Research
U.S. Market Outlook

SIFMA
Securities Industry and Financial Markets Association

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The Securities Industry and Financial Markets Association[1] is pleased to present the results of its annual issuance forecast for 2008 in the municipal, corporate, money market and securitization markets. This report provides information on anticipated issuance volumes and interest rate and credit spread outlooks for 2008. The forecasts are based on a survey of the Association's member firms conducted during December 2007. Specialists at member firm in each of the market sectors provided the forecasts, indicating key assumptions behind their projections.

In this year's edition, we continue our practice of expanding the depth of information about the specific market sectors. The enhancements in this year's survey and report reflect important trends and developments in the marketplace and include (a) the percentage of non-agency mortgage-backed securities issuance expected to be prime, Alt-A and subprime and (b) the consensus view on investment-grade and high-yield corporate bond issuance rating trends. In addition, the report introduces a section on equity market performance in 2008.

Credit Market Turbulence Expected to Reduce Issuance in 2008 to $3.4 Trillion From Elevated 2007 Level; Performance Forecast to Improve in Second Half

Market and Economic Environment

2007 came in as a lamb and left as a lion. For those with long memories, in the first half, credit spreads were at historically tight levels, credit quality metrics were quite favorable, volatility was low and the markets were awash with liquidity. Meanwhile, the equity indexes were setting new records supported by ample funding for corporate acquisitions under terms favorable to sponsors and issuers. As we have painfully experienced, the second half of the year had a completely different tone or, to continue with our analogy, let out a loud roar. The spillover from the housing and subprime markets, credit risk repricing, heightened investor risk sensitivity, dramatically diminished liquidity and reduced credit availability have left their mark. Credit spreads "blew out" across sectors, reaching the widest levels in several years, and, in some cases, record wides. The market sectors most closely aligned with housing have, of course, taken the most heat.

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Highlights Median responses to the survey:

- Total 2008 long-term issuance for the covered sectors is expected to be $3.40 trillion, lower than the $4.01 trillion issued in 2007.
- Long-term municipal issuance in 2008 will be $405 billion, down 4.7 percent from 2007 issuance volume of $425 billion.
- Corporate high-yield bond issuance will be $115 billion in 2008, 15.4 percent less than the $136 billion issued in 2007, and 2008 investment-grade issuance is projected to be $850 billion, 14.7 percent less than $996 billion in 2007.
- Commercial paper outstanding will be $1.76 trillion at the end of 2008, compared to $1.86 trillion on November 30, 2007 and $1.79 trillion in January 2007.
- Asset-backed securities (ABS) issuance in 2008 will be $325 billion, down 35.9 percent from the $507 billion issued in 2007. Credit card ABS is expected to supplant home equity ABS as the largest issuing sector.
- Mortgage-related issuance will be $1.70 trillion in 2008, down about 12.8 percent from the 2007 issuance volume of $1.95 trillion. Non-agency, or private label issuance share is expected to decrease by half the 2007 volume to $350 billion while agency issuance (combined MBS and CMO) is expected to increase by about 8.5 percent to $1.35 trillion. Indicative of tighter underwriting and shifting housing sector metrics, the prime mortgage share of private label underwriting is expected to rise from 27 percent to 52 percent.
- The S&P 500 will end the year at 1,600, an increase of 8 percent from December 20, 2007.

1 The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

New York
Washington
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While risks clearly abound, the consensus view as presented in SIFMA's recent economic outlook is for slower but positive GDP growth in the first half and picking up later in the year as the economy works through the housing sector contraction and credit market turbulence. Although consumer and corporate credit quality outside of mortgage and housing related industries have generally held up, there are evident threats on the horizon in the form of, for example, rising consumer lending delinquencies or higher corporate bond default rates later in the year. The key drivers for the 2008 market outlook are the length and severity of mortgage market and housing weakening; the magnitude of additional housing and structured finance credit losses and capacity for capital replenishment; the success of initiatives to free up interbank lending and credit markets; and the degree to which "bad news" has already been reflected in financial market pricing or the point at which markets become "oversold."

