

Bear Stearns Presents:

# **The Outlook for Fixed Income 2007**

January 4, 2007

**Bear, Stearns & Co. Inc.**  
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# **The Outlook for the U.S. Economy, Fed Policy and the Bond Market**

January 4, 2007

**John Ryding**

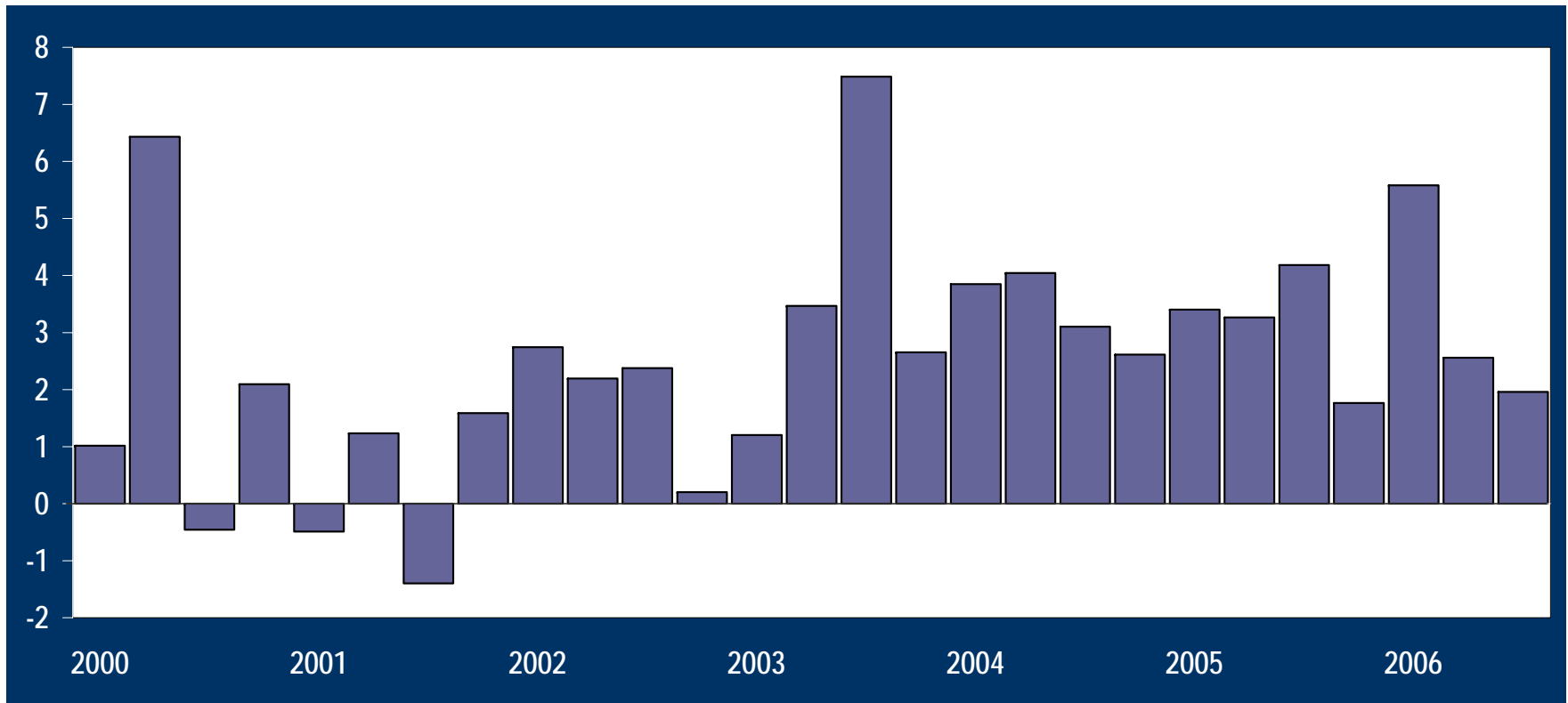
Chief U.S. Economist

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# Real GDP Growth

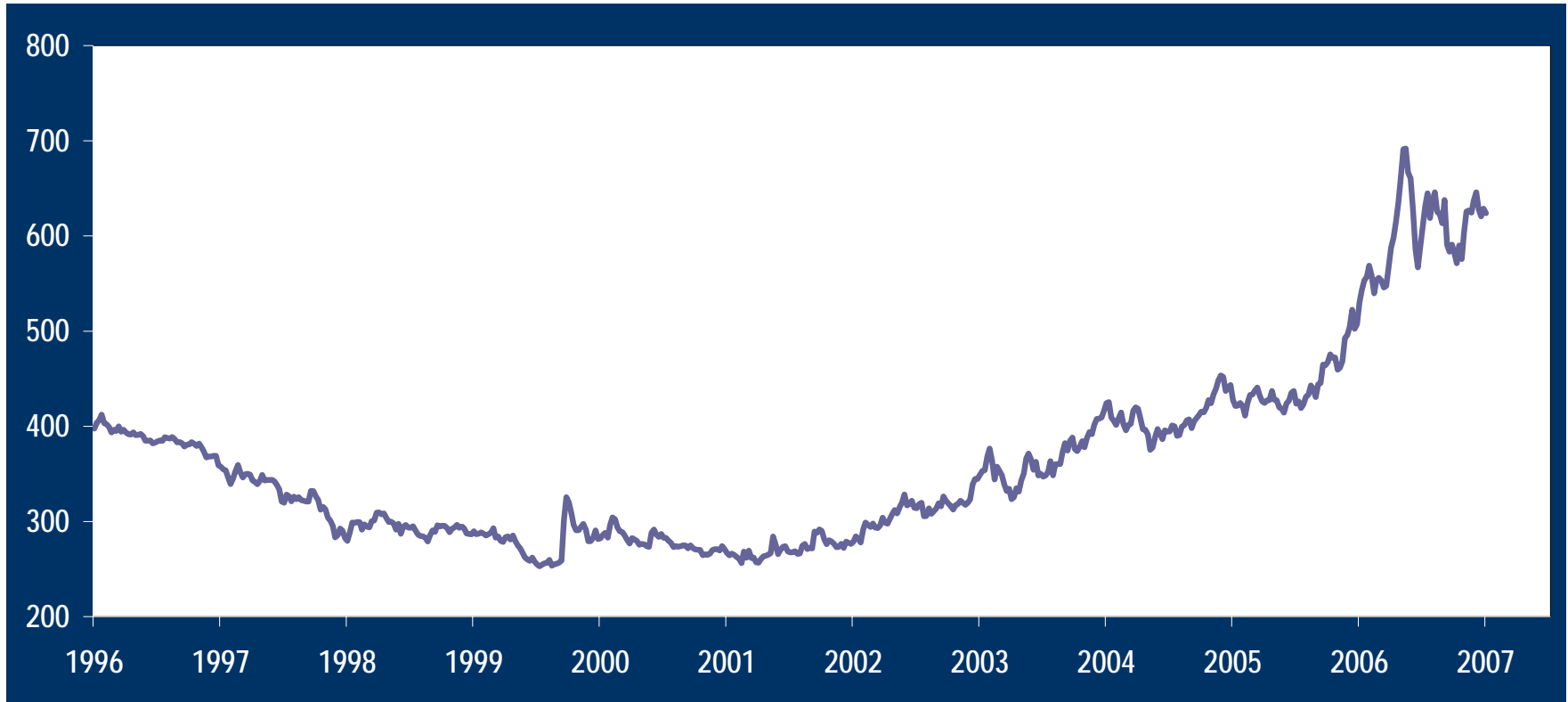
quarterly a.r. change; %



Source: Commerce Department

# Price of Gold

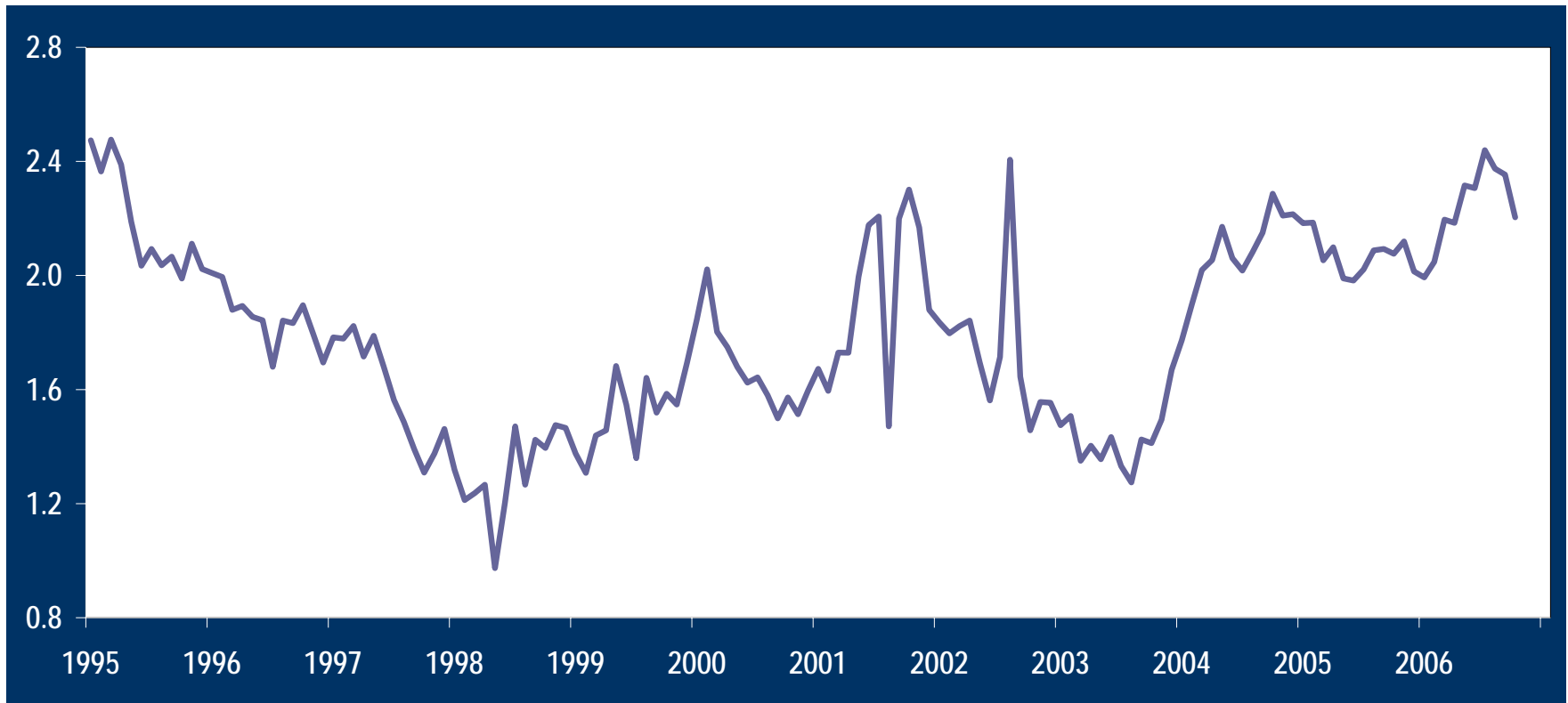
\$/troy ounce



Source: Wall Street Journal

# Core PCE Price Inflation

12-month change; %



Source: Commerce Department

# Bear Stearns Forecast Summary

	2006*				2007*				2006 <sup>+</sup>	2007 <sup>+</sup>
