

Market Update

Credit Crunch means market risks are weighted to the downside

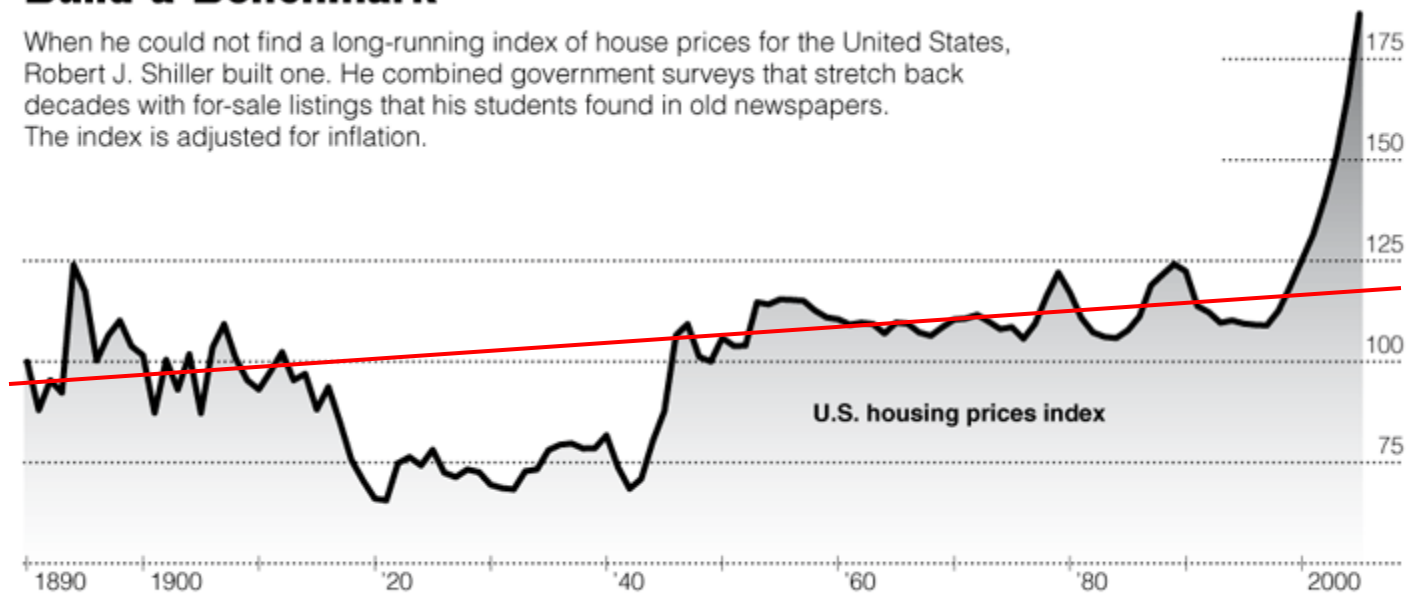
March 11, 2008

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The biggest housing bubble in the history of the US has ended...

Build-a-Benchmark

When he could not find a long-running index of house prices for the United States, Robert J. Shiller built one. He combined government surveys that stretch back decades with for-sale listings that his students found in old newspapers. The index is adjusted for inflation.

