

Research Quarterly



May 2004

Sustained Economic Growth Drives Bond Markets in 2004 and Leads to Rotation to Credit Sensitive Sectors

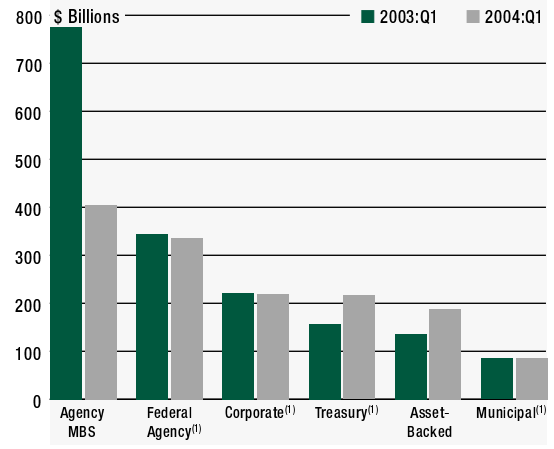
New issue activity in the U.S. bond markets reached \$1.46 trillion in the first quarter, about 15 percent lower than the same period a year ago and relatively unchanged from the fourth quarter of 2003. The year-over-year decline is attributable to slower mortgage market activity following three consecutive record years of mortgage-related securities issuance. Excluding the mortgage market, bond market issuance was higher than a year ago.

As we enter the second quarter, signs of sustained economic growth and its effect on Fed policy and interest rates dominate the market environment. The economic growth outlook is reflected in the improved employment trends, credit quality improvement and increased corporate profits. As a result, the ABS and corporate markets showed the sharpest issuance increase on a linked-quarter basis. We expect demand for capital in those sectors as well as continued financing requirements in both the federal government and state and local entities. With the growth-led rise in bond yields early in the second quarter, both investors and borrowers are in the process of adjusting to the developing market environment.

Highlights

- Treasury gross coupon issuance totaled \$215.9 billion during the first quarter, increasing 37.2 percent from the \$157.4 billion issued one year ago.
- Federal agencies' long-term issuance decreased slightly, to \$335.9 billion in the first quarter of 2004.
- Total municipal issuance totaled \$93.4 billion in the quarter, unchanged from last year.
- Corporate bond issuance remained relatively unchanged at \$219.5 billion from the first quarter of 2003.
- Asset-backed issuance increased 38.3 percent, to \$187.6 billion, up from the \$135.6 billion issued in the first quarter of 2003.
- Mortgage-related securities issuance decreased to \$404.4 billion in the first quarter of 2004, down from the \$776.1 billion issued one year ago.
- The outstanding volume of money market instruments, including commercial paper, large-time deposits and bankers' acceptances, totaled an estimated \$2.58 trillion as of the end of March.
- Bond mutual funds net inflows totaled \$8.9 billion, up from the net outflow of \$2.2 billion in the fourth quarter of 2003.
- Special Report – Asian securitization

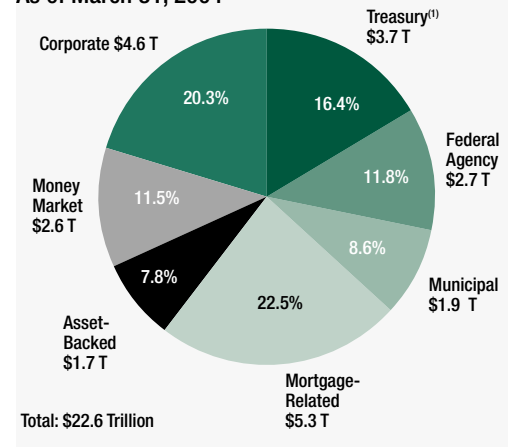
Issuance in the U.S. Bond Markets
2003:Q1 vs. 2004:Q1



⁽¹⁾ Includes long-term issuance

Sources: Thomson Financial Securities Data, U.S. Treasury, U.S. Federal Agencies, Inside MBS & ABS

Outstanding Bond Market Debt
As of March 31, 2004*



⁽¹⁾ Includes marketable public debt

* The Bond Market Association estimates

Sources: Federal Reserve System, U.S. Treasury, GNMA, FNMA, FHLMC, Bloomberg

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Treasury Coupon Issuance Shows Modest Growth in Q1, Lower Q2 Forecast on Rising Net Tax Receipts

Gross coupon issuance of U.S. Treasury securities totaled \$215.9 billion in the first quarter of 2004, a 37.2 percent increase over the \$157.4 billion issued in the first quarter of 2003. The first quarter coupon issuance was less than one percent higher than the \$214.9 billion issued during the fourth quarter of 2003, which may reflect anticipated higher tax revenues due to accelerated economic growth beginning in late 2003. The Treasury's net issuance of both bills and coupons totaled \$145.9 billion in the first three months of the year.

Total marketable Treasury debt outstanding reached \$3.72 trillion as of March 31, 2004, 4.1 percent higher than the \$3.57 trillion outstanding at the end of December 2003. The outstanding level of Treasury coupon securities totaled \$2.74 trillion at the end of the quarter, compared to \$2.36 trillion outstanding at the end of the first quarter of 2003.

The Department of Treasury in early May projected that the Federal budget deficit for FY 04 could be \$100 billion less than the earlier Office of Management and Budget projection of \$521 billion, which, of course, would affect issuance volume. Absent significant changes in fiscal policy, the consensus view has been that the deficit will recede after the current fiscal year.

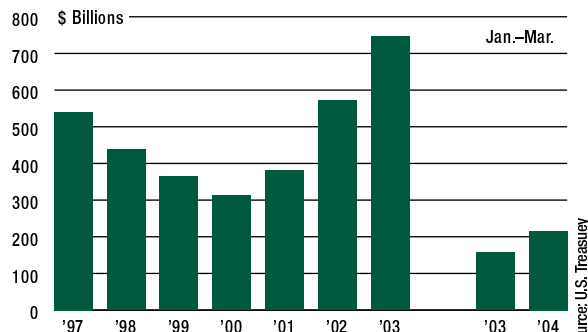
Trading Volume

Daily trading volume of Treasury securities by primary dealers averaged \$479.6 billion during the first three months of 2004, up 23.7 percent from the \$387.7 billion over the same period a year ago. Daily trading volume by primary dealers peaked in February at \$485.4 billion and declined to \$475.5 billion in March. Continuing geopolitical risk, macroeconomic uncertainties especially with respect to the employment outlook, and strong overseas demand have contributed to strong demand for Treasury securities. The yield on the 10-year Treasury note ended the quarter at 3.84 percent, but the yield has since risen to above 4.5 percent by the end of April—and further since then—based on data indicative of sustainable economic growth. Though the Treasury auction coverage ratios slipped a bit in the first quarter, they were still above the last six months' average. Treasury auctions continue to be well subscribed and the recent rise in rates could further spur demand in the second quarter. Non-U.S. investors have been net purchasers of U.S. Treasuries since the end of 2001.

Outlook

Treasury has projected net second quarter borrowing of marketable debt to be \$38 billion compared to the actual net borrowing of \$74 billion for the first quarter and an earlier projected second quarter level of \$75 billion. The lower Treasury projection reflects an increase in its report of net tax receipts in early May. The Treasury projects third quarter net borrowing at \$91 billion. In addition, Treasury stated its intention to expand TIPS issuance, including introducing the 5-year and 20-year TIPS. With the April tax data coming in, the Federal government's funding needs and strategy for the balance of the year are going to become clearer.

