Economic Outlook

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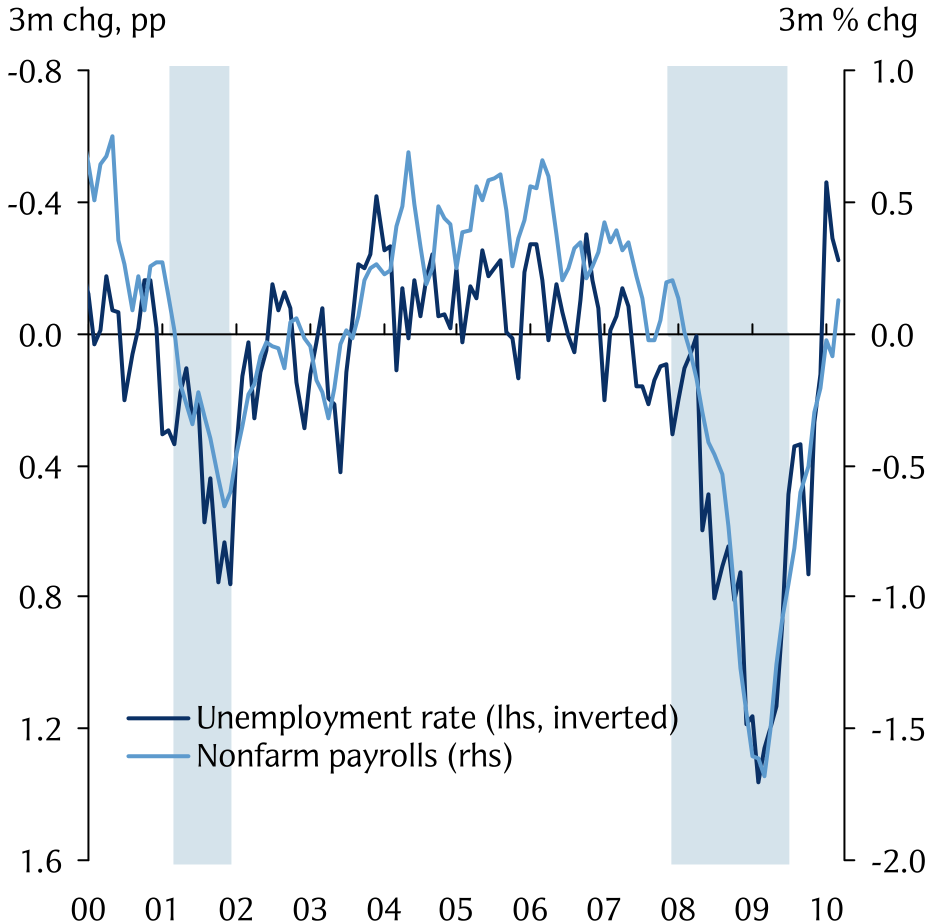
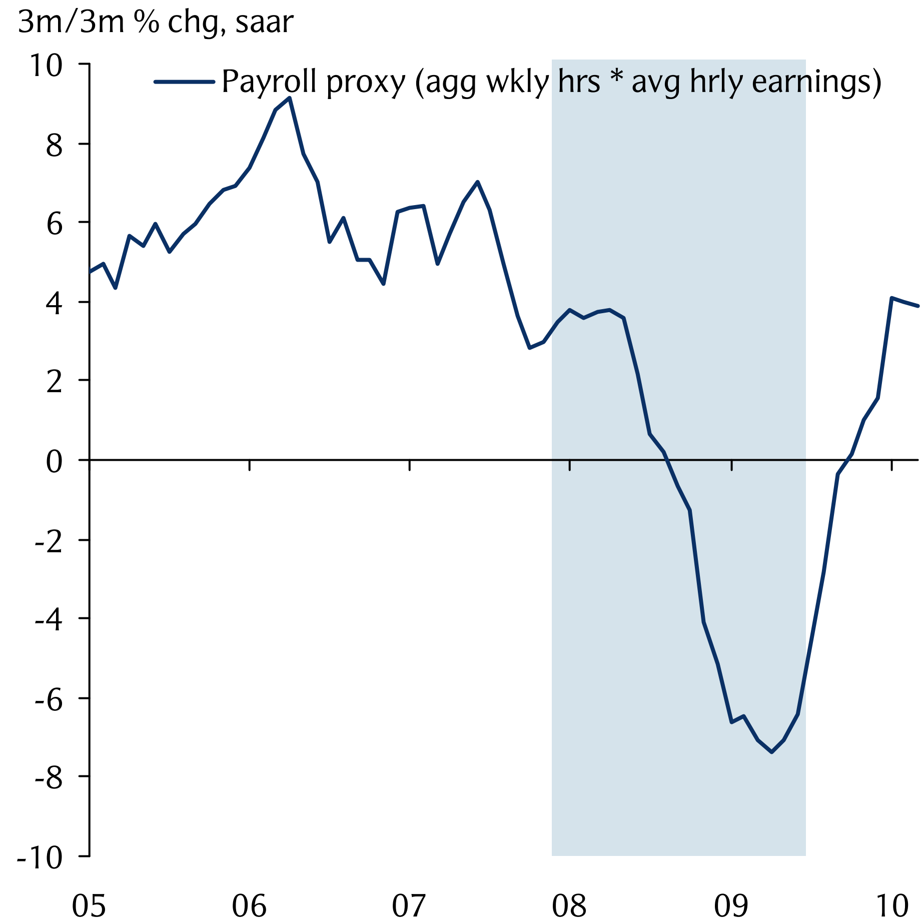
April 2010

PLEASE SEE ANALYST CERTIFICATION(S) AND IMPORTANT DISCLOSURES STARTING AFTER PAGE 21

The labor market is improving, boosting household income





Note: Shading indicates recession. Source: BLS, Haver Analytics, Barclays Capital

