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MORGAN STANLEY RESEARCH

Morgan Stanley & Co. LLC

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North America

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Events

All events require advance registration. Clients should contact their Financial Advisors.

Morgan Stanley Managed Care Town Hall
March 22, New York

Morgan Stanley Canadian Banks Conference
March 22, Boston

Morgan Stanley India Corporate Access Day
March 26–27, New York

Morgan Stanley European Financials Conference
March 27–29, London

US Economic Outlook

Value	2010	2011e	2012e	2013e
Real GDP Growth (Q4/Q4, %)	3.1	1.6	2.2	1.7
CPI Inflation (% change yr ago)	1.2	2.2	2.1	1.7

e = Morgan Stanley Research estimates

NORTH AMERICA

Best Ideas

Best Ideas are our leading stock investment insights — the best combination of highly differentiated research, favorable risk-reward profiles, and clear catalysts:

Differentiated research. We seek out-of-consensus thinking that incorporates fresh data and analysis. Analysts are expected to identify "what's in the price" and present a compelling challenge to market assumptions on key investment debates.

Favorable risk-reward profiles. Scenario analysis lies at the heart of our disciplined approach to research, so we look beyond single-point estimates and price targets. We examine the full risk-reward profile of the investment, assessing the range of plausible outcomes and the scenario skew as indicators of analyst conviction.

Clear catalysts. We require a clear roadmap for upcoming data and events in the following few months that can help corroborate our analysts' investment theses and drive a discernable change in market perceptions.

Additions and removals of stocks are published as part of regular, stock-specific reports.

Important Note: Best Ideas is not and should not be considered a portfolio. Each investment idea is chosen based on its own merit and without any consideration of the other investment ideas chosen. Specifically, there has been no effort to mitigate the risks of investing in any collective group of Best Ideas. Concepts important to a balanced portfolio, such as negative correlation and diversification, have not been considered. Treating Best Ideas as a portfolio will subject you to the risk of losing all or a substantial portion of your investments.

Morgan Stanley Research
Stock Selection Committee

Company	Ticker	Mar 6 Price($)	Price Target	Valuations ($): Bull	Base	Bear	EPS ($)* 2012	2013	Consensus EPS ($)* 2012	2013	Annual Growth in EPS* 2012-2014	P/E* 2.12	2013	P/B 2012	2013
BorgWarner	BWA.N	79.55	88	100	88	50	5.70e	6.67e	5.41e	6.41e	11.1%	14.0	11.9	3.2	2.5
CBS Corp.	CBS.N	29.08	34	42	34	22	2.39e	2.77e	2.34e	2.67e	11.4%	12.2	10.5	1.8	1.6
CenturyLink	CTL.N	38.61	50	55	50	34	2.45e	2.55e	2.40e	2.42e	(0.8%)	15.8	15.1	1.2	1.2
RenaissanceRe	RNR.N	72.15	87	104	90	60	9.63e	11.03e	8.17e	8.96e	14.0%	7.5	6.5	1.1	0.9
Schlumberger	SLB.N	73.79	100	140	100	54	4.69e	6.03e	4.69e	5.72e	–	15.7	12.2	2.7	2.4
Teradata	TDC.N	63.62	75	100	75	50	2.71e	3.20e	2.62e	3.02e	15.1%	23.5	19.9	5.8	4.6
Target	TGT.N	56.49	64	70	64	42	4.23e	4.76e	4.23e	4.82e	18.1%	13.3	11.9	2.4	2.5
Under Armour	UA.N	88.84	106	130	106	62	2.34e	3.30e	2.32e	2.98e	35.2%	38.0	27.0	6.0	4.9
Union Pacific	UNP.N	106.80	132	144	132	94	8.20e	9.40e	8.08e	9.28e	14.5%	13.0	11.4	2.7	2.4

Company	Ticker	Dividend Yield 2012	2013	FCF Yield Ratio 2012	2013	RNOA 2012	2013	Net Debt/EBITDA 2012	2013	Interest Cover 2012	2013
BorgWarner	BWA.N	0.0%	0.0%	4.1%	5.8%	22.4%e	23.8%e	0.0e	NM	21.0e	23.4e
CBS Corp.	CBS.N	1.4%	1.5%	10.3%	12.7%	11.1%e	12.5%e	1.7e	1.3e	7.3e	8.3e
CenturyLink	CTL.N	7.5%	7.5%	18.4%	13.0%	5.7%e	6.3%e	2.5e	2.4e	2.9e	3.0e
RenaissanceRe	RNR.N	1.5%	1.6%	–	–	16.4%e	16.7%e	1.4e	1.3e	11.3e	11.9e
Schlumberger	SLB.N	1.5%	1.5%	3.7%	3.8%	15.7%e	18.6%e	0.6e	0.5e	32.6e	41.3e
Teradata	TDC.N	0.0%	0.0%	2.9%	4.3%	41.6%e	45.3%e	NM	NM	NM	NM
Target	TGT.N	2.2%	2.6%	6.9%	24.7%	9.6%e	9.4%e	2.6e	2.0e	5.1e	6.1e
Under Armour	UA.N	0.0%	0.0%	0.5%	2.5%	20.1%e	23.8%e	NM	NM	11.4e	19.5e
Union Pacific	UNP.N	2.3%	2.6%	5.0%	5.6%	15.3%e	16.2%e	1.2e	1.1e	8.2e	9.3e

Source: Thomson Reuters, Morgan Stanley Research
** Uses consensus methodology; all other metrics use ModelWare methodology. For valuation methodology and risks associated with any price targets above, please email morganstanley.research@morganstanley.com with a request for valuation methodology and risks on a particular stock.*

NORTH AMERICA

Best Ideas

Research Updates on Best Ideas

RenaissanceRe (RNR, $72.15, Overweight, In-Line Industry view) *Gregory W. Locraft*

Soft market ends in 4Q. Broadening Y/Y improvement in pricing power proves the soft market has ended and should trend higher in 2012 and beyond; however, a hard market remains elusive. We reiterate our Overweight rating on RNR. With the P&C cycle improving, we recommend the strongest balance sheets — companies with ample excess capital to drive double-digit returns to shareholders through organic growth and/or buybacks/dividends. A large capital cushion and valuation near record lows also offers downside protection from unexpected losses while waiting for a bullish thesis to prove out.

See page 21

Under Armour (UA, $88.84, Overweight, In-Line Industry view) *Joseph Parkhill*

All charged up and ready to grow. Charged Cotton has been well received by consumers and is a large growth opportunity, our February AlphaWise survey indicates. We estimate that Charged Cotton could be a $300–450 million business in 5 years. We expect Charged Cotton to be one of the contributors to UA's sales acceleration in 2013.

See page 53

Union Pacific (UNP, $106.80, Overweight, Attractive Industry view) *William Greene*

More to the rail story than coal. Investors focused on weak coal trends may be under-appreciating the strength in volume growth benefiting other segments. While coal weakness remains a risk to the rails, we believe that investors are under appreciating the strength in other traffic segments, notably merchandise and intermodal. As such, we revisit and reaffirm our "Follow the Revenue Leaders" call — including UNP, one of our top picks for investors who want to insulate themselves from the coal debate weighing on the Eastern rails., as we believe UNP has upside to our 2012 estimates if recent volume trends follow normal seasonality.

See "Fast Track: More To The Rail Story Than Coal", March 5, 2012

Strategy and Economics

March 4, 2012

US Equity Strategy
Stock Ideas -
A "Quantamental" Approach

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Last month we began offering favored and not favored stock ideas, based on our quantitative frameworks and our fundamental analysts' recommendations. We break the screens into various buckets to address the needs of different investment disciplines, including by market capitalization (large and small) and style (growth, value, dividend income). As a reminder, we present three options for generating stock ideas:

1) Screens: Use the new monthly screens published here (see our full note for additional screens). For example, Exhibit 1 contains high-quality stocks currently rated Overweight by our analysts and in the top two quintiles of our 3- and 24-month alpha models.

2) Website: In order to search for stock ideas, or decompose our quantitative forecasts to see which factors we are using to predict return in different horizons and whether these factors are positively or negatively contributing to the forecasted alphas today, please see our alpha screener, at www.morganstanley.com/equitystrategy, or ask your Morgan Stanley salesperson for help.

3) Portfolio: Use our MOST Portfolio, which is run with a large-capitalization, low-turnover bias to mirror the challenge facing a long-only portfolio manager with classic turnover and risk constraints.

Compared to last month's stock screens, we observe MON, EMR, TRW, and FCX as incrementally more attractive, GOOG ($622) and AMZN as incrementally less attractive. Insurance names also screen poorly.

Exhibit 1

High Quality Names in Top Quintiles of MOST and BEST, rated Overweight by Morgan Stanley Analysts

Ticker	Company	Price ($)	Market Cap ($M)	MOST Quintile Latest	BEST Quintile Latest	Quality Rating	Analyst Rating
CVX	Chevron Corp.	109.76	216,992	Q1	Q1	1	Overweight
PFE	Pfizer Inc.	21.49	165,193	Q1	Q2	1	Overweight
MON	Monsanto Co.	80.15	42,913	Q1	Q2	1	Overweight
TGT	Target Corp.	56.76	37,989	Q1	Q2	1	Overweight
EMR	Emerson Electric Co.	50.18	36,854	Q1	Q1	1	Overweight

Source: Factset, Morgan Stanley Research. For important disclosures regarding companies that are the subject of this and subsequent screens, please see the Morgan Stanley Research Disclosure Website at www.morganstanley.com/researchdisclosures.

Exhibit 2

"Low Quality" Equities in Bottom Quintiles of MOST and BEST, Rated Equal or Underweight by Our Analysts

Ticker	Company	Price ($)	Market Cap ($M)	MOST Quintile Latest	BEST Quintile Latest	Quality Rating	Analyst Rating
AMZN	Amazon.com Inc.	180.04	81,931	Q5	Q5	4	Equal-Weight
EW	Edwards Lifesciences Corp.	72.30	8,248	Q5	Q5	4	Equal-Weight
VRTX	Vertex Pharmaceuticals Inc.	40.37	8,491	Q5	Q4	4	Equal-Weight
XL	XL Group PLC	20.97	6,620	Q5	Q5	4	Equal-Weight
SWKS	Skyworks Solutions Inc.	27.37	5,157	Q5	Q5	4	Equal-Weight

Source: Factset, Morgan Stanley Research

Strategy and Economics

Exhibit 3

Value Companies According to Our Value/Growth Model that Are Preferred by MOST, BEST, and Our Analysts

Ticker	Company	Price ($)	Market Cap ($M)	MOST Quintile Latest	BEST Quintile Latest	Value/ Growth	Analyst Rating
CVX	Chevron Corp.	109.76	216,992	Q1	Q1	V	Overweight
FCX	Freeport-McMoRan Copper & Gold Inc.	42.91	40,694	Q1	Q1	V	Overweight
SPLS	Staples Inc.	15.38	10,702	Q1	Q1	V	Overweight
UAL	United Continental Holdings Inc.	20.41	6,753	Q1	Q1	V	Overweight
TRW	TRW Automotive Holdings Corp.	45.48	5,628	Q1	Q1	V	Overweight

Exhibit 4

Value Companies Not Preferred by Our Quant Models and MS Analysts

Ticker	Company	Price ($)	Market Cap ($M)	MOST Quintile Latest	BEST Quintile Latest	Value/ Growth	Analyst Rating
XL	XL Group PLC	21.02	6,636	Q5	Q5	V	Equal-Weight
TMK	Torchmark Corp.	48.56	4,950	Q5	Q4	V	Underweight
GNW	Genworth Financial Inc. Cl A	8.96	4,398	Q5	Q5	V	Equal-Weight
AXS	AXIS Capital Holdings Ltd.	31.45	4,115	Q5	Q5	V	Equal-Weight
SFG	StanCorp Financial Group Inc.	39.58	1,752	Q5	Q5	V	Underweight

Exhibit 5

Growth Companies Preferred by MOST, BEST, and Our Analysts

Ticker	Company	Price ($)	Market Cap ($M)	MOST Quintile Latest	BEST Quintile Latest	Value/ Growth	Analyst Rating
MON	Monsanto Co.	80.15	42,913	Q1	Q2	G	Overweight
EMR	Emerson Electric Co.	50.18	36,854	Q1	Q1	G	Overweight
CF	CF Industries Holdings Inc.	189.23	12,390	Q1	Q1	G	Overweight
WU	Western Union Co.	17.44	10,819	Q1	Q2	G	Overweight
ABC	AmerisourceBergen Corp.	37.30	9,617	Q1	Q1	G	Overweight

Exhibit 6

Growth Companies Not Preferred by Our Quant Models and MS Analysts

Ticker	Company	Price ($)	Market Cap ($M)	MOST Quintile Latest	BEST Quintile Latest	Value/ Growth	Analyst Rating
AMZN	Amazon.com Inc.	180.04	81,931	Q5	Q5	G	Equal-Weight
FTI	FMC Technologies Inc.	51.19	12,238	Q5	Q5	G	Underweight
EW	Edwards Lifesciences Corp.	72.30	8,248	Q5	Q5	G	Equal-Weight
VRTX	Vertex Pharmaceuticals Inc.	40.37	8,491	Q5	Q4	G	Equal-Weight
BCR	C.R. Bard Inc.	93.47	7,857	Q4	Q5	G	Equal-Weight

Source: Factset, Morgan Stanley Research

Strategy and Economics

March 5, 2012

US Economics
Fed Thoughts: QE or Not QE?

Morgan Stanley & Co. LLC

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For some time, our call has been that the Federal Reserve will undertake additional balance-sheet action in the first half of 2012. This view has been in and out of consensus thus far this year, even though the Fed appears to have been adhering to a consistent story line throughout. Three observations support our assessment that there is a three-in-four chance of unconventional action by June.

1) The political calendar makes it likely that the Fed will want to keep a low profile in the second half of the year's campaign season. If the window for a policy move closes by June, the hurdle for action is lower before then.

2) Economic slack persists and inflation is running below the Fed goal in its medium-term projection. The dual shortfall provides justification and political cover for action.

3) Core decision-makers at the FOMC have consistently pointed to reasons the economy's performance will be subpar and at significant risk in the near term. We share the view that the fillip to growth associated with a restocking of inventories is fading and that real GDP growth will slow notably in the current quarter. Anxiety-inducing headlines that the economy is losing steam will be conducive to Fed action.

The most likely form of that action is open market purchases of Treasury and mortgage-backed securities funded through the creation of reserves — Quantitative Easing 3 (QE3) — at the April or June meetings. We expect it to total around $500-700 billion. This would dovetail with the expiration of the ongoing Operation Twist at the end of June.

An attractive alternative would be to expand the scale and scope of Operation Twist. It could stretch purchases out until the end of the year, implying total new purchases of about $400 billion, and include MBS as well as Treasuries. Moreover, the Fed would use the tools of monetary policy to sterilize the effects on the balance sheet, such as continuing to sell shorter-term Treasuries and arranging temporary reserve-draining operations. Operation Twist 2 (OT2) would allow the Fed to act sooner, say at the March or April meeting, and frame the initiative as support for the ongoing economic expansion. It would also buy some insurance from criticism by keeping the overall size of the balance sheet unchanged.

We made this Fed call late last year (see *Fed Thoughts for 2012: Into the Heart of Darkness,* December 27, 2011), and the first order of business is to mark it to market in light of what we have since learned. The Morgan Stanley outlook is that the US economy will expand this year and next at around a 2% rate, about that of potential output growth. Unfinished business from the financial crisis leaves the mortgage market impaired and households needing to improve their balance sheets. This balance-sheet improvement is likely to come the hard way — by increased saving — rather than through significant capital gains on equity and real estate holdings. That is because the forward calendar is chock-full of events in the US and Europe that may set back global financial markets and the economy. As a consequence, we think investors will not retain a durable-enough conviction about fundamentals to support an extended market rally. Without a continuing boost from wealth creation, the economy grows at trend. If so, resource slack and inflation will move sideways.

Some data have improved, of course. Readings on the labor market, including initial claims for unemployment insurance, have been decidedly more upbeat. We know now that real GDP expanded at a 3% annual rate in the fourth quarter of last year. However, about 2 percentage points of that growth owed to inventory stock-building. This is not the basis for sustained robust expansion, and as inventory levels settle down, we expect real GDP to slow appreciably. Indeed, our tracking estimate of growth this quarter clocks in at only 1%, down from 2.2% in late January.

The Federal Reserve has seen these data and seems to share a similarly cautious assessment of the outlook, at least judging by the summary of the economic projections of FOMC participants at the January meeting. It has a medium-term forecast in which it falls short of both parts of its dual mandate of maximum employment and stable prices. In other aspects of its communications, the Fed has been transparent in its intent. It apparently does not want market participants to get too enthusiastic about the outlook. Three specific aspects of their message deserve more attention.

Stronger incoming data have mostly been ignored by the Fed. There was almost no mention of favorable readings on activity and the labor market in the Fed's public statements earlier this year. Only late in the game, with the semiannual testimony to Congress, did Chairman Bernanke devote much attention to employment gains. Even so, the Chairman's reminder that "…the job market remains far from normal…" seemed to be the main takeaway.

Strategy and Economics

The emphasis is on the dark clouds, not the silver lining. Every Fed statement frets that "strains in global financial markets posed significant downside risk to the economic outlook." Deep down to their free-market bones, Fed officials are mostly Euro-skeptics who have trouble convincing themselves that a flawed currency union will survive. Fed economists working on the policy challenges posed by the zero bound to the nominal funds rate argue that it is best to front-load policy accommodation if there is a significant risk of an adverse event. That way, the economy is on a stronger footing if the blow does strike. The political calendar makes this insurance more important: Since the Fed likely wants to keep a low profile during the height of the campaign season, it should be quicker to act in the first half in anticipation of adverse shocks.

Follow the Fed and do not worry about inflation. The Fed has signaled in multiple ways that it doubts that a pickup in inflation is a material risk. It excised the sentence referring to monitoring inflation and inflation expectations from the January FOMC statement. In the summary of economic projections for that meeting, they forecast inflation to run below its goal in the medium term. The basic determinant of inflation in Fed-style models is resource slack, which they assert is considerable. After all, policy makers have not raised their assessment of the natural rate of unemployment or lowered the estimated growth rate of potential output. For good measure, the Fed raised its inflation goal a touch, to 2%, making sure there was white space between desired and actual inflation.

Reasons we are not wrong. Our three-in-four expectation of Fed action has moved out of consensus in the past few weeks. Some of the objections are easy to understand. After all, we also see a one-in-four chance that nothing happens. If the economy surges or equity investors continue to embrace risk, the Fed would cheerfully keep its plans on the shelf. Some of the objections, though, seem off kilter. In particular, we push back against three leading questions.

Doesn't the Fed need to see a fall in economic activity before it acts? No. In the discussion of the views of all the January FOMC meeting participants about whether additional balance-sheet changes were appropriate, a few preferred to act in 2012 and number remained open to that possibility "if the economic outlook deteriorated." That phrase just means that their forecast of economic growth has to soften, not that the level of activity has to drop. Also, that characterization was in the back of the book, which discussed the views of *all* those who are surveyed – the 5 governors and the 12 Bank presidents. What matters is the explanation earlier in the minutes that is limited to the 10 voters. There, a few members thought current and prospective economic conditions could warrant action "before long." Others would support this if "the economy lost momentum or if inflation seemed likely to remain below its mandate-consistent rate." In minutes math, a "few" plus "others" is likely a majority. Note that the first trigger only requires a slowing in economic expansion and that the second is already met in their published forecast.

Doesn't the recent run-up in oil prices take Fed action off the table? The Fed does have a problem because oil prices are 35% above their local bottom of October 2011. That creates an uncomfortable tension for a central bank, as headline inflation rises but spending gets hit because the US is a net importer of energy. However, Chairman Bernanke's academic work on the strong post-WWII association between energy price spikes and subsequent recessions puts part of the blame on the Fed's historical response. As long as inflation expectations are well anchored, the strong conclusion is that the central bank should ease policy to counter the blow to aggregate demand. Thus, the rise in oil prices and the risk that they go higher likely inclines the Fed to do more, not less.

How can Fed officials believe that further balance-sheet manipulation would work? Fed officials do not have outsized expectations for the efficacy of their policy instrument. But they feel a responsibility to use an instrument that most likely furthers their mission even if the benefits may be small. While the basis-point consequences of asset purchases might be modest, the Fed wants to be seen by the private and public sectors as willing to act when there is a need. For households and firms, QE3 or OT2 might boost confidence.

Reasons we may be wrong. We see a three-out-of-four chance that the Fed acts as the data soften and the equity rally fades. If the Fed is in a hurry or feels no need to push up inflation expectations, the action likely takes the form of sterilized asset purchases, i.e., the one-in-four chance of Operation Twist 2. Recent comments by Fed officials, along with press comments, make it more likely we are underestimating, not overestimating, their willingness to execute OT2. If the Fed needs to see some slowing in the economy either to get internal agreement or external insurance, the policy initiative waits until the April or May meeting and more likely entails asset purchases funded with reserve creation, or QE3. This option, which we peg at a one-in-two chance, would also be favored if the Fed desired greater currency depreciation. The possibility of no action hinges on a happy outcome for the Fed. It would not ease if payrolls expanded robustly and equity markets extend their rally. This requires that politics at home and the sovereign and banking crisis abroad do not intrude.

Strategy and Economics

March 2, 2012

US Credit Strategy
Getting Paid for Ratings Transition

Morgan Stanley & Co. LLC

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Ratings are back in the spotlight. From ratings impacts on collateral deliverable by European banks that borrow at the ECB, to forthcoming ratings action from Moody's on US banks, to the role of ratings in proposed bank regulatory capital guidelines, credit ratings continue to play a prominent technical role with investors across credit. Fundamentally, given continuing macro-economic uncertainties, the potential for a global growth deceleration in the back half of the year transitioning into 2013, and an environment that could favor debt-financed share repurchases, many investors see growing risk regarding ratings transitions, specifically downgrades.

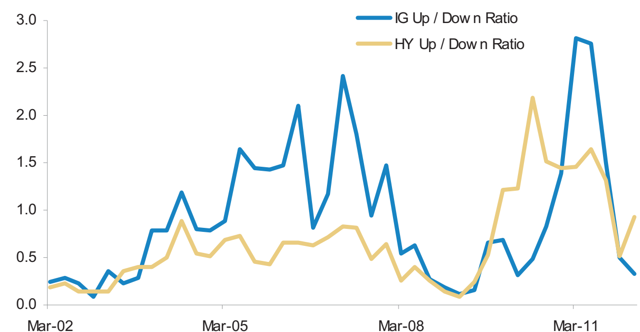
But quantifying the risk premium associated with ratings downgrades isn't straightforward, as other spread drivers such as liquidity or default risk profiles change coincidentally, making the downgrade's actual impact difficult to isolate. Using history as a guide, we examined this relationship and determined the implications for this risk premium going forward. In summary we found:

- Credit ratings have just started to drift lower, given economic improvement and a friendlier environment for capital-structure changes using leverage. This is particularly true in investment grade, but less so in high yield at this point.
- Breaking credit spreads into four components, the areas due compensation for defaults and/or ratings transition are small now but can change materially over time.
- Yes, expectations about moves in ratings can have a material effect, particularly at the high end of the ratings spectrum. But today's overall wide level of market spreads (at least compared to a long-run history) doesn't imply a market expectation of massive credit deterioration, in our view.

First, a turn in the upgrade/downgrade ratio? With systemic stresses fading, and financial conditions easing markedly over the last two months, we recently noted potential for a rising tide of shareholder-friendly activity that could manifest itself as debt-financed share buybacks (*Siding With Shareholders,* Feb. 17). And while it's still early in the year, Exhibit 1 shows that the upgrade/downgrade ratio of IG companies in the S&P 500 has taken a meaningful dip lower from the credit-favorable peak in early 2011. Activity in financials is a primary driver, but non-financials are seeing the same downgrade threats as organic growth decelerates. The HY story is less problematic, with a minor turn higher in the ratio this most recent quarter, as balance sheet discipline remains relatively high. Put simply, IG is no longer a deleveraging story (whereas HY has seen continued credit improvement), and ratings drift is a concern many IG investors should share.

Exhibit 1

A Dip in the Upgrade/Downgrade Ratio More Pronounced in Investment Grade than in High Yield



Source: Morgan Stanley, Bloomberg.

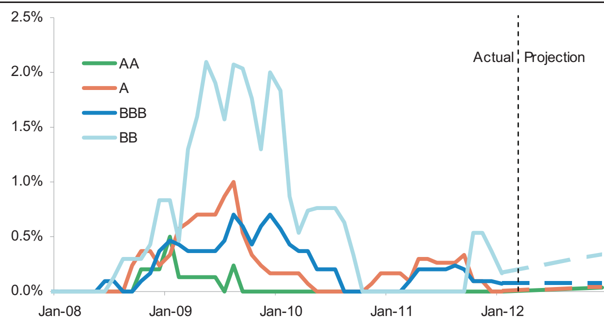
Breaking credit spreads apart into components. Clearly, credit spreads are meant to capture an assessment of any number of risks. This is particularly true in IG, where our prior work has shown that credit spreads historically have reflected breakeven levels that are typically a multiple of worst-ever defaults experienced over the life of an IG portfolio. As noted above, beyond just outright defaults, ratings transitions matter, and some compensation for bond liquidity is required as well. We have attempted to break an aggregate credit spread into four main components, discussed below, and explore how these metrics have evolved recently.

Component #1: Compensation for defaults. The first two outcomes – default and ratings downgrade – are fairly straightforward. In the default scenario, the spread component is calculated by taking the product of the previous one year's default probability and one-minus-the-recovery-rate, which we assume to be 40%. For AAA/AAs, defaults have been negligible, while A and BBB issuer defaults were non-zero towards the end of 2011 (Exhibit 2). Projections for defaults remain close to zero, with some marginal pickup forecast in BBs, but defaults alone don't seem to be a major fundamental driver of IG credit spreads.

Component #2: Compensation for downgrade potential. The downgrade scenario follows a methodology similar to that of defaults. We find the spread component by taking the product of the probability of downgrade during the past year

Strategy and Economics

Exhibit 2
One-Year Historical Default Rates Relatively Small But Can Still Help Explain Spread Changes



Source: Morgan Stanley Research, Moody's

and the incremental spread of the next lower ratings bucket six months ago. Here we assume that an average downgrade results in a one full rating drop. Yes, we may be overestimating the downgrade component embedded in spreads, considering the majority of downgrades, regardless of ratings buckets, are generally 1-2 notches and not a full rating cohort. But the limited meaningful spread data granulized at notches around a ratings cohort is a limiting factor in this analysis.

Component #3: Compensation for liquidity. Next we needed to determine the spread component attributable to liquidity. Here we regressed monthly spreads against an "inverted" time series of dealer holdings of corporates with maturities greater than one year to determine an estimate of the liquidity risk premium. The results imply that higher market liquidity translated to tighter spreads across the credit quality spectrum, matching our intuition.

Component #4: Compensation for the 'catch-all.' The non-downgrade non-default scenario is somewhat of a catch-all for the other risks/scenarios. This was calculated by taking the difference between the sum of spread components from defaults, downgrades and liquidity concerns, and the actual spread (of six months ago).

Putting numbers to the spread components. Our estimation of each component is more or less intuitive. Historically, the liquidity premium has comprised most of the risk premium, while compensation for defaults has typically been very small for IG. Downgrade risk is also a small component of the spread, but it has been rising across the credit-quality spectrum since mid-2011, as actual downgrades and concerns about future downgrades have become more prevalent.

We expect the downgrade-related risk premium to remain relatively high, while default premiums may remain low or fall further. Many high-grade issuers still possess strong balance sheets with large cash balances, suggesting that default becomes an even less frequent occurrence, keeping an already low risk premium in place. Meanwhile, downgrades have been increasing recently, particularly in the Financials space, as more than half of US downgrades year-to-date have been in the sector. And while we remain modestly constructive on IG credit and Financials generally, macroeconomic, regulatory and monetary headwinds are likely to persist in the short term, supporting a higher downgrade premium across both Financials and Non-financials.

What the outlook for ratings means for spreads. Ratings agency outlooks appear to modestly support our concern as their projected downgrades for 2012 remain relatively high, continuing the recent uptick. Using these projections, we can reverse engineer and then estimate future incremental changes to spreads over 2012. Furthermore, given the history, we can estimate the sensitivity of spreads to extreme downgrade rate scenarios to give a sense for the potential impact on risk premiums given a stronger or weaker than expected backdrop. We used minimum and maximum downgrade rates since 2007 to estimate the range of possible spread changes, and we show those ranges by ratings cohort in our *Credit Basis Report* of March 2.

So do ratings transitions really matter? In short, yes, but not as much as one might believe. Since the forecasts for downgrades are quite close to the past year's numbers, our methodology suggests spreads will stay more-or-less at current levels, assuming other factors are held constant (default expectations, liquidity concerns and the historical residual 'catch-all' component of spreads). This supports our viewpoint that credit is generally fairly priced given that index spreads (T+181 bps) are in the general zip code of our 'fair value' assessment of T+190bps. Alternatively, the wide level of spreads that persists today (at least versus a long-run history) cannot be explained by a market expectation of massive credit-quality degradation alone.

The one exception is AAs, as they had experienced a greater than usual number of Financials downgrades recently. The forecast now is for downgrade severity in this cohort to revert to historical norms, and as such AA spreads could tighten from here. Away from AA's, looking at the extreme scenarios for downgrades, we see that downgrade risk is somewhat limited to a +/-10 bp range of impact. While this may seem small for As and BBBs, it is important for the highest-quality credits, where a 10 bp move could account for nearly 10-20% of the current spread premium. But the tough reality remains that in analyzing IG credit spreads, many external factors – including day-to-day developments in Europe and US macro data – are much more likely to determine the path of spreads than the expectations of ratings moves alone.

