

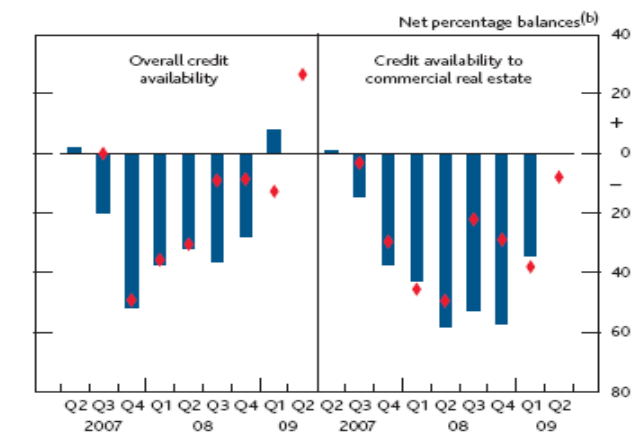
Credit Market Analysis

Credit conditions have improved, but talk of 'green shoots' and a low in swap rates may be premature

Credit conditions improve, as willingness to lend and the availability of funds rise

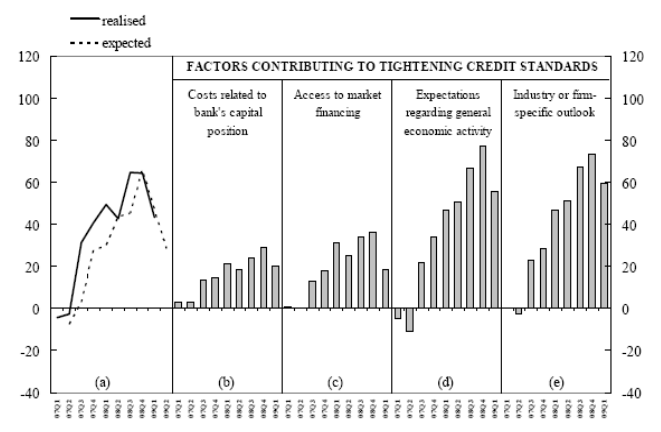
Latest bank lending surveys show that the pace of credit tightening has started to ease, though credit conditions remain very tight relative to historical norms. The Bank of England's credit conditions survey indicates that corporate credit availability actually rose, with the continued reduction in credit for commercial real estate more than offset by remaining corporate sectors. A net 8% of banks said that they increased the availability of corporate credit in Q1, compared with a net 28% saying they reduced corporate credit in Q4, as chart a shows. The improvement was driven by an improvement in lenders' willingness to lend and in the cost and availability of funds. Further, a net 26% of banks said they expect to improve credit availability in Q2, with the economic outlook seen to be less negative. There were similar outturns in the current and expected provision of credit for households.

Chart a: UK corporate credit conditions have improved in the past quarter



Source: Bank of England (chart shows net percentage citing looser credit standards; red dots show expectations in next quarter)

Chart b: Euro zone credit standards remain tight, but less so than in Q4



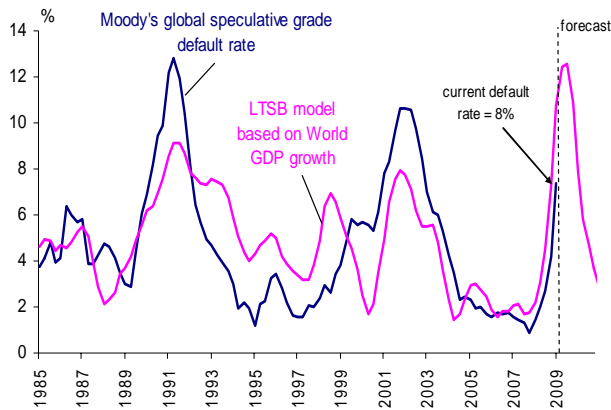
Source: ECB (chart shows net percentage citing tighter credit standards)

Credit conditions surveys for the euro zone and US paint a similar picture of relative improvement

Comparable surveys from the ECB and Fed paint a similar picture of relative improvement in credit conditions. The survey is particularly interesting for the euro zone, where companies rely more on banks for their financing needs than on capital markets. The ECB survey showed that a net 43% of banks reported tighter lending standards in Q4, down from 64% in Q4, see chart b. Nevertheless, this remains a high figure, reflecting concerns about the economic outlook, as well as restricted access to securitisation and medium/long-term debt issuance for wholesale funding, though state guarantees for bank debt securities and government recapitalisation plans have helped to ease funding pressures.