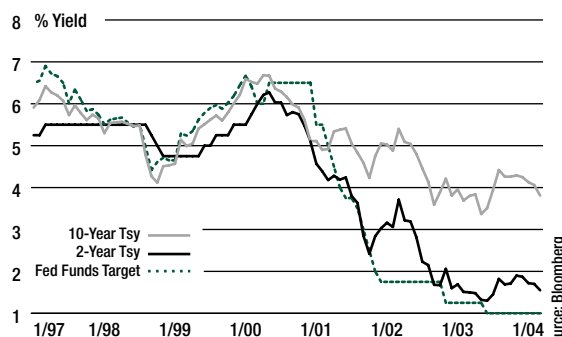
Issuance of U.S. Treasury Securities⁽¹⁾
1997–2004:Q1



⁽¹⁾ Includes only marketable coupon securities

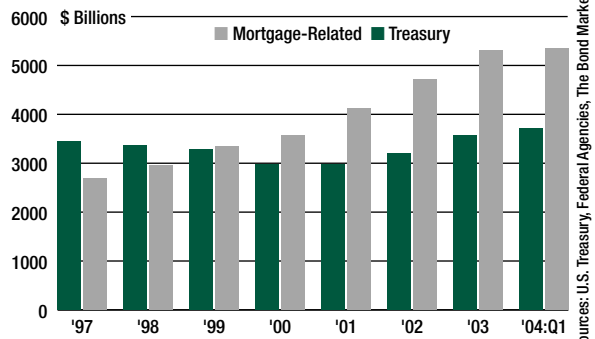
Source: U.S. Treasury

Treasury Yields and Fed Fund Rate
Jan. 1997–Mar. 2004



Source: Bloomberg

U.S. Treasury Securities Outstanding* vs. Mortgage-Related Securities Outstanding**

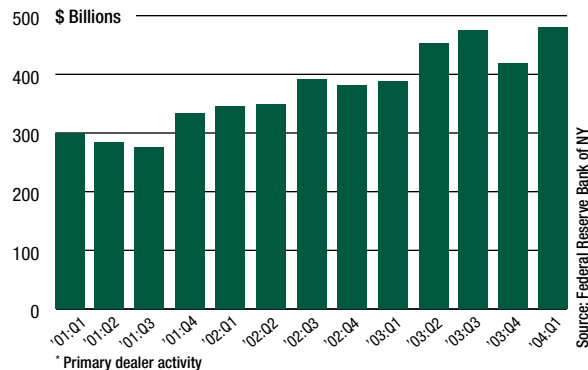


* Includes Marketable Public Debt

** Includes Agency MBS, Agency CMO and Private-Label MBS

Sources: U.S. Treasury, Federal Agencies, The Bond Market Association

Average Daily Trading Volume of Treasury Securities*
2001–2004:Q1



* Primary dealer activity

Source: Federal Reserve Bank of NY

Long-Term Agency Q1 Volume Stabilizes

Long-term issuance by federal agencies fell by 2.5 percent during the first quarter of 2003. On the strength of declining interest rates toward the end of the quarter, the strong and resilient conforming residential mortgage market continued to drive issuance volume, led by growth at both Freddie Mac and Fannie Mae, while the Federal Home Loan Bank System issuance declined from the torrid 2003 pace. Among the non-housing agency issuers, Sallie Mae volume rose slightly while the Tennessee Valley Authority volume was virtually unchanged from one year ago. Through the early part of the second quarter, rates were rising based on indications of sustainable economic growth. Considering the effect of interest rates, it is not unreasonable to expect more stable or even slower mortgage market growth through 2003 and the first quarter of this year. The Bond Market Association's quarterly survey of its government and agency research and market strategist committee projected a more moderate rate of agency issuance growth in Q2. Regardless of the direction of rates, we caution against employing a simple linear interest rate to agency issuance volume relationship. Over the last several years, analysts have consistently underestimated the strength of the residential housing market.

Long-Term Federal Agency Debt Issuance

\$ Billions	2003	2003:Q1	2004:Q1	YTD-to-YTD % Change	YTD-to-YTD \$ Change
FHLB¹	569.2	176.9	132.8	-24.9%	(44.1)
Freddie Mac	277.1	66.8	93.1	39.4%	26.3
Fannie Mae	347.8	76.5	92.6	21.0%	16.1
Sallie Mae	18.7	5.2	5.4	3.8%	0.2
FCS²	52.5	19.1	11.9	-37.7%	(7.2)
TVA³	2.2	0.1	0.1	0.0%	0.0
Totals	1267.5	344.6	335.9	-2.5%	(8.7)

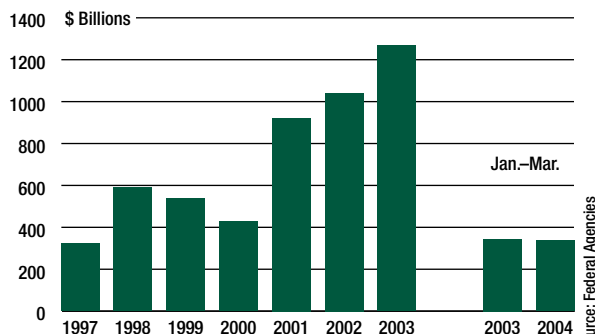
Short-Term Federal Agency Debt Outstanding

\$ Billions	3/31/03	12/31/03	3/31/04	% Change*	\$ Change*
FHLB¹	143.0	163.9	162.1	-1.1%	(1.8)
Freddie Mac	174.0	189.0	174.0	-7.9%	(15.0)
Fannie Mae	318.0	346	338.2	-2.3%	(7.8)
Sallie Mae	23.8	18.7	16.2	-13.4%	(2.5)
FCS²	16.1	12.9	13.8	7.0%	0.9
TVA³	3.3	0.9	0.3	-66.7%	(0.6)
Totals	678.2	731.4	704.6	-3.7%	(26.8)

*Percentage and \$ amount change between 12/31/03 and 3/31/04
¹Federal Home Loan Bank System

²Farm Credit System
³Tennessee Valley Authority

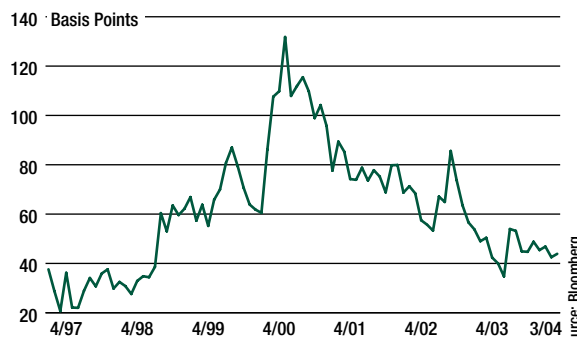
Long-Term Federal Agency Debt Issuance⁽¹⁾ 1997-2004:Q1



⁽¹⁾ Excludes maturities of one year or less

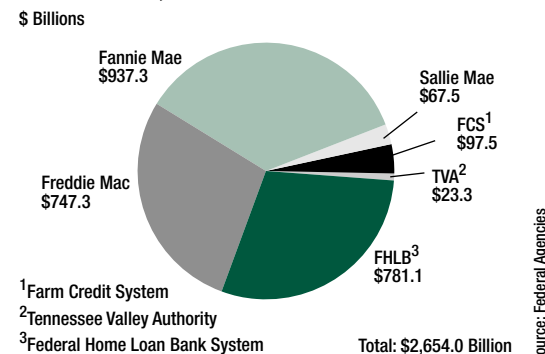
Source: Federal Agencies

U.S. Agency Spreads to U.S. Treasury—10-Year 1997-2004:Q1



Source: Bloomberg

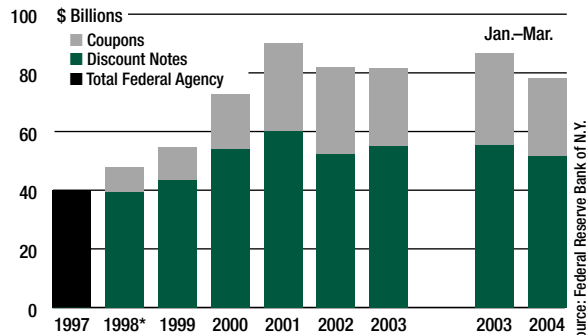
Total Federal Agency Debt Outstanding As of March 31, 2004



¹Farm Credit System
²Tennessee Valley Authority
³Federal Home Loan Bank System

Source: Federal Agencies

Average Daily Trading Volume of Federal Agency Securities⁽¹⁾ 1997-2004:Q1



⁽¹⁾ Primary dealer activity
 *First year in which specified maturity levels were reported

Source: Federal Reserve Bank of N.Y.

Late Quarter Surge Pushes Municipal Volume

Total short- and long-term municipal bond issuance reached \$93.4 billion in the first quarter of 2004, a less than one percent decrease from the same period in 2003, and an 11.4 percent decrease from the fourth quarter 2003 volume of \$105.4 billion. Driven by a more favorable rate environment late in the quarter, long-term municipal securities volume reached \$38.2 billion in March, accounting for more than 40 percent of the total long-term issuance for the first quarter. Higher and rising interest rates earlier in the first quarter led to lower refunding activity as higher rates reduced the number of refunding candidates. New money issuance grew, driven by a number of large deals and a continuation of a historically and relatively low interest rate environment. Notwithstanding significantly higher rates in the second quarter, we expect a significant supply of municipal securities in the coming months. State and local governments will continue to look to the bond market to finance infrastructure, general operations and other program expenditures. The increased supply coming to market late in the quarter may have had some effect of pushing up municipal yields relative to Treasuries. The higher yields may suggest attractive opportunities to buy and invest in municipal bonds.