Strategy and Economics

March 6, 2012

Global Cross-Asset Strategy
A Liquidity Lull

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Neil McLeish, Gerard Minack, Jason Draho

Central bank printing presses could be on idle for an extended period. The perceived success of the ECB's long-term refinancing operations (LTRO) in reducing tail risks, at least in the near term, means that quantitative easing in Europe is unlikely this year. In addition, the Fed is looking marginally less dovish than it did a few weeks ago, with our US economists suggesting there is a growing chance of extending Operation Twist rather than conducting QE3. Both of these developments reduce the chance of QE elsewhere.

The prospect of less monetary easing puts an even greater focus on growth. Our view has been that growth, not QE, was the primary driver of risk assets over the past few years, and the modest market reaction to the diminished prospects of more QE supports that. That direct relationship between growth and the markets should only be stronger if more QE is on hold. But growth also matters indirectly because it drives Fed action. Given the bullish sentiment of most investors, the market could continue to grind higher on a 'heads we win, tails you lose' mentality regarding growth: The market rises with good data, but it also rises with bad data because the Fed (and ECB) will open up the liquidity spigot as needed. Nothing like having your cake and eating it too!

Alas, this sanguine view isn't supported by the growth data sending strong risk-on signals. Indeed, US data continue to be mixed, with improved labor numbers offset by weakness in personal spending and income. Most confusing is the fact that we had a sizable drop in our US 1Q GDP tracking estimate from 2.2% in late January to 1% this week, at the same time that Bernanke acknowledged stronger data. Now with oil prices rising on Middle East tensions, and gasoline prices potentially reaching demand-destructive levels during the summer driving season, risks to growth can't be downplayed.

Is highly accommodative policy enough? All told, monetary policy is at least marginally less accommodative than was the case only a couple of weeks ago. For the US, Europe, and the rest of the world, we consider what monetary policy could look like and why.

US / Fed: Chairman Bernanke's comments did not change Vincent Reinhart's assessment that the probability of Fed action in 1H12 is 75%, with a 50% chance of QE3 by June and a 25% chance of extending Operation Twist (OT2) by early 2Q (see his US Economics comment in this issue). The Fed's desire to move sooner rather than later is motivated by the political calendar, as well as a desire to nurture the ongoing expansion. What has changed over the past few weeks is the increasing likelihood of OT2 at the expense of QE3.

Europe / ECB: With sovereign spreads continuing to come down and strong demand for post-LTRO peripheral debt auctions, further liquidity injections by the ECB look unlikely at this juncture. Indeed, our Europe economist Elga Bartsch now expects fewer refi rate cuts in 2Q, only 25 bp not 50 bp, and no longer expects QE sometime in 2H12 (*ECB To Do Less Later*, March 1). To us cynics, it's ironic that the unbridled success of the 3-year LTRO removes the prospect of further outright ECB balance-sheet expansion in the near term. Furthermore, in between the LTRO and QE debate, an important turn of events not so quietly took place – the ECB altered the game on private-sector involvement (PSI). To us, the fact that the ECB unilaterally swapped out its Greek bond holding into "new" bonds in order to avoid the imposed haircut set a clear precedent that private investors will likely be subordinated in the future. The unintended consequence of this is that it likely diminishes the market benefit to future ECB sovereign bond purchases, either through outright QE or through the existing securities market programme (SMP).

In addition, while lower funding stress is certainly a positive, it also alleviates the pressure on politicians in the euro periphery to undertake fiscal and structural reforms. The news that Spain relaxed its deficit reduction target is a case in point. Once again, European officials may have snatched defeat from the jaws of victory by relaxing too early.

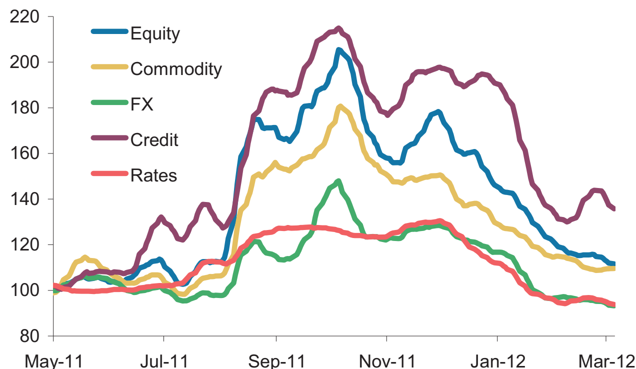
ROW / Emerging Markets: If the Fed and ECB both pass on the QE front, it will have knock-on effects for other central banks. For instance, the BoJ may not follow up on its recently announced $130 billion asset purchase plan with additional easing, especially with the yen weakening. But in EM, the net effect of less DM easing should be more easing. Without the Fed and ECB supplying liquidity, EM economies receive less implicit easing through capital flows. The monetary playbook suggests that if EM growth momentum continues to moderate, further easing is necessary. However, a complication relative to the so-called playbook for EM is the inflation risks posed by a rising oil price. Rate hikes are rather unlikely, but if oil and commodity prices generally maintain their upward trend, further easing could be off the table (see *Higher Oil Prices: What Does it Mean for AxJ?*, February 27). While much of EM is better equipped to handle the current energy price level than it was a year ago, it nonetheless is a binding constraint around monetary policy options.

Strategy and Economics

Grinding higher or tactical correction? The economic data offer a bounty for investors and strategists alike: There is something for everyone to justify their view. Bulls can point to the improving labor market conditions, while bears can emphasize weak income growth, persistently high leverage, or looming fiscal tightening. Thus, there is ammunition to argue both that markets can continue to grind higher and that a tactical correction is likely. Putting aside these subjective economic assessments, the price action also provides context for assessing the potential near-term market outcomes. For starters, volatility for all asset classes has fallen significantly over the past few months, returning to the lows prior to last summer's sell-off, with credit being the exception (Exhibit 1).

Exhibit 1

Volatility Has Fallen in All Asset Classes



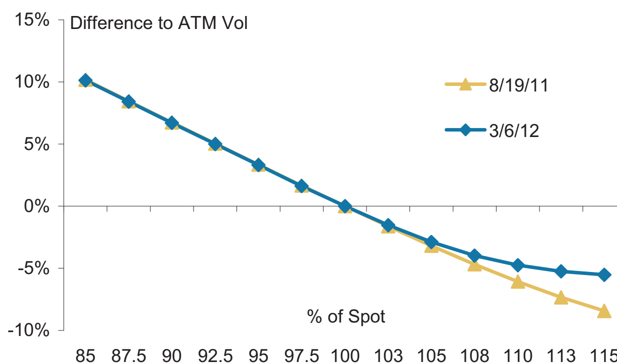
Source: Bloomberg, Quantitative and Derivative Strategies Group, Morgan Stanley Research

Focusing specifically on equities, three aspects of volatility tell the story of current investor thinking. First, realized volatility has fallen to exceptionally low levels. This reflects the slow, steady grind higher, as well as the Fed's effectively crushing volatility. However, since this is also occurring at low volumes, it suggests caution and complacency to some degree. Second, the implied volatility term structure is once again steep (its normal condition), which is a complete reversal from last August. Back then, the risks appeared to be front-loaded after the US credit rating downgrade, and on fears of a double-dip recession and sovereign stress in Europe. The current low short-term vol speaks to the fact that investors are fairly calm about the near term. However, the third aspect of volatility, the steep skew (Exhibit 2), implies that both tails are relatively fat, with investors willing to pay for downside and upside protection.

Putting this all together, it suggests a market in which investors are fairly comfortable with the view that risk assets can continue to grind higher in the near term, but they're also fearful of the other shoe dropping – whether on growth, Europe, or something else. And the interest in both tails is consistent with different interpretations of the growth data.

Exhibit 2

Skew Structure Implies Relatively Fat Tails



Source: Bloomberg, Quantitative and Derivative Strategies Group, Morgan Stanley Research

Bullish sentiment, underappreciated risks, and "tranquil" markets justify a cautious asset allocation, in our view. The low volatility suggests a complacency that isn't warranted given the risks, specifically on growth because of higher oil prices and in Europe after the LTRO and Greece bailout. On the latter, it's not obvious if a firewall exists around the rest of the periphery (or how it could work). Without a proper firewall, Portugal could be next in line for a potential debt restructuring. With these risks lingering, and valuations no longer overly cheap, we are clearly cautious on the markets, even though we fret about a continued grind higher without a tactical correction. We maintain our view that investors should continue to take risk down on the margin and implement tail hedges.

A few cross-asset implications from less QE. The prospect of less easing globally, if that comes to pass, shouldn't have much direct effect on equities and corporate credit. The performance of both asset classes should depend on how underlying economic growth evolves. However, equities have a greater sensitivity to growth at the margin, either way. The biggest effect of any change in monetary policy is likely to be more specific. Please see our March 6 *Cross-Asset Navigator* for details on areas where we would reduce risk and our existing trades that we would pare down.

Strategy and Economics

March 5, 2012

EM Macro Strategy
Fundamentally Flawed

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We see grounds for a correction in emerging-market risk assets in March. The key driver is likely to be the market pricing in weakening growth momentum – and higher oil prices would only serve to magnify these concerns. At the same time, prospects for imminent quantitative easing on the part of the Fed and ECB have receded. As a consequence, we think markets may price in more assertive easing by EM central banks. Mitigating the downside risk is the fact that funding market conditions have continued to improve, and market positioning in EM is reasonable. For details see our March 5 *Global EM Investor.*

On a cross-market view, we favor local bonds and rates this month over currencies and credit. We recommend reducing local duration outright and favouring the front end of curves (on a duration-equivalent basis). Long linkers and inflation breakevens may prove a reliable hedge against higher oil prices and geopolitical concerns. Credit is likely to outperform broader risk markets owing to favourable positioning. We recommend sustaining overexposure to commodity currencies and credit.

EM risk assets remained biased towards more strength through February, though the rally has slowed considerably from that seen in January. US economic strength has shown signs of faltering, but Europe has avoided for now a disorderly Greek default and completed a second 3-year LTRO with strong take-up, which helped keep investor risk appetite from diminishing, broadly speaking. Ongoing geopolitical concerns have kept the supply-risk premium on oil at elevated levels, prompting differentiated performance across EM, favouring commodity exporters over importers.

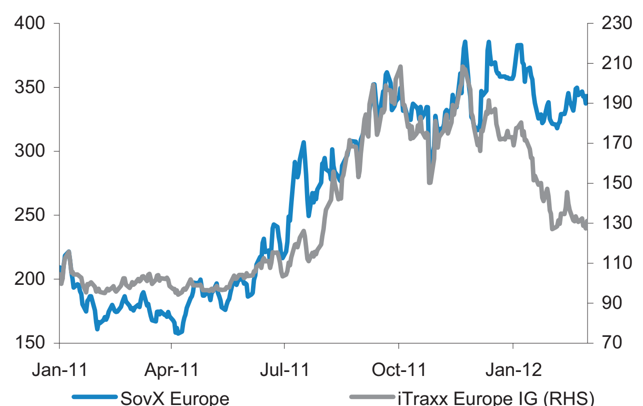
Looking for a tradable correction. With Greece near to securing a second package and the go-ahead on a debt restructuring operation, it's all systems go for a sustained run-up in EM risk markets – right? Not so fast. We argued for layering downside-risk hedges into portfolios last month, and this month we foresee a tradable correction.

Implementation remains the key risk for Greece. At the same time, the cohesiveness of policy response to ongoing European sovereign risks is likely to garner attention in the coming weeks. The viability of Portugal under the first bailout programme is increasingly in the spotlight, and the French elections loom on the horizon. Also, there are increasing signs of austerity fatigue, whether from Ireland or Spain. Ireland's call for a public referendum on the EU fiscal treaty and Spain's fiscal slippage relative to plan – a projected fiscal deficit of 5.8% of GDP versus 4.4% agreed upon with the EU – show growing public strains in pressing the austerity route.

And as much as the 3-year LTRO has served as a financing vehicle for Europe's banks, there's as yet no durable official backstop (firewall) to European sovereign problems. Under increasing consideration is intervention on the part of the ECB (via the SMP) in periphery bond markets. The potential subordination of private holders from official intervention is a factor that may become more readily priced into periphery bond markets, in the form of lower recovery values – lower prices and higher credit spreads. This would raise the cost of financing for issuers, EM included. But curiously, this dynamic does not yet appear to be reflected in broader credit and risk markets (see Exhibit 1).

Exhibit 1

SovX Europe and iTraxx Europe Spreads (bp)



Source: Morgan Stanley Research

Growing pains. The more pertinent consideration for markets in March is the potential for disappointment regarding global growth prospects. And supply-side disruptions leading to higher oil prices, on the back of geopolitical concerns, may only serve to exacerbate these concerns. This may also push back the feasibility of the Fed's engineering outright QE.

Strategy and Economics

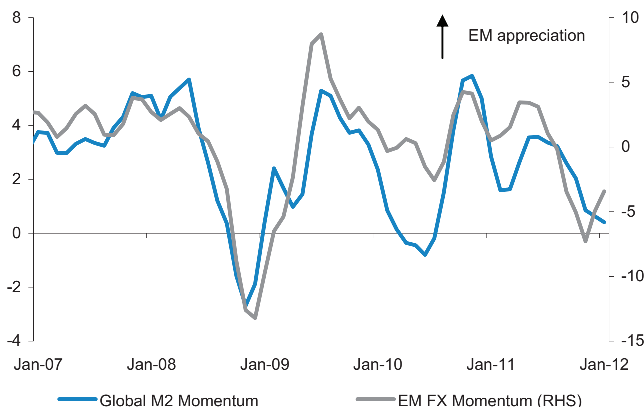
Our economists' US GDP tracker is currently highlighting 1% growth for 1Q (down from 2.2% earlier this year). For EM, we've consistently highlighted the weaker growth momentum, which has manifested itself in broadly lower-than-expected economic data. We believe that it's only a matter of time before the market prices in this out-turn.

Domestic demand conditions in export-oriented Asia remain subdued, and the scope for a durable rebound in growth there for 2012 is limited, according to our Asia economists. As many of these are small, open economies, between the DM and EM worlds, we think this does not bode well for global growth prospects, as trends in these economies tend to lead that of broader EM. On top of the slowing in loan growth (in part due to the reduction in off-balance-sheet activity), economic data in China for February may well solidify this view.

To drive home our concerns on the growth front, we've noted in the past the momentum in global monetary conditions, which is sliding towards tightening. And given that this argues for more easing, it is consistent with the EM risk market (currencies in particular) re-pricing lower, albeit with a lag. Both are diverging at present (see Exhibit 2). The markets are not priced for disappointment – quite the contrary, in fact – and this seems more important than the out-turn of the macro data itself.

Exhibit 2

Global Monetary Momentum (3m/3m % Change) and USD/EM



Note: Measures the momentum in M2 growth; a decline implies a tightening in monetary conditions, a rise implies a loosening in monetary conditions
Source: Morgan Stanley Research, Bloomberg

What's priced in? EM currencies are overbought, based on our market technical indicator (SAMI), and from a fundamental perspective are now largely at fair value, having traded well cheap to fair value since last October. Latin American currencies are flagged as rich, if only just so. EM sovereign credit spreads – based on the EM CDX – are also now below their long-term historical average. And though on a medium-term basis they are cheap to underlying fundamentals – given our view of steadily improving creditworthiness for EM sovereigns in the next 12-18 months – we see scope for a tactical widening in spreads this month.

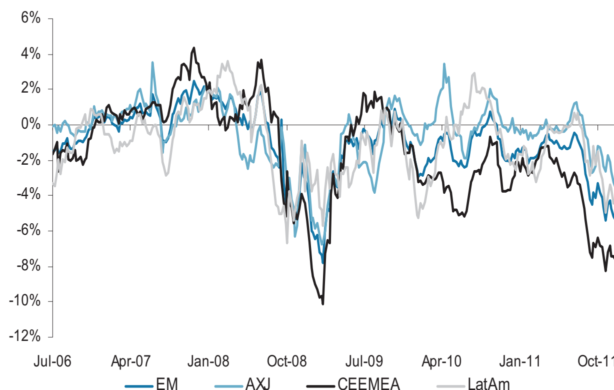
Prevailing valuations, therefore, are cause for concern. And it is here where we see the strongest grounds for a market correction this month. The question on the back of this: Should the market be bought or sold?

No sell signal (yet). We still see little compelling reason to sell the market outright from a tactical directional perspective. Funding-market stress remains well above what would be considered normal levels (below 20 on our EMFSI) but nevertheless continues to ease, reflecting the fact that liquidity provision on the part of global central banks has been deployed – and can be deployed further if and when required. In addition, overall positioning on the part of investors remains relatively modest – if not in core markets, at least for EM.

Inflows are continuing to see their way into funds, as the process of structural rebalancing – towards EM – of global portfolios continues. Absent a turn for the worse in funding conditions or market positioning, we don't see prospects for a sustained reversal to the downside in the market's overall direction – yet.

Exhibit 3

EM Currency Fundamental Valuation (% Rich/Cheap to Fair Value)*



Source: Morgan Stanley Research; *Based on EM TRAC valuation model

Strategy and Economics

March 4, 2012

China Economics
Downside Risks to Growth Capped; More Easing to Come

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Silver lining starts to shine, but a bigger push from monetary policy easing is needed. On a recent field trip to China, we noticed evidence of rising export growth momentum, as well as a substantial increase in property transactions in major cities in the last few weeks, which we believe will help cap the downside risks to growth in the near term. In addition, policy makers indicated that existing projects of government-driven infrastructure investment have been prioritized, most likely lifting infrastructure investment growth in the near term from the low level seen in 4Q 2011.

We have highlighted an early start to policy loosening since the end of 2011, but we believe monetary easing will have to step up to provide sufficient credit to the growth recovery. In particular, we noted that liquidity in the interbank market does not seem to have translated into notably looser financial conditions for the corporate sector, not least because of binding constraints such as the loan-to-deposit ratio and the direct control on loan drawdown.

More tolerance for property policy easing by 'stealth' to come. The central government hesitates to withdraw property-tightening policies, but we maintain our view that local governments will likely loosen the implementation of such measures after the National People's Congress and Chinese People's Political Consultative Conference towards the end of 1Q and early 2Q. Initial relaxation will likely benefit first-time property buyers, while leaving leveraged purchases for upgrade demand still constrained.

1) Downside risks to growth capped

We believe some positive evidence has started to emerge of trends that could cap the downside risks to growth we have highlighted since 4Q11 (namely soft external demand, property market weakness, and infrastructure investment deceleration caused by funding difficulties with local government investment vehicles). If we see further support from official data in these areas in the next one or two months, as well as effective delivery of policy easing, the risks will likely be biased towards the upside with regard to our baseline forecast of real GDP at 8.4% YoY this year.

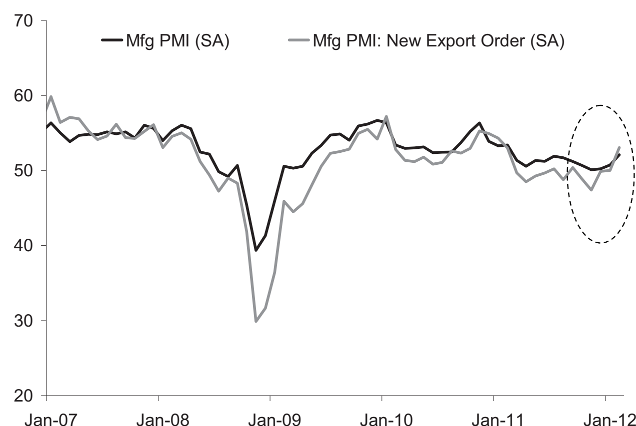
● **Exports:** Although January export growth seemed weak due to the Lunar New Year effect, we witnessed some positive developments in support of a small rebound. These included: i) better sentiment from exporters, as seen in the manufacturing PMI sub-index on new export orders (see Exhibit 1); ii) improvement in Korean exports, which tend to lead Chinese exports, especially the processing trade component; and iii) improvement in US consumer demand in certain markets, e.g., furniture.

● **Property:** In the past three weeks, both developers and property agents reported a strong pickup in residential housing transaction volume in first-tier cities, despite the lack of policy change or price cuts by developers (see Exhibit 2). It is possible that the better availability and lower costs of mortgage loans for first-time buyers compared to 4Q 2011 have stimulated some release of pent-up demand.

However, we admit it may be too early to call for a property market recovery at this stage. We cite three factors: i) the Lunar New Year effect prevents us from gauging such growth momentum with precision; (ii) the significant acceleration in sequential growth was amplified by a particularly low base at the end of 2011; and (iii) second-tier cities have yet to see a similar recovery in transaction volume.

Exhibit 1

Exporters' sentiment seems to have improved significantly



Source: NBS, Morgan Stanley Research

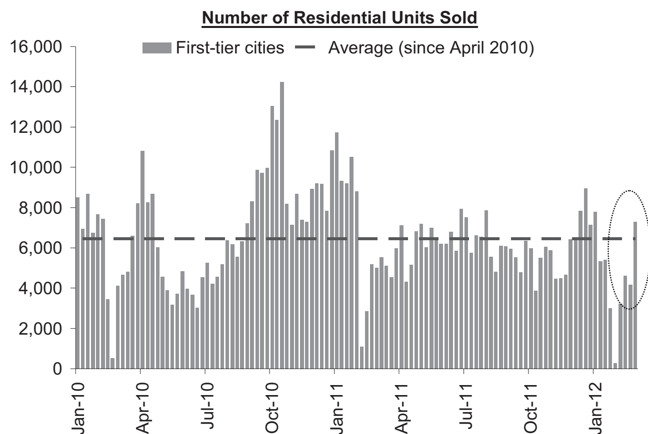
Strategy and Economics

Nonetheless, we believe this is worth watching closely – a broad-based increase in both firsthand and secondhand housing transaction volumes in top-tier cities has often been a prelude to changes elsewhere in the past.

● **Infrastructure:** There is likely to be an uplift to infrastructure investment growth in the near term from the recent low levels of 4Q 2011. The official release on government-driven project approvals confirms our earlier prediction that infrastructure investment has shifted more towards utilities (especially under the umbrella of CDM – clean development mechanism) and rural development (e.g., irrigation and water conservation and rural infrastructure construction). In addition, funding support to key projects and existing projects has been extended and verified by banks.

Exhibit 2

Residential housing transactions had a strong rebound in first-tier cities after the Chinese New Year



Source: CREIS, Morgan Stanley Research

2. But a bigger push from policy easing is needed

Liquidity in the interbank market does not seem to have translated into notably looser financial conditions for the corporate sector. We highlighted that policy loosening has been under way since the end of 2011. The market has also been expecting a strong rebound in bank loan extension after the Chinese New Year. Still, domestic media reported a possible disappointment of less than Rmb 700 billion of loans made in February. If bank loans in February indeed turn out to be less than Rmb 750 billion, as we forecast in our preview, it will confirm our suspicion that the liquidity released by the recent cut in the reserve requirement ratio has yet to be channeled to the real economy.

Supply-side constraints on loans, rather than demand-side weakness, should take the blame. On our field trip, we observed firm demand for bank loans and informal lending, but banks' responses were lackluster because of binding loan-to-deposit ratios (especially outside of the Big Five banks). In addition, the macro prudential measures introduced in 2010 (such as the direct control on loan drawdown) have hurt banks' capability in deposit creation and thus loan extension.

We believe monetary easing will have to step up to provide sufficient credit to ensure growth stabilization. As CPI inflation continues to trend downwards, policy makers will likely see fewer obstacles to promoting a more effective relaxation through multiple policy tools. The central government's "Rainy Day Fund" (Budget Adjustment Fund) could provide some cushion to a few existing government-driven investment projects, but we think further monetary easing is indispensable to a cash-strapped economy in the near term. We expect top decision makers to promote the usage of multiple tools to ensure easing in financial conditions by the central bank and the China Banking Regulatory Commission, including window guidance and fine-tuning of the existing macro prudential measures.

3. More tolerance for property policy easing by 'stealth' to come

We maintain our view that local governments will likely loosen the implementation of policy tightening measures after the NPC and CPPCC towards the end of 1Q and early 2Q. The central government has overruled local governments' recent attempts to relax the purchase restrictions, but we don't think it will take long before some forms of policy loosening take place.

In our view, initial relaxation will likely benefit first-time property buyers, while leaving demand still constrained for leveraged purchases of upgrade properties. We expect positive catalysts to come from follow-up measures to the Hukou system reform and the Ministry of Housing and Urban-Rural Development's decision to lower the requirement for non-local resident purchases. However, relaxation in top-tier cities and on mortgages for purchases of third (and above) housing would be more difficult to realize in the very near term.

Strategy and Economics

March 5, 2012

Global Commodity Strategy
Stay Long Gold

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Gold fundamentals still intact. Gold sold off 5.4% on February 29 after Fed Chairman Bernanke failed to comment on the likelihood of another round of quantitative easing, leading investors to believe that the timeframe of expanding easing measures will be pushed out. The one-day volatility was so high, prices actually posted a monthly high and low within hours. The sharp move lower – the second meaningful correction in gold's long-running bull market in the past six months – inevitably raised questions about the reasons for the sell-off. It also raised concerns about whether such a large daily move has any negative implications for the longevity of price uptrend. Simply put, we believe the answer is no. The sell-off last week was likely profit-taking, and the low-interest-rate environment of the next few years will likely remain bullish for gold fundamentals.

Investors pull out of the QE3 trade; selling began with Chairman Bernanke's testimony. The first large sell order, triggering the wave of gold selling on February 29, coincided with release of the Bernanke testimony before the House Committee on Financial Services. In his testimony reviewing current monetary policy, Bernanke notably failed to mention the likelihood with which the Federal Reserve would adopt a new round of Quantitative Easting (QE3) to confront risks to the US growth outlook. This strongly suggests that investors who sold on February 29 did so to cash out on a trade predicated on the early adoption of QE3.

The impact of these sell orders was magnified by a notable absence of buyers, in our view, around a key technical resistance level at US$1,791/oz on that day, and by the fact that February 29 was also the day on which bids for the second tranche of the ECB's LTRO program were completed. These factors coalesced to provide a perfect opportunity for profit taking. Profit-taking is always a short-term risk and should not be surprising, given the strong gold rally from a December 2011 low of US$1,525/oz to US$1,790/oz at the end of February.

Why do we think last week's price drop was due to profit-taking and not something more fundamentally damaging to gold's long-term uptrend? We believe that many of the pillars supporting a long-term gold uptrend remain intact, even absent another round of QE:

(1) Negative real interest rates and accommodative monetary policy;

(2) Recent data that highlight robust investment and physical demand, particularly in China;

(2) The desire to own a hedge against financial and inflationary risks; and

(4) Central banks not having been net sellers of gold during this rally.

Negative real rates should support gold. Negative real interest rates and accommodative monetary policy were and remain the key drivers of investment demand. Bernanke's testimony did nothing to remove this benefit when he reiterated the Federal Reserve's determination to maintain the target range for the federal funds rate at 0-0.25% out to late 2014. This statement, when originally made in January 2012, was worth nearly US$70/oz in one day. Under these circumstances, QE3 would have been icing on the cake for the monetary easing trade, but not the fundamental driver of bullish investor positioning. In other words, the increased likelihood that QE3 will not happen simply drove this particular trade out of the market, without destroying the broad liquidity rationale behind the gold uptrend.

Gold investment demand remains strong. Recent data highlight continued robust investment demand. The SDR Gold Trust holdings continue to show gains. Moreover, physical gold demand for investment purposes remains strong in China, as highlighted in the World Gold Council's recent report on gold demand trend7s in 4Q11 (published in February).

Besides the desire to hedge the potential inflation risks of accommodative monetary policy, investment demand continues to be driven by:

(1) Continuing concerns over the tail risk to financial assets in the Eurozone,

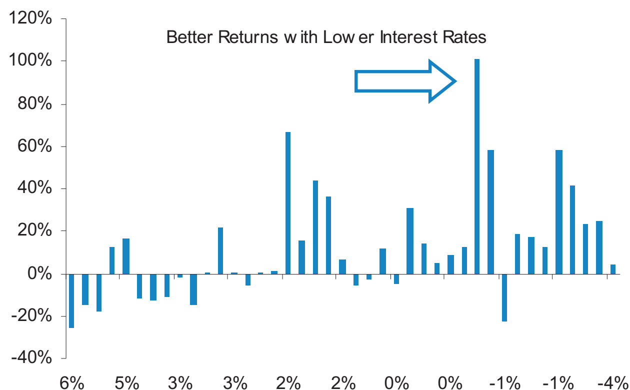
(2) Heightened concerns over the Iran/Israel stand-off, and

(3) Broader inflationary and growth concerns associated with high oil prices, especially in China.

As such, expectations of positive year-on-year returns on gold are consistent with the historically inverse trend between the real federal funds rate and real gold returns shown in Exhibit 1.

Strategy and Economics

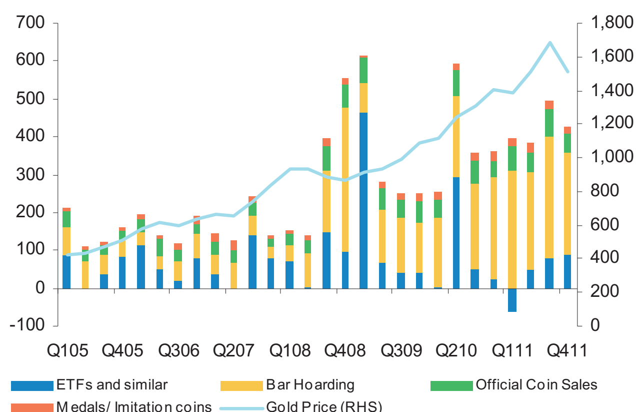
Exhibit 1
Federal Funds Rate Historically Inversely Correlated to Gold Returns
(Vertical axis: YoY gold returns, %; horizontal axis: real fed funds rate, %)



Source: Thomson Reuters, Morgan Stanley Commodity Research

A shift has occurred in official sector attitudes toward gold as a reserve asset. It is worth reemphasizing that central banks have not been net sellers of gold during this rally, indicating an important and continuing shift in official sector attitudes toward gold as a reserve asset. While it is possible that this sharp fall was associated with a central bank sale coming to market, we have received no indication that this is the case. Even if it subsequently is shown to have been the reason for February's sharp fall in prices, in our view, this would not confirm a general shift in official sector attitudes linked to changing perceptions of the risks to monetary policy, but more likely a one-off sale linked to a reserve portfolio adjustment.