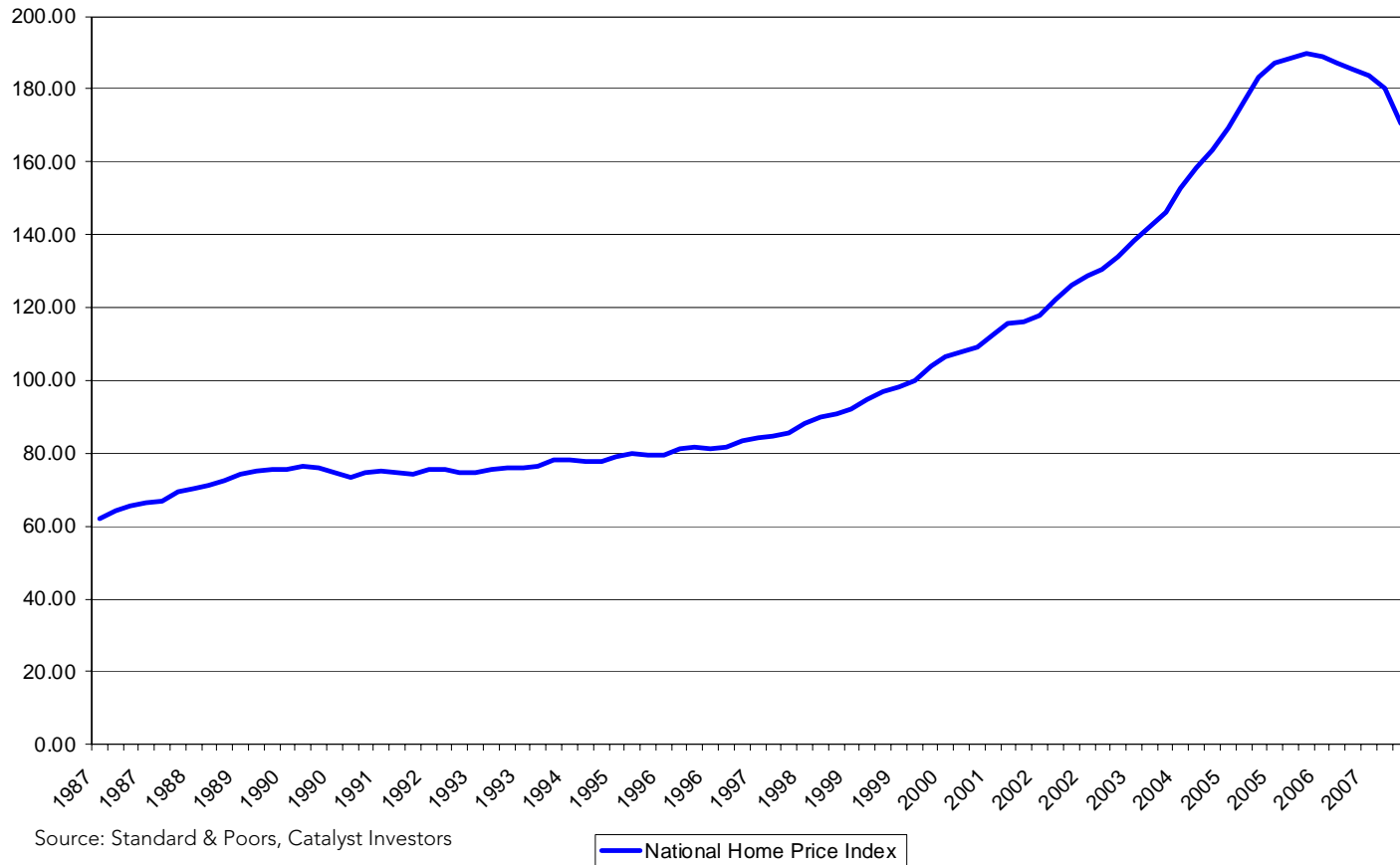


Source: "Irrational Exuberance," Robert J. Shiller New York Times

...inflation-adjusted house