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q		
	(percent)				(percent)				(percent)	
<b>Real Economy</b>										
Nominal GDP	9.0	5.9	3.9	5.3	6.0	6.4	6.2	6.1	6.0	6.2
Real GDP	5.6	2.6	2.0	2.8	2.9	3.2	3.1	3.0	3.2	3.1
Unemployment Rate	4.7	4.6	4.7	4.5	4.5	4.4	4.4	4.3	4.6	4.4
<b>Inflation</b>										
Chain-Weight GDP Deflator	3.3	3.3	1.9	2.5	3.0	3.1	3.0	3.0	2.7	3.0
Core PCE prices	2.1	2.7	2.2	2.1	2.6	2.7	2.7	2.7	2.3	2.7
<b>Interest Rates</b>										
Federal Funds	4.4	4.9	5.3	5.3	5.3	5.5	5.6	5.8	5.0	5.6
Two-Year Treasury Note	4.6	5.0	4.9	4.7	5.0	5.3	5.5	5.5	4.8	5.3
10-Year Treasury Note	4.6	5.1	4.9	4.6	4.9	5.1	5.3	5.3	4.8	5.2

\* Values are either quarterly changes or quarterly averages

<sup>+</sup> Values are either 4-quarter changes or yearly averages

Source: Bear, Stearns & Co. Inc.

