

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 publication regularly; the previous [Financial crisis update](#) was published on April 2.

- The relief rally has continued with declining fear of systemic risks in the financial system and increased risk appetite. The escalation of the financial crisis in mid-March and the downfall of Bear Stearns was followed by a relief rally brought on by a series of Fed initiatives, JP Morgan's offer to take over Bear Stearns, and better than feared results from some US investment banks.
- Most markets have shown continued improvement in recent weeks, but the improvement is not universal. In fact tension on money markets continues to rise. On top of this credibility of Libor calculations have been questioned.
- IMF has recently estimated that losses stemming from the US mortgage crisis may approach USD 1 trillion. Falling US house prices and rising delinquencies may lead to USD 565bn in mortgage-market losses according to the IMF in its latest [Global Financial Stability report](#).
- The financial crisis has abated recently, but it can flare up again with little or no warning. And the continued problems on money markets are a major concern. We doubt that we have seen the last bout of rising risk aversion and growing fear of systemic risks in the financial sector. However, what, when and how strong the next escalation of the financial crisis will be are questions tinged with much uncertainty.

Key things to watch going forward:

- 24 April - Credit Suisse Q1 2008 result
- 29 April - Deutsche Bank Q1 2008 result
- 6 May - UBS Q1 2008 results
- 13 May - MBIA Q1 2008 results
- 14 May - Freddie Mac Q1 2008 results
- 14 May - Fannie Mae Q1 2008 results
- A large number of European banks will also be reporting results in the next couple of weeks
- Earnings season in the US will continue in the coming days, but the large investment banks have all reported.
- How will the already implemented initiatives from the central banks work? And what new initiatives are in the pipeline from central banks?
- Early May - US Fed Senior Loan Officers Survey on Bank lending practices
- 9 May - ECB Bank Lending Survey

Financials - JP Morgan acquired Bear Stearns preventing a systemic meltdown

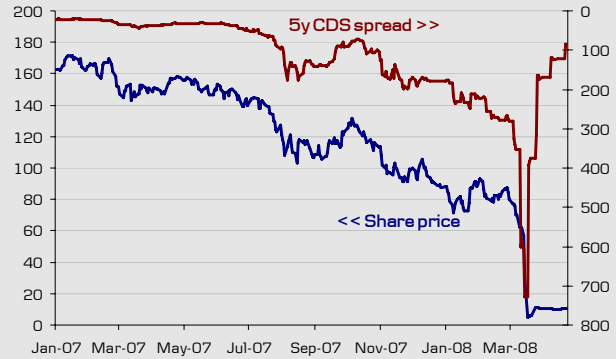
In mid-March Bear Stearns ran into liquidity problems and had to get funding from the Fed through JP Morgan. This step was taken only four days after Bear Stearns referred to liquidity rumours as 'ridiculous' in a press release. Bear Stearns's liquidity problems came from many directions.

As the rumours gained in strength the liquidity problems became a self-fulfilling prophecy. Traders stopped trading with Bear Stearns. Clients withdrew around USD 17bn within two days. Furthermore, as an investment bank Bear Stearns cannot access the discount window or participate in TAF auctions. Thus direct access to the Fed was closed until the introduction of the Primary Dealer Credit Facility (PDCF).

The result was the announcement that JPM had taken over Bear Stearns, marking a turning point in risk appetite and the fear of a systemic meltdown. Not surprisingly financial stocks have outpaced the general index since the high point in the financial crisis in mid-March.

The IMF has estimated that losses stemming from the US mortgage crisis may approach USD 1 trillion. Falling US house prices and rising delinquencies may lead to USD 565bn in mortgage-market losses according to the IMF in its latest [Global Financial Stability report](#). There are approximately USD 300bn in reported losses already and much more is in the pipeline according to the IMF.

Bear Stearns ran into big trouble



Equities: Financials vs. composite index



Monolines

The concern about monolines is that their rating will be downgraded which will impact the bonds they have insured. The rating of monolines is dependent on their capital. In the first quarter of 2008 we have seen spread widening and the liabilities (potential claims) of monolines have increased, thereby putting capital under pressure.

On April 23, 2008 Ambac issued its Q1 2008 report in which it stresses that its capital is exceeding S&P's AAA target level. In Q2 2008 Ambac is expecting to meet Moody's AAA capital target. Moody's has currently put Ambac on Negative Outlook on its AAA rating. Furthermore in Q1 2008 Ambac continued to generate positive operating cash-flow; however mark-to-market losses on CDOs and loss provisions related to RMBSs guarantees are substantial

If the underlying collateral is defaulting then Ambac as an insurer will step in. First, its insurance covers coupons and, secondly, on maturity notional amount. That is the potential pressure on liquidity right after a default is not critical. With rating agencies having a very close dialogue with Ambac we are awaiting their rating reviews and resultant actions.

