

Strategy

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Financial crisis update

The aim of this publication is to provide an overview of current stories/issues in relation to the financial market crisis. We update this regularly, the last time being on February 28. Key points in this issue are:

- The financial crisis has flared up again, and fears of systemic risks in the financial sector are high. Credit spreads have soared and equities have dropped. Municipalities and intra-Euroland spreads were two of the markets much harder hit this time around. The renewed tension brought a swift response from central banks – principally the Fed, which is clearly deeply worried. Yesterday's newest initiative contained a new Term Securities Lending Facility (TSLF), by which the Fed will lend up to USD 200bn of Treasury securities to primary dealers for an extended term of 28 days against collateral in other securities such as agencies and MBS. This is clearly intended to promote liquidity and foster the functioning of financial markets. The knee-jerk reaction from markets has been positive, but the long-lasting effects are yet to be seen.
- Despite avoiding downgrades from S&P and Moody's for now, the **monolines** like Ambac and MBIA remain in serious trouble. Fitch seems somewhat more worried and still has MBIA on negative outlook. In a broader perspective there is little doubt in our view that the heat remains on the monolines.
- A series of auctions of **municipalities** failed, as investor interest in the secured debt fell and the municipality market fell into disarray as hedge funds were squeezed to sell. The last few days have seen some buying and the new Fed initiative also helped bring the spread between municipalities and treasuries in from record highs.
- **Agency spreads** have also surged, hitting fresh multi-year highs.
- The renewed **money market** tensions brought a swift response from central banks mainly the Fed. However, a lot of the fundamental problems remain and there is risk of renewed tension going forward.
- Leveraged loans to finance buy-outs, **LBOs**, have been a burden for many banks since last summer. The prices of these loans in secondary markets have declined since the turn of the year. The bottom line is that recent price falls on LBOs in secondary markets, combined with the warning from S&P on the future performance of these loans, is unlikely to provide any relief to banks' balance sheets from the LBO front.
- Is **commercial real-estate** going to be the next domino to topple as the crisis escalates? Recent spread widening does not look pretty.
- The size of **asset-backed commercial papers** in the US has stabilised somewhat recently following large falls last year. However, new declines cannot be ruled out.
- The initial source of the shock driving the current crisis was the decline in the value of US **subprime mortgages**. The high rated ABX indices have renewed their downward trend pointing to a worsening outlook for subprime mortgages. Rating agencies seem to be falling behind reality and downgrades are expected. This is likely to result in more losses for banks. Reported subprime-related losses so far amount to around USD 175bn. Estimates of total losses range between USD 200bn and USD 400bn, so further write-downs seem in the pipeline.
- Each time the crisis flares up again new markets are affected. The **intra-Euroland yield spreads** have ballooned lately. For example, the 10 year government yield is now 61bp higher in Italy than in it is Germany.

Monolines

The monolines' effort to satisfy the credit rating agencies, Moody's and S&P, seems to be paying off – at least for now. For example, MBIA has succeeded in raising USD 3bn, eliminated its dividend and shut its asset-backed insurance business down for six months.

MBIA was removed from credit watch with negative implications and was instead assigned a negative outlook by S&P. S&P has affirmed Ambac's AAA rating and its negative credit watch with negative implications. In contrast, Fitch is still considering a downgrade of MBIA. However, even if the downgrade happens it will probably be one or two notches – not more as feared earlier.

However, in a broader perspective there is little doubt that the heat remains on the monolines. The current credit spread widening is a serious issue for them as it generates mark-to-market losses on a lot of their outstanding insurance liabilities.

The chart to the right displays how municipal bonds have lost against treasuries since October last year. Until last month losses compared to treasuries was deemed consistent with municipal bonds being traded as if the value of the underlying insurance protection, provided by the monolines, were close to worthless.

But in late February the market took a turn for the worse. A series of auctions of municipalities failed as investor interest in the secured debt declined and the market fell in disarray as hedge funds were squeezed to sell. The latest few days has seen renewed buying and the new Fed initiative has also helped. This has brought the spread between municipalities and treasuries back in from record highs but it remains very high.