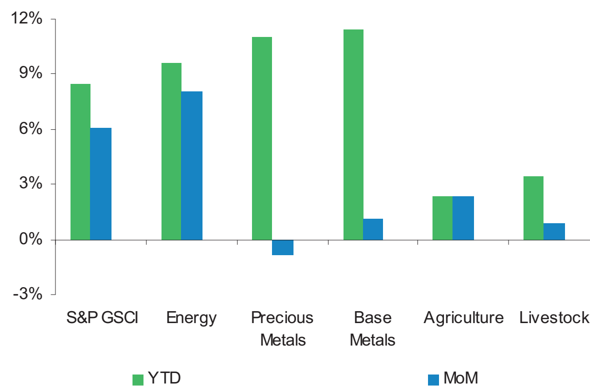
Exhibit 2
Central Banks Remain a Large Holder of Gold as a Reserve Asset
(Left axis: holdings by type; MT; right axis: gold prices, US$/oz)



Source: Thomson Reuters, Morgan Stanley Commodity Research

Commodities up in February, led by crude oil, as geopolitical tensions over Iran dominated headlines. The S&P GSCI ended February up 6.1% and outperformed the S&P 500 for the month by 174 bp. Crude oil clearly led the space, up 10.2% YoY as Iranian tensions continued to escalate, while the physical markets were slightly tighter than expected in Europe, owing to issues with the Forties crude-oil stream throughout the month. Nevertheless, we continue to believe that bearish fundamentals lag the bullish sentiment implied by the recent outperformance of crude oil. The biggest underperformer in the space was precious metals, which ended the month negative after the Fed appeared to back off its commitment towards another round of quantitative easing.

Exhibit 3
Energy Led the Commodity Complex in February (Total returns, % Δ)



Source: Bloomberg, Morgan Stanley Commodity Research

While recent US data have been undeniably more bullish, our economists believe much of the recent strength stems from temporary factors rather than the beginnings of a robust recovery. Indeed, they still believe that there is a 75% chance of another round of QE in the US. As such, we remain bullish gold. As for Brent, geopolitics will continue to dictate price action with upcoming US-Israeli meetings in Washington in focus. However, fundamentals show signs of weakening, and higher prices put our constructive 2H12 call at risk. With OPEC production continuing to run at high levels given an elevated oil price, the potential for supply outages to be resolved, and likely demand destruction, balances are looking more comfortable for 2H12.

Opinion Changes

March 1, 2012

Lowe's
It's Not You, It's Me — Upgrading to Equal-weight

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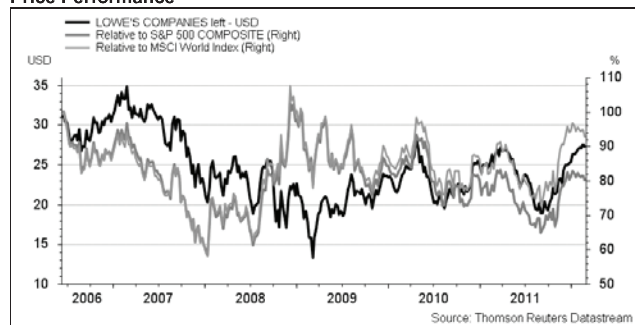
We are upgrading LOW as we have increased our Base Case value to $30, primarily due to 3-10% higher EBIT as well as buyback assumptions. We remain cautious on home improvement growth near term, but see potential upside risk and have increased industry growth estimates.

Stock Rating: Equal-weight	Reuters: LOW.N	Bloomberg: LOW US
Shr price, close (Mar 1, 2012)		$28.38
Mkt cap, curr(mm)		$35,247
52-Week Range		$28.46-18.07

Fiscal Year ending	01/11	01/12	01/13e	01/14e
ModelWare EPS($)	1.39	1.73	1.69	2.04
Prior ModelWare EPS($)	-	1.63	1.69	1.94
EPS($)**	1.47	1.70	1.81	2.19
P/E	17.8	15.5	16.8	13.9
Consensus EPS($)§	1.42	1.62	1.79	2.15
Div yld(%)	1.6	1.9	2.1	2.4

§ = Consensus data is provided by Thomson Reuters Estimates.
** = Based on consensus methodology
e = Morgan Stanley Research estimates

Price Performance



Company Description
Lowe's Companies is a home improvement retailer operating over 1,700 stores across 50 US states, 24 stores in Canada, and two in Mexico.
Industry View: Cautious — Retail, Hardlines

Upgrading to Equal-weight. We are upgrading LOW shares to Equal-weight as we believe that they have a balanced risk/reward profile and modest upside to our revised Base Case valuation of $30 per share. While we believe that a lull in recent optimism over housing could drive shares lower, increased conviction in a modest recovery in Lowe's revenue trends and early success in reshaping the balance sheet make us more constructive.

While we are clearly more positive on LOW, we do not believe it is time to be Overweight given relatively high valuation and our continued caution on the broader home improvement market. LOW's P/E multiple has expanded by roughly 3 turns to about 16x 2012e EPS of $1.81 over the past few months. This is a 5% premium to its 5-year historic relative multiple and thus we see further near-term multiple expansion as unlikely. We would look for a pullback in valuation or greater conviction in housing and home improvement trends.

Execution on internal efforts removes potential downside catalysts. Neither 4Q11 results nor 2012 guidance were drastically different vs. our expectations, but solid execution on balance initiatives and a fresh look at buybacks lead us to higher long-term EPS estimates. Management's 2012 guidance appears achievable, with easy comparisons early in the year (as comps were down in 1H11), return of capital is indeed accelerating, and while we remain cautious of a housing recovery, home improvement trends are outperforming our initial expectations.

We prefer LOW over HD in the near-term. Shares have outperformed hardlines over the past four months, but we still see modest upside. Given its accelerated buybacks, we see EPS growth picking up to 15-20% in 2013–14 even assuming relatively slow industry growth. We may be late to the party on Lowe's return-of-capital story, but believe buybacks will help shares to outperform HD ($47.46, Equal-weight) despite continuing to lag Home Depot's top-line growth. We expect Lowe's to repurchase ~35% of its shares through 2015 compared with ~20% for Home Depot.

Increasing Home Improvement (HI) industry estimates, but not ready for a commitment to the bull case. We still expect a more muted recovery in HI spend relative to bulls at ~3% growth for a few years as homeownership rates decline. However, we overestimated the near-term negative effects on the industry and home centers as a result of declining home prices and the shift to rental housing.

Sentiment around the housing outlook has improved significantly, but we remain somewhat more skeptical. In-line with Morgan Stanley's housing strategist Oliver Chang's work, we believe that home prices will remain constrained through 2012–13 as the market clears through distressed inventory and lending remains constrained. However, we believe we had

Opinion Changes

overestimated the near-term negative effects on the home improvement industry and the home centers as a result of declining home prices and the shift to rental housing. We now expect the overall industry to grow 3-4% in2012-2014 from our previous estimate of 1-2% and expect Lowe's to post 1.5-3% comparable store sales in 2012-2013 vs. our initial estimate of flat to 1% declines. Nonetheless, we believe we are below consensus as we see the recovery in home improvement spending as gradual rather than V-shaped.

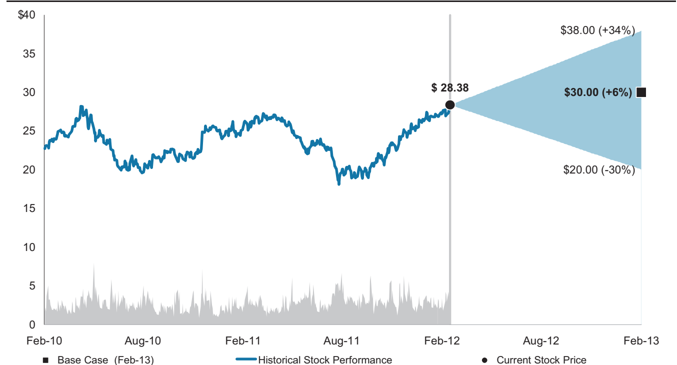
We have increased our estimates, but we remain well below management's long-term outlook, primarily due to lower revenue growth assumptions and as a result, lower margins as well. We have also made the following changes to our estimates: (1) Increased top-line expectations toward a 3-4% 2012–15e CAGR (compared with our prior 2-3% estimates); (2) Increased operating margin outlook as solid SG&A cost control has outweighed gross margin pressures; and (3) increased buybacks to $13.5 billion for 2012–15e vs. our previous estimate of $6.7 billion given our higher EBIT outlook combined with balance sheet control.

Near term, home centers may be benefiting more than expected from rental activity. Smaller organizations appear to be doing more of the conversion of single-family homes to rental properties and thus are likely using HD/Lowe's more than we originally anticipated for the rehab and repair work necessary in these conversions. While we note that these organizations are likely getting bulk discounts, and thus are lower margin sales to home centers, we believe that these sales are supporting traffic trends at HD and Lowe's. As highlighted by both home centers on their 4Q calls, sales to their respective professional segments are performing above the company average.

A recent DC trip keeps us cautious, but modestly more constructive, on home improvement. We recently met with several housing-related organizations and regulators in Washington, DC, to speak about drivers of US housing. With home prices having fallen for the better part of four years and existing home sales 20-25% below 2001–04 levels, those that we spoke with were cautiously optimistic about improving activity and expect home prices to rise 1.0-2.5% this year. Nonetheless, we believe there is room for continued caution with an overhang of 7-8 million mortgages in some state of delinquency and consumer balance sheets still stretched.

We came away with five key issues to watch: (1) household formation, (2) lending standards, (3) securitization standards, (4) Fannie Mae/Freddie Mac participation in programs, and (5) programs to convert real estate owned (REO) to rental.

LOW: Margin Improvement and Accelerating Buybacks Drive Outlook



Bull Case $38	15.5x Bull Case 2013e EPS	**Lowes achieves its bullish guidance of 10% EBIT margins by 2015E.** Long-term comp growth of 3-4% returns historical industry averages. By 2015E gross margins expand by 60-70bps and SG&A cuts add 180-190bps of margin expansion. Lowe's repurchases $16-17bn of stock by 2015.
Base Case $30	13.5x Base Case 2013e EPS	**Top-line & margins continue improvement in 2012, but LOW only reaches 8.5% LT margins.** LOW's comp grows to 1-2% in 2012 and~2-3% LT. SKU rationalization and cost mgmt provides 30-40bps of gross margin expansion. Lower labor, marketing, and op ex reductions result in 60-70bps of margin expansion by 2015. Lowe's repurchases $13-14bn of stock by 2015.
Bear Case $20	11.5x Bear Case 2013e EPS	**Housing improvement short lived, comps decline 1-2% in 2H2012-2013.** A reacceleration in home price declines reverse housing turnover improvement. Lowe's returns to stalemate in 2012/2013 and LT comps are flat to up 100bps. Lowe's deleverages from lower sales outlook and margins contract ~100bps by 2015E. Thus, LOW is only able to repurchase $8-9bn of stock by 2015.

Source: Thomson Reuters, Morgan Stanley Research

Valuation and Risks

We use an average of our DCF analysis and P/E multiple valuation to derive our $30 Base Case. Our DCF is based on a 7.9% weighted average cost of capital and 0% long-term growth rate. Our P/E multiple analysis is based on 11.4x 2016e EPS, which we discount back using a 9.8% ROE.

The biggest downside risk, in our view, remains a persistent housing slowdown. If the US experiences a more drastic shift toward rental housing than we expect, with the creation of large national property management companies, we could see a reacceleration in top-line pressures as the home centers are less suited to capture commercial market share than that of consumers. Near-term gross margin pressure could be greater than we expect as Lowe's is transitioning toward Everyday Low Pricing.

Upside risks exist if the macro economy experiences a significant reacceleration or if regulators take further action to ease mortgage lending or refinancing.

Opinion Changes

March 2, 2012

Insurance – Property & Casualty
Soft Market Ends in 4Q;
Upgrade RE to Overweight,
Downgrade TRV to Equal-weight

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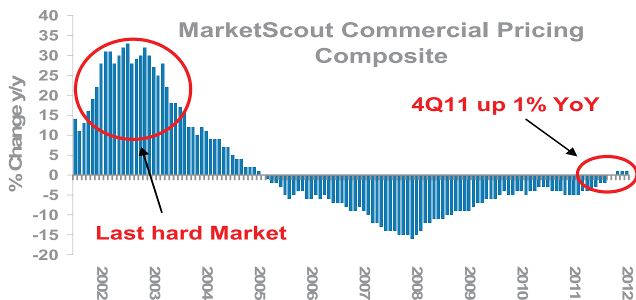
Broadening Y/Y improvement in pricing power proves the soft market has ended and should trend higher in 2012+; however, a hard market remains elusive.

4Q results confirm that casualty lines pricing power is heading higher. In 4Q11, only 4 of our 13 P&C companies beat the consensus estimates as of November 1, before cat losses led to downward EPS revisions (Thai flood losses, reserve increases across 2011 events). Casualty earnings are also under pressure as loss trends accelerate in workers' comp and professional lines and low yields punish investment returns. To restore returns, P&C managements are pulling on one of the few levers they control: pricing. Many will remember 2011 for cat losses and the resulting turn in property line pricing; but casualty lines pricing power is also headed higher.

Exhibit 1
Commercial Pricing Trend: Soft Market Is Over



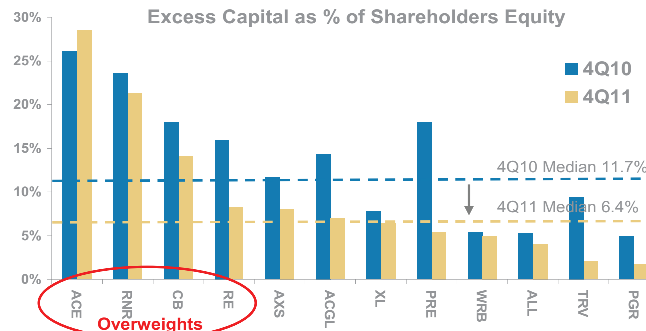
Source: MarketScout, Morgan Stanley Research

Upgrade Everest Re to Overweight on business mix, excess capital, and valuation (see next page).

Downgrade TRV to Equal-weight as our thesis has played out; others have more excess capital (see next page).

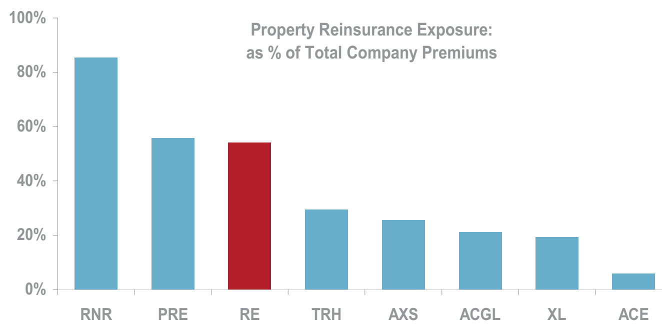
Reiterate our Overweight ratings on RNR (a Morgan Stanley Best Idea), ACE, and CB. With the P&C cycle improving, we recommend the strongest balance sheets — companies with ample excess capital to drive double-digit returns to shareholders through organic growth and/or buy-backs/dividends. A large capital cushion and valuation near record lows also offers downside protection from unexpected losses while waiting for a bullish thesis to prove out.

Exhibit 2
Excess Capital Estimate: RE Well Positioned



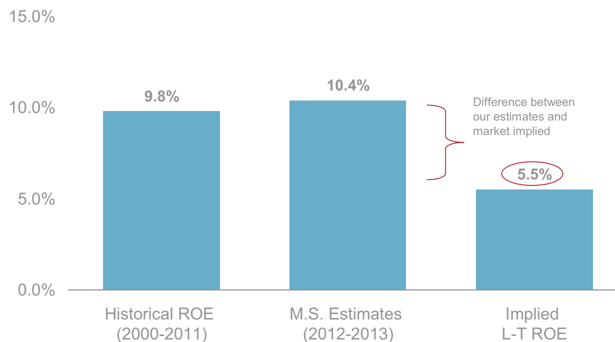
Source: Company Data, Morgan Stanley Research

Exhibit 3
Exposure to Global Property Reinsurance



Source: Company Data, Morgan Stanley Research

Exhibit 4
RE Stock Implies Far Lower ROE than Our Forecast



Source: Company Data, Morgan Stanley Research, Thomson Reuters

Industry View: In-Line
Insurance - Property & Casualty

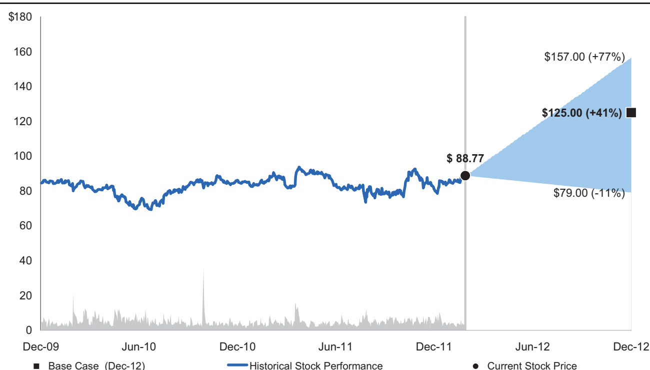
Opinion Changes

EverestRe (RE, $89, Overweight)

Upgrade RE to Overweight on business mix, excess capital, and valuation. RE has a 10%+ ROE, large exposure to the fastest growing P&C lines, and a strong balance sheet with $500m of excess capital to take advantage in the improving P&C marketplace. Our 2012-13e EPS are 8-11% ahead of consensus and our excess capital analysis is backed by our detailed actuarial reserve review. Despite our favorable fundamental outlook, RE trades near all-time lows at 80% of tangible BV (a 6% implied ROE per Morgan Stanley What's In the Price tool). Risk-reward looks compelling, with 40% upside in our Base Case and -10% downside in our Bear Case.

Exhibit 5

RE: 10%+ ROE at ~80% of BV as P&C Pricing Rises



Source: Morgan Stanley Research, Thomson Reuters

Bull Case: $157, or 1.2x 4Q12e Bull Case BVPS

- Better fundamentals, P&C cycle turn. Higher EPS due to better underwriting results, favorable reserve development and greater share buybacks. Valuation just below 10-year average, reflecting lower ROE given lower yields.

Base Case/Price Tgt: $125, or 1x 4Q12e Base Case BVPS

- Our target multiple of 1x BVPS is a discount to the historical average of 1.3x, reflecting below cross-cycle ROE in a P&C market showing incremental pricing improvement.

- 10% ROE and modest multiple expansion. Property re pricing improves, reserves remain adequate.

Bear Case: $79, or 0.8x 4Q12e Bear Case BVPS

- P&C pricing weakens; Outsized losses in both underwriting and investments within next 4 quarters. BV drops by 18% due to a large 1 in 100 catastrophe loss (9% impact) and investment portfolio losses ~50% of those experienced during the financial crisis (9% impact). Near trough multiple despite improving P&C pricing.

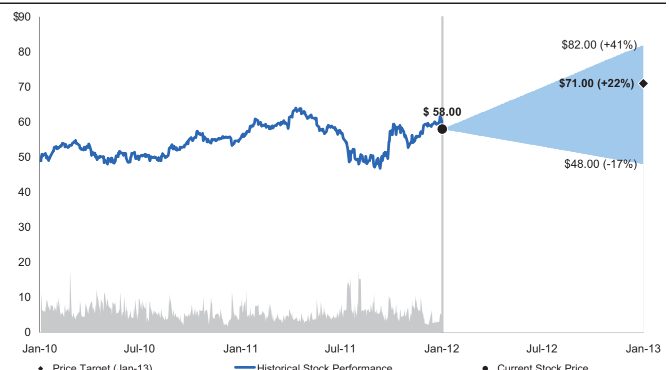
Risks to our price target: Catastrophe losses, investment losses, and reserve charges.

Travelers (TRV, $58, Equal-weight)

Downgrade TRV to Equal-weight as our thesis has played out; others have more excess capital. TRV still offers solid risk-reward in the improving P&C marketplace and we see nothing "wrong" with TRV's balance sheet, reserves or the forward fundamental outlook. However, our "capital return" thesis has played out and TRV shares have returned 25% (including dividends) to owners since 2Q10. We no longer see the same level of excess capital at TRV as at our other Overweights and our long-held view remains that excess capital is "king" as the P&C market transitions into the early stages of the next pricing cycle.

Exhibit 6

TRV: Return of Capital Has Played Out



Source: Morgan Stanley Research, Thomson Reuters

Bull Case: $82, or 1.2x 4Q12e Bull Case BVPS

- Better fundamentals, valuation returns to normal. Strong underwriting results, continued heightened reserve releases and higher investment income drive higher EPS. Payout ratio above 100% of earnings as TRV returns excess capital through buybacks and dividends. P&C hard market has arrived.

Base Case: $71, or 1.1x 4Q12e Base Case BVPS

- Delivering on plan. Deterioration in core underwriting margins offset by reserve releases, share buybacks and steady investment income. Valuation remains at discount to historic averages. ROE of ~9%.

Bear Case: $48, or 0.9x 4Q12e Bear Case BVPS

- Outsized losses in underwriting and investments in next 4 quarters. BV drops by 9% on a 1-in-100 catastrophe event (4% impact) and investment portfolio losses modestly above that seen in the financial crisis (5% impact).

Risks: Downside —c at & investment losses, reserve charges; Upside — cycle turn, better EPS, normal valuations, higher yields.

Companies mentioned: ACE (ACE, $72, Overweight), Chubb (CB, $68, Overweight), Renaissance Re (RNR, $72, Overweight).

Opinion Changes

March 1, 2012

ADTRAN
Downgrade to Equal-weight on Weak Carrier Capex

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It now appears Q1 could be more back-end-loaded than planned on continued weakness in carrier spending. The narrative around ADTN's core business is now more negative heading into the integration of the NSN acquisition and risk / reward is now to the downside.

Stock Rating: Equal-weight	Reuters: ADTN.O	Bloomberg: ADTN US
Shr price, close (Feb 29, 2012)		$35.25
Mkt cap, curr(mm)		$2,234
52-Week Range		$47.70-25.46

Fiscal Year ending	12/10	12/11	12/12e	12/13e
Consensus EPS($)§	1.66	2.10	2.19	2.49
ModelWare EPS($)	1.78	2.12	2.14	2.45
Prior ModelWare EPS($)	-	-	2.25	2.57
P/E	20.3	14.2	16.4	14.4
Div yld(%)	1.0	1.2	1.0	1.0

§ = Consensus data is provided by Thomson Reuters Estimates.
e = Morgan Stanley Research estimates

Price Performance

Company Description
ADTRAN, Inc. is a leading global provider of networking and communications equipment to service providers, distributed enterprises, and small and medium-sized businesses. ADTRAN products are designed to enable voice, data, video and Internet communications.

Industry View: Cautious — Communications Equipment & Data Networking

Adtran management presented at our conference: Despite investor hopes to the contrary, management has yet to see an upturn in carrier spending. These comments corroborate with those made by Juniper's CFO, also presenting at our conference, who agreed with Adtran's view on continued weakness in carrier spending. Finisar also cited a cautious carrier capex environment on its FQ3 conf call and that the turn in capex spending has not started.

This is all in line with our Cautious carrier industry downgrade on Dec 19, and we believe the recent rally in carrier-exposed companies has been premature suggesting many of these stocks, including ADTN, may have gotten ahead of themselves.

We still believe in the long-term story and that the recent acquisition of NSN's broadband business has upside, but given ADTN’s recent runup, we think risk/reward is to the downside. We have removed our price target and moved to Equal-weight: our new base case for ADTN is $33 based on 11x 2012 unlevered EPS of $2.23 and adding back $7.50/share in net cash. Compared to what we previously expected, the narrative around Adtran's core business is more negative heading into the integration of the NSN acquisition, implying we may not see improvements in fundamentals until Q1'13.

TMT Conf Takeaways: Speaker Jim Matthews, CFO

- **Adtran has not yet seen a snap-back in carrier capex in Q1 – particularly with tier-1 carriers.** While we believe this remains just a matter of time, the first two months of the quarter have provided no indication of a turn in spending. However, Adtran also noted it is not unusual for Q1 spending to be back-end-loaded and did not rule out that scenario this quarter. Nevertheless, it appears that with Feb and Jan order trends light we see potential risk to Q1 guidance of flat revenues with Q411.
- **Adtran continues to expect the drivers of growth going forward from carriers looking to deliver higher capacity broadband access using Adtran’s TA5K and fiber to the node products driving the Broadband Access business.** Cable operators are delivering triple play and telco operators are adding video in the equation, which, along with Carrier consolidation, has unleashed investments and favorable underlying trends based on bandwidth intensive applications and cloud computing, along with Ethernet services for Broadband Access or Internetworking products.
- **Int’l – last year Adtran saw nice growth in Broadband Access on FTTN with Telmex and from a broader base of carriers all over the world.** Every int’l region grew in excess of 20%, driven by Broadband Access. Adtran’s

Opinion Changes

comfort level regarding Telmex has improved: **Telmex revenues should be stable** following Phase 3 wins.

- **Adtran sees solid growth prospects for its enterprise internetworking portfolio** with SMBs and enterprise investing in higher bandwidth applications and cloud computing and connectivity growing. Adtran continues to expand that business and thinks 20%+ growth is sustainable driven by access routers, IP growth, Wi-Fi networks (BlueSocket), and other services. Management is working with the traditional VAR channel and dealer-based training is also growing interest based on margins and ease of doing business.
- **Optical Access, another growth area – up 25% in 2011 – was the lower of the 3 growth areas, between BB Access and Internetworking, driven by wireless backhaul infrastructure.** Adtran recently introduced new products that should fuel longer-term growth of optical networking edge capabilities by bringing transport features to the edge and it's a highly differentiated feature set.
- **Tier-2 carriers: Adtran is seeing growth in Broadband Access and expects that to continue this year,** aided by Broadband stimulus activity, which was light in 2011 as Adtran began to see "single digit millions of dollars" in Q3 and Q4: this should pick up in 2012 based on current customer activity, perhaps to "double-digit revenues per quarter" by the end of 2012 and into 2013.
- **The pending Nokia-Siemens acquisition gives Adtran immediate incumbency in terms of a broad base outside of North American carriers** and should be accretive in the first full year post close. In the first 6 months post close, Adtran is planning to transition the supply chain from a European supply chain to its own EMS supply chain in lower cost regions, leading to accretion in the latter 6 months post close. Overall, management believes it can raise gross margin by 10 pts from the first 6 months to second 6 months of year one post close, leading total gross margins to dip into the low 50s at consolidation, yet with the combined company exiting the first year back at the mid 50s. Adtran also expects some impact on the opex line from integration costs in first 6 months post close. Revenue synergies should come in the second year after the close of the acquisition.

We are lowering our revenue estimates slightly, to account for a weaker carrier capex spending environment for 2012; our Q1 and 2012 estimates reflect what we expect to be more sustained weakness in capex spending by tier-1 carriers. Our Q112E revenue / EPS go to $172.5M/$0.43 from $175M/$0.48 and our 2012E go to $780M/$2.14 from $795M/$2.40 on a slight downtick in carrier capex related trends.

Exhibit 1

ADTRAN Model Changes

$ in millions except per share data

	Q1-12E	Q2-12E	2011E	2012E	2013E
New Revenue	172.6	189.9	717.2	779.6	890.0
Old Revenue	174.9	191.8	717.2	794.6	918.0
Difference	**(2.3)**	**(2.0)**	**0.0**	**(15.1)**	**(28.1)**
New Gross Margin	56.6%	56.3%	57.8%	56.2%	56.1%
Old Gross Margin	56.7%	56.4%	57.8%	56.4%	56.2%
Difference (bps)	**(14)**	**(14)**	**0**	**(18)**	**(14)**
New Operating Margin	22.4%	25.0%	26.4%	24.9%	25.1%
Old Operating Margin	23.0%	25.4%	26.4%	25.6%	25.6%
Difference (bps)	**(59)**	**(47)**	**0**	**(77)**	**(46)**
New EPS	$0.43	$0.53	$2.12	$2.14	$2.45
Old EPS	$0.45	$0.54	$2.12	$2.25	$2.57
Difference	**($0.02)**	**($0.01)**	**$0.00**	**($0.10)**	**($0.11)**
New EPS, ex. stock comp	$0.47	$0.57	$2.24	$2.30	$2.61
Old EPS, ex. stock comp	$0.48	$0.58	$2.24	$2.40	$2.72
Difference	**($0.02)**	**($0.01)**	**$0.00**	**($0.10)**	**($0.11)**

Source: Company data, Morgan Stanley Research

Exhibit 2

ADTN: Balanced Risk Reward on Weak Capex

Bull Case $40	15x Bull Case CY12e unlevered EPS of $2.54 plus $7.50 in cash	**CenturyLink share gains continue, Telmex, Frontier, and broadband stimulus spurs stronger revenue gains for growth products as HDSL continues to grow from wireless back-haul demand, with additional upside from tier-1 customer win expected in early 2012; operating margin expands with revenue growth:** Total revenue grows 16%, Broadband access revenue grows 32%, optical access grows 14%, internet-working grows 30%, HDSL revenue is down just -20%, operating margin expands to 26.8%.
Base Case $33	11x Base Case CY12e unlevered EPS of $2.23 plus $7.50 in cash	**Strong broadband spending by CenturyLink, Telmex, Frontier, and others drives demand for broadband access, offsetting any impact from HDSL declines; limited incremental opex spend translates to operating margin expansion:** Total revenue grows 9%, Broadband access revenue grows 24%, optical access grows 1%, internet-working grows 28%, HDSL down -28%, operating margin 24.9%.
Bear Case $25	9x Bear Case CY12e unlevered EPS of $1.87 plus $7.50 in cash	**CenturyLink, Telmex, Frontier, and broadband stimulus impact muted; HDSL declines more severe; operating margin remains flat:** Total revenue grows just 3%, Broadband access revenue grows 20%, optical access declines 2%, Internet-working grows 11%, HDSL down -30%, operating margin declines to 23% from 26.4% in 2011.

