

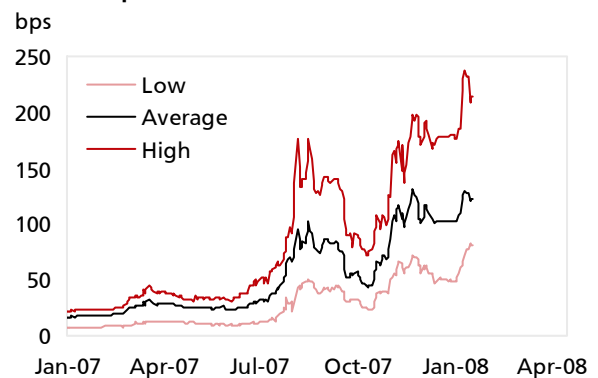
Trades: Swap spread narrowers & swap spread curve normalizers

- USD Libors continue to fall and this is easing somewhat the stress in the US interbank market. However, we caution that this is not a sign of lower credit risk in the banking sector. It is also not a signal that the worst is behind us in this credit crunch.
- While the *liquidity premium* may be diminishing amid liquidity injections from the Fed, *credit risk premia* remain high.
- We hence think that swap spread tightening and swap spread curve normalization have run their course for a while. The next big move down in swap spreads will only come amid an unwinding of the flight-to-quality trade.
- We recommend to stay away from these trades throughout the current earnings season and to re-enter only once there are signs that risk aversion is subsiding or levels improve substantially.

A substantial downward adjustment of risk premia is unlikely until uncertainty with regard to the health of banks' balance sheets subsides and the outlook for the US economy improves. Risk premia could fall once we get through the current earnings season without major negative surprises, but they are likely to remain at fairly high levels because recession fears continue to linger. In fact, many measures of credit risk are still rising.

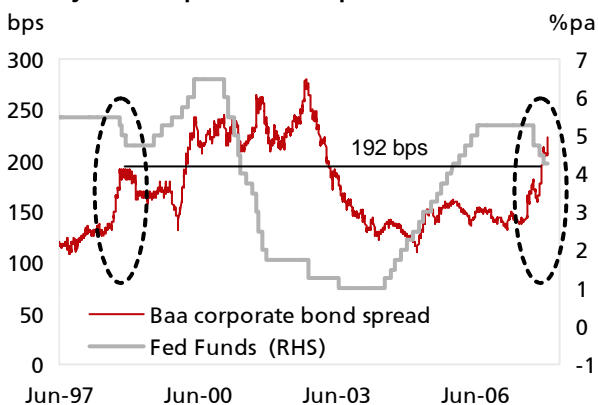
First, credit default swaps (CDS) spreads for major US banks suggest that perceptions of credit quality have deteriorated over the last three weeks¹. The chart on the right shows the high, low and average 5Y par CDS spreads for major US banks (Bank of America, Bear Stearns, Citigroup, Goldman Sachs, JP Morgan, Lehman Brothers, Merrill Lynch, Morgan Stanley). Clearly, the price of credit risk protection is still rising.

Par CDS spreads of US banks

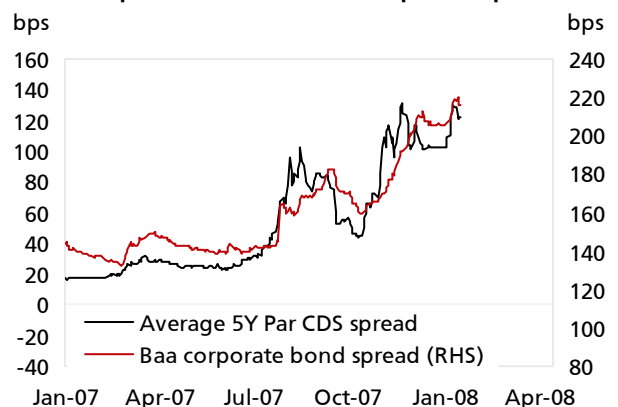


Second, there is no reason for cheer when it comes to corporate bond spreads. In the corporate sector of the US bond market,