Agency spreads

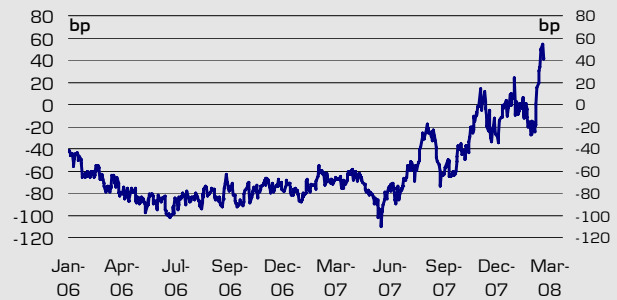
The 10-year spread between a Fannie Mae and government yields has surged recently, hitting fresh multi-year highs. There is little doubt that the spreading of the crisis to relatively solid bonds like agencies and municipalities has concerned the Fed a great deal, and it is probably one of the main reasons for the latest actions.

Yesterday's newest initiative contained a new Term Securities Lending Facility (TSLF), by which the Fed will lend up to USD 200bn of Treasury securities to primary dealers for an extended term of 28 days against collateral in other securities such as agencies and MBS. See [Coordinated central bank action](#) for details on the latest

Share prices of Ambac and MBIA



10Y spread: Municipal bond yield – Treasury bond yield



10 year spread between Fannie and government yields



Money markets

Money market pressures have escalated again lately. The spread between the Libor fixings and Overnight Interest Rate swaps (OIS) have increased again – especially for longer maturities. The spreads are still well below their highs of last year. However, the markets have also postponed the expected normalisation expanding forwards spreads between fixing rates and OIS. This indicates that the money market tensions now are expected to be of a more permanent nature.

The renewed turmoil on money markets and other markets prompted a swift response from central banks – not least the Fed.

On the one hand we see upside risks to money market spreads going forward due to a range of risk factors, including monolines, credit spread worries, annual bank statements etc. On the other hand central banks have shown great resolve and determination. Further problems will be met by more initiatives. Most likely the problems will linger on for a protracted period around the levels seen so far in 2008.

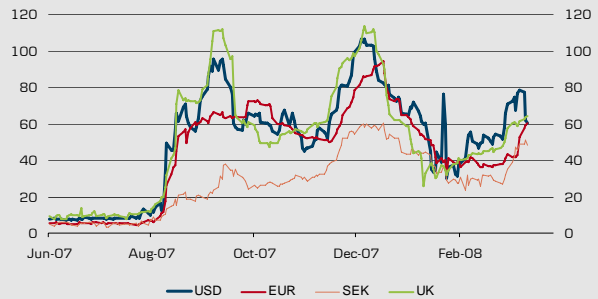
Leveraged buy-out loans

Leveraged loans to finance buy-outs, LBOs, have been a burden for many banks since investors started to shun them last summer. Banks are estimated to be sitting on a pipeline of around USD 150bn of loans that they have promised to make – but yet have to sell to investors. Since the end of last year, the values of these loans have been reeling in the secondary market, making it even more difficult for banks to unload the loans. The LCDX indices, displayed to the right, measure price developments in the secondary market for LBO loans.

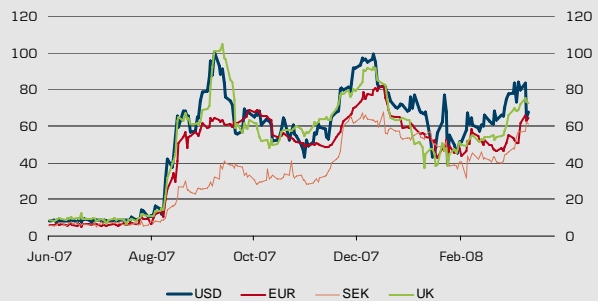
In addition to the declining value of LBO loans, S&P recently warned that a growing number of leveraged loans are in danger of breaching covenants or defaulting. The background is that many of the companies are carrying much more debt than they should, and this is worrying – particularly in the event of a US recession or further market turmoil.