Long-term municipal issuance with maturities of 13 months or greater decreased slightly to \$85.1 billion from the \$85.6 billion issued in the first quarter of 2003. Lower refunding volume led to the slight drop in issuance. In the current economic and interest-rate-environment, new money issuance is expected to drive growth over the next several months. Short-term securities issuance totaled \$8.2 billion in the first quarter of 2004, a 5.3 percent increase over the \$7.8 billion issued during the same period of 2003. The relative growth of short-term issuance may have reflected cost of funds considerations in financial markets characterized by a historically steep yield curve. Outstanding municipal bond volume reached an estimated \$1.93 trillion at the end of the first quarter, a slight increase from the \$1.90 trillion outstanding at the end of 2003.

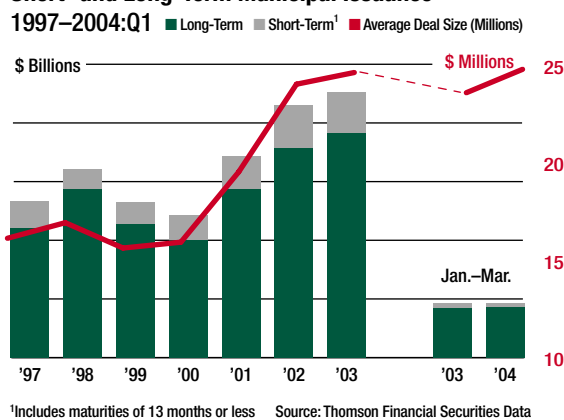
New Capital Issuance Supply Grows

New money issues totaled \$55.3 billion in the first quarter of 2004, up 2.4 percent from the \$54.0 billion issued in the same period of 2003, and accounted for over half of the long-term dollar volume in the quarter. The general government sector totaled \$20.5 billion, a 17.9 percent increase from the first quarter of last year. The second largest use of municipal bond proceeds, the education sector, declined 15.4 percent in the first quarter to a total of \$13.1 billion. Municipal issuance decreased across several other use of proceeds sectors as well, including the economic development, health care, industrial development and transportation sectors.

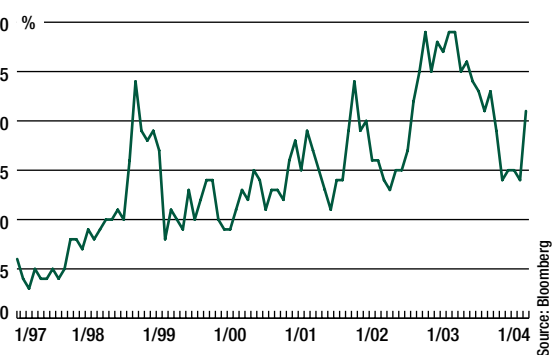
Refundings Affected by the Rate Environment

The volume of refunding activity totaled \$29.8 billion in the first quarter, down 5.8 percent from the \$31.6 billion in the same period of 2003. The decline was fairly consistent across the spectrum of use of proceed sectors, as the opportunities to refund debt diminished with the growth-induced interest rate trends. A notable exception was general government refunding issuance, which increased 41.7 percent, to \$13.3 billion in the first quarter of 2004, compared to \$9.4 billion in the same period of 2003. Refunding issuance in the education sector ranked second, with \$7.6 billion issued in the first quarter.

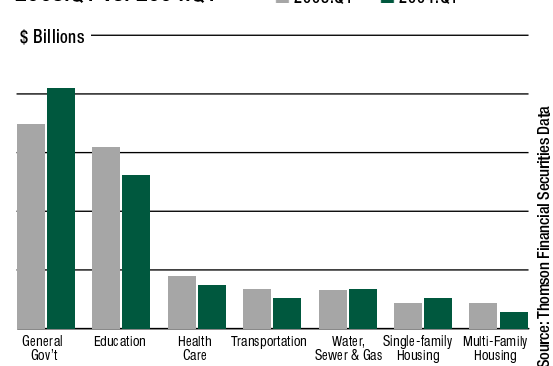
Short- and Long-Term Municipal Issuance



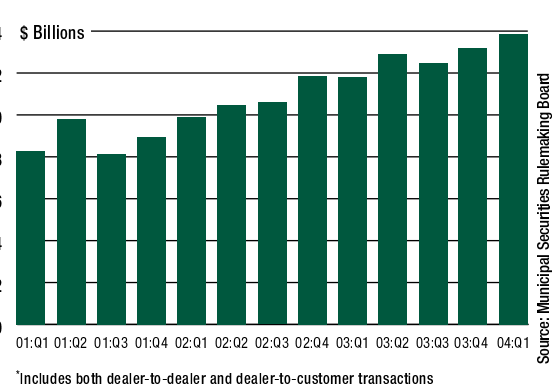
10-Yr Municipal G.O. AAA to 10-Yr Treasury Ratio



Municipal New Capital—Use of Proceeds



Average Daily Trading Volume of Municipal Securities*



Corporate Bond Supply Strong in Q1 on Tighter Spreads, Improved Credit Quality

Building on a positive 2003, the supply of new corporate bonds increased significantly during the first quarter of 2004. Total issuance volume reached \$219.5 billion, up 28 percent from the fourth quarter of 2003, though modestly lower (less than 1 percent) than for the same period last year. The strong first quarter of 2004 benefited from favorable market conditions—solid economic expansion, historically low interest rates, muted inflation, and the effects of accommodative fiscal and monetary policies. While 2003 issuance growth was boosted by higher cost debt, the drivers of first quarter growth were new capital spending and financing of emerging acquisition opportunities. After a prolonged period of restrained borrowing by nonfinancials, issuance grew noticeably during the first quarter reflective of the need to fund new capital investment. Looking to the next few months, corporate bond supply is likely to be sustained by economic expansion and resulting capital spending growth. Considering the rise in interest rates through the first month of the second quarter, the constraint to the higher issuance scenario is the direction of bond yields and Fed policy over the balance of the year.

Strong Quarter for MTN

Medium-Term Notes (MTNs) reached the highest level in a year, with a total volume of \$84.4 billion, up by 87.2 percent on a quarter-over-quarter basis and 32.3 percent year-over-year. The MTN growth was the result of corporate demand for external financing and issuer desire to take advantage of low rates during the quarter.

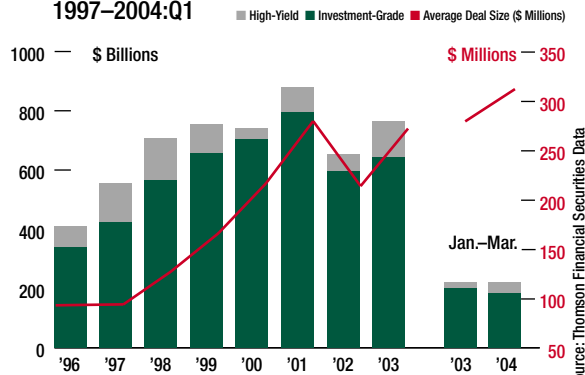
Reflecting both equity market performance and interest rates during the first quarter, total convertible bond issuance (including investment-grade and high-yield issues) rose 6.4 percent on a linked quarter basis to \$14.1 billion, though the volume was slightly lower, by about 0.6 percent, on a year-over-year basis. Convertible bond issuance growth can be explained by the stronger market appetite for equity-related issues, which had been flat since the surge in the second quarter of 2003. The equity market recovery that set the stage for a rise in new equity issues led to the flat-line trend in convertible issuance during the latter part of last year.

Credit Quality Gains

The broad improvement in corporate credit quality is the result of stronger economic fundamentals and increased corporate profitability. According to Standard & Poor's, U.S. corporate bonds downgrades declined to 64 percent (45 upgrades and 80 downgrades) from last quarter's 71 percent of total rating actions. Furthermore, the S&P U.S. speculative grade default rate declined to 4.7 percent for the twelve months ending in March, the lowest since mid-July 1999; and based on the first quarter data the aggregate global default rate is on pace to be at its lowest level since 1987.