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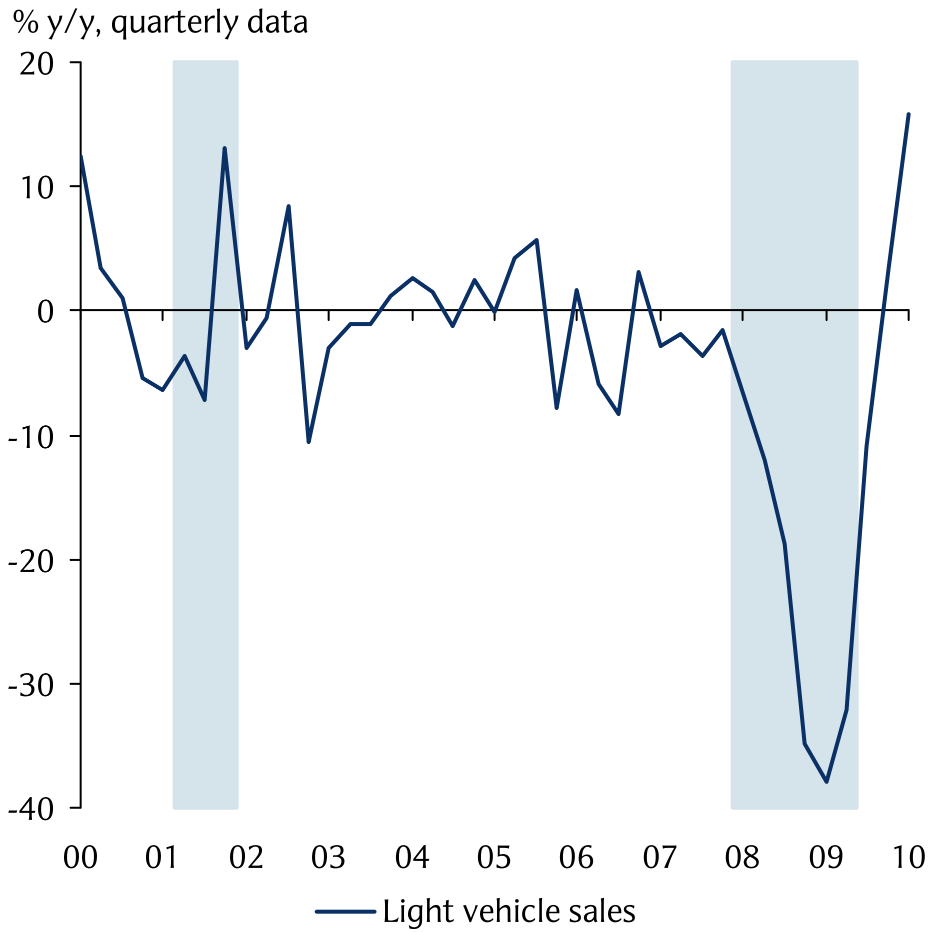
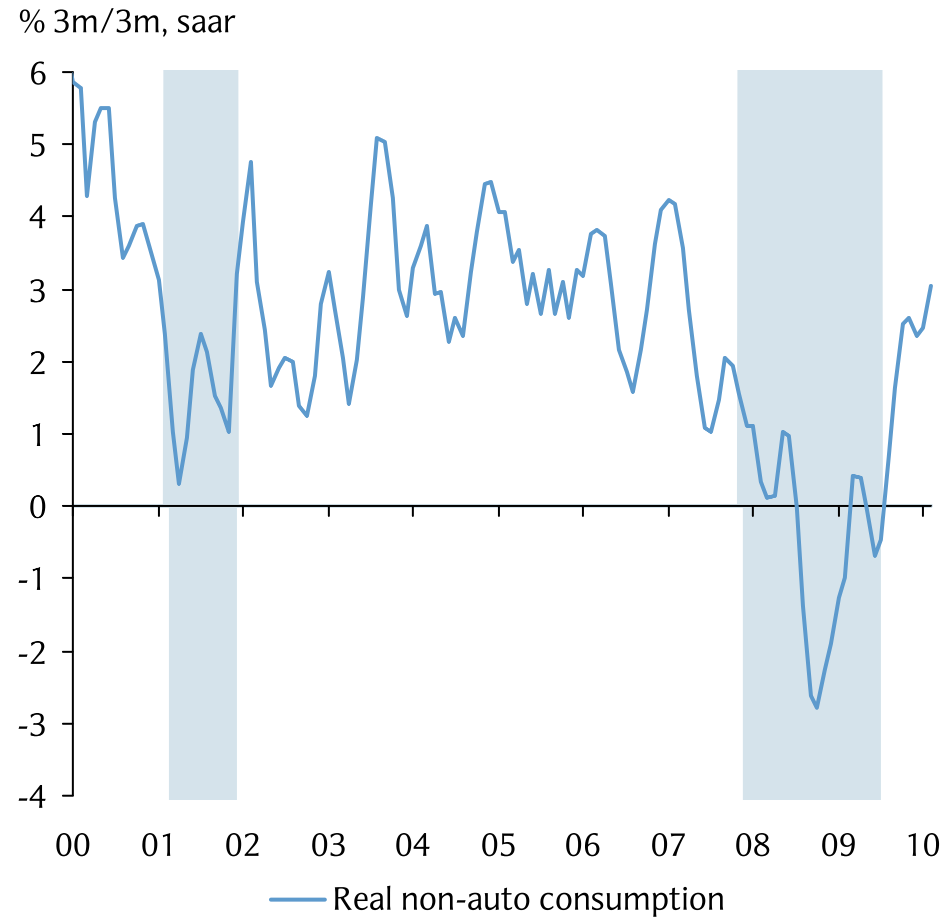
Consumers are spending the additional income they are earning





Note: Shading indicates recession. Source: BEA, Autodata, Haver Analytics, Barclays Capital