The Forecast

With this background, the median forecast is that bond issuance—including the municipal, corporate credit, asset-backed securities, and mortgage-backed securities markets—will decline 15.4 percent to $3.40 trillion in 2008, compared to an estimated $4.01 trillion in 2007. Despite declines, both corporate and municipal issuance for 2008 will remain near historically high levels. Issuance is expected to decline significantly in the sectors most affected by the subprime mortgage deterioration, including segments of the non-agency, or private label, mortgage-backed securities, home equity loan backed securities and asset-backed commercial paper markets. Issuance in substitute products are projected to increase or remain near 2007 levels, including agency mortgage-backed securities, other consumer loan-backed securities and conventional, or unsecured, commercial paper programs. Finally, the forecast is that lower interest rates will propel the S&P 500 higher despite the probability of slower profit growth.

The survey panelists' underlying assumptions and credit spread projections indicate an expectation that the operating environment should improve in the second half of the year, but risks will remain. The panelists expect much of the credit loss recognition to take place before year-end 2008; GDP growth to increase from the below-trend level in the second half of the year, enabling benchmark yields to rise at the long end later in the year; and credit spreads in most cases to be lower at year-end than at mid-year but remain well above levels a year ago. Generally, the key assumptions rely on a responsive Federal Reserve and the success of initiatives to open up the money markets.

THE FOLLOWING FIRMS CONTRIBUTED TO THE SURVEY:

Banc of America Securities
Barclays Capital
Bear Stearns
Citigroup
Countrywide Financial
Credit Suisse
Daiwa Securities
Deutsche Bank
Estrada Hinojosa
Euclid Financial
First Albany
First Southwest
Goldman Sachs
J.P. Morgan
Lehman Brothers
Merrill Lynch
Nomura Securities
Raymond James
UBS
Well Fargo

MUNICIPAL MARKET

Municipal Issuance Expected to Slip Modestly from Record 2007; New Money Deal Volume to Increase

Issuance

- The median forecast projects total municipal issuance to be $456 billion in 2008, a modest 5.4 percent decline from the record $482 billion issued in 2007.
- Long-term municipal issuance is projected to be $405 billion in 2008, 4.7 percent less than the $425 billion issued in 2007. The survey respondents' forecast for 2008 long-term issuance ranged from $395 billion to $450 billion.
- Short-term issuance is expected to be $51 billion, about a 10 percent decline from the $57 billion issued in 2007. Short-term issuance forecasts ranged from $50 billion to $76 billion.
- The lower long term volume forecast is based on the expectation that refunding activity will decline from 35 percent of total long-term issuance in 2007 to 22 percent in 2008, which translates to a sharp decline from $150 billion to $89 billion. The lower projected refunding level reflects an expectation of reduced volume of debt available for refunding in the coming year.
- Respondents mentioned two scenarios that could raise refunding costs and municipal yields. The first would be that the economy picks up, and interest rates rise. The alternative scenario is one of continued mortgage and credit market turmoil, further enveloping bond insurers, lowering the demand for municipal bonds and an investor "flight to quality" towards Treasuries. Panelists, however, generally expected the bond insurer situation to be resolved in the early part of 2008. If uncertainty about the financial strength and ratings of the insurers persist, panelists noted that the likely outcome would be that of a somewhat lower percentage of municipal bonds carrying bond insurance. They noted the strength of the underlying municipal bond credit quality and that investors are increasingly paying attention to the underlying municipal issuer as payer on the debt.
- Respondents expect new money issuance to increase in 2008 from 65 percent to 78 percent of total long-term volume, or an increase from $275 billion to $316 billion. The rise in new money issuance is boosted by the need to finance new development and infrastructure projects in a below-trend growth environment. Some jurisdictions are reporting lower tax revenues as a result of the housing market deterioration and its effect on the local tax base, housing prices and property tax assessments.
- General purpose financing is expected to continue to be the largest issuing use-of-proceeds sector in the coming year, followed by transportation and education.

MUNICIPAL ISSUANCE

$ Billions

	2007*	2008	% Change
Short-Term	57	51	-10.5
Long-Term	425	405	-4.7
Total	482	456	-5.4
Refunding as % of Total	35%	22%	-37.5%
Largest Issuing Sector	General Purpose	General Purpose	

* As of December 20, 2007

Source: Thomson Financial

10-YR MUNICIPAL G.O. AAA TO 10-YR TREASURY RATIO

	2007*	Projected June 2008	Projected December 2008
Ratio	92	86	85

* As of December 20, 2007

Source: Bloomberg

Interest Rate Outlook

- Survey respondents offered divergent views on interest rates in the coming year, with the majority expecting economic growth to raise the level of interest rates alter in 2008. The alternative view is a slowdown which would lower the interest rate levels.
- Respondents expect the yield curve to steepen, especially during the second half of 2008.
- Municipals yields are expected to decline relative to the Treasury benchmark closer to historical norms based on the implied assumption that credit conditions and monoline insurer situation ease. The median projection for the ratio of the yield on AAA G.O. municipal securities to the 10-year Treasury benchmark is 86.3 percent at the end of June and 85 percent at the end of 2008. The municipal to Treasury yield has been above 90 percent during December.

