



Invesco Perspective

Authored by Invesco's Worldwide Fixed Income
Structured Securities Research Team

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The impact of the financial crisis on structured securities and the current opportunity for investors

The credit market disruption, which commenced in 2007 with the collapse of the residential subprime mortgage market, has spread to many other fixed income assets and has notably impacted the valuation of structured securities. Forced selling due to portfolio de-leveraging, extreme mark-to-market volatility, and investor redemptions have severely impacted the prices of most debt instruments regardless of asset quality or fundamental performance. These market events have caused many structured products to trade at significant discounts, presenting opportunities to earn attractive yields by investing in securities trading below their fundamental intrinsic values.

We broadly view structured fixed income securities across three primary sectors - Commercial, Residential and Consumer - as determined by the underlying collateral assets. Each sector has experienced headwinds, to varying degrees, through the credit crisis, and in many areas, we believe assets have been oversold. We take a look below at each of these sectors, how they have been impacted by the global financial downturn, and opportunities for investors in certain undervalued securities.

Commercial

Market Overview: Portfolio de-leveraging and forced selling has amplified substantial declines in Commercial Mortgage-Backed Security (CMBS) pricing. Even the most senior CMBS, which benefit from substantial subordination, have been impacted as prices have declined across the sector regardless of fundamental performance or a security's seniority in the capital structure. The strong liquidity of the AAA CMBS market relative to other assets has resulted in additional CMBS spread widening as managers faced the challenge of quickly selling liquid assets to raise capital to meet investor liquidations.

Outlook: Despite historically low commercial real estate delinquency rates, investment performance is expected to deteriorate as the economy moves further into a recession. Commercial real estate is beginning to show signs of fundamental weakness and we expect retail store closings and increased office vacancies to continue to increase CMBS delinquencies. These risks are most prevalent in 2006 and 2007 transactions, which are often characterized by greater leverage and lower debt service coverage ratios.

While we expect further deterioration in the overall economy and the commercial real estate sector, we believe current spreads compensate for expected risk. High price volatility is expected in the near term as the threat of forced selling remains. We anticipate the pricing differential between stronger and weaker credits to increase as new investors begin to enter this sector in search of value. Eventually, we believe risk-taking will return to the marketplace and cause oversold asset prices to appreciate. As forced selling subsides and the market normalizes, AAA CMBS pricing will likely receive a greater benefit relative to lower-rated and less-liquid bonds, which we expect to lag in a recovery.



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Relative Value/Opportunity: We believe the current market dislocation provides the opportunity to identify mispriced commercial property fundamentals trading at a discount to the value of their expected cash flows. Given the current pricing environment, even the most senior AAA positions are now providing attractive yields on a hold-to-maturity basis.

When combining the fundamental concerns cited above with a lack of able buyers, CMBS pricing in many classes has become discounted to an implied loss rate greater than 2x the worst historical performance on record¹, which is 8% and was reached in the late 1980's.² Much like that period, we expect weak demand to impact real estate fundamentals; however, today's market has much lower vacancies as supply is less abundant. Senior AAA securities typically benefit from 30% credit enhancement in the form of subordination. This means in order for senior AAA bonds to suffer a principal loss, the mortgage pool would typically need to incur cumulative losses of 30%, which often exceeds Invesco's loss estimates by more than 3x. *Thus, we believe the sell-off in this high-quality market segment is overdone and there is significant value at current trading levels.*

Residential

Market Overview: As early as the middle of 2007, signs of cracks in the foundation of the residential space were developing. Distressed selling, due to de-leveraging, forced liquidations and redemptions, led to a significant increase in risk premiums. With risk premiums and risk aversion both at historical highs, the non-agency residential mortgage securitization market shut down. Secondary trading volume remains high from forced selling, but marginal buyers are scarce. These technical pressures have led to valuations that are dislocated from fundamentals in many cases.

Outlook: Housing metrics for supply all point to continued stress in 2009. For instance, we would like to see unsold inventories decline back from the June 2008 peak of 11 months to a historical equilibrium of 5 months. Housing affordability has recently improved with home prices and mortgage rates both dropping. However, credit availability will be one of the key drivers in allowing the housing market to reach a trough.

