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Cross-Asset Navigator: Global Implications of Deleveraging

Morgan Stanley

Morgan Stanley: Global Cross-Asset Strategy Team

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Global Cross-Asset Strategy

Cross-Asset Navigator

Global Implications of Deleveraging

The ramifications of European bank deleveraging will extend broadly, but the actual impact depends on exactly which assets are sold. We highlight recent work done by our strategy and analyst colleagues to address this issue. Our European banks team has done a deep-dive examination of what assets are likely to constitute the estimated €1.5 - €2.5 trillion in deleveraging they expect. Our Asia team suggests that a broad-based exit of European banks would not be enough to lead to a credit crunch if orderly, but it could still pose a significant challenge and funding risks. Last, our securitized products team estimates that European banks hold $474 billion in securitized product, a potential supply overhang weighing on the market.

Conference Call Friday November 18th, at 2.30pm GMT / 3.30pm CET / 9.30am EST with:

- Huw van Steenis – Head of European Banks Equity Research
- Greg Peters – Head of Global Cross-Asset Strategy
- Viktor Hjort – Head of Fixed Income Research, Asia
- Hans Redeker – Global Head of FX Strategy
- Vishwanath Tirupattur – Global Head of Securitised Products Research

DIAL - IN DETAILS:

All participants MUST register for this conference call using the URL below:
https://www.emea.tcconline.com/registration/event/28784670

4 charts: 1) impact to AxJ from European bank deleveraging; 2) impact to securitized products from European bank deleveraging; 3) how investors will seek yield in a low-return world; and 4) China to follow a path of steady and moderate growth (pg 9).
Global Cross-Asset Strategy Overview

Base Case (3-6 months)

On a long-term strategic perspective, we are bearish on developed market equities, while bullish on emerging market assets. DM is now in the midst of what is likely to be an extended period of deleveraging, leading to a subpar economic expansion. In contrast, the strong secular fundamentals for EM economies should continue.

The tactical outlook is now more balanced, but we wouldn’t alter our defensive view. Compared to a month ago, the case for tactical upside is less compelling, given the strong rally. While growth data are better and policy developments are moving in the right direction, Europe is far from resolved and the US debt debate will be back in the spotlight shortly.

A G10 recession is not our base case for 2012, but the impact of fiscal and monetary policy responses to weak growth is likely to be limited. If there is a DM recession in the next year, then risk assets have significantly further to fall.

The “comprehensive solution” announced this month by European officials is not a “silver bullet” on the debt crisis. While we have seen incremental progress, the details on bank recapss are lacking, and a levered-up EFSF looks increasingly in doubt. The key step remains a statement and timeline for moving toward fiscal integration, which would enable other policy measures to bridge the gap.

Slowing growth in EM is a risk, but growth should stabilize by year-end. A soft landing in EM still looks on track, and EM policy makers have some flexibility. However, EM is vulnerable to funding market stress and DM deleveraging, in addition to a DM recession.

- Italy sovereign yields stay above 7%. Debt costs that high are not sustainable and if they persist, the odds of a bailout increase significantly.
- The US economy stays at “stall speed.” If growth stays around 2%, recession is dangerously close; job growth close to 150k per month is needed for growth sustainability.
- Fiscal policy proves counter-productive. With US stimulus set to expire and fiscal consolidation elsewhere in DM, fiscal policy could tip a weak recovery into recession.
- Slower growth in Asia/EM. The risk is that policy cannot respond fast enough or in sufficient size. Although inflation remains high, Turkey, Brazil and others have already cut rates.
- Upside risk: China policy. Faster CNY appreciation and fiscal stimulus could contain downside growth risks in Asia, and boost markets.
- Upside risk: Coordinated policy response. Decisive monetary action by G10 central banks, with matching fiscal support.

Asset Class Views

We continue to favor a cautious strategic stance. The bear market rally could last through year-end, but we wouldn’t alter our defensive positioning. In DM, we favor credit over government bonds and equities, as credit is pricing in worse scenarios. Flight-to-safety assets (USD, JPY, gold) are attractive, given the number of events risks remaining in 4Q11.

