recovered its initial investment of $18.6 bn ($12.3 bn debt and $6.3 bn equity) and realized a profit of $3.8 bn.

Asking prices decrease: According to a report by Trulia, asking home prices decreased by 0.3% m-o-m and increased by 11% y-o-y. This is the first month over month decrease in asking prices since November 2012 and is likely a result of higher rates and lower investor demand.

Eminent Domain update

Last week the city of Richmond, California initiated contact with servicers to buy loans out of RMBS trusts and threatened to use Eminent Domain as a backup measure.

Over the past week, a lawsuit was filed in the US District Court of Northern California against the city of Richmond by RMBS trustees Bank of New York Mellon, Deutsche Bank and Wells Fargo seeking an injunction to this proposal. According to the lawsuit, out of the 624 loans, 85% are not in any stage of the foreclosure process and 81% never had a notice of default or are now current, and thus the seizure program would not address the harms that they seek to prevent. In addition, the FHFA stated that it is also considering legal action and is considering prohibiting the GSEs from doing business in cities that use Eminent Domain to seize loans.

Of the 624 loans that the city of Richmond is seeking to buy back, 180 are non-performing and unlikely to qualify for a FHA refinance, casting doubts on the viability of the plan for this subset. Based on the subset of eligible loans[2] we find in the CoreLogic database, the average delinquency depth of the delinquent loans in Richmond is 24 months with around 77% of the loans being delinquent for more than six months; the majority of these delinquent borrowers would likely not qualify for FHA underwriting criteria, which requires some evidence of positive credit history[3]. Without the ability to refinance these loans into FHA, it is not obvious how MRP would be able to help borrowers through modifications and make the plan economically viable at the same time. In addition, without the FHA refinance the only way that MRP could make the seizure of delinquent loans profitable is by paying significantly lower than the market price of the property and engaging in a whole loan sale.

[2] Owner occupied, first lien, LTV < 110% of the CLTV
[3] FHA underwriting criteria requires evidence of ability to pay, including a clean recent pay history on existing mortgages or compensating factors for delinquent loans. Recently originated FHA loans had an average FICO exceeding 700.

According to data cited in the BNY Mellon lawsuit, the price for delinquent/foreclosure loans appears to be significantly below the 80% of updated home price threshold cited in MRP presentation materials. Figure 2 shows the average price offered as a percent of loan balance and updated home price (using zipcode-level HPI indices). Even after adjusting for the margin of error associated with the HPI indices and distressed home price discounts, it appears that the offered price for delinquent loans are approximately 40-53% of the updated value of the home, and for loans in foreclosure, around 30-42% of the value of the home - significantly lower than the 80% of home price valuation numbers that were discussed in the proposal.

Fig. 2: Average price offered as a percentage of loan balance and home price (for deals with BNYM as trustee)

Current status	Avg LTV	Months dq	Loan Count	Px (as % of balance)	Px (% as of updated home price)
Current	114	-	71	64%	69%
Delinquent	123	7	27	34%	39%
Foreclosure	120	10	3	27%	32%

Source: BNYM complaint, Loan Performance, Nomura

Figure 3 shows the concentrations of PLS loans in cities that have entered into agreements with MRP; they include El Monte, North Las Vegas, San Joaquin, El Puente, Orange Cove and Pomona.

Fig. 3: Percentage of eligible borrowers by pool type and percentage of underwater borrowers in cities considering Eminent Domain

City	Subprime	Option ARM	Alt-A	Prime	% underwater	% delinquent
Richmond	415	212	296	164	62%	22%
North Vegas	1,819	418	974	113	84%	42%
El Monte	429	107	265	42	19%	28%
Pomona	1,199	331	575	114	26%	30%
La Puente	985	275	522	55	40%	28%
Orange Cove	71	3	14	1	65%	27%
San Joaquin	36	7	9		75%	37%

Eligibility criteria: Owner occupied, first lien loans with a current CLTV < 110% of the current LTV

Source: Loan Performance, Nomura

Going forward, it is possible that the court grants an injunction to this plan as requested in various lawsuits, similar to the injunction granted to KIRP earlier this year regarding planned note sales from Nationstar. If this does not occur, there may be a protracted court battle on this issue. If loans are seized out of PLS trusts and refinanced before a court rules that the seizures are illegal, there is uncertainty as to how this situation would be remedied – due to REMIC rules and the fact that the loan may not exist in the future due to a refinance, the most likely option would be for subsequent recovery payments plus damages to be paid to bondholders at a future date to compensate for the loss.

Renewed push to refinance underwater PLS borrowers

On Tuesday, President Obama gave a speech in Phoenix regarding housing policy where he mentioned a focus on helping more homeowners refinance their mortgage. The fact sheet included as part of this announcement included the following statement: “Expand eligibility for

refinancing to many hundreds of thousands of eligible borrowers who do not have government-backed mortgages by creating special programs through the Federal Housing Administration (FHA) or Fannie Mae and Freddie Mac."

One plan that has been discussed recently which would allow underwater PLS borrowers to refinance their loans is Senator Jeff Merkley's 'Rebuilding American Homeownership Act of 2013' bill. This bill proposes a mechanism for refinancing underwater PLS loans into a government-guaranteed loan through the creation of a new government entity. This bill was originally expected to have been introduced in January but was actually introduced in late July. Under the proposed bill, borrower eligibility requirements for the plan include the following:

- Borrowers must be current for the past six months and not more than 30 days delinquent over the past year
- First lien, owner occupied
- Updated LTV between 80 and 140
- Originated before May 31, 2009
- The new loan balance must not exceed conforming balance limits

The table below shows the estimated eligibility of the plan as of today. We estimate that 11% of subprime, 14% of Alt-A, and 17% of prime borrowers qualify for the plan based on the requirements listed above and have a WAC greater than 4.5%. The number of borrowers eligible for the plan today is 10-15% lower than the estimate in February 2013 when the initial draft of the bill was discussed, mainly due to improvements in borrower equity.

Fig. 4: Percentage of borrowers with refi incentive potentially eligible under the Merkley Refinance Bill

Sector	% with refi incentive
Subprime	11%
Option ARM	1%
Alt-A	14%
Prime	17%

Source: Loan Performance, Nomura

Separately, a pilot program similar to the Merkley bill was introduced earlier this year in Multnomah County, Oregon. In this program, funds from the Troubled Asset Relief Program will be used to refinance underwater loans in PLS deals that have a 105-125 LTV and only modest payment problems in the past, and borrowers must sign a hardship affidavit. The program was announced in late February and became operational in mid-June and thus we have not seen the effect of this program on prepayments yet.

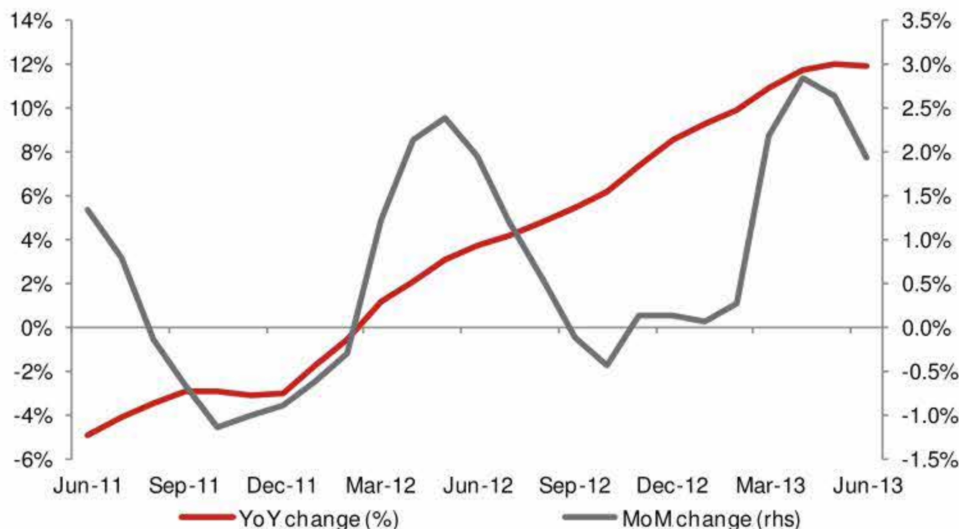
As we stated in the past, we expect that there is a low probability that this proposal is ultimately implemented given the legislative hurdles involved in creating a new government entity to refinance the borrowers. We expect that the government is unlikely to incur the significant budgetary cost associated with taking on this additional credit risk especially given the current contentious fiscal environment. Alternatively, if the bill assesses a special g-fee to pay for itself, that would make the plan less feasible.

