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Neil Dwane, CIO Europe at RCM, the active equity company with Allianz Global Investors comments on the outlook for the Financials sector:

"There is so much being written about Financials, so what can RCM add to the debate? Using a broad framework of subtitles: leverage and deleveraging, US and other housing markets, liquidity needs, normal levels of profitability in the future and future regulation, RCM can try to provide a roadmap for investors to assess the credit crisis as it crunches to a conclusion.

"Without the disastrous write-downs of the US Financial system in the last 8 months, S&P earnings growth is over 10%, aided by a weaker US Dollar. Yet is this the correct picture? As I write, the US Federal Reserve highlights that US Banks lending standards are now the tightest in 20 years, despite 2% interest rates and all the liquidity they can need from the "Fed window". US Banks are passing onto the real US economy all their home-made funding difficulties in a way which worsens the US housing market by increasing foreclosures and by making it harder to access fresh finance to "get on the property ladder".

"We have all been stunned by the leverage being carried by many banks around the world which has been the direct result of loose policy, with too low US interest rates, low inflation and poor oversight/regulation. This deleveraging can be seen in many markets as the volatility caused by the Global Investment Banks reducing their own balance sheet positions as well as those of their favourite hedge funds. Thus, today, we should not be surprised by the scale and persistence of the deleveraging as bank after bank remorselessly reduces its balance sheet, as profitably as it can or indeed after a transfusion of new equity - thus far, the RCM roadmap suggests that the new equity meets the current level of write-offs, so we have more of both to come. Further evidence of the deleveraging exists in the now urgent desire of many marginal Financials to offload "sellable" subsidiaries, like Merrill's its Bloomberg stake and Lehman's its asset management unit.

"US Housing and other property markets (both residential and commercial) have also suffered not only from excessive leverage but also from excessive optimism on the returns which could be generated. History teaches that the housing booms of the USA, UK and Spain/Ireland will revert to the mean and our RCM roadmap would suggest that this is a 4 year process, so we could see a bottoming of the US housing market towards the end of next year. Oh, and an aggregate fall of c 30 to 35 %, i.e. we are half-way today. Interestingly, the UK has seen a fall of c 8% so far with Spain yet to show any fall in housing prices at all - yikes!

"The importance of the housing and commercial property markets is that they are where the largest banking assets are held both in CDOs, loans etc and where the enormous balance sheets of Fannie Mae / Freddie Mac sit - where the write-downs are already so bad that these companies are bust without the US Treasury support. Thus the Bank balance sheets are under considerable write-down strain which is forcing them to hold onto their liquidity such that the policy makers have made no real progress after 12 months of getting the bank-to-bank financial artery pumping again. Indeed the recent Auction Rate Securities debacle has hastened many billions back onto unwilling balance sheets! Moreover, in the first half of 2008, the Financials sector will see enormous requirements to roll-over much short term funding, 500 bn USD, so our RCM map anticipates much more Central Bank generosity as banks gasp for liquidity.

The rescue of Fannie Mae and Freddie Mac

"The US Treasury has now ridden to the rescue of the US housing giants in order to assert control over the most sensitive part of the troubled US economy - the citizens' homes. Fundamentals remain poor with rising foreclosures and falling prices being exacerbated by the rising loan standards and shortage of credit. By standing behind these housing

giants, the US government can attempt to apply a tourniquet to the financial wounds being inflicted on US banks and their customers. However this conservator solution will merely bide time until a new administration is in place and a firmer solution will materialise only into Q2 next year. Will there be more credit available to arrest the decline in US housing? Not really, except that the recent intervention has lowered the cost of 30 year mortgages by just less than 0.5% so that some Americans will find the cost of home ownership easier to afford. Our RCM map suggests that housing prices may continue to fall for another 12 months in the USA and will have lasted at least 4 years by the time it has finished, But be under no illusions, the next US President will seek to boost the markets as positively as possible in the early parts of next year. Beware the US Dollar.

“Many market observers were pleased that the recent Bank results were no worse than expected but the RCM roadmap shows underlying sustainable profitability for banks has fallen c50%, now that the easy times and easy leverage are over and our roadmap shows worsening bad debts trends across all types of credit from residential and commercial property, to autoloans, to credit cards and record amounts of high yield, junk debt. At least leverage loans seem to be finished.

Lehman files for bankruptcy and the rescue of Merrill

“Lehman has filed for bankruptcy ending a torrid week of rumour and speculation and a fall of over 80%. The US Treasury declined to save Lehman and its fellow banks could not find the capital to fund a bad bank solution. Why? Well, the management of Lehman remained in denial about the seriousness of their balance sheet leverage, the credible valuation of their assets and their complacent approach to raising new funding. The company as a consequence has paid the price. Merrills rushed into the arms of Bank of America (BoA) who last night shut down its investment banking operations admitting failure. Surely BoA will not indulge the Merrills' investment banking operations anywhere near to the extent that the old Merrills' management had done? Capacity is being removed from the markets and Policy will not bail out all investors and losers. Not unless they have a vote at least. Moral hazard is back and negligent Boards will find there to be no willing supplier of capital except on very onerous terms. The key messages of this weekend remain that capital remains scarce, leverage and accounting for the leveraged assets remains incomplete and inconsistent and a New World order is being born where financial behemoths are best placed.

Regulation, it's coming back fast

“With economy after economy being forced to nationalise or bail out a bank, the Danes being the most recent, politicians and Central banks are moving to put in place more supervision and more transparency, less leverage and greater risk control all of which will mean lower returns to shareholders who have had to stump up dilutive rights issue contributions. Our RCM roadmap suggests that investors remain complacent over the changes to come, the lower returns and thus the earnings power of the sector in the future.

“So the RCM roadmap for Financials remains one of caution for at least the next 12 months and suggests that when looking for bargains in this sector, to search for Financials with exposure to under-banked and growing consumer markets and to avoid the ultra-competitive mature markets where customers are overleveraged, overbanked and over extended. Sentiment to be true has now plumbed a new low on the shocking headlines of this morning but there may be more to come before the sector as a whole finds it form again, sometime in the next decade.”

- Ends -

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