prices need to fall 30% to get back to trend

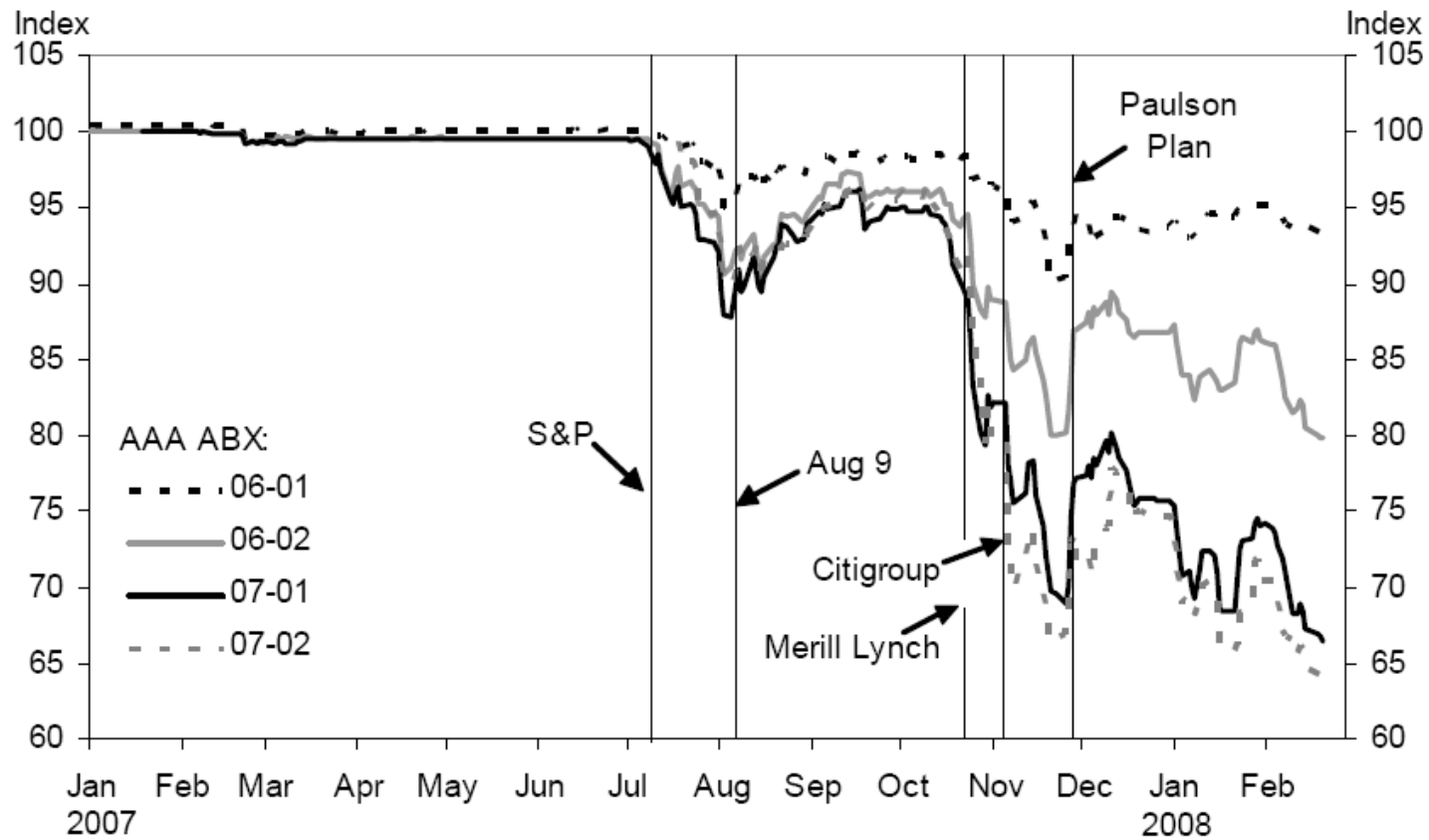
House prices have fallen about 10% nationally to-date...