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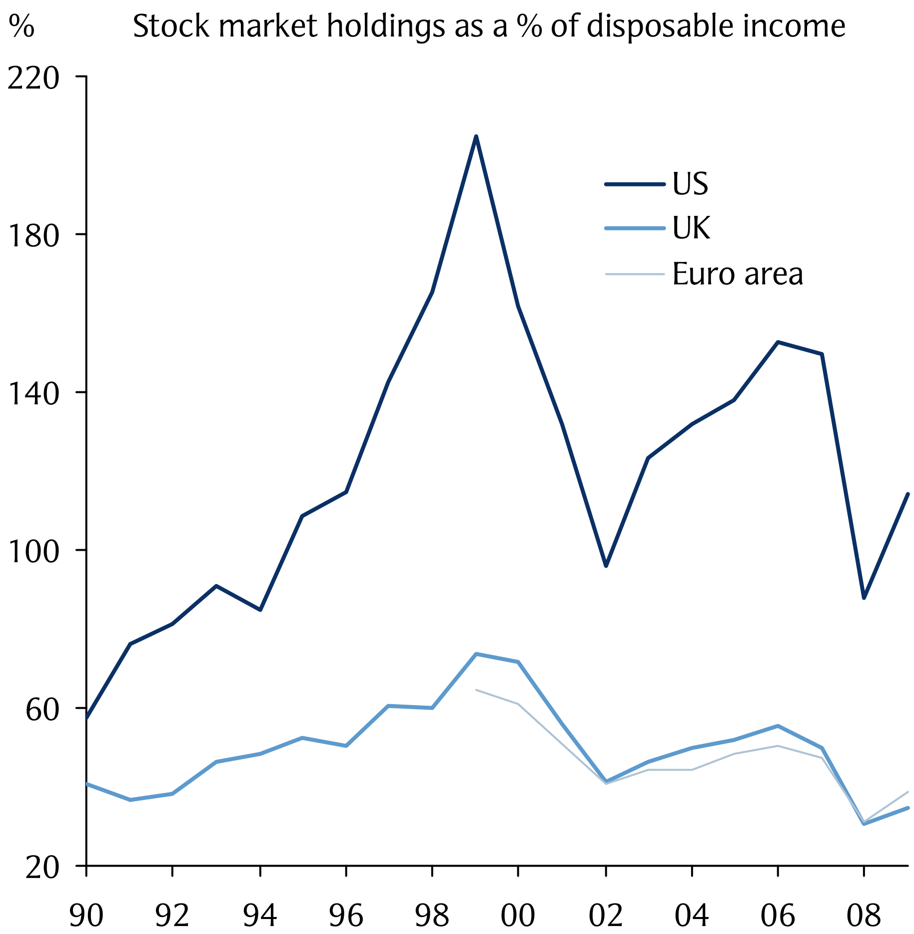
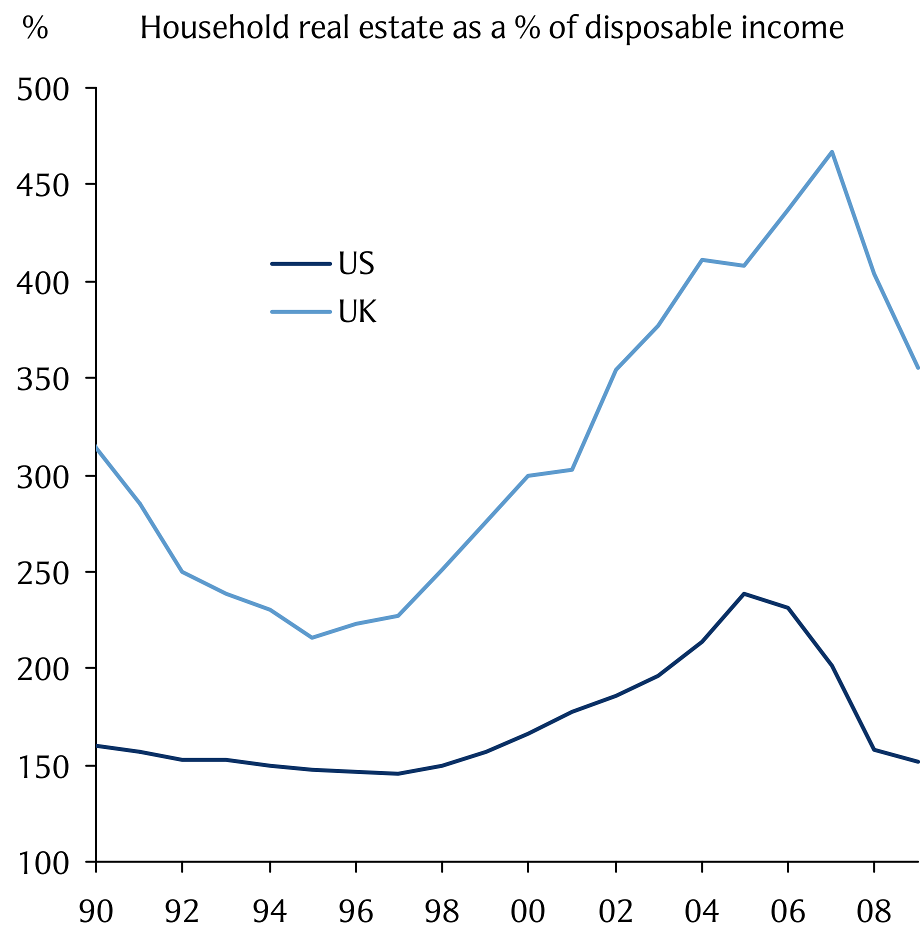
US households more exposed to equities, but less exposed to real estate





Note: Stock market data exclude holdings by defined benefit plans and life insurance companies as well as unquoted equities. 2009 real estate observation for UK is estimated using house price changes. Source: Federal Reserve, Eurostat, ONS, FTSE, Haver Analytics, Barclays Capital

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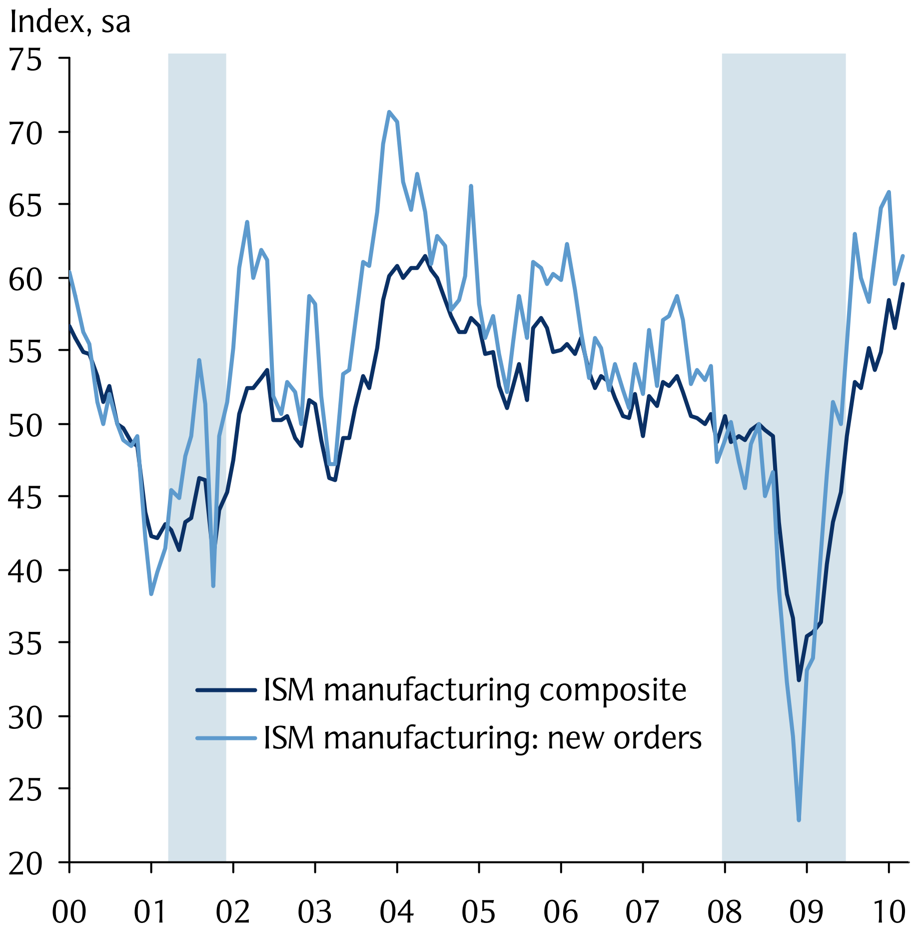
ISM inventories and exports are popping higher



Note: Shading indicates recession. Source: ISM, Haver Analytics, Barclays Capital