Source: Thomson Reuters, Morgan Stanley Research

Opinion Changes

February 29, 2012

Western Refining
Balanced Risk-Reward; Downgrade to Equal-weight

Morgan Stanley & Co. LLC

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WNR created value for shareholders with portfolio restructuring, and we believe there remains upside from potential formation of an MLP (possible in 2013) deleveraging and growth projects. However, shares now have balanced risk-reward.

Balanced risk-reward: downgrade to Equal-weight. Given recent performance (+33% YTD) and announcement of the main expected catalysts — Yorktown sale and debt repayment — and widening of the West Texas Intermediate-Louisiana Light Sweet (WTI-LLS) spread from 4Q12 levels, we believe WNR now has more balanced risk-reward. We upgraded shares to Overweight in October 2010 based on company-specific improvements, including sale of recently idled Yorktown refinery as terminal with debt repayment and restructuring and repositioned portfolio in higher margin markets. Since then, Yorktown was sold in December, the company's revolver restructured, and senior debt repaid. Structural widening of Mid-Continental crack spreads have aided in re-valuing WNR shares.

We have increased our price target to $21 from $19. WNR shares trade at 3.7x 2012e EBITDA, in line with peer group. On a mid-cycle basis (2014, in our model) with $4/bbl long-term WTI-LLS differentials, we expect EBITDA generation of ~$335 million and arrive at a similar $21 price target with refining segment EV/EBITDA multiple of ~5x. We increase our price target to $21 from $19 to reflect announcement of Yorktown sale and lower debt and growth projects (ex-El Paso expansion). Near term, we believe WNR should trade at a valuation below those of peers HollyFrontier and Marathon Petroleum, both of which have lower leverage, more diversified revenue streams with higher potential midstream earnings.

Further upside from possible MLP spin out and debt refinancing. Following completion of the company's logistics

Stock Rating: Equal-weight	Reuters: WNR.N	Bloomberg: WNR US
Price target		$21.00
Shr price, close (Feb 28, 2012)		$17.72
Mkt cap, curr(mm)		$1,609
52-Week Range		$21.75-11.18

Fiscal Year ending	12/10	12/11e	12/12e	12/13e
ModelWare EPS($)	(0.05)	3.12	2.89	1.74
Prior ModelWare EPS($)	-	3.19	2.98	1.73
P/E	NM	4.3	6.1	10.2
Consensus EPS($)§	0.01	2.96	2.86	2.41
Div yld(%)	0.0	0.0	0.9	0.9

§ = Consensus data is provided by Thomson Reuters Estimates.
e = Morgan Stanley Research estimates

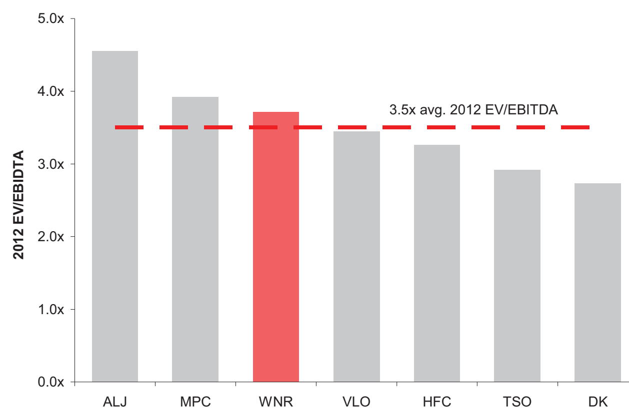
Price Performance

Company Description
Western Refining, Inc. is an independent refining and marketing company headquartered in El Paso, Texas. Western operates refineries in El Paso, and Gallup, New Mexico.

Industry View: Attractive – Refining & Marketing.

Exhibit 1

WNR's Valuation Has Moved in Line with Peers



Source: Thomson Reuters, Morgan Stanley Research

Opinion Changes

project (3Q12) in El Paso, we believe Western will have $20-30 million in midstream logistics EBITDA (and we think our method could understate this). Currently, Western likely does not have enough assets to form its own MLP, as the company needs enough assets to both form and then grow the MLP in order to sustain valuation and grow the General Partner Incentive Distribution Rights (IDRs) post-IPO. We believe continued investment could lead to a formation of midstream MLP in 2013 or after. We believe monetization of current assets via an MLP creates a $2/share uplift, which Western could realize by growing assets to a level possible for formation and IPO of MLP, and selling assets to MLP. We also believe WNR can continue deleveraging its balance sheet by calling its senior secured notes at 11.25% in mid-2013, which would reduce the cash position yet would be ~$0.33 accretive to EPS, we estimate.

Potential downside from faster narrowing of WTI-LLS in 2H12 and 2013. WNR benefits from a niche location in the US Southwest, with average realized crack spreads above benchmark Gulf Coast WTI margins. Western refineries receive some premium west Coast pricing for Arizona markets and discounted crude from growing production in the Permian. However, pipeline reversals starting in 2H12 will narrow the benefit with Seaway reversal from Cushing in mid-12 then West Texas Gulf expansion in late 12 and Longhorn reversal in early 2013 reducing oversupply in Western local market. Seaway expansions and early construction of the lower half of Keystone XL pose additional risk. Hedges offset some earnings downside, yet all refiners likely trade with lower differentials.

Exhibit 2

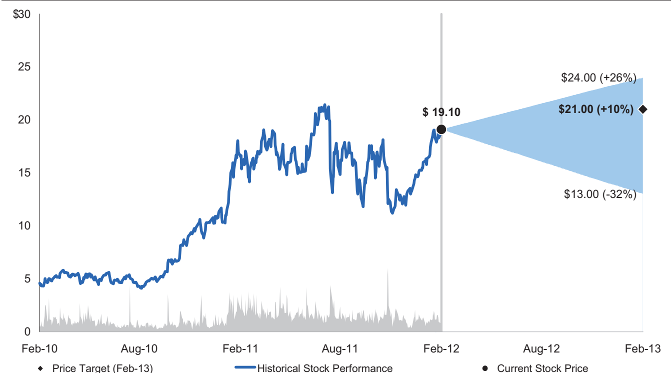
Potential Upside from Western's Midstream Assets

	Storage (MMbbl)	Utilization	Market rate ($/bbl)
Southwest Storage	5.3	85%	$0.50
Monthly Rev. ($MM)	2.3		
Annual Rev. ($MM)	27.2		
	Throughput (mbpd)		
Southwest Terminal	58.5	80%	$0.30
Daily Rev. ($M)	14.0		
Annual Rev. ($MM)	5.1		
El Paso Logsitics (3Q12)	20.0	100%	$0.75
Daily Rev. ($M)	15.0		
Annual Rev. ($MM)	5.5		
Total Midstream		Margin	
Revenue ($MM)	37.8		
Operating cost ($MM)	15.1	40%	
EBITDA ($MM)	**22.7**	**60%**	
MLP Multiple	14.0x		
Current WNR multiple	3.8x		
EV Uplift ($MM)	**231.4**		
$/share (not tax-adj.)	**$2.59**		

Source: Company Data, Morgan Stanley Research

Exhibit 3

WNR Risk-Reward: Balanced Outlook



Bull Case $24	Bull Commodity Deck	**Higher Mid-Con (MC) production drives wider WTI differential** MC 3:2:1: WTI = $19/bbl. WTI-LLS Spread widens to $12/bbl for full-year 2012 as Permian production leads to higher WTI differentials in Western Southwest region. Western generates midstream EBITDA to create MLP or sells logistics assets.
Base Case/ Price Target $21	3.2x 2012e EV/EBITDA	**WTI-LLS benefit through mid-2013; local market strength** MC 3:2:1: WTI 2012 = $17/bbl. WTI-LLS Spread: $10/bbl. Valuation implies a 3.2x 2012 EV/EBITDA. Company continued to receive premium crack spreads relative to benchmark with narrowing differentials in 2013 reducing earnings
Bear Case $13	Bear Commodity Deck	**WTI differential narrows and lower simple crack spread** MC 3:2:1: WTI 2012 = $12/bbl. WTI-LLS spread: $7/bbl Pipeline reversals and expansions narrow WTI-LLS, and weaker economy reduces simple crack spread.

Source: Thomson Reuters, Morgan Stanley Research

Potential Catalysts

- Announcement of a formal process to sell midstream logistics assets: Southwest terminal, storage, asphalt terminal and pipelines. Potential monetization of inventory.
- Higher production from the Permian basin increase differentials received at Western refineries located in the play.

Risks to Our Price Target

- Pipeline reversals occur more quickly than expected, eliminating WTI-linked vs. waterborne crude differentials and Mid-Con benefits.
- Unplanned refinery outage, leading to large swing in earnings generation with only two refineries.
- Levered balance sheet and high fixed charges lead to potential stress on debt covenants in weaker economic and crack spread environment.

New Coverage

March 5, 2012

Life Science Tools
Prefer Exposure to Commercial Markets over Academic; Overweight A, WAT, and TMO

Morgan Stanley & Co. LLC

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The group's performance YTD (+22%) creates a balanced risk-reward. Our AlphaWise surveys highlight downside risks to US academic spending in 2012-13 but suggest more resilient commercial demand than is generally feared. We favor leverage to commercial markets: A, WAT, TMO (all Overweight) vs. AFFX (Underweight).

We have initiated coverage of the Life Science Tools (LST) sub-industry with a balanced view of risk-reward, shaped by three key factors:

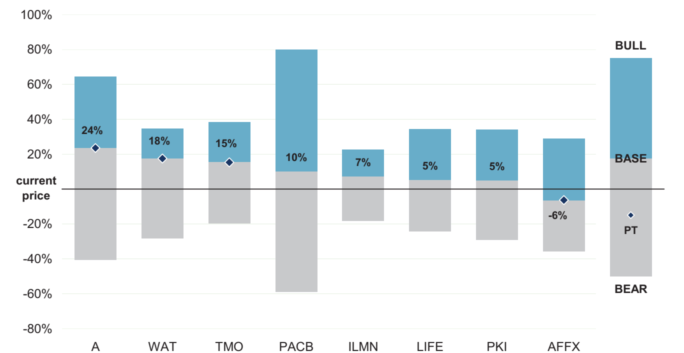
(1) *We have a more negative view than consensus of US academic spending in 2012 and 2013* (15% of industry revenues). Large funding cuts loom for next year and pressure from several years of tight funding is already evident.

(2) *Cyclical concerns appear overdone — we expect continued strength from the industry's expansion into industrial & applied markets* (40% of revenues). These markets include chemicals, energy, environmental testing, food testing, forensics, agbio, and diagnostics. While these markets limit visibility, our AlphaWise survey points to more resilient demand than assumed by Street.

(3) *China and emerging markets (EM) should remain a key LST growth driver.* China represents ~10% of revenues vs. ~3% in the S&P 500, and drove one-third of 2011 growth for LST. Our work shows that tools demand is less sensitive to macro forces than expected. Agilent, Waters and Perkin Elmer have most China exposure.

The average stock in our universe is up 22% YTD, outperforming the S&P 500 by ~9% despite pressure on 2012 academic spending and the impact of the slowing global economy on industrial/applied customers. With valuations relative to the S&P 500 roughly in line with history, we see limited scope for multiple expansion across the industry.

A, WAT, and TMO Offer Most Upside to Base Case



Source: Morgan Stanley Research Note: The chart shows percentage upside/downside to our base case valuations.

Stock Recommendations

Our Overweights are Agilent (our top pick), Thermo Fisher, and Waters. We looked at the impacts of academic budgets, applied market opportunities, and US and EM macro on our coverage to inform our top down view. Our company analysis has focused on business strategy, technology roadmap, product cycle outlook, financial model, and the competitive landscape. Our ratings are based on the intersection of:

- *Our fundamental view on each company's prospects.* We favor a commitment to R&D/innovation, product leadership, history of strong ROIC or outlook for improving ROIC, cost cutting flexibility and history of operating leverage.

- *The relative attractiveness of a company's end market positioning given the macro outlook.* We favor strong EM positioning and below average academic/government exposure.

- *Valuation and sentiment.* Our ratings scorecard ranks each company on these and other factors.

Agilent: Pricing in the cyclical Bear Case. Despite significantly reducing its cyclical exposure in recent years, the company still has amongst the highest degree of economic sensitivity vs. peers. Given worries over a cyclical slowdown, compounded by a FQ1 shortfall for the company's Test & Measurement business, Agilent trades at the widest discount to fair value in our coverage universe (on DCF, P/E, and ROIC), on our numbers. We look for a positive re-rating of the shares simply from producing in-line quarterly results given concern about a shortfall. We expect the company to generate above-above average organic growth, and coupled with

Industry View : In-Line
Medical Technology

New Coverage

significant margin expansion opportunity, we foresee accelerating EPS growth. ROIC performance (34% going to 41%, on our forecasts) also merits a higher valuation.

Thermo Fisher: No credit for superior EPS growth plus improving organic growth and returns. Thermo's stock is still being penalized for its 3Q11 shortfall, as the P/E discount to peers since then has widened. We see significant operational levers enabling sustainable 12-16% EPS growth for the next 5-plus years. We expect 15% upside in the stock over next 12 months based upon a 0.3 turn of P/E expansion and 14% EPS growth on average over the next two years. We argue that the stock's valuation (currently at ~8% discount to its historical relative P/E and 20% discount to our DCF) does not account for improving organic growth (from 3% in 2011 to 3.4% in 12 rising to 4.2% by 2015) plus an ROIC that should trough in 2012. Last week's initiation of a dividend is a significant positive in our opinion, not so much for the benefits of near-term return of capital (initial yield is modest at ~1%) but rather as it marks an improvement in management's capital allocation strategy. We expect management to adopt a more explicit long-term ROIC target, further helping the case for multiple expansion.

Waters: Share gains in its largest product area should support superior top line growth. Our AlphaWise survey work and diligence support our share gain assumptions and cyclical demand outlook. We anticipate better-than-expected share gains in the company's largest product area, ultra performance chromatography (UPLC), supporting our above consensus growth forecasts this year and next. While investors remain concerned regarding a cyclical slowdown (as the company's economic sensitivity is near the top of the peer group), our survey points to more resilient customer demand than generally assumed by the Street.

We rate Affymetrix Underweight — Legacy growth pressures still too severe. We expect revenues to decline in 2013 (model a decline of 3.7% Y/Y) vs. management's guidance of top line growth. As a result, our EPS forecasts are below guidance and we expect the stock to underperform peers. The company is still suffering significant declines in its core microarray businesses (gene expression and genotyping) which were evident in our AlphaWise survey of microarray customers. Even rapid growth in new growth businesses (Cytoscan, genotyping) is not likely to be enough to offset pressure from these legacy business declines in 2012. While the proposed eBio acquisition could be value-creating, uncertainty over closure has increased as Affymetrix last week waived provisions, allowing eBio to consider alternatives.

Our Equal-weight stocks are Illumina, Pacific Biosciences, Perkin Elmer, and Life Technologies.

Key risk: US academic funding (~15% of revenues). We assign a 60% probability to Sequestration in 2013 and see more intense spending pressure in 2012 and 2013 than consensus. Our diligence and AlphaWise survey indicate that US academic research spending will decline 3% in 2012 and 5% in 2013, with a downward bias. Most exposed are Affymetrix, Pacific Biosciences, Illumina, and Life Technologies.

Investment Debates Summary

(1): Will sequestration occur in 2013 and what will be the impact upon National Institute of Health (NIH) funding?

Market View: With the NIH F2012 budget set at +0.6% Y/Y growth, the outlook for F2013 and beyond is the key focus. Investors generally think either that sequestration will be avoided or that even if implemented, NIH is largely protected.

Our View: Odds (~60%) favor sequestration and we assume a 5% decline in LST-related NIH spending in F2013 as a result. Our survey of US researchers paints a more negative spending outlook for both F2012 and F2013.

(2) How economically sensitive will demand from the industrial and applied customers prove to be in 2012?

Market View: Instrument and 'industrial' exposed companies are deemed most at risk, whereas the impact on 'applied' customers (food, environmental testing) is more uncertain.

Our View: Our analysis shows the industry overall is less cyclical than feared. Our survey reveals the economy is having more of a positive influence upon spending for 2012.

(3) What happens to the industry in the event of a more pronounced China slowdown?

Market View: Investors are nervous, although the strong YTD performance suggests this concern has diminished.

Our View: China is more secular than cyclical. China's 12th Five-Year Plan provides significant government funding support for life sciences research, and LST spending is largely insulated from economic forces. Our research shows demand for food and environmental testing also exhibits low economic sensitivity.

Companies mentioned: Agilent Technologies (A, $43.72, Overweight), Affymetrix (AFFX, $4.27, Underweight), Illumina (ILMN, $51.35, Equal-weight), Life Technologies (LIFE, $47.59, Equal-weight), Pacific Biosciences of California ((PACB, $3.64, Equal-weight), PerkinElmer (PKI, $26.74, Equal-weight), Thermo Fisher Scientific (TMO, $57.25, Overweight), and Waters Corp. (WAT, $89.34, Overweight)

New Coverage

March 5, 2012

Harman International Industries
Backlog Emergence vs. Tech Convergence; Initiate Underweight

Morgan Stanley & Co. LLC

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Stock Rating: Underweight	Reuters: HAR.N Bloomberg: HAR US
Price target	$40.00
Shr price, close (Mar 2, 2012)	$48.80
Mkt cap, curr(mm)	$3,461
52-Week Range	$51.76-25.53

Fiscal Year ending	06/11	06/12e	06/13e	06/14e
ModelWare EPS($)	2.08	2.95	3.95	4.81
P/E	21.9	16.5	12.4	10.2
EV/EBITDA	8.1	6.6	5.2	4.2

e = Morgan Stanley Research estimates

Price Performance

Company Description
Harman International Industries is engaged in the developing, manufacturing and marketing of audio products and electronic systems. The company's product offerings are sold under brand names including AKG, Crown, JBL, Infinity, Harman/Kardon, Lexicon, dbx, BSS, Studer, Soundcraft, Mark Levinson, Becker, and Selenium.

Industry View: In-Line — Autos & Auto-Related

Expansion of Harman's scalable platform plus steep uptake of infotainment product should unlock near-term earnings upside, though this appears largely priced in at current valuation. In the longer term, competition from smart personal device platforms could constrain future earnings power/multiples.

Harman is in the right place at the right time with its scalable system, in our view. After several tumultuous years, Harman has just completed an extensive cost restructuring, which has already set margins on an improving track with further upside to come. Harman is now turning its attention away from costs and toward process/product optimization. Harman's new scalable platform should allow it to improve R&D efficiency, expand its end- market reach and grow profitability in the next 3 years.

But time could be running out as technological challenges loom. While Harman seems very well positioned as it executes its current backlog, growth beyond that 3-yr horizon could be constrained. Our analysis of the automotive infotainment industry sees emerging personal smart device (PSD) platforms as a significant medium-long term competitive threat to Harman's infotainment offerings. This includes direct integration of PSDs into the car at the low end and in-house OEM development of PSD OS-based custom solutions at the high end, with the middle-market comprising a mix of both solutions. While Harman can also leverage its strong brands and technology leadership with penetration growth of branded audio and in the Professional business, we do not see enough upside from these opportunities to offset the threat to its core Infotainment business.

Initiate at Underweight with $40 price target. The upside from near-term backlog looks largely priced in with the stock at 12.4x F2013e P/E and 5.2x EV/EBITDA (the group is at 10x / 4.8x). We expect the long-term multiple to de-rate due to the competitive threat from evolving technology.

Why Underweight?

- Near-term earnings potential appears strong as company rolls off legacy under-profitable business and transitions to its new scalable platform. However, this already appears to be priced into expectations.
- Longer-term competitive threats from peers catching up, OEM insourcing, and PSDs replacing infotainment systems; lower defensibility of competitive advantage compared to other secular suppliers could constrain growth, margins and long-term multiple.
- Little incremental cost opportunity with completion of STEP change program in 2011.
- Stock trades higher than the group average at 12.4x F2013e PE / 5.2x F2013e EV/EBITDA.

'3S' rating: 11.1/15

- **Size:** Best-in-class geographical distribution, strong balance sheet.
- **Significance:** High R&D, mid-pack content per vehicle.
- **Sustainability:** Infotainment is strong end market.

New Coverage

HAR: Near-Term Earnings Potential Looks Priced In; Long-Term Competitive Challenges Crimp Multiple

Price Target $40. We triangulate to valuation based our DCF analysis as well as historical and peer group multiples. For our DCF, we use a risk free rate of 4%, beta of 1.8, equity risk premium of 5.5% for a cost of equity of 14%, pre-tax cost of debt of 10% and WACC of 12%. We use a terminal growth rate of 1% on FCF from 2010–2016 to arrive at our price target.

Bull Case $60	13x Bull Case 2013e EPS of $4.60	**Still in the lead:** Competitors fail to catch up to Harman's scalable offering, PSD integration in cars doesn't catch on, emerging markets' infotainment uptake is strong, macro is better than expected.
Base Case $40	10x Base Case 2013e EPS of $3.95	**Infotainment penetration explodes:** Infotainment penetration grows, Harman deploys its current backlog successfully ,but further backlog growth slows as competitive alternatives emerge. Consumer margins eroded by competition and higher ad spend. Macro continues slow improvement.
Bear Case $30	10x Bear Case 2013e EPS of $3.00	**Competition intensifies:** Competitors catch up on scalable system and undercut Harman on price, PSD integration in car takes off, consumer margins are competed away, macro deteriorates or remains stuck in neutral.

Key Risks

Competitive threats: Scalable product can be replicated by customers, PSDs can replace infotainment systems over time, and OEMs can in-source development.

Consumer and professional businesses are highly competitive with low barriers to entry, which could erode margins over time

New organizational culture implemented to move beyond its recent issues may be a challenge.

Source: Thomson Reuters, Morgan Stanley Research

Harman International Industries Inc.: Key debates

DEBATE	MARKET'S VIEW	OUR VIEW
Where is Harman positioned in the current evolution of automotive infotainment systems?	*Harman's strong position at the high end of the market is defensible while the implications of the company's move into the middle market are still up in the air.*	The company's move into mid-market scalable systems is the right one, in our view, as it expands Harman's target market, Harman seems to have a lead over its competition, and margins are better than for custom systems. In the longer term, however, Harman's lead may not be defensible as competitors close the gap, OEMs insource development, and PSDs threaten to substitute infotainment systems.
What are opportunities like in Harman's other segments? (Branded audio, consumer, professional)	*Not a major focus area for the Street.*	Harman is looking to push deeper into the consumer space and expand the market for branded audio in both the automotive space and beyond, where margins are higher. However, a widely fragmented market with intense competition and low barriers to entry could erode Harman's margins over time in the consumer space. The Pro business generates strong margins but the opportunity for incremental organic growth is limited.
Has Harman managed a clean break from its past issues?	*Cost restructuring program is complete which means Harman can now focus on future growth.*	Harman has just reached a point where it is fully detached from its troubles of 5 years ago. The company has undertaken a comprehensive plan to cut costs and boost growth. However, this has also brought significant cultural change within the company, with the engineering heart and brain of the company moving away from Germany toward Silicon Valley and Asia. Like other companies in the auto industry attempting a cultural renaissance, Harman may find out that even established companies can go through growing pains.
Valuation	*12.4x F2013e P/E, 5x EV/EBITDA.* *HAR deserves a higher-than-group-average multiple because of the secular nature of its business.*	While the near-term opportunity looks strong, we believe the highly competitive nature of the business and the threat of rapid technological development obscure the longer-term outlook at Harman, which crimps the exit multiple on our DCF. Our DCF-based price target of $40 translates to 10x F2013e P/E and 3.7x F2013e EV/EBITDA.

Industry Analysis

March 2, 2012

Food
Addressing Feedback on Industry View and Key Calls

Morgan Stanley & Co. LLC

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On February 13, we initiated coverage of the food industry with an Attractive view and ratings on seven large-cap stocks: Overweight GIS, KFT, and MJN; Equal-weight HSY and K; and Underweight CPB and HNZ. We address below the most common areas of investor pushback and our responses.

Recent volume weakness weighing on results… An understandable source of pushback has been the impact of incremental weakness in US grocery volumes, which decelerated sharply in December/January and resulted in below-expectations results from GIS, SJM, THS, and SWY. The US consumer is clearly reacting to price increases in the past year, but some of the unexpected volume weakness (particularly in light of stronger February scanner data) may reflect temporary factors. Also, we are optimistic about the resiliency of top-line growth and C2012/F2013 EPS visibility, given continued rational pricing and moderating inflation.

…driving concerns about promotional risk: Weaker volumes have led to concerns about a material increase in promotions (particularly given moderating inflation); however, we think pricing and promotional trends will remain at constructive levels in 2012. Today's modest inflationary conditions are less conducive to dramatic promotional increases, and food manufacturers appear much more inclined to focus on mix/innovation than to sacrifice the pricing gains of 2011.

Attractive food industry view; we expect the stocks to benefit from: (1) improved earnings visibility as spot inflation declines materially in 2012, (2) sustained top-line growth, with manageable levels of elasticity and a rational promotional environment, (3) scope to reinvest "excess" pricing in marketing and innovation, and (4) value creation via strategic actions and higher cash returns.

Volume Weakness Weighing on Results

We wrote: Elasticity has been more moderate than feared: In contrast to recent pricing/inflation cycles (e.g., late 2008), price elasticity across most categories has been in line with company expectations, with manageable levels of volume decline.

Pushback: Given the incremental deterioration in US grocery volumes during December/January, sales and earnings objectives for C2012 could be challenged if trends do not improve.

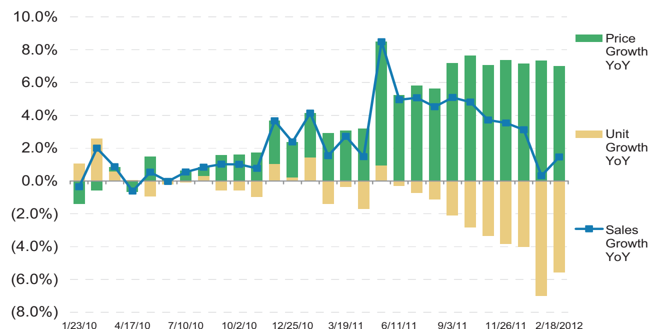
Our response: While this is an understandable near-term concern, we remain optimistic that industry top-line growth will remain resilient, with volume declines moderating as the industry begins to lap 2011 price increases.

Near term, this emerging dynamic creates a somewhat greater risk of muted top-line growth and gross margin expansion below our expectations. However, given the confluence of carryover pricing, proven cost reduction capabilities, and significantly moderating inflation, we think the group is positioned to support continued investment in brand-building and innovation in 2012. We also see potential gross margin and EPS upside in 2013, particularly for our Overweights.

In recent weeks, we have seen incremental weakness in US grocery volumes, with negative data from General Mills (which reduced F2012 EPS guidance), JM Smucker, TreeHouse Foods, and Safeway. At CAGNY, Campbell, Heinz, and Kellogg all said that US food sales slowed in December/January.

Packaged food companies have identified a number of factors contributing to soft Dec/Jan volumes, but we think the primary driver is accelerated pricing across the grocery store, both as pricing taken in late 2011 has reached shelves and as manufacturers have cut promotions and merchandising support.

Exhibit 1
Measured Channel Sales Slowed in Dec/Jan, but Improved in Feb. on Modestly Higher Promotions



Source: Nielsen, Morgan Stanley Research

Industry View : Attractive
Food

Industry Analysis

We do not entirely discount "temporary" drivers: (1) consumer "sticker shock" stemming from the pricing taken in 2011, particularly as merchandising levels declined; (2) purchasing tradeoff decisions during the holiday season; (3) higher fuel prices; (4) warmer weather (which encourages eating out); (5) a shift from center-of-the-store purchases to prepared food purchases at retail; and (6) weaker innovation year-over-year.

Somewhat encouragingly, aggregate measured channel sales for the companies under our coverage (ex-HSY/MJN) increased 0.6% year-over-year (price/mix +5.6%, units -5.1%) during the 4 weeks ended February 18. This marks a sequential improvement over the prior 4-week period (ended January 21), in which aggregate sales declined 1.5% (price/mix +6.4%, units -7.9%). It may be premature to interpret one month of data as an inflection point in volume declines and/or price elasticity, but we think it adds credibility to the thesis that December/January's more severe volume declines were at least partly affected by timing or weather.

Also, Kroger stated in its recent 4Q11 results that its food cost inflation moderated during the quarter, driving roughly flat tonnage growth during the quarter. Additionally, management appeared constructive on consumer sentiment, industry volume trends, and moderating inflation throughout the year.

Concerns About Promotional Risk

We wrote: We expect both pricing and promotional trends to remain at constructive levels in 2012, allowing for increased flexibility around both brand-building investments and margin expansion.

Pushback: With a weaker volume outlook, manufacturers may turn to significantly higher promotion to protect market share and stabilize volumes. The companies have generally indicated a desire to avoid this, but the precedent for this risk was set in 2009-10.