# Structured Credit Themes for 2007

January 4, 2007

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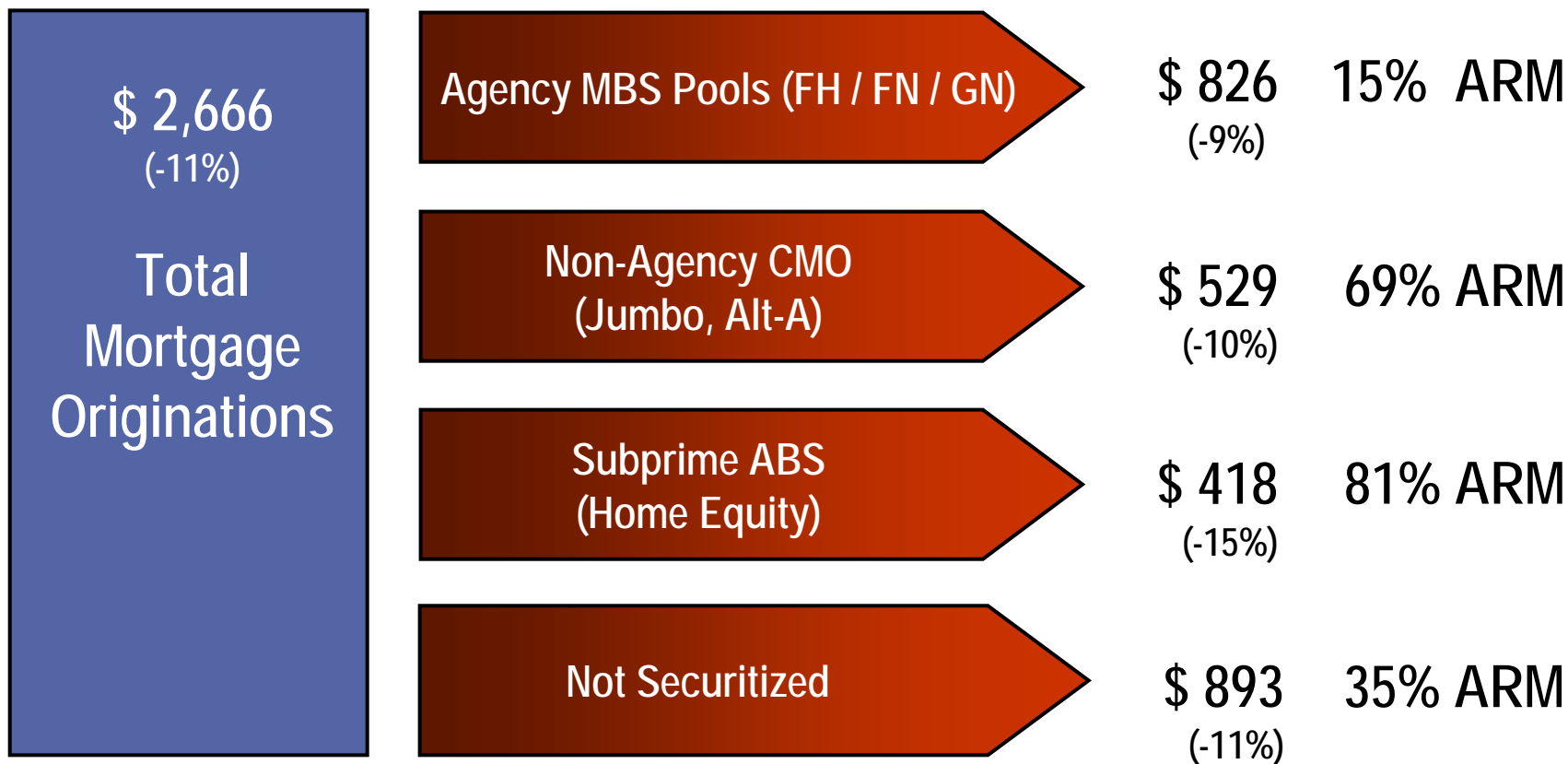
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## **Themes for 2007**

- HPA to slow from 7.7% to 4%
- Overall Non-Agency MBS issuance down 12%
- Tighter underwriting standards improve mortgage performance
- Corporate credit fundamentals remain stable
- Synthetics drive relative value ideas / structures
- 25%-28% equity yields and continued SS/AAA risk appetite keeps ABS CDO machine moving
- Robust corporate credit keeps CLO demand strong

# Projected US Mortgage Originations in 2007 (\$ Billions)



# Outlook for Funded US CDO Issuance

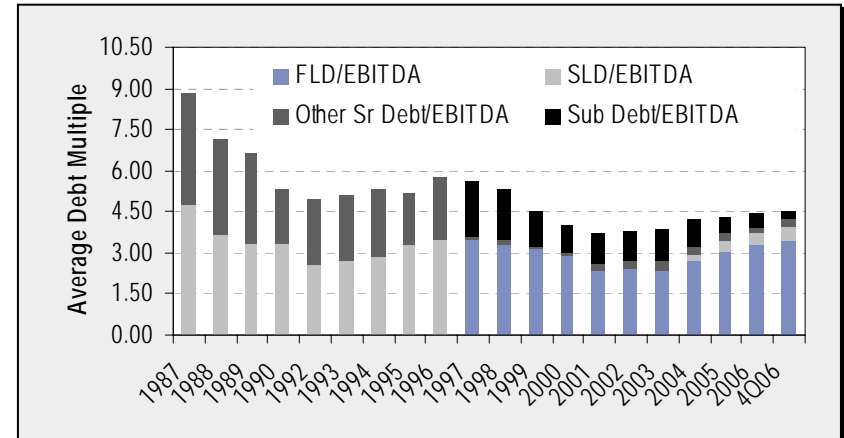
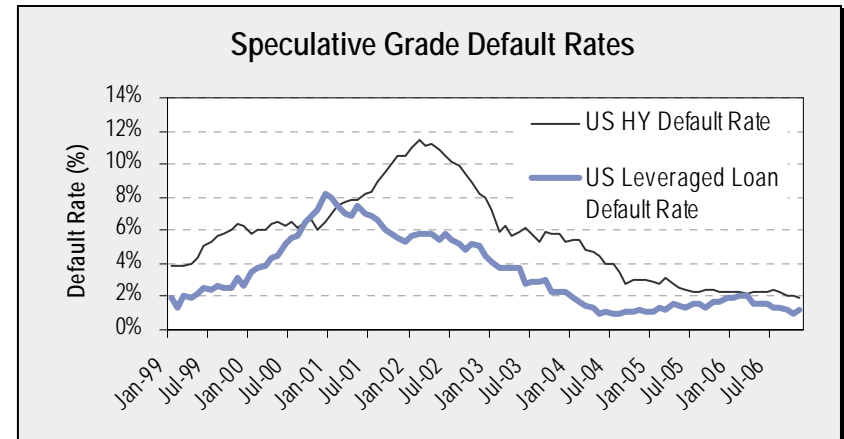
- **ABS CDO issuance should remain relatively stable**
  - Synthetics should pick up much of the slack from decreasing cash supply
  - Mezzanine AAA and Super-Senior investors will drive the “CDO-Arbitrage”
- **CLO issuance should rise by 7%-12%**
  - Strong credit fundamentals and abundant liquidity should maintain demand
- **Trust Preferred CDOs should benefit from a refinancing wave**
  - Non-Call period of \$ 25 BB of Trust Preferred securities expires in next 3-4 years
  - Current spreads remain tighter than at issuance in most cases
- **CRE CDOs should be another area of growth**
  - Investors gaining increasing comfort with the CDO technology
  - Enables issuers to lay off their B-note and mezzanine loan risk

