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MORGAN STANLEY RESEARCH
ASIA/PACIFIC

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Downunder Daily

Not-So-Happy New Year

Concerns about end-of-year funding pressure are contributing to renewed stress in short-end funding markets. The end-of-year turn used to be a big issue in short-end markets, with short-term LIBOR rates often spiking 50-100 basis points over the funds rate (compared with a more usual spread of 10-15 basis points). This seasonal pattern has not been evident over the past few years, but now – with markets more than usually fragile – it seems that this year could be different.

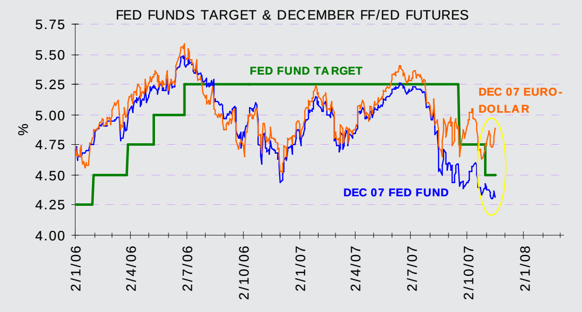
Exhibit 1 shows the Fed funds target and the implied yields on the December Fed funds future and the December Euro-dollar future. While the yield on the funds rate future is falling – implying growing confidence in another rate cut – the Euro-dollar yield is rising. In short, markets are pricing tighter funding conditions even if the Fed eases.

Exhibit 2 shows the dollar LIBOR curve. The stress in short-end markets has led to a rising front end out to 3 months, and this week has seen occasional spikes in very short-term rates.

These moves have accompanied a renewed lift in asset-backed commercial paper spreads. Although those spreads remain well off their August highs, they are now around 30 basis points above their late October lows (Exhibit 3). Moreover, the spread between AA and A2/P2 non-financial paper – a spread that reflects quality – spiked 40 basis points on Thursday. Just such a move presaged the August credit crunch. (Colleague Laurence Mutkin now provides a daily commentary on these indicators for those wishing regular updates.)

Exhibit 1

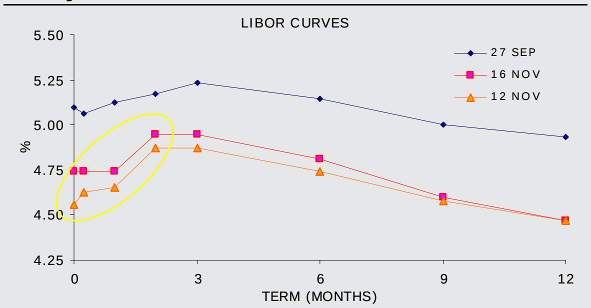
Euro-dollar Rises Despite an Easier Fed



Source: Bloomberg; Morgan Stanley Research

Exhibit 2

Kinky

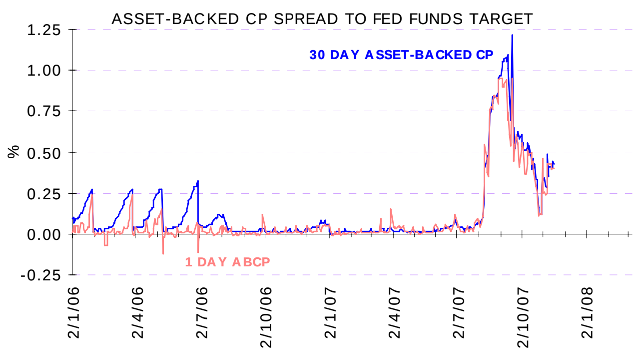


Source: Bloomberg; Morgan Stanley Research

The backdrop to these market moves is the continued re-intermediation of credit. Exhibit 4 tracks the 13-week change in outstanding asset-backed CP and commercial banks' commercial & industrial loans and holdings of non-government securities. The latter has accelerated as the former has shrunk, suggestive of the trend to bringing back on the balance sheet assets previously funded by ABCP.

Exhibit 3

Asset-backed CP Spreads Start to Widen Again



Source: Bloomberg; Morgan Stanley Research

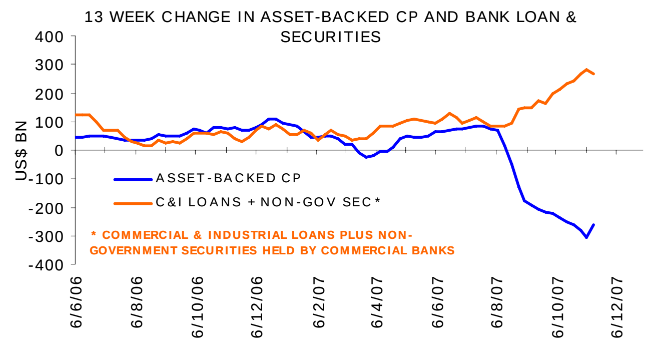
The bigger-picture point about all this is that 2007 probably marked the apogee of the securitization revolution. The trend to securitization may now face sustained setback as it becomes clear that the securitization wave of the past few years had several flaws:

- Greater moral hazard when loan origination is separated from ownership;
- The ever-increasing complexity of securitized instruments went hand-in-hand with reduced transparency and secondary-market liquidity;
- The process relied heavily on the now damaged credibility of the rating agencies;
- The benefits for banks are mixed if they provide finance to the buyers of their securitized products.

If we really are seeing a trend reversal, then there are likely to be periodic episodes of renewed stress in markets. Just as the expansion of securitization provided ready liquidity for a range of borrowers, a turn in the process will mean credit is either less plentiful or more expensive or both. Moreover, as a structural change, it will probably extend over quarters, or perhaps years, but certainly not weeks.

Exhibit 4

Back on the Balance Sheet



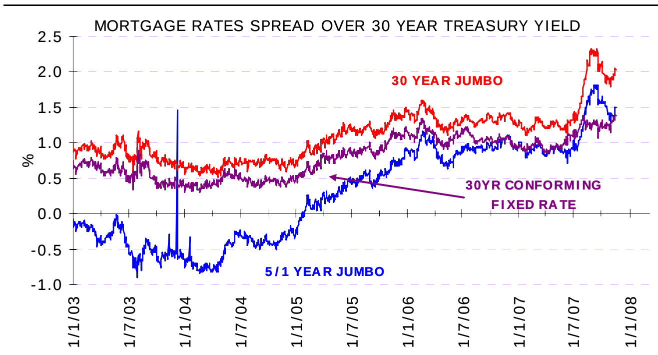
Source: Bloomberg; Morgan Stanley Research

On a one-year view, the most important point from this is the increased credit rationing to the US consumer. That is reflected in part in the widening spread between quoted mortgage rates and Treasury yields. Exhibit 5 shows the spread between a selection of mortgages and the 30-year Treasury.

This is very important. One of the key ways easier monetary policy assists the consumer is via lower mortgage rates, which allows borrowers to refinance their fixed-rate mortgages. That transmission mechanism is likely to be far less effective in this cycle because of the widening spread between Treasury and mortgage rates. The spread between the standard 30-year fixed-rate mortgage and the 30-year Treasury rate is now over 75 basis points wider than it was in 2003-4. The Fed may ease, but this time it may not work that well.

Exhibit 5

Another Set of Widening Spreads



Source: Bankrate.com, Bloomberg; Morgan Stanley

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