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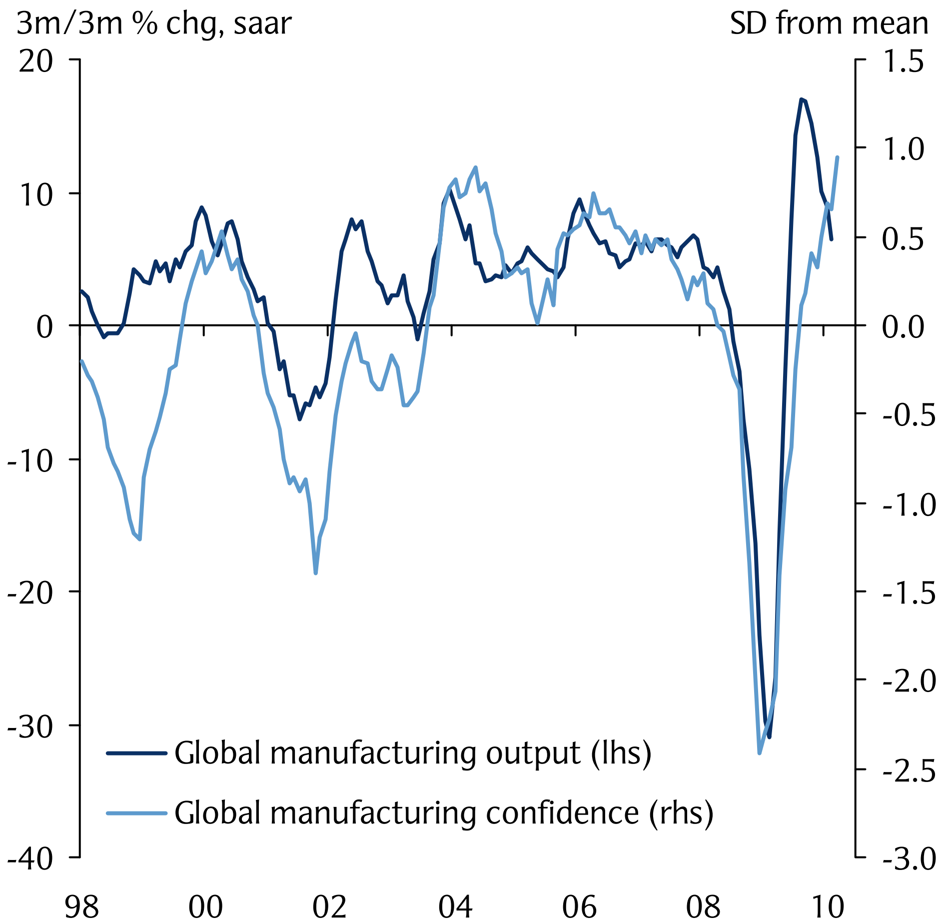
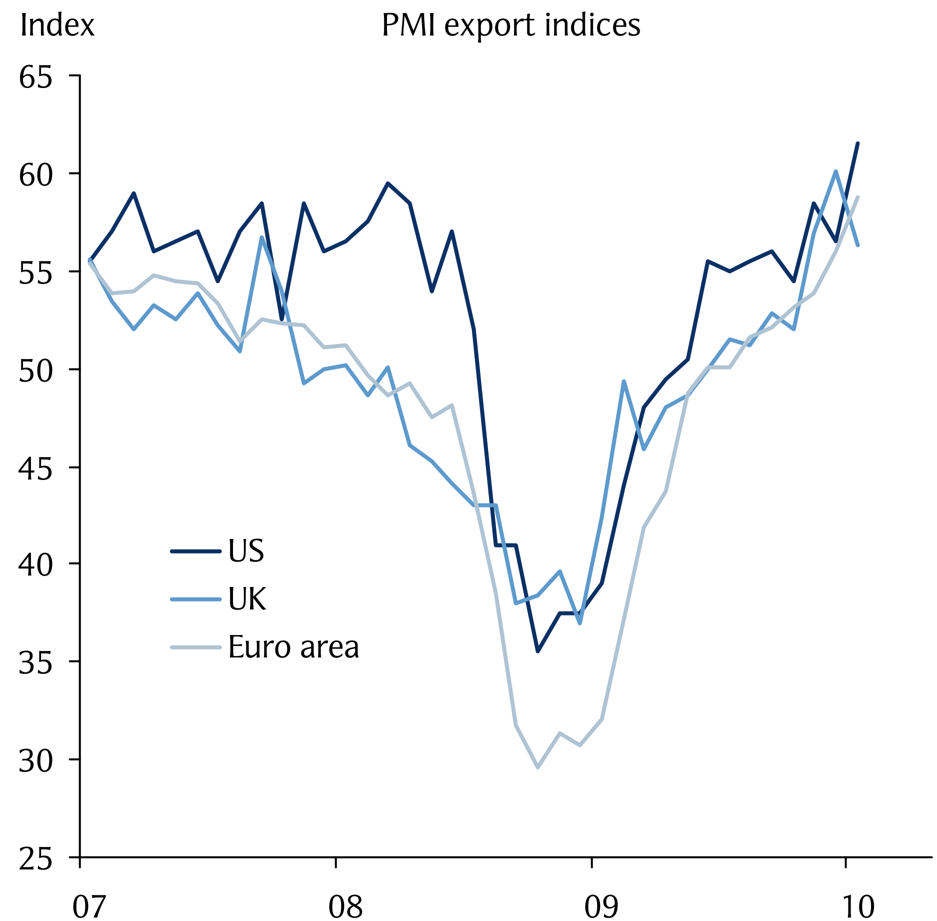
Global manufacturing confidence is at a cyclical peak





Source: Datastream, Markit, ISM, Haver Analytics, Barclays Capital

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US Rates Outlook

Ajay Rajadhyaksha, Head of US Fixed Income and Securitized Products Strategy
Anshul Pradhan, US Fixed Income Strategy

April 2010

Macro Views at the Start of 2010…

- Rate sell-off in Dec 2009 will take a breather in Q1…
  - …before rates start rising again by the end of Q1, and over Q2-Q4
  - 2s/10s should remain steeper than the forwards, and stay at record-steep levels
  - 5s/30s is a good way to put on steepeners, especially going into bond auctions
- Swap spreads should tighten, and 10-year swap spreads turn negative…
  - …driven by massive Treasury issuance as well as a deteriorating fiscal situation
- Sell gamma – low realized vol and range-bound rates in Q1, supply, and a weak mortgage option
  - …while we expected longer expiries to hold up better
- End of the Fed's asset purchase program would not be an 'event' for MBS spreads…
  - …though 15-20 bp of spread widening likely
- Housing and securitized markets pose far lower systemic risk…
  - …but home prices have very limited upside for several years

…and Macro Views Going Forward

- Rate sell-off should continue, though in a contained fashion…
  - …and the curve should stay steeper than the forwards for several months
  - Especially with the latest payroll report taking away a major part of the bond bulls' argument
- Fair value for 10-year swap spreads is still negative…
  - …though the near-term widening is not a surprise after the sharp move 2 weeks ago
- Gamma has little further downside – the focus should shift to intermediate expiries
  - The vol curve is too steep – sell 2y*10y hedged with 3M*10y
  - Supply of vol should continue to be a factor pressuring all options lower
- There should be little MBS spread widening left – and we turn Overweight on the basis now
  - Limited home price declines, especially as the latest HAMP program increases bottlenecks
- We still like many of the trades recommended at the start of the year, but a lot has already been realized
  - So conviction on trades is that much lower