Moody's Baa corporate bond spread & Fed Funds



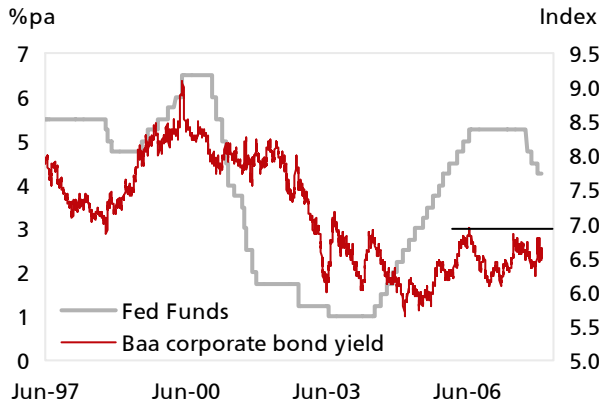
Par CDS spreads of US banks & corp bond spreads



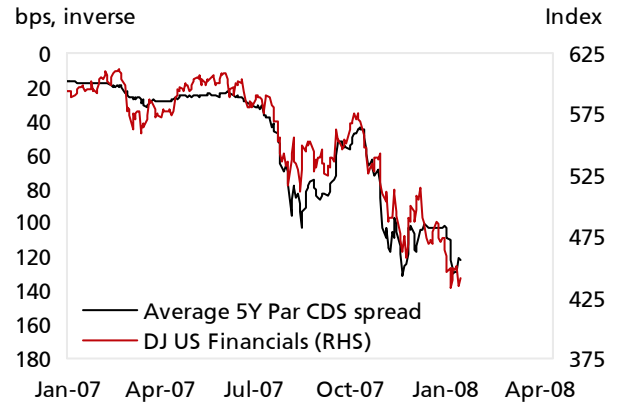
¹ Credit default swap (CDS) are bilateral contracts under which two counterparties agree to trade the credit risk of a third-party entity. That is, a protection buyer pays a periodic fee to a protection seller in exchange for a contingent payment by the seller upon a credit event (such as a default or failure to pay).

credit spreads of long-term bonds according to indices compiled by Moodys have risen above 1998 highs in the recent weeks to levels last seen between 1999 and 2001. Probably not surprisingly, corporate bond spreads have moved closely with banks' CDS spreads. Absolute yield levels, however, remain well below those in 1999-2001.

Fed Funds & Moodys Baa corporate bond yield level



Par CDS spreads of US banks & DJ Financials

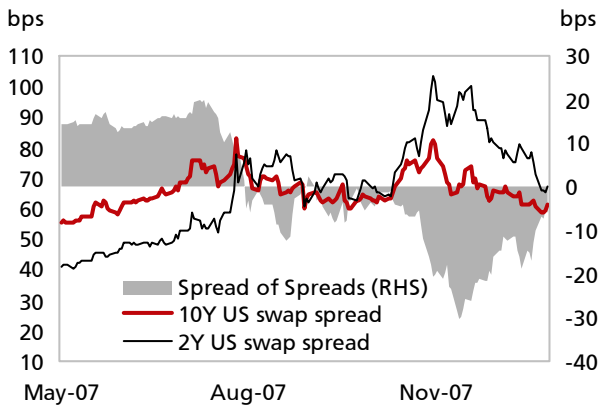


Lastly, bank valuations have continued to fall in the equity market. Price movements there too have exhibited a high correlation with CDS spreads. The DJ Financials Index has lost more than 25% since mid-2007. This compares with a correction of about 11% in the Dow Jones Industrial Average and the S&P 500 over the same period.

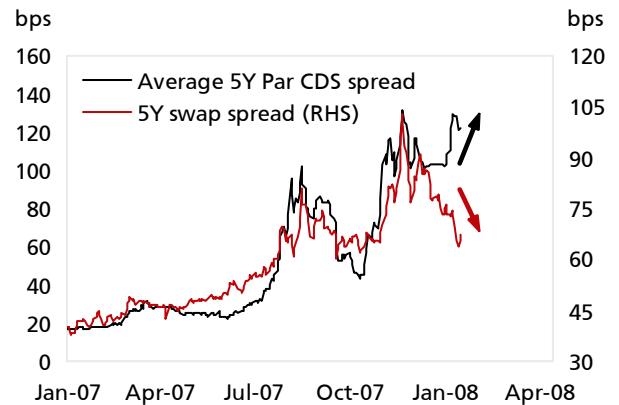
Swap Spreads

In contrast, swap spreads, which are essentially credit spreads too, have narrowed in both the 2Y and 10Y sector over the last couple of weeks and the swap spread curve has steepened from -30bps to -10bps over the same period. Clearly, swap spreads have behaved quite differently from CDS, corporate bond spreads and equities.

