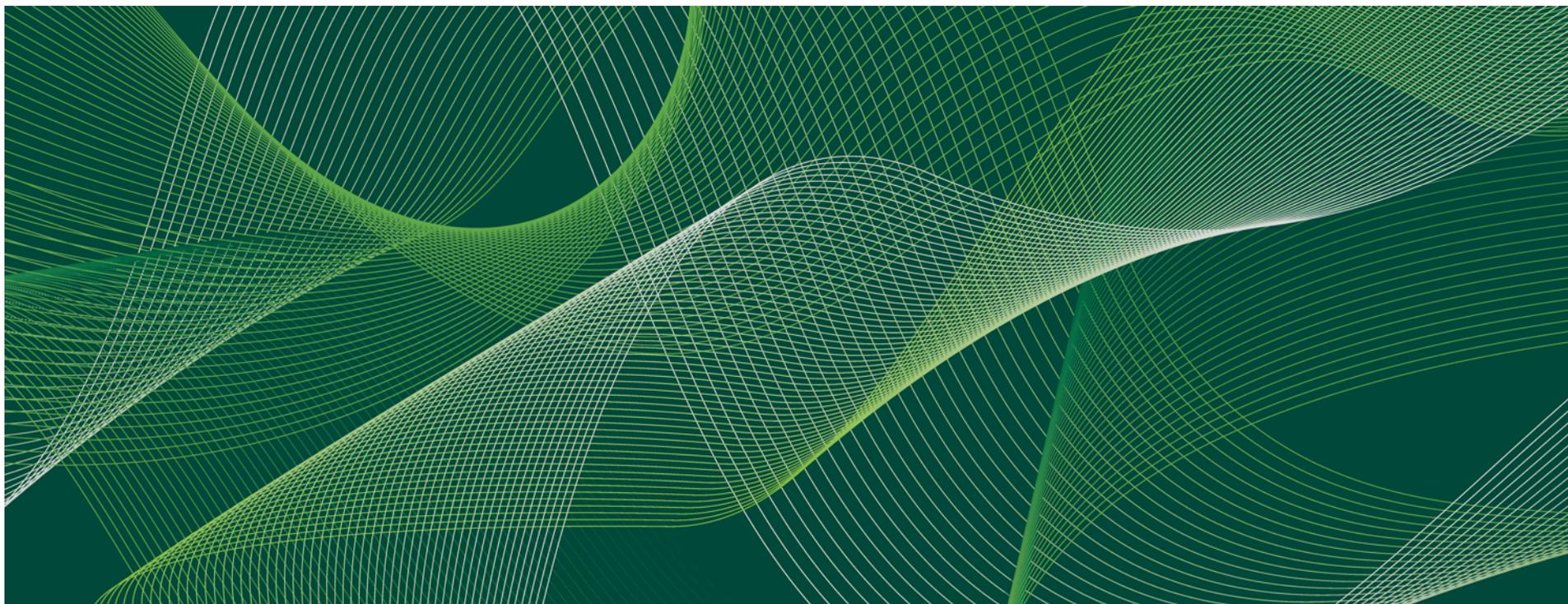


LEHMAN BROTHERS

April 2008

Lisa Watkinson

# Credit Market Outlook

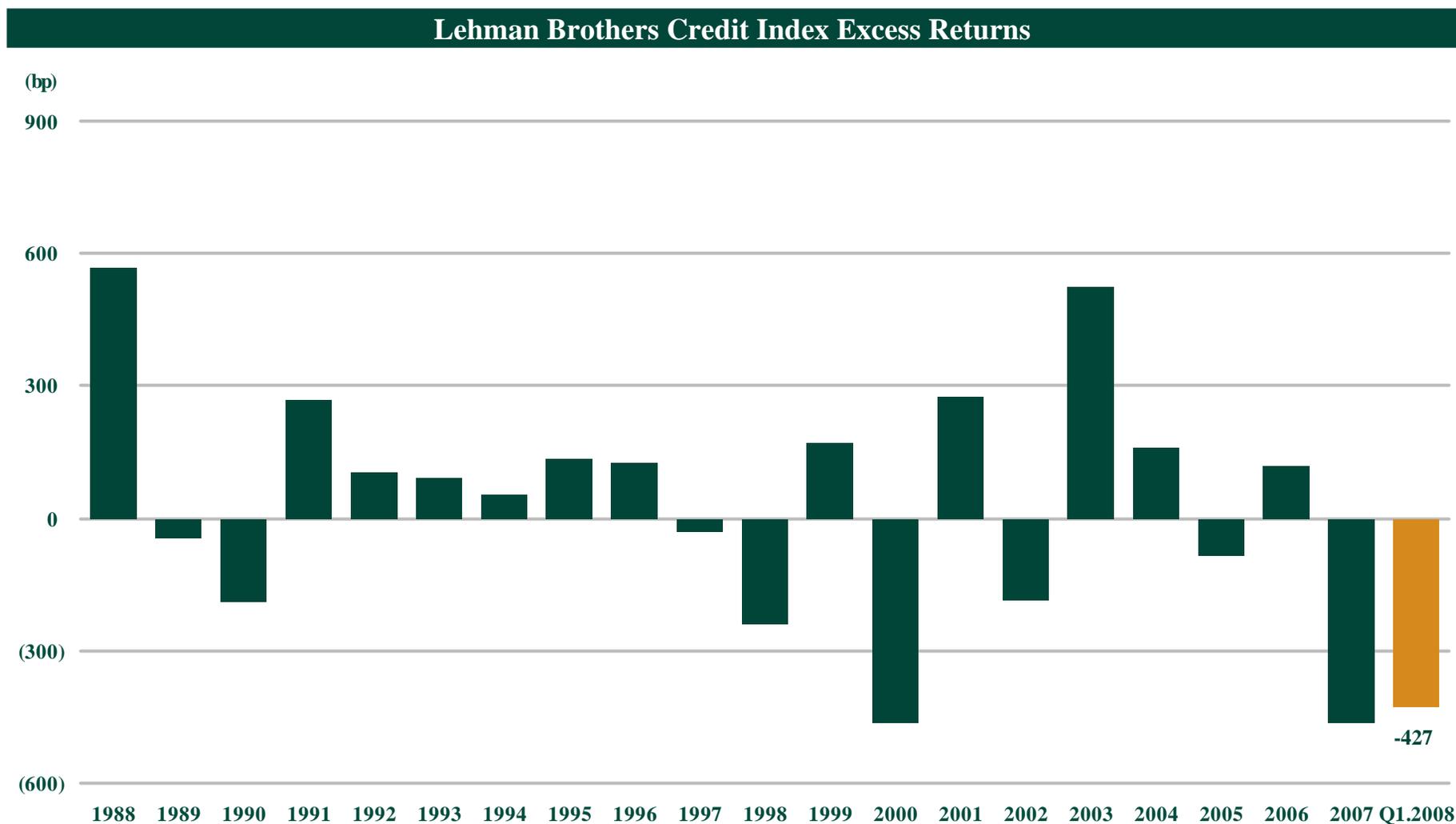


# Quick Overview

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<b>Technical Backdrop</b>	<b>Negative</b>
<b>Corporate Fundamentals</b>	<b>Mixed to Negative</b>
<b>Current Spread Levels</b>	<b>Positive</b>

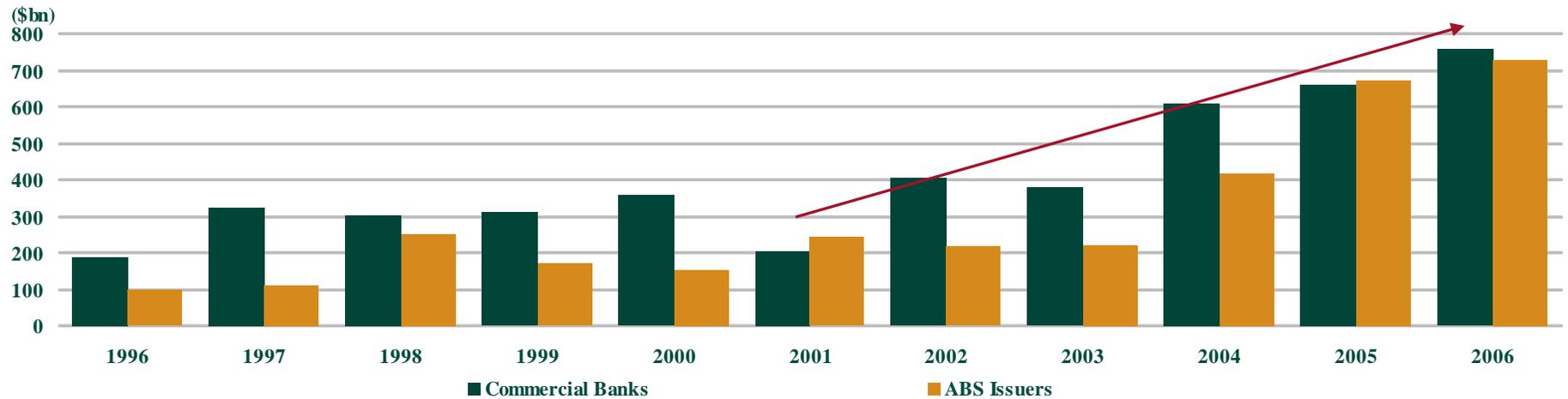
After a period of low volatility, 2007 was a turning point in the credit cycle. In 2008, credit has had its worst start to a year on record.