Housing Update

The CoreLogic June home price index posted an 11.9% year over year gain reflecting the 16th consecutive month of year-over-year increases. Based on the strong performance over the past month (+1.9%) we revise our HPA forecast to +10.5% in 2013, +4.5% in 2014, and +3% in 2015.

Despite higher rates in May and June, we have not seen a significant pull back in mortgage indicators yet, suggesting that the positive momentum for housing may continue in the near term. However, the lack of visible housing inventory is starting to ease, and by late 2013 we expect that the effect of higher rates and a lower contribution from investor demand will moderate the pace of future home price growth. In addition, DTI restrictions in the final QM rule will likely moderate the pace of future home price growth due to lackluster income growth.

Fig. 5: Home price growth (month over month and annual change)

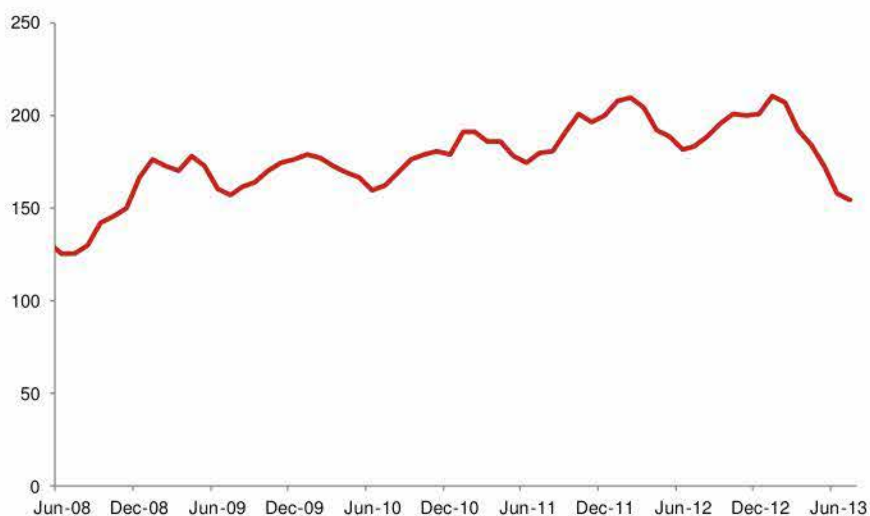


Source: Corelogic, Nomura

Effects of higher rates on housing indicators

Based on the recent rate selloff, overall affordability has dropped by 25% from its highs but still remains within the range of the past two years (Figure 6). We expect a modest impact on the overall demand due to this drop in affordability.

Fig. 6: Housing Affordability Index

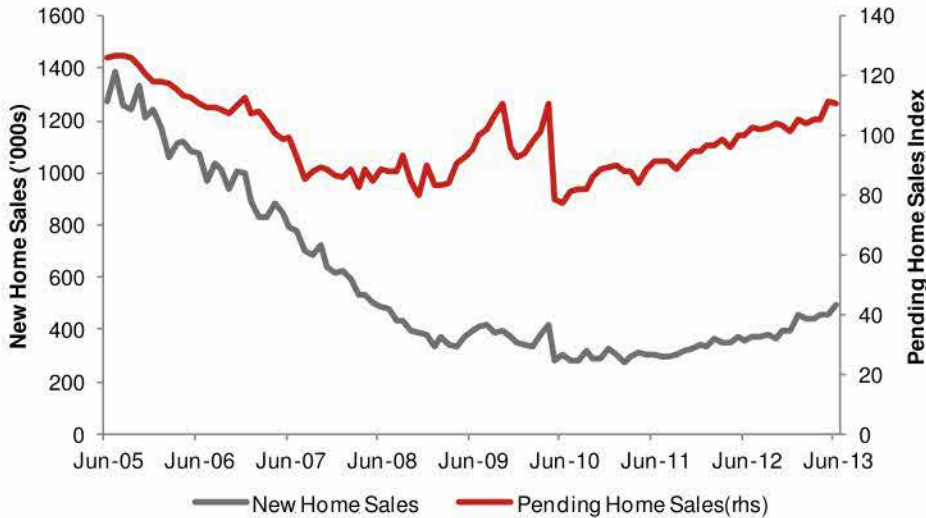


Source: NAR, Census Bureau, Nomura

Anecdotally, we hear that housing activity remained relatively strong over the past two months despite the effects of higher rates as buyers on the sidelines rush into the market. The economic indicators that have been released after the sell-off are showing mixed results regarding the effects of higher rates.

Pending Home Sales/New Home Sales: As both of these metrics are recorded at contract signing and not closing, the most recent releases in June should incorporate the initial effects of higher rates. However, both indices continued to post strong numbers last month: New home sales reached a five-year record high in June, while pending home sales dropped by only 0.3% from May to June and is up 11% over the past year.

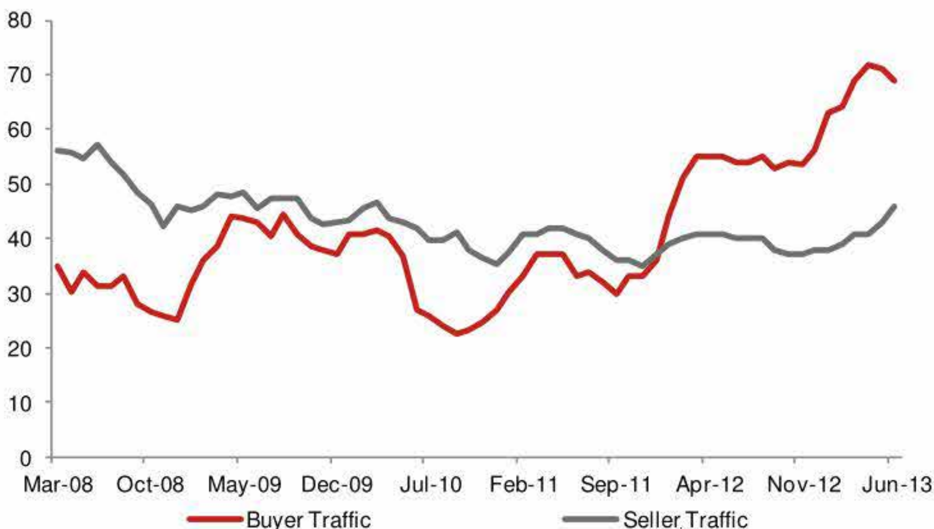
Fig. 7: New Home Sales and Pending Home Sales Index



Source: NAR, Census Bureau, HUD, Nomura

Indices of buyer/seller traffic: Buyer traffic remained healthy in June: according to the MBA buyer/seller traffic index, the buyer traffic index dropped from 71 to 69 in June but remains near five year highs. However, seller traffic increased to 46 from 43 in June indicating a moderate increase in supply (Figure 8).

