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Morgan Stanley Australia Limited+
Gerard Minack
Gerard.Minack@morganstanley.com
+61 2 9770 1529

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Downunder Daily

Wild and Wide

I'm bearish – really bearish – but even I admit that credit markets are now pricing in a very pessimistic outlook. This raises two issues that our strategists are grappling with: first, when to re-enter credit markets; and second, how to play the apparent discrepancy between credit and equity market pricing.

Note what's in the price: Exhibit 1 shows the current spread on a number of credit benchmarks and the historical range. Three notable points:

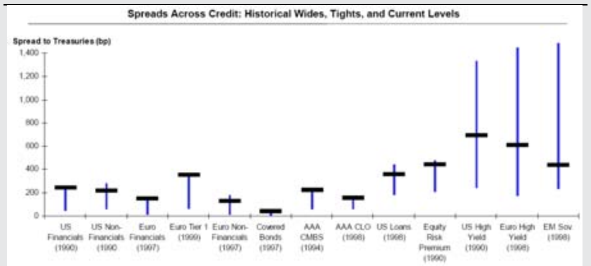
First, many developed-world spreads are at, or near, all-time wides relative to Treasuries. Several benchmarks hit new wides overnight.

Second, relative to their own history, investment-grade corporate spreads are at more extreme levels than non-investment grade.

Third, credit markets have achieved what equity markets have not: genuine decoupling. Emerging market debt has been relatively insulated, with sovereign spreads trading at the bottom quarter of the historical range. This contrasts with equity performance, where emerging markets have typically under-performed Wall Street recently. (Even so, our Asian credit team also sees a major disconnect between equity and credit: See Viktor Hjort, *Asia Credit Strategy: Why Equity Investors Should Look at Credit as an Opportunity*, 4 March.)

Exhibit 2 provides a more precise estimate of what's in the price for several of the major corporate credit benchmarks. Compare the second and third columns: The second column shows the default rate implied by the current spread, while the third column shows the worst default rate of any equivalent cohort seen since the 1970s. For investment grade corporate debt (the first and third rows), the break-even default rate is now double the worst default rate seen in almost 40 years.

Exhibit 1
Wilder and Widest



Note: Horizontal bars indicate current spreads. Year in parentheses indicates year spread data starts.
Source: Vishwanath Tirupattur, *State of the Market: ABS CDOs, CLOs and Structured Credit;* The Yield Book, iBoxx; Morgan Stanley Research

Exhibit 2
Bad, or Really Bad?

	Index Spread (bp)	Breakeven Defaults*	Historical Defaults~	A Year's Carry Pays for Widening (bp)	A Year's Carry Pays for Defaults (#)
iTraxx IG 5yr	109	7.8%	3.6%	26	2.3
XOVER 5yr	557	33.7%	39.9%	153	4.6
CDX IG 5yr	140	9.9%	4.7%	33	2.9
CDX HY 5yr	680	39.4%	42.6%	196	11.3
LCDX	450	48.3%	-	140	15.0
LEVX	460	41.5%	-	170	4.0

* Calculated as price of the index/loss on a single default
~ Default rate of the worst cohort for an equivalent portfolio (since 1970s)
Source: Neil McLeish, *European Credit: Approaching the Trough*, 27 February 2008; Morgan Stanley Research

Even in the one area where losses are likely to be beyond the historical norm – sub-prime mortgages in the US – the implied losses now look pessimistic. Exhibit 3 shows the break-even losses for 2006 sub-prime mortgages. The AAA-rated tranche is affected if losses exceed around 26% of the total pool. Current pricing implies 34% total losses. That is, for example, 68% of mortgage holders default, with the lender recovering 50% of the mortgage value. That's a Baghdad-like loss in property value.

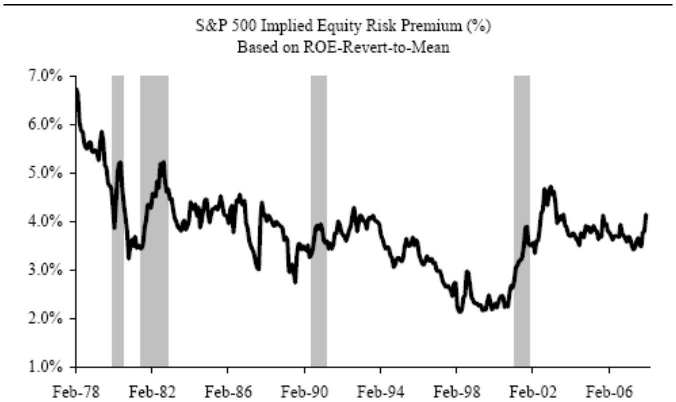
Exhibit 3
Bad, or Baghdad?

