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FEBRUARY 24, 2010

North America

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US Economic Outlook

Value	2008	2009e	2010e	2011e
GDP Growth (%)	0.4	(2.4)	3.3	2.8
CPI Inflation (%)	3.8	(0.3)	2.6	2.5

e = Morgan Stanley Research estimates

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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 in-corporates 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. The complete list appears weekly in *Investment Perspectives*.

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 port-folio, 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	Feb 23 Price	Price Target	Bull	Base	Bear	EPS* 2010	EPS* 2011	Consensus EPS* 2010	Consensus EPS* 2011	Annual Growth in EPS* 2010-2012	P/E* 2010	P/E* 2011	P/B 2010	P/B 2011
Bank of America	BAC.N	15.94	28	35	28	12	1.63e	2.37e	0.94e	1.96e	40.3%	9.8	6.7	0.6	0.6
Baker Hughes	BHI.N	47.06	100	122	100	25	2.50e	4.00e	2.03e	3.14e	55.7%	18.8	11.8	1.6	1.4
Danaher	DHR.N	74.64	85	101	85	62	4.05e	4.70e	4.06e	4.62e	14.2%	18.4	15.9	1.9	1.7
Walt Disney	DIS.N	30.92	37	49	37	25	1.98e	2.35e	1.98e	2.27e	18.4%	15.6	13.1	1.5	1.4
GSI Commerce	GSIC.O	24.23	32	41	32	18	0.48e	0.83e	0.25e	0.45e	59.3%	50.8	29.3	2.9	2.5
The Home Depot	HD.N	30.75	35	45	35	20	1.64e	1.85e	1.66e	1.78e	19.6%	16.7	13.4	2.7	2.6
Hewlett-Packard	HPQ.N	50.12	62	68	62	46	4.49e	4.94e	4.42e	4.85e	11.8%	11.2	10.1	2.5	2.1
Lincoln National	LNC.N	24.65	33	39	33	20	3.45e	3.90e	3.49e	3.91e	12.7%	7.1	6.3	0.7	0.6
Oracle	ORCL.O	24.48	31	38	31	17	1.60e	1.94e	1.58e	1.84e	-	12.6	10.7	2.8	2.4
Textron	TXT.N	19.53	30	40	30	16	0.69e	1.50e	0.43e	1.35e	69.9%	28.2	13.1	1.9	1.7
Union Pacific	UNP.N	66.39	80	96	80	52	4.57e	5.60e	4.22e	4.99e	17.9%	14.5	11.9	1.6	1.5

Company	Ticker	Dividend Yield 2010	Dividend Yield 2011	FCF Yield Ratio 2010	FCF Yield Ratio 2011	RNOA 2010	RNOA 2011	Net Debt/EBITDA 2010	Net Debt/EBITDA 2011	Interest Cover 2010	Interest Cover 2011
Bank of America	BAC.N	0.3%	1.9%	-	-	6.0%e	8.8%e	0.7e	0.5e	18.7e	27.9e
Baker Hughes	BHI.N	1.3%	1.3%	NM	NM	10.6%e	11.8%e	0.9e	0.7e	9.6e	15.4e
Danaher	DHR.N	0.2%	0.2%	6.4%	7.1%	10.9%e	10.9%e	1.0e	0.8e	11.7e	14.9e
Walt Disney	DIS.N	1.1%	1.2%	5.4%	5.1%	9.4%e	9.7%e	1.3e	1.0e	13.1e	14.8e
GSI Commerce	GSIC.O	0.0%	0.0%	7.8%	10.3%	4.7%e	7.9%e	0.1e	NM	1.1e	3.5e
The Home Depot	HD.N	3.1%	3.4%	7.6%	8.2%	9.8%e	11.0%e	1.9e	1.6e	4.7e	5.4e
Hewlett-Packard	HPQ.N	0.6%	0.6%	8.0%	9.9%	26.8%e	27.4%e	NM	NM	21.6e	22.8e
Lincoln National	LNC.N	0.2%	0.8%	-	-	10.9%e	8.5%e	2.9e	2.8e	5.3e	6.8e
Oracle	ORCL.O	0.8%	0.8%	8.5%	10.0%	28.5%e	28.6%e	NM	NM	14.1e	17.2e
Textron	TXT.N	0.4%	0.4%	5.3%	11.7%	2.8%e	5.8%e	7.2e	3.9e	3.0e	5.7e
Union Pacific	UNP.N	1.6%	2.0%	4.1%	6.6%	11.6%e	13.2%e	0.5e	0.2e	13.0e	21.1e

** Uses consensus methodology; all other metrics use ModelWare methodology*

NORTH AMERICA

Best Ideas

Research Updates on Best Ideas

Baker Hughes (BHI, $47.06, Overweight, Attractive Industry view) *Ole Slorer*

Expect estimates to undergo upward revisions. FactSet consensus 2010 EPS currently stands at $2.03, materially unchanged since the period immediately prior to the BJ Services announcement at the end of August 2009. During the interim: (1) Baker announced the transformative acquisition of a company that is highly levered to US rig count, and (2) the US rig count has jumped nearly 60%. We are revising our 2010 EPS estimate to $2.50 from $2.00 and we strongly reiterate our Overweight rating.