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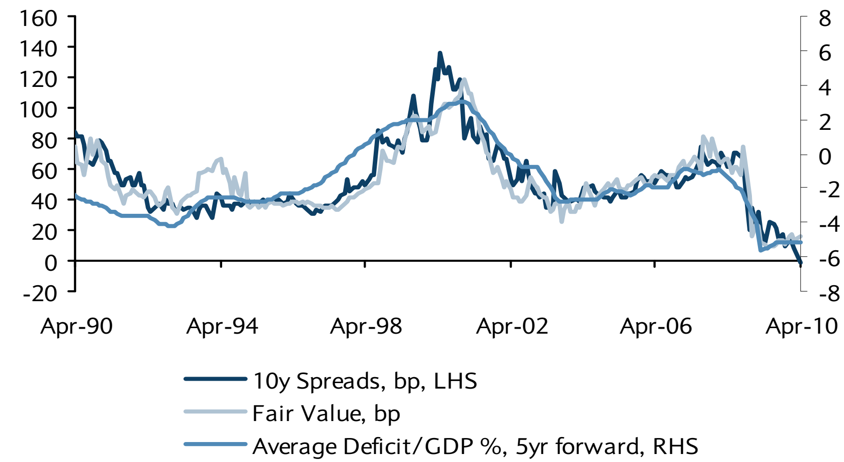
Macro Effects of the New Housing/Mortgage Programs

- HAMP program – 20-40% of all HAMP modifications
  - …but 3-4MM modified loans will still be very difficult
- FHA Refi program – 88bn in possible agency refis / 51bn in possible non-agency refis
  - Realistically, 50-60% of this universe of 140bn will end up refinancing
  - FHA supply should pick up by 50-100bn but impact on agency speeds is muted
- Housing – further slowdown in foreclosure to REO roll rates
  - Home price declines might be even more muted than our 4-5% forecast
- Banks – Losses should be 25-30bn lower on residential loan books
  - …led by lower losses on first liens, but the change is not huge given future bank losses of 800+bn
- Many operational challenges remain, and many questions are not yet answered…
  - …while debt forgiveness could increase moral hazard risk

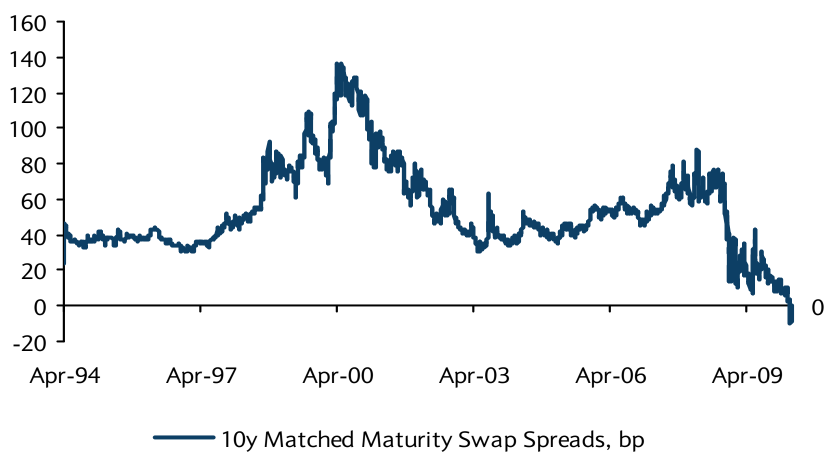
10y Spreads Should Trade in Negative Territory

- 10y spreads are still trading quite tight relative to history
- Forward-looking budget deficit expectations are the main driver
- 10y spreads should be trading in negative territory to reflect persistent deficits.

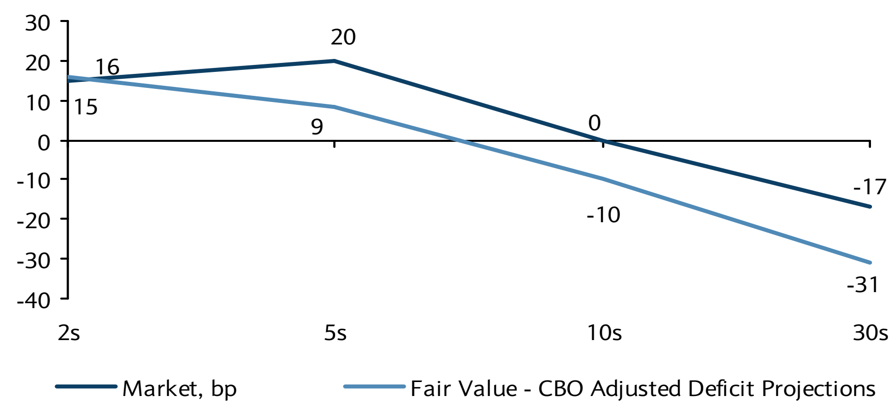
Main Driver: Budget Deficit Expectations



10y spreads: A Historical Perspective



10y Spreads Should be Negative



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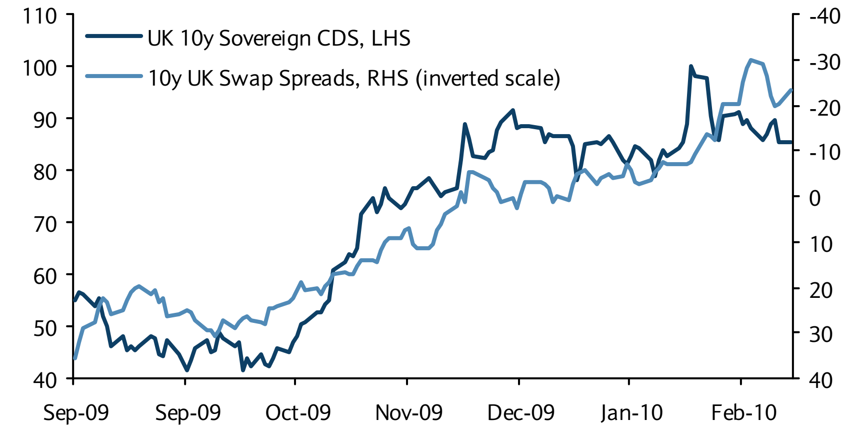
Source: CBO, Barclays Capital

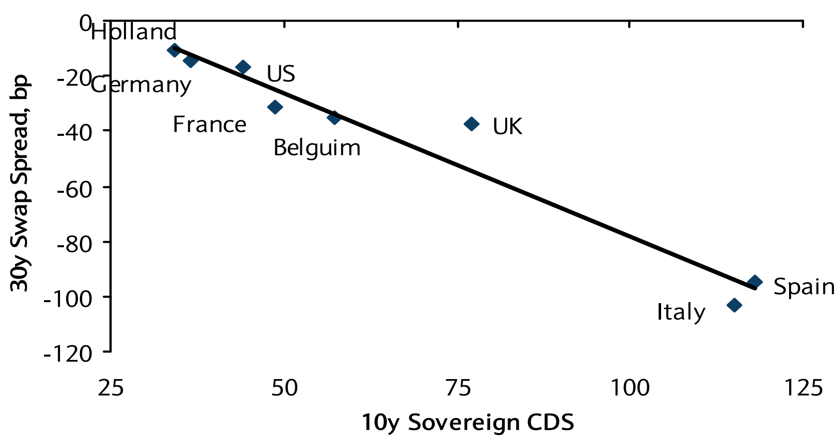
Government Debt: A Global Concern

- Spreads are trading at historically tight levels across the globe.
- Countries where government debt is perceived to be riskier have tighter spreads
- Spread tightening in UK as sovereign CDS spreads widened highlights the risk