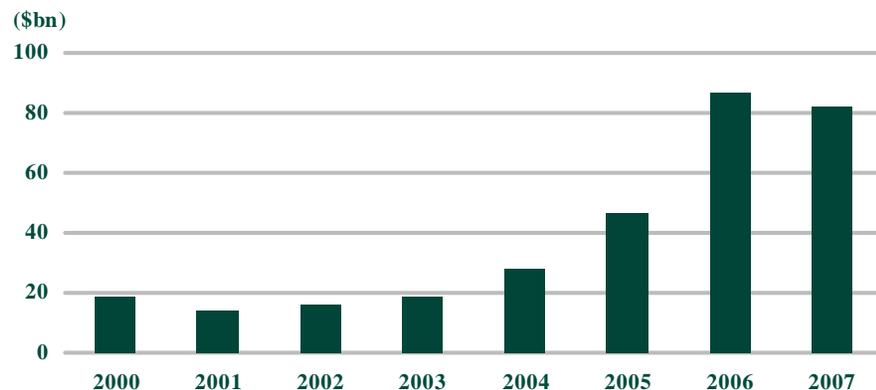
Source: Lehman Brothers.

# From 2002 to 2006, Securitization Markets Grew at a Rapid Pace

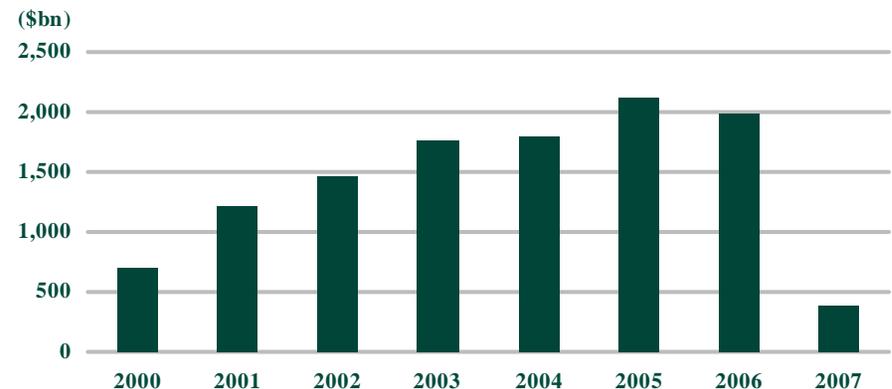
## Net Growth in Credit Market Assets Held By Commercial Banks and ABS Issuers



## CLO Issuance More than Quadrupled between 2000 and 2006



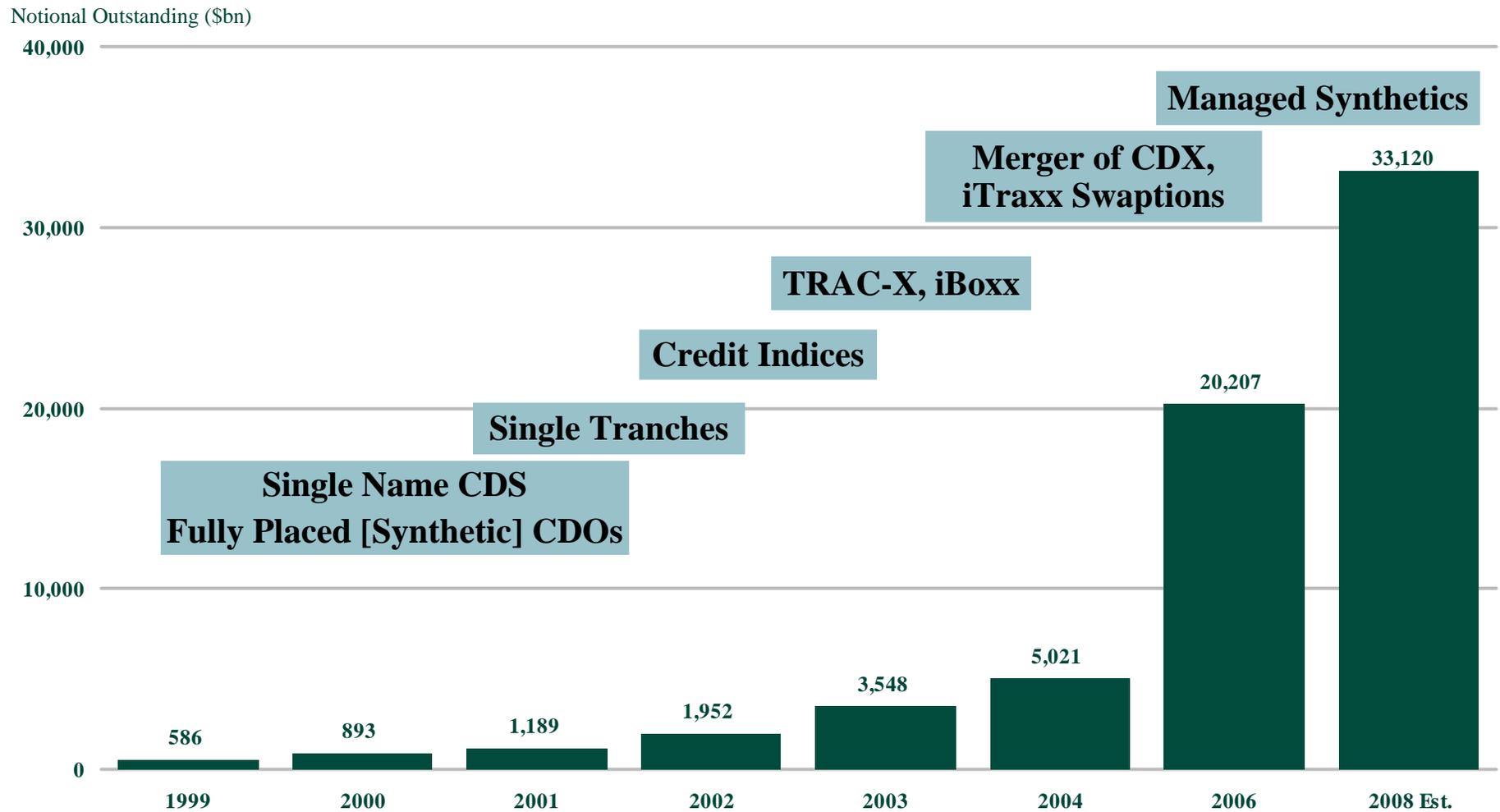
## Non-Agency Mortgage Origination Tripled between 2000 and 2005



Source: Lehman Brothers, Intex, IFR, Moody's, S&P, Federal Reserve

Note: Synthetic issuance only includes only public transactions that were in funded format, Securitized product issuance includes Non-Agency MBS, CMBS, CLOs and Consumer ABS.

# Credit Derivative Markets Mirrored The Growth With A Number of Structured Credit Products using Securitization Technology

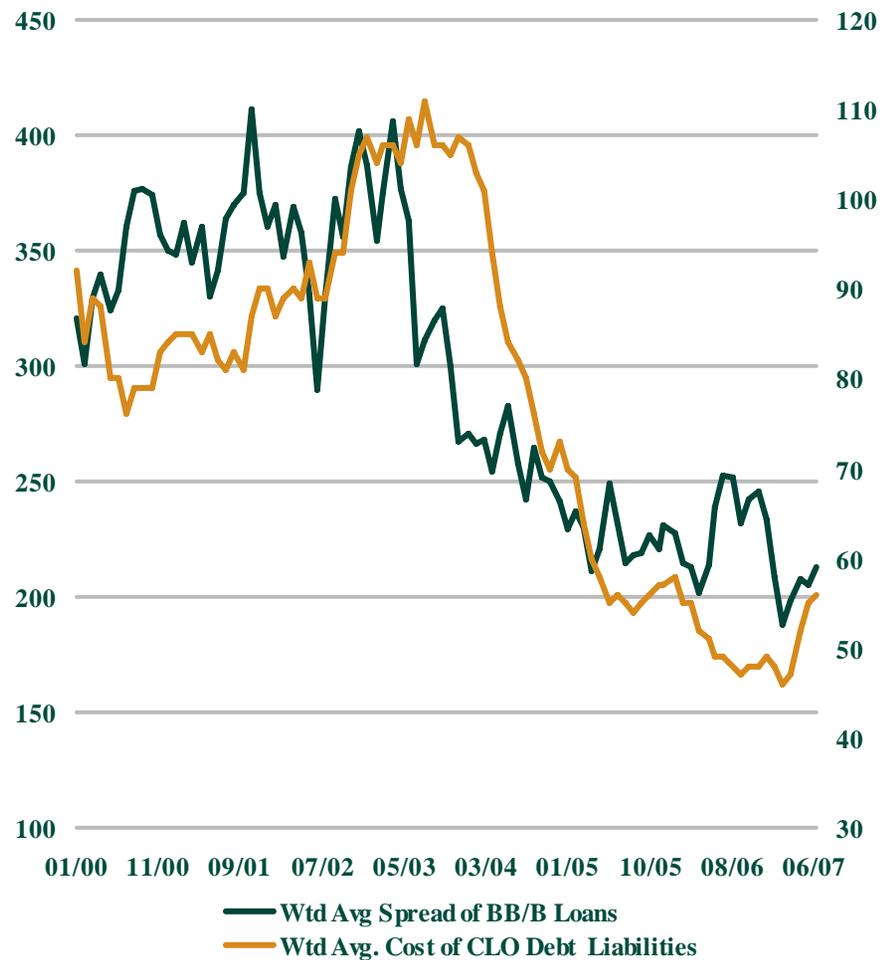


Source: BBA Credit Derivatives Report 2006.