The bottom line is that recent price falls on LBOs in secondary markets, combined with the warning from S&P on the future performance of these loans, are unlikely to provide any relief to banks' balance sheets from the LBO

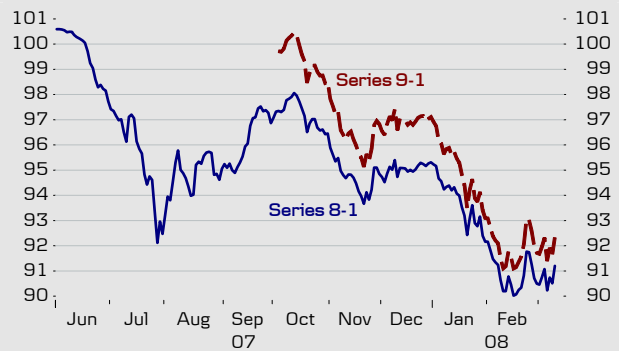
3M Libor/OIS spreads



6M Libor/OIS spreads



LCDX 5 Year indices



LCDX is a tradeable index with 100 equally-weighted underlying credit default swaps. These default swaps reference an entity whose loans trade in the secondary leveraged US loan market.

Commercial property loans

There is increasing speculation about commercial real-estate being the next domino to topple as the crisis escalates. The US economy is tanking and financial costs are escalating due to the financial crisis causing commercial real-estate values to decline.

The fear is evident in the CMBX indices of credit default swaps on US commercial property: the cost of insuring against defaults on US property loans has surged since the fall of last year. Very recently the indices have soared even higher – especially for the low rated indices.

The potential losses on commercial real-estate will feed through to the economy differently to sub-prime. While about 80% of sub-prime has been packaged into securities since 1995 only app. 28% of commercial real-estate has been securitised. This will probably slow the write-downs compared to sub-prime.

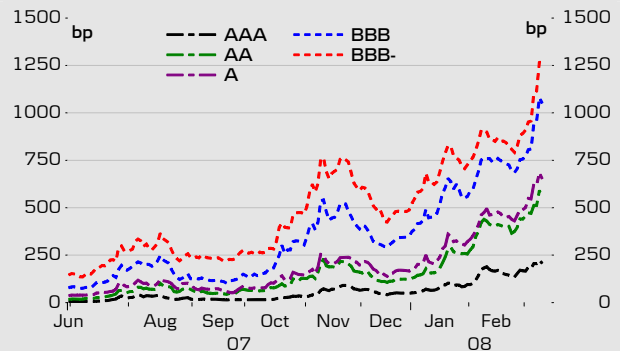
It is estimated that at the end of Q4 Bear Sterns, Citigroup, JP Morgan, Lehman Brothers, Merrill Lynch and Morgan Stanley had a combined exposure of USD 141bn towards commercial real-estate. How bad the write-downs will be depends on the economy.

The trend of rising costs of default protection is also an issue because it poses a negative risk factor for US non-residential construction spending, which has held up well so far in this cycle - in contrast to residential investments. The bottom chart illustrates how credit standards on commercial property loans in the US have been tightened substantially.

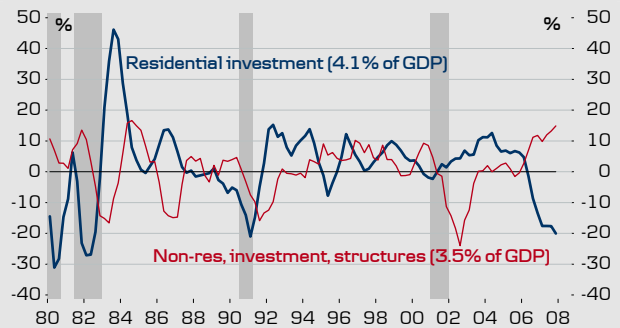
As can be seen in the chart in the middle the non-residential investments have been particularly strong in the last two years, thus compensating for some of the weakness in residential construction. This is important because the non-residential sector is almost as big as the residential construction sector.

To a great extent, job losses in residential construction have thus been absorbed by job creation in non-residential construction. If the latter starts to weaken as well there is a risk of a bigger hit to construction employment, with negative implications for the overall job market and hence private consumption.

