Morgan Stanley

MORGAN STANLEY RESEARCH
ASIA/PACIFIC

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# Downunder Daily

## Accelerating Unraveling

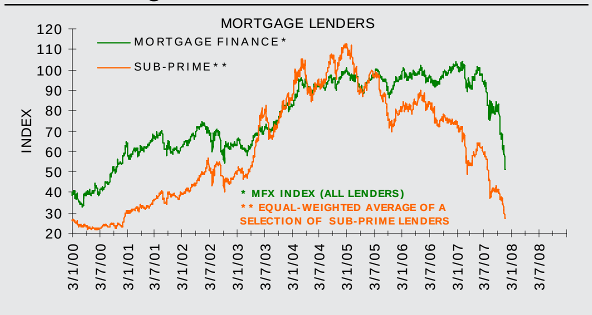
**We no longer have a sub-prime credit crisis: in our view, we now have a global credit crisis as one of the greatest-ever credit bubbles painfully deflates.** This is critical for all investors: low rates, plentiful liquidity and loose lending were pervasive supports for risky assets everywhere – and the businesses that made money creating, trading, rating, financing or owning them. A few points about this:

First, easy credit was very important to all risk assets, including equities. Easy money contributed to very strong economic growth. Rising asset prices have also directly contributed to reported profits. To give one example: Jerry Lou, our China strategist, has estimated that investment and non-operational income contributed 42% to reported EPS growth for China's A-share index over the past year. Reported EPS growth was 75%, while 'core' earnings growth was 33%. (For details, see *China A-share Strategy: 1H07 Result, Super Growth or Super Bubble?*, 3 September.) While this may be an extreme, my hunch is that earnings in most markets have been helped by the rise in asset prices. In short, the rising P directly boosted E.

Second, the tightening of global liquidity conditions is creating stress in many markets. This week saw notable problems in three areas: 1) America's mortgage agencies; 2) the monoline insurers; and 3) the covered bond market in Europe. A brief word on each:

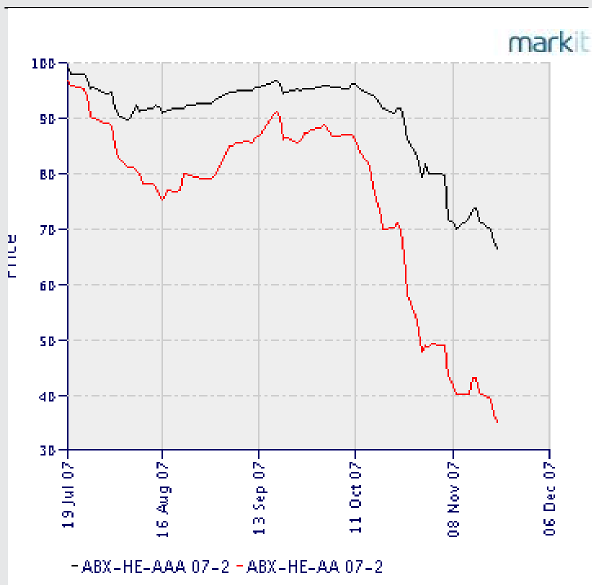
Freddie Mac is one of the big two mortgage agencies in the US. Combined, they own or guarantee around $4½ trillion of mortgages. Freddie Mac's losses mean that its scope for balance-sheet expansion is very limited. The broad picture is one where these agencies are likely to have limited capacity to provide finance at a time when other lenders are becoming far more restrictive.

Exhibit 1
**It's No Longer Just Sub-Prime**




Source: Bloomberg; Morgan Stanley Research

Exhibit 2
**Crushed**




Source: Markit; Morgan Stanley Research

This underscores the point that America no longer has a crisis in sub-prime mortgages, it has a problem in mortgages, full stop, in my view. This is now how markets see it. Exhibit 1 shows that most mortgage lenders were initially resilient in the face of the sub-prime implosion, but the mortgage finance index has now almost halved since June. Likewise, the ABX indices – which track residential mortgage backed security prices – have been crushed in the past month (Exhibit 2). As an aside, that points to further write-downs on structured products built atop these securities.

The stress in monoline insurers will likely add to these problems. These companies insure other borrowers' debt issuance; historically, the focus was on municipal paper. This allows the securities to have higher ratings than would otherwise be the case. The monolines insure around US$2.4 trillion of outstanding securities.

Several monolines have taken big losses on structured products they insured, as a result they are now in danger of being downgraded. If they are downgraded, the debt they have insured will likewise be downgraded.

The focus now is on ACA Capital Holdings, which posted a US$1.04 billion loss in the third quarter. Standard & Poor's is reviewing ACA's A rating; ACA has said it won't meet collateral requirements if its rating falls below A-.

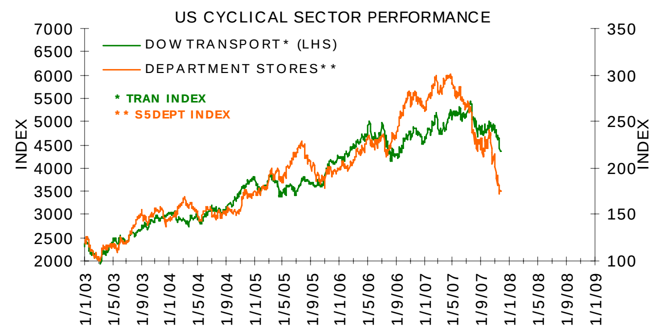
The third area of stress is Europe, where banks this week suspended trading in the US$2.8 trillion covered bond market. Covered bonds are mortgage-backed securities where the borrower is liable for repayments if the assets underlying the securities aren't sufficient to cover repayments. Because of that guarantee, these bonds had high ratings. However, Moody's on Tuesday warned that it may downgrade Northern Rock's covered bonds. As a result, spreads have widened to the point where banks have stopped providing prices on their bonds. While the market is likely to re-open, this marks a disruption to an important source of mortgage finance.

These three problems highlight the 'everything's-connected-to-everything' nature of global credit. It was always very unlikely that a serious problem in one part of credit could be ring-fenced. The sub-prime crisis has, in my view, signaled the end of the global credit boom. The tide has turned.

The final big picture point is that the final shoe to drop – the final nail in the multi-year rally in risk assets – will be when the spillover to real activity becomes clear. I continue to think that that's only a matter of time. Importantly, because this was a global credit boom, I expect that the global tightening in credit will have a global impact. This is not just a US issue.

The risk that this spills over to real activity is now getting priced into growth-related assets. Spot commodity prices are falling sharply, and cyclical equities are falling. Exhibit 3 shows two US indexes, Dow Transport and S&P Department Stores.

Exhibit 3
### This Signals Growth Concerns




Source: Bloomberg; Morgan Stanley

Emerging markets are likewise correcting. The Hang Seng index, for example, is down 18½% from its end-October high. This (again) shows that regardless of your view on the likelihood of economic decoupling, markets remain highly coupled. (As an aside, Japan's Topix is now 20% down from its peak, so using the semi-standard definition it is now in a bear market.)

The rise in growth-related concerns is very important to my view. I've kept on insisting that the decisive threat to the earnings-led equity market is when we see downgrades to earnings and economic forecasts. That now seems to be happening.

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| | Coverage Universe | | Investment Banking Clients (IBC) | | |
|---|---|---|---|---|---|
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| **Equal-weight/Hold** | **989** | **43%** | **312** | **44%** | **32%** |
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