Share prices of Ambac and MBIA

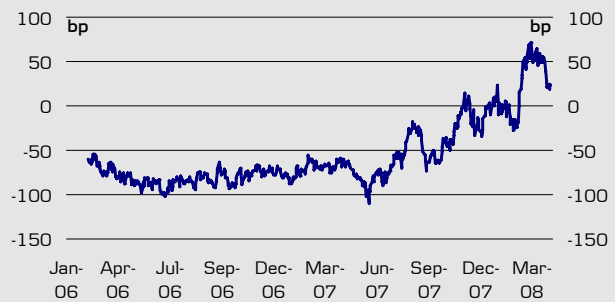


Municipalities

The chart to the right displays how municipal bonds have lost ground against treasuries. In early 2008, losses compared to treasuries were deemed consistent with municipal bonds being traded as if the value of the underlying insurance protection, provided by the monolines, were close to worthless.

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 into disarray as hedge funds were squeezed to sell. The initiatives from the Fed and the rise in treasury rates have narrowed the spread recently, but it remains quite wide.

10Y spread: Municipal bond yield – Treasury bond yield



Agency spreads

The 10-year spread between a Fannie Mae and government yields surged in the first half of March, 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 its latest actions.

The Fed initiatives have helped bring the spread tighter but it remains wide in a historical perspective. The rise in treasury rates has probably also helped. The Primary Dealer Credit Facility and Term Securities Lending Facility (TSLF) both accept securities such as agencies and MBS as collateral.

Money markets

Money market pressures continue to escalate: The spread between the Libor fixings and Overnight Interest Rate swaps (OIS) have increased again. The start of Q2 did not have an effect on the spreads. The continued deterioration on money markets is especially disturbing given the improvement on other markets.

There have been unconfirmed reports that some banks have reported lower rates than they actually meet in the market to blur their problems and hide their actual borrowing costs out of fear of looking desperate for cash. Libor rose after BBA announced a probe into the problems. If true underreporting could explain the recent rise in fixing rates as banks respond to heightened scrutiny. There is talk of changing the way fixings are collected.

The renewed turmoil on money markets and other markets have prompted a series of responses from central banks - not least the Fed. However, the initiatives have yet to calm markets down. The latest initiative is from the Bank of England which on 21 April announced the launching of a scheme to allow banks to swap, temporarily their high quality mortgage-backed and other securities for UK Treasury Bills. So far it has done little to dent the spread between libor and OIS.

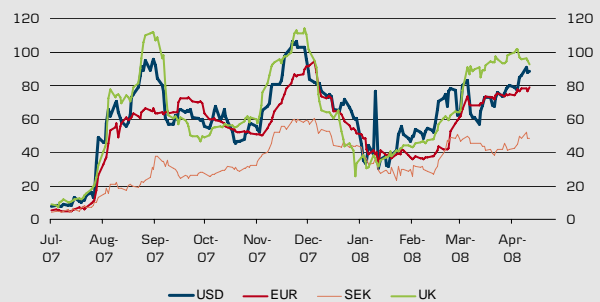
On the one hand we see upside risks to money market spreads going forward due to a range of risk factors, including monolines, misstated rates, credit spread worries and bank statements. And even though central banks have tried several initiatives they have yet to overcome the problems.

On the other hand, central banks have shown great resolve and determination. Further problems will probably be met by more initiatives. Most likely the problems will linger on for a protracted period of time.

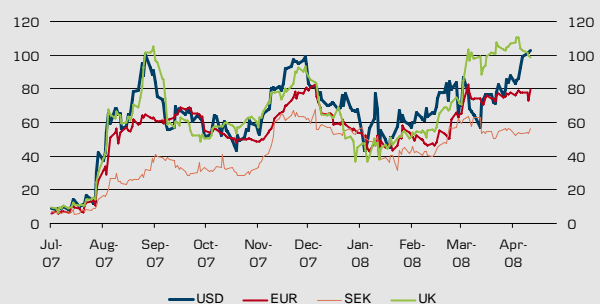
10 year spread between Fannie and government yields