See "2010 Consensus Too Low," February 24, 2010

Hewlett-Packard (HPQ, $50.12, Overweight, Attractive Industry view) *Katy Huberty*

Back to a 'beat and raise' story. Our thesis of a stronger-than-expected recovery in Hewlett-Packard's server and printing segments partially played out in the January quarter and we expect to see more evidence throughout 2010. Further, we believe H-P's exposure to a server and storage spending recovery is underappreciated.

See page 35

Home Depot (HD, $30.75, Overweight, In-Line Industry view) *Gregory Melich*

The turn: Margins above 9% in 2011 look realistic. We believe that the turn in housing is real, and we view HD's 4Q beat as a strong indication that 2010 will show progress on the path to recovery and 10% EBIT margins. We continue to believe the market underappreciates 2011 margin expansion and potential for shareholder return.

See page 37

Oracle (ORCL, $24.48, Overweight, In-Line Industry view) *Adam Holt*

Sun hardware is back in the game: Deal should be a positive for Oracle's hardware and software revenues, according to our survey of IT managers.. Sun and core Oracle revenues should surprise favorably in F2011; we remain aggressive buyers of ORCL stock, based on a strong potential for upside to F2011 expectations and a significant valuation discount to our large-cap coverage.

See page 45

Textron (TXT, $19.53, Overweight, In-Line Industry view) *Heidi Wood*

Improving signs in Us and European business jet traffic. We remain Overweight TXT with a business jet recovery a key catalyst. We look for a recovery at Textron's Cessna division and believe this is not fully priced in currently. January takeoff and landings data from the FAA and the owner of Europe's largest biz jet airport showed 10% Y/Y improvement for total biz jet traffic.

See "Improving Signs In US and European Biz Jet Traffic," February 19, 2010

Walt Disney (DIS, $30.92, Overweight, Attractive Industry view) *Benjamin Swinburne*

We remain Overweight DIS and have raised our estimates and price target following strong 1Q10 results. Our view on DIS is based on (1) leverage to an advertising and consumer recovery in 2010-11, (2) secular growth from key assets including ESPN, and (3) our view that consensus 2011 estimates underestimate Disney's operating leverage coming out of the current downturn.

See page 53

Morgan Stanley is currently acting as financial advisor to Hewlett-Packard Company ("Hewlett-Packard") with respect to its proposed offer to acquire 3Com Corporation ("3Com"), as announced on November 11, 2009. The proposed transaction is subject to the consent of the 3Com shareholders and other customary closing conditions. This report and the information provided herein is not intended to (i) provide voting advice, (ii) serve as an endorsement of the proposed transaction, or (iii) result in the procurement, withholding or revocation of a proxy or any other action by a security holder. Hewlett-Packard has agreed to pay fees to Morgan Stanley for its financial advice, including transaction fees that are contingent upon the consummation of the proposed transaction. Please refer to the notes at the end of the report.

Morgan Stanley is currently acting as financial advisor to a number of investors, led by First Republic's existing management, and including investment funds managed by Colony Capital, LLC and General Atlantic LLC with respect to their acquisition of First Republic Bank from Bank of America Corporation. The proposed transaction is subject to customary regulatory approvals, as well as certain customary closing conditions. Morgan Stanley expects to receive fees for its financial services that are subject to the consummation of the proposed transaction. Please refer to the notes at the end of the report.

Strategy and Economics

February 19, 2010

US Economics
We Can't Inflate Our Way Out

Morgan Stanley & Co. Incorporated

Richard Berner
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Inflation is not the solution. It's tempting to think that the US can inflate its way out of its fiscal problems. A faster, sustained increase in prices would erode the real value of past debt, and higher future inflation would reduce the real resources needed to service and pay back the promises we are making today. There is no mistaking the staggering value of those promises. On our projections, Federal marketable debt held by the public will jump from 60.7% of GDP at the end of FY 2010 to 87% of GDP in the next decade, a level not seen since the post-WW II period (1947). In absolute terms, such debt will more than double over that period from its January level of $7.2 trillion.