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Risks in the Forecast

- The dominant risks to the forecast were continued dislocation in the money markets and the resulting effect on investor access to leverage; the monoline insurer situation; and continued credit market uncertainty
- The consensus view was that the credit crunch should ease by the end of the first quarter and be a less important concern in the municipal market for the balance of 2008.
- A slower economy could raise the issuance level as projects that were expected to be financed out of a budget surplus would have to be debt financed.
- Housing bond issuance in connection with the Administration's Mortgage Revenue Bond proposal is not included in the forecast.

CORPORATE BOND MARKET

Corporate Bond Issuance Volume Slips From 2007 Record But Remains at Historically Level; Credit Concerns Present

Issuance

- The median forecast has total issuance of investment grade and high-yield corporate bonds declining by 14.8 percent in 2008 to $965 billion from the 2007 record level of $1,132 billion.
- Investment-grade issuance is expected to decline 14.7 percent to $850 billion from $996 billion through December 20, 2007, with forecasts ranging from $750 billion to $900 billion. Panelists expect a lower proportion of investment grade issuance to be concentrated in "A" and below-rated issuers in 2008 than 2007.
- High-yield issuance is expected to be $115 billion in 2008, a 15.44 percent decline from 2007 volumes. The high-yield issuance forecasts ranged from $95 billion to $120 billion. Panelists expect a lower proportion of high-yield issuance to be concentrated in "B" and below-rated issuers in 2008 than 2007.
- The expectation of a greater proportion of higher rated high-yield and investment grade issuance reflects increased investor risk sensitivity, reduced liquidity, tightened financing conditions, and the effect on corporate bond credit quality of anticipated slower profit growth rates, and below-trend GDP growth, with attention focused on the resilience of the consumer.
  - S&P Global Fixed Income Research recently commented on the higher risk premiums and increased probability of downgrades. S&P is forecasting rising U.S. corporate bond default rates, especially in the second half of 2008 and into 2009, from a 25-year low of around 1 percent in late 2007 to 3.4 percent a year from now, which is still below the long-term average.
- Summarizing, issuance will remain at the historically high level.
  - Positive drivers: According to J.P. Morgan analysis, investment grade bond redemptions at about $600 billion will be higher in 2008, especially in the financial sector, which is estimated to account for more than half of the redemption volume. Investment issuance is also likely to benefit from financial sector (which is the dominant investment grade issuer group) capital needs, borrowing at still relatively attractive all-in cost levels while benchmark yields are at historic lows (especially compared to short term funding costs), and higher financing needs as profits are expected to slow. During 2007, based on Merrill Lynch data, corporate acquisitions accounted for a record percentage of high-yield financing. High-yield issuance will be boosted by the remaining LBO issuance calendar that will be funded. While financial sponsor M&A is likely to be slowed by reduced and higher credit availability compared to earlier in

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CORPORATE BOND ISSUANCE

$ Billions

	2007*	2008	% Change
Investment-Grade	996	850	-14.7
High-Yield	136	115	-15.4
Total	1,132	965	-14.8

*As of December 21, 2007

Source: Thomson Financial

CORPORATE CREDIT SPREADS

	Dec. 07	Jun. 08	Dec. 08
AA Financial	188	178	150
BBB Industrial	185	175	150
CDX.NA.IG	77	81	83
CDX.NA.HY	491	525	488

Source: Bloomberg, Markit, Merrill Lynch, MarketAxess

CDX.NA.HY as of December 19; CDX.NA.IG as of December 20; AA Financial and BBB Industrial as of December 21.

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2007, strategic M&A deals should be in demand as corporations look to alternative growth strategies as organic growth moderates in the anticipated below-trend economic environment.

