

World Overview

Growth: The global economy is slowing, as anticipated, with modest growth on the cards for 2008. In the US housing starts dipped by 2.6% in August, employment fell by 4,000, retail sales held at 3.3% (y/y Jul) having fallen in June. The US most likely faces another 12 months of modest activity. Japan lacks domestic activity, with a contraction in growth in Q2 (-0.3% q/q), but business confidence has held up while consumers stay cautious. Growth in China showing some moderation as is Foreign Direct Investment.

Inflation: Demand side inflationary pressures have abated but some supply-side factors may push prices up. Food prices, normally considered erratic, look to be trending up in many countries: 4.2% in the US (y/y Aug), 18.2% in China (y/y Aug) and 3.0% (y/y Aug) in the UK. Food prices are particularly important for inflation expectations. However, underlying inflation is not worrisome, moderating to 2.1% (y/y Aug in the US), nudging up in Euro zone to 2.1% (y/y Sep) and in the UK within target at 1.8% (y/y Aug). In China, inflation at 6.5% (y/y Aug) may be troublesome later on. In most places, past policy tightening seems to have just about done its work.

Policy: Central banks will move with caution, despite potential economic impacts from the recent financial turmoil. Although inflationary threats are weak, a sudden easing of monetary policy is unlikely, without hard evidence of an unexpected deceleration in output. The US, with an eye on growth, cut by 50 bps in September: lower inflation and weaker job creation arguing for it to do so. The ECB are now less likely to increase rates as previously expected. Rates have now peaked but the downside of the cycle is probably a little way off, unless any serious economic perturbations resume.

Region by Region (changes in bold)

	Growth	Inflation Rate	Short Int Rate
USA	Weakening	Falling	Falling
Euro zone	Weakening	Steady	Stable
UK	Strong	Steady	Stable
Japan	Weakening	Falling	Stable
Canada	Strong	Steady	Stable
China	Strong	Rising	Rising
Australia	Strong	Steady	Rising

The Sub-Prime storm – Impact on Europe

This month we consider the impact of the sub-prime crisis. We will look at the direct impact on real estate and the 'knock-on' from depressed economic activity. Property induced financial turmoil is not new. In 1974 the Bank of England had to prevent the collapse of the UK banking system following binges of reckless real estate lending. The early 1990s economic downturn was exacerbated by poor bank balance sheets related to the downturn in property prices.

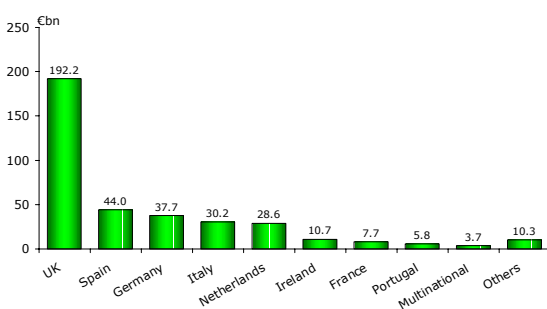
Since the 1990s, a motley combination of financial deregulation, rising asset prices, banking competition and, some might say, hubris has led, once more to aggressive bank lending to real estate. This time round a key factor is debt 'securitisation', which started in the United States and has spread rapidly across all financial markets. By packaging real estate loans and selling in the public debt market, banks have been able to escape their own balance sheets. In Europe for instance, in-house research shows that the total securitisation issuance has increased by 37% per annum since 2000 to reach almost €459 billions in 2006.

In fact, securitised debt originates in a range of sectors; from commercial property to credit cards (see chart 1). However, the lion's share in Europe is related to residential mortgages (RMBS) with a volume of €245 billion. Theoretically, pooling loans reduces the uncertainty of the cash flow, improves liquidity and increases investors' flexibility in exposure to real estate markets. Risk is transferred from primary lenders to others with broader more diversified portfolios.

Once the debt has been packaged and sold on, banks are able to get on with the job of lending. The resulting fall in the cost of capital to banks permits more marginal lending and stimulates demand for it. So, businesses and households take on debt when their ability to repay holds only in the most benign of economic circumstances.

Generally the risk on commercial real estate products is assessed as low, due to fairly small default rates and recourse to physical assets. However, the complex nature of some products means the "risk" has been so finely sliced and spread that it is hard to know where it currently sits. Moreover, the incorporation of CDOs and the like, into money market instruments means banks are not as free of risk as they may have thought. The first response of banks, in the current "crisis" was to cut their lending to each other forcing short term inter-bank rates up; central banks tried to ease this by injecting money into the system. The resulting uncertainty created a flight to quality, making packaged debt unattractive; with spreads on CMBS increasing significantly (to justify the risk as it is now seen).

Chart 2: UK the largest issuer in Europe



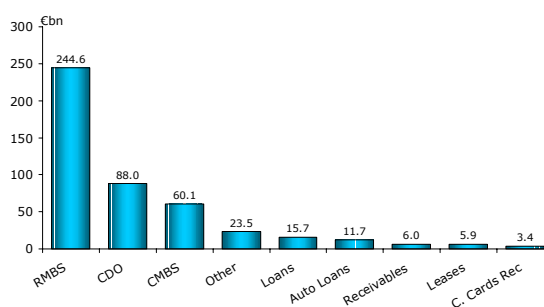
Sources: Thomson Financial, Dealogic, JP Morgan, Merrill Lynch, Structured Finance International, Bloomberg

The household sector will face higher borrowing costs and credit availability, particularly from re-mortgaging, will reduce. With reduced funds the housing market and retail sector will be hit. However, in the UK a cooling was on the cards from past monetary policy, but also further hikes were being factored in, which are unlikely now. Therefore, the impact in the retail and residential sectors may be "as expected": the price of credit rising through the market and not via central bank policy.

However, the cost of capital has increased across the board. The impact this has in terms of output lost or reduced investment is difficult to quantify at this point in time but it may be material. Already city job losses have been announced. OEF (Oxford Economic Forecasting) estimate that with the market for structured products contracting in the UK and the US, the GDP outcome might be 0.2% and 0.4% lower than they might otherwise be. Our estimate is that 0.1-0.2% of Euro zone growth is at risk. It is likely that the financial sector is going to shoulder the lion's share of the slowdown, so office returns will fall.

The initial reaction to the sub-prime situation has been a "flight" to quality, easing government bond yields in the UK and Euro zone. Across the market there will be a general re-pricing of risk, (i.e. paying attention to the nature of the underlying assets). In real estate this may mean a return to core assets. There have been previous "liquidity" crisis, which have not been recessionary, but have hit asset prices. Uncertainty, compounded by complexity, has created a feeling of panic which may not be rational and some players may now be over-pricing risk, leaving opportunities for calmer (and cash rich) players to pick up correctly priced assets.

Chart 1: European securitisation by origin



Sources: Thomson Financial, Dealogic, JP Morgan, Merrill Lynch, Structured Finance International, Bloomberg

As can be seen from chart 2, the UK, with its more mature financial sector, has a much larger share of the securitised debt market. Therefore, the UK is likely to feel the knock on effects more, although continental Europe will not be immune.

The most immediate impact is difficulty in raising finance. Real estate is a capital intensive sector and the "squeeze" on liquidity may have longer term impacts on construction activity, though this may prove beneficial in some markets heading towards oversupply. Investment deals may be hit and there is some evidence in the market that some transactions have been postponed or shelved.

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