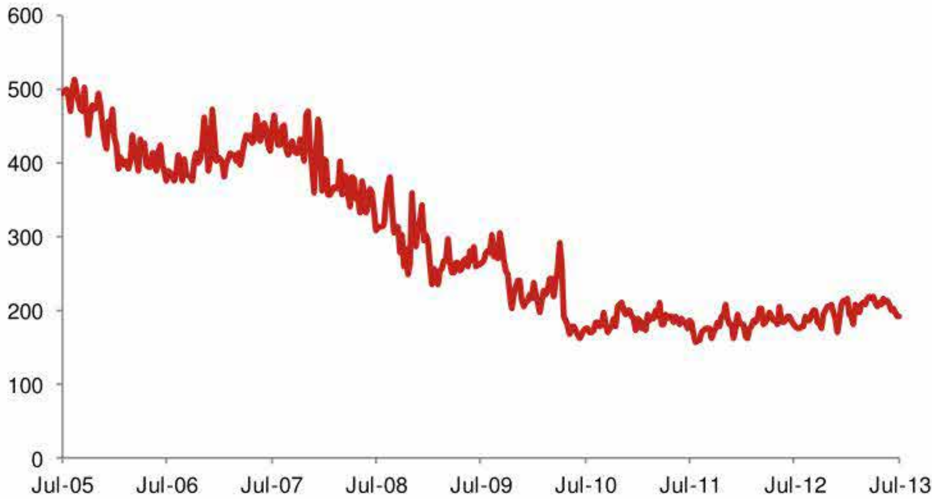
Fig. 8: Buyer and Seller Traffic Index (NAR)



Source: NAR, Nomura

MBA refinance/purchase index: The MBA purchase index is off 12% from its highs in early May. Although the magnitude of the decline is much lower than that for the refi index over the same period (57% drop), the purchase index is now only 3% higher than the average level in 2012.

Fig. 9: MBA Purchase Index



Source: MBA, Nomura

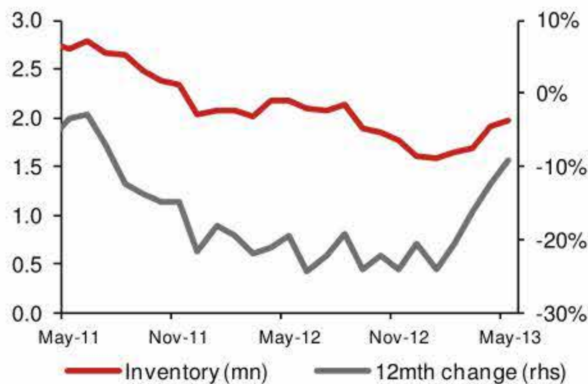
Supply is showing some signs of easing

The lack of supply is one of the main factors driving the recent home price appreciation with total visible housing inventory in late 2011 and 2012 dropping at a 15-20% annualized rate. Recently, the rate of inventory decline has slowed to a 7% year-over-year decline in June. Non-distressed supply was previously restricted because of a high share of underwater borrowers and potential fears that a borrower looking to trade up would not be able to find an attractive alternative given the lack of supply and bidding wars; we expect both of these factors to reverse going forward as home prices continue to improve, leading to more normal inventory levels.

Distressed supply continues to shrink, however, as both the share of foreclosures and short sales have dropped to a four-year low, accounting for a total of 15% of sales in the latest month. Over the next one-two years, we expect that the share of distressed sales to remain low due to increased modifications and continued backlogs in the foreclosure pipeline.

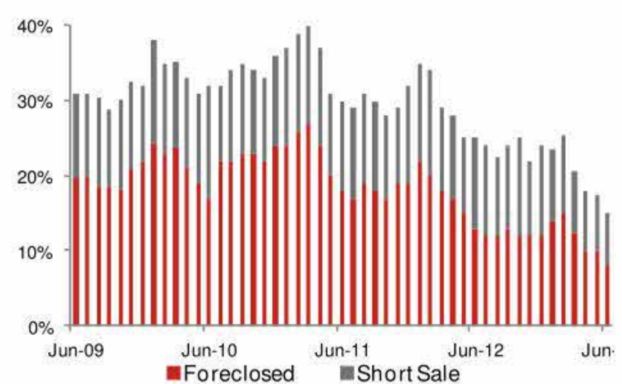
Over the past year, the 10% drop in distressed sales caused approximately a 1.5% positive impact on the home price index, but we do not forecast a similar contribution going forward. Although distressed supply is likely to remain low, it also appears that investor demand is starting to wane given the sharp rise in prices; the investor share of purchases dropped to 17% in June from an average of 20% in the previous six months.

Fig. 10: Single family housing inventory



Source: NAR, Nomura

Fig. 11: Distressed sales percentage



Source: NAR, Nomura

The underwriting box is slowly expanding

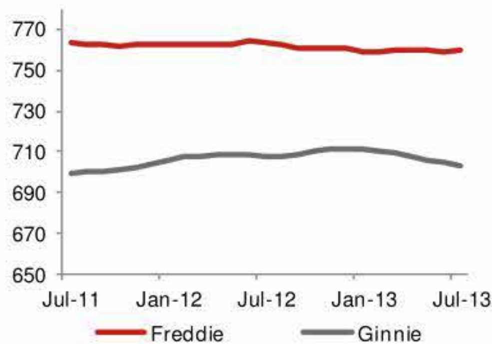
Recently, underwriting standards have eased slightly for new purchase loans. A continued expansion of the underwriting box should partially offset the negative impact of higher rates on housing demand. We track underwriting standards using data on agency originations as well as the MBA credit availability index.

Since the majority of new originations are still through the agency channel, we track the average FICO of new agency loans as a proxy for underwriting standards in this segment (Figure 12). The average FICO of FHLMC purchase loans and FHA/VA loans have dropped by approximately three-five points over the past year although they are still 30-60 points higher than pre-crisis levels. As originators become more comfortable with the new rep and warranty framework and as refinance volumes continue to drop, we expect originators to continue expanding the credit box gradually on agency loans.

In addition, the MBA credit availability index (MCAI) tracks credit availability based on stated underwriting parameters across a range of lenders. According to this index, mortgage credit availability increased by 2.2% from June and loosened for four months in a row. This increase was mainly driven by an increase in cash-out refi products being offered in addition to increasing offering to borrowers with high LTVs or low credit scores.

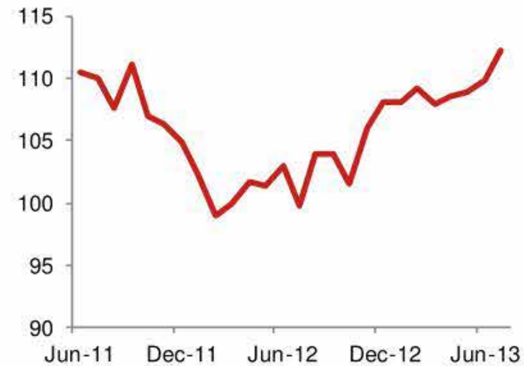
Over the short term, we expect lenders to continue to gradually ease underwriting standards which should result in increased demand for housing. However, over a longer time period we expect that the limits imposed by QM are likely to constrain the expansion of credit availability from bank lenders for Alt-A and subprime loans. While we expect that certain non-bank lenders will eventually lend to this segment, it is unclear how quickly these lenders can fill the void in lower credit lending.

Fig. 12: Average FICO for FHLMC purchase and GNMA loans



Source: Freddie Mac, Ginnie Mae, Nomura

Fig. 13: Mortgage Credit Availability Index (Mar 2012=100)



