

U.S. Subprime Loan Turmoil and Japanese Credit Markets

October 2007

Koyo Ozeki



In recent months, the U.S. subprime loan problem has evolved into a full-scale crisis that has roiled financial markets worldwide and significantly impacted monetary policy in various nations. The troubles have spread to a wide range of investors through credit products such as asset-backed securities (ABS) and collateralised debt obligations (CDOs), affecting not only the credit and stock markets but the global financial system itself. Like other global economies, Japan has felt some impact from the mess in the U.S. subprime sector. But based on what we've seen in Japanese credit markets thus far, we think the impact of the subprime loan crisis has been much lighter than in other markets, particularly Europe.

How the U.S. Subprime Problem Went Global

Though the specifics of the U.S. subprime mortgage mess have been widely dissected elsewhere, understanding its global impact requires a look at how this U.S.-based problem crept into the international financial system. The source of the subprime loan trouble was, of course, the emergence of the U.S. housing bubble and excessive lending to borrowers with poor credit. The first phase of the crisis in February and March this year took the form of an increase in reserve funds at financial institutions and the failure of some non-banks with large outstanding subprime loan portfolios. The impact at that point was largely limited to certain industries and corporations.

The second phase, starting around July, showed the problem spreading overseas to European financial markets, following news in August that a major French bank was freezing certain funds due to subprime loan losses. This signalled that the situation had precipitated a liquidity crunch in the U.S. and European financial systems. Liquidity in asset-backed commercial paper (ABCP) markets – short-term loans that are backed by assets such as mortgages that provide liquidity for many types of lending – dried up as far afield as Germany, Canada and Australia. Adding to this, a medium-sized U.K. financial institution experienced a sudden run in mid-September, causing the government to take the exceedingly rare step of guaranteeing all of the bank's deposits.

The rapid spread of the crisis into a global phenomenon stemmed from the wide dispersal of risk, as the loans were held by a broad scope of financial institutions and investors through securitized products backed by subprime loans. We believe that another important factor behind the rapid credit squeeze, however, was the massive leverage involved in these products via ABCP.

The spread of the subprime crisis makes it evident that what is happening is not simply the collapse of a U.S. housing bubble and falloff in securitized product prices. Rather, the numerous factors that have supported the narrowing in credit market spreads for some years now are unravelling, and markets are undergoing important structural changes. The elements of this change include the correction in housing prices, unwinding of leverage in financial markets, correction in risk premiums, and banks' reconsideration of the "off-balance-sheet-risk" business model. These factors illustrate clearly why the subprime loan problem sparked a liquidity crunch in the financial system, especially in the money markets. The crisis began with bankruptcies of non-banks, widened to the periphery of banks that sponsor or support ABCP programs, and erupted into an actual liquidity crisis at banks that rely heavily on wholesale funding, thus spreading ever closer to the core of the banking system.

Past Financial and Credit Crises

Period	Event	Cause	Macroeconomic Link
2H 1980s	S&L Crisis	Housing, Real Estate	U.S. Economic Downturn
End 1980s - Early 1990s	U.S. Commercial Bank Crisis	Commercial Real Estate	U.S. Economic Downturn
Mid 1990s	N. European Crisis	Commercial Real Estate	U.S. Economic Downturn
1997	Asian Currency Crisis	Forex, Short-term Financing	Asian Economic Downturn
1998	Russian Currency Crisis	Fiscal Deterioration, Forex	Russian Economic Downturn
	LTCM Collapse Japan Financial Crisis	Excessive Leveraging Real Estate Bubble, Structural Adjustments	- Japanese Economic Downturn
2001	Enron Failure	Irregular Accounting	-
2002	WorldCom Failure	IT Bubble Collapse, Irregular Accounting	-
2005	GM and Ford Problems	Decaying Auto Sector Earnings	-

Source: PIMCO

Figure 1

Connections Between The Subprime Crisis and Markets

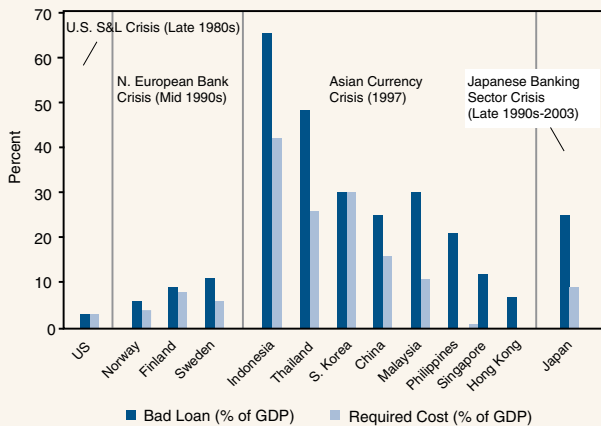
There are two main routes through which the subprime crisis spread into markets. First, there is the macroeconomic route of an economic slowdown via a correction in the housing market. The rise in housing prices gave consumers added borrowing power: thanks to higher prices, homes became veritable cash dispensers supporting U.S. consumption. The loss of this underpinning could have a considerable impact on consumption, affecting not only the U.S. economy, but other economies that export to the U.S.