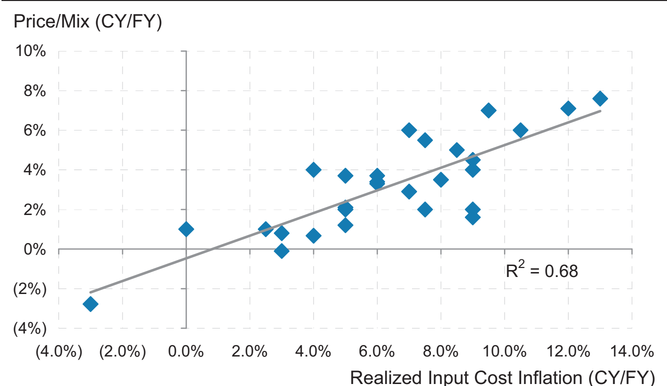
Our response: Given recent volume commentary, we do not dismiss the risk of increased promotional spending, though we expect pricing and promotions to remain at constructive levels in 2012, allowing for increased flexibility around brand-building investments and margin expansion.

We think a large hike in promotional spend is unlikely:

- *Companies do not want to a repeat of 2009-10.* The industry's promotional tactics during that deflationary period are widely viewed as a failure. Further, as manufacturers faced challenges negotiating pricing with retailers, they are unlikely to give back pricing, apart from selected categories.

- *History suggests modestly positive pricing in 2012, given an overall inflationary outlook.* The companies under our coverage have generally maintained consistent net pricing in response to specific levels of realized inflation. Our baseline expectation of 4-5% gross inflation in 2012 implies ~2% net pricing, consistent with the sales-weighted average of our company forecasts. Also, at the very least, food manufacturers should enjoy some benefit of carryover pricing in 1H12.

Exhibit 2
Based on Recent Historical Results, Mid-Single-Digit Inflation Has Implied 2-3% Net Pricing



Source: Company Data, Morgan Stanley Research

- *US food manufacturers are looking elsewhere to offset elasticity and margin pressure.* Given the weak US consumer and the pricing already taken in the past year, food companies seem to be focusing on expanding their emerging markets footprint, adjusting pack sizes and pricing, and driving positive mix through innovation, not on driving volume through promos.

- *Food retail commentary indicates that rational pricing behavior is likely to persist.* The managements of both Safeway and Kroger commented on their recent earnings calls that they expect the competitive environment to remain "rational."

Stock-Specific Pushback

Sources pushback on our Overweight- and Underweight-rated stocks: Some investors disagree with our view of MJN and KFT on valuation, given MJN's premium multiple and KFT's outperformance since the announcement of its spin-off. We think GIS is attractive at current levels (~14.4x 2012e P/E), but some investors are looking for further evidence of volume improvement. We think CPB and HNZ face secular and developed market headwinds, respectively, though some investors argue that these are already discounted.

Companies mentioned: Campbell Soup (CPB, $33, Underweight), General Mills (GIS, $38, Overweight), H.J. Heinz (HNZ, $53, Underweight), Hershey (HSY, $61, Equal-weight), Kellogg (K, $52, Equal-weight), Kraft Foods (KFT, $38, Overweight), and Mead Johnson (MJN, $78, Overweight).

Industry Analysis

February 29, 2012

Insurance — Life/Annuity
Variable Annuities Challenges Remain, but Light at the End of the Tunnel

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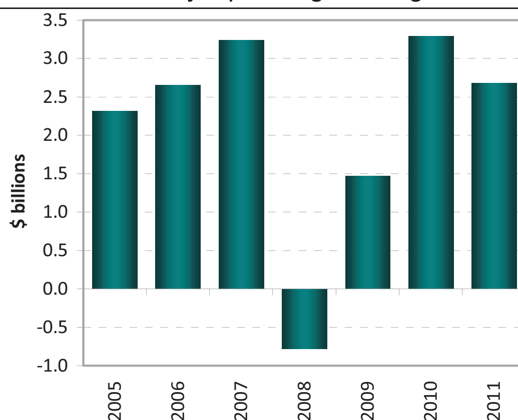
The variable annuity environment remains challenging, leading several companies to exit the market. More product re-pricing appears necessary, although our survey suggests the market can bear additional price hikes, ultimately leading to opportunities for companies such as Prudential and MetLife.

As is widely appreciated by investors, it remains a tough environment for variable annuity providers. Over the past three years, variable annuity profitability has rebounded, although it still remains highly volatile. At the height of the financial services crisis, variable annuity exposure was a substantial problem for several companies. In addition to seeing a severe hit to earnings, most companies saw their capital positions erode drastically, with hedging programs doing little to offset the statutory capital losses resulting from declining equity markets. However, with equity markets rebounding, profitability improved meaningfully in 2009 and 2010, although in 2011, earnings deteriorated due to the mid-year deterioration in markets.

Exhibit 1

VA Profitability Rebounds but Is Still Highly Volatile

Individual Annuity Operating Earnings: 2005-2011



Based only on US companies under coverage: AMP, HIG, GNW, LNC, MET, PFG, PRU
Source: Morgan Stanley Research, Company data

The variable annuity industry has already undergone significant change. The financial services crises brought an end to the “arms race” in variable annuities and began a period of de-risking in the industry. The reduction in risk exposures combined with the meaningful recovery of equity markets had generally led to an improvement of investors’ perceptions of the industry in years following the crisis. However, the improved investor sentiment toward the group proved to be short-lived, with the sharp decline in interest rates leading to renewed concerns over the profitability of new business.

The decline in interest rates has led to escalating hedge costs for variable annuities. Based on Milliman’s monthly hedge cost index, the costs for hedging variable annuity living benefit guarantees is near a record high. Companies have responded by raising prices and reducing product guarantee benefits; although, in our view, more needs to be done to restore adequate risk-adjusted returns across the industry.

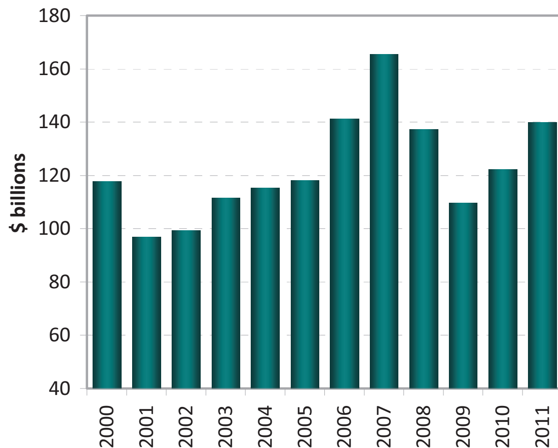
More product re-pricing is necessary — and possible for some — in order to re-establish adequate returns, in our view. The fees being charged only barely cover the hedging costs currently, which suggest companies have not gone far enough to restore adequate margins. The elasticity of demand to additional price and/or product design features appears low enough for companies to push through additional changes without materially impacting demand. Based on a survey we completed across several hundred Morgan Stanley Smith Barney financial advisors, most advisors (64% of those surveyed) are already expecting the trend of higher prices and reduced benefits to continue. Despite this, almost two-thirds of advisors we surveyed still expect sales to be flat to up over the coming year.

Moves by some companies to reduce the risk profile through other changes to their product design do not appear to have had any meaningful impact on demand. For example, several companies, including MetLife, have introduced volatility managed fund options in variable annuities. In order to be eligible for the maximum guarantee rates, investors must be fully invested in these lower risk funds. Essentially, this has the effect of shifting the cost of hedging volatility off the balance sheets of the insurers to the policyholder fund level. While this potentially limits some of the upside for policyholders, the more limited fund options do not appear to have dampened demand, according to the advisors we surveyed.

Industry View : In-Line
Insurance - Life/Annuity

Industry Analysis

Exhibit 2
Variable Annuity Sales: 2000–2011



Based on total industry sales ex-TIAA Cref; Source: VARDs – Morningstar

We expect only a few companies will be able to respond. Several companies have indicated that they are willing to see sales moderate in order to restore more acceptable returns. MetLife, for example, is targeting a 35% reduction in total variable annuity sales in 2012, while Prudential management has similarly talked about ensuring variable annuities do not become too large a portion of their total mix of business.

Not all companies appear well positioned to successfully push through additional product changes. In recent years, the industry has become increasingly focused in the hands of just a handful of companies. The top 5 companies back in 2008 accounted for just 44% of the industry's total sales (ex-TIAA Cref) — today, the same number account for nearly 60%. Financial advisors tend to form an affinity with just a handful of companies given the considerable time needed to fully understand new product offerings. Accordingly, for a company to essentially break into the variable annuity market, they need to come out with a more aggressive product design, and invest aggressively in their wholesalers and product marketing capabilities. This strategy can prove detrimental to returns, especially given the current macro challenges.

Other companies face more difficult choices. Already several companies have reached the conclusion that remaining in the variable annuity market is not in the best interest of their shareholders. The Canada-based insurers have largely withdrawn from the US marketplace, while several of Europe's insurers have also significantly reduced their presence. Genworth terminated new sales early in 2011, while Ameriprise significantly scaled back, ending third party distribution at the end of 2010. For other companies such as Hartford, we believe management may face a decision about whether to place the US annuity operations into a closed block.

The net result, in our view, is likely to be a more consolidated market place with stronger potential returns for the few companies remaining. While additional product re-pricing appears necessary, we believe various companies such as MetLife (Overweight, $38.29) and Prudential (Equal-weight, $61.31) are well positioned to push through the necessary changes without materially impacting their position in the market. If we are correct, then these companies should be able to benefit from a more oligopolistic market environment in the future, which we see as being a positive for their respective growth and return profiles.

Morgan Stanley is acting as financial advisor to Pan-American Life Insurance Group ("Pan-American") with respect to its definitive agreement to acquire select businesses and assets from MetLife, Inc., as announced on November 9, 2011. The transaction is subject to certain regulatory approvals and other customary closing conditions. Pan-American has agreed to pay fees to Morgan Stanley for its financial services that are contingent upon the consummation of the proposed transaction. Please refer to the notes at the end of the report.

Industry Analysis

March 6, 2012

Medical Technology
CSL's Growth Is Baxter's Gain

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Our analysis of plasma trends over the past several periods shows market growth remains healthy and suggests Baxter is poised for a positive inflection as SCIG momentum shifts to favor Baxter over CSL.

Baxter likely repeats CSL's success in SCIG. Our analysis of plasma growth trends over the past several periods shows market growth remains healthy and suggests Baxter is poised for a positive growth inflection as SCIG momentum shifts to favor Baxter (BAX, $57.84, Overweight) over CSL (CSL.AX, A$33, rated Equal-weight by Sean Laaman with an In-Line industry view for Australia Pharmaceuticals).

Over the past 18 months, CSL has grown its intravenous immunoglobulin (IVIG) business 24%, double Baxter's 12% growth, raising questions about competitive dynamics in the space. Our analysis focuses on Octapharma's product recall, subcutaneous immunoglobulin (SCIG) growth, and product mix as CSL converts its IVIG business to higher-priced Privigen (liquid) from Carimune (lyophilized, i.e. freeze-dried, and which requires reconstitution from its powdered form before infusion). Excluding these items, underlying growth at Baxter and CSL has been comparable at 7-9% despite the large optical growth disconnect (see exhibit, next page).

Strong growth in SCIG has been the biggest factor contributing to CSL's superior IG growth. CSL's Hizentra has been the nearly exclusive beneficiary of 25%-plus growth in the SCIG market worth about $300 million in 2011 and likely $400 million in 2012. Over the past several years, we estimate SCIG alone added 400-500 bps to CSL's IG growth rates.

Going forward, Octapharma should normalize, Privigen conversion is drawing to a close, and SCIG momentum should begin to tilt in Baxter's favor as it launches HyQ. Considering these factors together, it's likely CSL growth rates will decelerate meaningfully over the next 1-2 years.

We estimate that Privigen mix has increased from about 20% in C2008 to 60-65% today. We estimate favorable mix benefit from the higher Privigen prices has contributed roughly 200-400 bps to annual growth over the past several years. Going forward, this mix benefit will moderate substantially as (1) Cariumune has become a very small product, so the potential mix benefit from further conversion is modest, and (2) CSL is likely to retain a small Carimune business to preserve additional options for some customers. CSL's immunoglobin mix stands at roughly 60-65% Privigen and 20% SCIG, so Carimune represents only 15-20% of CSL's IG portfolio. Converting this last piece of Carimune business to Privigen is not a high priority for CSL, and would only increase sales by 2-4% in any event.

We expect SCIG momentum to swing strongly in Baxter's favor in the back half of 2012 and into 2013 as Baxter launches with the mid-2012 HyQ launch. HyQ will be strongly differentiated and should gain substantial share. Our prior survey work suggested Baxter could gain 20% share within one year of launch, and we believe Baxter's share could increase further to 40-50% over several years. Strong market growth means that CSL's SCIG business should still grow despite share losses, but growth could moderate closer to general IG market growth rates. Baxter has recently indicated that it will roll out the product more slowly in 2H12, in part due to capacity constraints, but the longer-term outlook remains very positive, in our view. For more detail on our views on the SCIG market in general and HyQ prospects in particular, please see our prior note *HyQ Expectations Going Higher; Raising Numbers* (September 30, 2011). HyQ is also an important pillar in Baxter's strategy to move away from episodic IVIG use into more prophylactic and chronic care. This initiative should drive more stable if not premium pricing and increase brand differentiation.

Our current Baxter estimates call for a modest IVIG acceleration from 3% in 2012 to 8% in 2013 as Octapharma headwinds ease, but we see upside to these estimates on stronger HyQ growth. We estimate HyQ could add 500 bps or more to Baxter's IVIG growth for several years and could be $0.15-0.20 accretive to EPS by 2015. We are modeling a 3Q12 soft launch for HyQ with more pronounced share gains and growth in 2013. We currently model HyQ sales of $15 million in 2012, $55 million in 2013, and $105 million in 2014, though we believe these estimates are likely to prove conservative.

Industry View : In-Line
Medical Technology

Industry Analysis

The exhibit below presents a growth reconciliation for IVIG and plasma results across the five largest global fractionators. Together, we estimate these companies account for roughly 70% of global sales of plasma-derived therapeutics and ~95% of IVIG sales. For Baxter and CSL, we've constructed an analysis to adjust for the impact of Octapharma, Privigen mix, and SCIG growth. Note that while the growth rates presented for Baxter, CSL, and Talecris consider only the IVIG business, the Grifols numbers shown include Grifols' entire Bioscience business. Grifols does not disclose IVIG sales separately, but we estimate roughly 50% of its plasma business is IVIG. For the full year 2011, Grifols did disclose that it grew IVIG volumes by 11%, stronger than overall Biosciences growth of 6.4%, though still short of Baxter's IVIG sales growth of 14% and CSL's of 24%. Prior to its 2H10 Octagam recall, Octapharma likely had a similar 50% mix of IVIG sales.

Plasma Growth Trends Over 2009-11 Show Importance of Octapharma, Mix, and SCIG

Plasma CC Growth Reconciliation	1H09	2H09	1H10	2H10	1H11	2H11
CSL IVIG Growth	**21.3%**	**7.9%**	**16.1%**	**21.8%**	**27.4%**	**21.6%**
Octapharma	0.0%	0.0%	0.0%	5.2%	9.6%	4.4%
Mix	2.0%	3.0%	3.0%	3.5%	3.5%	3.0%
SCIG	4.0%	4.0%	4.0%	5.0%	5.0%	5.0%
Normal Volume / True Price	**15.3%**	**0.9%**	**9.1%**	**8.1%**	**9.3%**	**9.2%**
Baxter IVIG Growth	**17.8%**	**11.0%**	**-8.5%**	**7.6%**	**19.5%**	**8.3%**
Octapharma	0.0%	0.0%	0.0%	4.4%	9.5%	1.4%
Normal Volume / True Price	**17.8%**	**11.0%**	**-8.5%**	**3.3%**	**10.0%**	**6.9%**
Talecris IVIG Growth	**42.4%**	**7.0%**	**3.7%**	**7.7%**	**--**	**--**
Grifols Standalone Plasma Growth	**10.5%**	**14.6%**	**8.5%**	**6.9%**	**--**	**--**
Grifols + Talecris Plasma Growth	**18.0%**	**8.9%**	**6.3%**	**5.9%**	**8.2%**	**4.7%**
Octapharma Plasma Growth	**20.5%**	**5.5%**	**-11.5%**	**-51.7%**	**--**	**--**

Source: Company Data, Morgan Stanley Research

Industry Analysis

March 4, 2012

Refining & Marketing
Crude Benefit Spreads to the Gulf Coast; All Benefit

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We have raised our estimate for refiners by 27% in 2013 to reflect our expectation for widening Gulf Coast differentials, where cost advantage supports secular strength.

Estimates raised as wider crude differentials move South. As US Mid-Con production grows, we believe the "Toll Road of Production Growth" will begin moving to the Gulf Coast (GC). We forecast that pipelines from Cushing to GC will lead to Louisiana Light Sweet crude (LLS) trading at a $1/bbl discount to Brent in 2012, $2/bbl in 2013 and up to $4/bbl in 2014. Wider Brent-LLS differentials in GC affects the West Texas Intermediate (WTI)-Brent differentials, as WTI prices below LLS — the results is an average 27% increase in our 2013 estimates for the refiners we cover. We mark our estimates for the quarter to reflect higher crack spreads and narrower retail margins. Although our estimates have increased, global refining supply and demand is less supportive for global crack spreads.

Key beneficiaries: VLO, MPC, HFC, DK, ALJ. We believe refiners benefit who have capacity directly on GC (Valero, Delek, Alon, Marathon Petroleum) or who are in the Mid-Con and barrels need Brent cracked imports will benefit as LLS trades under Brent (HollyFrontier, and to a lesser extent Tesoro). US exports should benefit relative to global exports and we believe Valero is better positioned than Asia- and Europe-based refining peers.

We also see some seasonal risk as we pass the halfway point of a December-May seasonal trade, where US refiners outperformed energy by 32% since December vs. 20% average outperformance in the past 10 years.

Why the seasonal trade works: Anatomy of the trade. In the last decade, refining equities have outperformed the S&P 500, by an average 26%, in eight out of 10 years from December-May. In our view, the seasonal trade can be explained by five main factors:

(1) capacity becomes the tightest during this period as US and European refining semi-annual turnarounds peak (4% of capacity in US in February-March,

(2) demand is the highest into peak Northern Hemisphere winter,

(3) tightening product balances (less supply, more demand) drive highest margins of the year,

(4) Street estimates generally follow cracks (average 20-50% positive EPS revisions in the season, and

(5) refiners have shown the highest correlation to EPS revisions among energy and within the market, especially during the Seasonal Trade period (Exhibit 1).

We believe this combination of events is responsible for historical, refining seasonal outperformance.

When the seasonal trade didn't work. The only years in the last decade the seasonal trade did not work were 2002 and 2008. In 2002, the refining equities outperformed December through April, followed by a 15% decline in May, leaving shares –5% absolute and in line with the S&P 500. This was a post-recession year with a warmer than average winter (by ~9%) that witnessed ~80% negative EPS revisions in Dec-May. In 2008, the group saw average absolute underperformance over that period (–38% compared to S&P 500's –20%), as the period was differentiated by the following factors: (1) crude prices rose 43% (to $127), triggering negative EPS revisions of 47% during the seasonal trade period; (2) the group was exiting the "golden age" of outperformance with absolute equities averaging 40% higher than current levels; and (3) US and macro fundamentals were deteriorating amid the rapid crude price rise. In those two years when the seasonal trade didn't work, refining equities didn't work on an annualized basis.

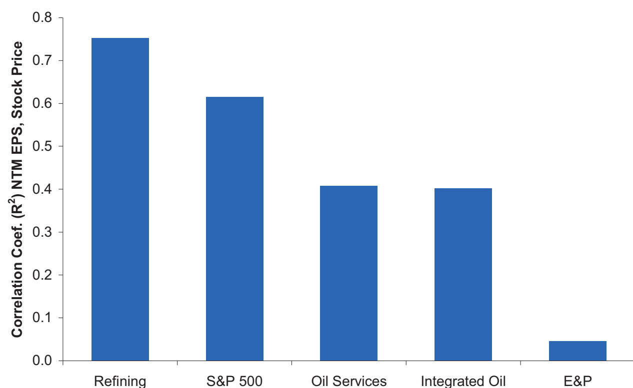
Companies mentioned: Alon USA Energy (ALJ, $10.15, Underweight), Delek US Holdings (DK, $13.35, Equal-weight), HollyFrontier (HFC, $33.28, Overweight), Marathon Petroleum (MPC, $42.18 Overweight), Tesoro Corp. (TSO, $27.60, Equal-weight), and Valero Energy (VLO, $26.02, Equal-weight).

Industry View : Attractive
Refining & Marketing

Industry Analysis

Exhibit 1

Forward EPS Estimates Drive Performance of Refiners' Equities



Source: Thomson Reuters, Morgan Stanley Research, 7 year average

Exhibit 2

Relative Refining Outperformance in Dec-May

Seasonal Trade (Dec-May)				Outperformance	
	Refining	Energy	S&P500	to Energy	to S&P
1999	-10.5%	15.5%	11.9%	-26.0%	-22.4%
2000	10.0%	10.3%	2.3%	-0.3%	7.7%
2001	86.1%	8.6%	-4.5%	77.4%	90.6%
2002	-5.7%	8.7%	-6.3%	-14.4%	0.6%
2003	21.8%	7.5%	2.9%	14.3%	18.9%
2004	39.3%	21.1%	5.9%	18.1%	33.3%
2005	47.8%	10.1%	1.5%	37.7%	46.3%
2006	33.2%	11.1%	1.6%	22.1%	31.5%
2007	39.3%	12.1%	9.3%	27.1%	30.0%
2008	-26.0%	13.0%	-5.5%	-39.0%	-20.6%
2009	55.3%	-2.6%	2.6%	58.0%	52.8%
2010	6.4%	-8.7%	-0.6%	15.1%	6.9%
2011	77.7%	22.6%	13.9%	55.1%	63.8%
2012	37.7%	5.7%	9.8%	32.0%	27.8%

Note: 2012 data represent December-to-date
Source: Company Data, Morgan Stanley Research

Sunoco (SUN)/Sunoco Logistics Partners (SXL) Transformation Begets More Upside — Stay Long

— Evan Calio, Stephen J. Maresca

Last week, we hosted a meeting with Brian MacDonald (Sunoco's CEO) and Michael Hennigan (CEO of SXL) at Sunoco's Corporate Office in Philadelphia. Our key takeaways:

(1) SUN is targeting a conversion to a yield-driven general partner (GP) company, views 2012 as a key "transition year", and we believe the yield and cash flow story will become clearer in 2H12;

(2) SUN's ability to increase buyback over 19% of total shares outstanding is not limited by the SXL spin-off if circumstances change. We see ability to reload any buyback, driving a higher yield with refinery sale and additional cash balances;

(3) The Philadelphia refinery sale/closure is expected in July. Political tensions regarding any closure remain elevated yet could facilitate a job-saving transaction;

(4) SXL has strong 2012 growth prospects with $300 million in organic capex and likely additional upside;

(5) Mariner East remains a possibility, though much longer-term, and could potentially become connected with fate of two refinery locations;

(6) SXL is interested in the North East terminals (Marcus Hook/Philadelphia), as Philadelphia has potential as an import hub, similar to NY Harbor; and

(7) Gulf Coast storage (Nederland, Texas) represents an increasing strategic alternative to Cushing.

SUN ($39.04) is rated Overweight with an Attractive Refining & Marketing industry view by Evan Calio.
SXL ($39.14) is rated Equal-weight with an Attractive Midstream Energy MLPs industry view by Stephen Maresca.

Company Analysis

February 29, 2012

Amylin Pharmaceuticals
Multi-Year Bydureon Analysis Highlights Risky IMS Trends

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Our IMS analysis demonstrates that consensus implies a stepwise Bydureon growth trajectory. We disagree with the estimates and approach.

Stock Rating: Underweight	Reuters: AMLN.O	Bloomberg: AMLN US
Price target		$8.00
Shr price, close (Feb 28, 2012)		$17.69
Mkt cap, curr(mm)		$2,588
52-Week Range		$18.45-8.03

Fiscal Year ending	12/10	12/11	12/12e	12/13e
ModelWare EPS($)	(0.94)	(0.72)	(2.11)	(2.40)
EPS($)**	(1.06)	(3.73)	(1.78)	(2.16)
Prior ModelWare EPS($)	-	-	(1.96)	(1.97)
Consensus EPS($)§	(1.25)	(0.65)	(1.37)	(1.00)

§ = Consensus data is provided by Thomson Reuters Estimates.
** = Based on consensus methodology
e = Morgan Stanley Research estimates

Price Performance

Company Description
Amylin Pharmaceuticals is a biopharmaceutical company primarily focused on the potential of new peptide hormone drug candidates and novel therapies for the treatment of diabetes, obesity, and other metabolic diseases. Amylin currently markets Byetta, a twice-daily GLP-1 agonist for treatment of type 2 diabetes, and Symlin, a partner to insulin to improve glucose control in both type 1 and 2 diabetes.

Industry View: In-Line — Biotechnology

We are Underweight AMLN as we see several fundamental risks, including commercial headwinds for both Byetta and Bydureon and balance sheet issues with a heavy debt burden (~$9/share net debt, ~$12/share gross debt) and little near term cash generation.

We analyzed the 2012–2016 Bydureon IMS TRx ramp necessary to meet our and Street estimates. While we suspect much of the recent stock strength is due to hope around strategic opportunities, fundamentals should come back into focus where our Bydureon concerns (i.e. cost, safety/toler–ability, delivery) remain. In light of the recent Bydureon FDA approval and US launch, we performed an IMS-based analysis to understand the sales trajectory necessary to meet our numbers vs. consensus.

Bydureon consensus implies best-in-class growth. Bullish investors note that 2012/13 consensus estimates (ranging from 5–15% above ours, ~85% of Victoza's IMS ramp), are achievable, with meeting estimates being a positive. Our 5-year IMS TRx model indicates that consensus embeds (a) major 2014 and 2016 sales inflections and (b) no sustained plateau or slower growth, implying Bydureon likely becomes the dominant marketed GLP-1 by 2014.

This stepwise growth pattern of lower near-term but aggressive outer-year estimates allows an increased chance of near-term estimate achievability while still supporting a high DCF valuation. Unfortunately, this inflection pattern is rarely if ever seen in IMS. We do not see the Bydureon pen (estimated for late 2012 /1H13 launch) as a major trend-changer (and inflection timing does not align), and we view the EXSCEL outcomes study as a longer term, less certain sales driver.

While intermediate scenarios exist, we see two basic outcomes as possible in light of Morgan Stanley's vs. consensus estimates:

(1) Bydureon launches on a 2012/13 ramp to meet either consensus or Morgan Stanley's forecasts (i.e. below Victoza). With a long-term IMS curve shape similar to Victoza, Byetta, and many recent launches, such a launch ramp should be viewed disappointingly as it implies possible sales misses in 1Q14 (at latest) and beyond and a DCF value below $10 (in our model with OpEx declining Y/Y in 2013-beyond).

(2) Bydureon launches on a best in class trajectory (i.e. about 20–30% better than Victoza and ~35+% better than consensus). This ramp (called "Pro-Forma Consensus" in this analysis) more clearly matches both the outer year (2014+) consensus estimates and the current stock price. We view this as unlikely.

Company Analysis

We envisage a third scenario in which Bydureon indeed undergoes some trajectory changes. Interestingly, while the pen device (expected late 2012/1H13) for Bydureon is seen by some — us not included — as a potential source of additional growth, the expected pen introduction is temporally separate from the two modeled inflections and thus an even more unlikely source of this type of growth, in our mind.

Finally, an alternate outcome is that the drug simply grows on a straight line for years. If one were to simply draw a straight line launch from launch to 2016 in order to both meet long-term consensus and avoid the unlikely infections, it would suggest (a) the drug will miss consensus estimates for at least some parts of 2012, 2013, and 2015; and (b) the drug would have a trajectory unlike any that we have seen to date.

Exhibit 1

Consensus (Actual and Pro-Forma) vs. Morgan Stanley Estimates ($mn)

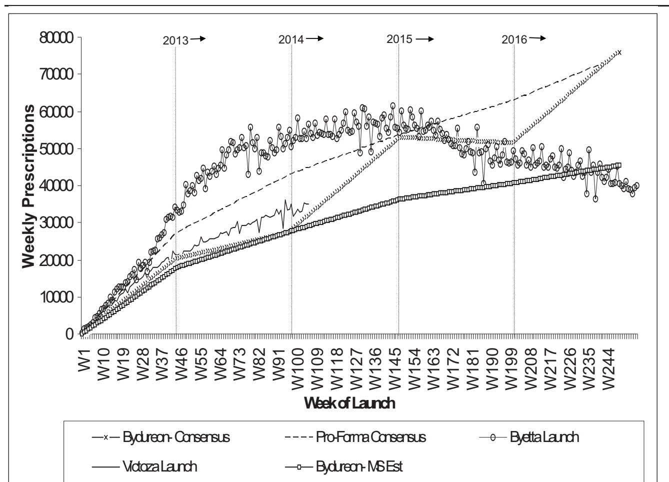
Consensus- Thomson	2012	2013	2014	2015	2016	2017*	2018*	DCF Value
US Byetta	$438	$296	$229	$198	$160	$145	$132	
US Bydureon	$133	$369	$637	$839	$1,060	$1,235	$1,432	
Total US Byetta/Bydureon	**$571**	**$665**	**$866**	**$1,037**	**$1,220**	**$1,380**	**$1,564**	**$16**
Consensus - Pro-Forma	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	
US Byetta	$438	$296	$229	$198	$160	$145	$132	
US Bydureon	$179	$544	$763	$939	$1,135	$1,339	$1,563	
Total US Byetta/Bydureon	**$617**	**$840**	**$992**	**$1,137**	**$1,295**	**$1,484**	**$1,695**	**$20**
MS	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	
US Byetta	$395	$213	$172	$147	$137	$125	$111	
US Bydureon	$118	$353	$505	$620	$709	$806	$916	
Total US Byetta/Bydureon	**$513**	**$566**	**$677**	**$767**	**$846**	**$931**	**$1,027**	**$8**

*Morgan Stanley extrapolation - Thomson Reuters only provides consensus through 2016

Source: Company Data, Morgan Stanley Research, Thomson Reuters

Exhibit 2

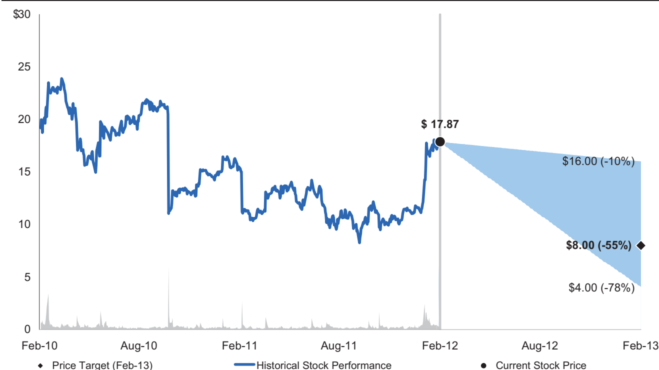
2012-16 IMS Drug Ramps: Morgan Stanley and Consensus (Actual and Pro-Forma) for Bydureon vs. Existing GLP-1 Launches*



* = Year markers on chart are for Bydureon launch only
Source: Company Data, Morgan Stanley Research

Exhibit 3

AMLN: Bydureon's Commercial Potential May Be Limited; Byetta Likely to Continue Declining



Price Target $8	Derived from a discounted cash flow analysis using a WACC of 10% and a terminal growth rate of 0% post 2030. The revenue driver in our model is the launch of Bydureon in 2012.
Bull Case $16	**Bydureon shows best in class growth.** Launch of Bydureon creates an inflection point in the GLP-1 market, which grows substantially over the ensuing few years. We assume Bydureon gains dominant share in this market and model 2018 US sales of ~$1.3bn. IMS prescriptions trends and quarterly sales numbers will be indicative of whether this scenario will become reality.
Base Case $8	**Bydureon growth inferior to Victoza's.** Some growth in the GLP-1 market, but less than our bull case. We model peak 2018 US Bydureon sales of ~$920mn. Key metrics to watch include IMS prescription trends and quarterly sales numbers.
Bear Case $4	**Bydureon struggles**. Bydureon falters commercially and Byetta continues to decline, but more modestly than in the base case. In this case, we model US Bydureon sales of $620mn and cost cutting to maintain profitability.