Adding fuel to the fire, a growing chorus of household-name economists from both sides of the political aisle are advocating higher inflation as the remedy for our fiscal maladies. Indeed, many believe that higher inflation will cure multiple ills, and that central banks should raise their inflation targets to as high as 4% from the current ones (some implicit) that cluster near 2%. From a policy perspective, we couldn't disagree more. As we see it, central bank responses to this financial crisis underscore the fact that inflation targets are medium-term goals to be met flexibly; they have not limited central banks from responding aggressively to the shock. Specifically, we believe that the Fed's "credit easing" programs have restored the functioning of many financial markets and enabled policymakers to offset the constraint of interest rates at the "zero bound." But the push for allowing more inflation to lubricate the economy is gaining adherents, so it's time for sober analysis.

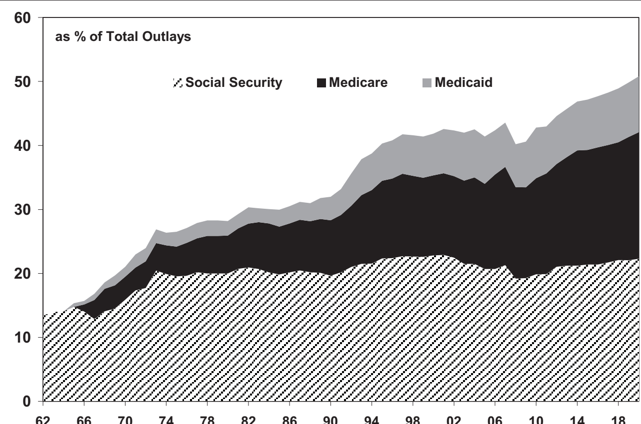
Our inflation view. Let's be clear: Our view is that inflation will stay low — at or below 2% — for the next two years. Near term, we expect that significant slack in goods, labor and housing markets will promote a decline in the core CPI toward 1%. January's 0.1% decline is on track with that view. Subsequently, we believe that narrowing slack, rising inflation expectations, and commodity prices will promote a gradual move in core inflation back to 2% in 2011.

However, there are some inflation tail risks: Monetary policy globally has been ultra expansionary; left unchecked, massive fiscal deficits could eventually pose an inflation threat, and central banks, especially the Fed, find themselves under more political pressure than at any time since the Great Depression. So the fear that the Fed cannot take away the punchbowl any time soon is understandable. While those tail risks are currently small, we agree with our colleague Joachim Fels — who has been warning of inflation risks for some time — that investors should consider inflation insurance. But a recommendation to buy protection against inflation tail risks is very different from expecting that inflation will — or could — rise by enough to erode the value of the debt.

Flawed strategy: Three hurdles. Indeed, we think three hurdles preclude eroding the real value of our debt with inflation. 1) Investors would recognize even a stealth inflation policy and would quickly push up yields. 2) Nearly half of Federal outlays are either officially or unofficially indexed, meaning that increments to debt would rise with inflation. 3) And the Fed is unlikely to acquiesce. Before examining those factors, it's worth looking back to see what history suggests.

The lessons from history may not apply. On the surface, it appears that history contradicts our view. After all, the combination of seignorage (the benefits to the sovereign from printing money) and unexpected inflation of the mid-1960s and 1970s pushed real rates sharply negative, limiting debt service and eroding the debt. My colleague Spyros Andreopoulos explores this issue in depth in a provocative recent piece (see "The Return of Debtflation?" February 10, 2010). His calculations show that rapid nominal growth brought debt held by the public from 108.6% of GDP in 1946 to just 36% of GDP in 2003. The calculations further show that inflation accounted for 56% of that decline, while real growth accounted for the remainder. Spyros acknowledges that his calculations implicitly assume that debt service is a constant share of GDP. In reality, debt service varies with changes in interest rates, the debt, and the

Exhibit 1
Roughly Half of Federal Outlays Are Linked to Inflation



Source: Congressional Budget Office, "The Budget and Economic Outlook: FY 2010 to 2020"

Strategy and Economics

maturity structure. So, if debt is growing relative to GDP and rates are rising with inflation, debt service/GDP will also rise, boosting the overall deficit and debt/GDP. That limits the ability of policymakers to inflate the debt away. Indeed, using an alternative framework, George Hall and Thomas Sargent calculate that during the period from 1945 to 1974, inflation accounted for only about 23% of the decline in debt/GDP ("Interest Rate Risk and Other Determinants Of Post WWII U.S. Government Debt/GDP Dynamics," January 19, 2010).