- Constraints: With the tighter financing environment, one would expect that new LBO deal volume will be significantly reduced for a period of time. Higher funding costs, trend towards a return to investor mandated conditions, and a more risk conscious investor universe also could lead to some pullback from other shareholder-friendly initiatives. With the possible exception of strategic M&A, below-trend economic growth is likely to limit corporate funding demands. Finally, the leveraged loan alternative will continue to cut into issuance volumes.

Credit Spread Outlook

- During the second half of 2007, corporate bond spreads widened to the highest levels in five years. The reasons have been widely reported, diminished liquidity, investor risk sensitivity, credit risk re-pricing, the effect of the subprime mortgage deterioration, credit market uncertainty, concerns about credit quality weakening after an extended period of solid and stable performance, and the stream of financial and housing sector losses.
- The survey panelists indicated a range of views about the corporate credit spreads in the coming year. The optimists or bulls point to weak dollar and global growth benefiting earnings, M&A, including private equity and non-U.S., bids supporting valuations, easing of short term interbank funding and money market strains, responsive Federal Reserve, economy continuing to grow though at a below-trend pace, strong non-financial corporate balance sheets and reduced event risk pressures as LBO volume slows, financial companies replenishing their capital, and “bad news” already incorporated in the spread “blow out” late in 2007. The pessimists or bears point to further financial write-downs, stalled interbank market, persistent weaker liquidity, rising financial sector funding costs passed on to corporate borrowers, negative earnings “surprises,” and housing sector and energy strains on the economy and consumer.[2]
- The “AA” financial spreads are expected to remain elevated but narrow during 2008 from 188 basis pints in late 2007 to 178 basis points at mid-year 2008 to 150 basis points at year-end. The forecasts reflect the effect on capital of the expected housing related write-downs of the sector through the first half of the year. Although still wide historically, tightening in the second half suggests that a large proportion of the remaining losses may be recognized in the first half and an improved financial market and economic environment in the second half.
- The industrial “BBB” spreads are expected to be 185 basis points at present to 175 basis points at mid-year and 150 basis points at year-end 2008. The relative spread differential with “AA” financials are indicative of the strength of corporate balance sheets, and second half improvement suggests an economic pick up in the second half of the year. At some point, there will need to be a return to the historic spread differential between higher rated financials and lower rated investment grade industrials.
- The investment grade CDX is projected to increase from 78 basis points to 81 basis points at mid-year and 83 basis points at year-end 2008. The direction is influenced by the presence of financial exposure in the index.
- The high-yield CDX spread is expected to widen to 588 basis points at mid-year and return to 488 basis points by year-end compared to the 491 basis points late in 2007. The project reflects the expectation of anticipated downward trend in credit quality metrics and the continued credit market liquidity concerns. Some second half tightening would suggest reduced strains from lower LBO deal flow, the market having priced in higher default rate expectations by the end of the year, and an improvement in credit market and economic conditions in the second half. Even with the projected second half tightening, the high-yield CDX index will still remain historically wide, 200 basis points wider than at the end of 2006.

2 Discussion draws from a Bear Stearns credit market analysis published December 4, 2007.

MONEY MARKET

Commercial Paper Outstanding Expected to Dip Slightly in 2007; ABCP to be Lower, while Conventional CP Volumes Grow

Forecast

- The outstanding volume of commercial paper (CP) is forecast to decline slightly from $1857 billion as of November 30, 2007, to $1,805 billion by the end of 2008.
- As a result of the fallout from subprime mortgage market deterioration, deleveraging, and money market disruption, asset-backed commercial paper declined by about 30 percent in 2007 with that decline concentrated in the second half of the year. Through this tumultuous period, ABCP market stability has benefited from strong investment ("AA") rated bank liquidity support.
- The median survey response forecasts financial ABCP to continue to decline to $710 billion by the end of 2008 from $837 billion as of November 30, 2007. The projected decline results in issuers and sponsors taking assets on balance sheet. Assuming that credit quality deterioration does not spread to other consumer assets, there is a view that some more established ABCP programs with longer track records may recover when conditions stabilize and investor demand returns. The liquidations so far have focused on programs that were more heavily invested in mortgage assets.
- Unsecured, that is, non-asset backed, financial CP outstanding is expected to reach $875 of 2008 compared to $829 billion as of November 30, 2007.
- The median forecast expects non-financial CP to total $225.0 billion, 17.9 percent over the $190.9 billion outstanding at the end of November 2007.
    - The growth is predicated on an expectation of a firmer tone in the money markets as a result of the Federal Reserve and other central bank initiatives to free up liquidity in the short term and inter-bank funding markets, demand for corporate acquisition funding and business capital investment spending growth. Below-trend economic growth expectations combined with liquid aggregate nonfinancial corporate balance sheets limit external funding demand. The trend of slower profit levels, however, could generate some incremental corporate demand for short-term funding.
- Euro CP is forecast to be $750 billion, lower investment grade A2/P2 commercial paper to total $75 billion and extendible notes of $17.5 billion at the end of 2008.