Next is the adverse economic effect of a credit crunch due to financial market disorder or lower credit capacity at financial institutions. Because banks boast fairly solid balance sheets, the markets initially dismissed the threat from this route. However, the advent of the liquidity crisis in August has made this a more realistic possibility. Past financial crises, particularly in Japan, have demonstrated all too clearly how a credit squeeze combined with asset deflation can create a truly dangerous situation.

Impact on Japanese Credit Markets

Though the overall impact from the subprime crisis in Japan has been more muted than in the U.S. and Europe, there have been some clear effects. Japanese share prices have tumbled more than 10% since July, and credit market spreads have widened roughly in line with those in the U.S. and Europe (Figure 3). This trend has been particularly striking in the credit default swap (CDS) markets, where overseas investors are

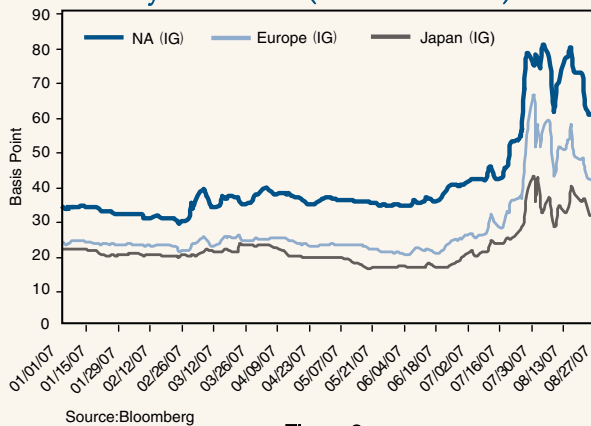
Scale of Past Financial Crises: Bad Debt and Public Debt Cost



Source: World Bank, OECD, PIMCO

Figure 2

5yr CDS Indices (Investment Grade)



Source: Bloomberg

Figure 3

the main players. Hedging activity by such investors caused the CDS index (iTraxx) to widen ahead of single name credits, moving in tandem with foreign market trends, albeit on a more modest scale.

On the other hand, the widening in Japanese cash bond spreads has been fairly limited, with each sector driven by its own particular factors (Figure 4). That is, the subprime loan situation has not necessarily produced a perfect correlation between Japan and the U.S. and Europe. For example, the spread widening in blue chips, which are highly sensitive to interest rates, was primarily due to expectations around July of a rate hike by the Bank of Japan, while triple-B bond spreads widened on the deteriorating creditworthiness of consumer loan companies. Also, there has been no great impact at this time on ABS or CDOs that are backed by domestic assets.

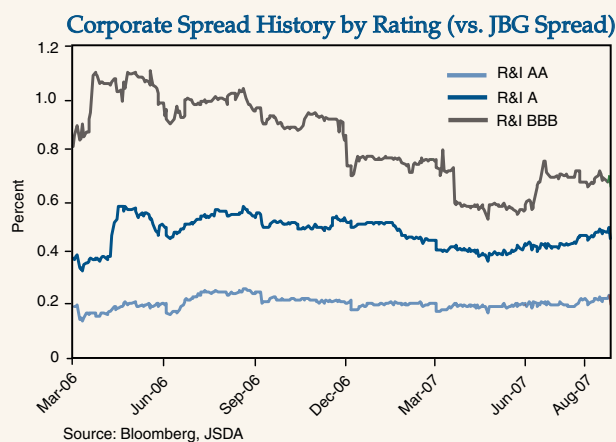


Figure 4

Spreads on Japanese bank capital in the Yankee and euro markets (bank’s subordinated debt bonds, preferred securities) widened greatly along with U.S. and European bank spreads. As a result, banks saw a sharp expansion in their CDS premiums due to the hedging needs of overseas investors and securities firms. To date, this is the movement that has most directly reflected the subprime-related widening in global market spreads. At the same time, domestic Japanese bond markets remain buoyant, and new issues continue to be absorbed smoothly at low spreads, differing starkly from their dollar-denominated bond counterparts.