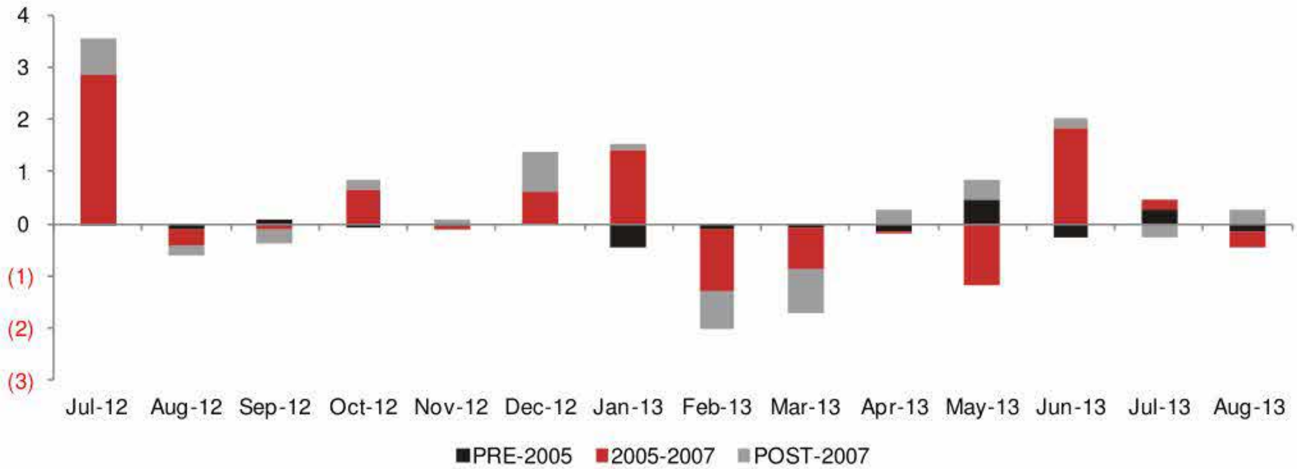
Source: MBA, Nomura

Appendix

Fig. 1: Overall trading volume over the past six months

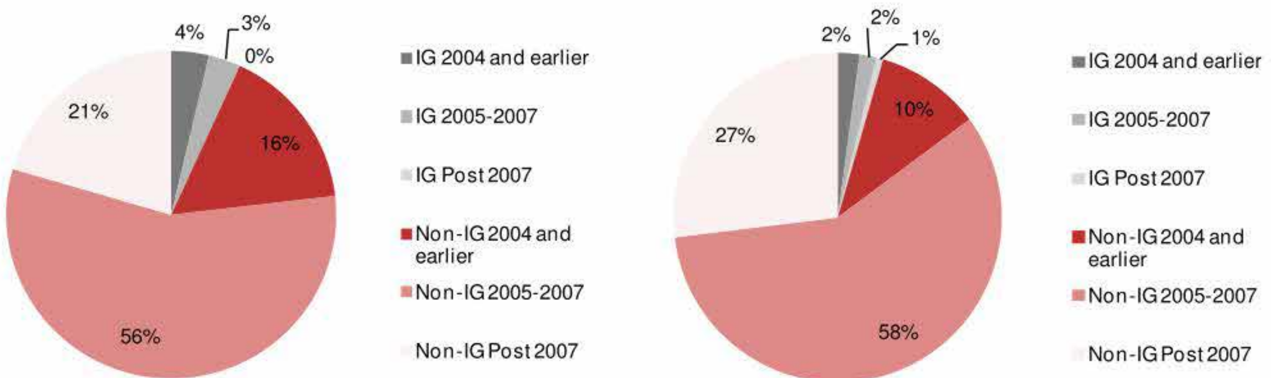
Source: TRACE, Nomura

Fig. 2: Monthly change in dealer position



Source: TRACE, Nomura

Fig. 3: Composition of trading activity for the past two weeks for Customer Buy (left) and Customer Sell (right) transactions



Source: TRACE, Nomura

Fig. 4: Summary of trading activity this week

Time period	Total Volumes (buy+sell+dealer)	Total Customer Buy Volume	Total Customer Sell Volume	Total IG Volume	Total Non-IG Volume	Total 2004 and earlier Vintage volume	Total 2005-2007 Vintage Volume	Post 2007 and later vintage volume
Last week	6.5	3.0	2.8	0.4	6.1	0.7	4.3	1.4
MTD	8.9	4.1	3.9	0.7	8.2	1.1	5.6	2.2
YTD	272.7	127.8	127.9	19.4	253.4	29.1	161.9	81.2

Source: TRACE, Nomura

CMBS Markets

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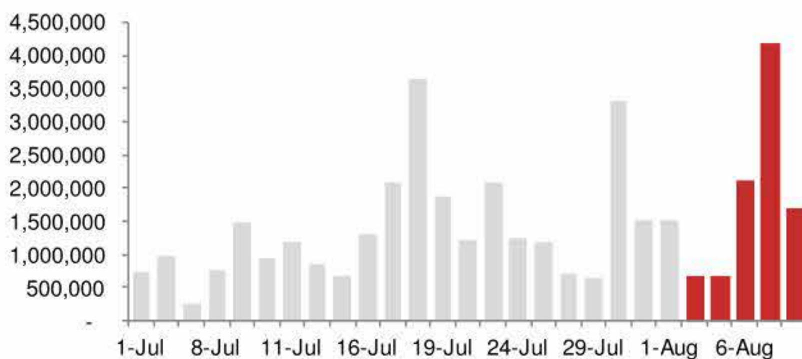
After a slow start to the week, CMBS spreads finished unchanged to marginally tighter, despite continued talk of Fed tapering, which caused equities to trade lower. Benchmark GG10 spreads closed 2bp tighter on the week, finishing at 149bp over swaps. The focus remained on new issue in the early part of the week following the placement of WFRBS 2013-C15. New issue paper was well bid and lower credit tranches priced moderately tighter than last week's offerings. Volume jumped considerably on Wednesday, aided by strong secondary volumes in new issue paper and continued A1A selling from the GSEs. According to TRACE data, a total of $4.1bn in investment grade and noninvestment grade paper exchanged hands on Wednesday, taking aggregate weekly volume north of $7.6bn (Figure 1).

Fig. 1: Daily TRACE volumes



Source: FINRA TRACE, IDC, Nomura

Positioning

While rates volatility has eased from its peak five weeks ago, it remains at elevated levels. As we had expected, increased market stability caused new issue benchmark AAA spreads to tighten to 100bp over swaps, and the latest new issue deal may price inside this level. While the benchmark spread reached a low of 72bp earlier this year, we believe spreads may fail to reach this level while rates volatility remains elevated and concerns regarding the end of the Fed's easing programs remain. However, the new issue credit curve remains steep, and we believe that spreads in the belly of the curve have more room to tighten. Therefore, we prefer adding long duration bonds further down the credit curve to take advantage of this flattening trend.

In addition, we also recommend owning AM and higher-quality AJ bonds that are likely to benefit from lower-than-expected default rates and severities, while remaining relatively immune from prepayment risk and shielded from interest rate volatility due to their shorter duration. Although we remain concerned that faster resolution rates may result in near-term losses and credit enhancement erosion to the detriment of lower-quality recent vintage AJ bonds, these tranches may experience additional price appreciation as investors are more confident in their loss projections.

CMBX Performance

Prices across the senior portion of the legacy ended Thursday's trade with a general decline on the week. On average across all series, AAA tranches outperformed closing 0.07% lower on the week, while AMs and AJs closed 0.71% and 1.34% lower. Within Series 6, prices for the BBB- tranche declined 0.89%, followed by a 0.72% decline on single-As and a 0.43% decline on subordinate AAAs.

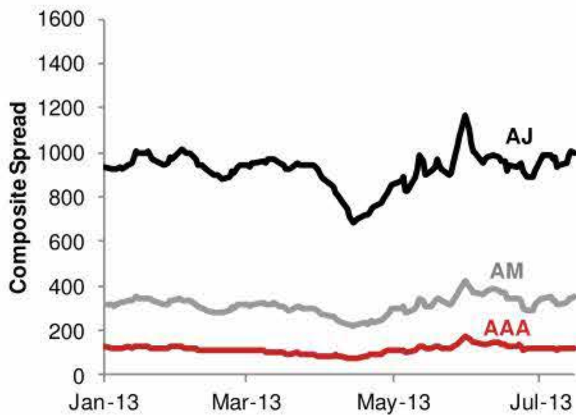
Fig. 2: CMBX weekly price changes (through Thursday's close)

	CMBX.NA.1			CMBX.NA.2			CMBX.NA.3			CMBX.NA.4			CMBX.NA.5			CMBX.NA.6		
	1-Aug	8-Aug	Diff	1-Aug	8-Aug	Diff	1-Aug	8-Aug	Diff	1-Aug	8-Aug	Diff	1-Aug	8-Aug	Diff	1-Aug	8-Aug	Diff
AAA	98.73	98.71	**(0.02)**	97.75	97.75	**-**	96.89	96.80	**(0.09)**	97.08	96.95	**(0.13)**	96.99	96.90	**(0.09)**	96.23	96.10	**(0.13)**
AM / AS	97.07	96.86	**(0.21)**	94.65	94.21	**(0.44)**	91.06	90.14	**(0.92)**	90.13	89.13	**(1.00)**	89.25	88.57	**(0.68)**	97.18	96.76	**(0.42)**
AJ	92.58	92.11	**(0.47)**	87.47	86.20	**(1.27)**	72.98	71.57	**(1.41)**	72.25	70.81	**(1.44)**	72.90	72.29	**(0.61)**			
AA	81.04	80.48	**(0.56)**	64.72	64.09	**(0.63)**	31.40	31.29	**(0.11)**	39.01	38.88	**(0.13)**	47.93	47.98	**0.05**	97.21	96.91	**(0.30)**
A	61.10	60.48	**(0.62)**	32.23	31.69	**(0.54)**	14.78	14.41	**(0.37)**	23.55	23.50	**(0.05)**	27.64	27.67	**0.03**	96.60	95.90	**(0.70)**
BBB	27.26	27.13	**(0.13)**	12.56	12.65	**0.09**	7.79	7.82	**0.03**	16.45	16.35	**(0.10)**	17.13	17.05	**(0.08)**			
BBB-	16.26	16.20	**(0.06)**	9.35	9.19	**(0.16)**	6.97	6.88	**(0.09)**	13.11	13.22	**0.11**	13.77	13.69	**(0.08)**	93.06	92.23	**(0.83)**