Case-Shiller National Home Price Index



...with further likely to go

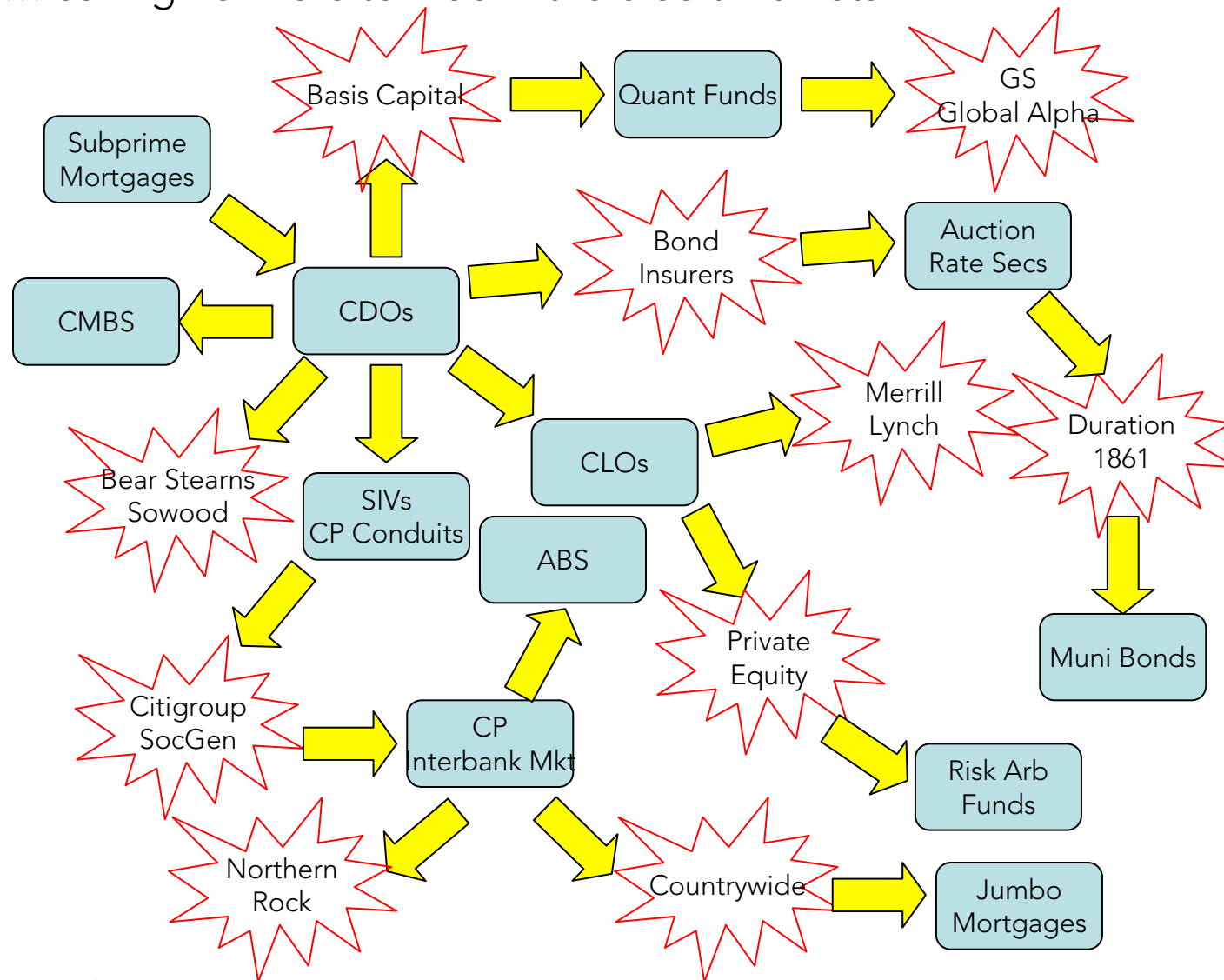
Credit quality declined during the boom...



Source: Goldman Sachs.