Stay UW DM equities, OW EM equities on a 6-month view. DM equities, particularly in Europe, are not as cheap and compelling after the rally, while the risks remain largely the same. EM equities are cheap and have underperformed DM, but continue to face near-term funding stress risk.

Neutral on Treasuries, going long Bunds. Better growth data have led to a Treasury sell-off, but talk of QE3 should keep rates range-bound. Bunds have cheapened up in the past month, and the market is not even pricing in 25bps in rate cuts by the ECB.

Stay constructive on credit. DM credit has rallied, but is still pricing in a fairly high probability of recession.

USD, JPY strength, EUR weakness. Expect USD and JPY strength as a risk-off trade; after rallying, risks to the EUR are to the downside on the unresolved debt crisis, a more dovish ECB and less capital repatriation.

A more neutral view on commodities. Our commodities strategists have moved to neutral on oil, given slowing demand growth and better supply. After correcting, gold remains an attractive medium-term defensive play.

Risk Factors / Catalysts

Relative Preferences

Source Morgan Stanley Research
Global Implications of Deleveraging

- We continue to review the implications of European bank deleveraging by highlighting recent work done by our strategy and analyst colleagues.
- Our European banks team estimates between €1.5 - €2.5 trillion in deleveraging, with the greatest risks to asset leasing, securitized assets, assets in Central and Eastern Europe (CEE) and Southern Europe, and commercial real estate assets.
- Our colleagues in Asia suggest that a broad-based exit of European banks would, on its own, not be enough to lead to a credit crunch if orderly, but it could still pose a significant challenge and funding risks.
- European banks hold $474 billion in securitized product. Only a portion of this may be sold, but the supply overhang is a weight on the market.

European banks are the epicenter of the current stage of global deleveraging. Our European banks equity analyst Huw van Steenis has been arguing since before the summer that deleveraging and a potential credit crunch were likely because of the banks’ exposure to sovereign risk, stress in the funding markets, uneconomic financing terms, and the need to recapitalize and shrink balance sheets. Now with the Italian 10Y bond yield hovering around 7%, weak Eurozone sovereign debt auctions, and the crisis infecting France, the escalating debt crisis is likely to accelerate bank deleveraging. Huw and team now expect between about €1.5 and €2.5 trillion deleveraging by European banks, with risks for bank earnings, lending and economic recovery.

As we’ve written recently, the implications of European bank deleveraging are far reaching, affecting credit access and potentially growth in emerging markets and contributing to financial market segmentation along regional lines (Banking on Borders, November 10 and DM Deleveraging, EM Stressing, November 1). Over the past week, our colleagues in Research have published a number of reports that look more deeply into what and how many assets that European banks might divest and the impact on AxJ and other regions and asset classes.

This week we want to highlight this work because of the broad and significant consequences of deleveraging. What follows is a shorter version of the report published by Huw and his team that provides details on potential European bank deleveraging and the associated risks. In particular, they see the greatest risks to asset leasing, securitized assets, assets in Central and Eastern Europe (CEE) and Southern Europe, and commercial real estate assets. In contrast, while they see growing risks to global trade finance, their assessment is that in a more orderly scenario this will be passed to local or global banks, although risks remain.

The withdrawal of trade credit reflects one of the bigger risks to EM, though more for CEE than Asia. Indeed, our Asia colleagues suggest that a broad-based exit of European banks from Asia would, on its own, not be enough to lead to a credit crunch if orderly and the exposures are less than commonly perceived (The Challenge to Asia of European Deleveraging, November 14). However, it would still pose a significant challenge, as the cost of capital rises and credit conditions weaken. In all scenarios, China is likely to play an important role. At 8% of total deposits (4% including China), the team believes that Asian banks could absorb European bank claims, if required. Moreover, policy-makers could alleviate credit constraints and respond to funding market stress by introducing cuts in cash reserve or required reserve ratios, conducting more open market operations and re-capitalizing state-owned banks.