# Mortgage Credit: Rise of the Phoenix?

- Reason to be optimistic about the credit quality of the 2007 vintage
  - Economic self-interest should force originators to improve loan origination
  - State / Federal guidelines should aid in removing “froth” from market
- Subprime
  - Across vintages: Remains levered to strength (or not!) of the housing market
  - 2006 vintage: Poor collateral quality and slowing HPA impacting loan performance
- Alt-A
  - Deterioration in performance much more idiosyncratic
  - Deal performance could vary widely especially due to tight credit subordination
- Option ARMs
  - Quality of underwriting of the stated income segment remains key to performance
  - Low front-end stress make the product residual friendly
  - Investments in debt tranches should account for higher defaults at back-end

# Corporate Credit: More of the Same

- **Robust Credit Fundamentals**
  - Earnings growth expected to remain strong
  - Default rates near all-time lows
    - Probable rise in 2007, but driven more by idiosyncratic factors than systemic deterioration
- **Resilient Market Indicators**
  - S&P VIX near all-time lows
  - US HY bond distress ratio around its lows
  - Liquidity remains plentiful
- **Fraying At The Edges**
  - Rising debt multiples / falling coverage ratios
  - Decreasing number of covenants
  - Ratings mix skewed towards the lower categories
    - 38% over B+ / 62% below BB-



## 2007: Year of...

- **ABX Index Tranches**
  - Expected to start trading by February 2007
- **Bespoke ABS CDOs**
  - Will get a fillip from the launch of index tranche trading
- **CDO Credit Default Swaps**
  - Ability to express levered relative value opinions from both sides
- **Synthetic Loan Structures**
  - Loan-CDS Index starts trading in Europe / Expected launch in US in Q1 07
  - Synthetic CLOs / Bespoke transactions should start gaining some traction
- **Basel II / Basel IA**
  - Should impact demand dynamics across the capital structure
- **Structural Innovations / ABS Derivatives**
  - Hybrid structures should come into their own
  - ABS CDS Options
  - Levered derivatives, especially in the corporate credit space

# Relative Value Trades for 2007: Flow Products

- **Stay short in duration:**
  - Short duration products offer the best value given our rate outlook and the shape of the curve
    - AAA floaters
    - Short CMOs
- **Structure is cheap:**
  - PACs are attractive vs. sequentials across the curve
    - Great opportunity to add convexity to portfolios
- **Slower speeds make premiums attractive:**
  - Premium ARMs such as 10/1s have added bonus of higher OAS from tail

# Relative Value Trades for 2007: Across Credit

## ■ Mortgage Credit:

- Long Residual / Short Mezzanine
  - Across Sectors: Alt-A / Option-ARM Residuals vs. Subprime mezzanine
  - Using the ABX indices as a proxy short against a Residual portfolio
- Long Below Investment Grade (BBs) / Short Investment Grade (BBB-s)
  - Thin tranche sizes imply similar performance in bearish HPA scenarios

## ■ ABS CDOs

- Optimistic On Housing: Long ABS CDO Equity / Short Specific Collateral Credits
  - Hedging idiosyncratic risk while retaining the upside
- Bearish On Housing: Short AA / A ABS CDOs
  - High correlation of losses in a bearish scenario could lead to a large repricing at the top
- Long MTA-backed ABS CDO Equity

## ■ CLOs

- Long CLO Equity

# Outlook for Corporate Credit 2007

January 4, 2007

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Co-Head Corporate Credit Strategy

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# 2007 Potential Return Outlook

## High Grade Scenarios

	4Q06	Scenarios			
Spread	102	102	105	107	107
UST 10-year	4.6	4.6	4.7	4.8	5.1
<i>Annual change (bps)</i>					
Spread		0	3	5	5
UST 10-year		0	10	20	50
<i>Returns attributable to:</i>					
Coupon		5.9	5.9	5.9	5.9
Spread		0.0	-0.2	-0.3	-0.3
UST 10-year		0.0	-0.6	-1.2	-3.0
LBOs		-0.3	-0.3	-0.3	-0.3
<b>Expected Return (%)</b>	<b>5.6</b>	<b>4.8</b>	<b>4.1</b>	<b>2.3</b>	

Source: Bear Stearns Credit Research

# 2007 Potential Return Outlook

## High Yield Scenarios

	4Q06	Scenarios			
Spread	330	315	330	350	360
UST 10-year	4.6	4.6	4.7	4.8	5.1
Defaults	1.8	2.3	2.3	2.3	2.3
<i>Annual change (bps)</i>					
Spread		-15	0	20	30
UST 10-year		0	10	20	50
<i>Returns attributable to:</i>					
Coupon		8.0	8.0	8.0	8.0
Spread		0.8	0.0	-1.0	-1.5
UST 10-year		0.0	-0.5	-1.0	-2.6
Defaults		-0.9	-0.9	-0.9	-0.9
<b>Expected Return (%)</b>	<b>7.8</b>	<b>6.6</b>	<b>5.0</b>	<b>3.0</b>	

Source: Bear Stearns Credit Research

# Four Legs Support the Credit Platform

## Economy / Macro

Employment is strong (4.5% UE, 4% wages)  
Inflation reasonable (TIPs 2.3%, PCE 2.4%)  
Fed is win-win-win (last hike, pause, cut)  
Lot of dollar-vested trade partners  
Housing/consumer = Fed/ low UE

## Technicals / Liquidity

CDOs/CPDOs driving spreads tighter  
Pension rules and Asia demand for long end  
Less natural demand for protection  
Continued lending to fund M&A and LBOs

## Credit Fundamentals

Corporate profit growth slowing but stable  
Defaults are below 2%  
Covenants and step-up protections  
Lot of balance sheet cash (\$750 billion SPX)  
LBOs and leveraging will continue

## Investors' View

Volatility is extremely low  
No punishment for risk taking  
Opportunity cost of being under-invested  
Competing asset choices vs. 5% CD rates