COMMERCIAL PAPER

$ Billions

	2007*	2008	% Change
Financial ABCP	837	705	-15.8
Financial CP (Non-ABCP)	829	837	1.0
Nonfinancial CP	191	220	15.2
Total	1,857	1,762	-5.1

* As of November 30, 2007

Source: Federal Reserve

Assumptions

- The panelists provided key assumptions driving the forecasts, including the projected GDP growth, Fed funds rate, and mergers and acquisition (M&A) deal volume.
- The assumptions of lower projected short rates and a steeper yield curve have the effect of a funding cost advantage at the short end and thus an incentive for issuers to tap the CP market. However, the forecast below-trend growth would appear to put limits on the demand for external funding. The most critical assumption, however, is conditions in the current uncertain and currently high cost (e.g. LIBOR spread over the three-month Treasury bill) short-term funding markets. The forecasts imply resolution in the coming year.
- The median forecast assumes below-trend GDP growth in 2008: 1.7 percent in the first two quarters; 1.8 percent in the third quarter; 2.1 percent in the fourth quarter.
- Consistent with the projected GDP growth rates and current credit market conditions, the panelists expect the Fed to be aggressive in lowering the target Fed funds rate to 3.75 percent in the first quarter, 3.50 percent by mid-year and 3.25 percent by the end of the year. Considering that the market response to Fed funds rate cuts have generally been tepid and temporary, the Federal Reserve and other central banks have expanded their

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tools to directly infuse liquidity in the money markets, including the introduction of the Term Auction Facility in December.

- The consensus of the CP panelists was that M&A volume growth would slow in 2008 compared to 2007 where a strong first half propelled the M&A volume this year. The expectation is undoubtedly driven by reduced access of buyers to debt financing as high yield bond and leveraged loan markets have tightened.
- Survey respondents also expect tax and accounting policy changes will be disadvantageous to commercial paper growth

ASSET-BACKED SECURITIES MARKET

ABS Issuance Falls on Weak Home Equity Sector; Credit Cards Expected to be the Leading Issuance Sector

Issuance

- The median forecast projects asset-backed issuance (ABS), which excludes private label residential mortgages, to be $325 billion in 2008, a 35.9 percent decline from the $507 billion in 2007.
- Home equity loan (HEL) issuance is forecast to fall by 71.9 percent to $63 billion from $222 in 2007 and would be the lowest volume since 2003. The sharp drop in volume is attributable to depressed HEL ABS pricing as credit spreads remain at historically wide levels, especially in the first half of the year, which reflect dramatically reduced liquidity and collateral performance deterioration. for example, as represented by the home equity derivative index, ABX, constituents. In addition, the issuance forecast takes into account lower available mortgage equity withdrawals (MEW) as national average housing prices decline and tighter underwriting in the primary HEL market.
- Credit card receivables are projected to replace HEL as the largest sector at $90 billion to 2008, a modest decline from the record level of $95 billion in 2008. As MEW recede, consumers are expected to turn more to credit cards which helps to explain the shift from HEL to credit card issuance. The panelists expect credit card issuance also to benefit from the recent period of relatively strong credit quality performance despite the recent uptick in delinquencies, reduced bankruptcy filings, and continued employment and income growth. Employment and income growth, though, is likely to slow in the first half of the year on anticipated below-trend GDP growth. While there is concern about the consumers' financial strength, to date, the consumer has generally held up despite rising food and energy costs, financial market volatility and the housing market weakness.
- The median forecast has auto loan ABS increasing to $75 billion, up 11.3 percent from the $67 billion in 2007. Despite an anticipated soft auto sale market and weaker credit market conditions, issuers are able to tap the markets to securitize loans.
- Student loan ABS volume is expected to decrease by 10.4 percent in 2008 to $55 billion from $61.4 billion, the result of broader reduced credit investor demand.