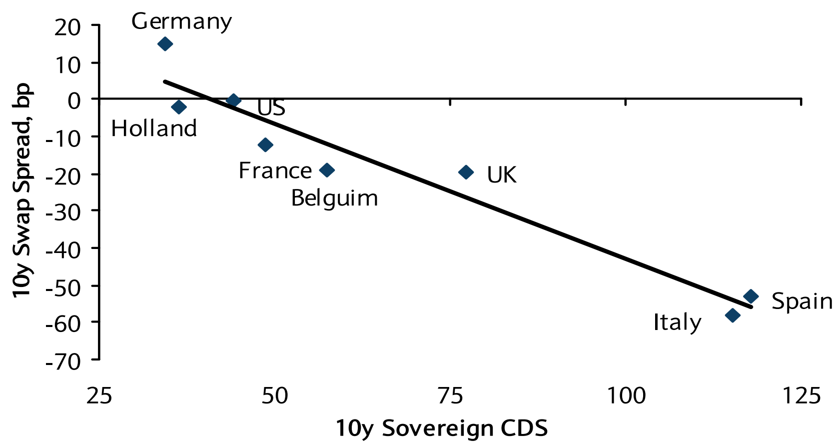
UK Experience: A Risk



30y Spreads and Sovereign CDS



10y Spreads and Sovereign CDS



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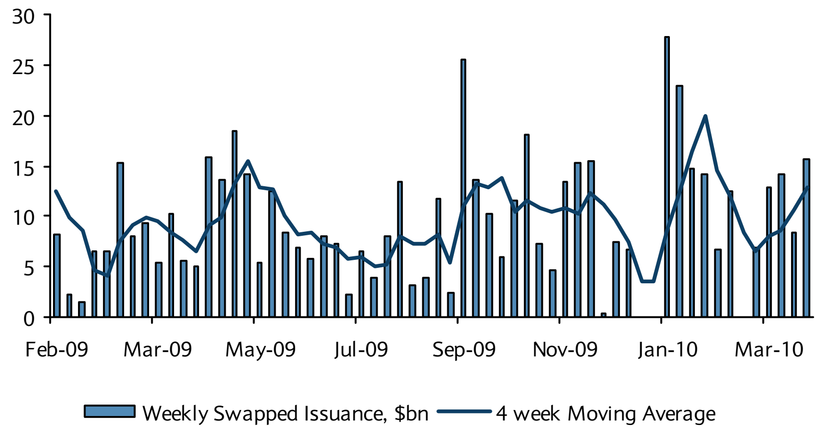
Source: Barclays Capital

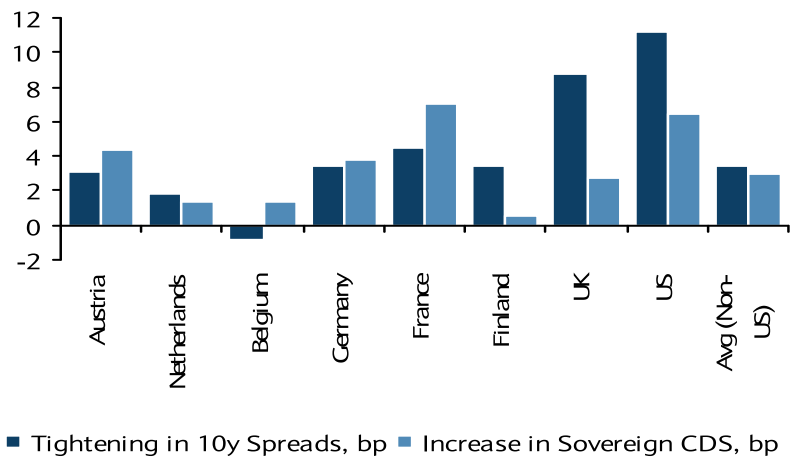
What happened two weeks ago?

- An increase in swapped issuance activity; however, not far from recent experience
- Increased concerns about government debt - sovereign CDS spreads widened and government yield curves steepened
- Investors were forced to unwind crowded spread widener positions

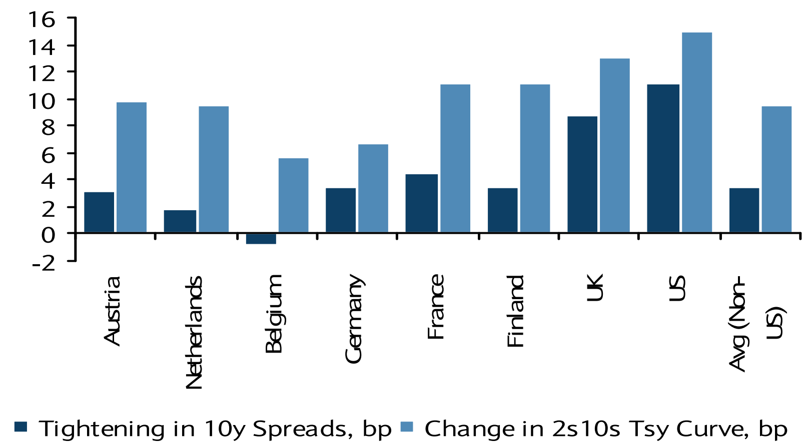
A Rise in Financial Issuance



Sovereign CDS Spreads Widened…



…and Yield Curves Steepened Globally



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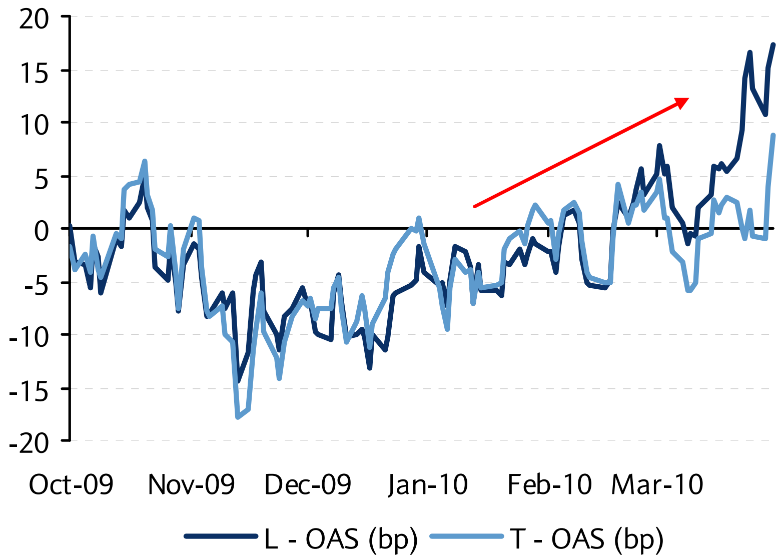
Source: Barclays Capital.