Source: Markit, Nomura

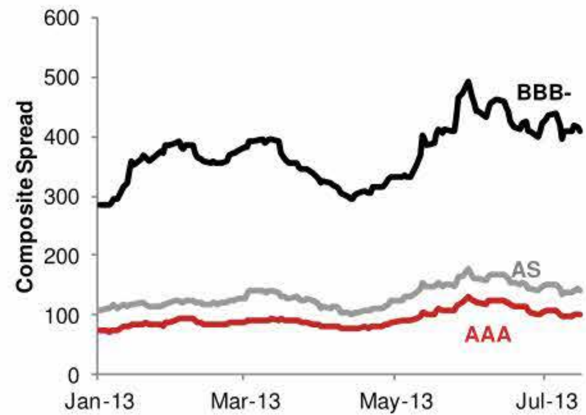
Implied spreads across the senior portion of Series 4 were wider. AM and AJ tranches closed 30bp and 57bp wider, respectively on the week, backing up to levels seen at the end of June (Figure 3). With the focus on new issuance, Series 6 fared better this week. AAA tranches widened 2bp, followed by a 5bp and 12bp widening among subordinate AAAs and BBB- tranches, respectively (Figure 4).

Fig. 3: CMBX.NA.4 implied spread levels



Source: Markit, Nomura

Fig. 4: CMBX.NA.6 implied spread levels



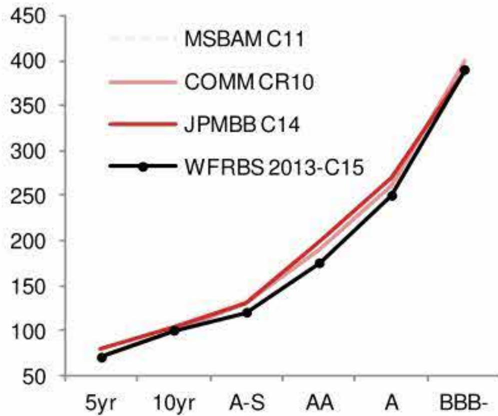
Source: Markit, Nomura

New issue trends

After placing three conduit transactions and one single-borrower deal last week, the pace of issuance slowed this week with the placement of one $1.1bn conduit transaction, WFRBS 2013-C15. According to *Bloomberg News*, the ten-year AAA class for the Wells Fargo transaction priced at 100bp over swaps, in-line with COMM 2013-CCRE10 that priced last week. Notably, pricing in the belly of the credit curve (AS, AA, A) tightened moderately, coming in 10-15bp from last week's placements.

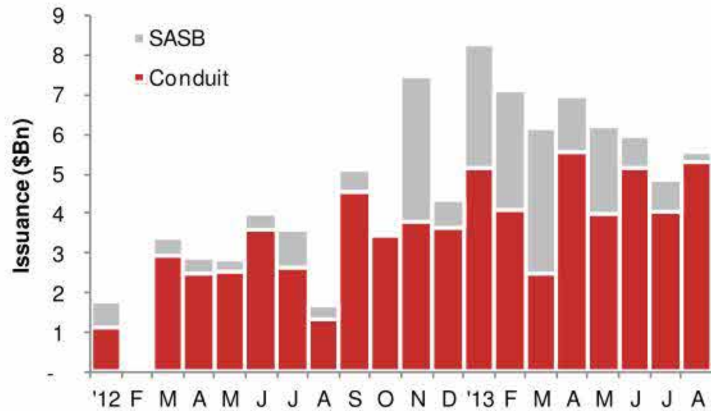
In the near term issuance is expected to remain elevated. Three transactions are currently in the marketplace, consisting of one single-borrower deal, an NPL transaction, and one conduit placement. JPMorgan is marketing a $250mn single-borrower transaction backed by 79 assisted living facilities (JPMCC 2013-ALC), while Oaktree is marketing a non-performing loan transaction (ORES 2013-LV2) collateralized by 1,151 NPL and REO properties. In the conduit space, Goldman, Jefferies, and Citi are in the market with a $1.2bn transaction (GSMS 2013-GHCJ14) and are shopping the ten-year AAA class at 98-100bp over swaps. Accounting for this week's placement and the current transactions in the marketplace leaves fixed-rate conduit placements just shy of $36bn and SASB issuance to slightly over $15bn.

Fig. 9: New issue credit curve



Source: Nomura, CRE, Bloomberg, CMA

Fig. 10: Monthly conduit + SASB issuance



Source: Nomura, CRE Direct, Bloomberg, Commercial Mortgage Alert

In the news

Property securing the Tishman Speyer DC Portfolio I loan sold

Commercial Real Estate Direct reports that Tishman Speyer has sold the Commercial National Bank Building to Paramount Group. Real Capital Analytics reports an unconfirmed sales price of $166.5mn. The property is one of four office buildings located in the Washington, D.C. area that secure a $217mn loan accounting for 6.9% of LBUBS 2007-C1. At origination, two mezzanine loans totaling $88.5mn were secured by ownership interests of the borrower. The loan is due to mature in January 2014 and is no longer subject to prepay restrictions.

Rouse reports second quarter earnings

Implications for CMBS

On August 5, Rouse Properties (NYSE: RSE) announced earnings for the second quarter of 2013. As we have noted previously, substantially all of Rouse's assets are former holdings of General Growth Properties. Of its 31 properties, 17 are secured in CMBS, with a total debt balance of $878mn (Figure 6). Several of its assets require re-tenanting and repositioning of the merchandising mix to maximize value, which it believes it can achieve by aggressively targeting tenants that cater to local demographics, improving property appeal, and repurposing big box space. Because of the collateral quality of Rouse's assets, we believe the firm serves as a strong public proxy for the performance of B quality malls.

We highlight the following themes from this quarter's results:

- The company acquired the Greenville Mall, a 460,000sf enclosed regional mall located in North Carolina, for $50mn and conveyed a deed-in-lieu of foreclosure for the $95.8mn Boulevard Mall loan (GECMC 2003-C2 and GMACC 2003-C2).
- The company refinanced the $63mn NewPark Mall loan (LBUBS 2001-C2) and the $51mn Valley Hills Mall loan (CSFB 2004-C2). The Valley Hills Mall now collateralizes a $68mn loan in COMM 2013-CCRE9.
- Four loans are scheduled to mature over the next 12 months. We expect the Southland, West Valley, and Washington Park Mall loans to pay in full. However, we are concerned about the performance for the $39.6mn Steeplegate Mall loan secured in BACM 2004-6, which matures in August 2014. The mall is 74% occupied, NOI is now 60% lower than 2008 levels, and debt service coverage has declined to 0.64x.
- Additionally, with a debt yield of 6.9%, the property would require a meaningful equity contribution from the borrower to pay off the loan. With approximately one year until

maturity and no indication of future plans by Rouse, we believe the company may be uncommitted to this asset.

- The announced redevelopment projects for the Bayshore Mall ($28mn loan in CSFB 2001-CKN5) and Sikes Senter ($56mn in JPMCC 2005-LDP3) may indicate that the company is prepping the assets for financing, raising the likelihood of early prepayment.
- We believe that the company will seek financing for these assets at or near project completion, which is estimated to occur between the fourth quarter of 2013 and the first quarter of 2014. This is approximately two years ahead of the slated maturity date for the Bayshore Mall loan and four years for the Sikes Senter loan.

