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ASIA/PACIFIC

Morgan Stanley Australia Limited+ **Gerard Minack**
Gerard.Minack@morganstanley.com
+61 2 9770 1529

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Downunder Daily

Prime Time

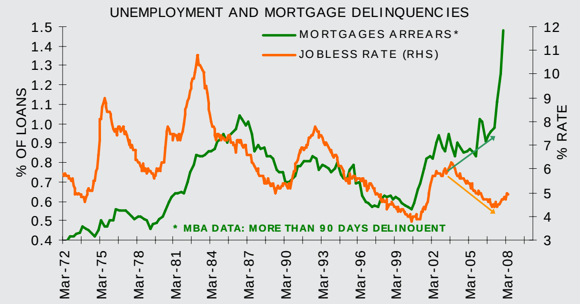
Remember that last year's credit distress occurred against a backdrop of a broadly healthy US economy: Not a single job was lost in net terms, and growth (outside residential construction) was reasonable. Things will get worse in a recession.

In particular, job losses will mean that delinquencies and foreclosures will spread from the mortgage exotica to the heartland: prime mortgages. Mortgage stress always rises when unemployment rises. Yes, the remarkable point about the 2002-06 expansion is that mortgage arrears rose even as unemployment fell (Exhibit 1) – a clear warning sign of how low lending standards fell – but there is likely to be a new wave of credit problems caused by economic weakness.

(As an aside, it's noteworthy that the rise in delinquencies also occurred without an interest rate shock. Borrowers are defaulting simply because they have too much debt, and their assets are falling. The Mortgage Bankers Association estimates that 40% of all foreclosures in the December quarter were borrowers who couldn't make payments on mortgages *before* loans were reset. A further 23% of foreclosures were borrowers who had had their loans modified – typically, the reset was delayed – but still defaulted.)

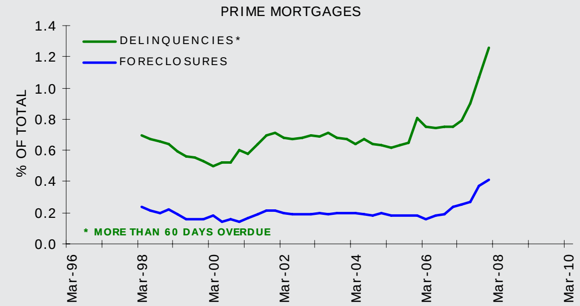
The weakness spreading matters a lot. Despite the focus on sub-prime, that accounts for around one-quarter of mortgages outstanding. Recession threatens a material deterioration in the credit quality of the other 75% of the mortgage pool. The latest Mortgage Bankers Association data show this deterioration now under way in the prime mortgage pool (Exhibit 2). Twenty percent of new foreclosures in the quarter were *prime* adjustable-rate mortgages. (The MBA data split prime and sub-prime mortgages from 1998 onwards.)

Exhibit 1
Job Losses Are Always Bad for Credit



Source: BLS, MBA; Morgan Stanley Research

Exhibit 2
Prime Under Pressure



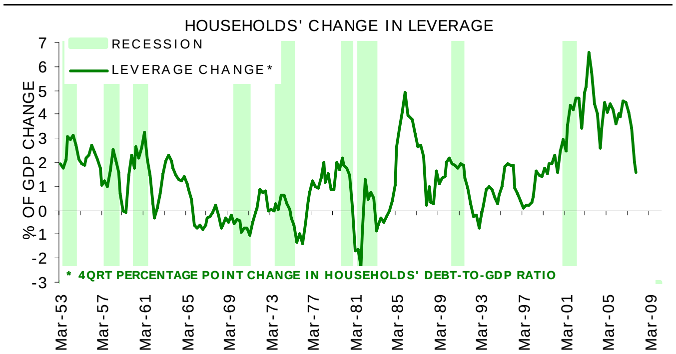
Source: MBA; Morgan Stanley Research

As credit distress spreads – with all that implies for further declines in house prices and household wealth – the feedback to consumer behaviour is likely to intensify. Despite last year's problems, the household sector continued to borrow and continued to extract equity from housing wealth, all of which support spending. These supports are likely to disappear through the course of 2008.

Exhibit 3 shows the change in household leverage (the four-quarter change in the household sector's debt-to-income ratio). Household leverage kept rising through last year, although it was well down on the growth seen in prior years. However, as the chart shows, in most recessions the household sector stops increasing its leverage. In this cycle – with the starting-point for leverage at an all-time high, with banks tightening lending standards to an unprecedented extent, and with house prices falling – I expect a significant period of deleveraging.

Exhibit 3

Still Increasing Leverage

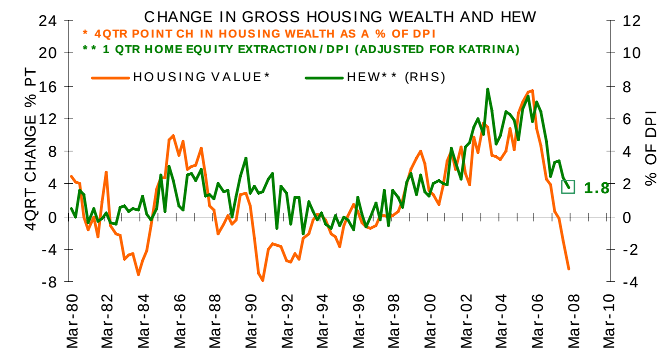


Source: Federal Reserve, NBER; Morgan Stanley

The increase in leverage last year was in part due to the ongoing use of home equity withdrawal. Exhibit 4 shows that the household sector extracted equity equivalent to 1.8% of income through the course of last year. However, with household wealth now falling, expect home equity extraction to evaporate this year.

Exhibit 4

Still Home Equity Extracting

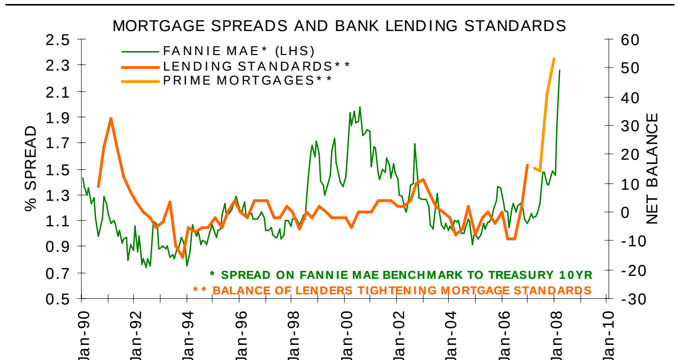


Source: Federal Reserve; Morgan Stanley Research

With underlying economic conditions worsening, it's noteworthy that the latest market to 'break down' is that for mortgage-backed Agency paper. The spread between Agency paper and Treasuries is at the highest level since 1986 (Exhibit 5). This is an important development that represents another major headwind for Fed policy.

Exhibit 5

Agency Spreads Blow Out



Source: Federal Reserve, Bloomberg; Morgan Stanley Research

All this underscores one simple point: It is very early in the US recession cycle. Credit and macro indicators will get far worse from here, with all that implies for financial sector losses and earnings for the non-financial sector. My view remains that this is simply not in the price of many assets.

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(as of February 29, 2008)

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MORGAN STANLEY RESEARCH

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