

December 4, 2007

Downunder Daily

A Bigger Band-Aid

The political response to America's housing finance crisis has started. Authorities are encouraging greater 'mortgage restructuring' – largely delaying the re-sets on adjustable-rate mortgages (ARMs) – and US Treasury Secretary Paulson has proposed "temporarily" waiving taxes on state and local government bonds issued to help refinance sub-prime borrowers. The details on these initiatives are not clear, and some (such as the tax exemption on the bonds) require Congressional approval. But here are some broad thoughts:

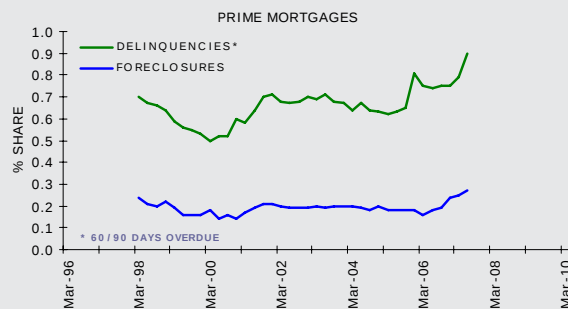
First, the heart of the problem is simple: Too much money was lent to people who couldn't afford it. That implies that someone will have to take a loss. There are no costless ways to fix this problem, and, for now, it seems that most of that cost will be borne by the private sector.

Second, I believe that the single most important factor determining the ultimate losses will be how the economic cycle unfolds. As I've noted before, we are seeing significant credit stress in what remains a reasonably healthy economy. If there is a recession, the credit losses will escalate. Our US strategy team already estimates that bank provisioning will need to rise sharply, given the outlook for rising delinquencies. Assuming a 60% recovery rate, the provisioning required is around US\$354bn. Unsurprisingly, the team is cautious on financials. (See Abhijit Chakrabourti, *No Country for Old Men*, 2 December.)

Third, credit stress is clearly now a macro-economically significant issue, so the policy response – if successful – may reduce the risk of a recession. Treasury officials have estimated that around 2 million sub-prime borrowers face mortgage resets (an increase in debt payments as they move off low 'teaser' rates). The *New York Times* says that Federal officials predict that 500,000 of those borrowers could lose their homes.

Exhibit 1

It's Not Just a Sub-prime Problem

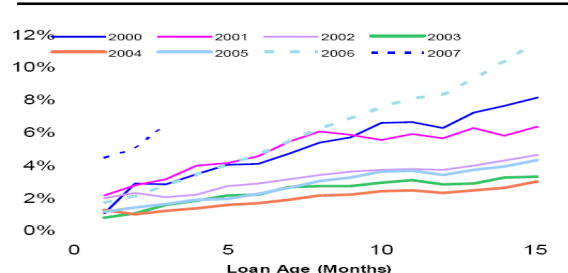


Source: MBA; Morgan Stanley Research

Exhibit 2

2007 Sub-Prime Delinquent Before Resets

2006 and 2007 Delinquencies Above Trend



Source: Loan Performance; Morgan Stanley Research

Morgan Stanley does and seeks to do business with companies covered in Morgan Stanley Research. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of Morgan Stanley Research. Investors should consider Morgan Stanley Research as only a single factor in making their investment decision.

For analyst certification and other important disclosures, refer to the Disclosure Section.

+ = Analysts employed by non-U.S. affiliates are not registered pursuant to NASD/NYSE rules.

December 4, 2007
Strategy and Economics

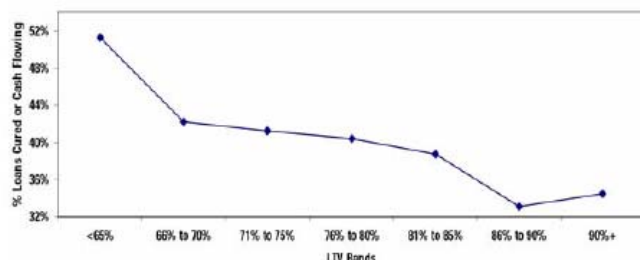
However, it's not clear to me that the proposals announced so far go far enough to turn around what appears to be an already dire situation. Here are two signs of how deep the problem is:

- Exhibit 1 shows delinquencies and foreclosures for prime mortgages – both are at decade highs. America does not have a sub-prime crisis, it has a credit crisis.
- Exhibit 2 shows delinquency rates for sub-prime mortgages by loan vintages. 2007 vintage loans have seen the worst delinquency rates in this cycle – and this is occurring even before the re-sets hit.