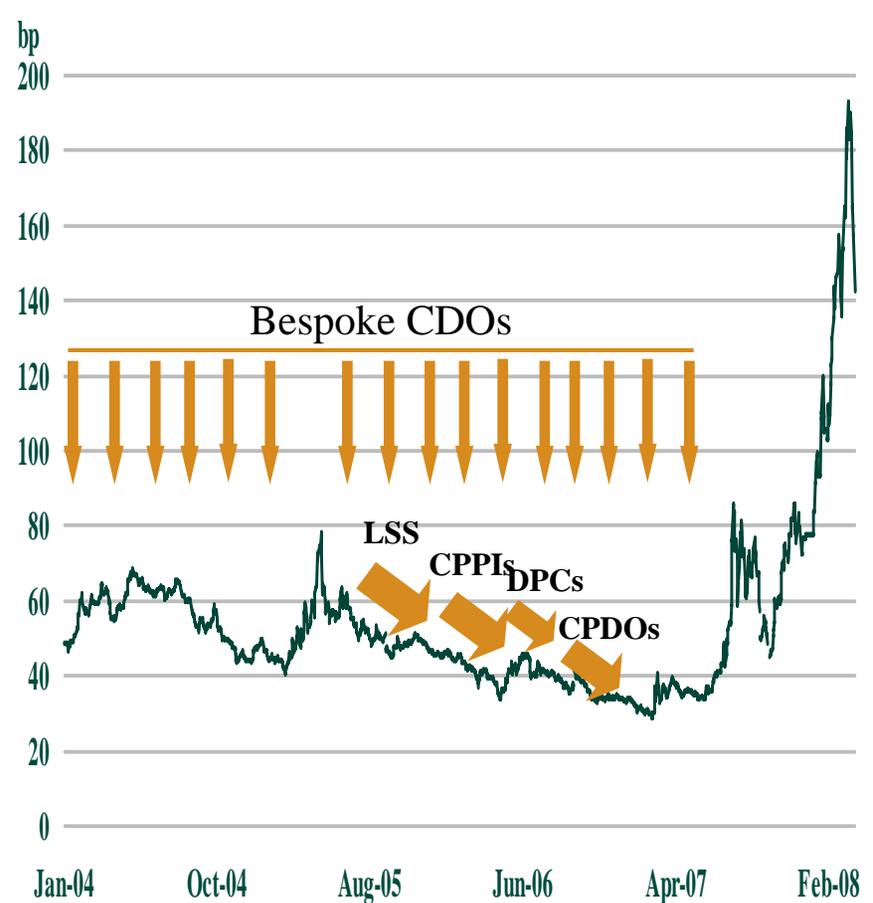
The historical data shown does not imply, forecast, or guarantee future results.

# Development of a Variety of Structured Credit Products Helped Distribute Risk Better and Decreased the Cost of Borrowing by Narrowing Credit Spreads

## Loan spread vs. CLO Funding Costs

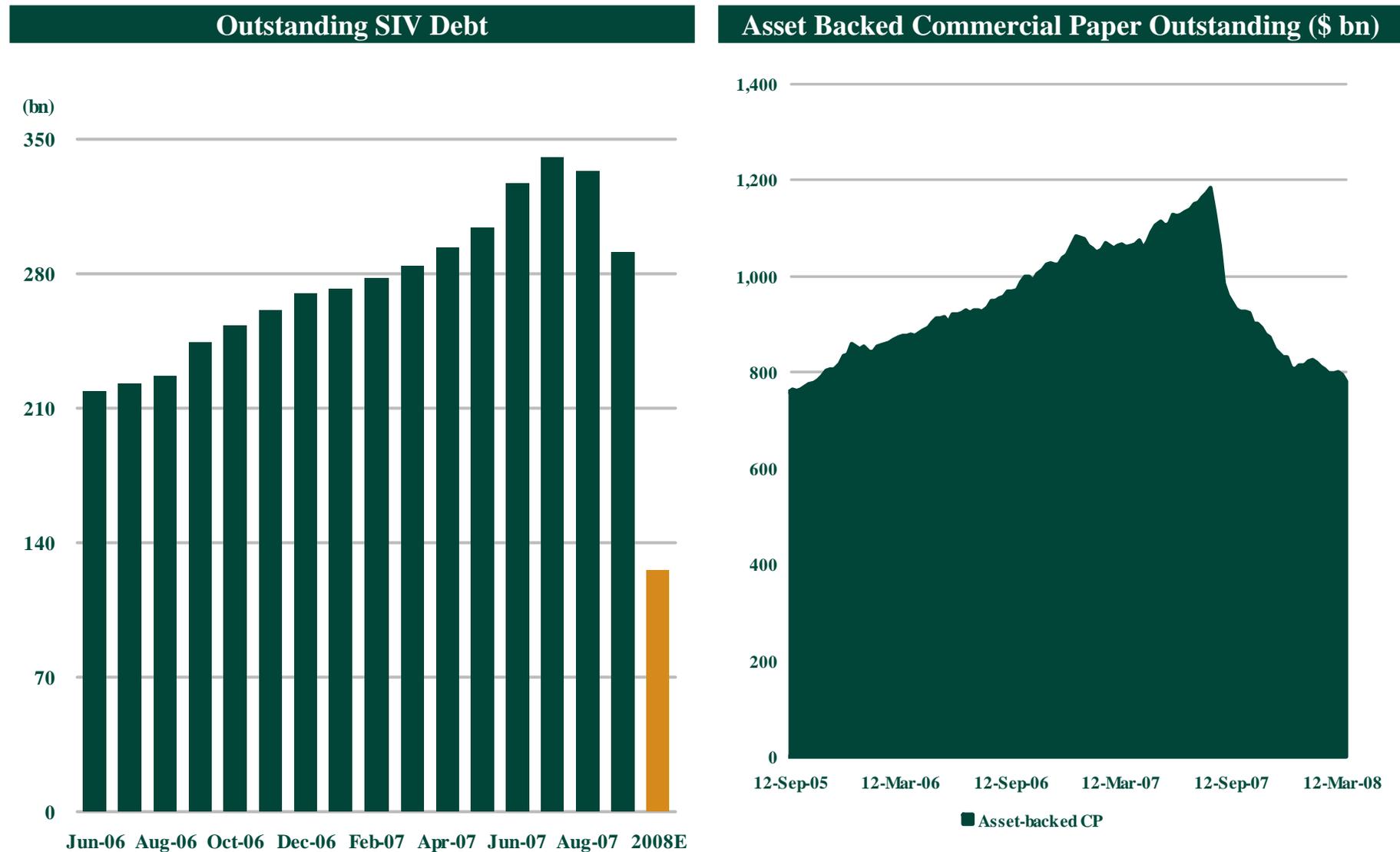


## Introduction of Structured Credit Instruments vs. CDX IG On-The-Run



Source: Lehman Brothers

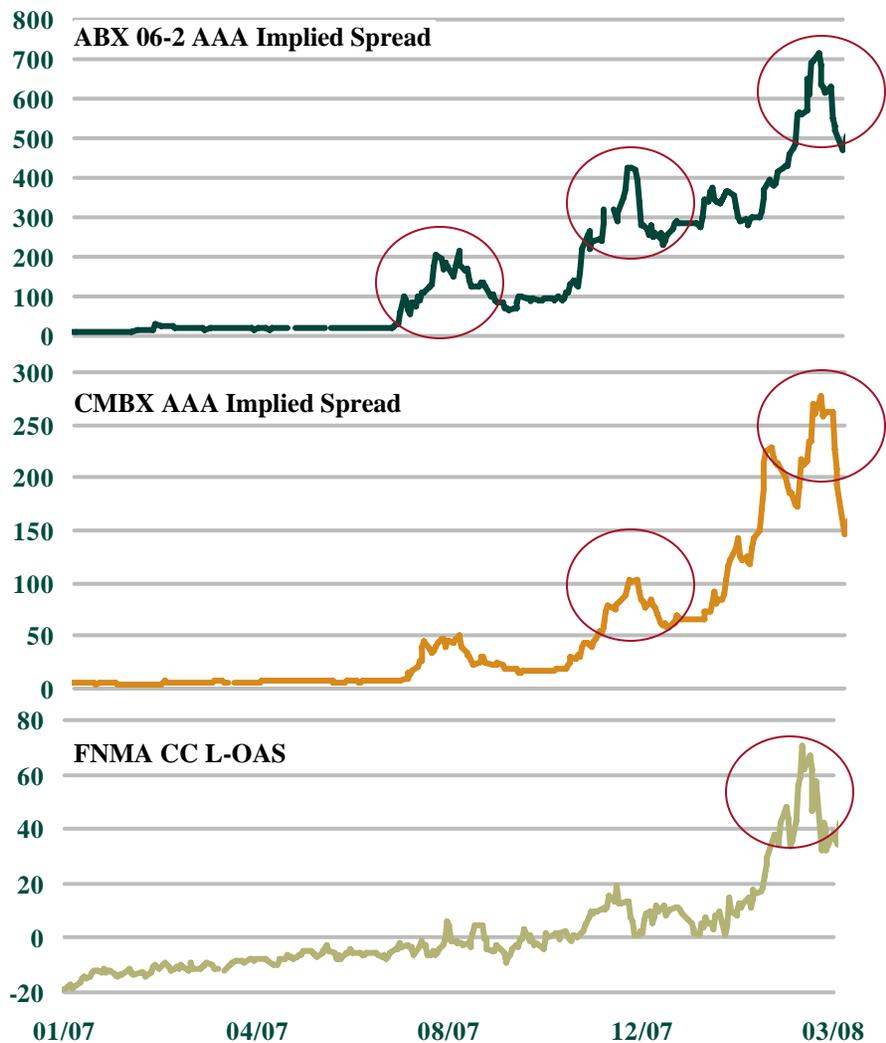
# As Mortgage Defaults Increased, Short Term Funding for Structured Finance Securities Diminished. Many of These Vehicles Were Forced To Deleverage