During 2008, the Fed initiated numerous programs totaling more than \$5 trillion aimed at improving short-term financing markets, providing liquidity to financial institutions and, more recently, lowering mortgage rates in an attempt to spur demand for home purchases and refinancing. Given their actions thus far, we feel the Fed will remain committed to assuring that short-term financing markets continue to function efficiently, which will bring down borrowing costs over time. The FDIC has also initiated programs totaling \$1.78 trillion to improve confidence and functioning in the banking system and attempt to reduce foreclosures through uniform guidelines for loan modifications. Additionally, the Treasury Department has initiated several programs totaling over \$1.15 trillion that impact the short-term financing and mortgage markets. The main program under the Treasury is the Troubled Asset Relief Program (TARP). In our opinion, providing banks with relatively low-cost capital infusions will improve the functioning of financing markets, as banks make loans supported by new capital infusions. It is highly likely that banks will deploy some of this capital in the agency MBS market, resulting in tighter MBS spreads and thus lower borrowing costs. The Federal Housing Administration has developed a program utilizing \$300 billion in capital aimed at preventing foreclosures by providing more appropriate loans for distressed borrowers. Preventing foreclosures will have an overall positive impact on the housing market, reducing losses among lenders and resulting in more available capital to lend in other markets.

¹ "Commercial Mortgage Defaults 30 Years of History", by Esaki and Goldman in the Winter 2005 edition of CMBS World

² Barclays data, based on loss dispersion approach



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We expect these government policy initiatives to contribute to recovery, but remain cautious on the timing of their implementation. However, the government has clearly demonstrated that it intends to support the housing market and it is likely that the new administration will be even more aggressive on this front.

Relative Value/Opportunity: Structured securities related to residential mortgages have progressed further through the credit cycle versus other asset types. Rating agency actions have been broader and more severe, resulting in more technical pressure on valuations. *We expect that residential security valuations will experience improvement in advance of a housing sector recovery.*

Consumer

Market Overview: The consumer was highly leveraged going into the recession and we expect deterioration in the overall economy to accelerate as a result. Lower interest rates and reduced risk premiums previously fueled demand for consumer credit. A shift to more stringent lending, significant reductions in overall credit availability and growing job losses will likely lead to an elevation in default rates across consumer-related assets. We expect the current recession to be longer and deeper than prior recessionary periods. It will take additional time for many households to de-lever their balance sheets and the natural relationship between total debt levels and income levels to normalize.

Outlook: Performance to date of consumer credit has held up relatively well compared to the deterioration experienced in mortgage-related collateral. However, our outlook for the near-to-intermediate term consumer sector performance remains negative as the economy moves further into recession. The recent contraction in the credit market and significantly reduced consumer spending has led to a considerable slowdown in business growth and profitability, which has forced many employers to eliminate jobs in an effort to cut costs. We expect the unemployment rate to rapidly approach 8.5%-9.0% through year-end 2009 eclipsing the most recent historical high experienced in 1992. This strained macro environment will have a pronounced impact on the fundamental collateral performance of credit card and auto loan pools. Excess spread will continue to decline in credit card trusts as accelerating defaults more than offset the likely positive impact of risk re-pricing on portfolio yields. In addition, used car valuations will continue to be depressed as reduced demand for new vehicles and rising dealer inventories contribute to auto valuation declines. We anticipate rating actions to be muted in the higher-rated classes of both sectors. The expected decline in collateral performance is mitigated by strong fundamental credit analysis, including security selection, quality of underwriting, and structural features.

Relative Value/Opportunity: As the market sizes up the potential impact of government intervention, price volatility of consumer-related asset backed securities over the near-to-intermediate term will likely continue. Market illiquidity has contributed to pushing spreads to extremely wide levels. New issuance is expected to increase as a result of the implementation of the Term Asset-Backed Securities Loan Facility (TALF), which was recently announced by the Federal Reserve and targeted to commence in February 2009. While details have yet to be finalized, TALF is expected to re-establish consumer lending and investor demand for consumer ABS as it provides non mark-to-market recourse financing for consumer ABS. We expect new investors to enter the primary market and eventually increase prices in the secondary market as a result. While this segment remains challenged, we recommend very selective investments in short-duration, well-seasoned, prime quality collateral pools that can withstand reasonable deviations in collateral performance.



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Conclusions

Credit markets began the new year on a slightly more positive tone with the tightening of TED spreads, declining CP rates and anticipated implementation of TALF. While we expect further deterioration on the horizon, we believe current yields compensate for expected risk in select areas of the structured securities markets.

In the near-term, investors should focus on AAA CMBS as it offers greater risk-adjusted yield than many other assets and, with an active secondary market, provides relatively better liquidity. As risk-taking returns, we expect senior AAA CMBS to lead the recovery and reward those who have committed capital. And, despite lower spreads relative to the commercial and residential mortgage sectors, we expect carefully selected short-duration consumer ABS, collateralized by prime pools, to benefit from secondary market spread compression following the TALF implementation.