Rating	Approx. Losses that can be Sustained	As a Multiple of 2000 Losses	% of 2006 Rated Volume
Aaa	26%-30%	4.3x	80.8%
Aa	18%-21%	3.0x	9.6%
A	13%-15%	2.2x	5.0%
Baa	10%-11%	1.7x	3.5%
Ba	7%-8%	1.2x	1.1%

Source: Vishwanath Tirupattur, *State of the Market: ABS CDOs, CLOs and Structured Credit*; Moody's; Morgan Stanley

While credit indicators seem unremittingly – arguably unrealistically – bleak, equity markets are, on most measures, not at extremes. Exhibit 4 is a measure of the US equity risk premium from our US strategy team. It is not at the levels usually associated with recession.

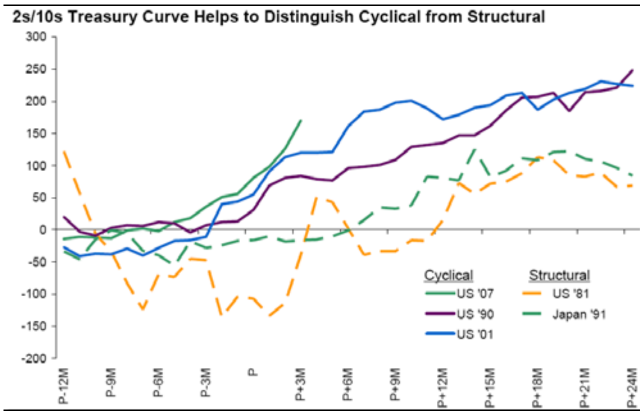
Exhibit 4
On the Other Hand…



Source: Abhijit Chakrabortti, *US Portfolio Strategy: Face/Off – Credit Versus Equity*, 3 March 2008; Morgan Stanley Research

US strategist Abhijit Chakrabortti sees three scenarios for the credit-equity disconnect to play out. First, if credit is correct, it's clear that investors will need to be short equity and high-yield credit/long investment grade credit. Second, if credit gets the direction right, but is too pessimistic, then a short equity/long credit strategy would also look good. Finally, if equities are correct, then long credit – including high-yield – and moderately long equities is the strategy. In other words, under almost any scenario, investors who are looking to add risk to their portfolios should be moving into investment grade credit. Put another way, under almost any scenario, there's a strong relative-reward case for moving into investment grade credit. For more details, see *Face/Off – Credit Versus Equities*, 3 March.

Exhibit 5
What to Watch: Risk of 'The Big One'



Source: Neil McLeish, *European Credit: Approaching the Trough*, 27 February; Bloomberg, Reuters Eco-win; Morgan Stanley Research

Calling the bottom for credit on an absolute basis is trickier. Our credit strategists are flagging the obvious value, but are waiting for better entry points. The tactical issue is that the unwind of leverage amongst credit investors, hedging by institutions caught with now-unwanted credit risk, and growing counter-party concerns are leading to a pessimistic over-shoot in credit markets. Historically, value alone has not been sufficient to signal a market bottom. (See Neil McLeish, *European Credit: Approaching the Trough*, 27 February.)

Finally, it's worth considering the risk that credit markets have got the story right: that the very bleak pricing is an accurate reflection of what may unfold. This boils down to the risk that the looming economic downturn will bring down the debt super-cycle, and that developed economies will enter an extended period of deleveraging, much of it involuntary. My own view is that this is a material risk. Neil McLeish, head of our European credit team, offers one clear-cut market indicator that would warn of this risk eventuating: the yield curve. As Neil notes, the Fed's early action in this cycle has led to an unusually rapid steepening in Treasury curves (2 year-10 year). In structural turning points, the yield curve stays flat or inverted, as it did in Japan in the early 1990s or the US in the early 1980s (Exhibit 5). In this context, a flattening of the curve now would be a very bearish signal – one suggesting that credit markets have got the world right.

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The Americas
1585 Broadway
New York, NY 10036-8293
United States
Tel: +1 (1) 212 761 4000

Europe
25 Cabot Square, Canary Wharf
London E14 4QA
United Kingdom
Tel: +44 (0) 20 7 425 8000

Japan
4-20-3 Ebisu, Shibuya-ku
Tokyo 150-6008
Japan
Tel: +81 (0) 3 5424 5000

Asia/Pacific
Three Exchange Square
Central
Hong Kong
Tel: +852 2848 5200