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Downunder Daily

The Curate's Credit Egg

Last year's credit problems came in several areas. The good news is that one problem – stress in short-end funding and inter-bank lending – seems to be on the mend. The bad news is that other stress symptoms are not. Worst, last year's credit stress occurred against a broadly healthy economic backdrop: Things will get worse if there's a US recession.

Action to settle inter-bank markets seems to be working. The raft of unconventional measures – which boiled down to central banks offering funds at rates that banks have been unwilling to provide to one another – now seems to be settling things. Exhibit 1 shows that US$ LIBOR rates are now falling towards the Fed funds target and the overnight indexed swap rate (which reflects investors' expectations for the funds target). The spread remains unusually wide, but is much narrower than in December.

Exhibit 2 shows spreads for asset-backed commercial paper. As with LIBOR rates, spreads remain wide, but are narrowing. As importantly, the stock of asset-backed CP increased by US$8.3bn in the latest week, following declines in 19 of the prior 20 weeks (which saw a cumulative fall of $378bn).

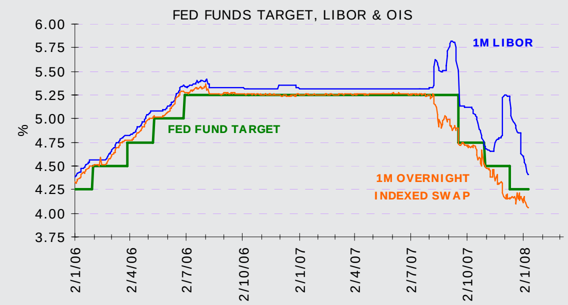
Similar improvement is apparent in European, UK, and Australian markets. For more details on short-end stress, please see the regular updates from Laurence Mutkin (the latest, *Money Market Update*, 8 January).

It is an important achievement to settle the inter-bank market. This is at the heart of the financial system, and for it to malfunction was a serious and immediate concern to policy-makers.

Elsewhere, however, there are no signs that the credit crunch is relenting. Exhibit 3 shows a selection of credit indicators. None is improving. So while policy-makers have been able to lower the cost of funds for banks lending to one another, funding spreads for non-banks continue to widen.

Exhibit 1

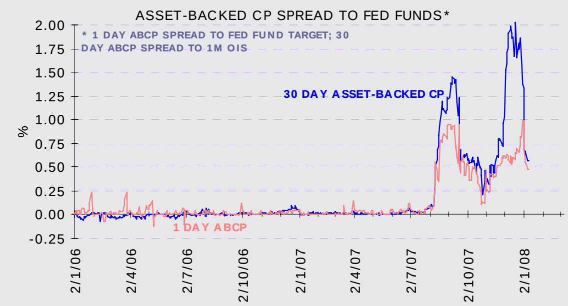
Inter-bank Short-end Stress Eases…



Source: Bloomberg; Morgan Stanley Research

Exhibit 2

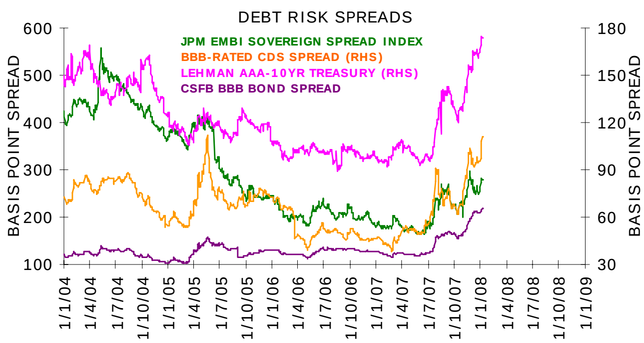
…As Do Strains in Asset-backed CP



Source: Bloomberg; Morgan Stanley Research

In fact, not only are spreads wider, but for many borrowers, absolute funding costs are higher. Exhibit 4 shows US corporate bond yields: Lower-rated investment-grade and sub-investment-grade yields are higher in absolute terms.