Those assumptions are critical in evaluating history, because it turns out that the US postwar experience was anomalous for three reasons. First, a rapid decline in defense spending yielded a significant "peace dividend." Defense spending tumbled from 37% of GDP in 1945 to 11% by 1955, bring the deficit from 12% of GDP in 1945 to outright *surplus* by 1947. Second, the Fed implicitly agreed to finance the war by holding down interest rates through the early 1950s. The Korean War brought a surge of inflation and a recognition that the Fed needed more independence. In 1951, the Treasury-Fed Accord empowered the Fed to raise interest rates to address inflation. Also, wartime legislation prohibited the Treasury from issuing bonds with coupons greater than 4¼%. Consequently, debt managers shortened the maturity of issuance to get under the ceiling. Higher inflation and market pressures eventually forced repeal and also brought down debt/GDP.

Hurdles to inflating. Looking ahead, there are several hurdles to being able to inflate away the debt. First, market participants seem unlikely to be fooled by unexpected inflation — certainly not for long enough or by enough to dent the debt. Despite what some might view as inflation complacency, the transformation of financial markets over the past 50 years, including the growing use of instruments to protect against inflation, suggests much more sensitivity to inflation risks than in the postwar period.

Indexation. Second, nearly half of Federal outlays are linked to inflation, meaning that increments to debt would rise with inflation. Social Security, which accounts for one-quarter of Federal outlays, is officially indexed, and Medicare and Medicaid are "unofficially" indexed. Over the period 2009-2020, CBO estimates that these three programs will account for 72% of the growth in total Federal outlays and about that share of the growth in debt. And CBO's assumptions may be conservative, as they are required by law to assume a sharp cutback in physician reimbursements under the Medicare program. Those cuts have been delayed every year since 2003.

Enter the Fed. Finally, while many view the Fed as politically constrained, we have no doubt that Fed officials will not tolerate a significant rise in inflation, much less encourage it. Of course, starting in the mid-1960s through 1979, monetary policy did appear to sanction higher inflation. Having been at the Fed from 1972 to 1980, I wouldn't say that then-Chairman Arthur Burns explicitly chose inflation; rather he didn't think inflation had much to do with monetary policy. That was then. As much as the Fed seems to be in disfavor today, there is no question among even its sharpest critics that the Fed should be independent and responsible for price stability. And Fed officials are acutely aware of the pressure that large deficits put on the central bank. As Kansas City Fed President Hoenig noted recently, "The founders of the Federal Reserve understood that placing the printing press with the power to spend was a formula for fiscal and financial disaster."

Venting market pressures: Rates or currencies? Even setting aside all those hurdles, with core inflation declining again, it would take some time to boost inflation sufficiently to meaningfully erode the debt. That's all the more reason to pay attention to the other ways that fiscal pressures may vent in financial markets. Put simply, sovereign credit risk may not immediately create inflation risk; it may instead translate into real interest rate or currency risk. Indeed, our call for a rise in nominal 10-year Treasury yields to 5½% is a story about real rates, in which a revival of private credit demands collides with massive Treasury borrowing needs. Global investors will likely demand a concession to buy US debt, or they will diversify away from it. Financial markets will, when provoked, find ways to "punish the printers" — in this case, meaning those whose fiscal policies are clearly on an unsustainable path.

That's especially a risk in the current US political setting. The decisions to retire by key senators on both sides of the political aisle are partly the result of moves to the left by Democrats and moves to the right by Republicans. With both parties losing their moderate members in the middle, the distance between them becomes ever harder to bridge, and there is less mass in the center to achieve practical solutions. And practical solutions to our budget and economic challenges are needed soon.

For financial markets, there is an element of complacency around such gridlock. Market participants are used to thinking that political gridlock is good: It prevents politicians from interfering with the marketplace. The financial crisis exposed the flaws in that reasoning with respect to appropriate financial regulation. Indeed, gridlock today is more likely to be bad for markets, as our budget problems are the result of past policies and can only be solved with political action. The risk is that further significant pressure on interest rates — significant enough to be perceived to threaten the expansion — may be needed before leadership emerges to break the logjam.

Strategy and Economics

February 19, 2010

Global Equity Strategy
Indicator Alert

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We expect to become more cautious on equities when leading growth indicators roll over. We know the risk of over-finessing a timing call, but we expect choppy, range-bound markets for some time, so we think tactical timing will be important, unfortunately. There's a hint of an inflection point in some leading indicators, but we will wait to see clearer signs before changing our call. Our hunch is that we'll get the sell signal in the June quarter.