In this context, it's also worth noting the limited scope of the measures so far announced. First, the loan restructuring seems likely to exclude property investors. Second, it won't apply to borrowers already in financial difficulty ("some of these homeowners will become renters again," as Mr. Paulson put it overnight). Third, it won't apply to borrowers who run into problems for other reasons (say, losing a job).

Exhibit 3

Average 12-month Loan Cure, by LTV Bands



Source: Moody's; Morgan Stanley Research

Fourth, it is in any case not clear how successful mortgage restructuring is even for the borrowers who qualify. Academic Joseph Mason notes that the success rate on other loan modification schemes depends on the loan-to-value ratio of the mortgage. The 'cure' rate drops significantly once the LVR exceeds 85% (Exhibit 3). The overall re-default rate on modified loans is 35-40% over two years. Moreover, the ultimate loss rate is typically higher if the foreclosure is delayed.

Exhibit 4

Sub-prime Mortgage Servicers

Top Subprime Servicers at June 30, 2007

(Dollars in Millions)

Rank	Company	Location	Servicing Vol	
			6/30/2007	6/30/2006
1	Countrywide Financial	Calabasas, CA	\$125,812	\$115,615
2	Chase Home Finance	Woodcliff Lake, NJ	\$81,647	\$78,406
3	Option One Mortgage (E)	Irvine, CA	\$68,000	\$74,060
4	CitiFinancial (E)	Baltimore, MD	\$66,000	\$62,000
5	GMAC ResCap	Minneapolis, MN	\$57,681	\$74,126
6	Argent/Ameriquest Mtg. (E)	Orange, CA	\$57,000	\$112,000
7	Home Loan Services, Inc.	Pittsburgh, PA	\$53,660	\$43,893
8	Ocwen Loan Servicing, LLC	W Palm Beach, FL	\$53,122	\$46,385
9	Wells Fargo Home Mortgage	San Francisco, CA	\$52,189	\$47,202
10	Homeq Servicing Corp.	N Highlands, CA	\$50,188	\$42,298

Source: National Mortgage News; Morgan Stanley Research

Finally, the proposals will likely sharply increase costs for lenders and mortgage servicers. Of course, those costs may be less than the cost of wholesale foreclosure, but this emphasizes the point that there will be substantial costs regardless of the options.

Take the mortgage loan servicers as an example. They are typically paid around 12½-50 basis points of the outstanding principal balance, augmented by incentives that provide the servicers' incentive to maximize cash flow from the loans. They usually have to modify fewer than 1% of loans, but now may have to modify 10-20%.

Mason notes that "the vast majority of bank failures since 1992 have involved substantial issues of MSR [mortgage servicing rights] and residual valuations. ... Having MSRs worth more than the value of capital created a high risk that valuation difficulties can wipe out a substantial portion of a firm's underlying capital with the stroke of a pen." (*Mortgage Loan Modification: Promises and Pitfalls*, <http://www.lebow.drexel.edu/PDF/Docs/20071003LoanModificationPaper.pdf>)

Exhibit 4 lists the top sub-prime mortgage servicers. Countrywide, the top servicer, values its mortgage servicing rights at US\$20bn on its balance sheet; the firm's equity is \$15bn (as at 30 September).

While there will likely be more initiatives announced to address the credit problem, we believe that given the size of the credit bubble, there seems little chance that it can deflate without material macroeconomic (and market) pain.

Disclosure Section

The information and opinions in Morgan Stanley Research were prepared or are disseminated by Morgan Stanley Asia Limited (which accepts the responsibility for its contents) and/or Morgan Stanley Asia (Singapore) Pte. (Registration number 199206298Z, regulated by the Monetary Authority of Singapore, which accepts the responsibility for its contents), and/or Morgan Stanley Asia (Singapore) Securities Pte Ltd (Registration number 200008434H, regulated by the Monetary Authority of Singapore, which accepts the responsibility for its contents), and/or Morgan Stanley Taiwan Limited and/or Morgan Stanley & Co International plc, Seoul Branch, and/or Morgan Stanley Australia Limited (A.B.N. 67 003 734 576, holder of Australian financial services license No. 233742, which accepts responsibility for its contents), and/or Morgan Stanley India Company Private Limited and their affiliates (collectively, "Morgan Stanley").

