Morgan Stanley

MORGAN STANLEY RESEARCH
ASIA/PACIFIC

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November 20, 2007

Downunder Daily

E-bubble Case Study

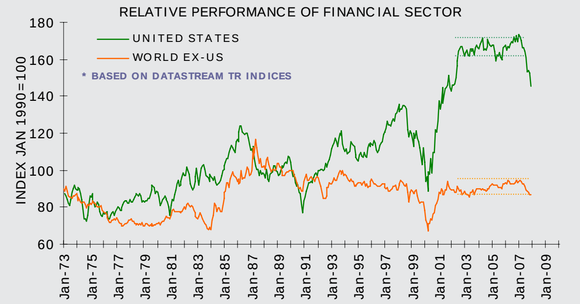
The financial sector is a case study in the earnings-driven nature of the current cycle. Until recently, the financial sector broadly matched the performance of the overall market through the past four years, building on a decade-long period of substantial out-performance in Anglo markets. Exhibit 1 shows the relative performance of financials in the US and in the rest of the world.

Notably, the market gains through the entire 15-year super-cycle for financials were driven almost solely by earnings. Exhibit 2 shows the US financial sector index and consensus forecast earnings since 1985. The chart is constructed so that the sector is on a PE of 14 when the lines intersect. The only time the sector PE traded above 14 on a sustained basis was in the late 1990s. That historically high PE reflected market conditions at the time. In fact, that elevated absolute PE rating coincided with the sector trading at its largest sustained PE *discount* to the non-financial sector (Exhibit 3).

Indeed, it's one of the great ironies of the past 15 years that investors never seemed to believe in the sustainability of the financial super-cycle, with the sector in the US trading at wide discount to the non-financial sector. The same is true globally, where financials changed from trading at persistent PE premium to the market through the 1970s and 1980s to trading at a persistent PE discount through the period of strong earnings growth (Exhibit 4). (As an aside, the large mining companies continue to trade at PE discounts to the overall market, suggesting that investors likewise were slow to price in the putative super-cycle for commodities.)

Exhibit 1

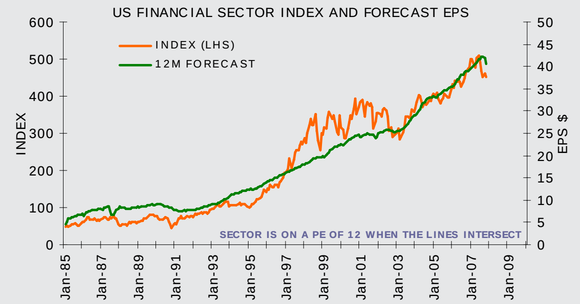
Financial Sector Out-performance Built On…



Source: DataStream; Morgan Stanley Research

Exhibit 2

…Earnings Out-performance

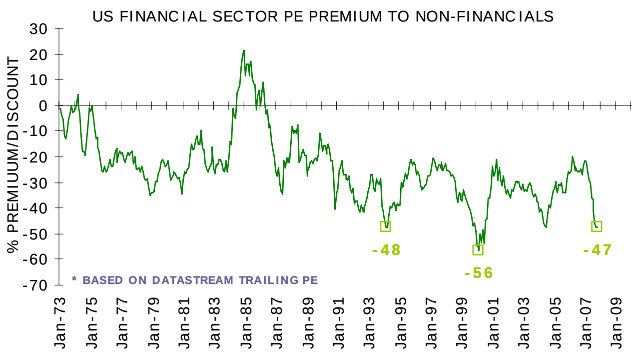


Source: IBES, DataStream; Morgan Stanley Research

My view is that the curtain is now coming down on the Anglo financials' super-cycle. This largely reflects my bearishness on household sector finances and the medium-term outlook for asset prices. There are two comments to add here:

Exhibit 3

Persistent PE Discount

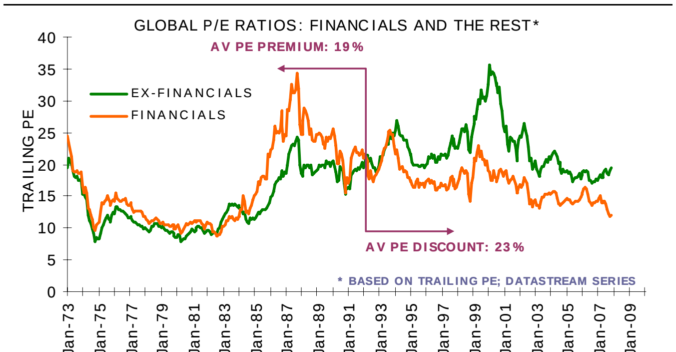


Source: DataStream; Morgan Stanley

First, our US banks team, led by Betsy Graseck, is now seeing evidence of spillover from mortgage distress into rising credit card delinquencies and charge-offs (see *Banking – Large-Cap Bank, Card Delinquencies Rising*, 16 November). Our banks team is cautious on the sector, as it anticipates credit problems spreading.

Exhibit 4

Financials' Global PE Discount

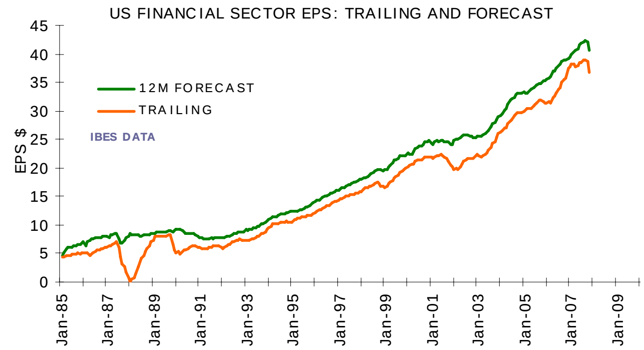


Source: DataStream; Morgan Stanley Research

Second, the focus now is on the uncertain extent of asset write-downs and rising charge-offs, but the problem goes deeper. Take sub-prime as an example. Even if there wasn't a single dollar lost on outstanding loans, the point is that the remarkable growth in loans – and the recurrent income those loans produce – will not be repeated going forward. In other words, the problem for lenders is not just the losses on existing loans, but the prospective structural drop in loan demand going forward. Put another way, clearing the deck on bad loans will not restore lending (and profit) growth to what was seen before.

Exhibit 5

Never Forecast an Earnings Decline



Source: IBES, DataStream; Morgan Stanley Research

The financial sector now appears set to have the third earnings bubble to pop in this cycle. The first two bubbles to pop were homebuilders and mortgage lenders. In my view, there are several lessons from how those bubbles deflated for the financial sector. First, the bear markets have been extended affairs: Homebuilders and mortgage lenders hit new bear-market lows this month, having peaked in mid-2005. Second, what triggered the decline was not higher rates, but the turn in earnings expectations. That is, earnings disappointment pops earning bubbles. Third, consensus forecasts never came close to anticipating the extent of the earnings decline.

My view is that we are likely to see a repeat with the broader financial sector. As is usual, consensus earnings forecasts have an uncanny link to trailing earnings (Exhibit 5). In particular, the consensus never forecasts earnings declines. That means that the finance sector will likely face an extended bear market as earnings expectations fall over an extended period, typically in response to disappointing reported earnings (or near-term guidance).

The final lesson is that the biggest trap for investors when an earnings bubble pops is the value trap: seeing a stock or sector that, on current forecasts, looks cheap. The risk is that the E keeps falling. There have been several attempts to buy the dip in homebuilders, and each one, so far, has proved premature.

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(as of October 31, 2007)

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