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Downunder Daily

The Widening Debacle

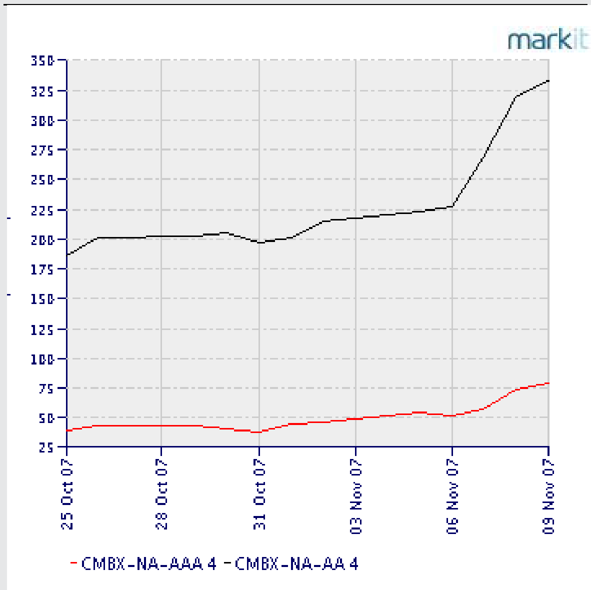
The credit debacle is getting both wider and deeper. Obviously, this means more pain for those directly involved. Moreover, the unraveling of the great credit bubble is becoming the single biggest threat to growth – and hence equity markets – for next year.

The stress signs that roiled markets in August are returning, but they are broadening. Prices for residential mortgage backed securities (RMBS) are now almost in free-fall (more on that below). As noteworthy is the contagion: Commercial mortgage backed securities (CMBS) are now under pressure (Exhibit 1). Corporate credit spreads are likewise widening, although most measures are not yet back at the August peaks (Exhibit 2). In the US, the stock of outstanding asset-backed commercial paper fell by US$15.7bn in the latest week, after five consecutive weekly increases (cumulative increase of $26.9bn).

The focus, for now, remains on the RMBS market. Colleague Andrew Sheets has provided a back-of-the-envelope estimate of the marked-to-market losses on sub-prime RMBS issued since 2005 (Exhibit 1). Andrew has used prices for the ABX indexes, matched to rating and issuance date of sub-prime RMBS. This provides a rough estimate of losses if the stocks of RMBS were marked to current ABX prices. The losses now stand at around US$250bn.

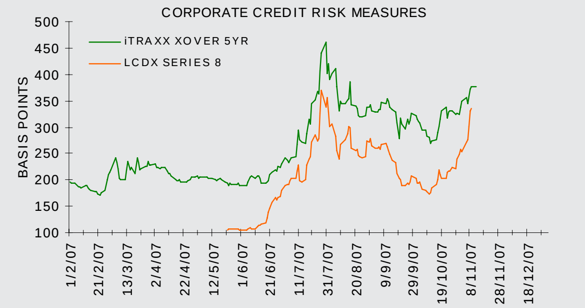
The very rapid deterioration in ABX prices suggests that the write-downs announced by major US banks over the past few weeks may already be inadequate. Neil McLeish, our head of European credit, provides an estimate of CDO exposure by Citicorp, Merrill Lynch, and UBS (the three largest issuers of CDOs in 2007). These estimates are in Exhibit 4. (CDOs are bundles of lowly rated RMBS. The ABX indices reflect pricing in RMBS, not pricing for CDO tranches.)

Exhibit 1
CMBS under Pressure…



Source: Markit; Morgan Stanley Research

Exhibit 2
…Likewise Corporate Debt



Source: Markit, Bloomberg; Morgan Stanley Research

Amidst this blizzard of bleak news, perhaps the final point to note is that Neil thinks that AAA-rated ABX indexes are perhaps the one asset now pricing in an extreme bear scenario. Exhibit 5 shows the combinations of mortgage default and recovery rates implied by prices on the 07-1 AAA-rated ABX index. At current prices (the middle contour in the exhibit), the breakeven point is, say, a combination of 45% default with a subsequent recovery of only 10%. Alternatively, if the recovery on the defaulted mortgage is 60%, then the breakeven is a default rate of 100%. I'm a bear, but I have to admit that these are extreme outcomes.