Source: Morgan Stanley Research, Thomson Reuters All above valuations are DCF-based.
NOTE: We have modeled scenarios based on what we consider to be the key drivers of the stock's value over the next 12 months. There is, however, the potential for outright upside in the stock price due to other factors that we consider to be relatively unlikely.

Risks to our price target

- Upside: Bydureon could exceed our expectations. Bydureon has shown some of the best glucose reduction and weight loss data to date. We may be underestimating the impact of these data and 1x weekly convenience on prescribing habits.
- Upside: Amylin may have strategic value.

Morgan Stanley alphawise proprietary research

Company Analysis

March 1, 2012

Biogen Idec
BG-12 Still the Value Driver

Morgan Stanley & Co. LLC

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Additional analyses of our proprietary AlphaWise US/EU multiple sclerosis survey continue to support upside to BG-12 expectations. BG-12 remains the central long-term value driver despite limited near term BG-12-related catalysts.

Limited launch risk. Our December 2011 survey of ~120 US and EU (Germany/France) neurologists points to a strong launch with BG-12 gaining ~14% and ~22% total patient share after one and two years. Physician surveys are directional rather than precise guides, but our survey implies little risk to consensus launch expectations, a key investor concern.

BG-12 consistently strong across key markets including 1) US and EU across total (23% and 20%) and treatment naïve (26% and 27%) share, 2) community and academic-center based neurologists with 21% and 23% total share, and 3) Avonex (26%), Copaxone (24%), and Rebif/Betaseron (18%) high prescribers.

Supports a 2nd-line focused EU pricing strategy. EU pricing disparities between Avonex and second-line agents like Tysabri and Novartis' Gilenya create a clear strategic question for BG-12. Our EU survey responses support 2nd-line or later focused pricing with 1) similar treatment naïve and switch share for BG-12 (27% and 26%), 2) 20%+ switching rates after 2 years on therapy, and 3) efficacy perceived as superior to ABCRs.

Avonex cannibalization manageable. Biogen's Avonex is the largest source of BG-12 share in our survey (~40% of BG-12 share vs. ~25% total share at baseline, consistent in US and EU). Thus, physician targeting will be key for the BG-12 sales force with Teva's Copaxone also a major source of BG-12 share.

A share and positive mix driver. Biogen's total MS share (Avonex, BG-12, and Tysabri) increases from 32% currently to 44% two-years after BG-12's launch in our survey.

Stock Rating: Overweight	Reuters: BIIB.O Bloomberg: BIIB US
Price target	$140.00
Shr price, close (Feb 29, 2012)	$116.47
Mkt cap, curr(mm)	$28,107
52-Week Range	$123.23-67.74

Fiscal Year ending	12/11	12/12e	12/13e	12/14e
ModelWare EPS($)	5.03	5.34	6.44	8.27
P/E	21.9	21.8	18.1	14.1
Consensus EPS($)§	-	6.18	7.01	8.50

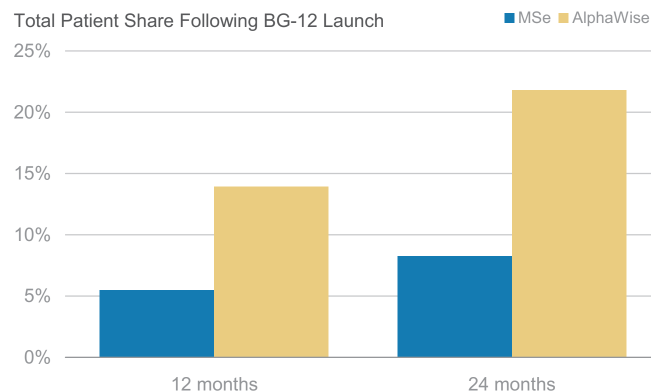
§ = Consensus data is provided by Thomson Reuters Estimates.
e = Morgan Stanley Research estimates

Price Performance

Company Description
Biogen Idec discovers, develops, manufactures and markets therapies for the treatment of neurodegenerative diseases, hemophilia and autoimmune disorders.

Industry View: In-Line — Biotechnology

Exhibit 1
Survey Suggests Room for Upside to Our Forecasts for BG-12



Source: Morgan Stanley Research, AlphaWise

Company Analysis

Our December 2011 AlphaWise Survey suggests room for upside to already high BG-12 expectations, as we discussed in our recent initiation (*Biogen: A Good Growth Story is Hard to Find*, published on February 9, 2012). In this note, we review the primary conclusions from our survey and examine underappreciated aspects of the BG-12 commercialization story including: 1) trends in key commercially important markets including US versus EU trends and community practice versus academic/specialty center, 2) the importance of physician targeting to manage Avonex erosion, 3) the European pricing strategy, and 4) BG-12's impact on total MS market share *and* mix. .

AlphaWise Survey Positive for BG-12

AlphaWise implies strong launch trajectory Our AlphaWise survey of 122 US and EU neurologists (62 US, 60 EU) implies that *total* BG-12 share will be in excess of 20% within two years post launch, with ~15% after 12 months and ~20% after two years. For treatment naïve patients and patients undergoing a therapy switch for efficacy and/or tolerability reasons, our survey suggests an impressive 27% and 26% share respectively, after two years.

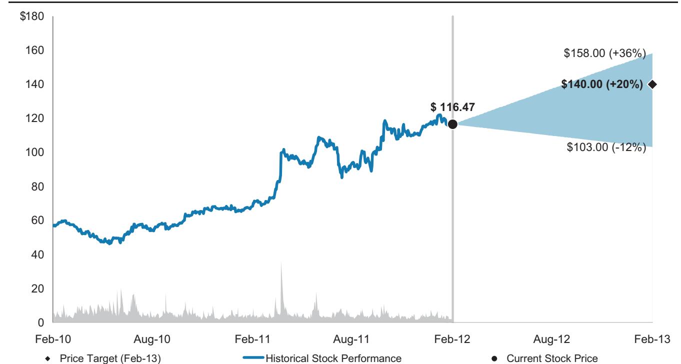
Oral drugs to gain significant share in MS. While at <5% share today, our survey indicates that within three years post BG-12's launch as much as 1/3 of patients may be on an oral therapy with BG-12 likely representing the vast majority. In a $13-14B MS market, this implies ~$4B in sales by year three for orals assuming no growth.

Room for upside. With 14% and 22% of total patients on BG-12 after one and two years post-launch respectively, our survey suggests upside potential to MSe of 5% and 8% respectively *and* our Bull Case of 6% and 12%. Physician surveys tend to overstate share leaving us comfortable with our Base Case, but our survey clearly suggests our above-consensus BG-12 estimates may still be conservative.

Moreover, as evidenced by Novartis' Gilenya, BG-12 has the potential to grow the market by catalyzing a return to therapy among patients previously discontinuing therapy. Respondents expect ~30% of patients currently off-therapy to return to treatment due to the availability of BG-12 by 3 years post the BG-12 launch. US neurologists estimate 32% of off treatment patients versus 26% in the EU.

Exhibit 2

BIIB: Positive Outlook for BG-12, Pipeline Risk-Reward Positive



Price Target $140: Derived from DCF analysis which assumes a discount rate of 10% and terminal growth rate of 0%.

Bull Case $158	DCF-based Valuation, 16x 2014e EPS adjusted for BG-12 milestones	**BG-12 ~$6B in peak sales, Pipeline comes through** **MS Franchise:** BG-12 ~$4B in peak sales, Tysabri makes meaningful first line in-roads, Avonex erosion proves modest driving a double digit 5 year revenue CAGR and >20% EPS CAGR through 2016+ **Pipeline**: PEG-Avonex blunts BG-12 ABCR erosion for Biogen or hemophilia finds commercial success
Base Case $140	DCF-based Valuation, 15.5x 2014e EPS adjusted for BG-12 milestones	**BG-12 reaches ~$3.5B in sales, Tysabri Accelerates, No Pipeline** **MS Franchise:** BG-12 ~$3.5B in peak sales, Tysabri gains significant second line share, Avonex erosion manageable driving a high single digit 5 year revenue CAGR and high-teens EPS CAGR **Pipeline**: Minimal pipeline value
Bear Case $103	DCF-based Valuation, 12x 2014e EPS adjusted for BG-12 milestones	**BG-12 and Tysabri Disappoint, No Pipeline Success** **MS Franchise:** BG-12 plateaus near ~$1.5B in peak sales while Tysabri struggles to gain traction in earlier lines of therapy. The 5 year revenue CAGR reaches the mid-single digits with low double digits on the bottom line **Pipeline**: Fails to deliver

Source: Thomson Reuters, Morgan Stanley Research estimates

Key Value Drivers & Debates

- PEG-Avonex is underappreciated with potential for monthly dosing
- Balance of BG-12 driven margin expansion and reinvestment is key
- Filling out Phase I/II pipeline is important for the long term
- Tysabri collaboration margin expansion potential significant

Key Risks

- BG-12 expectations are high and execution risk remains
- Tysabri post-JCV reacceleration still unclear
- ALS Phase III catalyst is high risk
- Avonex and Tysabri cannibalization by BG-12 unclear

Company Analysis

March 1, 2012

Fusion-io
Sustainable Product Leadership in Fast Growing Market; Resume Coverage at Overweight

Morgan Stanley & Co. LLC

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Our meetings with Fusion-io along with less competitive product launches increase our confidence in FIO's market opportunity, product leadership, and expected margin recovery. We resume coverage at Overweight with a $35 price target.

Large market opportunity: We continue to believe the enterprise flash market could more than double over the next year, growing from $2B today to $20B over time with FIO maintaining its lead in the fastest growing segment called server-side flash (80% share today). We view the ramp of its new ioDrive2 product, maturing customer pipeline (strategic and core), and growing international presence (China 15% of revenue in C4Q) as key catalysts to accelerating growth above consensus estimates of only 34% in FY13. Our $35 price target implies a 7.9x EV/Sales multiple, the upper end of comparable data center peers, to our FY13 revenue estimate of $473M (+42% Y/Y).

Differentiated product: Software is the key to FIO's competitive lead and longer-term vision. We believe competitive product offerings lack full integration with data center ecosystems and are often behind the cost and reliability curve. Over half of FIO's customers are using its products for persistent storage in scale-out environments, which demonstrates the trust and deep customer relationships FIO built over the last several years. What's more, the company's recent acquisition of ioTurbine is opening large opportunities in virtualized environments where data input/output (I/O) is becoming a large problem.

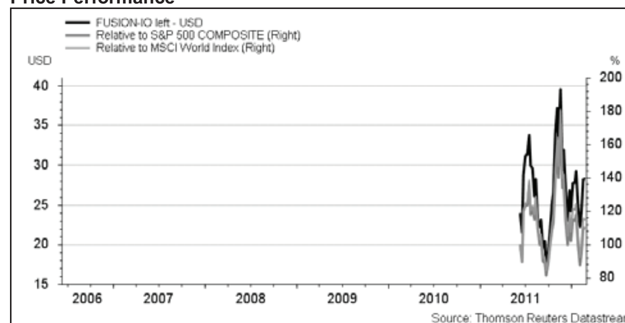
Margin recovery on track: Product mix and large strategic deals will likely continue to pressure margins in C1Q, but the 50% lower cost per GB of ioDrive2 should start to return margins towards FIO's long-term range of 56-58%, as it accounts for a majority of units in C2Q. Given the lack of competitive offerings, we do not see pricing pressure as a cause of recent margin declines.

Stock Rating: Overweight	Reuters: FIO.N	Bloomberg: FIO US
Price target		$35.00
Shr price, close (Mar 1, 2012)		$29.70
Mkt cap, curr(mm)		$3,236
52-Week Range		$41.69-14.91

Fiscal Year ending	06/11	06/12e	06/13e	06/14e
ModelWare EPS($)	0.09	(0.12)	0.11	0.32
EPS($)**	0.19	0.25	0.48	0.68
Consensus EPS($)§	-	0.24	0.35	0.60
P/E, consensus	-	123.8	84.6	49.6
EV/rev	59.2	8.8	6.2	4.3

§ = Consensus data is provided by Thomson Reuters Estimates.
** = Based on consensus methodology
e = Morgan Stanley Research estimates

Price Performance



Company Description
Fusion-io develops solid-state storage memory solutions that improve the processing capabilities within a data center by moving active data closer to the CPU — a process called data decentralization. Fusion-io's integrated hardware and software solution reduces latency, increases data center efficiency, and transforms legacy architectures into next generation data centers.

Industry View: In-Line — Systems and PC Hardware

Investment Thesis

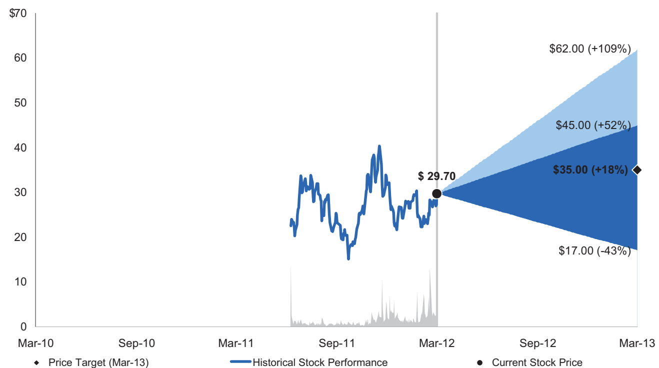
- Fusion-io is well positioned to ride the rapid adoption curve of enterprise flash with its leading market position, lower-cost product introduction, and growing distribution partnerships.
- Near term, rapid adoption of enterprise flash helps Fusion-io increase its penetration of a $1B pipeline. Long term, Fusion-io becomes a strategic data center partner as customers adopt its software solutions.

Key Value Drivers

- Software-based solution with direct access to customers keeps FIO atop the value chain.
- Measured investment trajectory drives operating leverage over time
- Sustainable L-T gross margin as new software offerings and leading-edge NAND offset competitive pressure

Company Analysis

FIO: Growing Customer Base and Market Opportunity Should Drive the Share Price



Extreme Bull Case $62 6.2x EV/Sales	**Full conversion of $1 billion pipeline.** $1+ billion revenue run-rate in FY13 (+201% Y/Y) drives operating margin to high-end of FIO's target range (25%) and tax rate to 30% -- EPS of $1.50, +213% Y/Y. 6.2x EV/Sales is in line with next generation data center peers.
Bull Case $45 6.2x EV/Sales	**50% penetration of $1 billion pipeline in FY13.** $720 million of revenue in FY13 (+116% Y/Y) drives operating margin to low end of FIO's target range (20%) and EPS of $0.90, +88% Y/Y. 6.2x EV/Sales is in line with next generation data center peers.
Base Case / Price Target $35 7.9x EV/Sales	**25% penetration of $1 billion pipeline in FY13.** We model $473 million of revenue in FY13 (+42% Y/Y) with gross margins returning to the long-term range of 56-58%. Operating leverage increases margins to 13.8% from 8.8%. As a result, FY13 EPS nearly double to $0.48 from $0.26. Beyond FY13, EV/Sales remains toward the high end of the peer group range of 4-8x.
Bear Case $17 4.0x EV/Sales	**No penetration of $1 billion pipeline in FY13.** All of the 15% Y/Y revenue growth in FY13 comes from the core business (sold through OEM partners) without new 10% customers. A more robust enterprise (core) customer base is a positive L-T, but overall growth is well below expectation. Concerns increase about the company's long-term ability to sell add-on software. FIO trades at the low end of next generation data center peers due to disappointing customer win rates and revenue growth vs. investor expectations.

Source: Thomson Reuters, Morgan Stanley Research

Potential Catalysts

- Conversion of the $1 billion strategic customer pipeline over the next year
- Incremental marketing efforts from channel partners, IBM, HP, Dell
- New software offerings and maintenance attach

Investment Risks

- High customer concentration (two strategic customers make up 58% of LTM revenue)
- Dependent on OEMs for a large percentage of revenues going forward
- Competition from fast followers beginning to enter the market in 2012
- Access to or pricing of NAND supply could impact revenue or gross margin
- Gross and operating margin volatility due to revenue lumpiness

Company Analysis

February 29, 2012

J.P. Morgan Chase & Co.
2012 Investor Day Wrap-Up

Morgan Stanley & Co. LLC

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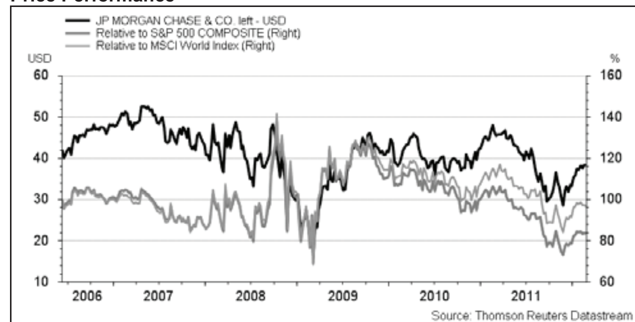
This best-in-class franchise is currently the cheapest money center bank equity, on our forecasts. Organic reinvestment driving market share gains means pretax margin should rise. We see room to lift the dividend and improve valuation. JPM expects the Volcker Rule to be manageable as long as it's "reasonable."

Stock Rating: Overweight	Reuters: JPM.N Bloomberg: JPM US
Price target	$42.00
Shr price, close (Feb 28, 2012)	$39.21
Mkt cap, curr(mm)	$148,683
52-Week Range	$47.80-27.85

Fiscal Year ending	12/11	12/12e	12/13e	12/14e
ModelWare EPS($)	4.48	4.46	5.18	6.27
P/E	7.4	8.8	7.6	6.3
Consensus EPS($)§	4.53	4.66	5.37	5.86
Div yld(%)	3.0	2.9	3.5	4.3

§ = Consensus data is provided by Thomson Reuters Estimates.
e = Morgan Stanley Research estimates

Price Performance



Company Description
J.P. Morgan Chase is one of the largest diversified financial companies globally.

Industry View: In-Line — Banking-Large-cap Banks

JPM looks well positioned in the current banking environment. At JPM's annual Investor Day on February 28, management reaffirmed its ROTE target of 16%. JPM gave detail on the Investment Bank trading business (by product average number of trades per quarter and average revenue per trade). JPM also highlighted key 2012 growth opportunities by segment.

The investor day highlighted challenges the group faces (rates staying lower for longer, expense pressures, regulation), but we think JPM's best-in-class franchise is well positioned to take share and win through this environment. JPM is the cheapest money center, measured by both P/E and P/B when you factor in ROE, in our view. At current levels, if you buy JPM, for every 1% point of ROE, you are paying 0.8x 2013e EPS (vs. BAC at 1.9x, C at 1.3x, and GS at 1.1x).

Commentary on the Volcker Rule was in line with expectations, suggesting that as long as it's "reasonable," the Volcker Rule shouldn't be an issue for JPM. The company argued that the vast majority of its trading business is flow — and provided newly disclosed supporting data. The question remains on what the tail risks are, as averages can mask risk/opportunity; that said, the data add to investor mosaic on trading revenues. The share-gain commentary did not cover whether Europe was a contributor. The expense management theme echoed throughout the day as JPM guided to flat expenses in 2012 while still reinvesting in the business.

We still see potential for upward EPS revisions as JPM demonstrates share gains and efficiency saves. Management's through-the-cycle ROE targets imply 43% upside to our 2013 EPS estimate…but "normalized" is more likely to be achieved in 2014 or later, in our view.

Themes from February 28, 2012 Investor Day

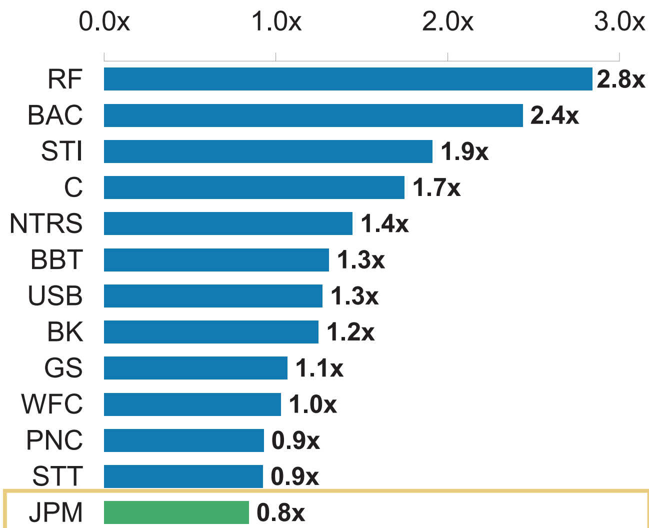
- Building business for the long term.
- Reaffirmed ROE goals.
- More capital management coming: Expect dividend payout of 30%-plus over time plus stock buybacks or special dividends to manage capital.
- Best-in-class returns.

Next catalysts: Stress test results out by mid March (we expect a 5 cent dividend hike to $0.30/quarter and share buybacks of $7.1 billion in 2012); stabilization in Europe; lower market volatility; and positive operating leverage from share gains.

Company Analysis

Exhibit 1

JPM Is Cheapest Bank in Our Coverage Group Per Unit of ROEE on an 'Apples-To-Apples' Basis*



Source: Company Data, Morgan Stanley Research e = Morgan Stanley Research estimates
* ROEE = Return on Economic Equity; Economic Equity puts all banks on an apples-to-apples basis as we change any prior deals that were pooling deals to purchase deals to better compare bank returns.

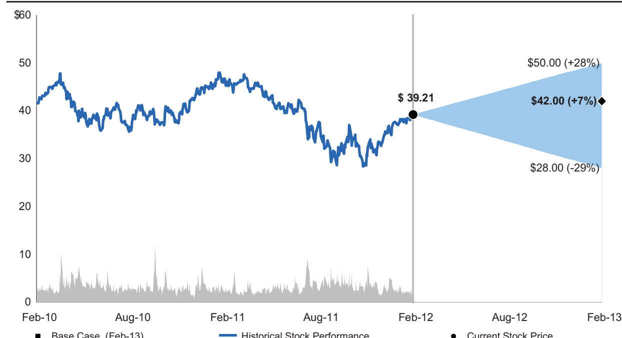
Valuation and Risks

Our price targets are based on probability weighted residual income valuation and bear case valuation. We expect that the market will start to value bank equities off of longer-term, normalized earnings as credit improves, required capital is determined, and loan growth starts to inflect positively — in 2011 for Commercial & Industrial (C&I), 4Q11 for card, 2H12 for residential mortgage, and 2013 for Commercial Real estate). Our Bull Case intrinsic values use residual income valuation and our Bear Case intrinsic values are based on 2009, bottom-of-cycle, bear case, price-to-tangible book multiples. We assume a 5.0% risk-free rate and a 4.5% equity market risk premium.

For JPM shares specifically, upside risks include faster loan growth, faster expense reductions, faster card improvement, more reserve release, higher share buybacks, and slower deterioration in housing credit losses. Downside risks include stricter-than-expected regulatory interpretation of financial reform legislation (especially derivatives), higher credit losses than we are currently anticipating, stymied market share gains in global markets, higher foreclosure, legal/regulatory related costs, and thinner net interest margins. Additionally, risks to our normalized earnings outlook include the inability to repurchase stock.

Exhibit 2

JPM: Risk-Reward View



Price Target $42		Based on base case residual income.
Bull Case $50	P/TB= 1.3x 2012 Bull Case Tang. BV	**Faster, stronger US recovery**. Greater global GDP growth. Credit improves more rapidly than our base case. Valuation based on bull case residual income.
Base Case $42	P/TB = 1.1x 2012 Base Case Tang. BV	**Modest US recovery.** Sub-par economic growth. NPL decline continues through 2012. Price target based on probability weighted intrinsic value derived from residual income valuation and bear case valuation.
Bear Case $28	P/TB = 0.6x 2012 Bear Case Tang. BV	**Double-dip US recession**. Slower global GDP growth. Market does not look through to normalizing EPS, nor does it discount strategic options. Valuation based on TBV.

Source: Thomson Reuters, Morgan Stanley Research,

Investment Thesis

- We are Overweight JPM given its growing market share, efficiency focus; exposure to European resolution, which improve capital markets; and declining mortgage foreclosure costs in 2013, all of which should lead to rising ROE.
- We expect JPM's stronger balance sheet and market position will enable it to take share. We believe that JPM's capacity to take share in tough markets makes it a great way to play the 2H12 macro risk/opportunity.

Key Value Drivers

- Card – Stable net interest margin (NIM) a positive given other product yields are under pressure.
- Retail – Tightening expense belt, opportunity to drive positive operating leverage
- Investment Bank – Road map to European resolution would lower volatility and unlock IBD pipelines.
- TSS – Pulling in cheap deposits.
- Commercial Bank – C&I loan growth and cheap deposits

Potential Catalysts

- Europe resolution
- Lower market volatility
- Positive operating leverage
- Increased share in non-US capital markets activities
- Commercial loan growth
- Market share gains
- Rising yields

Company Analysis

March 6, 2012

Oracle
FQ3 Should Be the Gateway to Better Performance

Morgan Stanley & Co. LLC

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February-quarter results are likely to come in well given a benefit from slipped deals, a better IT spending picture and incremental positives from recent M&A and new products. With low expectations for FQ4 (May), growth set to ramp in C2H12, and valuation near all-time lows vs. the group, ORCL appears set to outperform.

Elements of a solid FQ3. ORCL has underperformed the NASDAQ by 1400 bps from the weak FQ2 print, as a high perceived bar for FQ3 raised investor concern. Several factors give us confidence ORCL can put up a solid FQ3 when it reports on March 20. Oracle's intense focus on business that slipped from FQ2 likely bolstered guidance for FQ3 — potentially adding $100–150 million in "reclaimed" license revenues in FQ3. This trims FQ3 license seasonality by 7 percentage points, back in line with the 5-year average. Our checks also suggest large deals have improved, new sales capacity is ramping and new hardware boxes (Exalytics/Big Data) will help in FQ3.

We believe ORCL shares remain attractive. ORCL is now trading near historical lows against the broader software group (Exhibit 1) and at only 12x C2012e EPS versus our view of sustainable mid-teens earnings growth.

Expecting progress in FQ3 on key transitions. We believe FQ2 will have marked the trough for Oracle, and see growth upticking in FQ3 ahead of a more meaningful re-acceleration in the back half of C2012. We see this driven by: (1) new sales capacity coming online as Oracle manages through the addition of 3,000 sales people (1,700 incremental); (2) Fusion Apps becoming a more material driver; (3) New Exa products reaching critical mass to offset the a shrinking commodity hardware business; (4) easier compares; and (5) contribution from recent and pending acquisitions, which we estimate represents ~$500 million in license revenue, or 5 percentage points of growth yet to be added to numbers for F2013.