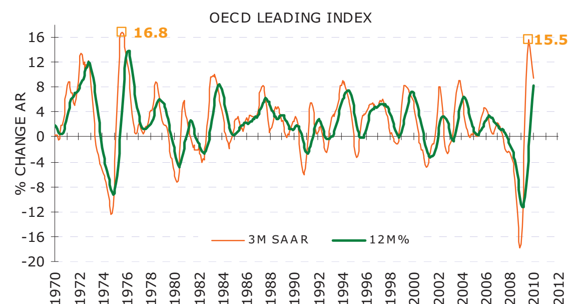
We don't think that developed equity markets have started a secular bull market. We expect an extended period of (broad) range-bound trading. In this context, we think leading cycle indicators will be important guides to the wax-and-wane in stocks that we expect.

We are putting more emphasis on growth indicators than, say, liquidity or interest rate measures for several reasons: First, our sense is that investors have unusually low conviction about the durability of the economic recovery. Consequently, we suspect that weakness in the leading indicators would lead to unusual consternation. Sovereign stress, which could limit the ability of policy makers to respond to slower growth, is likely to exacerbate investors' concerns.

Second, leading growth indicators sent a timely 'buy' signal this time last year. The ISM, for example, ticked higher just before Wall Street troughed (a signal that, unfortunately, we initially ignored.) Third, in previous examples of extended range-bound markets – periods that typically followed major bear markets – it was often the swing in growth indicators (rather than liquidity or rates) that seemed best to track fluctuations in equities.

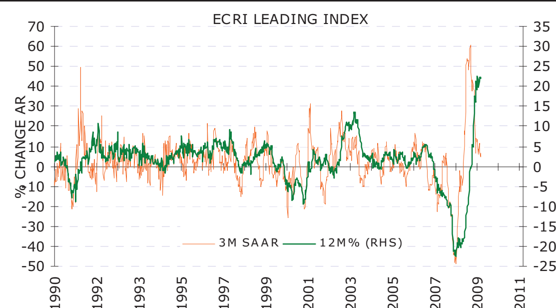
What are the leading indicators saying now? Most remain strong. Exhibits 1 and 2 show the OECD's leading index and the ECRI leading index. Both are at very strong levels on a 12-month change basis, although both are decelerating at the margin (over 3 months). Exhibit 3 shows the ISM and IFO indices – again, both are strong. In fact, most purchasing manager indices are robust (and the regional series in the US have been stronger still in February). We don't think that manufacturing is representative of the broader economy in this cycle, a point reinforced by the desultory performance of other sector-specific sentiment indicators (such as for small business). Nonetheless, indicators such as the ISM continue to provide a good guide to important market variables, such as analyst earning revisions.

Exhibit 1
A Hint…



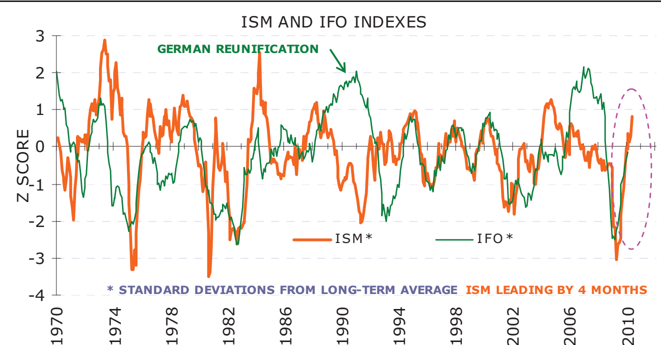
Source: OECD; Morgan Stanley Research

Exhibit 2
…Of A Peak



Source: ECRI; Morgan Stanley Research

Exhibit 3
No Peak Here Yet



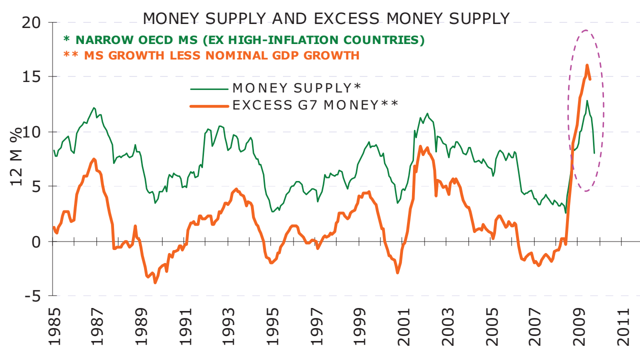
Source: ISM, IFO; Morgan Stanley Research

Strategy and Economics

Finally, liquidity growth is starting to slow (Exhibit 4) – although, as our *Global Monetary Analyst* colleagues note, the stock of excess liquidity remains high. Historically, risk assets have correlated with the change in liquidity measures, rather than their level.