The securitized market could also be potentially impaired by deleveraging. Our strategy team estimates that European banks hold €348 billion ($474 billion) in securitized assets that are potentially subject to sale (European Bank Deleveraging: Implications for Securitized Products, November 14). This consists of USD assets in the range of €169 - €249 billion ($230 - $339 billion) and EUR-denominated assets in the range of €99 - €179 billion ($135 - $244 billion). Whether these assets are sold will depend on funding as well as capital relief considerations. The effects of potential asset sales will not be uniform across asset classes. Asset classes such as CLOs and prime European RMBS (particularly in the senior tranches) are positioned to be less disrupted. However, others such as US RMBS (particularly subprime, alt-A and option ARMs) are more sensitive to supply pressures – and they may see further price declines as a result of the asset sales. In the latter cases, even if there are no actual sales, the threat of potential sales would be an enduring overhang.
What Are the Risks of €1.5-2.5tr Deleveraging?

Huw van Steenis
Francesca Tondi
Magdalena L Stoklosa
Alice Timperley
Anil Agarwal
Betsy L. Graseck

We still see multi-year balance sheet retrenchment and challenging fundamentals – with risks to credit supply, bank earnings, ability to achieve new capital ratios and economic recovery. This note with our global and credit colleagues takes our previous work forward a few steps in assessing the risks to the real economy and bank earnings – as well as who may pick up the lending being shed by European banks.

- We introduce a ‘heat map’ of risks we are watching, and with our credit and global colleagues we will keep an ongoing track of how these play out.

- We have done a deep dive on the four main buckets of assets that banks are looking to shrink – as well as what they cannot shrink. It has firmed up our top down views of the risks of €1.5-2.5tr potential shrinkage in banking assets. We have spent extensive time meeting with non-European banks, private equity and non-core bank units to assess the potential of European assets being sold to other players – and on the whole we think there will be considerable potential for asset buyers.

- This work gives added conviction to our concerns for bank earnings in some areas: our numbers are significantly below market expectations for Spanish and Italian banks, and gives us caution on many restructuring stories (we are UW CBK – which we add to our least preferred with this note – and RBS, and for example we think CS will need to cut the dividend over 60%). We also remain cautious on Central & Eastern Europe (CEE)/Southern & Eastern Europe (SEE) and we feel relative winners will be the national champions.

Our thesis has been that we think banks could delever by ~€1.5-2.5 trillion over the next 18 months with risks to SME lending, trade finance, syndicated lending, asset leasing, CEE banking and parts of wholesale/investment banking. This is why we have argued since July that we see the risks of a ‘grinding’ credit crunch in Southern/peripheral Europe/SEE, although we hope intense policy response will reduce this risk.

It is also why in August we put out a think piece arguing the case for a pan-European temporary bank guarantee (See European Banks: The Stress in Bank Funding and Policy Options).

A key issue is that we think policy makers – and some investors – have underestimated the importance of bank funding on banks’ ability to lend profitably. Regular readers will know that we argue funding is as big a concern as asset quality given the €1.7 trillion of bank funding rolling in the next three years, which is a remarkable challenge to achieve in today’s market. Simply put, the euro-zone sovereign crisis is re-pricing all bank liabilities – from equity to repo, with major knock-on implications.

Why shrink balance sheets rather than raise equity?

The self-reinforcing loop of stress in sovereign funding, stress in bank funding and stress in bank solvency is likely to overhang European economic recovery and lead to material balance sheet shrinkage. We see the drivers as three-fold:

- the approach of Basel 2.5/3 shifting risk weights;
- the stress in bank funding ($ funding for euro-zone banks and unsecured term funding more broadly); and
- weakened balance sheets from the euro-zone crisis (and EBA recap simply adds to this).

Even before the European sovereign crisis intensified, future regulation (Basel 2.5 and 3) was forcing banks to reconsider their business models (see Wholesale & Investment Banking Outlook: Reshaping the Model, Huw van Steenis et al, March 23, 2011). This process has accelerated for European banks as the sovereign crisis has increased the cost and scarcity of unsecured funding (particularly USD) and raised pressure on banks to raise capital to protect against systemic risk in the region.

In addition, in October, the European Banking Authority announced that European banks must reach 9% Core Tier 1 by June 2012 including notional losses on euro-zone sovereign books. Per EBA calculations, a total of ~€106 billion of new capital will be required to bring the system up to this threshold. However, our European team’s analysis suggests the €106bn will only really drive €50-70bn of fresh capital – of which €38bn is already committed to Greece and Portugal. The large listed banks have said many would rather shrink than raise equity (see Recap Rally, Jackie Ineke et al, 28 October 2011 and European Banks: Some progress supports our national champion call by Huw van Steenis et al, October 28, 2011 for more details). A less promising earnings outlook makes the ability to earn into new Basel 3/G-SIFI and other
regulations far more challenging, and credit and equity markets’ impatience on trajectories will likely drive behaviour.