3M Libor/OIS spreads



6M Libor/OIS spreads

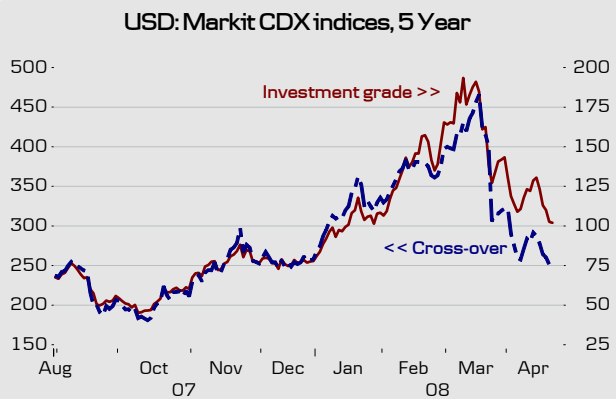
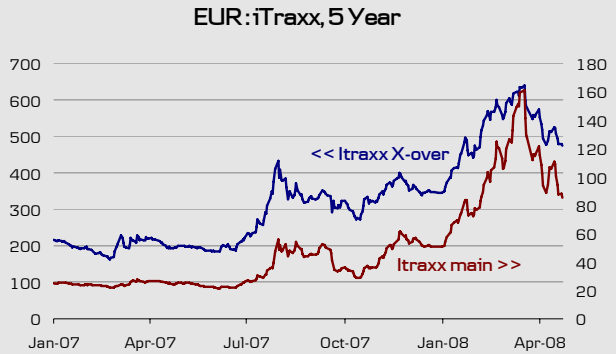


Credit spreads

After the bailout of Bear Stearns, credit markets have seen a massive tightening. The systemic risk arising from lack of liquidity has been reduced and banks are recapitalizing to address solvency issues. Since the peak on March 17, 2008, credit spreads tightened massively. Eg, iTraxx Europe has tightened 75bp (-53%) while iTraxx Crossover has tightened 165bp (-74%).

The iTraxx Europe index is composed of CDSs on 125 investment grade entities while the iTraxx Crossover index is composed of 50 sub-investment grade entities.

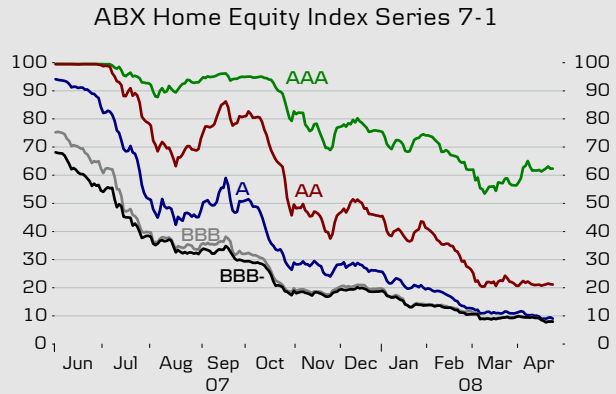
The CDX Investment grade CDS index is composed of 125 investment grade entities domiciled in North America. While CDX Crossover CDS index is composed of 35 sub-investment grade entities domiciled in North America.



Subprime mortgages

The credit quality of the underlying US subprime mortgage bonds continues to deteriorate, especially for the loans originated in 2006 and 2007. However, looking at the market prices of the loans in the ABX indices we see a somewhat different story. Prices on the highest rated tranches, AAA, and some older AA tranches are actually increasing while other vintages and tranches are basically unchanged.

This diverging price behaviour can, to some extent, be explained by increased confidence regarding the probability of investors getting some of the value of their investments back. Earlier this year investors feared that their investments basically had no value - also the AAA tranches and prices dropped significantly. Now investors are a little more confident.



Leveraged buy-out loans

The balance sheet and credit risk burdens from leveraged loans on banks balance sheets are declining as banks are taking various steps to offload loans. Banks are among others executing block-sales of loans to private equity groups and securitizing loans to be used in central bank repo facilities. The recent liquidity initiatives by the Fed, especially the Primary Dealer Credit Facility (PDCF) programme, have supported CLOs to be used in the Fed Window. These actions can to some degree explain the recent spread rally in the LCDX indices.



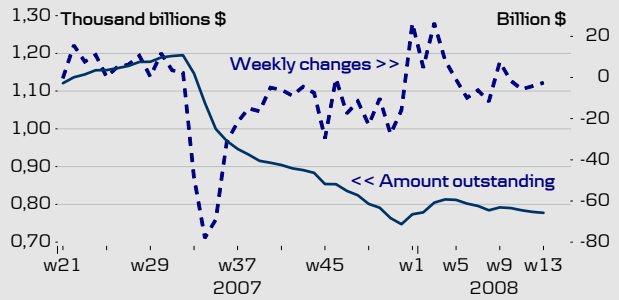
The LCDX index is an index with 100 equally-weighted loan CDS (LCDS) showing the price development in the secondary US leverage loan market.