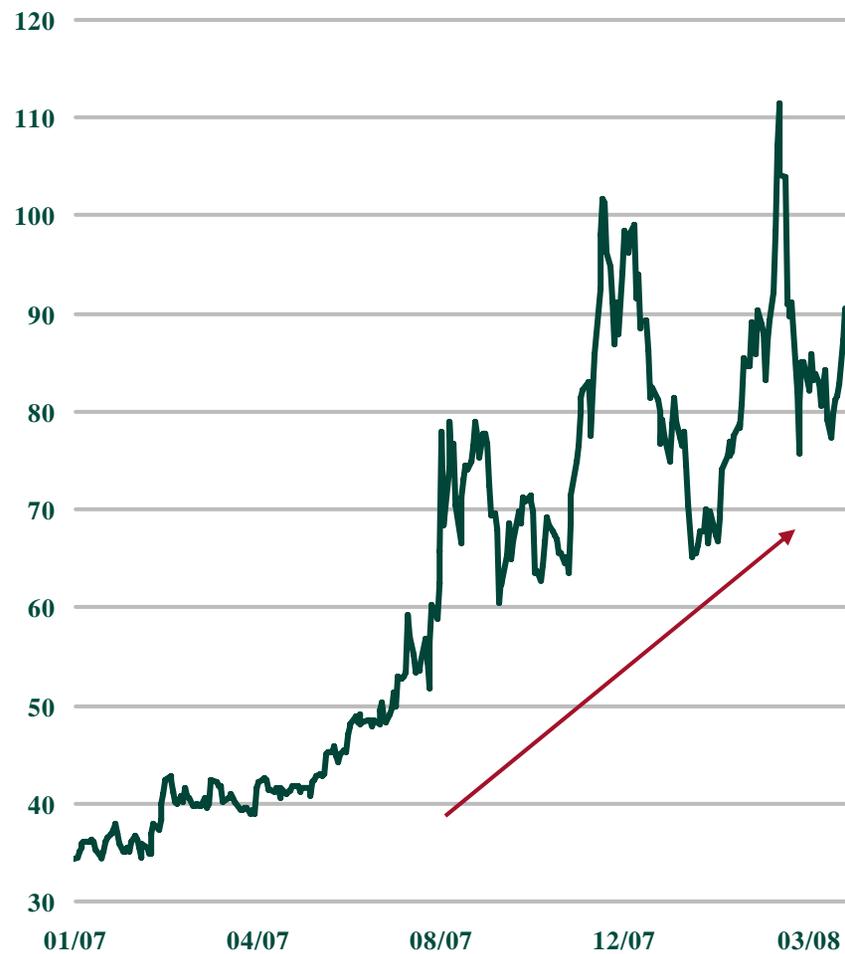
Source: Moody's, Lehman Brothers.

# After Starting in Subprime, the Deleveraging Trend Gradually Spread to Other Asset Classes and Morphed into a Full-blown Liquidity Crisis

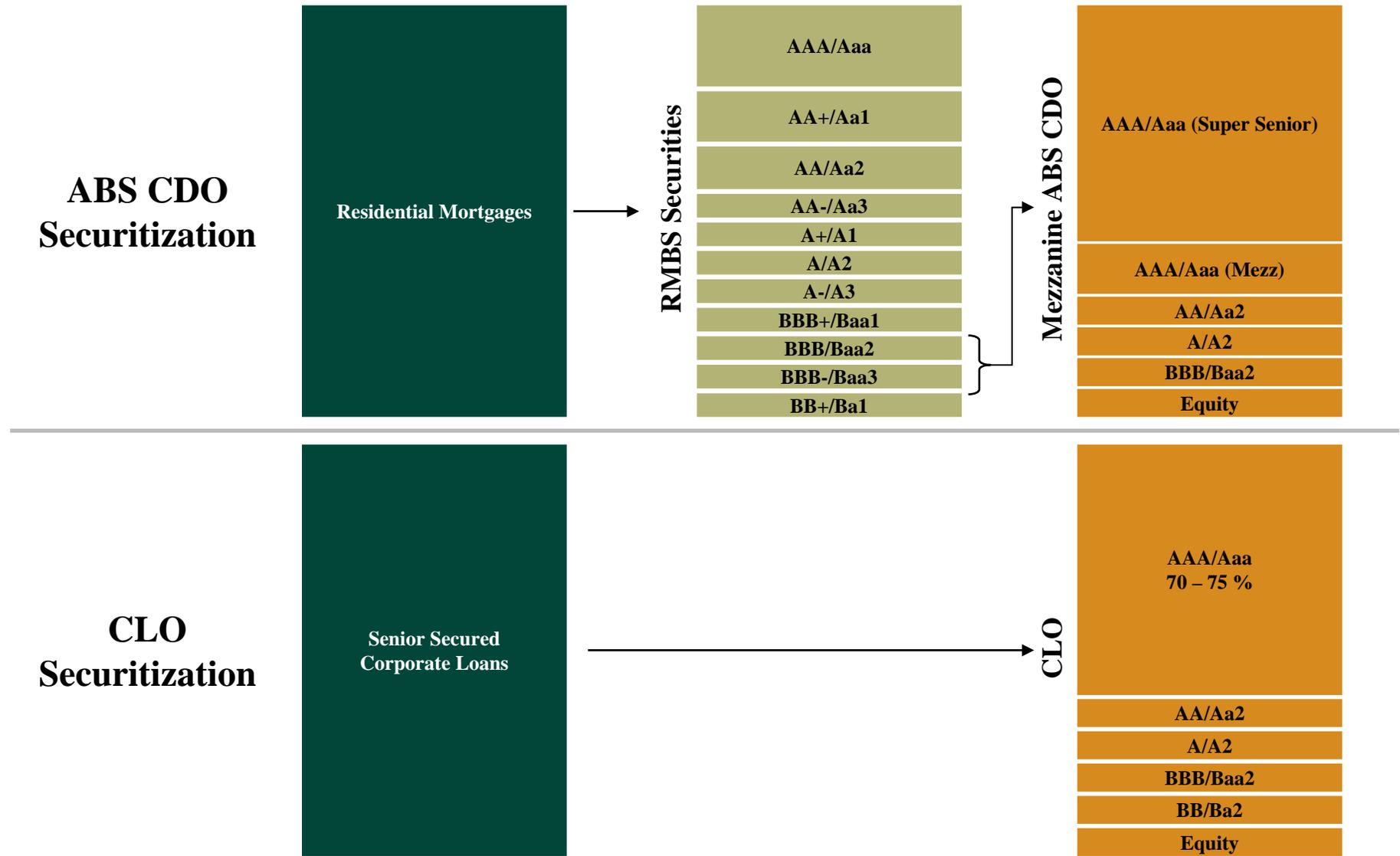
### ABX vs CMBX vs. FNMA L-OAS Spread (bp)



### 2-Year Swap Spreads (bp)

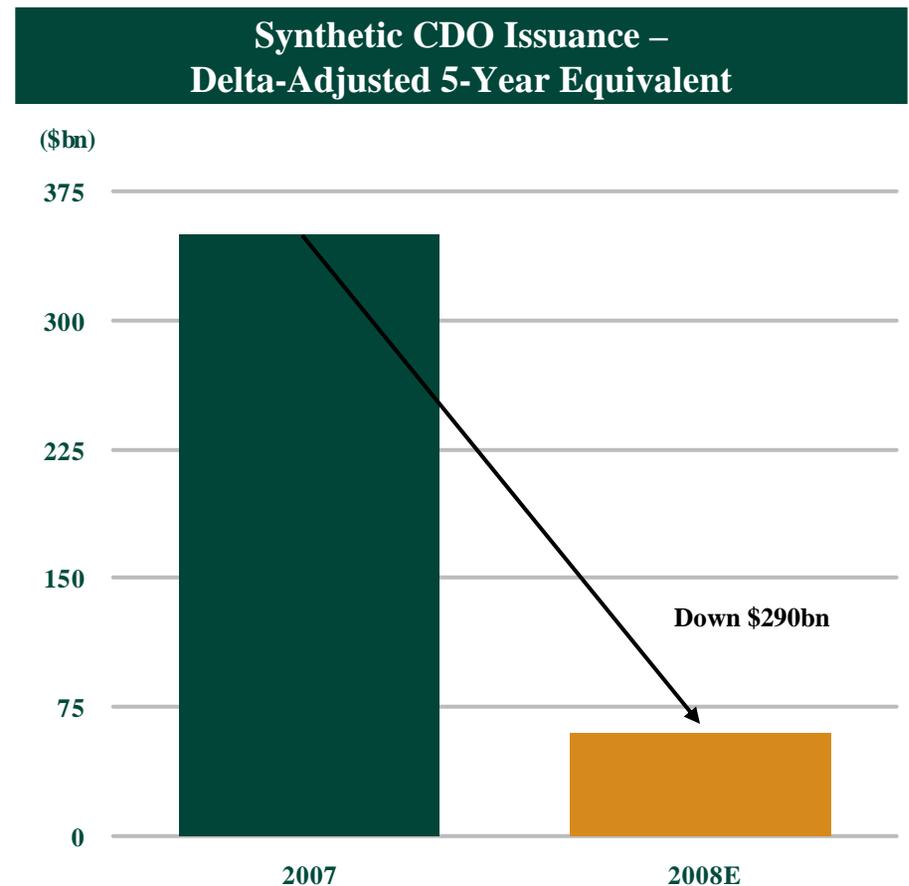
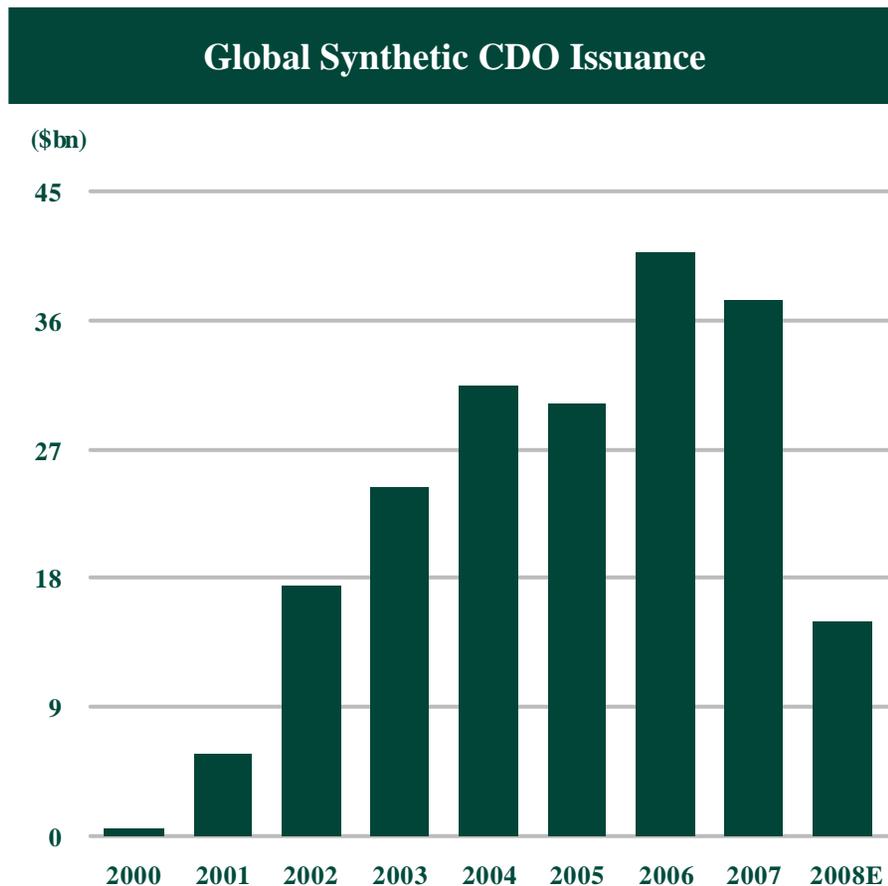