CMBX Index, Series 1-1, Markit, spread



Residential and non-residential construction spending



Senior Loan Officer Survey: Credit standards on commercial loans

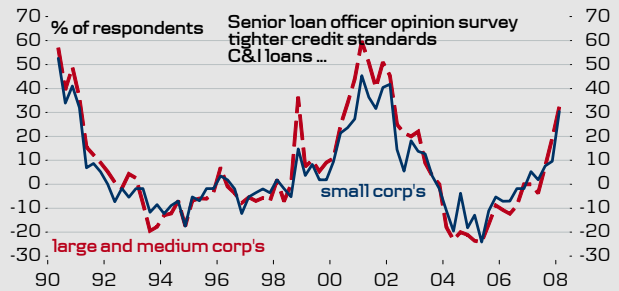


Lending standards

According to the Fed's Senior Officer Loan survey (4 February 2008) banks are tightening credit standards for corporate clients. This represents a risk for the US economy. A similar tightening of credit standards is present in ECB's euro area Bank Lending Survey (18 January 2008). The bottom chart indicates that the tightening credit standards also pose a risk for global defaults.

Until the next set of surveys one can only speculate about the development since the last. But given the development in the economy and on financial markets it is a fair guess that things are even worse at the moment.

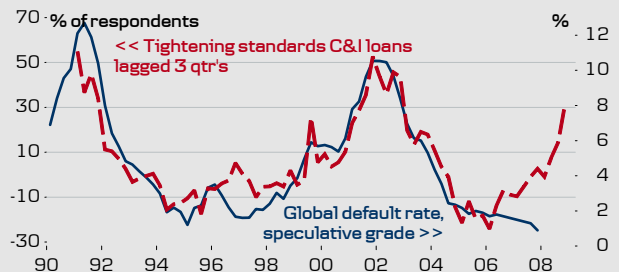
Senior Loan Officer Survey: Credit standards



Euro area Bank Lending Survey: Changes in credit standards applied to loans/credit lines to enterprises



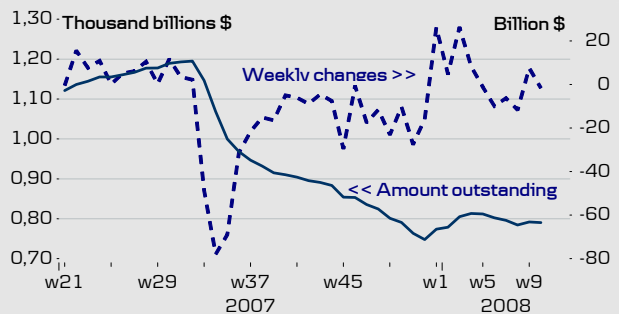
US lending standards and global default rates



Asset-backed commercial paper

The size of the asset-backed commercial paper market has been contracting as banks were bringing off-balance investment vehicles back onto their balances. The drop in the outstanding amount has stopped since year end, but the risks are for the drop to resume.

US Asset-backed commercial paper market, weekly changes



Credit spreads

Credit spreads continue to trend higher into uncharted territory with little relief in sight. The unwinding of structured credit continues as the negative spiral is still in place. The European Itraxx indices have been hit relatively hard compared to the US Markit CDX indices. Itraxx Main has tripled since the start of the year.

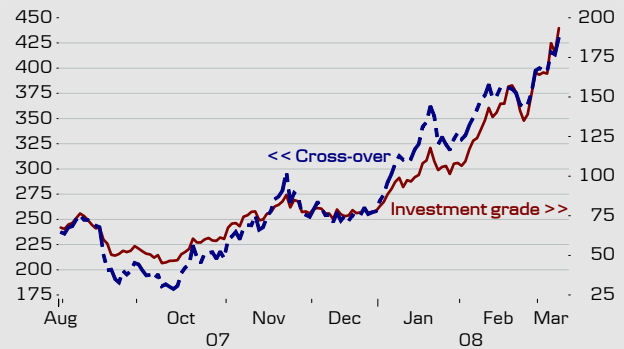
Itraxx EUR Main is composed of 125 investment grade entities. Itraxx EUR Cross-over is composed of 45 sub-investment grade entities.

Markit CDX CDS index is composed of 125 investment grade entities domiciled in North America. Markit CDX index is composed of 35 sub-investment grade entities.