ABS ISSUANCE[1]

$ Billions

	2007	2008	% Change
Home Equity	222	63	-71.7
Credit Cards	95	90	-4.9
Auto Loans	67	75	11.3
Student Loans	61	55	-10.4
Other	61	42	-31.3
Total	507	325	-35.9

[1] Excludes CDOs and Mortgages
Source: Thomson Financial

Investment Grade Credit Spreads

- As with spread products generally, ABS spreads blew out in the second half as a result of credit risk repricing, the spillover from the mortgage sectors, and diminished liquidity and investor risk tolerance. The credit spread widening trends were most pronounced and dramatic in HEL products. The weaker performance was clearly warranted in the case of HEL and subprime mortgage collateral credit quality and the documented stream of rating downgrades. According to Deutsche Bank calculations, excluding CDOs, the vast majority (in excess of 95 percent) of ABS downgrades in the 2005-2007 vintages sector were HEL.

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- The non-HEL consumer ABS credit spreads reflect reduced market liquidity and credit investor demand, exacerbated by disruptions in the money markets, heightened volatility and wider swap spreads. The underlying collateral performance has remained relatively stable in other consumer sectors, especially in the case of prime auto and credit cards where charge-offs remained below long term averages. The consumers' financial strength (or vulnerability), however, has been a recurring theme for 2008 among market and economic analysts. Such concern is certainly justified in view of the anticipated slower economic and employment growth in the first half of the year, housing weakness, credit availability and higher energy and food prices.
- The panelist spread projections suggest spreads will remain close to current levels in the first half of the year but tighten in the latter half of 2008 which reflect the consensus view in the SIFMA year-end economic outlook that economic growth will pick up after a below-trend first half and anticipation of a housing sector "bottoming out" in late 2008 or 2009. The projected tighter spreads later in the year probably also reflect reduced supply pressures as issuance slows, the effect of Federal Reserve and other central bank initiatives to free up money and credit markets and tighter underwriting.

MORTGAGE-RELATED MARKET

Total Mortgage-Related 2008 Volume Declines; Shift to Agency Issuance

Mortgage Market Themes

- The three dominant themes in the mortgage-related securities issuance forecast in 2008 build on the mortgage trends in 2007. First, issuance will be lower, indicative of the persistent weakening in the housing and residential mortgage credit sectors during 2007 and into 2008. Second, agency mortgage-related securities will be the dominant source of issuance, reflecting the new mortgage market economics and historically wide pricing differentials between agency and non-agency (private label) securities. Third, prime mortgage-backed securities will comprise a much larger share of private label issuance, a result of tighter underwriting standards and investor sensitivity to weak credit performance of subprime mortgages.
- Several trends should be noted before presenting the specific results.
  - As represented in the SIFMA annual economic outlook survey, the consensus was that housing sector is expected to begin to recover in the latter half of 2008, and home prices will "bottom out" in 2009. The weakened housing market, declines in national home prices and tighter underwriting, combined with credit market volatility and diminished liquidity, are important factors in the lower mortgage-related issuance projection and increased prominence of prime mortgages.
  - The Initial mortgage resets of adjustable rate mortgages (ARMs) are due to peak in 2008 and 2009, increasing mortgage market risk exposure and borrower stress. This has led to loan modification initiatives such as the Paulson Plan.
  - The mortgage markets will be adjusting towards a supply and demand balance. Lower housing prices, tighter underwriting and market volatility will slow prepayment speeds. Despite lower forecast gross issuance in the coming year, slower prepayments result in net supply growth of outstanding MBS. On the demand side, the traditional buyers of MBS, GSEs and banks, have limited capacity to add to their portfolios in the first half of the year. Constraints, including capital limitations, could ease later in the year. A third important source has been and will continue to be non-US investors who take into account such risk considerations as volatility, valuation and the value of the dollar, against opportunities imbedded in historically low prices (wide spreads) for mortgage products and their need to hold a level of dollar-denominated assets. In

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MORTGAGE-RELATED ISSUANCE

$ Billions

	2007	2008	% Change
Agency Pass-throughs	1,019	1,110	8.9
Agency CMO	225	240	6.7
Non-Agency MBS	706	350	-50.4
Total	1,950	1,700	-12.8

NON-AGENCY MBS ISSUANCE (%)

$ Billions

	2007	2008
Prime	27	52
Alt-A	40	28
Subprime	33	20

30-YR FIXED MORTGAGE RATES (%)

2008:Q1	2008:Q2	2008:Q3	2008:Q4
6.10	6.20	6.35	6.70

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the interim, other mortgage investors, including new "opportunity fund" investors, would be a valuable source of liquidity.