**Bank funding roll is considerable – €1.7tr of debt due to refi for the major banks in the next three years.** We think a step change in the pricing and availability of senior unsecured debt as well as dollar funding challenge many businesses. Whilst intense ECB support has helped, lack of a temporary bank debt guarantee plan is unfortunate, we feel.

**Funding is no small issue.** European banks lost $100bn of CP over the summer alone — making some major European banks more dependent on the ECB for funding. Given the dollar is the functional currency of global trade, this will impact European banks’ ability to be global lenders — and hence why we and our Asian colleagues Fiona Simpson and Anil Agarwal and global colleagues Greg Peters and Neil McLeish have been so intensely focused on the risks to emerging market lending — see for instance Greg’s recent note Cross-Asset Navigator — November 1, 2011 — DM Deleveraging, EM Stressing. In addition, we think a raising of say €1-2bn of extra equity for a French or Italian bank would not change the minds of dollar investors to provide cheap dollars if the investors are worried about a poorly managed sovereign crisis with insufficient firewalls. See European Banks: Euro-TARP - 10 things you need to know and European Banks: ECB Lending Survey & funding strains underscore policy challenge.

We think banks will in any case shrink and may delever ~EUR1.5-2.5tr in two years with risks to CEE/EM lending, SME lending, trade finance, leasing, commodity finance and wholesale banking. We think shrinkage is likely to focus on wholesale and financing assets in the Northern banks — we think much of some categories will be picked up by foreign banks. But we also see the risk of a ‘grinding credit crunch’ in Southern Europe and SEE, although we hope intense policy response will reduce this risk.

Whilst we came up with our estimate with a combination of bottom up and top down work, we were struck that Mark Carney – Governor of the Canadian central bank and newly appointed head of the FSB – said in a speech last week that he also saw the risk of €1.4-2.5tr asset shrinkage. He noted in his speech in London: “Current difficulties in the European banking sector should be seen in this light. Stresses there could trigger sharp swings in global liquidity, with consequences across financial systems and economies. The deterioration in funding markets in Europe has had important spillover effects on broader European financial conditions. Lending standards for businesses and households have tightened significantly and, partially as a consequence, economic momentum has slowed. Indeed, despite the major steps taken in recent weeks by European authorities, the Bank of Canada now expects the euro area to experience at least a brief recession as a result”.

We think that there are four broad buckets of bank deleveraging likely for banks (1). We think €1.5-2.5tr likely, depending on degree of sovereign stress.