While Structured Credit Instruments are Very Different From ABS CDOs Because They are Not Resecuritizations, Appetite Is Limited For All Products With the Structured Moniker



# The Drop In Demand Will Lead to a Big Decline in A Key Source of Demand for Credit Risk

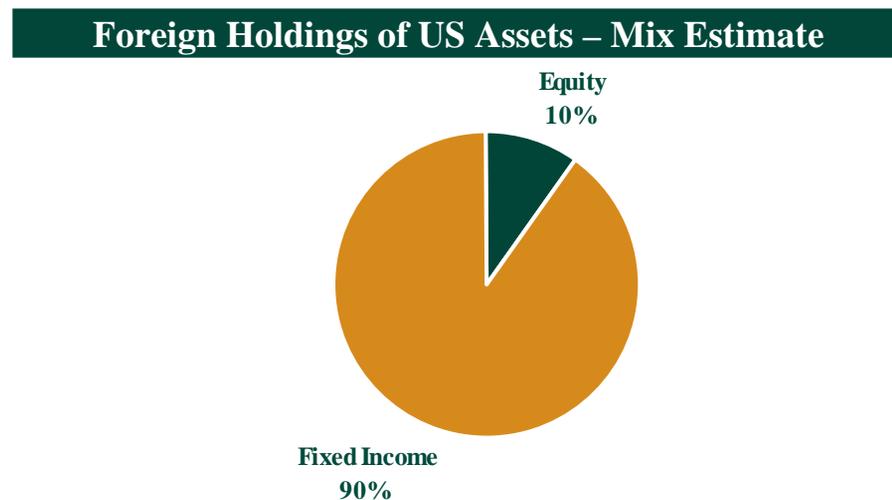
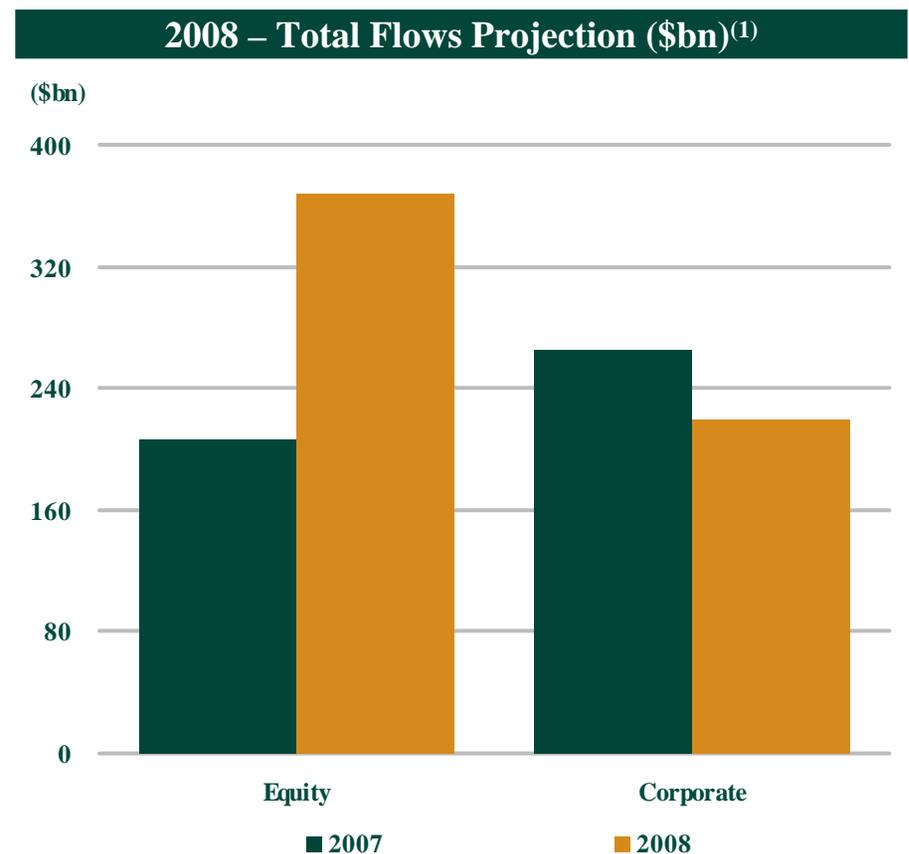
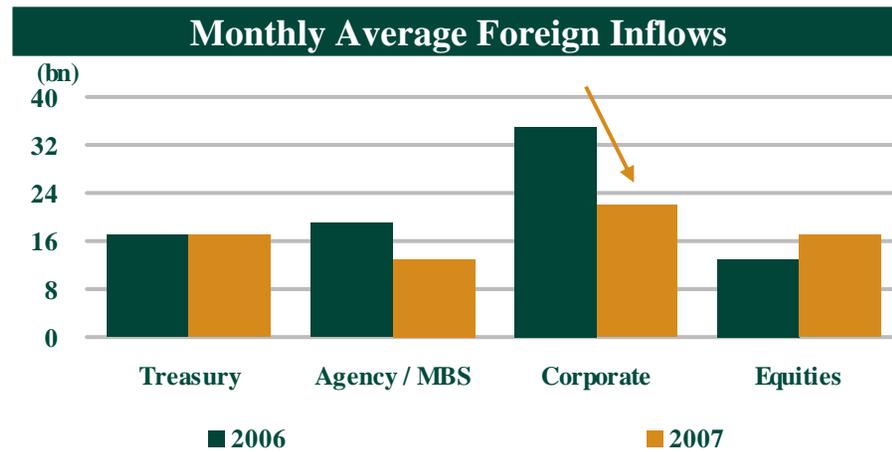
- ◆ We expect Synthetic CDO Issuance to decline by approximately 60% in 2008 due a combination of limited investor confidence in structured products and rating agency models
- ◆ A 60% drop in issuance and decreased leverage on new deals would result in approximately a \$290bn drop in 5year equivalent notional demand for risk



Source: Lehman Brothers, Intex, IFR, Moody's, S&P.

Note: Synthetic issuance only includes only public transactions that were in funded format. 2008 Estimate is based on a projected decline of 57% in cash and 50% in synthetic transactions.

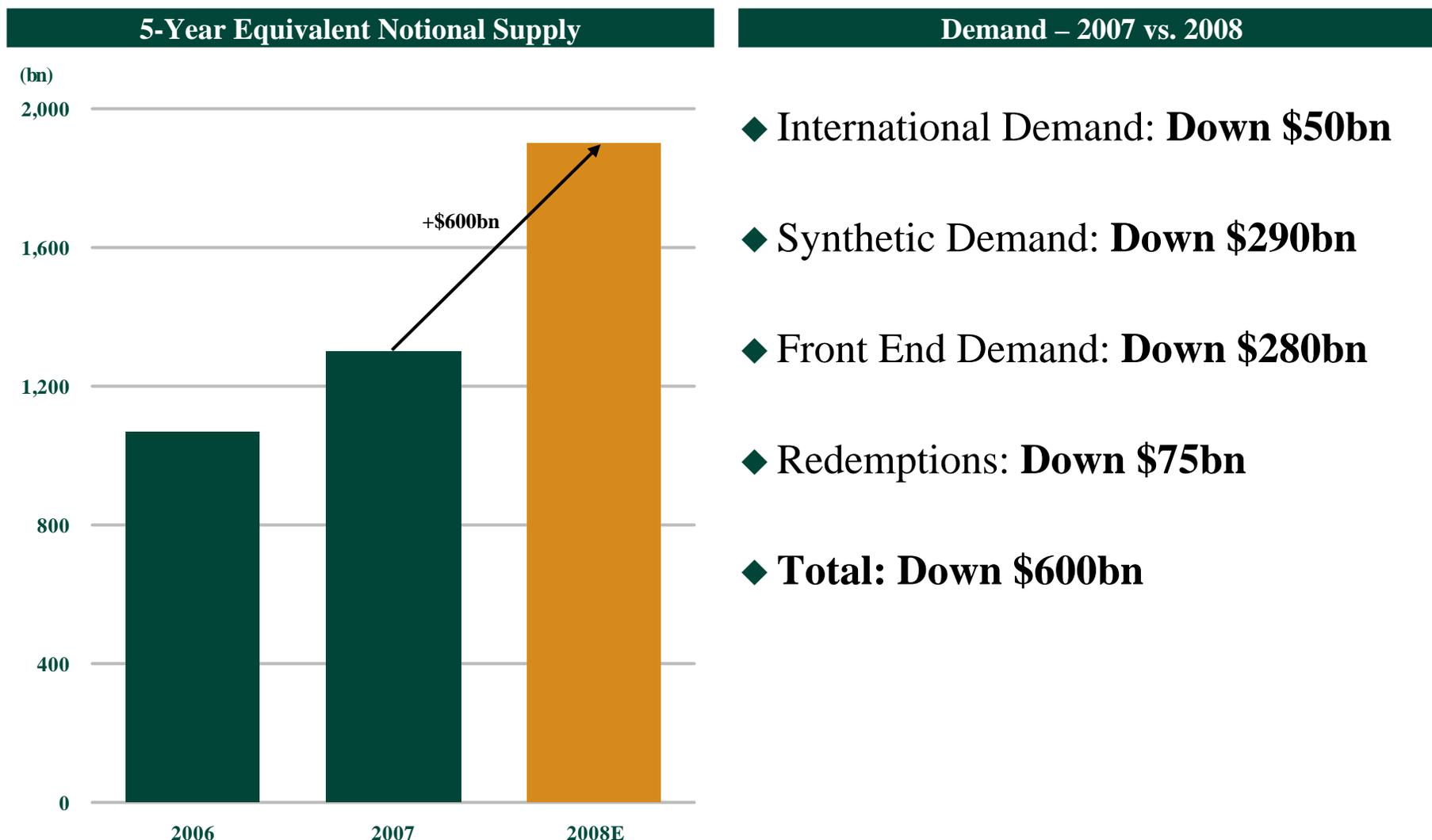
Inflows from abroad have also slowed and will likely remain biased towards equities muting another source of demand