# Sectors in Focus

## High Grade

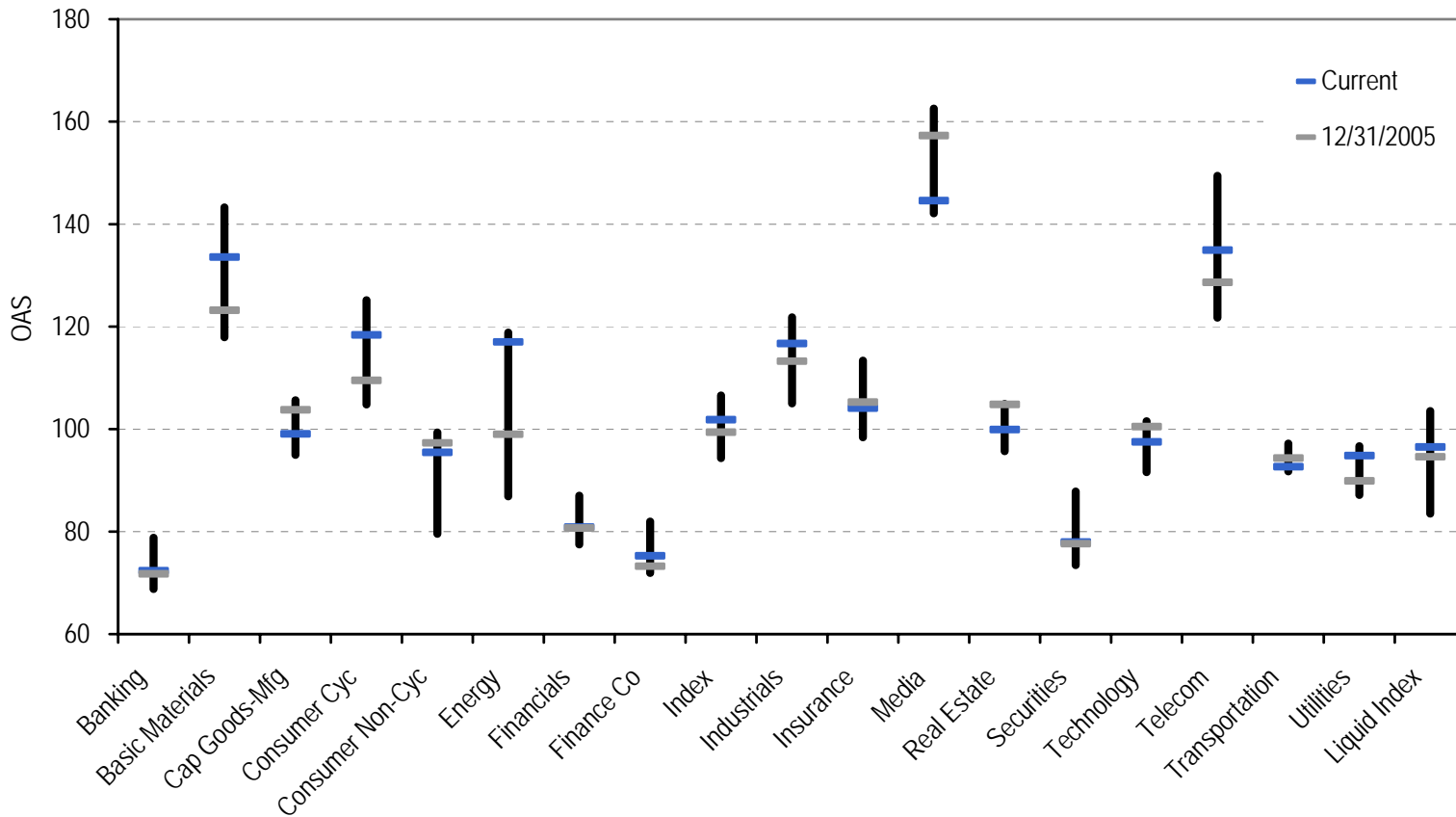
Relative Value Opportunities	
Autos	Media/Cable
Energy	Supermarkets
Homebuilders	Telecom
LBO-Resistant	
E&P	Financials
Utilities	Railroads
LBO / Event Risk Potential	
Consumer Products	Media/Newspapers
Industrials	Retailers

## High Yield

Relative Value Opportunities	
Autos	Homebuilders
Energy	Retailers
Cable	Wireless
Defensive	
Gaming	Satellites
Healthcare	Media/Directories
Cable	Wireless

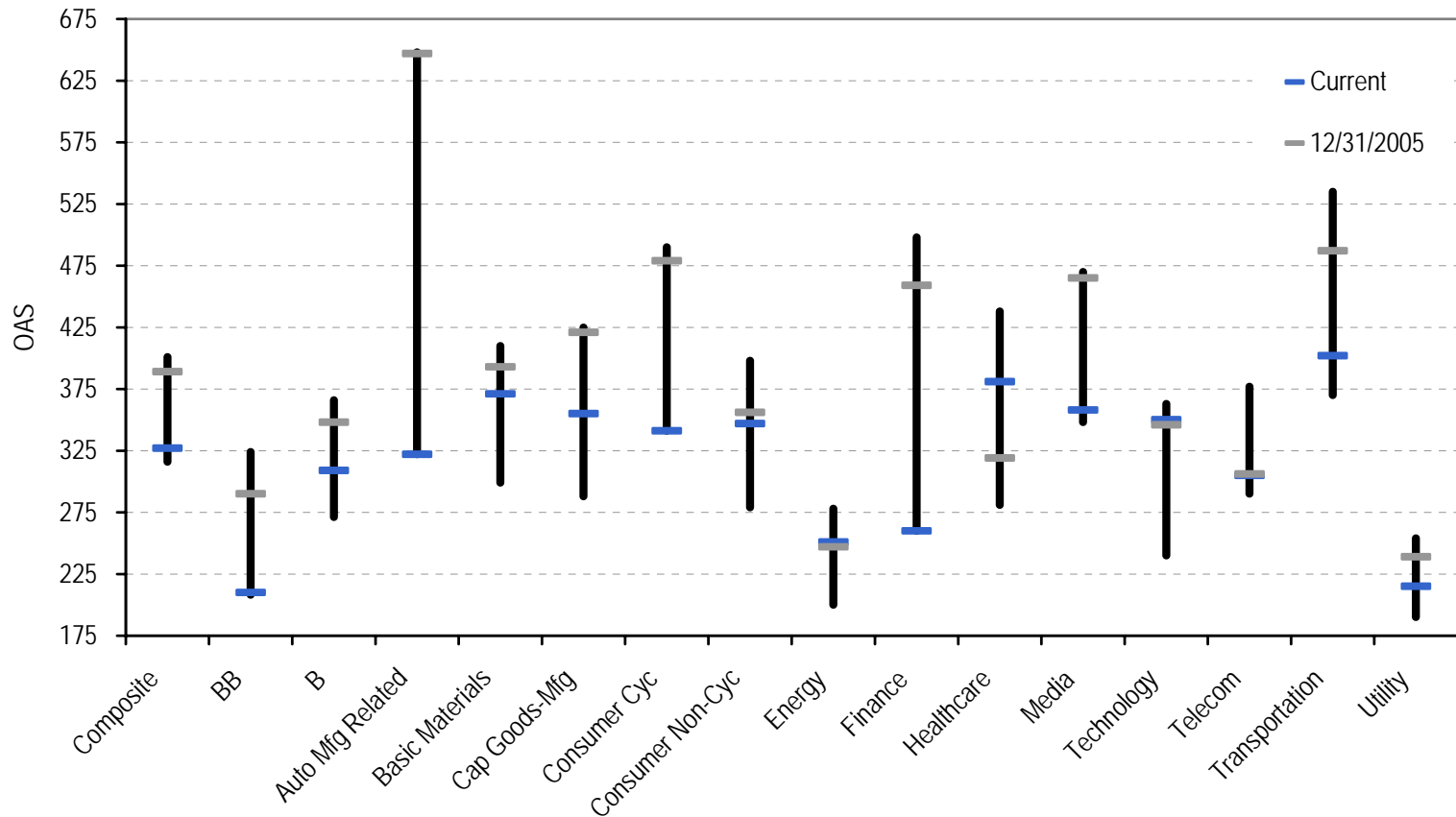
# Bear Stearns High Grade Corporate Index