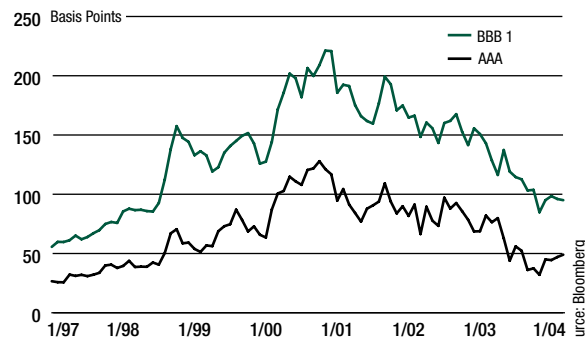
Supported by the favorable credit quality trends, investment-grade spreads are the tightest in nearly five years. Moreover, high-yield

Corporate Bond Issuance⁽¹⁾
1997–2004:Q1

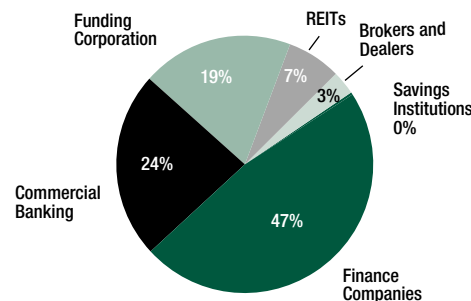


⁽¹⁾ Includes all non-convertible corporate debt, MTNs, and Yankee bonds, but excludes all issues with maturities of one year or less, CDs and federal agency debt.

U.S. Corporate Spreads to U.S. Treasury—10-Year
1997–2004:Q1



Corporate Debt Outstanding—Financial Sectors
As of March 31, 2004*



* The Bond Market Association estimates

spread tightening has been the story of the past year and was at the narrowest level in at least five years during April. According to the Merrill Lynch corporate bond indices, as reported by Stone and McCarthy, the average investment-grade yield fell by 63.5 basis points during 2003 and by 34.8 basis points during the first quarter, making the investment grade index yield level the lowest in over a decade.

As with the rest of the fixed-income markets, yields moved up in April on the strength of economic growth-induced rate movements. Looking ahead, while recent events suggest rates are unlikely to return to first quarter levels, spreads could remain stable on the strength of economic growth and profit levels. Should rate volatility continue, the investor appetite may be tested, and spreads could suffer, especially after such a protracted rally.

Strong High Grade Issuance Leads Growth in 1Q

New issue volume of non-convertible investment-grade bonds rose 31.3 percent, to \$185.1 billion issued in the first quarter of 2004. On year-over-year basis, this represents an 8.5 percent decline. Issuance from financial institutions still dominated the marketplace. Commercial banks, investment banks and credit institutions boosted total combined new issue market shares to about 65 percent, compared to the average 2003 quarterly share of 51.7 percent. Issuance from the mortgage finance industry grew for the fourth consecutive quarter, with total volume of \$6.7 billion.

High-Yield Surge Continued

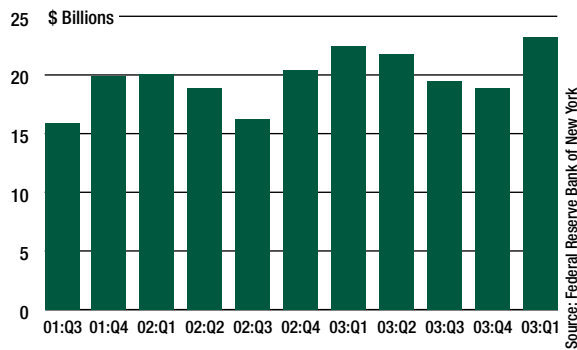
New issue volume of non-convertible high-yield corporate debt (below BBB) maintained its remarkable momentum. Total volume during the first quarter was \$34.4 billion, almost doubling the high-yield issuance of \$18.8 billion during the first quarter 2003. On a linked-quarter basis, new supply rose 12.4 percent from the previous level of \$30.6 billion. The leisure industry led the high-yield growth in the quarter to \$4.3 billion, triple the sector's average quarterly issuance in 2003, while the radio and television sector bounced back to \$4 billion from \$2.6 billion in the fourth quarter. The strong supply data confirmed the investor appetite for high-yield debt in the current rate environment.

The increasing high-yield supply, in addition to the effects of a higher rate environment in the second quarter, may test the high-yield market. Improving profits and credit quality have characterized the rally over the last year. An important consideration is the overall credit quality for the high-yield market as more high-yield issuers tap the market.

Trading Volume Hits Highest Level Since 2002

The average daily corporate trading volume by primary dealers for bonds with maturities of greater than one year increased 20 percent in the first quarter, to \$23.2 billion, up from \$18.9 billion during the fourth quarter of 2003. This was the highest level since 2002, which reflects the strong performance of the corporate sector in the first quarter. According to MarketAxess, and based on information disseminated through the NASD's TRACE system, total estimated trading volume in the first quarter was \$579 billion, about an 8 percent increase based on estimated average daily trading volume.

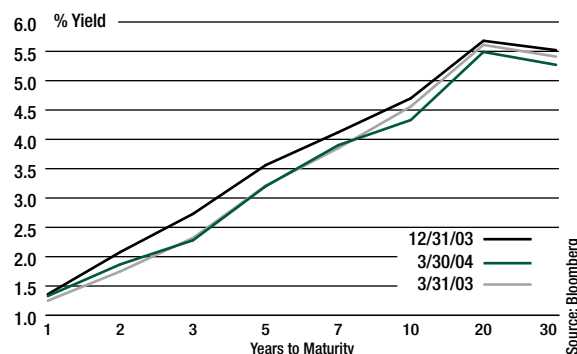
**Average Daily Trading Volume for Corporate Bonds⁽¹⁾
2001:Q3–2004:Q1**



⁽¹⁾ Primary dealer activity; excludes all issues with maturities of one year or less

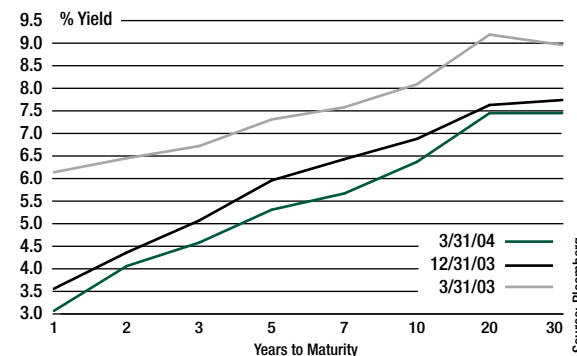
Source: Federal Reserve Bank of New York

U.S. Corporate: AAA Industrial Yield Curves



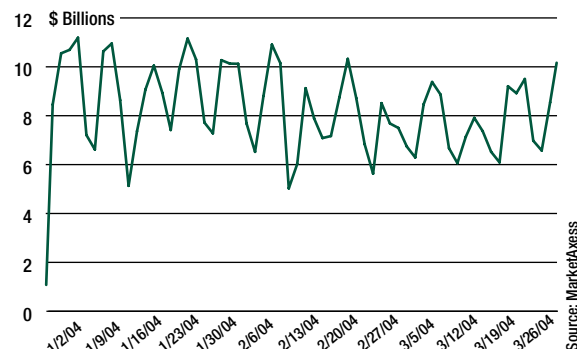
Source: Bloomberg

U.S. Corporate: BB Industrial Yield Curves



Source: Bloomberg

**TRACE Daily Trading Volume*
2004:Q1**



* As of April 4, 2004

Source: MarketAxess

ABS New Issue Activity Remains Strong

The asset-backed securities (ABS) market maintained its remarkable growth through the first quarter of 2004. Issuance totaled \$187.6 billion, up 38.3 percent from the \$135.6 billion issued in the first quarter of 2003. The ABS market was driven by the strong performance of the home equity loan (HEL) securitization market. Undoubtedly fueled by the low-interest-rate environment, refinancings and product expansion again led to HEL origination growth during the quarter. Through the early part of the second quarter, mortgage rates have risen on the strength of indications of sustained economic growth. An anticipated rise in interest rates poses a challenge for maintaining the rate of HEL growth in 2004, as mortgage market activity may subside and issuers may benefit from the use of alternative forms of capital funding. With economic and employment expansion, issuance of non-home equity ABS products, such as credit card receivables and auto loans, could benefit. Furthermore, income and jobs growth enhances credit quality outlook for all consumer loans. As we have commented in the past, recent history suggests caution and that the resiliency of the residential mortgage product sector should not be underestimated.