- Current concerns about credit quality should keep in place a private label spread premium over agency securities.
- Money market volatility and historically high costs (for example, LIBOR and repo rates) increase mortgage portfolio funding costs and thus restrain liquidity. The so-called TED spread (three-month T-bills to LIBOR) is the widest in well over a decade. The recent introduction by the Federal Reserve and other central banks of the Term Auction Facility likely to help and provide some relief.
- Picking up on a recent Lehman Brothers analysis, three factors play into the current difficult non-agency MBS conditions, liquidity, credit quality expectations, financing costs (including AAA spreads over Treasury benchmarks) and leverage (increased required subordination levels).

Forecast

- The median survey forecast has total mortgage-related securities, including agency and non-agency pass through and collateralized mortgage obligations (CMO), decreasing by 12.8 percent in 2008 to $1,700 billion from the estimated $1,950 trillion in 2007.
- Agency mortgage-related securities (MBS) issuance is expected to be $1,110 billion, up 8.9 percent from the estimated $1,019 billion in 2007. Survey panelists project issuance of agency CMOs to be $240 billion compared to $225 billion in 2007.
- Panelists project private label MBS to be about half of last year's level at $350 billion, compared to $706 billion in 2007. The private label share of total issuance is expected to decline from 33 percent in 2007 to 20 percent in 2008. As a point of comparison, based on Bear Stearns data, non-agency MBS was above 50 percent of total issuance in 2005-06.
- Prime mortgages will become the dominant non-agency MBS collateral in 2008, accounting for 52 percent of non-agency MBS issuance, nearly double the 2007 share. Alt-A and subprime are expected to be 28 percent in 2008, down from 40 percent in 2007.
- Survey respondents expect the 30-year mortgage rate to increase during the year. According to respondents, the 30-year fixed rate mortgage interest rate will gradually increase from around 6.10 percent in the first quarter to 6.70 percent at the end of the year. As of December 20, the 30-year rate was 5.74 percent. Most participants expect that, during 2008, the yield curve will become steeper.
- The majority view is that the AAA MBS option-adjusted spreads to Treasuries will tighten during 2008 with the stronger consensus for a tightening in the second half. This opinion is consistent with a view that some housing market measures will show a "bottom" during the second half of the year and the markets, to some extent, will reduce the current substantial premium over the course of 2008.

EQUITY MARKET

Equity Market Expected to Rise in 2008

- The median forecast has the S&P 500 to reach 1,600 at the end of 2008 or an 8 percent increase during the year.
- The principal driver propelling equity prices is expected to be the historically low interest rate environment. The consensus view is that the Federal Open Market Committee is likely to cut rates based on the expectation of below-trend growth, especially in the first half of the year, housing weakness and credit market uncertainty.
- The equity market outlook is constrained by credit market liquidity conditions and lower profit growth. However, current market price-to-earnings ratios are well within historical range, providing a cushion against slower earnings growth. While U.S. growth is expected to be held back by credit market and housing concerns, global growth so far has held up. If profits exceed expectations, there is thus room for equity market appreciation through multiple expansion.
- Record corporate mergers acquisitions (M&A) supported equity market appreciation, especially during the first half of 2007. Several considerations lead industry analysts to expect M&A growth over the next few years. Tighter financing conditions in the bond and leveraged loan markets are certainly slowing leveraged buy-outs (LBO) and, to some degree, financial buyer motivated M&A in general. As opportunities for organic growth diminish in a below-trend economic growth environment, however, corporations will turn to strategic M&A. Thus, strategic buyer M&A is likely to be the more important motivation for acquisition, at least during the early part of 2008. It should also be noted that financial buyers, including private equity and hedge funds, have funds available for investment following the extended period of capital raising. Finally, the demand for capital in financial and housing related industries provide another impetus for deal making.

EQUITY MARKET*

$ Billions

	2007	2008	% Change
S&P 500	1,477	1,600	8.3

* 2007 S&P 500 index value as of December 20