US MBS/Residential Credit Outlook

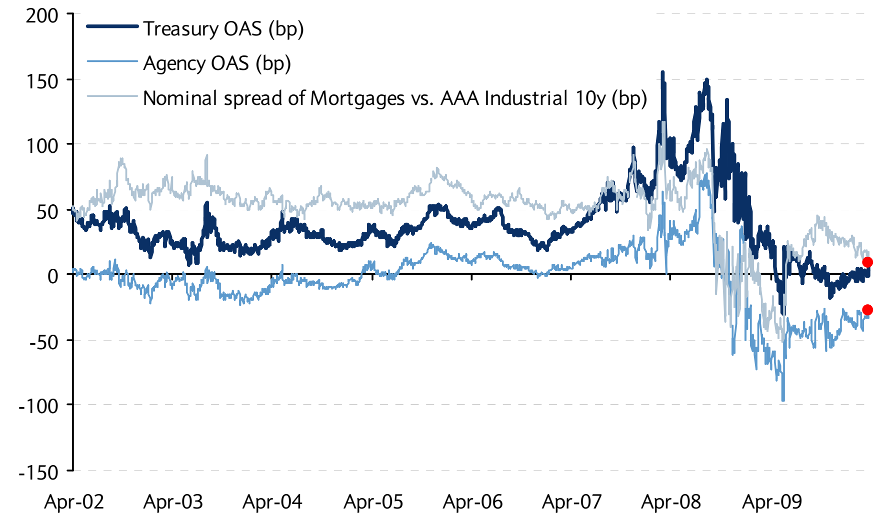
Sandeep Bordia
Head of US Residential Credit Strategy
April 2010

Agency MBS OAS has widened

Current Coupon L-OAS and T-OAS has widened



MBS remain rich to other assets



- Treasury and Libor OAS have diverged recently on account of rapid tightening of swap spreads last week
- OAS widening over the past couple of weeks comes as the Fed ends its MBS purchase program
- Despite this however, we believe agency mortgages are still trading rich as spreads to Treasury, agency debt and credit are still below historical averages

Source: Barclays Capital

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The coupon-by-coupon Fannie cleanup scenario

- Fannie Mae announced clarifications regarding its buyout timeline on March 18, 2010
- The announcement confirmed that buyouts would occur coupon by coupon, with 6.5s bought out in the April report, 6.0s in May, and 5.5s and 5.0s in the June report
- We expect speeds on credit-impaired 6.5 cohorts to exceed 85 CPR in the April report, and 6.0 cohorts to be exceed 70 CPR in the May report.

FN 30y prepayment forecast

		Actual CPR	Projected FNMA (reporting month)		
Coupon	**Vintage**	**Mar**	**Apr**	**May**	**Jun**
5	2008	15.7	20.6	18.2	33.9
	2007	17.6	22.6	20.6	53.8
	2006	18.2	21.8	21.2	52.6
5.5	2008	21.9	27.2	25.4	48.9
	2007	24.0	30.3	28.1	65.5
	2006	23.1	29.1	27.1	65.5
6.0	2008	26.1	33.3	68.7	27.3
	2007	26.7	35.7	81.3	29.4
	2006	22.8	29.8	75.5	28.3
6.5	2008	28.0	85.0	30.5	29.1
	2007	29.3	93.3	33.1	32.1
	2006	22.2	87.1	29.9	28.7

Source: Barclays Capital

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New initiatives announced

- Bringing ***debt forbearance to the top of the HAMP*** waterfall, along with ***earned forgiveness***
  - Targeted at underwater borrowers with MTM LTV > 115
  - Effect of lower redefaults overcomes extension to result in moderate upside for senior securities

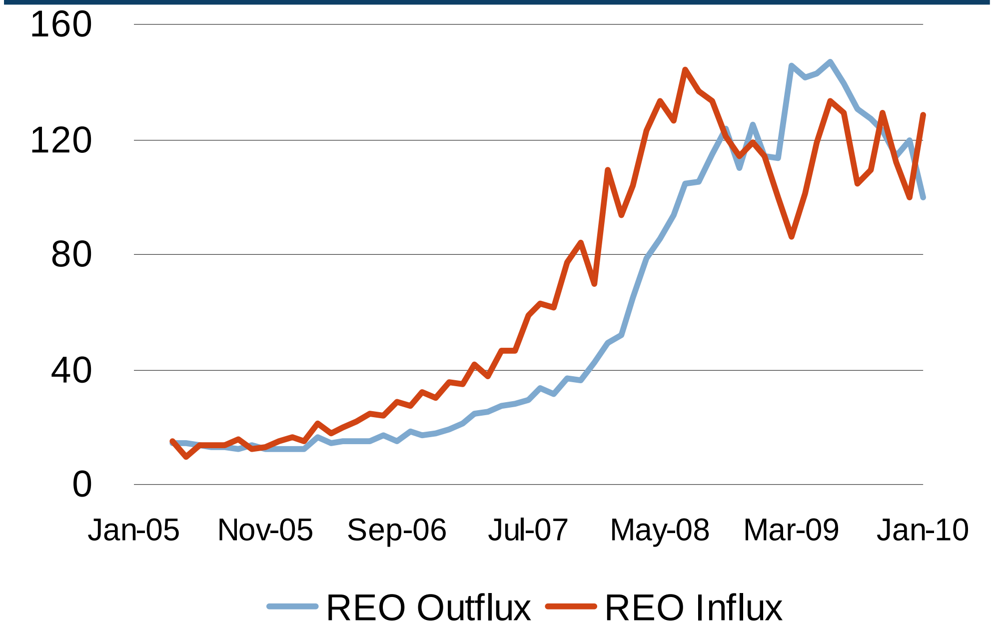
- ***FHA short refinancing program*** for non-FHA current borrowers
  - Underwater current borrowers have part of debt forgiven and are refinanced into new FHA loan, second lien resubordinated subject to CLTV < 115
  - Given stringent eligibility criteria (full FHA underwriting) few borrowers expected to qualify

- ***Other updates to HAMP and HAFA***
  - Greater scrutiny about offering HAMP to borrower before foreclosure
  - New payment reduction scheme for unemployed borrowers
  - Increase incentives in HAFA to encourage foreclosure alternatives
  - Will hold up the foreclosure to REO process

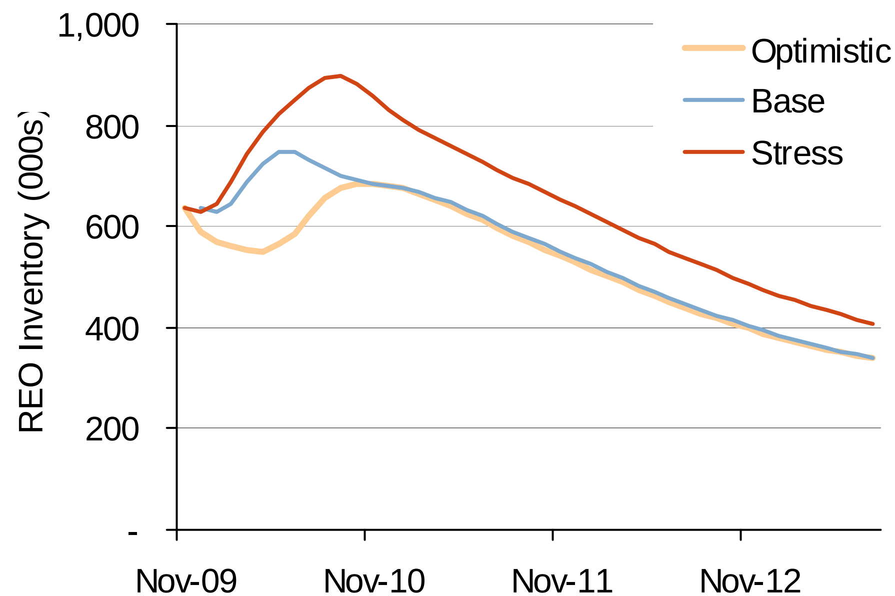
Implications for the housing market

- The slowdown in the HAMP foreclosures and modifications will delay near-term distressed supply – effect to be visible in 3-6 months
- Increases likelihood of limited or no additional declines in 2010 at cost of long drawn recovery – bolsters our view that government will do whatever it takes

