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Morgan Stanley Australia Limited+

Gerard Minack
Gerard.Minack@morganstanley.com
+61 2 9770 1529

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Downunder Daily

A Three-Paced Bear Market

Developed-world credit has entered a bear market. However, the degree of stress is uneven across three areas: 1) short-end financing; 2) housing-related credit; and 3) corporate credit. Here are some thoughts:

First, there's general agreement that credit risk was under-priced earlier this year. While policy makers have worked to settle dysfunctional markets (particularly the short-end funding markets), they are not aiming to restore credit pricing to any particular level – and specifically not aiming to restore pricing to the levels seen earlier this year.

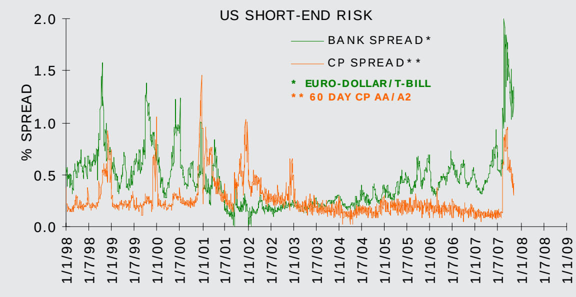
Second, the turn in credit markets has occurred in what remains, US housing aside, a fundamentally healthy global economy. Credit fundamentals (and pricing) would inevitably deteriorate further if macro conditions deteriorate. Part of my big-picture bearishness on credit is because I'm likewise bearish on the macro.

Third, while short-end funding markets seem to be past the point of maximum stress, spreads remain unusually wide (Exhibit 1 shows two examples).

The outlook is cloudy. As we saw with Northern Rock, problems can arise quickly and from unexpected sources. I think periods of high risk aversion are likely going forward. Lenders are now more reliant on capital markets for support, which can make a loss of confidence towards a particular institution self-fulfilling. Moreover, the growth in interlocking derivative obligations increases the likelihood – and the potential severity – of periodic concerns about counterparty risk.

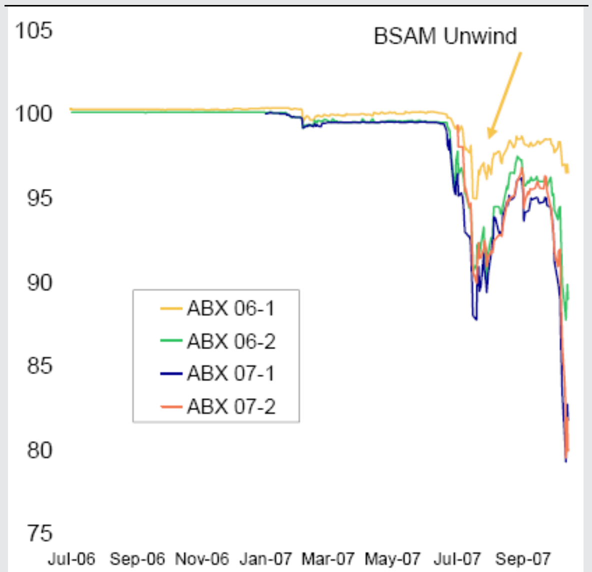
Fourth, the renewed deterioration in housing-related credit – the one area where the fundamentals have clearly worsened – shows how markets have had to continually re-assess the depth and impact of the US residential recession. It also highlights some of the unattractive features of the 'new technology' of debt, in particular, lack of price transparency and transactional liquidity.

Exhibit 1
Short-end Spreads Off Highs, but Elevated



Source: Federal Reserve, Bloomberg; Morgan Stanley Research

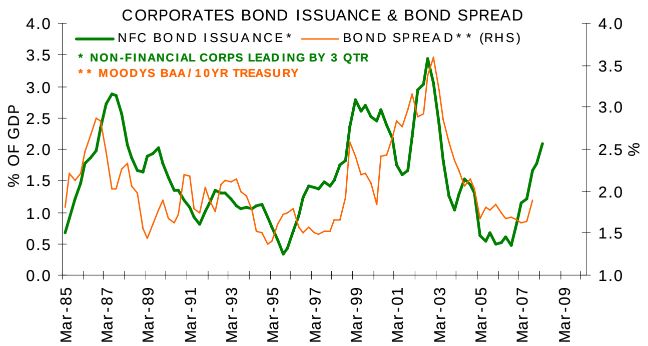
Exhibit 2
AAA-rated ABX



Source: Greg Peters, *Credit Strategy Conference* Call, 5 November; Markit; Morgan Stanley Research

Exhibit 2 shows pricing for AAA-rated RMBS, as reflected in the ABX indexes. It would be typical market behaviour to see prices overshoot on the low side. But finding a floor on market prices requires clarity on the economic and employment outlook – something not likely for a few quarters.