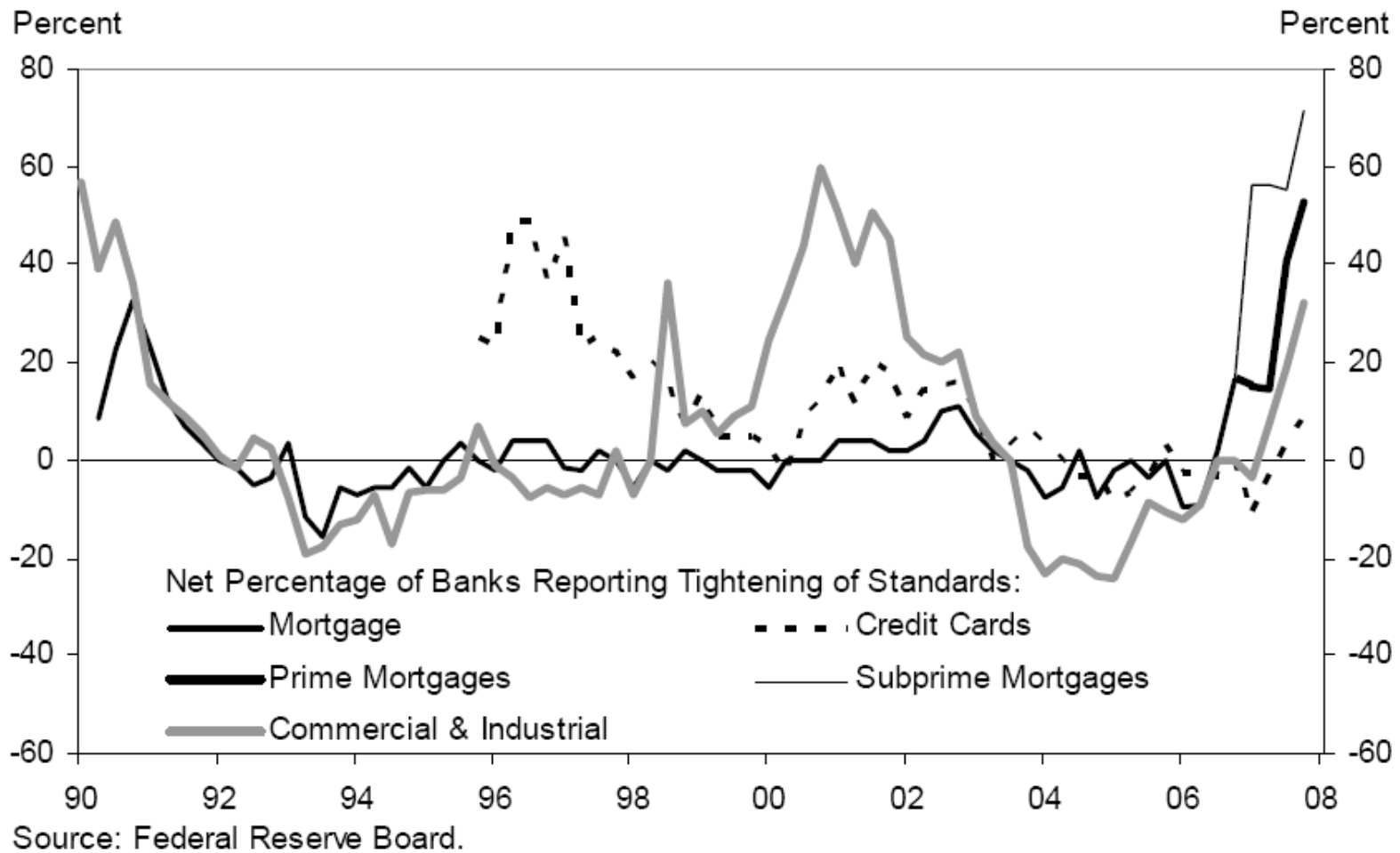
...and in 2007 the subprime bust was on...

