UBS

Global Equity Research

Americas

UBS Investment Research

Broker Update

Diversified Financial

Sector Comment

Stop The Insanity

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- **CDS Spreads Driving Stock Prices in the Short-Term**

In terms of MS & GS and the recent sell-off in their shares, if this is not an issue of liquidity like Bear Stearns, and not an issue of solvency like Lehman, we find it disconcerting that the illiquid CDS market (or the rating agencies) can have so much influence on the fate of these companies and alter the landscape of the brokerage industry.

- **Macro Backdrop is Weak…**

We get the bad earnings environment (ROEs will be anemic in the near term), bad economy (global GDP growth is slowing), higher future funding costs, lower leverage, and we especially get the fact that the root of our problems (falling home prices, wide bid/ask spreads, rising unemployment) haven't changed.

- **…But Both MS & GS Have Strong Liquidity and Capital Positions**

Aside from the macro headwinds, both MS & GS have strong capital and liquidity positions (both boosted liquidity in 3Q), the Fed and bank/broker lending facilities have expanded to cover just about the whole balance sheet, both firms have pre-funded their issuing needs for the next 6 months, and they have reduced bad asset exposures vs. tangible common equity (1.0x at GS, 1.4x at MS).

- **Bank Deposits Are Not Necessarily a Cure All**

We think investors should be focused on risk management and performance and not just whether you have retail deposits (banks go out of business too last we checked – and at this rate, following money fund redemptions, deposits could be around the corner). In our view, a lack of confidence and forced consolidation into firms that are "too big to fail" can't be the final solution/answer.

Overview

So tons of insanity in the markets, but in terms of MS & GS, if this is not an issue of liquidity like Bear Stearns, and not an issue of solvency like Lehman, isn't this a bit disconcerting that the illiquid CDS market (or the rating agencies) can have so much influence on the fate of these companies and alter the landscape of the brokerage industry? We get the bad earning environment, bad economy, higher future funding costs, lower leverage, and we especially get the fact that the root of our problems (falling home prices, wide bid/ask spreads on problem assets and rising unemployment) haven't changed, **BUT** both MS and GS have strong capital and liquidity positions, the Fed and bank/broker lending facilities have expanded to cover just about the whole balance sheet, both firms have pre-funded their issuing needs for the next 6 months or so, both have reduced their problem asset exposures (problem assets to tangible common equity at GS is 1.0x, MS is 1.4x, while MER was ~3x and LEH was ~4x), have priced remaining exposures at what we think are reasonable levels, and don't have the same concentration risk issues that the others had.

Long-term, CDS spreads should matter as they will reflect incremental funding costs (and the brokers can't make money at current funding levels); short term however, if you have the liquidity and capital to withstand the storm (and we think both GS and MS do), why should CDS spreads be having such a big impact on the stocks? We think the concern is that a falling stock price/wider CDS spreads either has counterparties/clients pull and/or has the rating agencies make more noise, but the group of 10 banks that formed the $70 billion facility probably aren't about to pull lines from each other. Plus, why should the rating agencies react if liquidity/capital/balance sheets are OK (again, looks like Lehman was a solvency issue, not just a low stock price). At the heart of these issues is available funding, all in funding costs and the inherent mismatch of short-term funding and longer duration, levered balance sheets. As Goldman put it yesterday, this should be about risk management and performance and not just whether you have retail deposits (banks go out of business too last we checked – and at this rate, following money fund redemptions, deposits could be next).

Anyway, the world should really be concerned about this because if we continue to squeeze the financial system's balance sheet and see fewer players in the business, the available credit to corporations and hedge funds will shrivel up and the cost of capital will continue to skyrocket across the board (should owners stop lending out their securities and brokers stop facilitating shorting?). In our view, a lack of confidence and forced consolidation into firms that are “too big to fail” can’t be the final solution/answer.

■ Statement of Risk

Economic and geopolitical factors, regulatory and litigation issues, interest rates and Fed policy, as well as market fluctuations and activity levels in the capital markets could materially affect operating results.

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Each research analyst primarily responsible for the content of this research report, in whole or in part, certifies that with respect to each security or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about those securities or issuers; and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that research analyst in the research report.

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UBS Investment Research: Global Equity Rating Allocations

UBS 12-Month Rating	Rating Category	Coverage[1]	IB Services[2]
Buy	**Buy**	57%	38%
Neutral	**Hold/Neutral**	36%	35%
Sell	**Sell**	8%	29%
UBS Short-Term Rating	**Rating Category**	**Coverage[3]**	**IB Services[4]**
Buy	**Buy**	less than 1%	31%
Sell	**Sell**	less than 1%	38%

1:Percentage of companies under coverage globally within the 12-month rating category.
2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.
3:Percentage of companies under coverage globally within the Short-Term rating category.
4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

Source: UBS. Rating allocations are as of 30 June 2008.

UBS Investment Research: Global Equity Rating Definitions

UBS 12-Month Rating	Definition
Buy	FSR is > 6% above the MRA.
Neutral	FSR is between -6% and 6% of the MRA.
Sell	FSR is > 6% below the MRA.
UBS Short-Term Rating	**Definition**
Buy	Buy: Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.
Sell	Sell: Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.

KEY DEFINITIONS

Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months.

Market Return Assumption (MRA) is defined as the one-year local market interest rate plus 5% (a proxy for, and not a forecast of, the equity risk premium).

Under Review (UR) Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation.

Short-Term Ratings reflect the expected near-term (up to three months) performance of the stock and do not reflect any change in the fundamental view or investment case.

EXCEPTIONS AND SPECIAL CASES

UK and European Investment Fund ratings and definitions are :
Buy: Positive on factors such as structure, management, performance record, discount; Neutral: Neutral on factors such as structure, management, performance record, discount; Sell: Negative on factors such as structure, management, performance record, discount.

Core Banding Exceptions (CBE) : Exceptions to the standard +/-6% bands may be granted by the Investment Review Committee (IRC). Factors considered by the IRC include the stock's volatility and the credit spread of the respective company's debt. As a result, stocks deemed to be very high or low risk may be subject to higher or lower bands as they relate to the rating. When such exceptions apply, they will be identified in the Company Disclosures table in the relevant research piece.

Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report.

Additional Prices: Goldman Sachs, US$133.01 (16 Sep 2008); Lehman Brothers, US$3.65 (16 Sep 2008); Morgan Stanley, US$28.70 (16 Sep 2008); Source: UBS. All prices as of local market close.

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