Exhibit 3
Marking-to-market RMBS

Estimates of RMBS Issuance by Rated Tranche ($Bn)							MtM Loss ($Bn) based on ABX Pricing					
	All Subprime	AAA	AA	A	BBB	BB/Other	Subprime	AAA	AA	A	BBB	BB/Other
Year	100%	80.8%	9.6%	5.0%	3.5%	1.1%	100%	80.8%	9.6%	5.0%	3.5%	1.1%
2005	625	505	60	31	22	7	64	26	8	12	13	5
1Q06	140	113	13	7	5	2	30	15	5	4	4	1
2Q06	165	133	16	8	6	2	35	18	6	5	5	1
3Q06	160	129	15	8	6	2	48	28	8	6	5	1
4Q06	135	109	13	7	5	1	41	24	7	5	4	1
1Q07	95	77	9	5	3	1	34	22	5	3	3	1
Total: 2005-1Q07	**1,320**	**1,067**	**127**	**66**	**46**	**15**	**251**	**133**	**39**	**35**	**33**	**11**

Source: Andrew Sheets, Inside Mortgage Finance; Morgan Stanley

These calculations matter if you're an investor, or thinking about investing, in these instruments. For most other investors, there are some bigger-picture points to make:

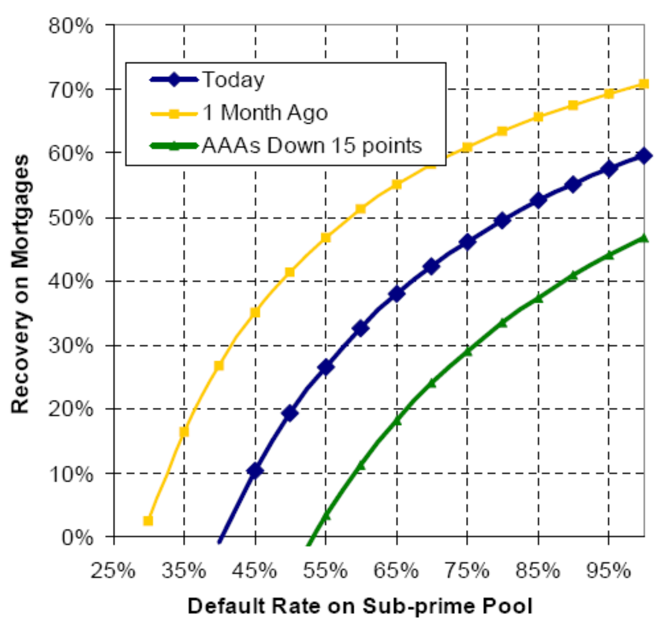
Exhibit 4
CDO Exposure for Top Issuers

Net Exposure Remaining ($Bn)	C*	MER	UBS
Super Senior Positions			
High Grade ABS CDOs	$ 28.4	$ 8.3	$ 3.7
Mezzaine ABS CDOs	$ 5.0	$ 5.3	$ 13.0
CDO-Squared	$ 0.1	$ 0.6	$ -
Other ABS CDO	$ -	$ -	$ 3.5
Total ABS CDO SS	**$ 33.5**	**$ 14.2**	**$ 20.2**
Other ABS CDO Risk	$ 1.8	$ 1.0	$ 1.8
ABS CDO Loss Reported	**$ 11.0**	**$ 6.9**	**$ 3.1**
Exposure Remaining	**$ 35.3**	**$ 15.2**	**$ 22.0**
as % of Market Cap.	*20%*	*31%*	*22%*

Note: These are Morgan Stanley Research estimates. For MER and UBS, net exposure is based upon numbers reported by the respective firms. *For Citigroup, we netted the upper end of its estimation of losses from reported gross positions, using marks similar to those used by Merrill Lynch on similar positions.
Source: Neil McLeish, *Weekly Credit Wrap: Bear Market, but What's in the Price?* 7 November; Morgan Stanley Research

First, the likely RMBS/CDO losses – either realized or on a marked-to-market basis – are not the key figures to focus on in assessing the impact on growth. This is the key figure: Over the past four years, around $2 trillion of sub-prime mortgages were written. As I've noted before, that $2 trillion was used to push up the price of established homes, finance the construction or new homes, furnish those homes, and probably support lifestyles that the borrowers did not have the income to sustain. We can now say with high confidence that those borrowers will not get another $2 trillion in the next four years. That is the measure that captures the growth impact of the credit bubble popping.

Exhibit 5
ABX 07-01 Breakeven Mortgage Default and Recovery Rates



Note: Assumes no meaningful pre-payments (which would push breakeven default/loss severity higher).
Source: Neil McLeish, *Weekly Credit Wrap: Bear Market, but What's in the Price?* 7 November; Morgan Stanley Research

Second, the issue that Greg Peters has raised – the loss of faith in the credit rating system – is also important. This is analogous to the damage that the TMT implosion did to sell-side equity research – except it's far more important. The rating agencies are important players in the financial system. No equity investor is mandated to hold only stocks that brokers rate a 'buy', but there are fixed income investors who can hold only paper given a specified rating by the rating agencies. Moreover, the cloud over the rating system puts a cloud over the entire process of securitization. If the ability to securitize is meaningfully restrained, that points to a material restraint on financials' ability to lend across segments and across markets. That is bad for growth, not just in the US, but globally.

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