...leaving nowhere to hide in the credit markets



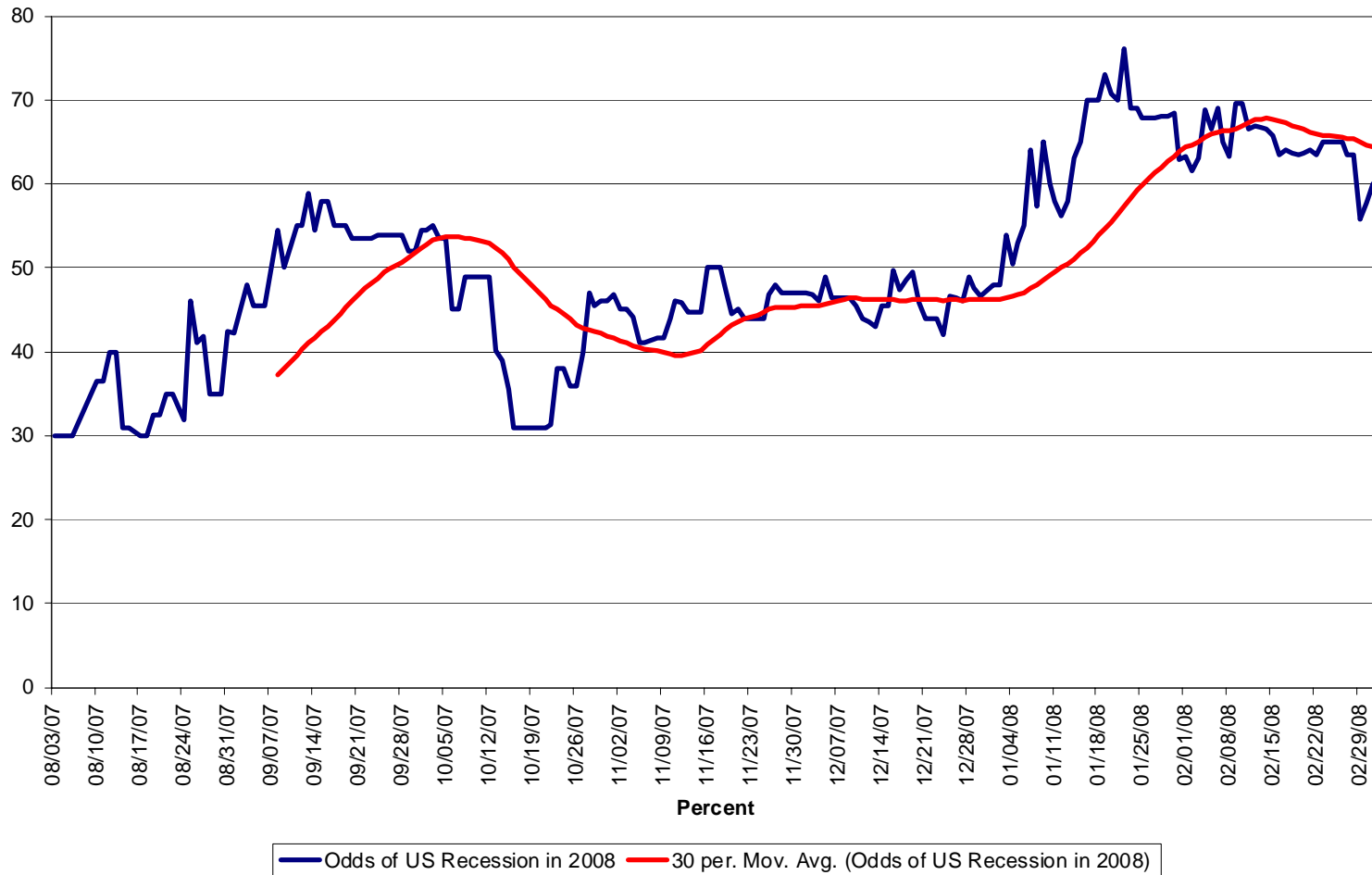
Source: Catalyst Investors

Banks are tightening lending standards...



