BEAR STEARNS

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Lowering Our Outlook

The difficulties in mortgage and commercial paper markets are triggering a material inflection point in the credit cycle and market interactions. Though the immediate problems should be resolved over time, there are negative implications for U.S. and global economic and earnings growth, especially in 2008, from the breakdown in parts of the market architecture.

- Underlying the market turbulence is the plentiful liquidity of recent years, fueled by unusually low real interest rates in the U.S. and abroad. Low rates and tightening credit spreads encouraged leveraging in many assets and discouraged price evaluation. It also added substantially to the complexity of financial instruments. The long period of relatively low interest rates allowed a degree of maturity mismatching to creep in (longer term assets funded by short-term liabilities.) We note the unprecedented extent of this global liquidity expansion, in particular the long period of negative and very low real interest rates. As a result, we think the evolution of this financial crisis will be different from earlier ones.

- A key factor in the turbulence is the de-commoditization of U.S. mortgages, at least for now. The bond rating agencies had played a critical role in the standardized evaluation of mortgages. That role has been undermined in recent weeks, and will be difficult to rebuild.

- The de-leveraging process has spread to emerging markets, as reflected in their currencies, equities and bonds. We think prices in other asset classes will be reevaluated in light of the financial system problems. We think a broader de-leveraging may be unfavorable for recent outperformers -- many commodity prices, the euro, emerging market currencies, and many of the fastest rising equities. So far, most of the real estate concerns have centered on U.S. residential real estate, but we think those concerns might widen.

- We think the Fed and ECB will take more aggressive steps. One issue is whether these are effective in helping restore market activity. After several rounds of interventions by central banks, 10-year swap spreads, TED spreads and other critical arbitrage functions have still not been resolved, suggesting the complexity in these market interactions. Additional overnight and longer-duration liquidity injections will help some, but, as Japan showed earlier this decade when it provided 30 trillion yen of excess bank liquidity, this tool alone may not be enough to restart aggressive bank involvement in key markets. Though not the same situation as today, we note the Fed's success with rate cuts in 1987, when financial markets seized up but the real economy did not end up slowing down. We think the Fed may cut rates or lower the discount rate; while helpful, a key issue is whether this ends up improving the trading environment.

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- Part of the sell-off is a normal correction, and can't by itself be used as a signal of a coming economic slowdown. Many assets had reached peak prices earlier in 2007 and have moved back from extremes -- credit spreads had been too wide, emerging market currencies and the euro too strong, financial structures too complex, commodities too high; risk-takers had the upper-hand.

- In addition, the sell-off is beginning to price in a series of problems for the financial system and a reduction in the growth outlook. Some key variables in how this progresses: government action; the length of time to improve the trading environment related to mortgages; the application of the huge reservoirs of liquidity in the U.S. and abroad to these problems; as discussed in our earlier pieces, the split between how much of the asset price appreciation and global growth represented true progress versus how much was dependent on plentiful liquidity and complex structures.

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