Operational highlights

On August 5, Rouse Properties announced earnings for the second quarter. The firm reported core FFO of $17.2mn ($0.34 per diluted share), up from $14.4mn ($0.29 per diluted share) in the prior year period. Core NOI totaled $38.7mn in the second quarter compared with $36.9mn in the prior year period. Excluding the effects of acquisitions, dispositions and termination income, core NOI totaled $33.9mn on a same property basis, unchanged from the prior year's quarter (Figure 1).

Fig. 1: Operational Statistics

	2Q'13	2Q'12	Chg
Occupancy (%)	86.5	85.6	0.90bp
Sales PSF	297	293	1.3%
Base Rent PSF	38.63	38.01	1.6%
Occupancy Cost (%)	12.4	12.7	-0.30bp

Source: Nomura, Rouse publicly-filed documents

Development and redevelopment activity

During the quarter, Rouse announced capital projects at Bayshore Mall, Lansing Mall, and a cosmetic capital project at Sikes Senter Mall. Both Bayshore and Sikes Senter are securitized in CMBS, while the Lansing Mall is unencumbered. Based on the company's capital investment and focus on these assets we believe that Rouse is committed to these properties and we expect them to perform. In addition, we also believe that the company will seek financing for these assets as capital projects near completion which is consistent with its goal of generating excess proceeds. As evidence, Rouse recently refinanced the $59.7mn Lakeland Square Mall loan secured in MSC 2004-T13. While completion of the $13mn capital project is not expected until the fourth quarter of 2013, the property was given a $70mn loan, which has been securitized into COMM 2013-CCRE7.

Located in Eureka, CA the Bayshore Mall collateralizes a $28mn mortgage secured in CSFB 2001-CKN5 that is scheduled to mature in September 2016. Through the first three months of 2013, collateral was 71% occupied, generating annualized NOI and DSCR of $2.4mn and 0.82x, respectively. Since year-end 2012, occupancy has declined 7% from 78%, and total income has declined by 11%. Under the capital redevelopment project, Rouse plans to spend $8.3mn to convert unproductive space to accommodate new tenants, which includes TJ Maxx, Ulta, and The Sports Authority. The project is expected to be completed in the first quarter of 2014.

At Sikes Senter, Rouse is implementing a cosmetic renovation plan that includes the installation of new flooring, lighting, upgrading interior and exterior signage. The mall collateralizes a $56.2mn mortgage, which is secured in JPMCC 2005-LDP3. At year-end 2012 the property was 97% occupied and carried NOI DSCR of 1.24x. Completion of the renovation is expected to occur in the fourth quarter of 2013.

At the Lansing Mall, Rouse is investing $14.9mn to replace vacant anchor space with a Regal Cinema and adding multiple outparcels. The project is expected to conclude in the third quarter of 2014.

Acquisition and disposition activity

Subsequent to the quarter, Rouse acquired the Greenville Mall for $50.3mn, assuming a $41.7mn mortgage (not securitized). Located in North Carolina, the 460,000sf mall generates in line shopping sales of $375psf and is anchored by Belks, JCPenney and Dunham's Sports. According to Rouse the asset is the only enclosed regional mall within a 40 mile radius.

On the disposition front, the company provided a deed-in-lieu of foreclosure The Boulevard Mall located in Las Vegas, NV. As we have written previously, the property collateralizes a $95.8mn mortgage securitized across GECMC 2003-C2 and GMACC 2003-C2. The collateral is 89% occupied and produces NOI debt service coverage of 0.99x. Based on current NOI and a stressed cap rate methodology, we project a 20% to 30% loss severity range for this asset.

Financing activity

During the quarter the company obtained financing for two loans. Consistent with our expectation, Rouse refinanced the $62.9mn NewPark Mall loan securitized in LBUBS 2001-C2, replacing it with a $71.5mn, four-year, non-recourse floating rate loan with a coupon of Libor+405bp. It also placed a new $68mn non-recourse mortgage loan on the Valley Hills Mall (COMM 2013-CCRE9), defeasing the $52mn loan secured in CSFB 2004-C2.

Rouse faces four upcoming maturities within the next 12 months, as the loans on Southland Mall, West Valley Mall, Washington Park Mall, and Steeplegate Mall come due (Figure 2). With debt yields in excess of 12% for Southland, West Valley, and Washington Park, we believe that Rouse will be able to successfully refinance these assets. However, we are concerned about the impending maturity of the $39.6mn Steeplegate Mall loan.

Fig. 2: Rouse's upcoming maturity schedule

Deal	Loan Name	Prepay	Bal ($mn)	Location	Occ %	NOI	DSCR	DY	Maturity
GCCFC 2004-GG1	Southland Mall	(1)	71.9	Hayward, CA	91	11.11	1.93x	15.5%	Jan-14
BSCMS 2003-T12	West Valley Mall	(1)	47.1	Tracy, CA	94	6.18	1.31x	13.1%	Jan-14
WBCMT 2004-C12	Washington Park Mall		11.0	Bartlesville, OK	95	1.60	1.81x	14.5%	Apr-14
BACM 2004-6	Steeplegate Mall	(1)	39.6	Concord, NH	95	2.74	0.64x	6.9%	Aug-14

Source: Nomura, Trepp, Rouse publicly-filed documents

Steeplegate: a continual decline in occupancies and NOI

Scheduled to mature in August 2014, the Steeplegate Mall faces a variety of performance issues. Through the first three months of 2013, the collateral generated annualized NOI of $2.7mn which is sufficient to create five consecutive annual declines, an aggregate drop of 60% since 2008. Over the same timeframe, occupancy has declined from 97% to 86% based on remitted data (Figures 3 and 4). According to Rouse's second quarter 2013 filings, mall occupancy is substantially lower, totaling 74%. The substantial drop in occupancy is mainly caused by the closure of Circuit City (7% of NRA), as well as national brands such as Gap and Coach.[4]

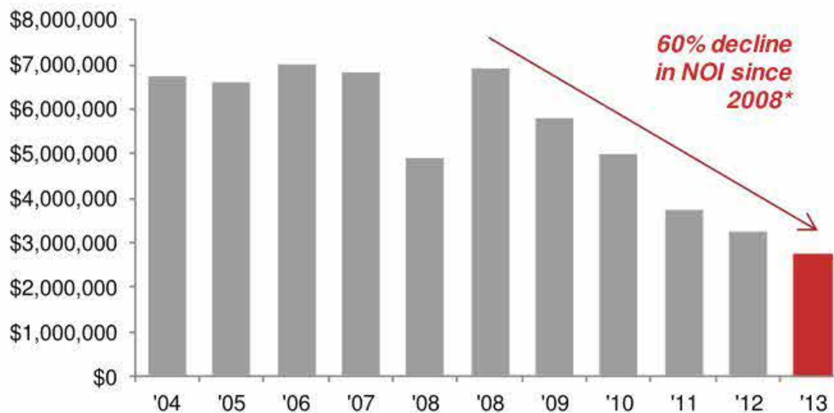
Based on current NOI, cash flow is substantially below debt coverage levels and the asset's current debt yield of 6.9% indicates that refinancing would require a meaningful equity contribution from the borrower to right size the value. Through the first quarter of 2013, the property generated NOI DSCR of 0.64x.

On the company's fourth quarter conference call in March, Rouse stated that cap rates for B Malls, or mid-market malls, are transacting in the 7% to 8% range. Applying a 7.5% cap rate to current NOI indicates a current valuation of $39.1mn, roughly equivalent to the outstanding debt. This implies that the company would have to fund $16mn in equity to reach a 65% LTV, which is the conduit average for retail loans securitized in 2013. While this contribution would sufficiently recapitalize the asset, we believe the property is unlikely to obtain financing in its current condition without a capital investment plan.