2Y, 10Y Swap Spread & Spread of Spreads

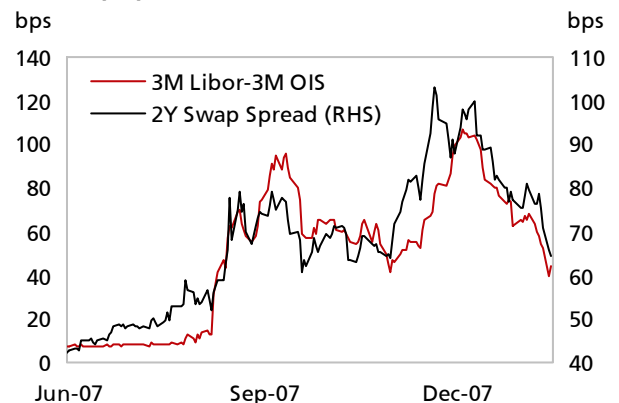


Par CDS spreads of US banks & swap spreads



Both, the fall in rates as well as the rise in the spread curve, are to a large extent the result of lower Libors. Spreads have been compressed (especially at the front end) as the floating leg's rates profile has shifted downwards substantially from mid December, bringing swaps closer to bonds, which have remained anchored by expectations for 125-150bps of cumulative Fed easing by the end of this year.

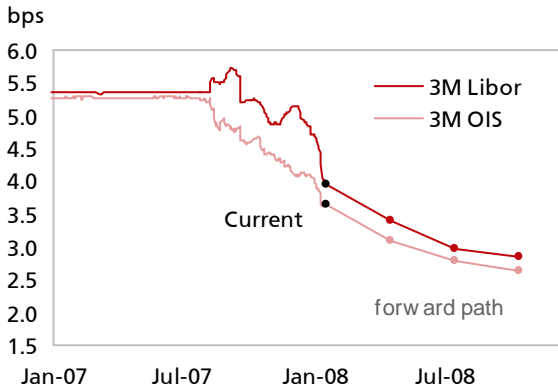
2Y Swap Spread vs 3M Libor - 3M OIS



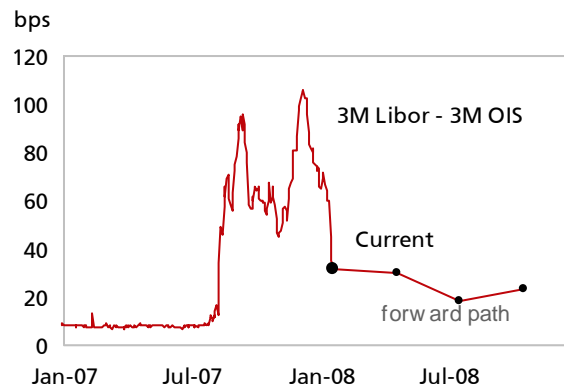
In line with market expectations, we think Libors could fall further in the coming weeks. A fall in the 3M rate to 3.0% from 3.95% currently over the coming three to six months, as priced in by the market, is reasonable given expectations for further Fed easing. At that level 3M Libor would still trade 20bps above the 3M OIS rate, i.e. at a spread that is 10bps below current levels but also still 10bps higher than under normal conditions.

The fall in Libors relative to the corresponding OIS rates would mean somewhat more downward pressure on swap spreads. However, as the charts below show, after a 70bps correction since mid-December, the Libor/OIS spread tightening has likely run its course for a while.