Exhibit 4

Liquidity Measures Inflect



Source: OECD, Morgan Stanley Research

As we noted above, we think that growth indicators could be unusually potent market signals in this cycle. Work by our European strategy team shows that they are useful market timing tools even in normal cycles. What follows is taken from Edmung Ng's *Equity Implications Of Rollover In Growth Leading Indicators*, 8 February.

Edmund looked at the performance of European equities relative to four leading indicators: the OECD leading index; ISM new orders; IFO expectations; and the ECRI leading index. The ECRI was the most reliable indicator in the sense that it gave the fewest bad signals (that is, equities fell over 80% of the time in the six months after the ECRI peaked). The median 6-month equity performance after the ECRI peaked was a fall of 8%. In both Europe and the US, equities underperform government bonds by around 9½%, on average, in the six months after the ECRI peaks.

Exhibit 5

Sector Rotation Once the Peak Passes

Rank sector performance of European sectors 6 months after peak of index

	OECD World leading index	ISM New orders	IFO Expectations	ECRI Leading index	Average
Telecommunications	2	1	1	3	1.8
Consumer Staples	3	2	4	2	2.8
Health Care	4	3	3	1	2.8
Utilities	1	5	5	4	3.8
Information Technology	5	8	2	9	6.0
Industrials	6	6	6	8	6.5
Energy	10	4	8	5	6.8
Materials	7	7	7	6	6.8
Consumer Discretionary	9	9	10	7	8.8
Financials	8	10	9	10	9.3

Note: Shows ranking of sector performance 6 and 12 months after the 1st rollover in growth indicators post NBER recessions; ranking is done based on first hit ratio (i.e. probability of sector to outperformance) and median performance. OECD World (Total OECD + Major 6 EM) peaks on Nov-72, Feb-76, May-81, Sep-83, Jan-92 & Sep-02; ISM NO peaks on Jun-50, Feb-55, Feb-59, Dec-61, Jan-73, Feb-76, Nov-80, Dec-83, Sep-91 & Mar-02; IFO expectation peaks on Dec-72, Dec-75, Jan-84, Oct-94 & May-02; ECRI leading index (growth) peaks on May-71, Feb-76, Apr-81, May-83, May-91 & May-02. Note this analysis for sectors only include peaks in growth indicators post 1973 due to limited availability of sector data.
Source: Edmund Ng, *Equity Implications of Rollover In Growth Leading Indicators*, 8 February 2010; Morgan Stanley Research

Leading indicators are also useful for timing sector rotation. Exhibit 5 provides a rank order of historical sector performance in the six months after each leading index peaks. If this pattern repeats, and broadly we see no reason why it shouldn't, then the relative sector winners should shift dramatically over the next couple of quarters. It's particularly noteworthy that Financials perform poorly once leading indicators peak. Our European banks team last week downgraded Financials. For more details, see Huw van Steenis, *Banks: Elevated Sovereign Funding Costs And European Banks*, 16 February.

Strategy and Economics

February 19, 2010

Global Credit Strategy
An Ocean Between

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Contrasting US and European credit. For the better part of the last year, our global view of corporate credit was broadly unified in both message and direction. As credit valuations across the globe converge, while economic and valuation messages across these markets become more dispersed, we believe regional distinctions in our views become increasingly warranted. We are mindful that credit, especially investment grade, is less dependent on growth than other risk assets to drive performance. Yet regional differences are notable, and growing more pronounced. Downside surprises to recent euro-area data have left the region dangerously close to stall-speed, while better-than-expected growth numbers out of the US and Asia ex-Japan point to a more sustained recovery.

For European investors, we view fundamental and valuation trends in the US as reasons to be relatively less constructive on the European credit market (see *Problematic Relatives – Downgrading EUR IG Credit*, February 12, 2010). For US investors, we believe that different trends argue for more conviction regarding a 'buy the dip' strategy in the face of the current pullback (see *Macro Masking Micro*, February 5, 2010) and similarly in Asia (see *Reverse Contagion*, February 12, 2010).

A differing relative valuation picture. Pricing off of the German Bund curve, € cash bonds have enjoyed an unintentional lift from the sovereign crisis — now trading unusually close to broader € fixed income. The US picture remains quite different. Despite weaker growth with larger downside risk, European non-financial credit trades at tighter spreads but is 0.5x more geared than US markets. We see a similar story in the bonds of banks. We highlight here bonds from the USD and EUR markets from the same issuer, but with very different valuations. We also offer cross-Atlantic trade ideas, by sector, which benefit from differing valuation and economic trends between regions.