Analyst Certification

The following analysts hereby certify that their views about the companies and their securities discussed in this report are accurately expressed and that they have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report: Gerard Minack.

Unless otherwise stated, the individuals listed on the cover page of this report are research analysts.

Global Research Conflict Management Policy

Morgan Stanley Research has been published in accordance with our conflict management policy, which is available at www.morganstanley.com/institutional/research/conflict/policies.

Important US Regulatory Disclosures on Subject Companies

The research analysts, strategists, or research associates principally responsible for the preparation of Morgan Stanley Research have received compensation based upon various factors, including quality of research, investor client feedback, stock picking, competitive factors, firm revenues and overall investment banking revenues.

Certain disclosures listed above are also for compliance with applicable regulations in non-US jurisdictions.

STOCK RATINGS

Different securities firms use a variety of rating terms as well as different rating systems to describe their recommendations. For example, Morgan Stanley uses a relative rating system including terms such as Overweight, Equal-weight or Underweight (see definitions below). A rating system using terms such as buy, hold and sell is not equivalent to our rating system. Investors should carefully read the definitions of all ratings used in Morgan Stanley Research. In addition, since Morgan Stanley Research contains more complete information concerning the analyst's views, investors should carefully read Morgan Stanley Research, in its entirety, and not infer the contents from the rating alone. In any case, ratings (or research) should not be used or relied upon as investment advice. An investor's decision to buy or sell a stock should depend on individual circumstances (such as the investor's existing holdings) and other considerations.

Global Stock Ratings Distribution

(as of November 30, 2007)

For disclosure purposes only (in accordance with NASD and NYSE requirements), we include the category headings of Buy, Hold, and Sell alongside our ratings of Overweight, Equal-weight and Underweight. Morgan Stanley does not assign ratings of Buy, Hold or Sell to the stocks we cover. Overweight, Equal-weight, and Underweight are not the equivalent of buy, hold, and sell but represent recommended relative weightings (see definitions below). To satisfy regulatory requirements, we correspond Overweight, our most positive stock rating, with a buy recommendation; we correspond Equal-weight and Underweight to hold and sell recommendations, respectively.

Stock Rating Category	Coverage Universe		Investment Banking Clients (IBC)		
	Count	% of Total	Count	% of Total % of Rating IBC	Category
Overweight/Buy	987	43%	324	45%	33%
Equal-weight/Hold	981	42%	311	43%	32%
Underweight/Sell	348	15%	88	12%	25%
Total	2,316		723		

Data include common stock and ADRs currently assigned ratings. An investor's decision to buy or sell a stock should depend on individual circumstances (such as the investor's existing holdings) and other considerations. Investment Banking Clients are companies from whom Morgan Stanley or an affiliate received investment banking compensation in the last 12 months.

Analyst Stock Ratings

Overweight (O or Over) - The stock's total return is expected to exceed the total return of the relevant country MSCI Index, on a risk-adjusted basis over the next 12-18 months.

Equal-weight (E or Equal) - The stock's total return is expected to be in line with the total return of the relevant country MSCI Index, on a risk-adjusted basis over the next 12-18 months.

Underweight (U or Under) - The stock's total return is expected to be below the total return of the relevant country MSCI Index, on a risk-adjusted basis, over the next 12-18 months.

More volatile (V) - We estimate that this stock has more than a 25% chance of a price move (up or down) of more than 25% in a month, based on a quantitative assessment of historical data, or in the analyst's view, it is likely to become materially more volatile over the next 1-12 months compared with the past three years. Stocks with less than one year of trading history are automatically rated as more volatile (unless otherwise noted). We note that securities that we do not currently consider "more volatile" can still perform in that manner.

Unless otherwise specified, the time frame for price targets included in Morgan Stanley Research is 12 to 18 months.

Analyst Industry Views

Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.