3M Libor vs 3M OIS: historical and forward



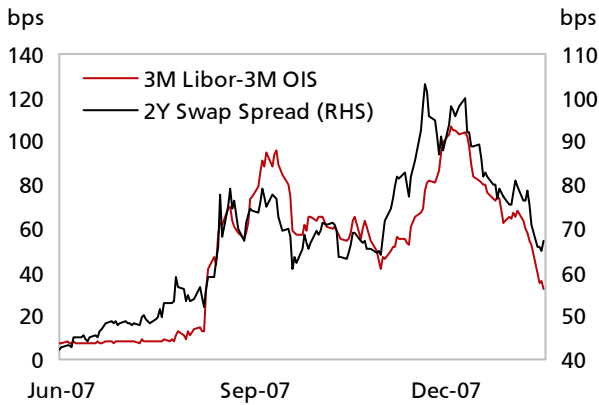
3M Libor vs 3M OIS Spread: historical and forward



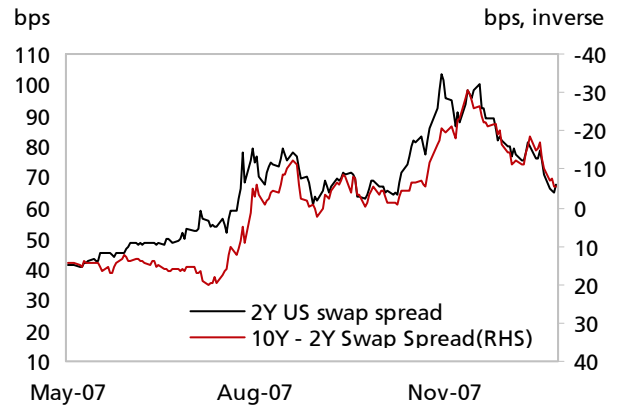
Undoubtedly the upcoming bank earnings reports are critical for swap spreads. We expect further downward pressure on swap spreads unless perceptions of bank credit quality deteriorate dramatically further and send Libors sharply higher. In fact, recent history suggests that swap spreads, contrary to other credit spreads, could narrow somewhat further amid an improving demand/supply situation for term funds, even if CDS and corporate bond spreads remain high.

We take the recent divergence between Libors and CDS as a sign of better liquidity conditions and think Libors are unlikely to rise markedly again with the Fed having indicated that it intends to conduct biweekly auctions under its new Term Auction Facility for as long as necessary to address elevated pressures in short-term funding markets. This bodes well for swap spread narrowing. Moreover, with the 2Y bond trading at extremely rich levels, we also think it unlikely that major swap spread widening at the front end of the spread curve could come from lower bonds yields.

2Y Swap Spread vs 3M Libor - 3M OIS



Swap Spread Curve vs 2Y Swap Spread



Bottom line, with Libors back close to normal levels and short-dated bonds at rich levels, we think that swap spread tightening and swap spread curve normalization have run their course for a while. With no more substantial downward pressure from Libor/OIS spread contraction, the next big move down in swap spreads will only come amid an unwinding of the flight-to-quality trade, which we don't expect to happen in the weeks ahead. We hence recommend to stay away from these trades throughout the current earnings season and to re-enter them only once there are signs that risk aversion is subsiding or levels improve substantially on negative news. As long as a flight to quality premium remains priced into short-dated Treasuries, swap spreads will remain fairly wide.

Sources: Bloomberg, DBS Bank

Singapore Sales Team

Investor Advisory:

Donne Lee	(65) 6878 5821
Rina Ooi (Fixed Income Distributions)	(65) 6878 2088
Sebastian Lee, Cecila Tan, Ian Gan (Active Trading Group - Margin FX)	(65) 6878 6775
V. Arivazhagan (Passive Managed Products)	(65) 6878 8264
Wilson Teo, Tricia Tai, Wong Sook Kuan,	(65) 6227 2273

Regional Structured Product Advisory:**(65) 6222-3200**

Thio Tse Chong
Yip Peck Kwan, Amiel Gaa, Brandon Sim, James Tan

Toll Free from:
 US - 1866 277 3324
 Japan - 0053 165 0042
 Korea - 00308 651 0000
 Thailand - 0018 0065 6486
 Taiwan - 00801 651 509
 Thailand - 0018 0065 6486
 Philippines - 1800 1651 0393
 Thailand - 0018 0065 6486
 India - 0006517 (2) 6222 320
 Indonesia - 0018 0365 7716
 Malaysia - 1800 801 464

Corporate Advisory I:**(65) 6878 5367/8**

Teo Kang Heng
Rebekah Chay, Wesley Foo

(65) 6223 2292/ 3383/ 6222 2393

Corporate Advisory II:**(65) 6878 2090/1**

Liang Eng Hwa
Loo Hock Leong, Lisa Wong

(65) 6224 5433

Debt Capital Market:

Lum Moe Tchun

(65) 687 88102

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