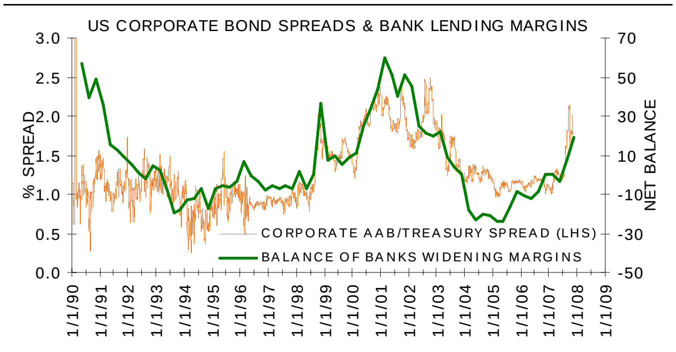
Exhibit 3
Supply Pushing Up Spread



Source: Moody's, Federal Reserve; Morgan Stanley

Finally, the risks around corporate credit seem set to increase – although how quickly that becomes evident will depend on the economic cycle. Our credit teams have warned that the underlying fundamentals have shifted for the worse, but they turned tactically bullish in August when pricing seemed to get too far ahead of those slow-moving fundamentals. (Neil McLeish, our European credit strategist, took profits on that call last week, turning neutral on corporate credit.)

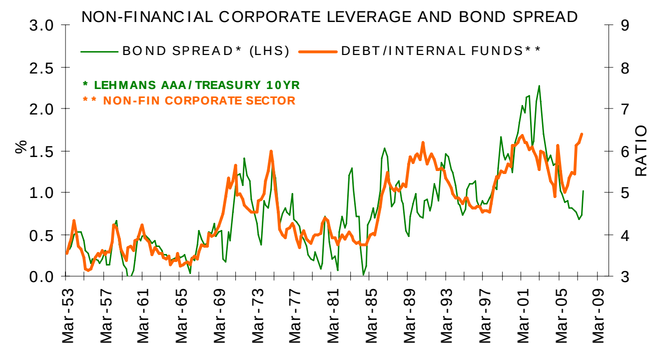
Exhibit 4
Banks Widening Spreads



Source: Lehman Bros, Federal Reserve, DataStream, Morgan Stanley Research

Several medium-term relationships point to deteriorating corporate credit pricing. First, supply usually leads spreads, although the lag can be a few quarters (Exhibit 3). Second, we are now seeing banks aiming to widen their spreads (Exhibit 4). Third, debt/internal fund ratio has started to rise (Exhibit 5).

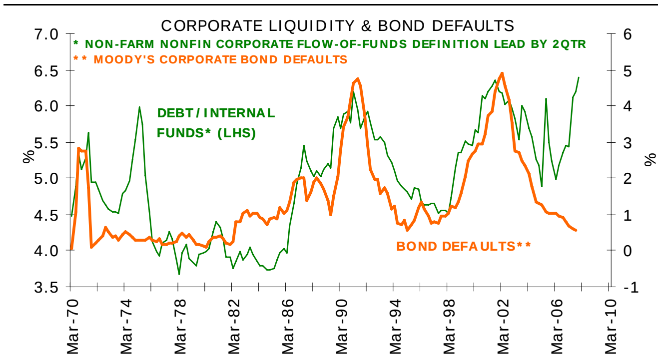
Exhibit 5
Debt Levels Also Point to Wider Spreads



Source: Federal Reserve, Lehman Bros, DataStream; Morgan Stanley

What hasn't happened yet, of course, is any sign of rising defaults. Moody's default series, for example, remains at cycle lows (Exhibit 6). This fits with the underlying health of the economy, and is why there have been trading opportunities as spillover from stress in household credit pushed corporate credit pricing too far away from still-solid fundamentals. But the key point now is that the trend seems to have turned, and corporate credit seems increasingly likely to be a sell-rally story.

Exhibit 6
Defaults Still Very Low



Source: Moody's, Federal Reserve; Morgan Stanley Research

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New York, NY 10036-8293	London E14 4QA	Tokyo 150-6008	Central
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