In-Line (I): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be in line with the relevant broad market benchmark, as indicated below.

Cautious (C): The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark, as indicated below.

Benchmarks for each region are as follows: North America - S&P 500; Latin America - relevant MSCI country index or MSCI Latin America Index; Europe - MSCI Europe; Japan - TOPIX; Asia - relevant MSCI country index.

Stock price charts and rating histories for companies discussed in Morgan Stanley Research are available at www.morganstanley.com/companycharts or from your local investment representative. You may also request this information by writing to Morgan Stanley at 1585 Broadway, (Attention: Equity Research Management), New York, NY, 10036 USA.

Other Important Disclosures

For a discussion, if applicable, of the valuation methods used to determine the price targets included in Morgan Stanley Research, and the risks related to achieving these targets, please refer to the latest relevant published research on these stocks. Research is available through your sales representative or on Client Link at www.morganstanley.com and other electronic systems.

Morgan Stanley Research does not provide individually tailored investment advice. Morgan Stanley Research has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. The securities/instruments discussed in Morgan Stanley Research may not be suitable for all investors. Morgan Stanley recommends that investors independently evaluate particular investments and strategies, and encourages investors to seek the advice of a financial adviser. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives. The securities, instruments, or strategies discussed in Morgan Stanley Research may not be suitable for all investors, and certain investors may not be eligible to purchase or participate in some or all of them.

Morgan Stanley Research is not an offer to buy or sell or the solicitation of an offer to buy or sell any security/instrument or to participate in any particular trading strategy. The "Important US Regulatory Disclosures on Subject Companies" section in Morgan Stanley Research lists all companies mentioned where Morgan Stanley owns 1% or more of a class of common securities of the companies. For all other companies mentioned in Morgan Stanley Research, Morgan Stanley may have an investment of less than 1% in securities or derivatives of securities of companies and may trade them in ways different from those discussed in Morgan Stanley Research. Employees of Morgan Stanley not involved in the preparation of Morgan Stanley Research may have investments in securities or derivatives of securities of companies mentioned and may trade them in ways different from those discussed in Morgan Stanley Research. Derivatives may be issued by Morgan Stanley or associated persons.

Morgan Stanley and its affiliate companies do business that relates to companies/instruments covered in Morgan Stanley Research, including market making and specialized trading, risk arbitrage and other proprietary trading, fund management, commercial banking, extension of credit, investment services and investment banking. Morgan Stanley sells to and buys from customers the securities/instruments of companies covered in Morgan Stanley Research on a principal basis.

With the exception of information regarding Morgan Stanley, research prepared by Morgan Stanley Research personnel are based on public information. Morgan Stanley makes every effort to use reliable, comprehensive information, but we make no representation that it is accurate or complete. We have no obligation to tell you when opinions or information in Morgan Stanley Research change apart from when we intend to discontinue research coverage of a subject company. Facts and views presented in Morgan Stanley Research have not been reviewed by, and may not reflect information known to, professionals in other Morgan Stanley business areas, including investment banking personnel.

Morgan Stanley Research personnel conduct site visits from time to time but are prohibited from accepting payment or reimbursement by the company of travel expenses for such visits.

The value of and income from your investments may vary because of changes in interest rates or foreign exchange rates, securities prices or market indexes, operational or financial conditions of companies or other factors. There may be time limitations on the exercise of options or other rights in your securities transactions. Past performance is not necessarily a guide to future performance. Estimates of future performance are based on assumptions that may not be realized. Unless otherwise stated, the cover page provides the closing price on the primary exchange for the subject company's securities/instruments.

To our readers in Taiwan: Information on securities/instruments that trade in Taiwan is distributed by Morgan Stanley Taiwan Limited ("MSTL"). Such information is for your reference only. The reader should independently evaluate the investment risks and is solely responsible for their investment decisions. Morgan Stanley Research may not be distributed to the public media or quoted or used by the public media without the express written consent of Morgan Stanley. Information on securities/instruments that do not trade in Taiwan is for informational purposes only and is not to be construed as a recommendation or a solicitation to trade in such securities/instruments. MSTL may not execute transactions for clients in these securities/instruments.