EUR:iTraxx, 5 Year, Series 8



USD: Markit CDX indices, 5 Year



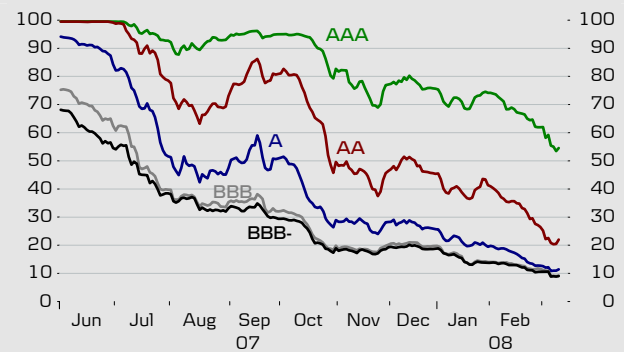
Sub-prime mortgages

The initial source of the shock underlying the current crisis was the decline in value of US subprime mortgages. ABX, derivatives indices measuring price developments in the less liquid market for US subprime mortgage bonds.

The high-rated indices continue to drop, while the low-rated indices are bottoming out at very depressed levels. S&P500 and Moody's have not yet downgraded the AAA securities, but downgrades are probably imminent.

According to Bloomberg none of the 80 AAA securities in ABX meet the criteria S&P had even before it tightened ratings standards in February. Bloomberg also mentions a specific AAA bond where 43% of the underlying mortgages are delinquent - hardly AAA material.

ABX Home Equity Index Series 7-1



Sub-prime losses

Uncertainty about the scale and distribution of subprime-related losses continue to weigh down on financials. Estimates of subprime-related write-downs range from USD 200bn to USD 500bn. The reported losses so far amount to approximately USD 175bn. Unless the most optimistic estimate of total write-downs (USD 200bn) turns out to be true, further subprime-related write-downs are in the pipeline.

There is still a steady stream of bad news and write-downs due to losses on sub-prime. Fortis, for example, reported a 1.5bp euro write-down only a few days ago. It would be foolish to think that we are out of the woods yet and further write-downs are on the cards.

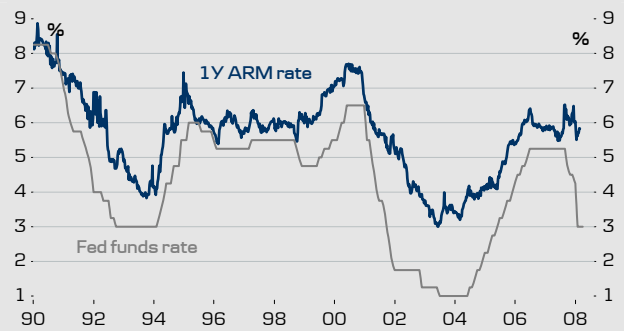
Equities: Financials vs. composite index



Mortgage interest rates facing US consumers

It is remarkable how the rates on 1Y Adjustable-Rate-Mortgages, ARM, have remained stable in the face of the dramatic easing of US monetary policy. Combined with the general tightening of lending standards this means the transmission mechanism from monetary policy to the economy is less effective at the moment. To compensate for the spread widening and tighter lending standards, the Fed has to cut deeper than normal to get the same effect.

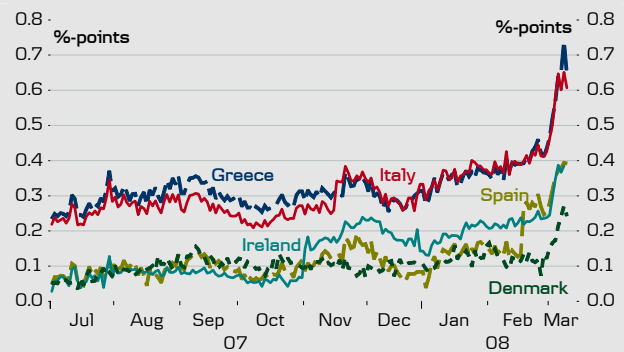
USD: 1Y ARM rate and Fed funds target



Intra-regional spreads in Euroland

The 10-year yield spread between Germany and other Euroland countries (and Denmark) has soared recently. For example the 10 year government benchmark in Italy now yields 61bp more than the corresponding German bond. It is quite difficult to justify the spread widening with fundamentals. Unwinding of risk and flight to quality reactions combined with self-feeding mechanisms created a situation with very poor liquidity in the Euroland bond market resulting in soaring yield spreads between Germany and other Euroland countries.

10 year government yield spread vs. Germany



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First date of publication

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