Japanese financial institutions and investors also did not have great exposure to subprime loans or ABS and CDOs in the first place – the leading banks have an average exposure of a less than one percent of total assets – so we feel that the chances of any change in credit risk are negligible. Banks have firmed up their balance sheets and boast ample deposit-loan ratios, leaving little risk of a liquidity crunch similar to that in the U.S. and Europe (Figure 5).

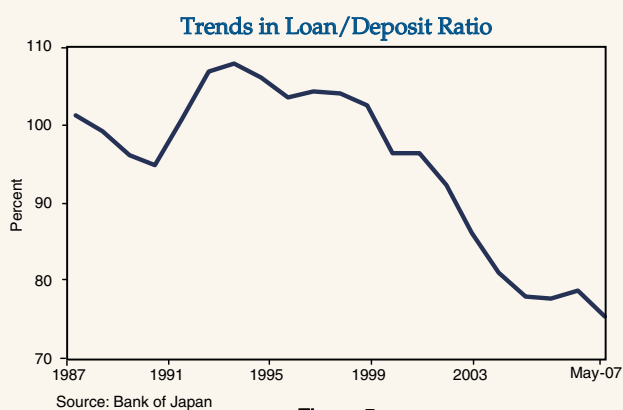


Figure 5

Japan Investment Implications

Thus, Japanese markets have been fairly isolated from the subprime loan troubles, and the reaction to the crisis has been much different from that in foreign markets. The question is how long this situation will continue.

There are five ways in which global market trends could influence Japanese markets:

- (1) A direct impact through a widening in samurai bond spreads or purchasing of Japanese-name credits in CDS markets by overseas investors seeking protection;
- (2) Changes in Japanese share prices due to a shift in stance by foreign investors, affecting credit markets through the impact on investor risk tolerance and market sentiment;
- (3) The impact of global market performance on corporate bond markets through changes in asset allocation by domestic investors;

(4) A U.S. economic slowdown that damages the fundamentals of Japanese corporations, prompting a widening of credit spreads;

(5) Changes in global money flows or the long-term risk tolerance of investors.

The first two are already a reality, but the impact has been mild, as discussed above. The key now will be the potential effect from macroeconomic factors such as asset allocation, fundamentals and global money flows.

Setting aside short-term market fluctuations, we believe that the credit market correction worldwide is not simply a matter of the amount of losses incurred due to subprime loan exposure. We feel that it stems rather from ongoing changes in the structural factors that have supported the narrowing in spreads in recent years. In this sense, we suspect that the correction could persist for the long term and that the effect on

Japanese markets could slowly but surely intensify. The correction in risk premium levels is a global theme, and Japan cannot remain isolated from this trend forever.

Credit markets experience major periods of transformation once every few years. Some bond spreads have widened too much, and such times offer a buying opportunity. In these periods, when price distortions in the market tend to reach high proportions, it is best to step back and look at market movements from a wide perspective and pursue cross-market investment opportunities. We see this as crucial to adding alpha.

Koyo Ozeki
Executive Vice President

Past performance is no guarantee of future results. A Collateralized Debt Obligation ("CDO") is a type of structured credit product and an asset-backed security. It is backed by bonds, loans, or another type of security. The investments of the CDO are funded through the issuance of several tiers of securities, the repayment of which is linked to the performance of the underlying asset class that serve as collateral for the CDO liabilities. The value of some mortgage- or asset-backed securities may be particularly sensitive to changes in prevailing interest rates; when interest rates rise the value of the security generally declines. The credit quality of a particular security or group of securities does not ensure the stability or safety of the overall portfolio. The charts and graphs are for illustrative purposes only and are not indicative of the past or future performance of any PIMCO product.

The Dow Jones iTraxx CJ (Japan) Index is comprised of the 50 most liquid names in Japan, with a cap of 10 names for each sector. The Dow Jones iTraxx Europe Index is comprised of 125 equally weighted European names selected by a dealer poll based on volume rankings and includes sector indices for: Financials (Senior and Subordinated), Non-Financials, Autos, Consumer cyclicals, Consumer non-cyclicals, Energy, Industrials, and TMT. The Dow Jones Credit Default Index (CDX) IG Index is composed of one hundred twenty five (125) investment grade entities (issuers) domiciled in North America, distributed among five (5) sub-sectors. The entities are determined every six months by a consortium of dealers who make a market in the security.

This article contains the current opinions of the author but not necessarily those of Pacific Investment Management Company LLC. Such opinions are subject to change without notice. This article has been distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. No part of this article may be reproduced in any form, or referred to in any other publication, without express written permission of Pacific Investment Management Company LLC. ©2007, PIMCO.

P I M C O

840 Newport Center Drive
Newport Beach, CA 92660
949.720.6000

A company of  Allianz
Global Investors

PER038-092607