To our readers in Hong Kong: Information is distributed in Hong Kong by and on behalf of, and is attributable to, Morgan Stanley Asia Limited as part of its regulated activities in Hong Kong. If you have any queries concerning Morgan Stanley Research, please contact our Hong Kong sales representatives.

Certain information in Morgan Stanley Research was sourced by employees of the Shanghai Representative Office of Morgan Stanley Asia Limited for the use of Morgan Stanley Asia Limited.

Morgan Stanley Research is disseminated in Japan by Morgan Stanley Japan Securities Co., Ltd.; in Hong Kong by Morgan Stanley Asia Limited (which accepts responsibility for its contents); in Singapore by Morgan Stanley Asia (Singapore) Pte. (Registration number 199206298Z) and/or Morgan Stanley Asia (Singapore) Securities Pte Ltd (Registration number 200008434H), regulated by the Monetary Authority of Singapore, which accepts responsibility for its contents; in Australia by Morgan Stanley Australia Limited A.B.N. 67 003 734 576, holder of Australian financial services licence No. 233742, which accepts responsibility for its contents; in Korea by Morgan Stanley & Co International plc, Seoul Branch; in India by Morgan Stanley India Company Private Limited; in Canada by Morgan Stanley Canada Limited, which has approved of, and has agreed to take responsibility for, the contents of Morgan Stanley Research in Canada; in Germany by Morgan Stanley Bank AG, Frankfurt am Main, regulated by Bundesanstalt fuer Finanzdienstleistungsaufsicht (BaFin); in Spain by Morgan Stanley, S.V., S.A., a Morgan Stanley group company, which is supervised by the Spanish Securities Markets Commission (CNMV) and states that Morgan Stanley Research has been written and distributed in accordance with the rules of conduct applicable to financial research as established under Spanish regulations; in the United States by Morgan Stanley & Co. Incorporated, which accepts responsibility for its contents. Morgan Stanley & Co. International plc, authorized and regulated by Financial Services Authority, disseminates in the UK research that it has prepared, and approves solely for the purposes of section 21 of the Financial Services and Markets Act 2000, research which has been prepared by any of its affiliates. Private U.K. investors should obtain the advice of their Morgan Stanley & Co. International plc representative about the investments concerned. In Australia, Morgan Stanley Research and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act.

The information in Morgan Stanley Research is being communicated by Morgan Stanley & Co. International plc (DIFC Branch), regulated by the Dubai Financial Services Authority (the DFSA), and is directed at wholesale customers only, as defined by the DFSA. This research will only be made available to a wholesale customer who we are satisfied meets the regulatory criteria to be a client.

The information in Morgan Stanley Research is being communicated by Morgan Stanley & Co. International plc (QFC Branch), regulated by the Qatar Financial Centre Regulatory Authority (the QFCRA), and is directed at business customers and market counterparties only and is not intended for Retail Customers as defined by the QFCRA.

The trademarks and service marks contained in Morgan Stanley Research are the property of their respective owners. Third-party data providers make no warranties or representations of any kind relating to the accuracy, completeness, or timeliness of the data they provide and shall not have liability for any damages of any kind relating to such data. The Global Industry Classification Standard ("GICS") was developed by and is the exclusive property of MSCI and S&P.

Morgan Stanley has based its projections, opinions, forecasts and trading strategies regarding the MSCI Country Index Series solely on publicly available information. MSCI has not reviewed, approved or endorsed the projections, opinions, forecasts and trading strategies contained herein. Morgan Stanley has no influence on or control over MSCI's index compilation decisions.

Morgan Stanley Research, or any portion hereof may not be reprinted, sold or redistributed without the written consent of Morgan Stanley.

Morgan Stanley Research is disseminated and available primarily electronically, and, in some cases, in printed form.

Additional information on recommended securities/instruments is available on request.

The Americas

1585 Broadway
New York, NY 10036-8293

United States

Tel: +1 (1) 212 761 4000

Europe

25 Cabot Square, Canary Wharf
London E14 4QA

United Kingdom

Tel: +44 (0) 20 7 425 8000

Japan

4-20-3 Ebisu, Shibuya-ku
Tokyo 150-6008

Japan

Tel: +81 (0) 3 5424 5000

Asia/Pacific

Three Exchange Square
Central

Hong Kong

Tel: +852 2848 5200