While official institutions have diversified away from fixed income assets, given the current size of equity exposure there is scope for further diversification. Assuming an fixed income/equity shift to 85%/15% and a \$130bn slowdown in official flows<sup>(1)</sup>, foreign purchases of US corporate bonds would decline by \$50bn in 2008

Source: Lehman Brothers; TIC.

# Putting it All Together, the Supply / Demand Imbalance Will Likely Continue To Weigh On Credit



Source: Lehman Brothers.  
Note: Approximation using spread duration.

## Moving to Fundamentals, Domestically, the Macro Backdrop has Deteriorated. The Consumer is Facing Massive Headwinds

### Consumer Backdrop – 2007 vs. 2008

Factor	January 2007	Current	Impact
Unemployment Rate	4.6	5.1	Negative
Payroll Growth (6-Month MA)	189K	2K	Negative
Gas Prices	\$2.30	\$3.39	Negative
Lending Standards	Loosening	Tightening	Negative
Housing Wealth Effect	1.1%	(0.3%)	Negative
Trailing 12-Month S&P 500 Return	15%	-7.56%	Negative
Savings Account Yield	4.08%	2.57%	Negative
30-Year Jumbo Mortgage Rate	6.07%	7.02%	Negative

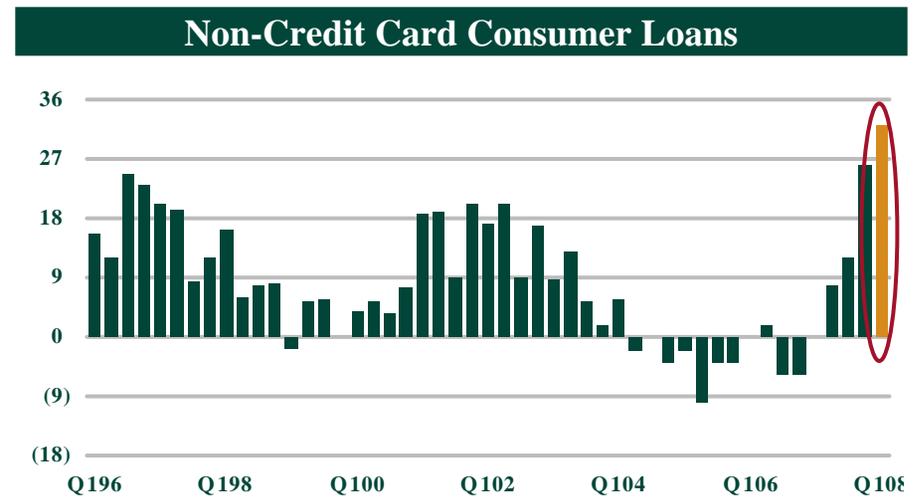
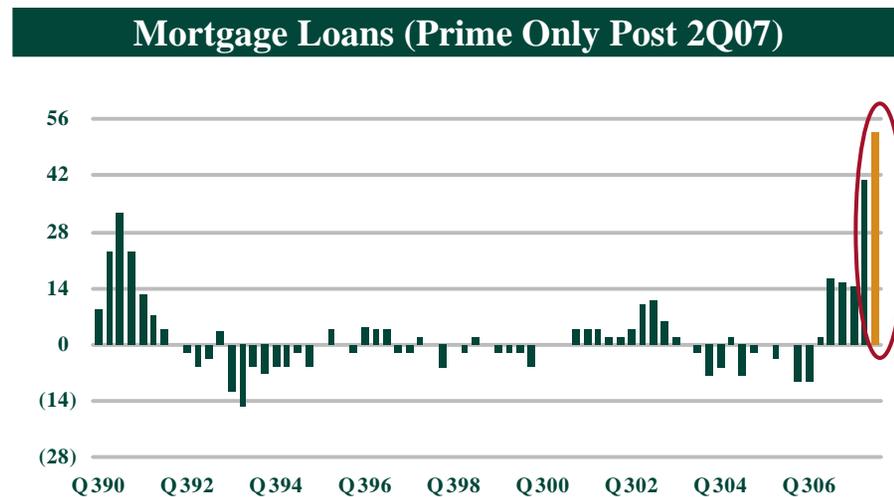
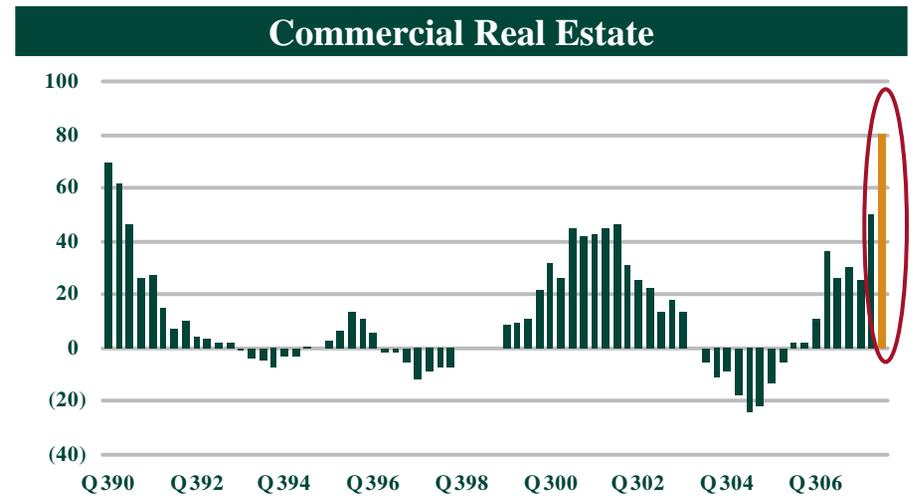
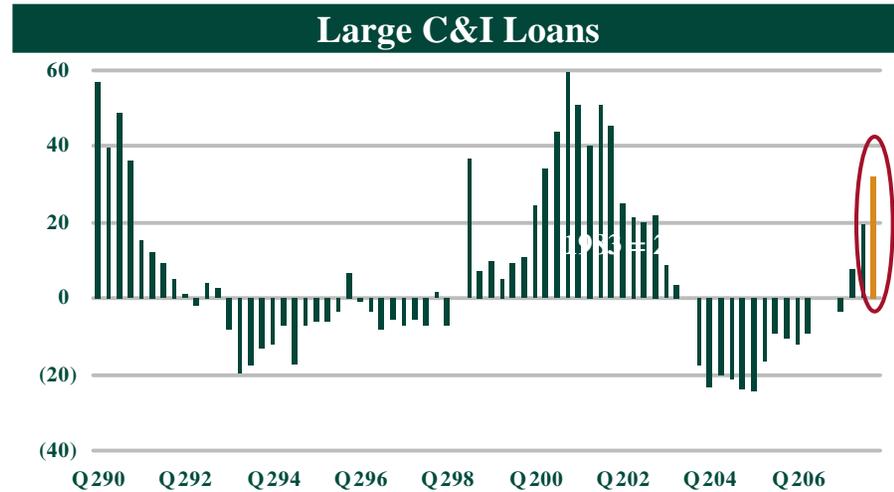
### State of the Consumer – December 2006 vs, Current

Factor	December 2006	Current	Impact
Consumer Confidence	110.0	64.5	Negative
Automobile Sales (SAAR)	16.6	15.3	Negative
Holiday Retail Sales (YoY)	5.9	4.2	Negative
Credit Card Delinquency Rate	3.92	4.55	Negative
Auto Loan Delinquency Rate	1.27	2.67	Negative
Prime Mortgage Delinquency Rate	2.57	3.24	Negative
Subprime Mortgage Delinquency Rate	13.33	17.31	Negative

Source: Bloomberg.