Stock Rating: Overweight	Reuters: ORCL.O	Bloomberg: ORCL US
Price target		$33.00
Shr price, close (Mar 5, 2012)		$30.24
Mkt cap, curr(mm)		$154,643
52-Week Range		$36.50-24.72

Fiscal Year ending	05/11	05/12e	05/13e	05/14e
Revenue, net($mm)	35,668	37,091	39,852	43,069
EPS($)**	2.23	2.35	2.62	2.95
P/E**	15.3	12.9	11.5	10.3
ModelWare EPS($)	2.10	2.24	2.53	2.86

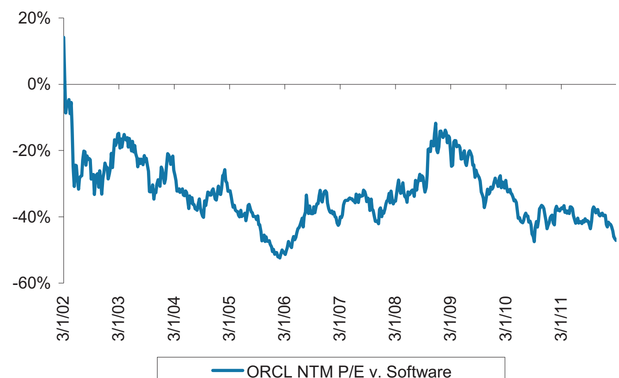
** = Based on consensus methodology
e = Morgan Stanley Research estimates

Price Performance

Source: Thomson Reuters

Company Description
Oracle provides a broad portfolio of enterprise software from applications to operating systems. Its core database management software includes Oracle11g, which is used to store and access data across numerous platforms. The company also offers business applications automating a broad range of business processes across many verticals.
Industry View: In-Line — Software

Exhibit 1
ORCL Trading Near 10-Year Lows Relative to Broader Software Group

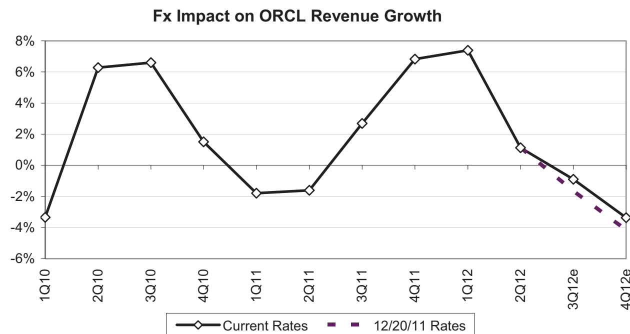


Source: Thomson One, Morgan Stanley Research

Company Analysis

Exhibit 2

While Better Than Forecast, Currency Still ~90bps Headwind in FQ312 Growing To ~340bps in 4Q



Note: Analysis uses a GDP weighted bucket of selected currencies from each region - Americas = USD, CAD, MXN, BRL -- EMEA = EUR, GBP, SEK, NOK, CHF -- APAC = YEN, AUD, KRW, TWD

Source: Thomson One, Company data, Morgan Stanley Research

Exhibit 3

Our Estimates Are Mostly in Line with Consensus for FQ312; Below on Total Revenue for 4Q12

	3Q12		4Q12		FY12	
	MS	Cons	MS	Cons	MS	Cons
License Revenue	$2,277	$2,267	$3,892	$3,898	$9,715	$9,720
YoY Growth	3%	2%	4%	4%	5%	5%
Total Revenue	$9,014	$9,023	$10,911	$11,170	$37,134	$37,414
YoY Growth	2%	2%	1%	3%	3%	5%
Non-GAAP EPS	$0.57	$0.56	$0.76	$0.76	$2.35	$2.34

Source: First Call, company data, Morgan Stanley Research

Engineered Systems starting to push through the fog. The decline of Oracle's commodity x86 business continues to weigh on the overall hardware business and obscure the momentum of the Exa-products. We think progress here should start to show in the combined numbers in F2013 and our proprietary hardware model points to Oracle seeing these new systems start to drive overall hardware product growth in the back half of C2012. Engineered systems (Exa-products plus SPARC SuperCluster and the Big Data Appliance) were almost +200% Y/Y in FQ2 according to the company and we believe should continue to show 100%-plus Y/Y growth in FQ3. Based on our proprietary hardware model, engineered systems could represent over 10% of hardware product revenue for the first time in FQ3.

Getting serious about SaaS. Oracle is sharpening its focus on cloud-based delivery and believes they now have a strong Software as a service (SaaS) ERP offering with all Fusion modules available in multi-tenant or single-tenancy delivery models. Based on our discussions, the demand for SaaS options among the early Fusion customers has been surprisingly strong. With the recent acquisitions of RightNow (closed 1/25/2012) and Taleo (expected to close mid-C2012), Oracle looks to buttress its public cloud application portfolio in the customer service and strategic HR management segments. With subscription revenues from these deals reported in Oracle's non-GAAP license line, the potential exists for a material ramp in inorganic contribution heading into F2013. By our estimates, RightNow and Taleo should add ~18% of growth to the application license business, and double the inorganic growth in overall license growth from 2.7% in F2012 to 5.4% in F2013.

Valuation Methodology and Risks

Our $33 price target bases on 12 times our C2013e EPS of $2.77, or 1.2x C2011-C2013e EPS growth, in line with large cap software. We see mildly increasing confidence in the core business, but little credit given for acquired growth. As IT spending becomes more volatile, we believe Oracle will sustain modest organic constant-currency revenue growth of mid- to upper-single-digits through C2013. While the Sun acquisition materially raises EPS estimates, investors appear to be giving ORCL little credit for acquired growth and multiples should returned to 12x.

The key risks we see to our target are increased execution risk from the large, unprecedented Sun acquisition as well potential deterioration in the IT spending environment.

Company Analysis

March 1, 2012

Staples
The Upside Opportunity: Large, but Longer Term

Morgan Stanley & Co. LLC

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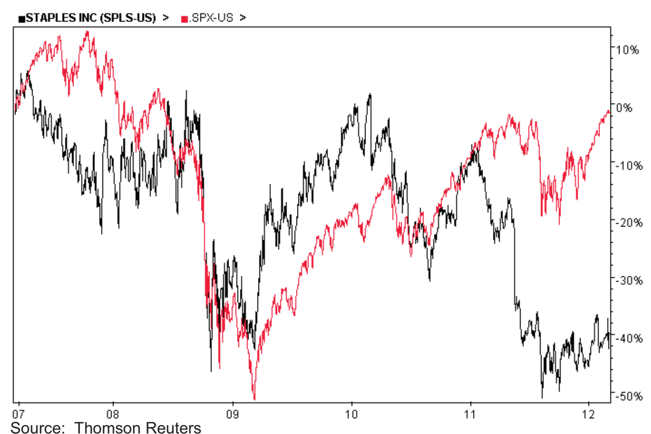
We remain Overweight as we think 2-3% revenue growth is sustainable as core office products have stabilized and adjacent category sales are driving growth. At ~10x 2012e EPS, secular concerns appear fully reflected, but SPLS has been removed from the Best Ideas list due to a lack of near-term catalysts.

Stock Rating: Overweight	Reuters: SPLS.O	Bloomberg: SPLS US
Price target		$19.00
Shr price, close (Mar 1, 2012)		$15.38
Mkt cap, curr(mm)		$10,840
52-Week Range		$21.50-11.94

Fiscal Year ending	01/11	01/12	01/13e	01/14e
EPS($)**	1.27	1.37	1.50	1.61
ModelWare EPS($)	1.40	1.52	1.61	1.67
Prior ModelWare EPS($)	-	1.48	1.60	1.75
P/E	15.9	9.6	9.5	9.2
Consensus EPS($)§	1.28	1.37	1.49	1.66
Div yld(%)	1.6	2.7	2.9	3.1

§ = Consensus data is provided by Thomson Reuters Estimates.
** = Based on consensus methodology
e = Morgan Stanley Research estimates



Source: Thomson Reuters

Company Description
Staples is an office products company that serves customers of all sizes in 26 countries throughout North America, Europe, Australia, South America, and Asia. The company operates three segments: North American Delivery, North American Retail, and International Operations.
Industry View: Cautious — Retail, Hardlines

The ultimate Bull Case for SPLS revolves around three key tenets and we see upside to shares even in the less extreme version that we assume in our Base Case. We believe management is focused on these issues, but it could take longer to see progress than we had expected.

(1) Improving operating environment: Largely out of the company's control, but we are seeing improvement. White-collar and small business jobs growth accelerated to 1.5% and 2% in January, respectively, and Office Depot/OfficeMax gained footing in their respective 4Q results — which we view as a necessity for long-term stability in the industry. Further, all three companies noted stability in core supplies with growth in adjacencies.

(2) Increasing efficiency in stores and international: Staples management remains focused on growth initiatives as well as improving efficiency. We believe the two go hand in hand as new categories improve efficiency on a per-square-foot basis, particularly with no net store growth and store sizes/rents decreasing. Still, we believe investors would like to hear greater emphasis on reducing costs given the change growth outlook over the past few yeas.

(3) Opportunity in using return of capital to drive EPS and add shareholder value: We agree with management's prudent balance of dividend growth and buybacks, but see upside to utilizing modest amounts of leverage given current interest rates. Net leverage is ~2.5x, and below 0.5x excluding leases. Management is focused on repaying maturities as it approaches a $1.5 billion note due in January 2014. It is not callable, but addressing the maturity should be a catalyst at some point. Staples repurchased 5% of its shares in 2011 and we assume similar levels near term, but our Bull Case assumes 35% of shares are retired by 2015.

We reiterate our Overweight rating for longer-term investment. Having reached a cyclical bottom, we believe Staples is poised to benefit from modest growth in office supplies and to drive revenue growth in adjacent categories. At ~10x forward P/E and a 3% dividend yield, we believe that the market is assuming long-term secular declines for Staples, which we believe is unwarranted. Our $19 price target is the average of two valuation methodologies: (1) a DCF assuming an 8.8% WACC and 0% long-term growth rate and (2) a P/E multiple analysis, with SPLS trading at an 11 x forward multiple over the next five years.

Company Analysis

SPLS: Steady Improvement in Core and New Categories Drive Positive Risk-Reward Skew

Bull Case $23	13x Bull Case 2013e EPS	**Macro improvement and success in adjacencies.** Modest improvement in economic growth and revenue growth of 3-5%. Comp store sales grow at 2-4% through 2016 as copy and print and EasyTech reach 15-20% of retail sales. North American Delivery (NAD) revenues grow mid-single-digits as Staples reaches ~10% market share in facilities and breakroom. Int'l margins grow toward the company's 7.5% with slight revenue growth.
Base Case $19	11x Base Case 2013e EPS	**Steady macro improvement and mild success in adjacencies.** Comp store sales grow ~1-2% for the next few years as copy and print and EasyTech offset flat core retail sales. NAD revenues grow 3-4% as facilities and breakroom revenues add to modest core growth. International margins remain in low single digits.
Bear Case $11	8x Bear Case 2013e EPS	**Further cyclical headwinds heighten concerns of secular decline.** Reacceleration of industry declines feed secular concerns. Adjacent category initiatives gain little traction, driving low-single-digit organic revenue declines in 2012-2013 and mid-single-digit EBIT declines. This drives multiple compression as well as a low-single-digit decline in EPS.

Source: Thomson Reuters, Morgan Stanley Research

Potential Catalysts

- With expected FCF of $1.1-1.3 billion per year and $1.2 billion of cash at year-end 2011, we expect Staples to continue its measured growth in payout.
- We expect ~10% per year dividend increases and repurchases of 15-20% of shares outstanding over the next 4 years.
- Staples management usually announces its dividend increases following a board meeting that occurs the week after it reports 4Q earnings, i.e. early March.

Key Risks

- Further macro weakness in Europe could drive losses to Staples International in the near term. Still, we view Staples' exposure to international markets (~20% of revenues and 10% of EBIT) as a positive long term.
- We do not expect Staples to participate in industry consolidation given regulatory concerns. However, it could make tuck-in acquisitions whose returns we could not predict. Management has stated this is an option.

Company Analysis

February 29, 2012

Tenaris S.A.
Tubulars Unappreciated, Reiterate Overweight

Morgan Stanley & Co. LLC

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Growing demand in premium OCTG and a tight seamless market should allow Tenaris' top line to outpace the rig count and margins to expand in 2012. We see upside to our above-consensus estimates on favorable mix, and expect positive earnings revisions to drive outperformance.

Tenaris appears well positioned to take advantage of a secular shift in mix toward premium OCTG (oil country tubular goods). We believe increasingly complex drilling, growth in deepwater, and higher standards for safety are the key drivers of this trend. Tenaris has guided that OCTG volumes in 2012 for unconventional plays are expected to grow by 15-20% Y/Y, while deepwater volumes are expected to increase by 50%. We expect Tenaris to capitalize on the trend as high-end tubes currently represent ~55% of its total seamless volumes and are expected to surpass 60% by the end of 2012 and 70% on a longer-term view.

Change in behavior from winning market share to allocating to key customers. In early 2011, OCTG manufacturers were engaged in a battle for market share, pressure pricing and driving EBIT margins to trough levels in the mid-teens. However, we have seen a shift in behavior, with Tenaris and Vallourec increasingly focused on allocating capacity to customers. Seamless prices have also improved by 10-15% in the second half of 2011 and lead times have increased. Higher prices against flat raw material costs should further help boost margins in addition to the uplift from a positive mix shift.

Revising our above-consensus estimates modestly higher and increasing our price target to $52 from $49. Our new estimates reflect volumes continuing to outpace the rig count as well as higher realized prices from a shift in product mix toward premium OCTG — but no pricing increases, offering additional upside if pricing does improve. Our new price target assumes a multiple of 12.5x our 2013e EPS of $4.15, about in line with the historical average.

Stock Rating: Overweight	Reuters: TS.N Bloomberg: TS US
Price target	$52.00
Shr price, close (Feb 28, 2012)	$39.01
Mkt cap, curr(mm)	$23,026
52-Week Range	$51.06-23.30

Fiscal Year ending	12/10	12/11e	12/12e	12/13e
ModelWare EPS($)	1.84	2.26	3.15	4.15
Prior ModelWare EPS($)	-	2.23	3.10	4.00
Consensus EPS($)§	1.92	2.21	2.91	3.46
P/E	26.7	16.5	12.4	9.4
EV/EBITDA	14.2	8.8	7.1	5.3
EBITDA($mm)	2,013	2,449	3,290	4,160
Rev hist grth, y/y(%)	(5.5)	29.3	22.1	20.1

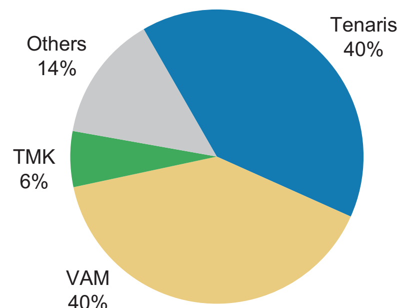
§ = Consensus data is provided by Thomson Reuters Estimates.
e = Morgan Stanley Research estimates

Price Performance

Company Description
Tenaris produces and sells seamless and welded steel tubular products primarily for energy and industrial applications. It also manufactures welded steel pipe products that are used in the construction of major pipeline projects.

Industry View: Attractive — Oil Services, Drilling & Equipment

Exhibit 1
Tenaris Is One of the Primary Beneficiaries of the Shift Toward Premium, with 40% Market Share

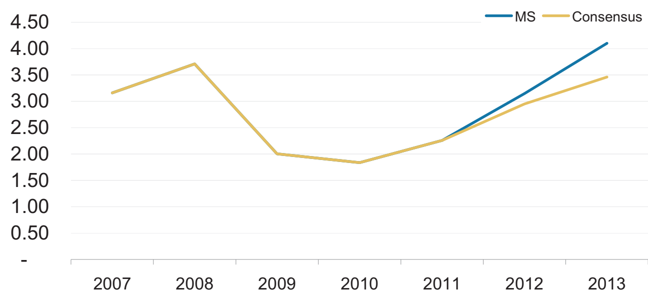


Source: Company Data, Morgan Stanley Research

Company Analysis

Exhibit 2

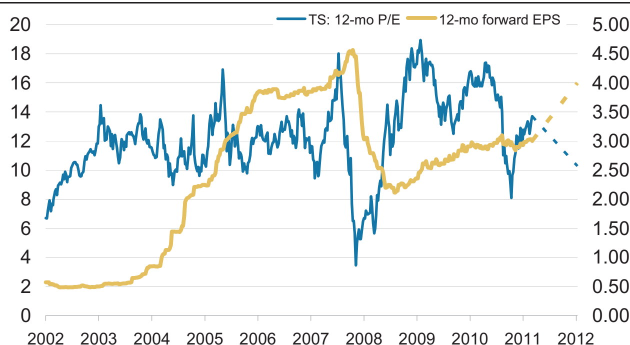
Our EPS Expectations Are Noticeably Above Consensus, and We Expect EPS to Surpass $4 in 2013



Source: Thomson Reuters, Company Data, Morgan Stanley Research

Exhibit 3

We Expect Positive Earnings Revisions Toward ~$4/sh for 2013 by Year-End to Drive Shares



Source: Thomson Reuters, Morgan Stanley Research

Why Overweight?

- Tenaris is one of our favorite long-term secular growth stories, as the company holds the leading position in the premium segment of the global OCTG/flow line/riser market.
- We see three primary drivers of growth: (1) strong deepwater outlook with the number of deepwater floaters increasing from ~175 today to ~225 by 2014, (2) increase in unconventional oil-related activity, (3) continued growth in the international land rig count.
- In the near-term we expect Tenaris to benefit from the pickup in seamless pricing that we already saw in 2H11 and a continued shift in mix.
- We expect a shift in mix toward premium OCTG to drive higher realized prices and margin expansion over the coming years. We estimate that premium as a percentage of global OCTG demand will increase from 19% in 2011 to 22% in 2012, which represents a growth rate of over 20%.

Potential Catalysts

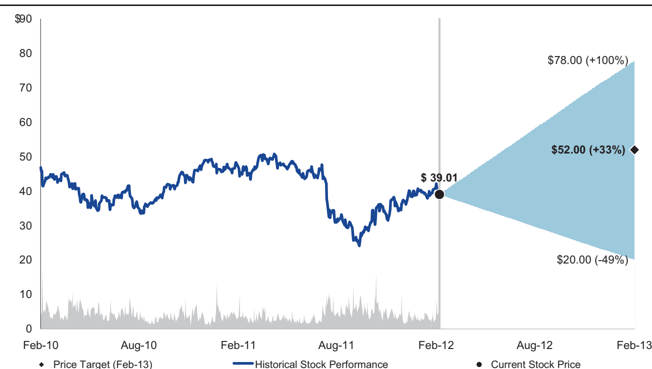
- Improved international pricing and margins
- Pickup in Iraq, where we expect Tenaris to play a major role
- International shale development
- Plant in Veracruz, Mexico, reaching full capacity this year (2012), further benefiting margins

Risks

- Cost increases in hot rolled coil and scrap could outpace growth in pricing, pressuring margins.
- Pickup in seamless imports in the US, as in 2008.

Exhibit 4

TS: Pickup in Deepwater and Shale to Shift Mix to Premium



Price Target: $52		Based on ~12.5x our 2013e EPADS estimate of $4.15, in line with the historical average.
Bull Case $78	13x 2013e EPADS of $6.00	**70% premium and modest pricing improvement.** Faster than expected growth in ultra-deepwater rig deliveries, while international shale markets in China, Argentina, and continental Europe really begin to ramp up. Demand for sour service also picks up, requiring higher-priced premium alloy tubes.
Base Case $52	12.5x Base Case 2013e EPADS of $4.15	**Expansion in deepwater and US shale activity, and tightness in international land as the international land rig count reaches new highs.** We expect these factors to drive demand for premium OCTG, representing over 50%-plus of the company's mix, resulting in increased plant utilization despite recent capacity additions. Margins reach 27% in 2012 and volumes surpass 4Mt, but still below levels witnessed in 2007 and 2008.
Bear Case $20	1 x Book value of $20/ADS	**Delays for offshore rig deliveries from shipyards coupled with global recession.** A global GDP slowdown would depress commodity prices, resulting in decreased demand and pricing for OCTG, with margins below 20%. Price competition is particularly intense in the US, while demand in the Middle East and Brazil is more resilient as national oil companies take advantage of lower prices to move forward with their programs, likely holding Tenaris's earnings at or above $3/ADS.

Source: Thomson Reuters, Morgan Stanley Research

Company Analysis

March 5, 2012

Under Armour
All Charged Up and Ready to Grow

Morgan Stanley & Co. LLC

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Charged Cotton has been well received by consumers and is a large growth opportunity, our February AlphaWise survey indicates. We estimate that Charged Cotton could be a $300-$450M business in 5 years. We expect Charged Cotton to be one of the contributors to UA's sales acceleration in 2013.

We believe Charged Cotton will become a bigger role in sales growth over the next several years. Taking into account survey data which looks at current penetration, consumer's intentions (new and repurchase), as well as potential replacement cycle, we estimate Charged Cotton could contribute $300-450M in annual sales within the next five years. Furthermore, we expect it to contribute to 3% sales growth in 2012, escalating to 6% total sales growth in 2013.

The survey says: Those that bought it love it and will buy again. 96% of those that bought the product said they would likely buy the product again in the next 12 months (66% "definitely"). Satisfaction ratings for Charged Cotton among those that bought the product had 86-99% satisfaction rates in product attributes such as price (86%), fit (93%), dries faster (98%), design (98%), and comfort (99%).

Lots of room to grow. Our survey finds among likely buyers of athletic apparel in the next 12 months, 60% have never heard of Charged Cotton (with awareness even lower among women). Once made aware, 61% of those who have not purchased the product would become interested. More importantly, over half of those interested in buying Charged Cotton do not currently own performance apparel at all, which suggests Charged Cotton should be incremental to the category.

What is charged cotton? Under Armour's Charged Cotton is its new performance apparel product introduced in 2011. Charged cotton is cotton fabric infused with moisture wicking material allowing it to retain cotton's softness and dry five times faster than ordinary cotton.

Stock Rating: Overweight	Reuters: UA.N Bloomberg: UA US
Price target	$106.00
Shr price, close (Mar 2, 2012)	$92.22
Mkt cap, curr(mm)	$4,864
52-Week Range	$92.52-52.62

Fiscal Year ending	12/11	12/12e	12/13e	12/14e
EPS($)**	1.84	2.34	3.30	4.28
P/E**	39.0	39.4	28.0	21.5
Consensus EPS($)§	1.83	2.32	2.98	3.80
ModelWare EPS($)	1.77	2.26	3.27	4.28
RNOA(%)	28.3	20.1	23.8	28.1

§ = Consensus data is provided by Thomson Reuters Estimates.
** = Based on consensus methodology
e = Morgan Stanley Research estimates

Price Performance

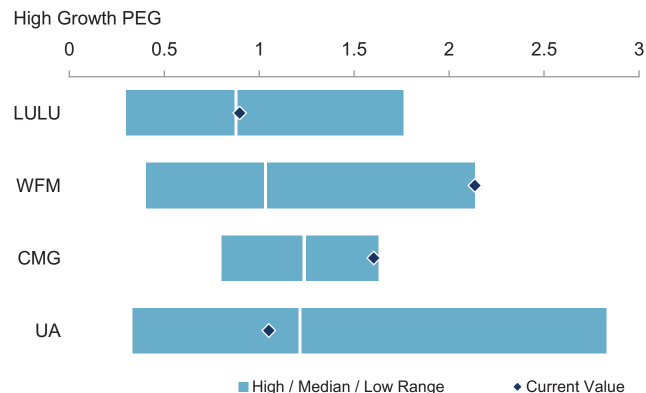
Source: Thomson Reuters

Company Description
Under Armour is engaged in the design, development, marketing and distribution of branded performance products.

Industry View: In-Line — Retail, Branded Apparel

Exhibit 1

UA Is Trading the Below Its Average PEG — Unique Among High-Growth Retail Peers



Source: Company Data, Morgan Stanley Research
LULU covered by Kimberly Greenberger, WFM by Mark Wiltamuth, and CMG by John Glass

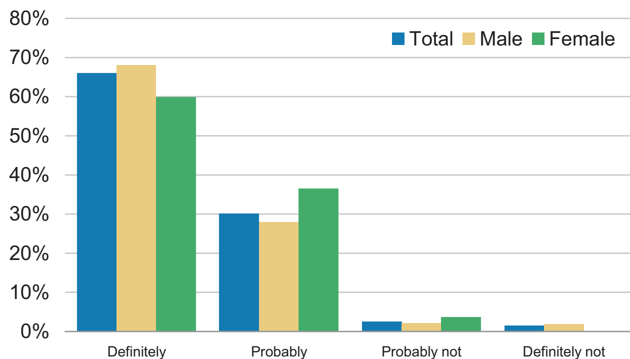
Company Analysis

We base these estimates on (1) new adopters of the product, (2) the anticipated replacement rates indicated by respondents, (3) assuming respondents interested in charged cotton eventually purchase it, (4) Women grow from 25% of charged cotton spending to 40% (similar to athletic apparel overall), and (5) Charged cotton consumers grow their spending modestly beyond mere replacement

High product satisfaction suggests promising potential to serve the broader athletic market and women in particular. Consumers were highly pleased across all the categories surveyed (Exhibit 3). Results were particularly telling for women. Across the categories of comfort, fit, design, and dries faster women were more likely to be "very satisfied" than men. Also, the overall high satisfaction with price gives us confidence the consumer can accept a premium price point (charged cotton's price satisfaction ~8% greater than general performance apparel).

Beyond charged cotton, Under Armour's other new offerings likely poise it to further attract women to the brand. UA's focus on improved fit with offerings such as the new scoop neck and studio yoga pant should continue to grow the women's business from ~30% of total revenues. As the survey indicates women were pleased across the board with the quality of charged cotton so further improvements in design and fit should only perpetuate success in this demo. We have already heard encouraging commentary surrounding UA's new yoga pants from recent channel checks.

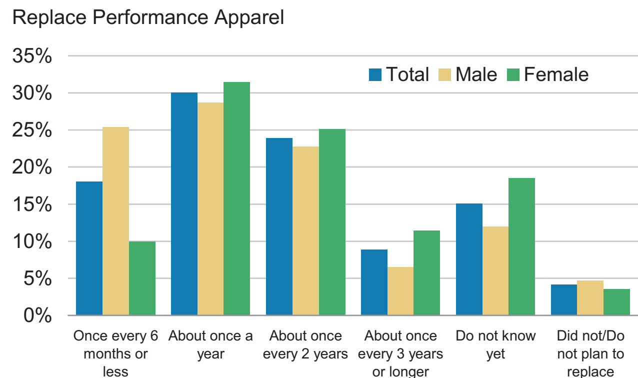
Exhibit 2
Charged Cotton: Repurchase Intent Is High



Source: AlphaWise, Morgan Stanley Research

$106 price target. Our target is based on 32x our 2013 estimates of $3.30. That multiple is in line with its five-year average and implies a PE to growth ratio of less than 1, below its five-year average of 1.2x.

Exhibit 3
Athletic Apparel Has a Strong Replacement Rate



Source: AlphaWise, Morgan Stanley Research

Risks / Where we could be wrong: As a high beta and high multiple stock, UA does risk multiple contraction should the market correct, which could cause shares to underperform. If sales growth should slow below 20%, we also believe the stock could de-rate and pressure the shares. Finally, if operating improvements (better inventory levels and gross margin expansion) do not materialize, UA may not reach our EPS estimates or price target.

UA: Sales Momentum Most Likely to Drive the Stock

Bull Case $130	35x Bull Case 13e EPS of $3.75	**High 20s Revenue Growth & 13% Op Margin in 2013.** Product innovation and strong consumer demand puts revenue growth in the high 20s for the next two years. Sales leverage and gross margin improvement drive operating margins to 13% in 2013. Multiple holds onto 2013 estimates of $3.75.
Base Case / Price Target $106	32x Base Case 13e EPS of $3.30	**22% Top-Line Growth in 2012 Accelerating in 2013.** Top line remains robust, driven by direct-to-consumer growth (factory outlets) and new product introductions. Margins expand to 12.5% in 2013. Five-year average multiple of 32 holds on '13 EPS.
Bear Case $62	25x Bear Case 13e EPS of $2.50	**Demand Weakens to 10-15%. Revenue Growth and Margins Fail to Expand:** Revenue growth slows to low double digits and margins contract to 10% due to some gross margin pressure as well as SG&A de-leverage. Valuation contracts to 25x with negative earnings revisions

Source: Thomson Reuters, Morgan Stanley Research

International

March 2, 2012

Asia/Pacific Coal
Stock Prices Move Ahead of Coal Prices: Take Profits

Morgan Stanley Asia Limited+

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What's Changed

Industry View: Indonesia Coal	**Attractive to In-Line**
Industry View: China Coal	**Attractive to In-Line**

We are downgrading our view on the China and Indonesia Coal industries to In-Line. Weak demand in China and the region will likely cap coal prices, dampening stock price performance in 1H12. Shenhua and Adaro are our top picks.

The downgrade in our view on the China and Indonesia Coal industries to In-Line is prompted by the sectors' outperformance vs. local markets, despite a demand slowdown and pressure on pricing for coal. We believe that the market has priced in an earlier recovery in coal prices than we expect; hence, our 2012e earnings, on average, are 10% below consensus for our China coal coverage, and 11.5% below consensus for the Indonesian names. In China, we are downgrading our ratings on Yanzhou to UW and on Fushan to EW. In Indonesia, we are lowering our ratings for ITMG to EW and for PTBA and BORN to UW. Shenhua and Adaro remain our only OW-rated stocks and our top picks. We believe that both stocks deserve to trade at a premium to their peers, due to their resilient earnings profiles and strong operational capabilities.

We expect coal prices to stay under pressure in the near term because of weak coal demand and high inventory levels. At the same time, however, supply growth in both China and the region is slowing, which should allow coal prices to find a bottom in the near term. There are already indications that regional coal prices are holding steady at around US$115-120/tonne. Coal prices in China are still declining as demand continues to adjust to changes in prices and supply. We expect coal prices to trough in 1H12. We assume a 5% rise in the domestic coal price in China for 2012 as a whole, and the regional coal price to average US$126/tonne for the year.

In this report, we discuss the three main themes that support our expectations for the Asia/Pacific Coal industry and stocks in the next 12 months.

(1) Coal prices will trough in 1H12

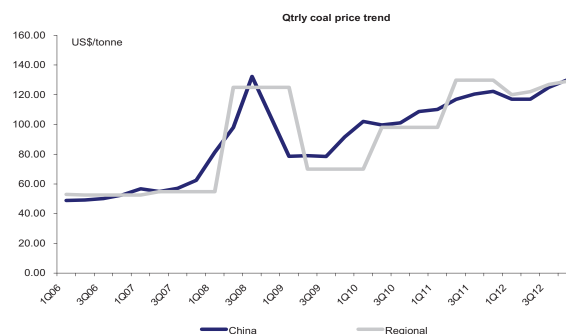
We expect coal prices to decline modestly as downward pressure remains on the industry, and to bottom out in the first half of the year. Regional supply/demand is in balance, but we expect a slowdown in all areas of demand for coal, from power to cement. In addition, uncertainty in the outlook for Indian coal demand is a major source of weakness for regional prices. Therefore, earnings generated from coal are likely to fall, impairing the performance of coal stocks.