<table>
<thead>
<tr>
<th>Category</th>
<th>NPLs/Distressed (1)</th>
<th>Performing loans and high grade securities (2)</th>
<th>Run-offs (3)</th>
<th>Non-core divisions (4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets in focus</td>
<td>• Securitised assets (heavily downgraded/impaired)</td>
<td>• Asset leasing (aircraft, car etc)</td>
<td>• Syndicated lending</td>
<td>• Custody</td>
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<td></td>
<td>• Repossessed CRE</td>
<td>• International syndicated loans</td>
<td>• Trade Finance</td>
<td>• International – especially EM units</td>
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<td></td>
<td>• Legacy Assets</td>
<td>• Unsecured consumer finance</td>
<td>• Working capital for SMEs</td>
<td>• Asset mgmt/private banking</td>
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<td></td>
<td>• Other impaired credits (i.e. Icelandic banks, Lehman, Greece)</td>
<td>• AAA securitized products</td>
<td>• Market making</td>
<td>• EU mandated divestments</td>
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<tr>
<td></td>
<td>• Synthetic CDOs</td>
<td>• Infrastructure/project finance loans</td>
<td>• CEE lending</td>
<td>• Insurance operations</td>
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<td></td>
<td></td>
<td>• Leveraged, SME (non core regions), real estate, shipping loans</td>
<td>• Commodity financing</td>
<td>• Trading and derivatives business</td>
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<td></td>
<td></td>
<td>• commodity financing</td>
<td>• German public sector lending</td>
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<td></td>
<td></td>
<td>• Focus on not consuming $ funding</td>
<td>• Capital relief clearly the objective too</td>
<td></td>
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<tr>
<td>Rationale/pricing</td>
<td>• Capital relief clearly the objective – both today and under B2.5/3.</td>
<td>• Aspire to sell for 95-99c/$ to free-up funding – especially to free $ funding</td>
<td>• Focus on not consuming $ funding but capital relief clearly the objective too</td>
<td>• Wide variation in pricing</td>
</tr>
<tr>
<td></td>
<td>• Large provisions already taken. Material work out needed or risk view</td>
<td>• Funding relief is of high importance</td>
<td>• Capital relief clearly the objective</td>
<td>• Capital relief clearly the objective</td>
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<td></td>
<td>• Basel 3 and capital relief of insurance operations a consideration.</td>
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<tr>
<td>Recent examples</td>
<td>• RBS: CRE to Blackstone/CIC</td>
<td>• ING: Car leasing to BMW</td>
<td>• BNP to shrink cash B/S by 5%, Soc Gen by 10%, Cred Ag by 5%</td>
<td>• HSBC: US cards business</td>
</tr>
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<td></td>
<td>• UBS: Student loan sales</td>
<td>• RBS: Aviation finance</td>
<td>• UBS to shrink FICC RWAs by SFr 100-125bn &amp; CS by 100bn (ie~10%)</td>
<td>• Numerous EM units (Poland, Turkey etc)</td>
</tr>
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<td></td>
<td>• AIB: CRE to Wells Fargo for $3.3bn</td>
<td>• SAN: 25% of US consumer finance to private equity</td>
<td>• No landmark deals but more anecdotal about reduced lines</td>
<td>• CBK, Lloyds, Dexia, RBS, ING all have mandated programmes</td>
</tr>
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<td></td>
<td>• Dexia: fin assets pf</td>
<td>• State Street: Sec products ($1tb)</td>
<td>• Commerz/Eurohypo ending new CRE lending &amp; reducing CEE</td>
<td>• SAN stated they are considering sale of Spanish insurance ops ($2-3bn)</td>
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<td></td>
<td>• LLOY: sec product pf</td>
<td></td>
<td></td>
<td>• About to close sale of Latam insurance business to Zurich for $1.5-2.5bn.</td>
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<tr>
<td>Buyers</td>
<td>• Hedge funds, credit funds, private equity and some US banks</td>
<td>• Pricing and Supply, but also with risks to the economy if grid lock in many asset finance markets and also if haircuts to sell are much higher</td>
<td>• US banks for $ finance</td>
<td>• Wide variety of financial players and some private equity</td>
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<td></td>
<td></td>
<td>• The biggest risk to economy/markets, although many lines to good corporates should be picked up by non-EU banks</td>
<td>• US/Asian banks for trade finance</td>
<td></td>
</tr>
<tr>
<td>Risks to economy/markets</td>
<td>• Lower, although overhang will impact asset prices</td>
<td></td>
<td></td>
<td>• Material given impact on core equity of sellers if weak prices</td>
</tr>
<tr>
<td>Sizing</td>
<td>€50-100bn</td>
<td>€500-1000bn</td>
<td>€500-1000bn</td>
<td>€100-700bn</td>
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### Exhibit 2