Trade #1 — Looking to the Banks: Total debt/EBITDA may be the bread-and-butter of credit analysis, but we sense the 'leverage' that remains most on the minds of investors is that of the US and European banks. Financial repair on both sides of the Atlantic has been material, impressive and central to the sector's leadership role in market performance in 2009. Our focus here, however, is on the more recently divergent trends between the two markets. In the face of diverging economic views by region, but rather similar valuation levels between US and European banks, such distinctions are increasingly germane.

On several fronts, the headwinds for the European banking sector appear greater. The region faces a more difficult backdrop of weaker growth that we noted earlier, in contrast to our forecasts of a *relatively* more rapid improvement in the US picture. Despite this challenge, European reserves against non-performing loans (NPLs) remain less conservative than their American counterparts. In Europe, banks have put aside about 50¢ for every dollar of NPLs. US banks, in contrast, boast roughly an 80¢ cushion to every dollar in bad debts (on 2009 numbers).

The faster shrinkage in US bank balance sheets in 2008-09, while painful for corporates and households, has provided US banks with better flexibility to support economic growth and improve their own solvency as they enter 2010. US bank loan to deposit ratios stand at 115% versus 145% at the start of the crisis, meaning that the ability of banks to self-fund loan growth is now much greater. In Europe, however, the loan/deposit ratio still hovers around the ~135% range from ~145% highs, as the deleveraging in Europe slowed in 2009 relative to 2008.

Although we feel that a better US banking story is widely flagged (and hardly out of consensus), we think it notable, given relative pricing. In the EUR bond market, investors face a number of opportunities to switch out of European banks into US banks with lower leverage and better economic tailwinds. In Exhibit 1, we highlight several examples.

Exhibit 1

Bank Credit Trade Ideas

Credit	Maturity	Rating	Price	Z Spread	TCE/TA	10e Tang. Book Value Growth
JPMorgan	Aug-11	A+	106	22	5.3%	5%
Deutsche Bank	Mar-11	A+	103	-5	2.7%	10%
Citigroup	Mar-13	A3	107	185	6.4%	-2%
Monte dei Paschi	Jul-13	A1	106	54	3.8%	2%
Bank of America	Mar-15	A2	100	154	4.5%	14%
Commerzbank	Feb-15	Aa3	107	75	0.9%	-12%
Bank of America	Jun-16	A2	113	176	4.5%	14%
Intesa San Paolo	Nov-16	Aa2	100	76	4.3%	6%

Source: Morgan Stanley Research, Bloomberg e = Morgan Stanley Research Estimates

Trade #2 — EUR vs. USD Cash Valuations at the Issuer Level: Another way to play the valuation divide is to switch out of EUR-denominated bonds into the USD bonds of the same issuer. Exhibit 2 compares cash bond trades in the same issuers where the USD market offers greater yield and spread

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for similar maturities. For equivalent credit risk, USD bonds are offering meaningfully higher spreads and yields, in a currency our FX strategists expect will appreciate 8% against the euro this year (see *FX Pulse: Euro Strains*, February 4, 2010). For investors for whom cross-currency trades are impractical, we still find these relationships useful in highlighting the differing valuations between the two markets.

Exhibit 2

Better Spread, Higher Yield, Stronger Currency

Credit	Ccy	Maturity	Price	Yield	Z spread
Anglo American plc	USD	Apr-14	$120	4.14%	186
	EUR	Apr-15	$110	3.76%	116
Akzo Nobel NV	USD	Dec-13	$107	3.51%	135
	EUR	Jan-14	$116	3.26%	106
British American	USD	Nov-18	$127	5.58%	206
Tobacco plc	EUR	Jun-17	$109	3.91%	86
Cargill Inc	USD	Nov-17	$108	4.81%	136
	EUR	May-17	$106	3.94%	93
Deutsche Telekom AG	USD	Aug-18	$112	5.05%	149
	EUR	Mar-18	$118	3.97%	81
Enel SpA	USD	Sep-17	$111	4.58%	118
	EUR	Jun-18	$106	3.88%	70
Pfizer Inc	USD	Dec-18	$113	4.70%	109
	EUR	May-17	$106	3.58%	55
WPP Group plc	USD	Jun-14	$102	5.33%	292
	EUR	Jan-15	$104	4.34%	179
Portfolio Average	**USD**	**Oct-16**	**$112**	**4.71%**	**166**
	EUR	**Sep-16**	**$110**	**3.83%**	**98**