Leading ABS Sectors

The home equity sector was the largest component in the ABS market, accounting for 47.4 percent share of total ABS issuance in the quarter. New issue activity surged to \$88.9 billion in the first quarter of 2004, a 74.3 percent increase from one year ago and 56.4 percent higher than the last quarter of 2003. Yield spreads on three-year home equity securities tightened slightly during the first quarter. Tighter first quarter spreads may reflect expectations of improved credit quality.

New issue activity in the credit card sector decreased 38.8 percent, to \$13.2 billion in the first quarter of the year, down from the volume of \$21.5 billion during the first quarter of 2003, which may reflect the use of HEL to consolidate higher cost unsecured consumer debt. The decrease on a linked quarter basis was less pronounced, with issuance totaling \$14.3 billion in the fourth quarter of 2004. Yields spreads of 3-year credit card ABS were virtually unchanged during the quarter.

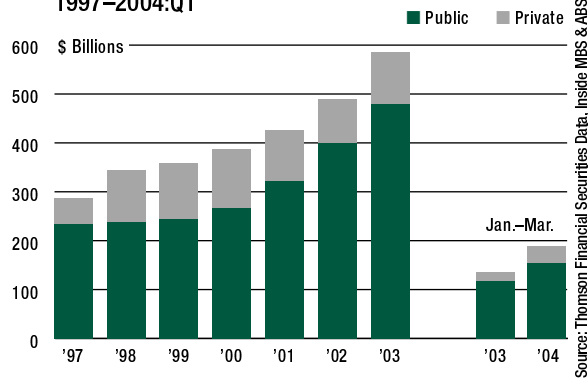
Securitization of auto loan receivables decreased to \$17.8 billion in the first quarter of the year, down 5.6 percent from volume in the same time period one year ago and down 17.8 percent from the fourth quarter of 2003. Yield spreads for 2-year prime auto ABS have narrowed every month since November of 2003, tightening almost 10 basis points by the end of first quarter.

New issue volume in the student loan sector continued to be strong during the first quarter of the year, building on a stellar year in 2003. Volume was down slightly on a year-over-year basis totaling \$10.3 billion compared to a volume of \$10.5 billion one year ago. On a linked-quarter basis, the volume increased 7.8 percent from the \$9.6 billion issued in the fourth quarter.

Asset-Backed Commercial Paper

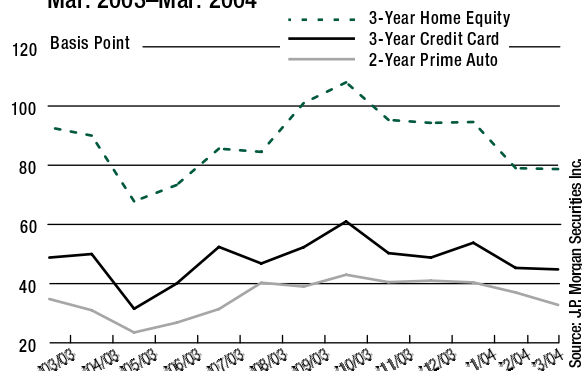
Outstanding asset-backed commercial paper (ABCP) decreased slightly to \$710.1 billion at the end of March 2004, down 1.0 percent from the \$717.3 billion outstanding volume at the end of 2003. However, the market seems to be poised to grow based on indications of corporations seeking additional external funding sources – for example, rising loan demand and gains over the past year in high yield corporate bond issuance. ABCP continues to represent over half of the commercial paper market. The decline in the ABCP market may be attributed to accounting challenges presented by FIN 46.

Issuance of Asset-Backed Securities 1997–2004:Q1



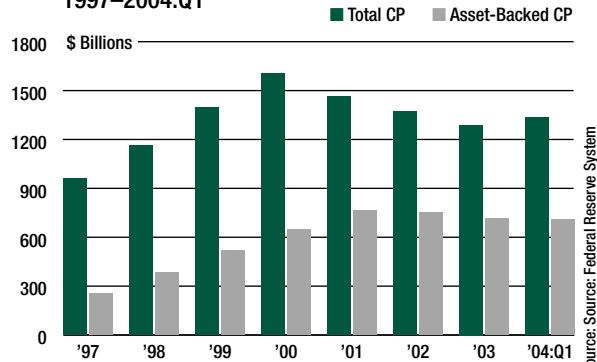
Source: Thomson Financial Securities Data, Inside MBS & ABS

Asset-Backed Spreads to U.S. Treasuries Mar. 2003–Mar. 2004



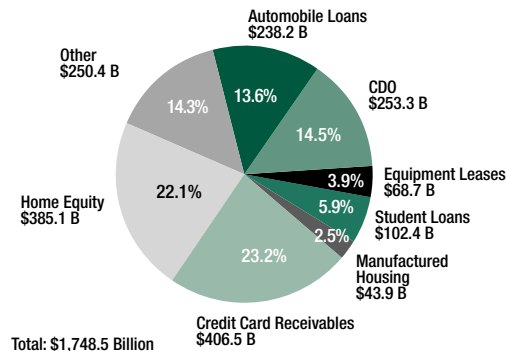
Source: J.P. Morgan Securities Inc.

Commercial Paper Outstanding 1997–2004:Q1



Source: Federal Reserve System

ABS Outstanding by Major Types of Credit As of March 31, 2004



Sources: Federal Reserve System, The Bond Market Association

Mortgage-Related Securities Issuance Slows From Record 2003 Pace as Rates Rise

Issuance of mortgage-related securities, which include agency and non-agency pass-throughs and CMOs, totaled \$404.4 billion in the first quarter of 2004, considerably less than the \$776.1 billion issued during the same period of 2003 and down 26.8 percent from the \$552.2 billion in the fourth quarter of 2003. After two unprecedented years of record issuance growth, mortgage-related volume decreased for the second straight quarter. First quarter issuance was the lowest since the first quarter of 2001 when the mortgage market surge began in earnest. Issuance volume, though, picked up late in the quarter on the strength of lower mortgage rates.

The slower issuance volume is attributable to trends in the primary mortgage origination market. According to the Mortgage Bankers Association, mortgage originations decreased to an estimated \$590 billion in the quarter from the \$632 billion in the fourth quarter of 2003. The consensus view is for mortgage rates to rise in the upcoming months, which would likely negatively affect issuance volumes of mortgage-related securities.

Yet, we should emphasize that the strength and resiliency of the mortgage market have been consistently underestimated by the “experts” in recent years. There are at least two reasons to temper any pessimism about the mortgage market. First, many consider housing the investment of choice as housing sales and price appreciation continue to increase and we continue to see record levels of home ownership. Second, the emergence of serial refinancings suggest the economics and psychology have changed. Consumers will refinance for a smaller interest rate benefit as the mortgage market becomes more efficient and closing costs decline. Still, if, as expected, mortgage rates increase, MBS issuance will fall.

Agency Issuance Drops Sharply

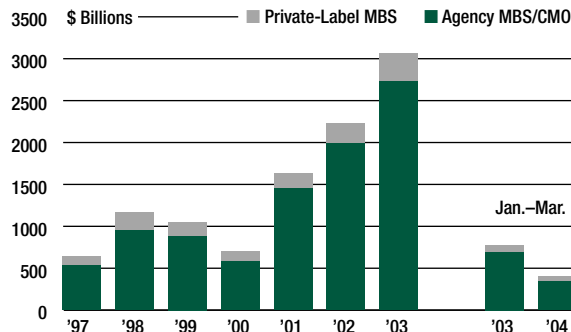
Total issuance of agency mortgage-backed securities (MBS) decreased to \$253.8 billion in the first quarter of the year, down 48.5 percent from the \$492.9 billion during the same period a year ago. As mortgage originations and refinancing slowed in the first quarter, issuance decreased by 35.6 percent compared to the fourth quarter, and by 20.1 percent compared to the first quarter of 2003. Fannie Mae’s issuance totaled \$129.0 billion in the first quarter, down 55.9 percent from the \$292.6 billion issued in the same period of 2003. The Freddie Mac MBS volume decreased 39.2 percent in the quarter, down from the \$149.1 billion volume in the first quarter of 2003. Similarly, Ginnie Mae’s guaranteed mortgage securities volume decreased 33.4 percent, to \$34.1 billion.