**Where we see the greatest risks from European banks deleveraging – our heat map**

| Emerging Markets – we see greatest risks to CEE | High in SEE/CEE | We see major risks in CEE/SEE where European banks represent ¾ of the banking system. 12 of the 16 major European banks in CEE (representing ~78% of these banking assets) either had a capital shortfall in the recent 9% test or are TARP recipients. We expect the greatest strain in SEE although EBRD helping. |
| EM – Asia/latam | Much lower than CEE | We see growing risks to global trade finance – French banks looking to reduce $ dependency represent 25% of outstanding trade finance. In an orderly scenario we think this will be passed to local banks or selected global banks (HSBC, STAN, JPM, C). If the deleveraging were to become disorderly, we could see a repeat of what happened in 2008-09 when European banks reduced their exposures by 20%. Within this, STAN and HSBC – which today are over ½ of the European banks lending to the region – were far more stable – (7)% vs (31)% for non-UK banks. |
| Southern and Peripheral Europe | High | We are concerned that stresses in bank and sovereign funding as well as capital challenges will impact Spain and Italian banking markets. We note the largest capital deficits in the EBA stress tests outside of the programme countries were in Spain and Italy. We also note the significant increase in Italian bank usage of ECB lines – standing at €105bn (or 2.7% of bank assets). |
| $ assets e.g. commodity finance & parts of syndicated lending | Likely to be passed to US/global banks | Continental European banks, notably the French, are looking to reduce their need for $ funding by not renewing or limiting new loans. Our deal by deal analysis of the last 3 months suggests some are being picked up by leading US large cap banks (such as JPM, C, USB, WFC) as well as some Asian and international banks. |
| Structured credit and securitised assets | High on overhang | ~€0.5tr of existing structured credit assets (about 2/3 in $) held by European banks will continue to act as an overhang in the market, impacting asset prices. We also think European investment banks may look to shed 1/4-1/2 of their Basel 3 RWAs in fixed income and legacy assets over the coming years, e.g. we forecast CS to shrink theirs by 48% and UBS by 55%. |
| Commercial Real Estate | Mixed, some weak spots | We see some lenders constraining CRE lending (e.g. CBK’s Eurohypo announced it has suspended all lending outside Germany). Asset quality and large concentrations in portfolios, particularly in UK banks to Ireland and within Spanish banks, remain a focus. |
| Leasing (aircraft, car, shipping) | Possible buyers to replace | Over 25% of outstanding aircraft leasing is reportedly for sale*. We think Japanese banks could be buyers and beneficiaries given their funding profiles. Asian & some US banks could find opportunities too. Private equity should be rarer given funding. |
| Non-core Units (various) | Mixed | Assets that can be sold to private equity & non-funding heavy (private banking, custody, asset management, & some parts of insurance) look reasonably supported, but those that require heavy bank funding – including EM bank units – may not see such compelling pricing, impacting those banks dependent on large asset sales – hence our caution on RBS, CBK etc |

* according to Dow Jones News 6th November 2011 (unconfirmed).  Source: Morgan Stanley Research
Clearly policy response is the key swing – macro and bank related

The reason we have been focused on this since July was our realisation that the Greek default process started before an adequate firewall was put in place. This is not to say that parts of the firewall aren’t there – for instance, we have regularly spoken on the role the ECB is playing in aiding weak banks in the South/periphery. 21% of Greek bank lending, 15% of Irish bank lending, and 8% of Portuguese bank lending is dependent on ECB repo facilities. What we have been highlighting, though, is that this dependency from loss of faith in the sovereign has started to infect Italian and, to a lesser extent, French and Spanish banks, where usage of the ECB facility is at new highs of 2-3%. However, we feel parts of the firewall are simply inadequate.

The incentive to delever is considerable (and why we feared a “crash diet”). It is also why we argued in a think-piece the parts of the firewall are simply inadequate.

Impact on stock calls

Clearly, bank deleveraging has been a theme we have been running with for a long while and so we are not making major changes to earnings with this note – however, we are making two changes to our most/least preferred – taking HSBC out of most preferred and adding DnB, and adding Commerzbank to our least preferred (replacing RI).

Most preferred: Whilst we have earnings expectations below the market for 3/4 of the stocks we cover – and have found a strong relationship between earnings revisions and bank stock moves over the last year – we feel relative winners will be the national champions who have franchises which over time should become reasonably profitable again. The 6 we highlight are SBER, BNP, BARC, DnB (replacing HSBC), KBC and Deutsche. We appreciate these calls will only work if Europe finds a decisive way to support Italy and Spain via the ECB. Should we be wrong on this, we think these stocks will disappoint. We take HSBC out, after Steve Hayne cut estimates materially following a disappointing Q3 trading statement. Whilst we still think it is a strong long-term idea, given uncertainties on Household charge offs, we take out and replace with DnB, which remains an Overweight.