REO influx rate will remain contained



REO stock will remain high for a long time



Source: NAR, MBA, LoanPerformance, Barclays Capital

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Overall banks losses will come down slightly

- 1st lien refi likely to help banks by slightly lowering overall losses
- More front-ended losses from HAMP but lower overall losses for both 1st and 2nd liens
- Resi loan losses will be lower by about 5-10%

Bank 1st and 2nd lien losses

	Assets	Current loans		Delinquent Loans		REO	Total	
		Prev. Loss	New Loss	Prev. Loss	New Loss	Loss	Prev. Loss	New Loss
Loans secured by 1-4 family first liens	1741	138	123	92	86	6	230	209
Loans secured by 1-4 family junior liens	188	26	25	9	8	0	35	33
Home equity loans	667	71	65	17	16	0	88	80
Total	2596	236	212	118	96	0	354	322

Source: FDIC, Barclays Capital

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Current non-agency trade recommendations

Type	Trade	Rationale
Overall View	• Favorable on prices	• Higher yields than other risky assets • Muted supply, strong demand and cheap leverage • Systematic risk premium widening can be hedged out using CDX.HY
Outright Long	• 2H06 Subprime PAAAs and LCF AAAs • Alt-A ARM SSNR 2006/07 • 2005 OA SSNRs	• Outright best yields by 2-3% vs. other non-agy sectors • Pickup yield, reset risk is overstated. • Yield pickup in cleaner collateral, recast risk overblown
Levered Long	• Jumbo /alt-A Fixed SSNR	• Stable profiles with high levered yields
Recovery Trade	• ABX 07-2 LCF vs. 1.12x ABX 06-2 PAAA • Long 2007 Subprime LCF/PAAAs outright	• Downside hedged out with option like upside profile • Best price pickup in a recovery
PrimeX	• PrimeX ARM could be a good substitute for cash	• Rate Modification risks decreased. However, final structure/cash-synthetic basis will determine viability
Reremics	• Long Sr Mezz	• Attractive risk-reward profile

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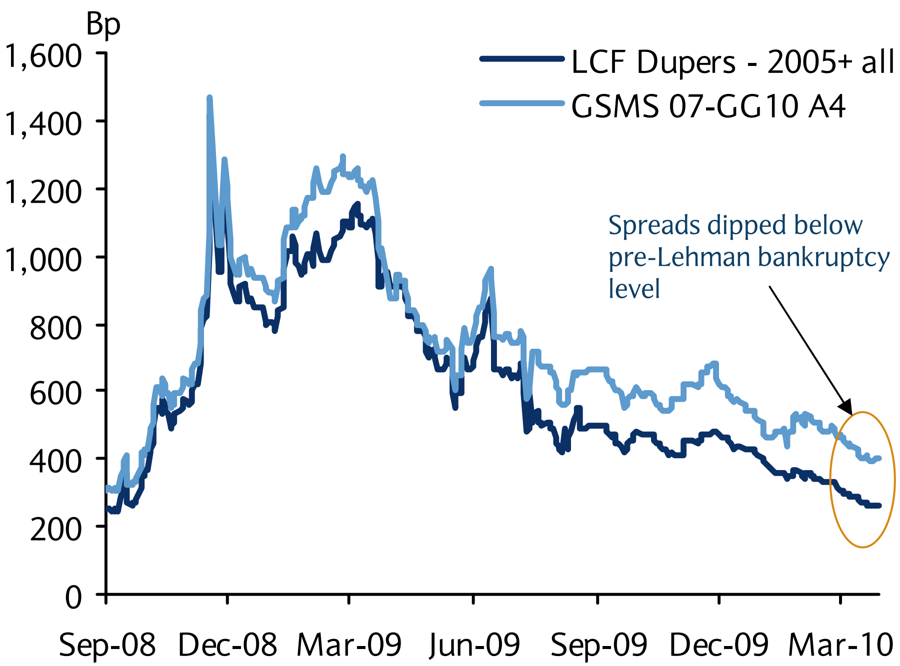
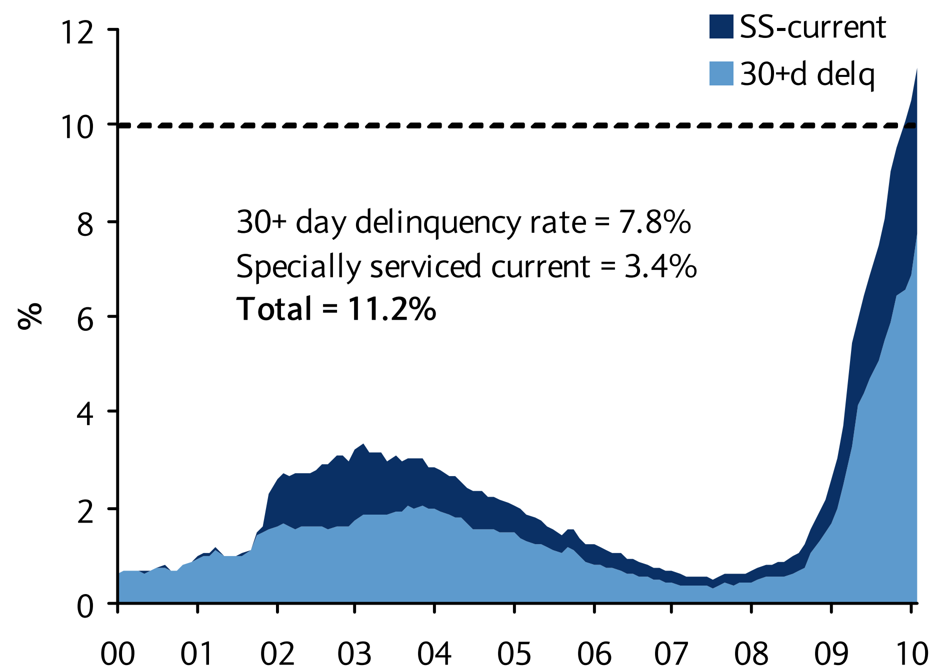
CMBSN SSNRs rally despite continued credit deterioration

- Impressive rally in March and spreads tightened over 65bp
- Mounting credit pressure

Impressive Rally over the Month



Special Serviced Loans Continue to Rise



Fixed rate conduit / fusion universe only. Source: Barclays Capital

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