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, and the outstanding amount of asset-backed commercial paper has probably found a new level around that seen in 2005 before the ABCP increased significantly.

US Asset-backed commercial paper market, weekly changes



Commercial property loans

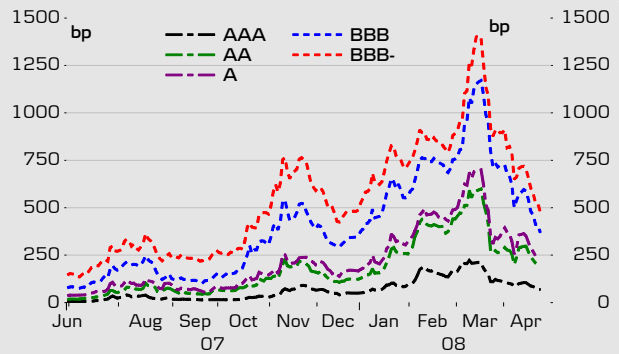
Since the Fed's bailout of Bear Stearns in mid-March the CMBX indices have rallied massively with the oldest vintage (Series 1-1) seeing the largest spread tightening. For the highest-quality tranches investors no longer fear that their investments will be wiped out. However, as the US economy and US property market have not yet stabilised, we expect continued deteriorating credit fundamentals in US CMBS. That said, a lot of negative expectations are already priced in.

The problems in commercial real-estate are also an issue because they present 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 (as can be seen in the chart in the middle). To a great extent, job losses in residential construction have thus been absorbed by job creation in non-residential construction.

Non-residential construction is now starting to feel the heat from a stalling business cycle and tighter credit conditions following the financial crisis. Several indicators suggest that non-residential construction is facing a potentially severe slowdown. Incoming data is already showing a significant deceleration in non-residential construction activity. With the correction in residential construction activity still having legs, the negative impact from the overall construction industry is set to re-intensify in the coming quarters. See our analysis [US: Non-residential construction hits the wall](#) for more detail.

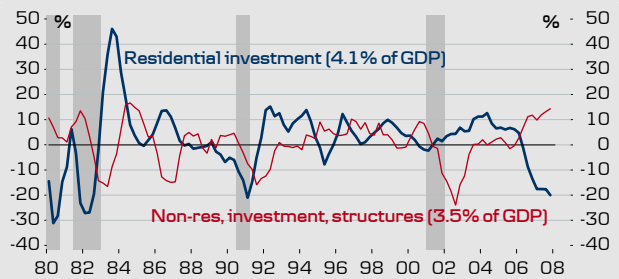
The chart on the right illustrates how credit standards on commercial property loans in the US have been tightened substantially.

CMBX Index, Series 1-1, Market, spread



Development in the US commercial property markets can be seen in the CMBX indices. The CMBX indices consist of 25 CDS on US CMBS.

Residential and non-residential construction spending



Senior Loan Officer Survey: Credit standards on commercial real estate loans



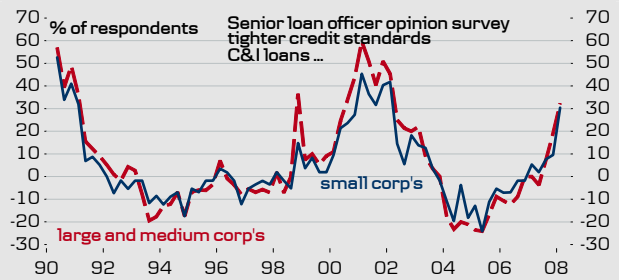
Lending standards

According to the Fed's Senior Officer Loan survey (February 4, 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 the ECB's euro area Bank Lending Survey (January 18, 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.

The next Senior Loan Officer Survey is due in early May. ECB released the last two editions of the Bank Lending Survey one month earlier than normal, but has now ended this exception. The next Bank Lending Survey will be published on Friday, May 9.

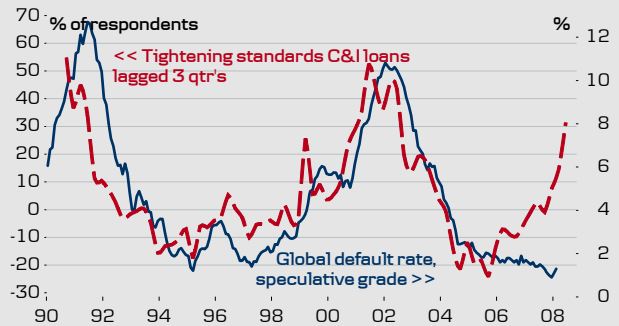
Senior Loan Officer Survey: Credit standards