[4] Ben Leubsdorf, "Gap's departure leaves hole", The Concord Monitor, 28 January 2011, http://www.concordmonitor.com/news/4592658-95/steeplegatemall-gap-coach-newsshop

With approximately one year until maturity and no indication of future plans by Rouse, we believe the company may be uncommitted to this asset. Barring any substantial leasing activity over the next year, we believe this asset faces heightened default risk at maturity.

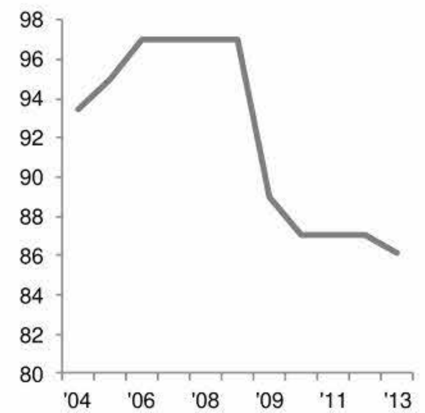
Fig. 3: Steeplegate NOI trend since securitization



*Based on 1Q'13 annualized NOI

Source: Nomura, Trepp

Fig. 4: Steeplegate occupancy trends



Source: Nomura, Trepp

Assessing the likelihood of loan prepayment

Following the resolution of these four assets, Rouse will have fulfilled its CMBS maturity obligations until 2016. However, five loans within its portfolio would still retain their prepayment option, as specified under GGP's bankruptcy resolution. Based on prior commentary, several factors influence Rouses decision to refinance an asset including:

- Decreasing the amount of recourse financing
- Reducing the weighted average interest rates
- Laddering and extending the debt maturity profile
- Generating excess refinancing proceeds.

Using Rouse's criteria, we can estimate the likelihood of loan prepayment. For our estimates, we apply a 7.5% cap rate to the most recent NOI to value the properties and assume the assets can secure takeout financing at a 65% LTV and a 4.73% interest rate. We base our cap rate assumption on commentary from Rouse, our LTV estimate on historical data, and our interest rate equates to the recent rate given to the Valley Hills Mall.

At this cap rate, all five of the remaining loans carry a valuation in excess of their current loan balance. However, none of these malls could refinance at a 65% LTV without an equity contribution from the company. As a result, we believe that Rouse will likely concentrate its financing efforts on the upcoming 2014 maturities (Southland and West Valley) and malls with a current capital investment program, such as the Bayshore Mall and Sikes Senter. Thereafter, the company may potentially invest the loan proceeds into the remaining malls to rehabilitate the assets before refinancing (Figure 5).

Fig. 5: CMBS loans open to prepayment ($ in millions)

Deal	Loan	Occ	Bal. ($mn)	Maturity	NOI	Value @ 7.5% cap	proceeds @ 65 LTV	Rem. Term (mo)	Current cpn %	Int. savings from refi @ 4.73%	Prepay Net Benefit
GCCFC 04-GG1	*Southland Mall*	*90*	*71.9*	*Jan-14*	*11.1*	*148*	***24***	*5*	*3.62%*	*(1)*	***24***
BSCMS 03-T12	*West Valley Mall*	*92*	*47.1*	*Jan-14*	*6.5*	*87*	***9***	*5*	*3.43%*	*(0)*	***9***
BACM 04-6	*Steeplegate Mall*	*87*	*48.6*	*Aug-14*	*2.7*	*36*	***(25)***	*12*	*4.94%*	*1*	***(24)***
LBUBS 01-C3	Vista Ridge Mall	93	72.4	Apr-16	7.4	98	**(8)**	32	6.87%	5	**(3)**
JPMCC 01-CIB2	Collin Creek Mall	97	61.0	Jul-16	5.0	67	**(17)**	35	6.78%	6	**(11)**
CSFB 01-CKN5	Bayshore Mall	71	28.1	Aug-16	2.4	32	**(7)**	36	7.13%	3	**(4)**
GECMC 05-C4	Grand Traverse Mall	83	60.8	Feb-17	5.6	74	**(12)**	42	5.02%	3	**(10)**
JPMCC 05-LDP3	Sikes Senter	97	56.2	Jun-17	5.3	71	**(10)**	46	5.20%	3	**(7)**

Source: Nomura, Trepp

Fig. 6: CMBS exposure to Rouse Properties (sorted by maturity date)

Deal	Loan Name	Prepay	Bal ($mn)	Location	Occ %	DSCR	Maturity
GCCFC 2004-GG1	Southland Mall	(1)	71.9	Hayward, CA	90	2.26x	Jan-14
BSCMS 2003-T12	West Valley Mall	(1)	47.1	Tracy, CA	92	1.64x	Jan-14
WBCMT 2004-C12	Washington Park Mall		11.0	Bartlesville, OK	99	1.83x	Apr-14
BACM 2004-6	Steeplegate Mall	(1)	39.6	Concord, NH	NA	0.64x	Aug-14
LBUBS 2001-C3	Vista Ridge Mall	(1)	72.4	Lewisville, TX	93	1.04x	Apr-16
GCCFC 2006-GG7	The Mall at Turtle Creek		79.0	Jonesboro, AR	90	1.07x	Jun-16
JPMCC 2001-CIB2	Collin Creek Mall	(1)	61.0	Plano, TX	97	0.87x	Jul-16
CSFB 2001-CKN5	Bayshore Mall	(1)	28.1	Eureka, CA	71	0.82x	Sep-16
GECMC 2005-C4	Grand Traverse Mall	(1)	60.8	Traverse City, MI	83	1.34x	Mar-17
JPMCC 2005-LDP3	Sikes Senter	(1)	56.2	Wichita Falls, TX	97	1.24x	Jun-17
WBCMT 2005-C22	Knollwood Mall		36.7	St. Louis Park, MN	91	1.29x	Oct-17
GECMC 2003-C2	Boulevard Mall*		56.9	Las Vegas, NV	89	0.99x	Jul-18
GMACC 2003-C2			38.9				
UBSBB 2012-C2	Pierre Bossier Mall		47.7	Bossier City, LA	86	1.97x	May-22
UBSBB 2012-C2	Southland Center Mall		77.7	Taylor, MI	87	1.38x	Jul-22
WFRBS 2012-C10	Animas Valley Mall		51.3	Farmington, NM	92	1.84x	Nov-22
COMM 2013-CCRE7	Lakeland Square Mall		69.7	Lakeland, FL	94	1.83x	Apr-23
COMM 2013-CCRE9	Valley Hills Mall		68.0	Hickory, NC	86	1.62x	Jul-23

**A deed in lieu of foreclosure has been provided to the lender*

Source: Nomura, Trepp, Rouse publicly-filed documents

Vornado reports second quarter earnings

Implications for CMBS

On August 5, Vornado Realty Trust (NYSE: VNO) released second-quarter earnings reporting strong results for New York office and street retail, strip centers and malls, while the DC office market remained soft. Due to the sizeable exposure to Vornado within CMBS, the firm's strategies are likely to have a significant impact. Across its portfolio, Vornado has a total of $14.4bn in encumbrances, of which approximately $6.3bn is securitized within fixed-rate conduit CMBS transactions.

We highlight the following themes from this quarter's results:

- Regarding **Skyline**, Vornado's largest distressed asset, company commentary indicates that resolution of the $678mn Skyline Portfolio loan is likely to come in the form of an A/B Note split and an equity contribution. Additionally, Vornado unveiled the signing of an 182,700sf lease with the US Fish and Wildlife Service at the Skyline Technology Center, which boosts Skyline Portfolio occupancy by 6.9% to 61.7%.
- Based on portfolio occupancy, accumulated interest forbearance, as well as the amount of capital expenditures necessary to rehabilitate the portfolio, we stand by our initial assessment of a 40% loss severity.
- Vornado is currently negotiating a workout for the $120mn **Montehiedra Town Center** loan secured in GCCFC 2006-GG7. Based on Vornado's desire to reposition the asset and its strength as sponsor, we believe that it may obtain a modification involving a 70/30 A/B Note split.
- The firm faces minimal maturity risk. The company used existing cash to repay the $97mn **Broadway Mall** loan secured in GCCFC 2003-C2, despite a 0.67x DSCR and a 5.9% debt yield. After this repayment, the firm has only $177mn worth of maturing mortgage debt left for 2013 and an additional $236mn in 2014, none of which is included in CMBS.
- The company continues to display its commitment to simplifying the corporation, disposing of $1.2bn of non-core assets to date in 2013, in addition to the $1.7bn sold in

2012. The firm also announced an additional $500mn of non-core asset dispositions; however, we believe that this activity is concentrated among smaller balance retail assets, and its effect on CMBS is likely to be limited.