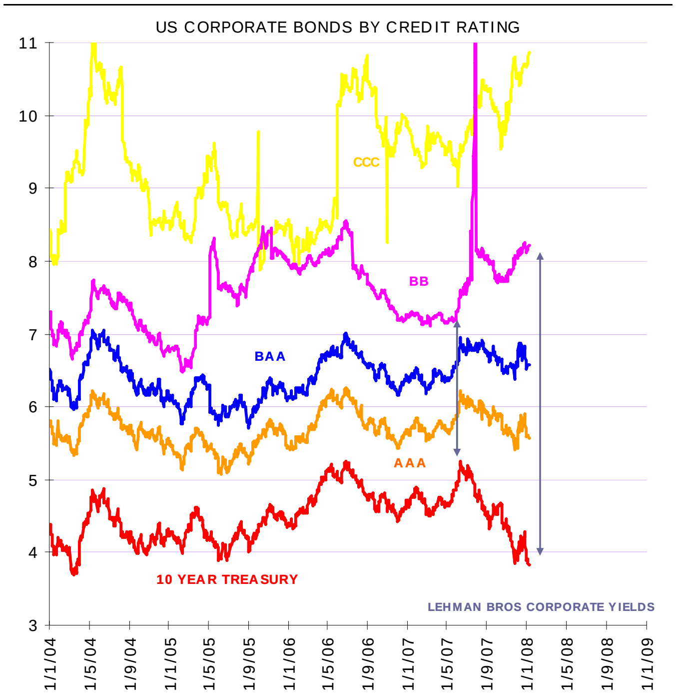
Exhibit 3
No Signs of Narrowing Long-end Spreads



Source: Bloomberg; Morgan Stanley

Within the investment-grade universe, there has been a growing dispersion that matches the relative performance of equities last year: a strong bias to global cyclicals.

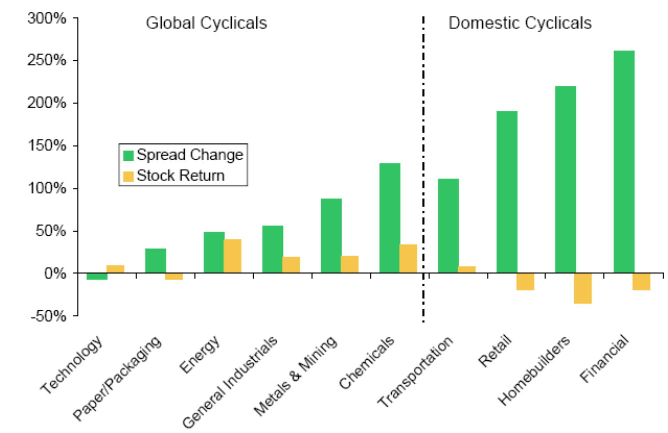
Exhibit 4
Absolutely Higher Rates



Source: Bloomberg; Morgan Stanley Research

Our US credit team is skeptical that the divergence between these two sectors will persist in 2008. Certainly, a global slowdown would test the resilience of global cyclicals – in terms of both relative equity performance and the relative performance of their debt pricing.

Exhibit 5
Split Between Global and Domestic Cyclicals

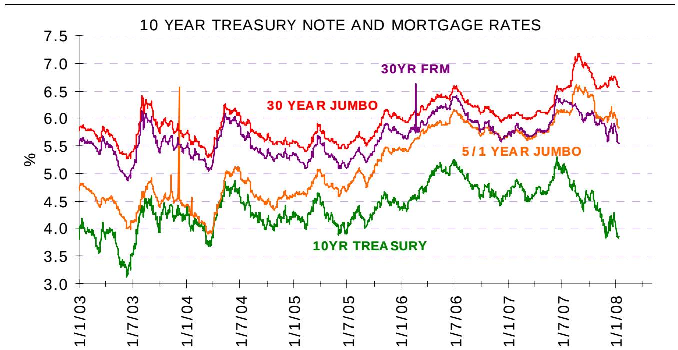


Source: Greg Peters, *Credit Basis Report: Global Cooling*, 4 January; Bloomberg; Morgan Stanley Research

Finally, there has likewise been no improvement in mortgage-related credit conditions. Mortgage rates (for new borrowers) remain elevated, despite the fall in long-end Treasury yields (Exhibit 6).

All this suggests that while financial system stress is moderating, credit conditions have significantly tightened for most borrowers, a factor that will tend to damp growth.

Exhibit 6
New Home Buyers Face Higher Costs



Source: Bloomberg; Morgan Stanley Research

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(as of December 31, 2007)

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