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



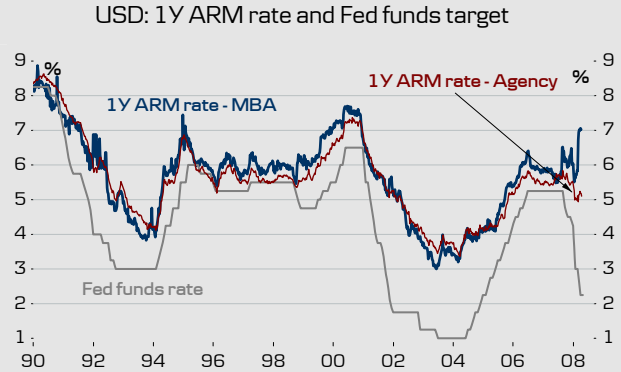
US lending standards and global default rates



Mortgage interest rates facing US consumers

It is remarkable how the rates on 1Y Adjustable-Rate-Mortgages (ARM) have failed to come down in the face of the dramatic easing of US monetary policy. While agency ARM rates have eased a little, non-agency ARM rates have risen significantly. This is illustrated in the chart showing the MBA sourced ARM rates (a weighted average of agency and non-agency rates) against ARM agency rates.

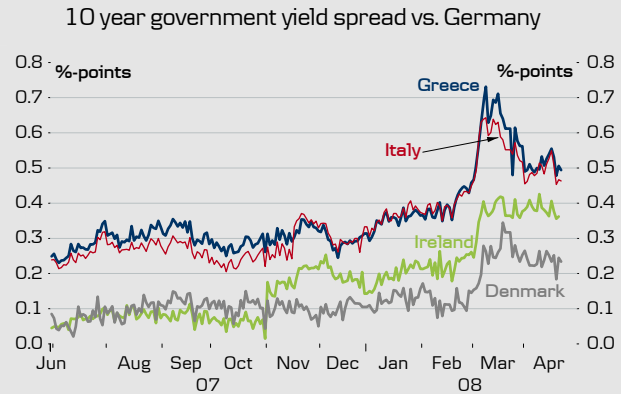
Combined with the general tightening of lending standards this implies that the transmission mechanism from monetary policy to the economy is less effective in the housing market than is usually the case. To compensate for the wider spreads and tighter lending standards, the Fed has to cut deeper than normal to get traction in the housing market.



Intra-regional spreads in Euroland

The 10-year yield spread between Germany and other Euroland countries (and Denmark) has come back in a little recently, but remains significantly wider than at the beginning of 2008. 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 which resulted in soaring yield spreads between Germany and other Euroland countries.

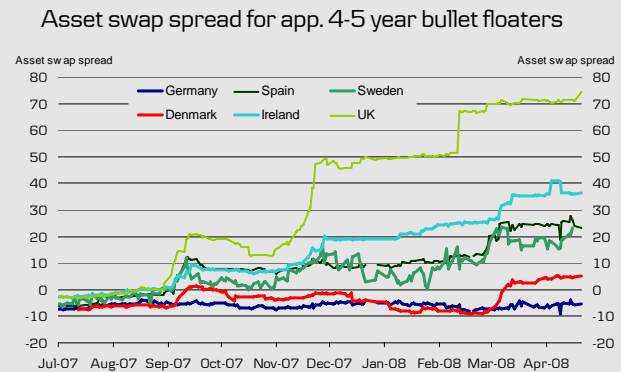


European Covered Bonds

One of the markets that show no improvement even as the general sentiment has improved is the European covered bond market. UK remains the hardest hit followed by Ireland, Spain and Sweden. Denmark fared well for a long time, but the asset swap spread widened mid-March. Germany has not been hurt.

The following bonds is used in the graph:

UK = BRADBI 3.875 05/04/2011	Sweden = SVSKHB 6.000 12/19/2012
Spain = CAIXAB 4.500 11/21/2012	Ireland = AIB 3.750 04/30/2013
Germany = DGHYP 3.250 01/19/2012	Denmark = RD 4.0 01/01/2012



Emerging markets spreads

Typically emerging markets are among the hardest hit, when a crisis escalates, but this time things are different. Much stronger fundamentals have helped reduce the spill-over effect on emerging markets this time around. That said, the EMBI stripped spread (see graph) has widened significantly since mid-2007, but remains well below previous crisis levels.

A more selective case by case approach to emerging markets going forward may prompt local crises, but emerging markets as a whole look stronger than they did previously.

Emerging markets stripped spread over treasuries



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First date of publication

Please see the front page of this research report.

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