2006 Sector Trading Ranges, as of 12/08/06



# Bear Stearns High Yield Index (BSIX)

2006 Sector Trading Ranges, as of 12/08/06



# Where Could Potential Market Stress Come From?

<p><b>Economy / Macro</b></p> <p>Housing hard landing (low probability)</p> <p>Inflation hits 3% (moderate probability)</p> <p>GDP below 2%, recession fears (low prob.)</p> <p>Severe dollar weakness (low prob.)</p>	<p><b>Systemic Concerns</b></p> <p>Corporate profit growth drops sharply</p> <p>Multiple credit defaults (weak LBOs)</p> <p>Hedge fund leverage problems</p> <p>Global liquidity stalls</p>
<p><b>Episodic Stresses</b></p> <p>LBOs and rumors widen spreads</p> <p>Stock market corrections / VIX spikes</p> <p>Subprime mortgage contagion</p>	<p><b>Exogenous / Unpredictable</b></p> <p>Terrorism                      Tax hike rhetoric</p> <p>Bird Flu                              Corporate fraud</p> <p>Oil shock                              New war or confrontation</p>

# 2006 Credit Events & Market Movers

## High Grade LBOs (8)

CCU	Clear Channel
EOP	Equity Office Properties
FSL	Freescale Semiconductor
HET	Harrah's Entertainment
KMI	Kinder Morgan Inc.
H	Realogy Corp.
TSG	Sabre Holdings
UVN	Univision

## High Grade M&A

ABS	Albertsons
CD	Cendant Corp
KMG	Kerr-McGee
KRI	Knight-Ridder
MYG	Maytag (WHR)
SVU	SUPERVALU (ABS)

## CDS Succession Events

AT	Alltel Corp.
VZ	Verizon

## Active LBO Speculation

CAR	Avis
CBS	CBS
FD	Federated
GPS	Gap
JNY	Jones Apparel
RSH	RadioShack
RRD	RR Donnelley
RRD	SLE
LUV	Southwest Airlines
TRB	Tribune Co.

## Major High Yield LBOs

CVC	CSC Holdings Inc.
GP	Georgia-Pacific Corp.
HCA	HCA Inc.
STN	Station Casinos

# Outlook for Emerging Market Debt 2007

January 4, 2007

**Carl Ross**

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**Bear, Stearns & Co. Inc.**