Operational highlights

Vornado reported comparable Funds from Operations of $244mn for the quarter, or $1.30 per share, a 22% increase from the prior year's quarter. FFO gains are primarily attributed to strong EBITDA growth among the New York segment and modest growth within the retail segment, which offset a continuation of poor performance in the DC market.

The firm reported $3.5bn in liquidity consisting of $1.1bn of cash and $2.4bn of undrawn revolving credit facilities, a $1bn increase from year-end 2012. The liquidity build is attributed to proceeds from asset sales and secured debt financing. In addition to the $1.7bn in non-core assets sold in 2012, Vornado has disposed of $1.2bn year to date. In the second quarter, Vornado disposed of 12 assets, including LNR, assets in San Jose, Philadelphia, and a portfolio of small retail assets.

It also completed a $550mn refinancing of Independence Plaza (previously secured in COMM 2005-FL11 and 2006-FL12), generating $137mn in its share of proceeds. The company's existing cash was used to repay $149mn in mortgage debt, which included the $97mn Broadway Mall loan that was previously secured in GCCFC 2003-C2. The firm has only $177mn worth of maturing mortgage debt left for 2013 and an additional $236mn in 2014, none of which is included in CMBS.

Segment results

Vornado's portfolio of assets is divided into four major segments, comprising its New York holdings of office and retail properties, its DC office portfolio and its portfolio of retail strip centers and malls. The firm also retains a smaller segment of other assets containing properties such as the Chicago Merchandise Mart, 555 California Street, and its real estate fund. Vornado's New York and Washington businesses together account for approximately 90% of company EBITDA.

The **New York** segment produced $235.7mn of comparable EBITDA which is $28.2mn or 13.6% ahead of last year's second quarter. The division benefited from increased leasing activity across all product segments, a decline in subletting and broad demand from a variety of tenants. On the call it stated that, with a 12% availability rate, New York is near a "tipping point" to becoming a landlord's market.

The 300,000sf of sublease space put on the market by AXA at 1290 Avenue of the Americas (VNDO 2012-6AVE) has been leased, with Morgan Stanley, Sirius, and Remi Martin taking space. The property is now 97.4% occupied.

Within its **Retail** segment, the strips and malls business generated $53.9mn of comparable EBITDA, approximately 3% ahead of last year's second quarter. High barrier to entry locations and strong anchors continue to drive segment leasing.

The **Washington** segment generated $84.8mn of comparable EBITDA in the three months ending June 2013, which is nearly 7% behind last year's second quarter. BRAC-related vacancies and a sluggish lease environment continue to weigh on the performance of this segment. Segment occupancy declined by an additional 20bp from the first quarter to 83.6%, impacted by a 54.8% occupancy rate at Skyline. Vornado expects the sluggish performance to bottom in the third quarter, before rebounding in the fourth, causing full-year 2013 EBITDA to come in $10-$15mn lower than 2012.

Skyline to secure a new tenant and a modification

While Vornado's news on the Washington segment was generally negative, the firm reported positive developments for the Skyline Portfolio. During the earnings call, the company announced that it is in the process of signing an 182,700sf lease with the United States Fish and Wildlife Service who will move into Skyline Technology Center in mid-2014. The Washington Business Journal reported previously that Vornado was in contention for the

$8.7mn lease.[5] The building was fully vacated by BRAC in late 2011. With this lease, Vornado will have re-leased over 54% of the 2mn sf of BRAC space that has expired to date. The signing of the Fish and Wildlife Service will raise occupancy for Skyline by 6.9%, taking the overall level to 61.7%. Fish and Wildlife will join Analytic Services who moved into 88,000 square feet earlier this year. As we estimated last quarter, the addition of the Fish and Wildlife lease has the potential to add $5.2mn to NOI, increasing DSCR levels from 0.96x to 1.09x.

Background

As a refresher, this $896mn loan is securitized pari passu across three trusts, GECMC 2007-1, JPMCC 2007-LDPX and BACM 2007-1. The loan is collateralized by a first mortgage on eight multi-story office buildings containing approximately 2.56mn sf located in Falls Church, Virginia. At securitization the portfolio was 97% occupied and generated $52.9mn in NOI resulting in 1.34x debt service coverage. The portfolio was largely impacted by the Base Realignment and Closure (BRAC) statute, which required the Department of Defense to relocate from 2.4mn square feet in its buildings in Northern Virginia to government-owned military bases.

As a result of the consolidation, portfolio occupancy declined to 86% by year-end 2011. The loan was transferred to the special servicer, CW Capital, in the first quarter of 2012, who executed an interest forbearance agreement for the duration of the modification negotiations which has accumulated to $47.5mn.

On the call, Vornado indicated that it is in the final stages of negotiation and has an agreement on the structure of the modification for this loan. According to the company:

> ***"the arrangement will allow us to infuse the capital that's necessary to re-lease that building in approximately the middle of the capital stack of the loan where we think we have a secure interest...the lender would also rather have us lease up the property...than giving back the keys right now"***

Vornado expects the modification documents to become public over the next two to three months. The commentary suggests that the special servicer will grant a modification in the form of an A/B note split, in line with our initial assessment in July 2012. Based on portfolio occupancy, the size of the forbearance, as well as the amount of capital expenditures necessary to rehabilitate portfolio, we stand by our initial assessment of a modification involving an A/B note split, resulting in a 40% loss severity upon resolution.

Fig. 1: CMBS exposure to Skyline

Loan	Deal	Bal ($mn)	Pct	Occ	'12 DSCR	Maturity
Skyline Portfolio		**678.0**		**58%**	**0.96x**	**Feb-17**
	GECMC 2007-C1	203.4	7%			
	JPMCC 2007-LDPX	203.4	5%			
	BACM 2007-1	271.2	13%			

Source: Nomura, Trepp

Negotiating a modification for Montehiedra

On the conference call, Vornado noted that it is negotiating for a modification of the $120mn Montehiedra Town Center loan secured in GCCFC 2006-GG7, which transferred to the special serving in June. According to the company, the asset has deteriorated and is currently impacted by several competing centers. Through the first three months of the year, the asset reported an NOI DSCR of 1.05x, down from 1.14x for the full-year 2012. The collateral is now 89% occupied, down from 98% at securitization, and faces additional rollover risk with the Marshall lease expiry in January 2014.

[5] Daniel J.Sernovitz, "Arlington bracing for loss of Fish and Wildlife headquarters", *The Washington Business Journal*, 13 June 2013, http://www.bizjournals.com/washington/breaking_ground/2013/06/arlington-bracing-for-loss-of-second.html?page=all

On the call Vornado indicated that it plans to add capital and redevelop the asset into an outlet center if negotiations with the special servicer were successful. A local newspaper reported that the company has plans to expand the mall by 120,000sf beginning in 2014.[6]

Given Vornado's strength as sponsor and its desire to invest in the center, we believe that the special servicer, C-III, may offer a modification in the form of an A/B Note split. With limited market comps we apply a conservative 9% cap rate to 2013 annualized NOI of $7.7mn, implying a $96.5mn valuation. This would imply a near-70/30 split under an A/B modification structure which would be sufficient to cause $177,000 in interest shortfalls monthly.

Fig. 2: Montehiedra Town Center

Loan	Deal	Bal ($mn)	Pct	Occ	'12 DSCR	Maturity
Montehiedra Town Center	GCCFC 2006-GG7	120.0	4%	89%	1.05x	Feb-17

Source: Nomura, Trepp

[6] Alex Diaz, "Montehiedra to 'shape up' retail market by converting to outlet mall", *Caribbean Business*, 28 February 2013, http://caribbeanbusinesspr.com/prnt_ed/montehiedra-to-shake-up-retail-market-by-converting-to-outlet-mall-8188.html

Disclosure Appendix A-1

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