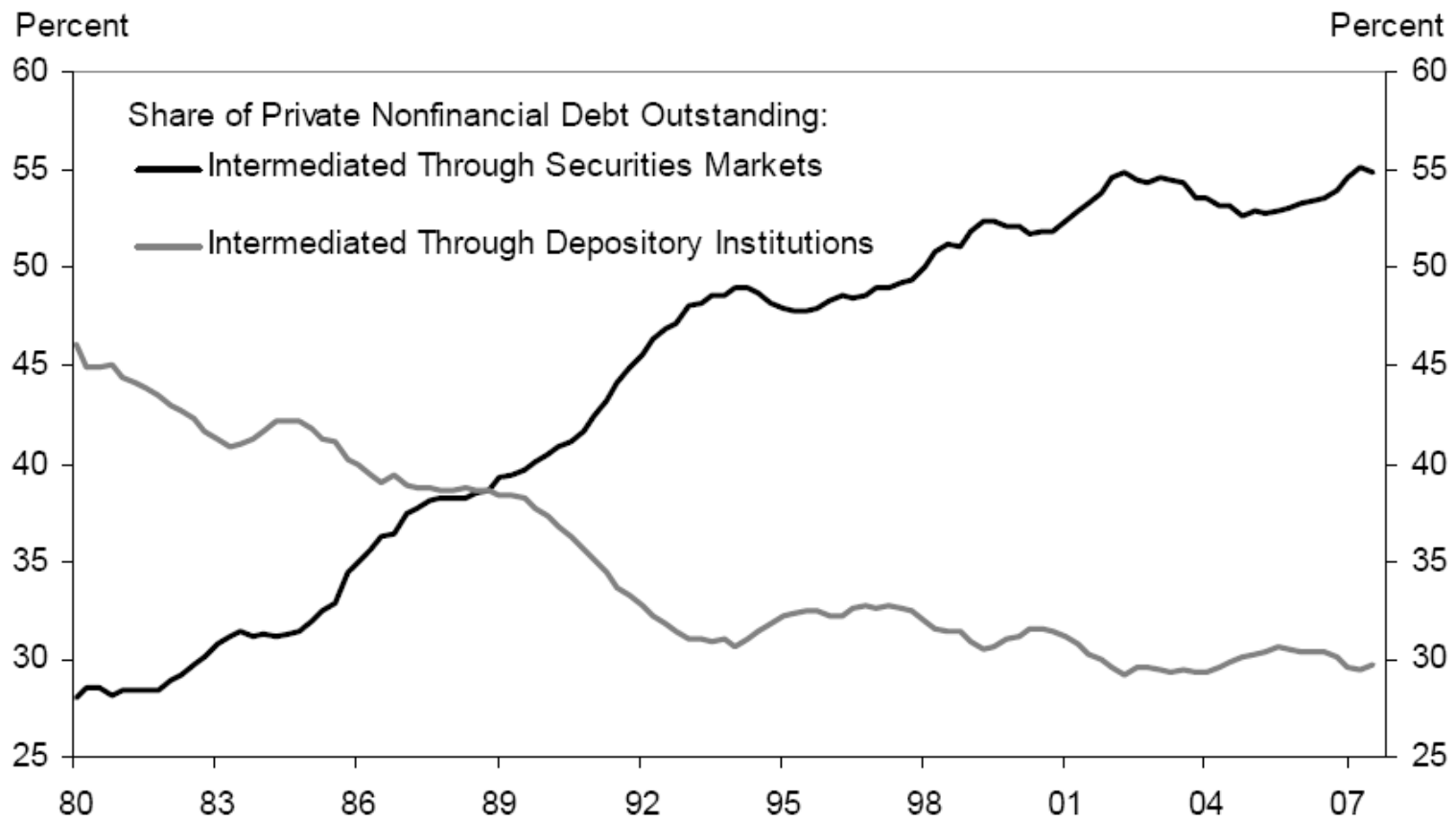
...and the odds of recession in 2008 are now at 59%

Intrade - Odds of US Recession in 2008



Source: Intrade.com, Catalyst Investors

The US debt market is now mostly driven by the securities markets...



Source: Morgan Stanley calculations based on Federal Reserve Flow of Funds Accounts.

...but the Wall Street investment banks are essentially insolvent...

Gross Leverage Ratios (Assets/Equity):

Goldman Sachs: 21.6x

Morgan Stanley: 33.4x

Merrill Lynch: 31.9x

Lehman Brothers: 30.7x

Bear Stearns: 33.5x

...and the GSEs could need a government bailout

Gross Leverage Ratios (Assets/Equity):

Fannie Mae: 20.1x

Freddie Mac: 29.7x

The i-banks and hedge funds will likely come under Fed supervision...

	Assets	Liabilities	Capital	
	(\$bn)	(\$bn)	(\$bn)	Leverage
Commercial banks	10793	9693	1100	9.8
Savings Inst	1914	1687	227	8.4
Credit Unions	748	659	89	8.4
Brokers/hedge funds	5397	5226	171	31.6
GSEs	1633	1567	66	24.7
Leveraged Sector	20485	18804	1681	12.2

Source: Authors' calculations based on Flow of Funds, FDIC Statistics on Banking, Adrian and Shin (2007), and balance sheet data for Fannie Mae, Freddie Mac, and broker-dealers under Goldman Sachs equity analysts' coverage.

...and may be forced to merge into commercial banks before it's all over

The resultant financial system deleveraging could spell the end of a long era



Source: Barrons

What it means for the economy

- Economy-wide debt deflation
- Tight credit for small businesses, real estate
- Low interest rates
- Continued dollar weakness
- Elevated commodity prices
- Wide credit spreads
- Higher savings rates
- OK environment for multinationals, tech
- Narrower trade deficit
- More regulation of financial markets