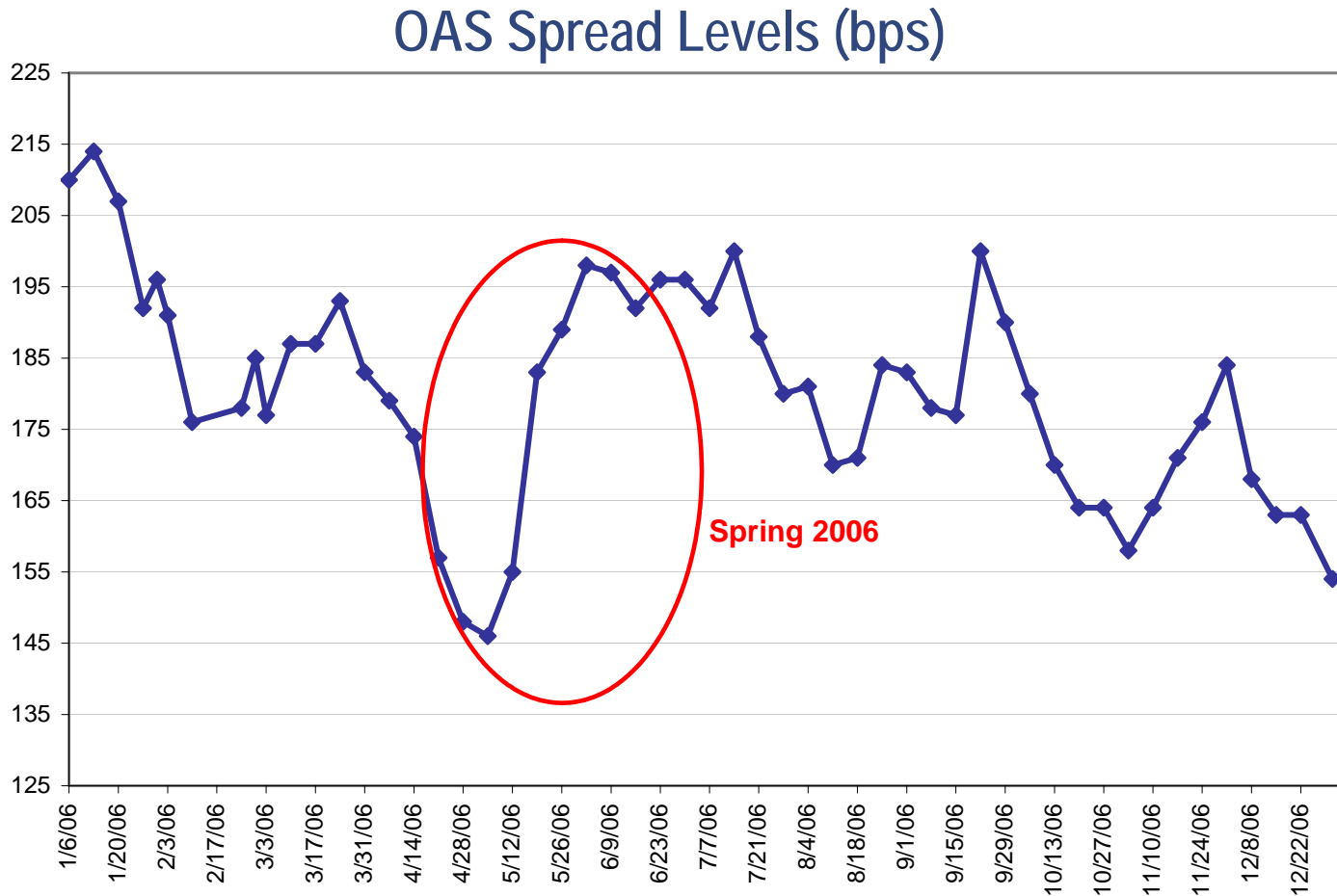
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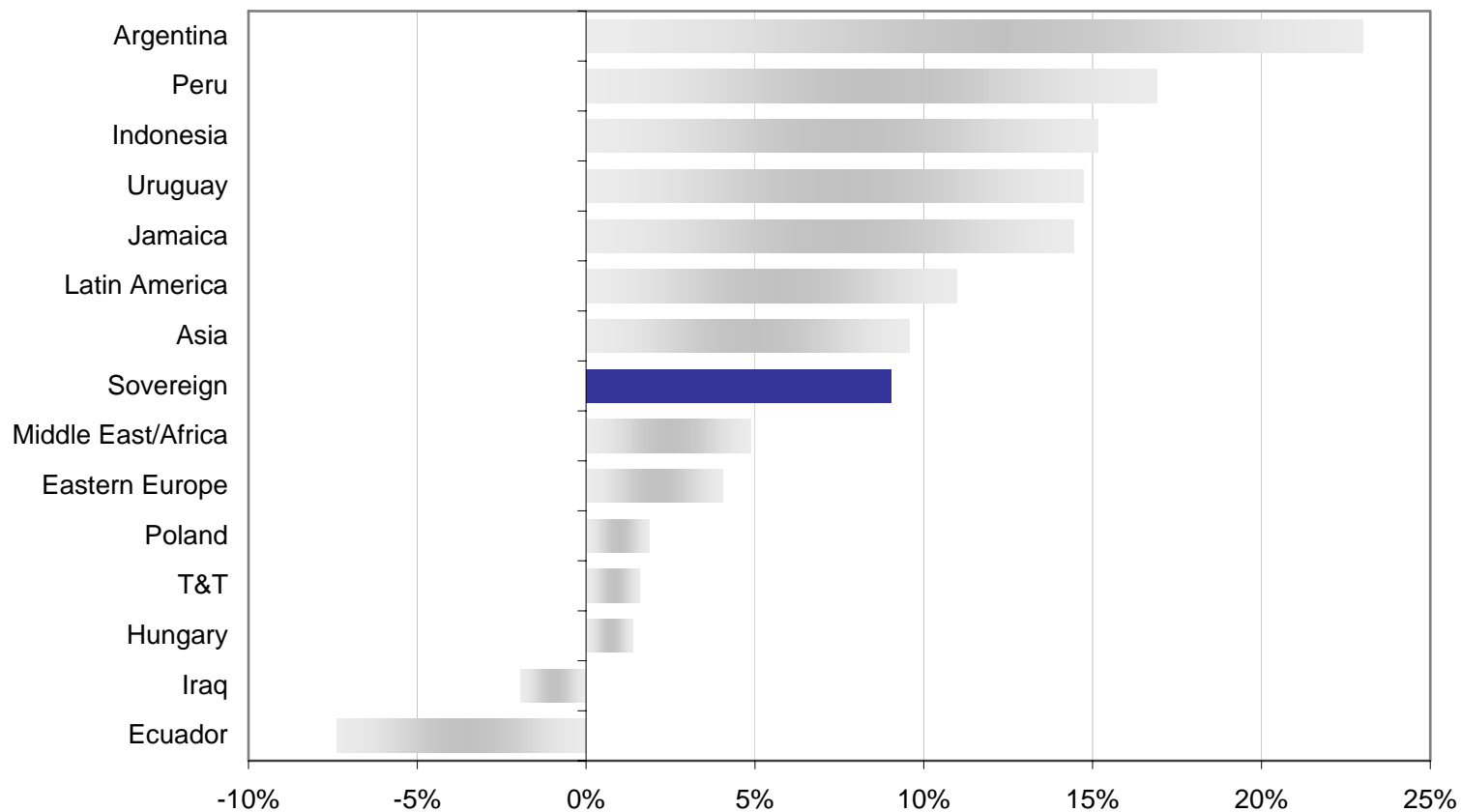
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# BSEMIC Index of Emerging Market Sovereign Debt