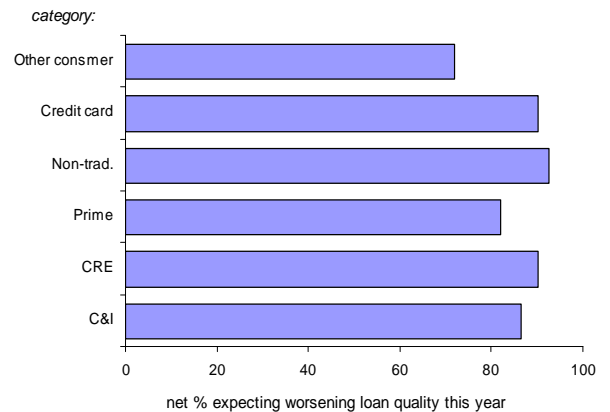
Both the BoE and ECB surveys were conducted before recent non-conventional policy announcements, namely the BoE's further £50bn of asset purchases and the ECB's intention to buy €60bn of covered bonds, and these measures are expected to further improve the flow of credit. In the US, the latest April Fed survey showed a second consecutive quarterly fall in the net percentage of domestic lenders reporting tighter lending standards for businesses, though at 40% the figure remained high and therefore the availability of credit was still tight by historical standards.

Chart c: Global corporate default rates are set to rise further in the coming year



Source: Moody's, LTSB Corporate Markets Economic Research

Chart d: Despite relative improvements in credit conditions, loan quality is expected to deteriorate this year



Source: Federal Reserve

'Green shoots' may still wither, as credit quality continues to deteriorate and default rates rise this year

Credit spreads have fallen in recent weeks, in tandem with the recovery in equity prices and the relative improvement in credit conditions. This is consistent with recent leading economic indicators, suggesting that the worst of the economic downturn may be behind us, but we know that talk of 'green shoots' was premature back in 1991 and it may be again. Despite these relative improvements in bank lending surveys, credit quality is set to worsen before it improves, even based on the expectation that the worst of the global economic downturn may be behind us. Global corporate defaults have risen to 8% and our model shows that it is set to rise significantly further in the coming year, peaking around 13% and the risk is that it could be higher, see chart c. Indeed, the Fed credit survey shows that a high proportion of lenders expect loan quality to deteriorate this year, with more than 90% expecting the quality of non-traditional (including subprime), credit card and commercial real estate loans to worsen, while 87% expect the quality of commercial and industrial loans to deteriorate.

A risk remains that it may be premature to call a low in swap rates

The outlook for interest rates and swaps remains highly uncertain and there is still a risk that expectations swaps have bottomed, supported by basic technical indicators, could be premature. Our interest rate and swaps forecasts, based on our econometric model, are provided in the table below. Volatility will persist and there is still a risk 5-year swaps, for example, will edge back below 3% in the next 3-6 months.

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Table: interest rate forecasts

	latest 13-May-2009	Q3 2008	Q4 2008	Q1 2009	Q2 2009 forecast	Q3 2009 forecast	Q4 2009 forecast	Q1 2010 forecast	Q2 2010 forecast	10-year avg
UK										
BoE repo rate	0.50	5.00	2.00	2.00	0.50	0.50	0.50	0.50	0.50	4.60
3m libor	1.38	6.30	2.77	1.65	1.3	1.2	1.0	1.0	1.3	4.90
2y govt yield	1.05	4.01	1.05	1.19	1.3	1.3	1.5	1.6	2.1	4.60
10y govt yield	3.52	4.45	3.02	3.17	3.3	3.4	3.6	3.8	4.1	4.70
3yr swap	2.50	5.27	2.88	2.48	2.5	2.5	2.5	2.7	3.2	5.20
5yr swap	3.13	5.19	3.16	3.02	2.9	2.9	3.0	3.2	3.6	5.20
10yr swap	3.81	5.05	3.45	3.61	3.5	3.6	3.8	4.0	4.3	5.20
AAA corporate spread (OAS)	131	231	243	136						70
BBB corporate spread (OAS)	799	435	784	941						210
Europe iTraxx (series 9)										
Main index	153	117	178	195						
Crossover index	935	573	1029	1146						

Source: LTSB Corporate Markets, Bloomberg, Merrill Lynch indices

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