Agency collateralized mortgage obligation (CMO) new issue activity decreased to \$86.9 billion in the first quarter of 2004, down 57.0 percent from the \$201.9 billion issued in the first quarter of 2003. On a linked quarterly basis, though, CMO issuance increased 11.4 percent in the first quarter, up from the \$78.0 billion issued in the fourth quarter.

Non-Agency MBS

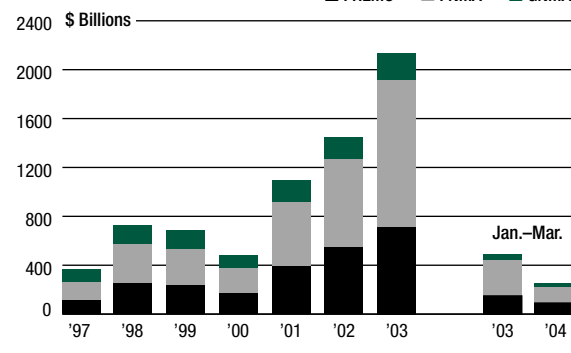
New issuance of non-agency MBS decreased 21.7 percent in the first quarter, to \$63.7 billion, down from the \$81.3 billion issued in the same period of 2003. Volume also decreased in the first quarter when compared to the \$80.1 billion issued in the fourth quarter of 2003.

Issuance of Mortgage-Related Securities 1997–2004:Q1



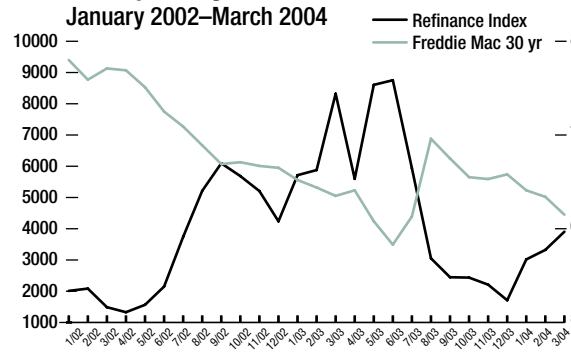
Sources: Fed. Agencies, Thompson Financial, Inside MBS & ABS, Bloomberg

Issuance of Agency Mortgage-Backed Securities 1997–2004:Q1



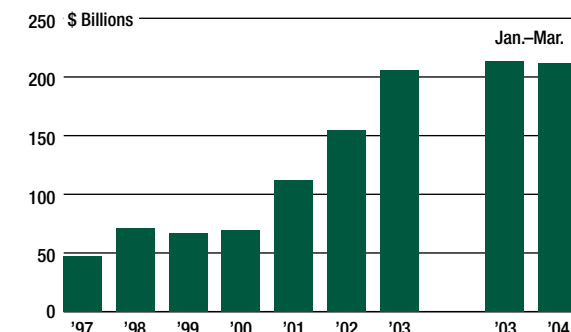
Sources: GNMA, FNMA, FHLMC

MBA Refinance Index vs. Freddie Mac 30-Yr Monthly Average Commitment Rate* January 2002–March 2004



Sources: Freddie Mac, Mortgage Bankers Association of America

Average Daily Trading Volume of Agency Mortgage-Backed Securities⁽¹⁾ 1997–2004:Q1



Source: Federal Reserve Bank of N.Y.

⁽¹⁾ Primary dealer activity

Outstanding Repo Agreements Increase

The average daily volume of total outstanding repurchase (repo) and reverse repo agreement contracts totaled \$4.49 trillion in the first quarter of 2004, an 11 percent increase over the average daily volume of \$4.04 trillion in 2003. Daily outstanding repo agreements increased 11.4 percent, to an average of \$2.63 trillion in the first quarter, compared to \$2.36 trillion in the same period of 2003. Overnight and continuing repo agreements increased 22.9 percent to an average daily outstanding of \$1.45 trillion in the first quarter of 2004. And term repo agreements increased 20.9 percent to an average daily outstanding of \$1.18 trillion. Average daily outstanding reverse repo increased to \$1.85 trillion in first quarter, a gain of 9 percent over 2003's level of \$1.69 trillion. On a linked quarter basis, total repo agreements increased every quarter since 2003. Overnight and continuing reverse repo agreements increased 3.4 percent to an average daily outstanding of \$566.2 billion in the first quarter of 2004. Term reverse repo agreements increased 18.9 percent to an average daily outstanding of \$1.23 trillion. The data represent financing activities of the primary dealers reporting to the Federal Reserve Bank of New York and include repo and reverse repo agreements involving U.S. government, federal agency, agency mortgage-backed and corporate securities.

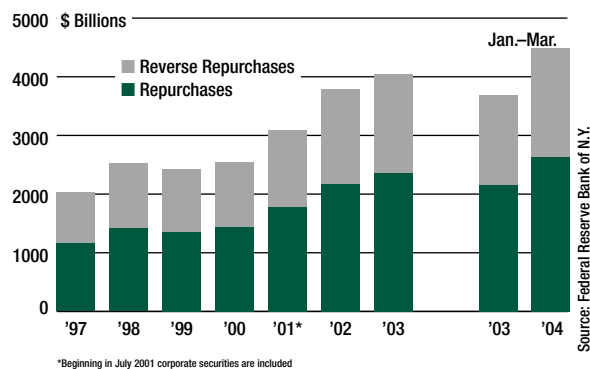
CP Increases as Economic Recovery Gains Strength

The outstanding volume of money market instruments, including commercial paper (CP), large time deposits and bankers' acceptances (BAs), totaled an estimated \$2.58 trillion outstanding at the end of March 2004, an increase of 2.3 percent compared to the end of 2003. CP outstanding totaled \$1.34 trillion at the end of first quarter 2004, up 3.9 percent from the end of 2003 when CP outstanding was \$1.29 trillion. Financial CP outstanding stood at \$1.23 trillion at the end of March, 3.4 percent higher than the end of 2003 level of \$1.19 trillion. Outstanding non-financial CP rose 9.1 percent, to \$110.6 billion at the end of the first quarter, rebounding from a decade-low \$101.4 billion at the end of the 2003.

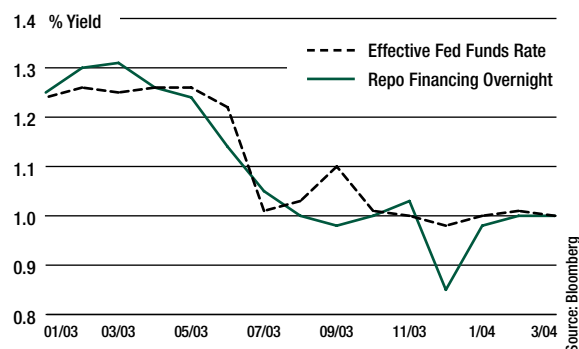
First quarter data confirmed the anticipated 2004 growth in CP financing, based on a growing economy, improved credit quality, increased corporate sector growth and renewed M&A activity. Increased CP outstanding during the first quarter mirrors other indicators of increasing demand for corporate credit. We should particularly note the turnaround in non-financial CP outstanding which had slumped over the last several quarters. According to a recent S&P report, the annual downgrade/upgrade ratio of U.S. non-financial CP programs improved for the first time in six years. The long-awaited manufacturing recovery in 2004 is expected to fuel non-financial CP issuance based on the need to finance investments in capital spending and inventory increases.

The outstanding level of large time deposits rose to an estimated \$1.24 trillion as of March 31, 2004, slightly higher than 2003's year-end level of \$1.23 trillion. Bankers' acceptances totaled an estimated \$4.3 billion at the end of the first quarter, relatively unchanged from the outstanding levels at the end of 2003.