# Lending standards continue to tighten for consumers and corporates

## Fed Senior Loan Officer Survey: Net % of banks reporting tightening of standards



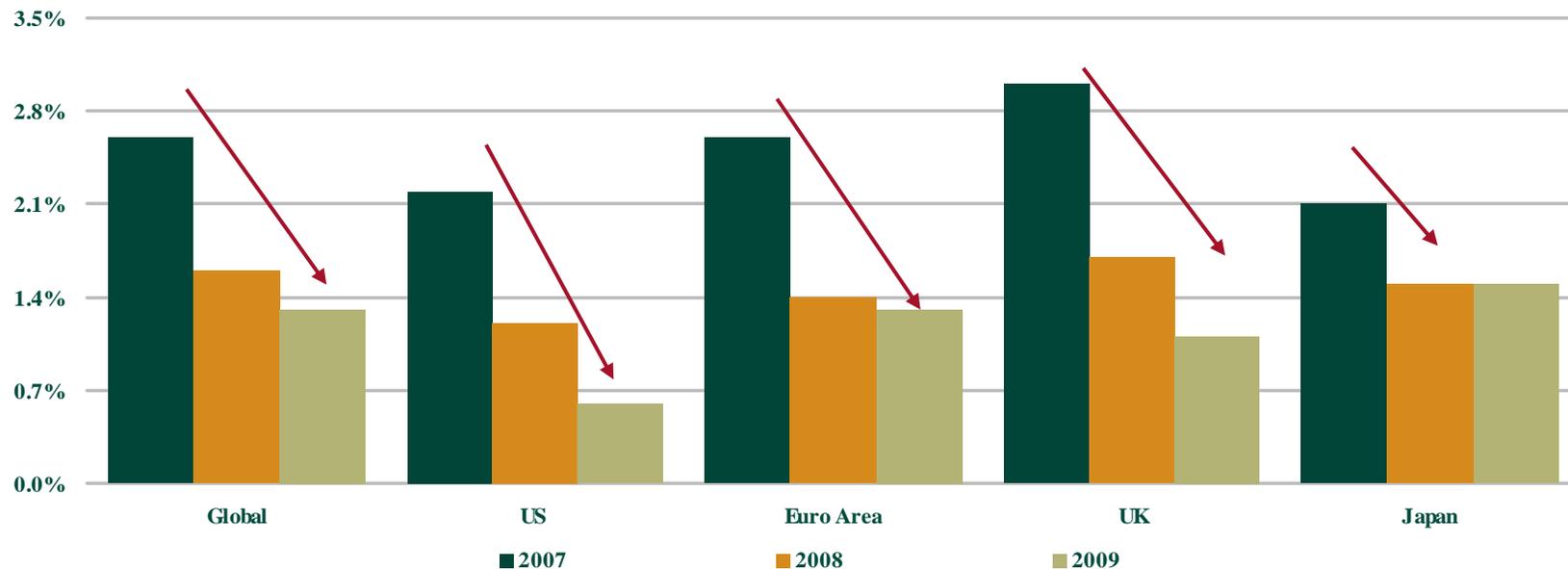
Source: Federal Reserve.

On the back of all of these issues, growth is expected to slow. Importantly, we believe this will be a global slowdown...

### Lehman Economics on Global Growth

- ◆ We expect an extended period of slower growth as housing hits the US consumer and credit dislocation crimps activity. Aggressive fiscal and monetary easing – with a 1% terminal funds rate – should prevent a deep recession
- ◆ Despite strong fundamentals in EM, the world will not be able to “decouple”: we expect a slowdown across the board

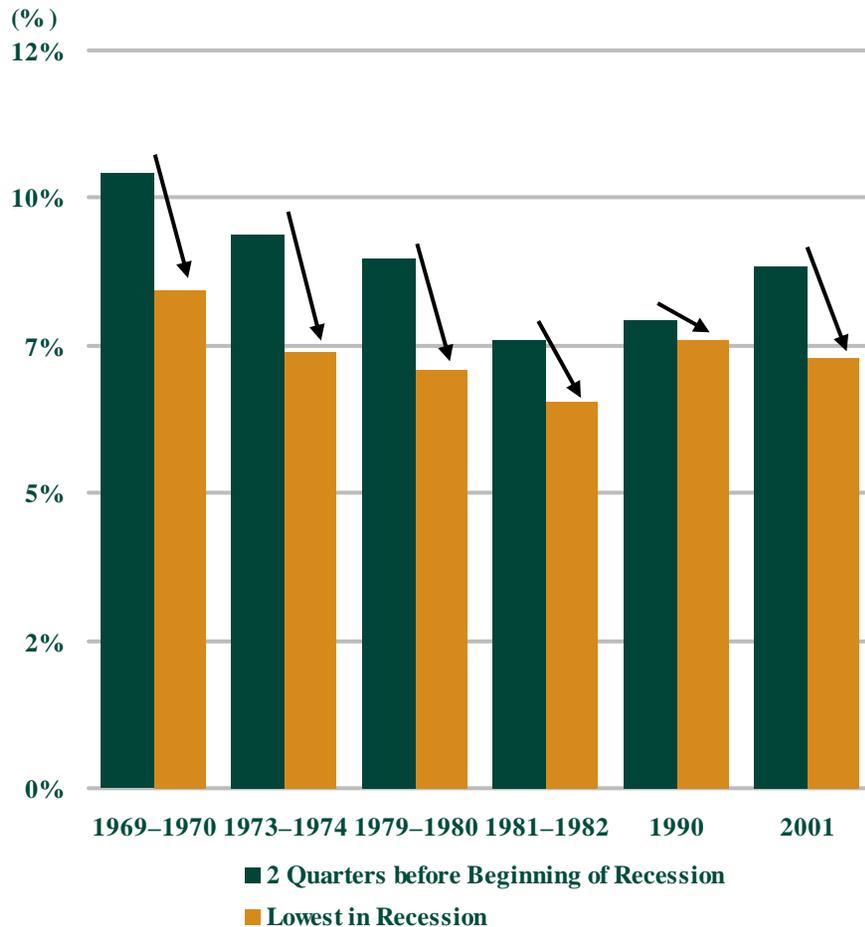
### 2007 GDP Growth vs. 2008 & 2009 Estimates



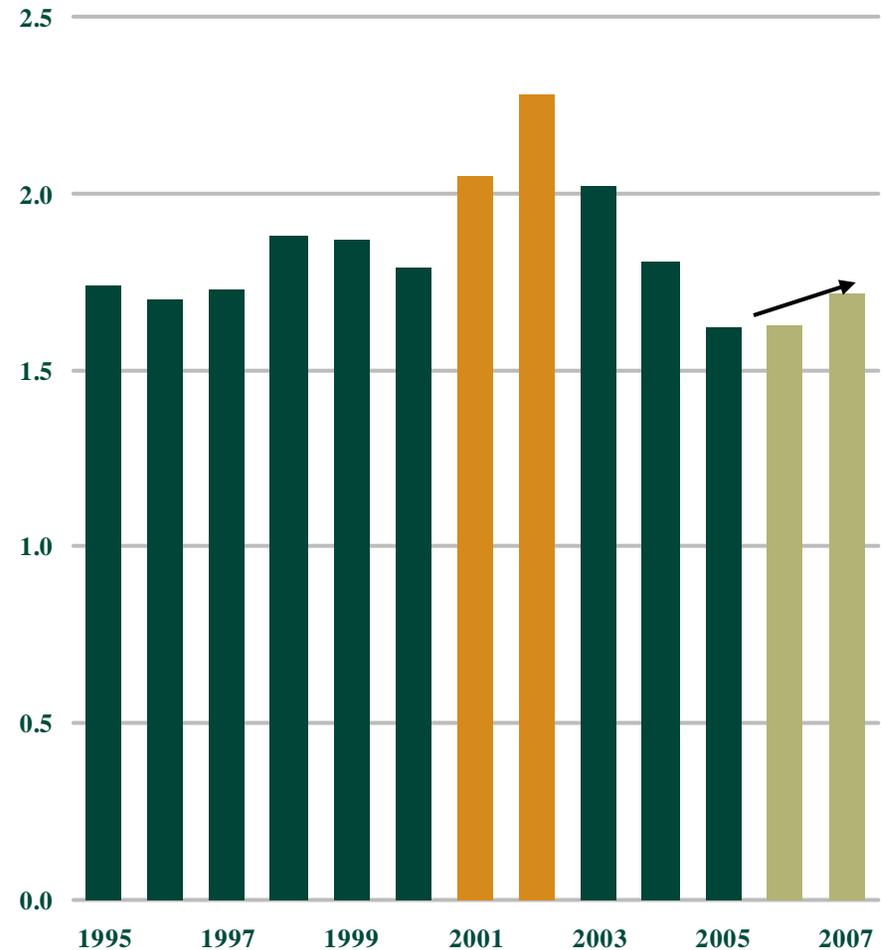
Source: Lehman Brothers Economics.

With global growth slowing, we would expect corporate fundamentals to deteriorate. However, unlike the previous cycle, leverage for non-financials is starting off at lower levels and is a minor positive