(2) Catalysts for potential rebound in coal prices from 2H

China has the ability to resize supply in response to demand trends while filling the gap from imports, providing support for regional coal prices. Moreover, we believe that India will eventually resolve the issues concerning its coal shortfall, and, irrespective of the outcome, the country will have no choice but to import coal. As India lacks sufficient domestic supplies of coal, any incremental demand is equal to an increase in imports, which would further lift regional coal prices. Therefore, we prefer companies that are defensive and able to ride out a period of trough prices but also be in a position to take advantage of a potential recovery in regional prices.

Exhibit 1

Regional prices have hovered between US$115-120/ton YTD. We expect coal price to stay weak for the first two quarters of the year



Source: Bloomberg, Morgan Stanley Research

(3) What is key for 2012: Earnings resilience and production growth

Discipline in supply is important in China to maintain a stable ASP, and we think the most attractive names are not the fastest growing but those with the most defensive earnings structure, e.g., Shenhua. In Indonesia, producers are smaller and more

International

fragmented, having little impact on regional prices. In this market, we like those with the fastest growth while maintaining an efficient cost structure, e.g., Adaro.

China

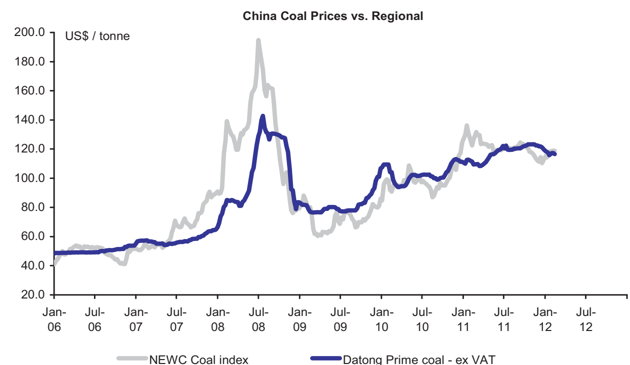
- We have raised our earnings forecasts for Shenhua and China Coal for the next two years to reflect better-than-expected production volumes in 2012 and 2013.
- We like Shenhua, one of our two top picks, for its strong operational capabilities, earnings resilience and appealing valuations. We also see Shenhua as strongly positioned to benefit from the potential upturn in coal demand.
- We think the valuation for China Coal is fair, and we maintain our Equal-weight rating. We estimate 12% volume growth in 2013, driven by the restart of mines, and a 6.1% increase in the coal price as more volume is shifted to spot pricing. However, we think China Coal needs to demonstrate that it has successfully addressed several operational issues.
- We have downgraded our rating on Yanzhou to UW from OW. In our view, the stock looks overvalued, trading at similar valuations to Shenhua's. We have lowered our earnings estimates by 25-35% for the next two years because of the company's significant exposure to coking coal.

Indonesia

- We have cut our earnings forecasts for Indonesian coal companies by an average of around 20% for 2012 and 2013. As mentioned, Adaro is our top pick in the sector.
- We have lowered our rating for ITMG to EW from OW. While fundamentals remain strong (steady growth with exposure to high-quality coal), we believe that the likelihood of reserve acquisitions for long-term production growth for ITMG is low and will cap stock price performance.
- We have cut PTBA's rating to UW from EW, as we believe the stock will struggle with production increases, due to its reliance on PTKA for rail transportation. We do not believe the stock deserves to trade at a premium valuations to peers'.
- We continue to rate Bumi UW, as we do not expect a major improvement in its debt situation this year.
- We have cut Borneo to UW, as we are concerned about weakness in coking coal prices for the rest of the year. In addition, we believe that Borneo's purchase of a 23% stake in Bumi plc introduces the potential for increased distraction and volatility in Borneo's share price.

Exhibit 2

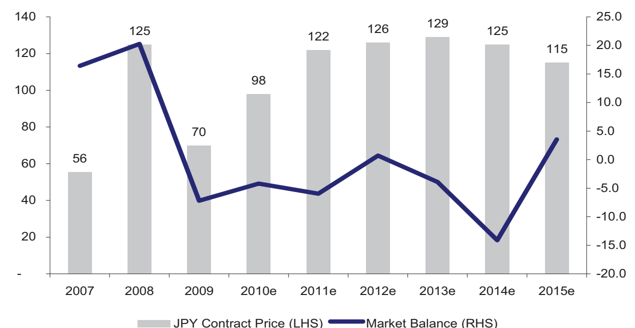
Coal prices have hovered in the US$115-120 range YTD, and we expect coal prices to remain weak in the near term



Source: Bloomberg, Morgan Stanley Research

Exhibit 3

We estimate average regional coal prices will be marginally higher in 2012, after weakness in the 1H



Source: Bloomberg, Morgan Stanley Research. e = Morgan Stanley Research estimates

Closing prices (as of February 28, 2012): Shenhua (HK$35.70, Adaro (Rp1,900), Yanzhou (HK$19.30), China Coal (HK$10.96), Fushan (HK$3.33), PTBA (Rp20,550), ITMG (Rp43,200), Bumi (Rp2,425), Borneo (Rp850) .

International

March 1, 2012

Carnival
Resembling an Airline?

Morgan Stanley & Co. International plc+

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We publish our latest channel checks (mixed), update for fuel (5% EPS cut) and assess whether CCL's share price weakness makes for a good buying opportunity (not yet). The material margin drop that CCL has seen over the last five years, as oil has jumped, has created a riskier, even airline-like, business model.

Stock Rating: Equal-weight	Reuters: CCL.N, CCL.L
Price target	$30/£19
Shr price, close (Feb 29, 2012) Plc	£18.48
Shr price, close (Feb 29, 2012) Corp	$30.30
52-Week Range	£16.00 - £27.90
Mkt cap, curr (mn)	$23.7bn/£14.9bn

Fiscal Year ending	12/11	12/12e	12/13e	12/14e
ModelWare EPS (US$)	2.42	1.80	2.50	2.85
Prior EPS (US$)**	-	1.90	2.50	2.80
Consensus EPS (US$)	-	2.09	2.55	2.77
P/E (US listing)	12.5	16.8	12.1	10.7
P/E (UK listing)	12.1	16.3	11.7	10.3
Div yld (%)	3.3	3.3	5.0	5.8

e = Morgan Stanley Research estimates

Price Performance

Company Description
Carnival Corp & plc is the world's largest cruise ship operator with c.50% of the North American market and 40% in Europe. Its 90 ships cover the Carnival, Princess, Holland America, P&O, Cunard, Costa, and Aida brands, and it has 18 ships on order. It is a dual listed company that is a member of both the S&P 500 and FTSE100 indexes.

Leisure and Hotels/Panama
Industry View: In-Line

GICS Sector: Consumer Discretionary
Strategists' Recommended Weight: 6.6%

MSCI Europe Weight: 8.6%

It is tempting to view Carnival's recent share price weakness as a buying opportunity... Since the Concordia tragedy, CCL Corp shares have underperformed the S&P 500 by 18% and underperformed Royal Caribbean by 11%, and CCL Plc shares have underperformed the FTSE 100 by 22%. However, weak demand since the accident and some other unfortunate incidents are unlikely to be permanent, and the recent oil price spike may be temporary. In addition to providing an update on our latest channel checks and for fuel/FX movements, we look at whether Carnival is a good long-term investment.

… but we think it is too soon to buy CCL shares. We can see the long-term attraction given solid US demand, low cruise penetration in Europe, low capacity growth, depressed yields, and a possible buying opportunity given recent share price weakness. However, we have three main concerns:

1. **Weakening cruise demand:** Our survey suggests weak volumes and prices, with other unfortunate incidents not helping, and we forecast CCL's 2012 yields at –2.5%.

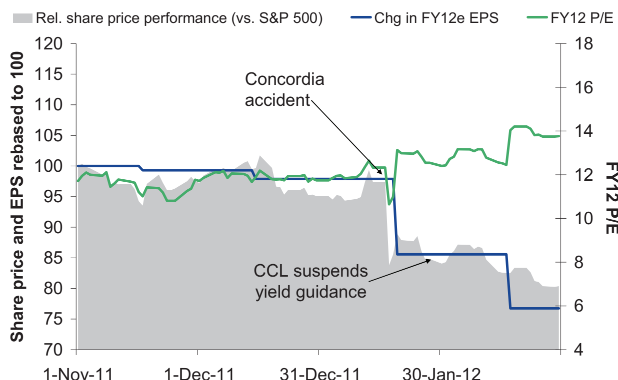
2. **Fuel cost risk:** While bunker fuel has recently lagged crude oil, external events, tight refining margins, and new environmental regulations mean that downgrade risk is high.

3. **CCL's business model is higher risk:** Over the last 5 years rising fuel costs have effectively caused operating margins to halve (Exhibit 2, next page), making CCL significantly more geared to fuel changes, yet it remains unhedged. We think its business model is starting to resemble other forms of transport, which could lead to a long-term valuation de-rating.

Our longer-term view is that, while CCL offers good cyclical upside, it is also facing structural headwinds … On a cyclical basis, yields should recover given the solid US economy, low supply growth, and ticket price catch-up, and the company generates strong FCF ($7 billion cumulative FCF over 2011-14e is 30% of the current market cap). Structurally, though, we argue that its business model has changed fundamentally over the last five years, and with its fuel/sales ratio now exceeding its operating margin, and the company more exposed to external events with an unhedged fuel policy, it has a much more volatile income stream and is arguably starting to resemble an airline. As CCL and RCL generate over double the EBITDAR per passenger of airlines, hotels and tour operators, they could arguably afford to swallow further fuel cost increases.

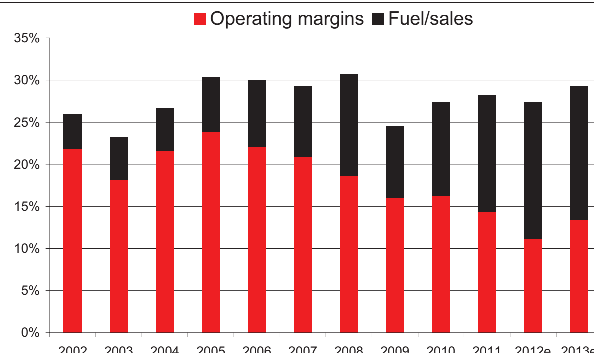
International

Exhibit 1
CCL has underperformed the S&P 500 by 18% since the accident and 2012 consensus EPS are down 22%



Source: Datastream, Morgan Stanley Research

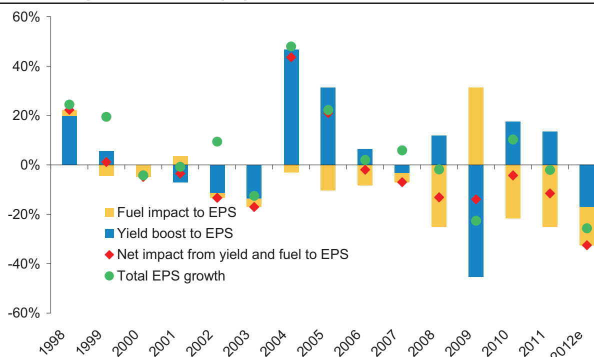
Exhibit 2
Rising fuel costs have eaten up around half of CCL's operating margin



Note: 2003 distorted by the acquisition of P&O Princess.
e = Morgan Stanley Research estimates Source: Company data, Morgan Stanley Research

… and a riskier business model should warrant a lower multiple; stay Equal-weight. We conclude that, while yields should recover, such that we forecast 39% EPS growth in 2013 on the back of 4% yield growth, higher fuel costs seem to have permanently dampened margins and returns. This has led to higher operating leverage (1% on yield now equates to 8% on EPS), and this should warrant a lower valuation multiple than the shares have historically enjoyed. The shares have been steadily de-rated for the last 5 years, and we think a P/E of 12x recovered EPS is fair. We therefore rate CCL Equal-weight, with a preference for Hotel stocks as our cyclical plays in our Europe Leisure & Hotels coverage. We raise our price target to £19 from £18 as we now use 2013 rather than 2012 to assess our valuation, and stock market multiples are higher.

Exhibit 3
The net EPS impact on CCL from yields and fuel has been negative every year since 2005



e = Morgan Stanley Research estimates Source: Company data, Morgan Stanley Research

Exhibit 4
Carnival: Roughly Balanced Risk-Reward

BULL CASE $43/£27: Net revenue yields (constant FX): +2% FY12, +5% FY13, +3% FY14; Bunker fuel ($ per m.t.): 740 FY12, 720 FY13, 734 FY14; EPS ($):$2.53 FY12, $3.50 FY13, $4.10 FY14; 2013 P/E 12x, in line with the base case.

BASE CASE $30/£19: Net revenue yields (constant FX): -2.5% FY12 (Costa -15%, other brands flat), +4% FY13, +2% FY14; Bunker fuel ($ per m.t.): 740 FY12, 762 FY13, 784 FY14; EPS ($):$1.80 FY12, $2.50 FY13, $2.85 FY14; Average of five valuation methods (= 2013 P/E 12x).

BEAR CASE $21/£13: Net revenue yields (constant FX):-5% FY12, +3% FY13, +2% FY14; Bunker fuel ($ per m.t.): 850 FY12, 822 FY13, 844 FY14; EPS ($):$1.00 FY12, $1.70 FY13, $1.80 FY14; 2013 P/E 12x, in line with the base case.

PRICE TARGET METHODOLOGY & RISKS: We value CCL on a 2013e P/E of 12x (16x 2012e), in line with its recent multiple (bearing in mind declining valuation over last two decades), and implying a 2013e FCF yield of 8% (3% in 2012e). Key risks are how the following uncertainties play out: the Concordia tragedy, European exposure, and exposure to oil and external events.

Source: Thomson Reuters (historical share price data), Morgan Stanley Research estimates

International

March 1, 2012

China Unicom
The Growth vs. Profitability Conundrum

Morgan Stanley Asia Limited+

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We recommend using weakness in China Unicom as an opportunity to add to positions. Consensus earnings outlook for 2012 has fallen in recent months, but the bulk of the earnings downgrade is because of the company's strategy to accelerate growth in 2012, which should create value in future. The stock is on Morgan Stanley's Asia/Pacific Best Ideas list.

Consensus 2012e EPS for CU is down 12% YTD – but revenue estimates are up and EBITDA estimates down only 2%. The earnings downgrades are therefore mostly attributable to higher depreciation (because of capex), finance costs, and lower dividend from TEF. These items have a modest NAV impact, but the 2012e earnings impact is exaggerated given the low base effect (net margin of only 2.4%).

Our bottom-up analysis of CU's P&L shows an incremental 15mn 3G customers can dilute Rmb1.5-2bn of profit in the first year, but add as much as Rmb2-3bn annually in the next one to two years. This is the result of upfront subsidies, dealer commissions, and depreciation associated with capex. It is not a coincidence that consensus net profit estimates are down ~Rmb1.5-2bn in the past three months, as market expectations of subs growth has risen from 25-30mn to 40-45mn.

Our study of 3G pricing over the past 12-18 months shows there has been no change in CU's (or others') subsidy or tariff strategy for 3G (barring some price cuts from China Mobile in 3Q11 and launch of lower entry plans for 3G by all operators). As a result, the "per unit" profitability levels are intact despite market concerns about rising competition.

Modest earnings estimate and PT changes reflect higher growth: We increase our 2012 3G net add assumption for CU (again) from 34mn to 40mn, causing a Rmb450mn cut in our 2012 profit estimate. Our profit estimates for 2013-14 are largely unchanged, and we maintain our DCF-based target price of HK$19, implying 36% upside.

Stock Rating: Overweight	Reuters: 0762.HK Bloomberg: 762 HK
Price target	HK$19.00
Up/downside to price target(%)	36
Shr price, close (Feb 29, 2012)	HK$14.00
52-Week Range	HK$17.68-12.10
Sh out, dil, curr(mn)	23,958
Mkt cap, curr(mn)	US$43,254
EV, curr(mn)	US$49,905
Avg daily trading value(mn)	US$75

Fiscal Year ending	12/10	12/11e	12/12e	12/13e
ModelWare EPS(Rmb)	0.16	0.21	0.43	0.61
Prior ModelWare EPS(Rmb)	-	0.27	0.45	0.60
Consensus EPS(Rmb)§	0.18	0.23	0.41	0.66
Revenue, net(Rmbmn)	171,298	212,591	257,210	284,784
EBITDA(Rmbmn)	59,592	64,662	76,726	86,967
ModelWare net inc(Rmbmn)	3,851	5,116	10,376	14,509
P/E	58.0	62.1	26.3	18.8

§ = Consensus data is provided by Thomson Reuters Estimates.
e = Morgan Stanley Research estimates

Company Description
China Unicom provides telecom services in China, including cellular, fixed-line, data, and Internet services. The company operates an advanced telecom network system based on fiber-optic transmission and a core switching network. China Unicom listed on the Hong Kong Stock Exchange in June 2000

China Telecommunications
Industry View: In-Line

A Deep Dive into CU's Earnings Estimate Revisions

To understand the recent spate of earnings downgrades, we have aimed to de-construct both the top-down and bottom-up drivers of CU's earnings moves in the past three to six months. First, we have tracked how consensus estimates for revenue, EBITDA, EPS and 3G net adds have moved in the past three to six months. We then conducted a sensitivity analysis of CU's net profits to subscriber adds, given the heavy upfront costs associated with subscriber acquisition, particularly postpaid 3G users. Finally, we tracked 3G pricing plans in the past 12 months to see whether the pricing / competitive environment has changed in the past 12-18 months. Our conclusions:

1) Although CU's 2012-13e EPS have been cut by 12% YTD and 20% in the past six months, revenue estimates are marginally up, whereas EBITDA forecasts are down just 2-3%. The bulk of the earnings cuts, therefore, are attributable to higher depreciation, finance costs and lower dividend from Telefonica. Each of these factors has a modest NAV impact, but the impact on earnings is exaggerated because of the low base.

International

2) According to our estimates, an incremental 15mn 3G subscriber additions can shave off Rmb1.5-2bn of earnings in the first year, but contribute as much as Rmb2-3bn annually in subsequent years, with likely more in outer years if churn can be controlled and customer spending gradually lifted. It is not a coincidence that Street forecasts for CU's 2012 net profit estimate are lower by roughly Rmb1.5-2.0bn, while market expectations of 3G net adds have risen from 25-30mn to 40-45mn in the past three to six months.

3) 3G pricing for all three operators was largely stable in 2011 and has remained so thus far this year. Subsidy spending as a percentage of revenue has also remained largely unchanged, implying that the competitive environment is not deteriorating, as has been feared. Indeed, China Telecom launched the iPhone 4S with indicative pricing almost the same as CU's, which indicates the company did not intend to start a price war. We believe competition among Chinese telcos remains under control and steady shift of share from CM to CU and CT will continue throughout 2012-13.

Where Are We vs. Consensus?
Our 2012 EPS estimate is ~4% above consensus, mainly because of our expectation of faster revenue growth, in our view. Our OW rating on CU is in line with the Street's recommendations, as 58% of analysts surveyed by Bloomberg have OW/Buy ratings on the stock compared to 24% EW/Hold ratings and 18% UW/Sell ratings.

Valuation: Based on our new estimates, CU is currently trading at 2012e EV/EBITDA of 4.9x, a 20% discount to the regional average despite an above-average EBITDA growth outlook of ~11%. The headline P/E of 26x looks expensive, but we believe is justified by a 2012-15e EPS CAGR of 31%.

We value the wireless and fixed-line businesses separately, using a higher terminal growth rate for the wireless business. We use a 2013 DCF and a WACC of 10.7% in valuing both businesses. Our terminal growth rate assumptions are 3% for wireless and 0% for fixed line. We have also adjusted the asset value by incorporating CU's 1.37% stake in Telefonica. Whereas previously we were splitting CU's working capital equally between fixed and mobile, now we are passing most of the working capital changes to mobile, which is the growing business. That shifts value from mobile to fixed.

Downside risks to our PT include: 1) Poor execution in 3G, which is critical to long-term earnings for the group; and 2) faster-than-expected development of 4G/LTE in China.

China Unicom (0762.HK) Risk-Reward View: Market Share Gain; Operating Leverage

Case	Description
Bull Case HK$27.00	**Mobile EBITDA margins (on service revenue) improve from 32% in 2012E to 41% at terminal years,** ~300bps above base case due to increasing scale and stable competition; Mobile capex/sales decline from 35% in 2012E to 15% at terminal levels; Fixed-line EBITDA margins decline from 40% in 2012E to 38% at terminal years, 300bps above base case due to cost control; Fixed-line capex/sales decline from 55% in 2012E to 15% at terminal years.
Base Case HK$19.00	**Mobile EBITDA margins (on service revenue) improve gradually from 30% in 2012E to 38% at terminal years** due to increasing scale; Mobile capex/sales decline from 35% in 2012E to 18% at terminal levels; Fixed-line EBITDA margins decline from 40% in 2012E to 35% at terminal years due to falling voice revenue; Fixed-line capex/sales decline from 55% in 2012E to 20% at terminal years.
Bear Case HK$13.00	**Mobile EBITDA margins (on service revenue) improve from 28% in 2012E to 35% at terminal years,** ~300bps below base case due to intensifying competition; Mobile capex/sales decline from 35% in 2012E to 20% at terminal levels; Fixed-line EBITDA margins decline from 40% in 2012E to 30% at terminal years, 500bps below base case due to accelerating fixed to mobile substitution; Fixed-line capex/sales decline from 55% in 2012E to 20% at terminal years.

Source: FactSet, Morgan Stanley Research

International

March 2, 2012

Jiangxi Copper
Demand Too Weak to Support Current Price: Time to Take Profits

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What's Changed	
Rating	**Overweight to Underweight**
Price Target	**HK$20.00 to HK$17.00**

Stock Rating: Underweight	Reuters: 0358.HK Bloomberg: 358 HK
Price target	HK$17.00
Up/downside to price target(%)	(20)
Shr price, close (Feb 28, 2012)	HK$21.35
52-Week Range	HK$28.45-11.30
Sh out, dil, curr(mn)	3,463
Mkt cap, curr(mn)	Rmb60,052
EV, curr(mn)	Rmb63,116
Avg daily trading value(mn)	Rmb323

Fiscal Year ending	12/10	12/11e	12/12e	12/13e
ModelWare EPS(Rmb)	1.51	2.12	2.15	2.27
Prior ModelWare EPS(Rmb)	-	2.12	2.26	2.45
Consensus EPS(Rmb)§	1.42	2.16	2.15	2.07
Revenue, net(Rmbmn)	76,139	89,756	89,077	100,423
EBITDA(Rmbmn)	7,512	10,294	10,733	12,054
ModelWare net inc(Rmbmn)	4,988	7,341	7,460	7,872
P/E	14.4	6.4	8.1	7.6

§ = Consensus data is provided by Thomson Reuters Estimates.
e = Morgan Stanley Research estimates

Company Description
Jiangxi Copper is China's largest copper producer, with a cathode capacity of 940ktpa, 14% of the national total. The company owns several of China's top mines, with reserves (measured and indicated and inferred) of 11.8 million tons. Jiangxi Copper also has a downstream processing capacity of 490ktpa..

China Nonferrous Metals & Mining
Industry View: In-Line

With the stock price up 90% from its recent low, we see limited further upside. Its price already implies an expected rally in the copper price from policy easing, yet demand in China remains weak.

We have lowered our PT to HK$17 from HK$20; we see limited upside after a 90% rally from its recent low: Our channel checks suggest that demand in China remains weak – too weak to support the current copper price implied in the stock price (12% premium to the spot copper price). Volume growth from Jiangxi's domestic mines is slowing, and overseas projects face delayed start time.

Our channel checks with copper product producers reveal the following trends: Utilization rates at downstream producers are low and order flow from clients is weak, with little evidence to suggest a sharp pick-up in industrial activity after Chinese New Year.

Power generation accounts for 46% of Chinese copper demand; copper is used in wiring and transformers. Planned investment in the grid in China for 2012 will be Rmb309.7bn, only up 2.6% Y/Y. Our channel checks suggest many wiring producers expect orders will remain weak as there is no detailed plan yet for investment in the power system. Bidding from China State Grid and China Southern Power Grid will not start until end-2Q12.

White goods account for 16% of copper demand in China. Three forms of government subsidies concluded at the end of 2011 – home appliances to the countryside; purchases of energy-saving appliances; and trading in old appliances for new. In addition, white goods are affected by a slowdown in property sales. Appliances makers are facing declines in sales while white goods inventory levels are at historical highs. Export sales also declined 20% in 2H11. Midea, one of the major appliance producers, has cut its workforce by more than 40% in some areas.

Jiangxi Copper's stock price implies a copper price that's 12% above current spot
The current stock price is implying a copper price of US$4.22/lb, 12% above the current copper spot price. We reach this conclusion by dividing the current enterprise value by 5.3x (the average 2012e EV/EBITDA multiple for the global copper sector average). In our view, investors who may be applying such a multiple to the shares believe JXC can earn EBITDA on a sustainable basis of approximately Rmb10.9bn or c.Rmb51,405/t.

We believe the easing cycle benefit is already priced in
We believe the stock price is building in a copper price with a possible benefit from the easing cycle.

International

Volume growth slowing, overseas projects delayed
Management guided for its copper volume to increase 10kt in 2012, and it has turned less bullish on volume growth. Mined volume will remain in the 210-220kt range for the next few years. The company's future growth relies on two overseas projects, Aynak in Afghanistan and Northern Peru Copper. However, both are facing further delays and will likely commence in 2015 rather than 2014 as previously guided.

Need to see more M&A progress
The company has made no progress in M&A, after the acquisitions of the Aynak and NPC projects in 2007, and both of these met with difficulties. The company has a low gearing ratio and its SOE status gives it easier access to bank loans. The company is looking for brownfield projects which, at current metal prices, will likely be expensive. As China has a lack of copper resources, the likely possibility for the company is in frontier countries, where more risks are involved.

Current valuation lacks support
Jiangxi Copper's stock has rallied 90% from its 52-week low (on October 4, 2011) – a stronger rally than its global peer average of 60%. During the same period the SHFE copper price gained 11%. Based on our estimates, this 11% change in the copper price will result in a 19% change in Jiangxi Copper's 2012 earnings. The company's fundamentals have not improved since October, in our view, and management has given a more cautious outlook on its volume growth.

JXC currently trades at 2012e P/E of 7.8x and P/BV of 1.3x; discounts of 37% and 21% compared to the global copper averages of 10.5x and 1.6x, respectively. The discount between JXC and global peers has narrowed from historical average, yet the fundamentals have not improved, in our view. We think the current valuation is pricing in expectation of benefits from potential Chinese easing.

Our PT is derived using Morgan Stanley's residual income model, which discounts our base-case earnings through 2017 and then normalizes them by our cost of equity of 10.9%, with a steady-state growth rate of 4%. We calculate our cost of equity assumption using a risk-free rate of 2.6%, a market risk premium of 7.23%, and a beta of 1.05.

Upside risks include: 1) Higher-than-expected copper prices: We calculate that a 10% change in copper prices would cause the company's EPS to change ~17% in 2012. Its share price has a high correlation with copper prices of 84%. 2) Higher-than-expected mining volume growth from earlier start of overseas projects. Higher-than-expected metal price policy easing in China and faster recovery in DM countries will increase demand for copper. 3) M&A could increase the company's growth potential if accomplished at accretive prices.

Jiangxi Copper (0358.HK) Risk-Reward View: We See Limited Upside after Recent Rally

Bull Case HK$24.50	**Bull-case pricing, NPC in 2014, includes Aynak:** Copper – US$4.07/lb, gold – US$2,066/oz, and sulfuric acid – Rmb500/t. NPC project is commissioned one year earlier than management's guidance of 2015, and Aynak production starts in 2015.
Base Case HK$17.00	**Base-case pricing and NPC in 2015:** Copper – US$3.70/lb, gold – US$1,845/oz, and sulfuric acid – Rmb450/t. Includes contribution from NPC project, which starts in 2015, as guided by management.
Bear Case HK$10.10	**Bear-case pricing, excludes Aynak and NPC:** Copper – US$2.78/lb, gold – US$1,611/oz, and sulfuric acid – Rmb400/t. No contribution from either Aynak or NPC project. TC/RC falls to record lows of US$10/t and USc1/lb as a result of copper concentrate tightness, and stays at that level for 2012-14.

Source: Morgan Stanley Research, Thomson Reuters

Morgan Stanley ModelWare is a proprietary analytic framework that helps clients uncover value, adjusting for distortions and ambiguities created by local accounting regulations. For example, ModelWare EPS adjusts for one-time events, capitalizes operating leases (where their use is significant), and converts inventory from LIFO costing to a FIFO basis. ModelWare also emphasizes the separation of operating performance of a company from its financing for a more complete view of how a company generates earnings.

Disclosure Section

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For valuation methodology and risks associated with any price targets referenced in this research report, please email morgan-stanley.research@morganstanley.com with a request for valuation methodology and risks on a particular stock or contact your investment representative or Morgan Stanley Research at 1585 Broadway, (Attention: Research Management), New York, NY 10036 USA.

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(as of February 29, 2012)

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Underweight/Sell	**464**	**16%**	**124**	**12%**	**27%**
Total	**2,918**		**1058**		

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Colin Weiner 1+212 761-6184
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Toni Kaplan 1+212-761-3620
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Jiayan Zhou 1+212-761-5766
Machinery
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Nonferrous Metals, Gold
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Evan Kurtz 1+212-761-7583
Coal
Wes Sconce 1+212-761-6004

MEDIA

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Bernard McTernan 1+212-761-4786
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TECHNOLOGY

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Enterprise Software
Adam Holt 1+415 576-2320
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