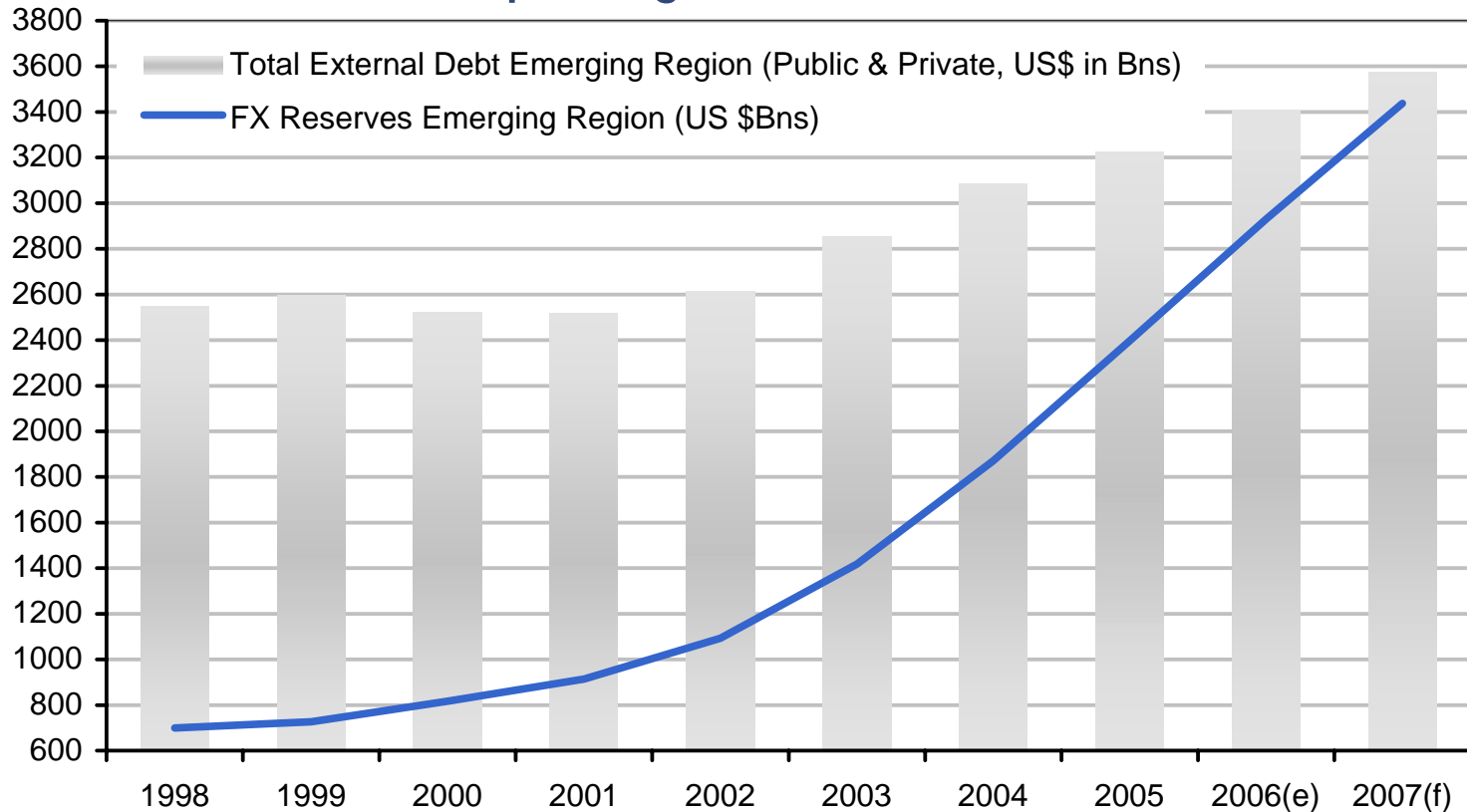
# BSEMIX Ranked Returns

YTD as of December 31, 2006



# Emerging Economies

## Improving "Balance Sheet"



Source: IMF World Economic Outlook

# BSEMIX Countries

## Current Ratings and Outlook

Countries	Moody's		S&P		Fitch	
	Rating	Outlook	Rating	Outlook	Rating	Outlook
<b>Latin America</b>						
Brazil	Ba2	STA	BB	POS	BB	STA
Colombia	Ba2	STA	BB	POS	BB	POS
Dominican Republic /1	B3	NA	B	POS	B	POS
Ecuador	Caa1	POS	CCC+	STA	B-	STA
Guatemala	Ba2	POS	BB	STA	BB+	STA
Peru	Ba3	POS	BB+	STA	BB+	STA
Uruguay /1	B3	NA	B	STA	B+	POS
Venezuela	B2	STA	BB-	POS	BB-	STA
<b>Asia</b>						
China	A2	POS	A	STA	A	POS
Hong Kong	Aa3	POS	AA	STA	AA-	POS
Korea	A3	POS	A	STA	A+	STA
Pakistan	B1	STA	B+	POS	NR	NA
<b>Eastern Europe</b>						
Hungary /1	A1	NA	BBB+	NEG	BBB+	NEG
Poland	A2	STA	BBB+	STA	BBB+	POS
Serbia	NR	NA	BB-	POS	BB-	STA
Ukraine	B1	POS	BB-	STA	BB-	POS
<b>Middle East/Africa</b>						
Lebanon	B3	NEG	B-	NEG	B-	STA
Turkey	Ba3	STA	BB-	STA	BB-	POS

Source: Bloomberg.

# Emerging Markets 2007 Scenarios

## Base Case

- Our BSEMIX index spread will tighten by 10–20 bps over the course of the year.
- China will likely continue growing at a 10% rate in real terms.
- Commodity prices are likely to remain high and emerging market fundamentals are likely to continue to improve.

## Upside Case

- Our BSEMIX index spread tightens by 30 bps to 120–130 bps over U.S. Treasuries returning between 8%–10% for the year.
- Foreign central banks continue to purchase dollar assets, keeping U.S. Treasury yields low.
- U.S. inflation outlook remains well-behaved.

## Downside Case

- Our BSEMIX index spread will widen by 50–60 bps over the course of the year placing the yearly return in negative territory.
- The U.S. enters into a recessionary weakness as a result of weakness in housing and the U.S. consumer.
- Commodity prices fall / global growth slows.

# BondStudio<sup>®</sup> Simulations

Expected BSEMIX 12 Months Returns  
Under Different 10-Year UST Yields and BSEMIX Spread Scenarios

UST 10 Yr. Yield	BSEMIX INDEX SPREAD OVER 10 Yr. UST (bps)				
	+130	+140	+150	+160	+170
<b>4.00%</b>	<b>11.98</b>	<b>11.33</b>	<b>10.67</b>	<b>10.01</b>	<b>9.37</b>
<b>4.50%</b>	<b>8.87</b>	<b>8.23</b>	<b>7.60</b>	<b>6.98</b>	<b>6.36</b>
<b>5.00%</b>	<b>5.89</b>	<b>5.29</b>	<b>4.68</b>	<b>4.09</b>	<b>3.50</b>
<b>5.50%</b>	<b>3.06</b>	<b>2.48</b>	<b>1.90</b>	<b>1.33</b>	<b>0.77</b>
<b>6.00%</b>	<b>0.36</b>	<b>-0.20</b>	<b>-0.75</b>	<b>-1.29</b>	<b>-1.84</b>

*Source: F.A.S.T., EM Fixed Income Research. Note: The current spread of the BSEMIX at the time of presentation is +154bps to U.S. treasuries. Our base case scenario for 2007 calls for a tightening in spread on the index to +140-150 bps..*

# Emerging Markets 2007 Regional Outlooks

## Latin America

- Another year of positive economic growth on the back of high commodity prices, higher investment rates and lower interest rates.
- Fiscal accounts likely to continue to improve.
- Liability management operations and buybacks will provide erosion in the supply of bonds.

## Asia

- Noise in the political space expected to increase due to a heavy elections calendar and recent unconventional political maneuvering.
- Rates of economic growth, while ranging between 5%–6% or higher in good years, may disappoint as this growth has been driven by consumption and export rather than by investments.

## Eastern Europe, Middle East and Africa

- Similar to Asia, elections are set to dominate the policy agenda in the EMEA region.

## **Emerging Markets 2007 Corporate Debt Outlook**

- Constructive outlook for EM Sovereigns is supportive of a positive environment for EM corporates.
- Expect another year of healthy issuance levels.
- Increased institutional maturity ,especially in places like Mexico and Brazil, will focus EM corporate debt in the view of yield-hungry investors as an interesting investment proposition and not as a one-off bet.
- Growth of the local currency markets will lead to interesting investment opportunities with investor-friendly financing structures.

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