### Corporate Share of Profits Typically Fall During Recessions



### IG Industrial Debt / EBITDA

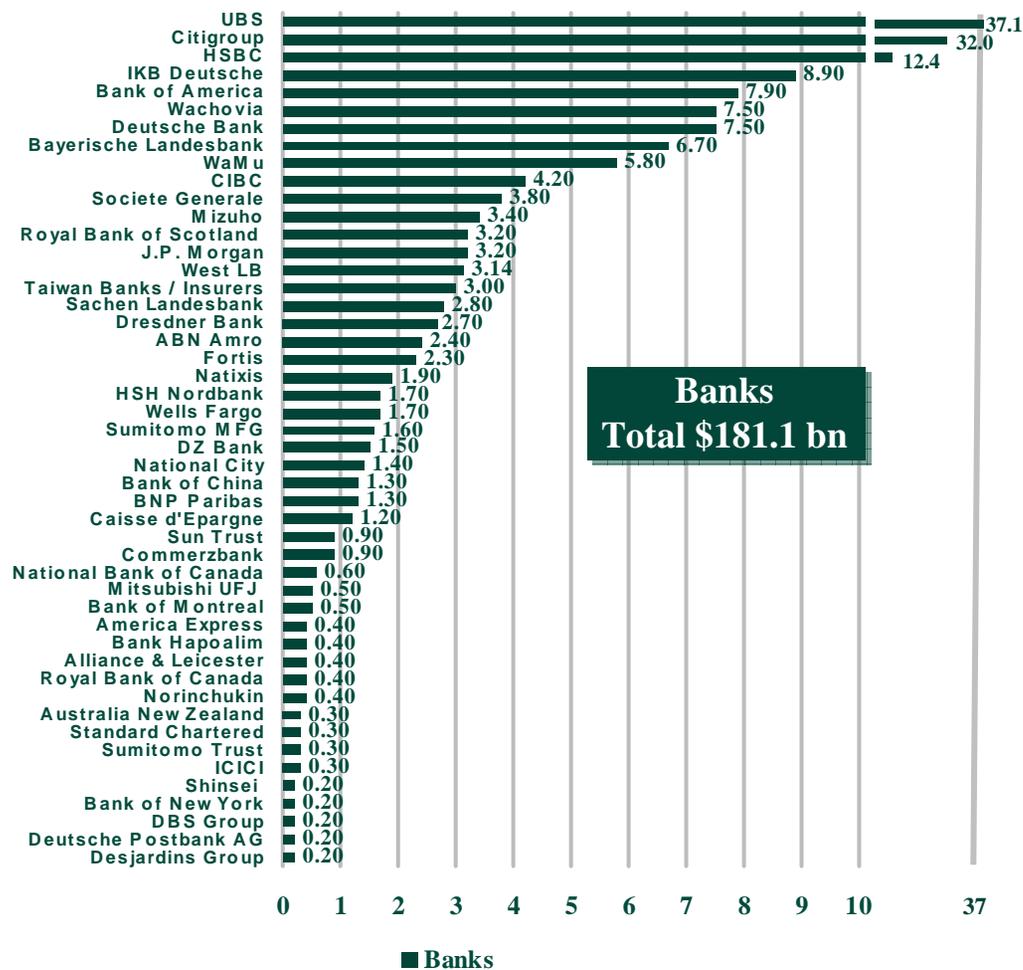


Source: BEA, Commerce Department, Lehman Brothers Economics, Q4 Estimates.

# With Respect To Financials, Many Issuers Have Seen Large Losses and Seen Significant Erosion in Their Book Values

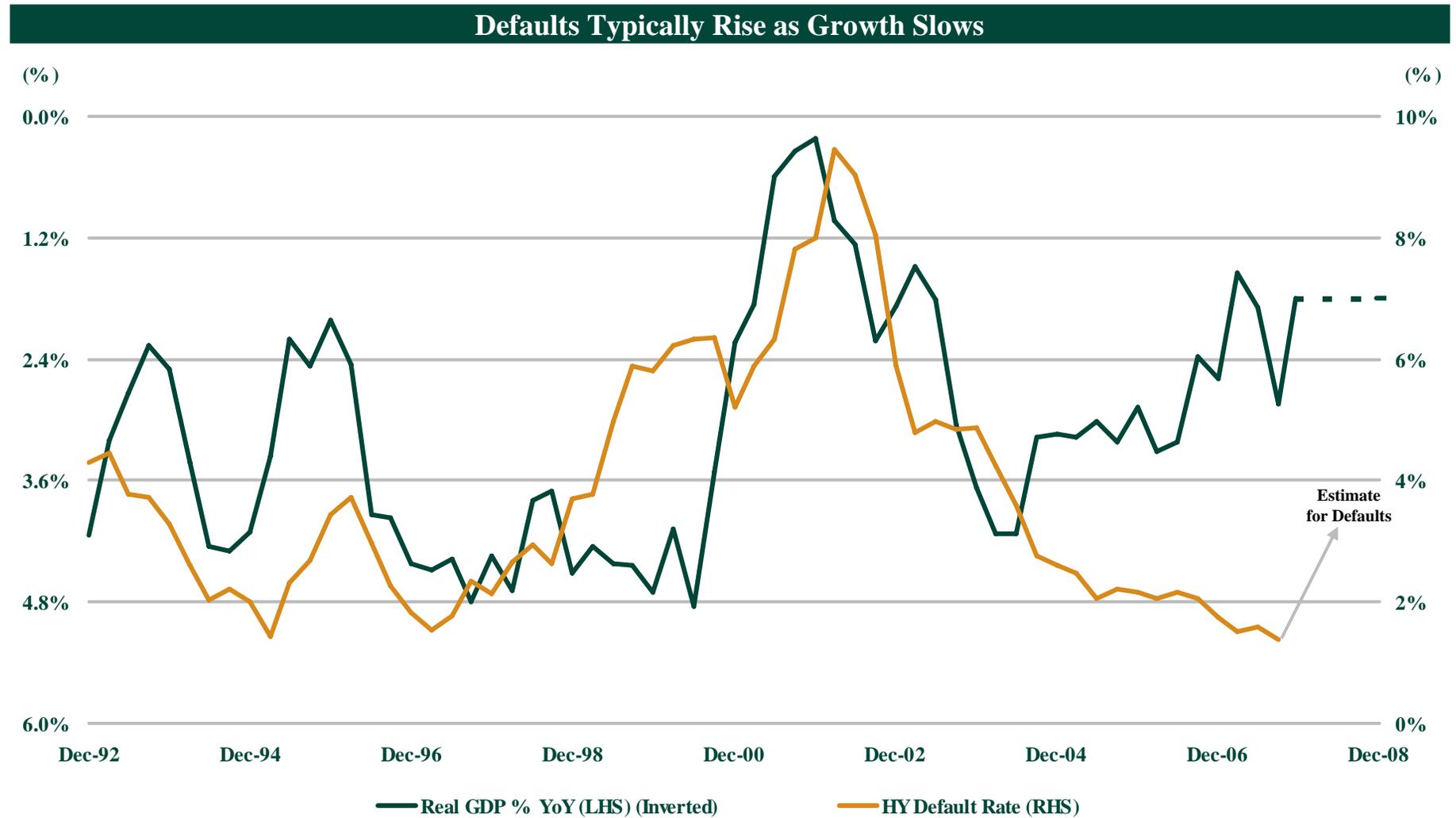
## Financial sector write-downs exceed \$290 billion

\$U.S. in billions



Source: As of April 14, 2008. Lehman Brothers Research

Overall, as the market struggles with liquidity and asset quality issues and fundamentals deteriorate across industrials due to weaker growth, we expect default rates to pick up from multi-year lows



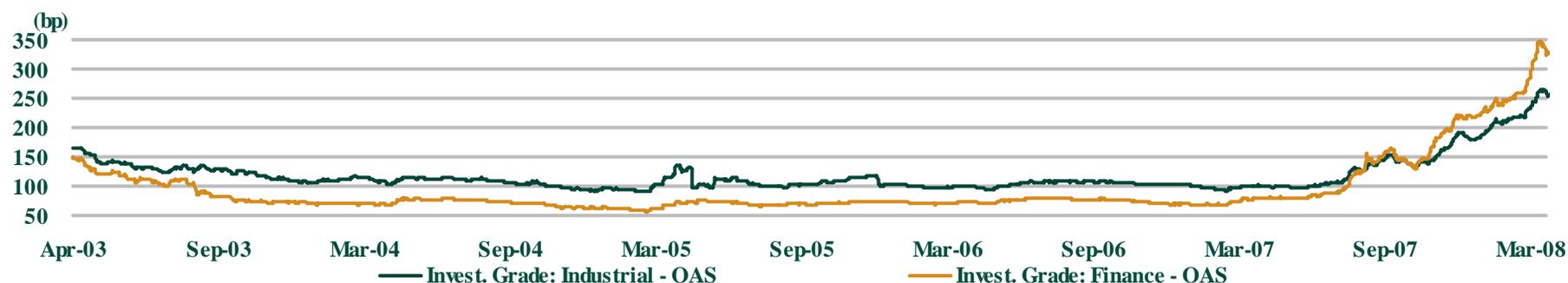
Source: Lehman Brothers, Federal Reserve, Moody's.

We remain generally bearish on investment grade credit despite current valuations. However, this has become a more bifurcated view.

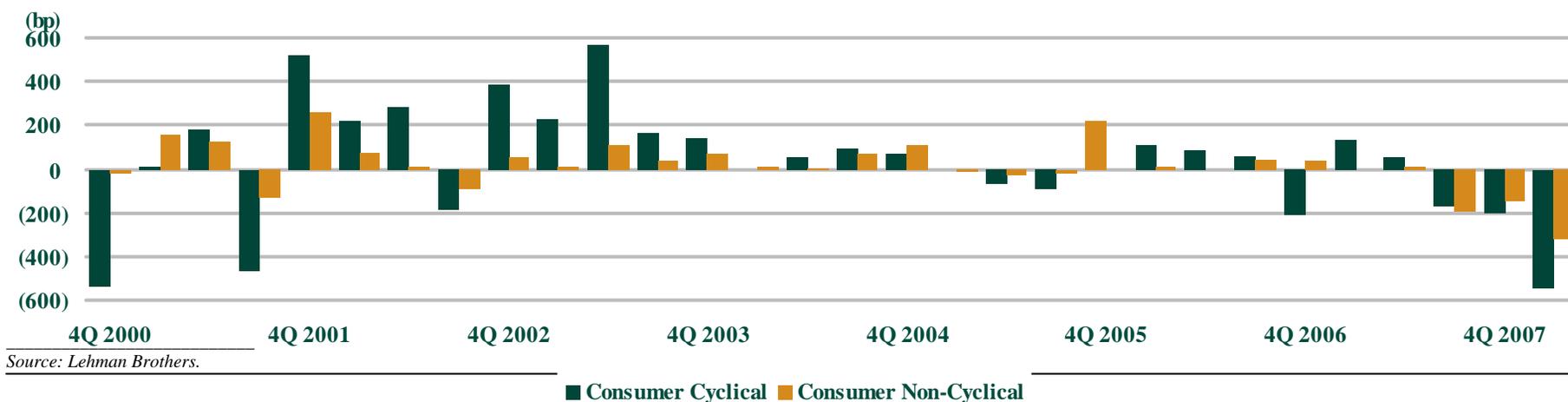
**High quality financials, especially money center banks and brokers provide attractive value but we remain cautious on independents and regional banks due to ongoing asset quality concerns.**

**Given our expectations for slower growth we believe that the credit cycle turn will continue. We thus expect more cyclical sectors to remain under pressure.**

### Industrial vs. Financial OAS



### Consumer Cyclical vs. Non Cyclical – Excess Returns



Source: Lehman Brothers.

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