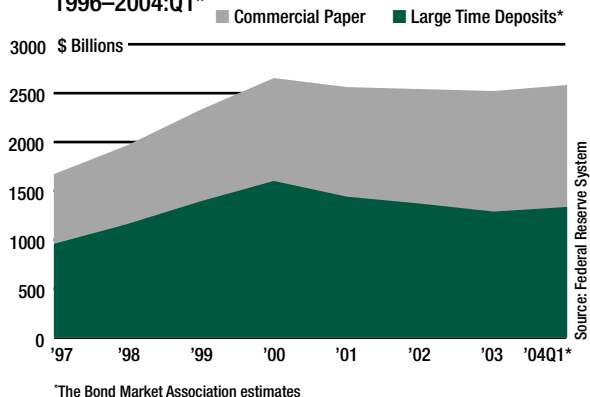
Financing by U.S. Government Securities Dealers
Average Daily Amount Outstanding 1996–2003



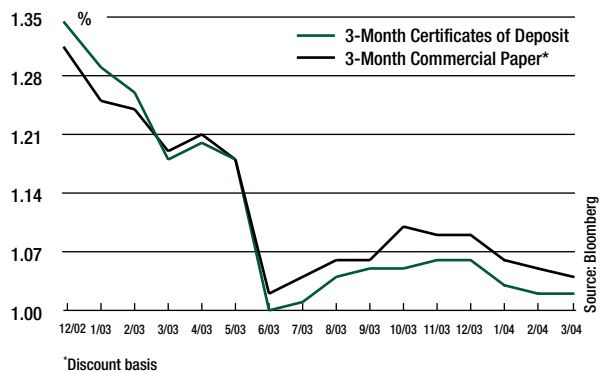
Repo financing Overnight vs. Effective Fed Funds Rate Jan. 2003–Mar. 2004



Outstanding Money Market Instruments
1996–2004:Q1*



Domestic Money Market Interest Rates
Monthly Average Jan. 2003–Mar. 2004



Positive Net Cash Flows into Bond Mutual Funds in the First Quarter

Investors returned to bond funds during the first quarter of 2004 as a result of an unexpectedly sharp interest rate decline driven by lagging employment growth and global terrorism fears. Thus, investors found value in the lower risk profile and safety of bond mutual funds. By contrast, the market environment during the second half of 2003—higher rates, accelerating economic growth, rising corporate profits and appreciating stock prices—drew investors to equity funds following the period of massive inflows into bond funds earlier in 2003.

During the first quarter of 2004, bond mutual funds had a net cash inflow of \$8.9 billion, compared to the \$2.2 billion outflow in the fourth quarter. During the height of the bull market in bonds in the first quarter of 2003, net inflows totaled \$43.0 billion. Net assets of bond mutual funds increased 3.0 percent in the first quarter, to \$1.28 trillion, up from the \$1.24 trillion at the end of 2003. Net assets of mutual funds combined increased to \$7.63 trillion at the end March.

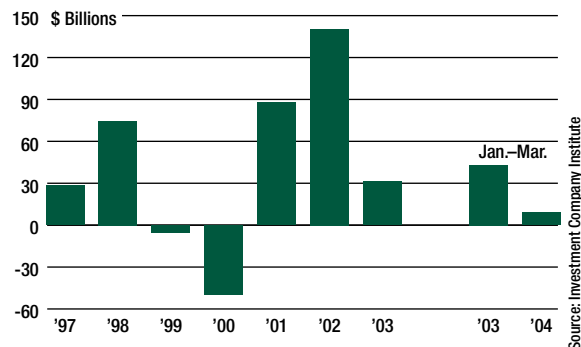
The inflows into bond funds in the first quarter were the result of the favorable market environment. As is typically the case, bond mutual fund flows are driven by interest rates as well as investor's relative return expectations regarding the opportunities from alternative asset classes, specifically equities. Of course, the interest rate outlook as well as the outlook for the stock market are in turn affected by such macroeconomic factors as employment and economic growth. While the consensus view is that the economic growth prospects benefit equity funds, the higher interest rate level may indeed offer investors favorable bond mutual fund buying opportunities.

Bond Mutual Fund Sectors Gain in Q1

Treasury bond funds experienced an inflow of \$3.6 billion in the first quarter of the year, which reflects the macroeconomic and market trends already cited. With the recent rise in general price indices, investors may well find funds that focus on Treasury inflation-protected securities increasingly attractive. Similarly, municipal bond funds enjoyed a marked reversal from last year with an inflow during the first quarter of the year reaching \$2.4 billion. MBS bond funds had a reduced net outflow of \$2.8 billion in the first quarter.

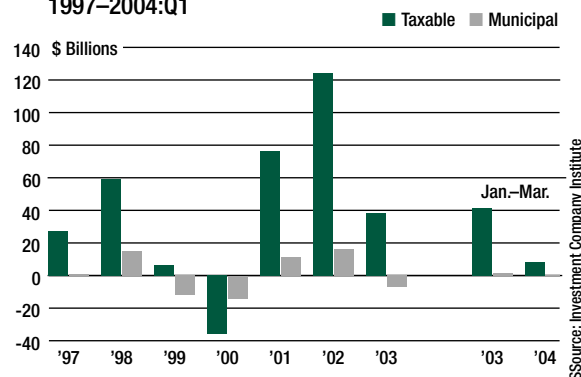
The investment-grade bond fund sector had the largest increase in the first quarter with an inflow of \$7.6 billion. These funds benefited from the search for yield in the low-interest-rate environment and a “flight to quality” in the first quarter. During the latter half of 2003, high-yield corporate bond funds had more favorable net cash flows than other bond fund sectors, which experienced net outflows or at least diminished inflows. In the first quarter, high-yield bond funds had the largest outflow totaling \$2.4 billion. There are a couple possible explanations—investors may feel that the extended spread tightening rally in high-yield may have been peaking, or they may be concerned about the effect of the market environment during the quarter which favored high quality over high yield. With evidence of sustained recovery, rising corporate profits and improved credit quality, investors may once again favor high-yield bond fund investments.

Net Cash Flow of Bond Mutual Funds 1997–2004:Q1



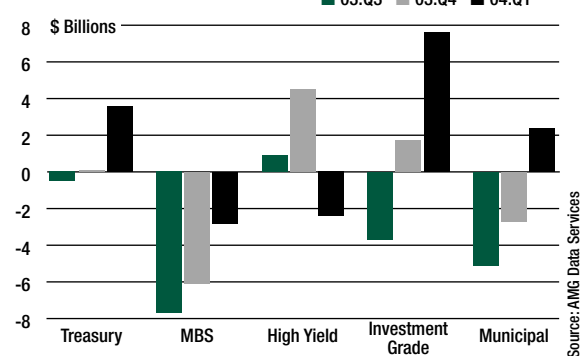
Source: Investment Company Institute

Net Cash Flows of Taxable vs. Municipal Mutual Funds 1997–2004:Q1



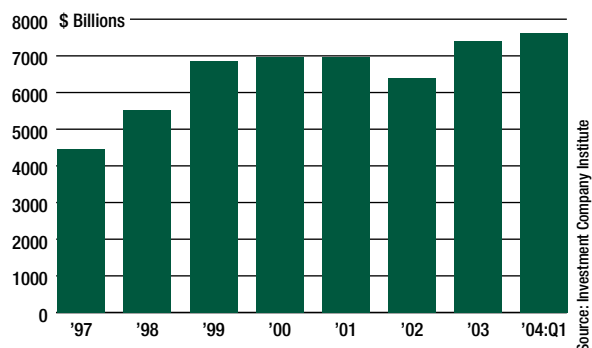
Source: Investment Company Institute

Net Cash Flows of Mutual Funds by Sector 2003:Q3, Q4 and 2004:Q4



Source: AMG Data Services

Net Cash Flow of Money Market Mutual Funds 1997–2004:Q1



Source: Investment Company Institute

Asia-Pacific Securitization Market Primer: 2003 Review and Outlook

This special section provides an introduction to securitization markets in Asia, as well as an outlook for the remainder of 2004. By way of definition, the Asian market encompasses the Asian continent and Australia. We present this topic because of the growth of the Asian-Pacific securitization market in recent years and the growing significance of Asia in the global structured finance marketplace. Issuance volume has surged from virtually zero in 1997 to its current scale, as Asian securitization issuance has consistently increased over the last six years.

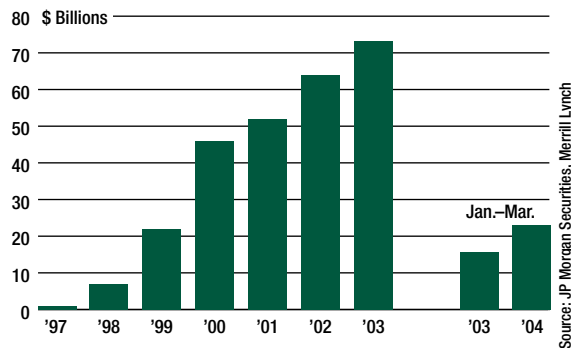
In 2003 there was a strong pipeline of structured products in the Asia-Pacific region, with total supply reaching approximately \$73.2 billion, or about 16.3 percent of the U.S. securitization market and 34 percent of the European market. There are four drivers leading to Asian structured finance growth and the market's attractiveness to investors: economic recovery in the region, legal reforms, more credit quality stability and new product development. As the global economic recovery strengthened, greater optimism about regional macroeconomic prospects took hold, and sovereign debt ratings improved. Furthermore, policy makers have recently made a greater push to focus attention on responding to legal and institutional marketplace concerns. We anticipate all of these trends to be in place for the coming year. The fact that the Asian structured marketplace absorbed about \$23 billion in new issues during the first quarter bodes well for a continued growth in 2004.