We have also spent quite a bit of time debating across the global team how material a theme this could be for some players – notably Japanese banks, some of the well funded large cap US banks and also some non-bank financials. For the moment, our view is clear that this should help the alternative asset managers the most – although we should be clear that the deleveraging process will also be negative for parts of their business. For the Japanese and US banks, we think this could be an interesting theme to watch, although today not material enough to move the dial given the profound macro headwinds.

Least preferred: In the last month we downgraded Commerzbank and RBS. Whilst the specifics differ materially, at the core was the deleveraging process, which will likely be more challenging and costly than we and the market would have hoped for, as well as weaker growth meaning the core business is less profitable (for example, in the case of RBS, the investment bank). We add Commerzbank to our least preferred list replacing Raiffeisen, which no longer has any downside to our base case and has the most upside of the 6 stocks in our least preferred list. It remains Underweight rated.

Our least preferred are MPS, BP, Bankinter, RBS, Lloyds, CBK. It is worth highlighting that the deleveraging theme has also had an impact on the way we view many other stocks. For instance, we wrote recently that we thought it would prove more costly for UBS and Credit Suisse to shrink their fixed income and legacy assets by 45-55% – with UBS having SFr 80bn of legacy risk weighted assets and CS having SFr 60bn of structured credit RWAs to downszie. It also informs Bruce Hamilton’s downgrade of retail focused asset managers (for example, Schroders UW) on the risks to retail flows as banks seek to cannibalise funds for funding.

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**Global Cross-Asset Chart Corner**

**AxJ Credit**

If European bank deleveraging is orderly, we do not believe an AxJ credit crunch would ensue. We feel that AxJ’s exposure to European banks is manageable, particularly as 58% of all European exposures to AxJ are actually due to UK banks, for which AxJ is largely a core growth market. Risks include adverse impacts to credit conditions and supply, and pressuring deposit gathering for financials. To alleviate pressures, AxJ policymakers could cut cash reserve or required reserve ratios, conduct more open market operations, or re-capitalize state-owned banks.

![Graph showing AxJ’s exposure to different regions and countries]

Source: BIS, CEIC, Morgan Stanley Research

**Securitized Products**

European bank deleveraging may have a substantial impact on securitized products. By our estimates, European banks hold €348bn ($474bn) of securitized products that are candidates for asset sales. The decision to sell or hold is dependent on funding and capital relief considerations. US RMBS may be most at risk, even if there are no actual sales, due to their supply sensitivity. The ABX 2006-2 AAA index dropped by ~$12 points during the Maiden Lane II sale, while European banks hold subprime and alt-A RMBS with ~$50bn of total carrying value.

![Graph showing ABX 2006-2 AAA index and Maiden Lane II auctions]

Source: Mark-It, Federal Reserve of New York, Morgan Stanley Research

**Asset Managers**

As investors search for yield in a low-return world, EM/global debt allocations are likely to increase by >50% over ~3 years. Due to the low rates/returns in DM, investors will likely turn to (i) international, (ii) real asset, and (iii) income product. Japan saw a 6x rise in foreign debt allocations in the decade ended 2010, which may be instructive for Western markets in future years. Multi-asset and absolute return will provide the best opportunities, in our view, as benchmark-relative product takes a second seat to outcome-oriented product. As investor/regulator scrutiny reduces interest in synthetics, we also expect a rotation towards physical product.

![Graph showing foreign and domestic allocations]

Source: Bank of Japan, Investment Trust Association, Morgan Stanley Research

**China Economics**

China should follow a path of steady and moderate growth, in our view. China’s economy will likely grow below its underlying trend in the months to come, but ongoing policy un-tightening and targeted easing should provide some countervailing support. The MS China Business Conditions Indices largely stabilized in October while inflation continues to ease and credit conditions improved. The latter improvement reflects the State Council’s package of measures to help small companies in response to a liquidity crunch in SMEs, and we expect credit conditions to gradually improve.

![Graph showing China Business Conditions Indices]

Source: AlphaWise, Morgan Stanley Research

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*Morgan Stanley Research* November 17, 2011

*Cross-Asset Navigator*
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<th>Stock Rating Category</th>
<th>Coverage Universe Count</th>
<th>% of Total</th>
<th>Investment Banking Clients (IBC) Count</th>
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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 received investment banking compensation in the last 12 months.

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