Despite disruptions caused by SARS in Q1 2003, total issuance in 2003 surpassed the 2002 record by 14 percent. Australia led, with volume reaching \$32.2 billion, up about 20 percent from 2002, accounting for 44.9 percent of total volume. As the other two major markets, Japan (44.8 percent share) and Korea (3.5 percent), scaled back issuance from the 2002 level, Australia accounted for nearly 100 percent of the net growth. With respect to asset class, RMBS was the largest sector, representing about 46 percent of total market issuance. The Asian CDO market took off in 2003 and registered the strongest growth rate. CDO growth is indicative of the fact that Asian issuers have started to find benefit in balance sheet management through asset securitization, and investors throughout the region have become increasingly familiar with the asset class.

Improving Credit Environment

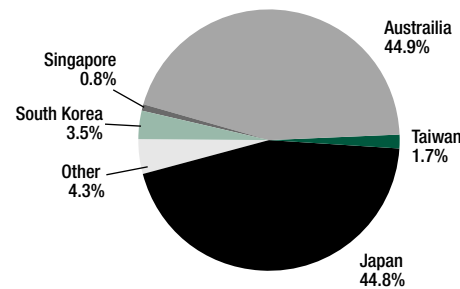
Relative to other regions, a case can be made that there was more credit quality stability in the Asia-Pacific market in 2003. According to Moody's Investors Service, among transactions originally rated "B" or above, the percentage of downgrades in Asia was lower than for U.S. transactions. As mentioned above, the improvements in economic fundamentals and credit profiles explained the relative rating stability. Introduction of sophisticated rating methodology by the rating agencies and improved credit enhancement techniques also strengthened the quality and raised the ratings higher than they would have been without these marketplace developments. Nevertheless, the proportion of unrated private transactions indicate that the ratings data may not fully reflect aggregate regional credit risk exposure. Another implication of the data is that, despite recent market developments, deal transparency remains a significant hurdle for investors.

Issuance in Asia-Pacific
ABS & MBS Markets 1997-2004:Q1



Source: JP Morgan Securities, Merrill Lynch

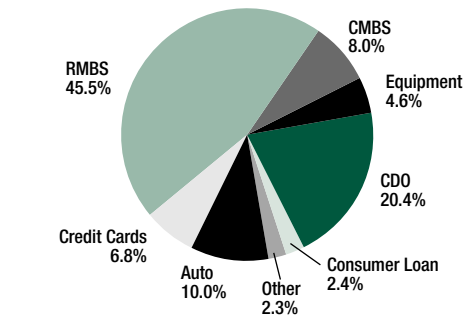
2003 Structured Finance Issuance by Asset Region



Total: \$73.2 Billion

Source: JP Morgan Securities, Merrill Lynch

2003 Structured Finance Issuance
By Collateral Type



Total: \$73.2 Billion

Source: JP Morgan Securities, Merrill Lynch

In newer emerging structured finance markets including India and China, the lack of third-party credit enhancement holds back transaction and market growth. Yet the rate of economic growth in China and India, combined with the potential scale of structured finance issuance, especially in China, suggests impressive potential opportunities over the next several years.

Major Markets

Japan, Australia and Korea account for more than 90 percent of total structured product supply. Their market dominance is the result of a number of shared favorable conditions: the legal structure supporting ownership of collateral; more developed primary lending markets providing suitable assets; greater willingness of banks to securitize assets; and more developed cross-border and swap market available to non-local foreign investors.

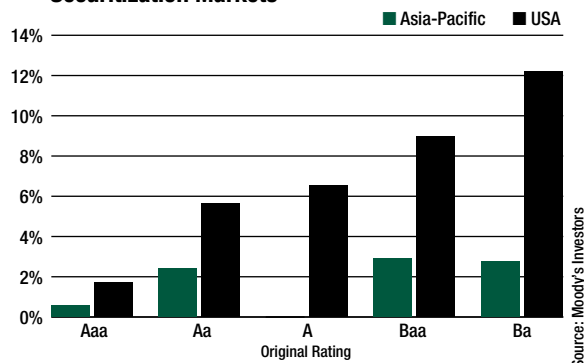
Activity in Australia surged in 2003, indicative of the escalating housing market which accounted for 90 percent of its securitized issuance last year. Offshore issuance increased significantly as well, representing 58 percent of total volume, up from 45 percent of total Australian new issues. Banks are keen to issue RMBS as means of diversification, reducing financing costs and removing mortgages from their balance sheet, and investors were attracted by the relatively higher yields in the global low interest rate environment, as well as the currency appreciation of the Australian dollar against the U.S. dollar. As Australian bond markets tend to closely track movement in the U.S. market, yields have drifted higher as the market anticipates the Fed and the Australian monetary authority (RBA) tightening perhaps by the year's end, which may slow or at least moderate the growth momentum in the Australian market.

Japan's share of Asian securitization issuance shrank to 44.8 percent from the previous 51.7 percent market share. The reduction in relative issuance volume was the result of CMBS retrenchment, as there was an excessive supply of office buildings in the major business districts. Furthermore, low interest rates and tighter corporate spreads fueled issuance growth in straight corporate bonds and away from structured finance products. AAA ABS yield spreads widened during the second half of the year, as a result of a major bond sell-off in Japan as investors moved into equities.

2004 Outlook

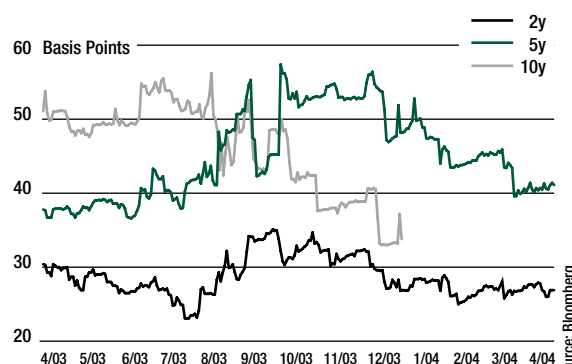
We expect generally favorable recent trends in the region to continue and lead to sustained Asian market growth in 2004 and beyond. From the issuer or supply side perspective, the RMBS market in Australia will continue to lead the way. Another source of strength is the Japanese economic recovery as Japanese credit quality is expected to stabilize as the economy recovers and policy initiatives are implemented. Taiwan and some other recent market entrants to the securitization marketplace will be under the spotlight as the "new kids on the block," but these markets should grow as new products gain acceptance. Growth in Korean consumer finance-backed issuance will likely be under some pressure in the coming year. In addition, some central banks' possible tightening as well as the generally higher interest rate environment may cap the growth momentum. From the demand or investor perspective, liquidity arising from global investors searching for yield generating investment opportunities will keep the markets thriving and expanding.

Downgrades in Asia & U.S. Securitization Markets



Source: Moody's Investors

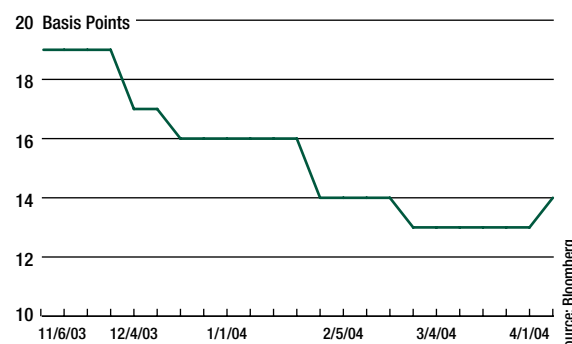
Japanese AAA ABS Yield Spread Over JGBs⁽¹⁾



Source: Bloomberg

⁽¹⁾ Yield data for 10 year ABS only available until 12/18/2003

Australian AAA 3-Year MBS Spread to Libor



Source: Bloomberg