Source: Morgan Stanley Research, Bloomberg

Trade #3 — Putting the Trade on Across the Atlantic: Finally, we end with a simple screen to prosecute our views across regions: long US corporates with strong fundamentals, little to no exposure to Europe and still attractive valuations (especially in relative terms) versus short fundamentally weak, tight-trading European names. Particularly in the cyclical arena, we would rather avoid names exposed to weaker European growth and, in many cases for the names in our table, pick up spread at the same time. For example, we like being long International Paper, a strong free-cash-flow generator, with leverage now under 2x, and most of its sales in North America — versus Svenska, with an additional turn of leverage, half the free-cash-flow generation as a share of total debt, and predominantly European revenue generation. An investor would pick up over 40 bp and more than double the spread per unit of leverage (SPL) by swapping into IP and out of SCACAP.

A world increasingly without borders. In our 2010 credit outlook, our global team viewed the year ahead as one that would still provide opportunity in credit markets — but we suggested that the performance to be had would be measured, more volatile, and frankly a bit disappointing relative to the outsized returns most credit investors booked in 2009 (and may mistakenly expect to continue). We believe that the developing macro backdrop, when coupled with valuation differences, leaves the euro area exposed relative to opportunities we see on the other side of the Pond. Common across the developed markets are the draining of liquidity and government support facilities, uncertainty regarding the macro picture, and fiscal worries related to sovereign (and municipals, for that matter) — courtesy of the massive private-to-public debt transfer. The recovery in credit markets is bound to get more uneven from here, yet we believe that the US credit markets are poised to travel the less bumpy path. (For details see our *Credit Basis Report* of February 19, 2010.)

Exhibit 3

Credit Trade Ideas: Long US/Short Europe

Sector	View	Name	Rating	5yr CDS	Total debt/EBITDA	SPL (bp/x)	FCF to debt	European exposure
Consumer	*Long*	Comcast	BBB+	120	2.1x	56	18%	0%
Cyclical	*Short*	BSkyB	BBB+	75	2.6x	29	23%	100%
Consumer	*Long*	Safeway Inc	BBB	95	2.8x	34	20%	0%
Staples	*Short*	Casino Guichard	BBB-	110	3.9x	28	-10%	73%
Consumer	*Long*	DirecTV Group	BBB-	125	1.4x	87	29%	0%
Staples	*Short*	SES	BBB	67	3.3x	20	8%	62%
Industrials	*Long*	Union Pacific Corp	BBB	65	2.0x	32	9%	0%
	Short	Assa Abloy	A-	59	2.8x	21	22%	50%
Materials	*Long*	Freeport-McMoRan	BBB-	160	0.8x	200	44%	16%
	Short	Koninklijke DSM	A-	51	2.6x	20	40%	52%
Materials	*Long*	International Paper	BBB	133	1.9x	70	46%	13%
	Short	Svenska Cellulosa	BBB+	90	2.9x	31	19%	76%
Telecom	*Long*	Verizon Comm.	A	80	1.8x	45	23%	0%
	Short	Deutsche Telekom	BBB+	70	2.8x	25	14%	76%
Utilities	*Long*	PPL Corporation	BBB	134	4.3x	32	8%	0%
	Short	Iberdrola SA	A-	95	6.3x	15	-2%	77%

Source: Morgan Stanley Research, iBoxx, Bloomberg, Factset

Strategy and Economics

February 23, 2010

Europe Equity Strategy
The Cost of Capital Is Going Up

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The cost of capital looks set to rise, and we reiterate our view that the current correction phase in equities is not over: There may be rallies, but we recommend selling into strength. There is 6% downside to our 1030 MSCI Europe index target. We believe there is upward pressure on the cost of capital from two sources. First, the monetary authorities in Asia have already started to tighten monetary policy as their economies rebound strongly and inflation looks set to rise in the coming months (our economists expect China to start hiking base rates in April). In addition, the Fed has raised the discount rate and announced plans to start to wind down its unconventional support policies over the next few months.

Second, concerns over the sovereign fiscal outlook are increasing the 'risk' in the 'risk-free' rate. The size of the debt burden that prompted the financial crisis has not fallen, but rather was transferred to the public sector. One of the most important macro themes for the next few years in developed markets will be how easily countries can service and pay down these deficits. Greece may well be a taste of things to come, but the speed and extent of any contagion are hard to predict. We think that the 50-year low in government bond yields (real and nominal) in this cycle will not be seen again for many years.

Size of government debt issuance raises 'crowding out' concerns. Our economists expect European governments to raise over €1.6 trillion of gross bond and bill issuance in 2010 (around €550 billion net). The scale of such issuance could raise a significant 'crowding out' effect, whereby government bonds suck up the vast majority of capital.

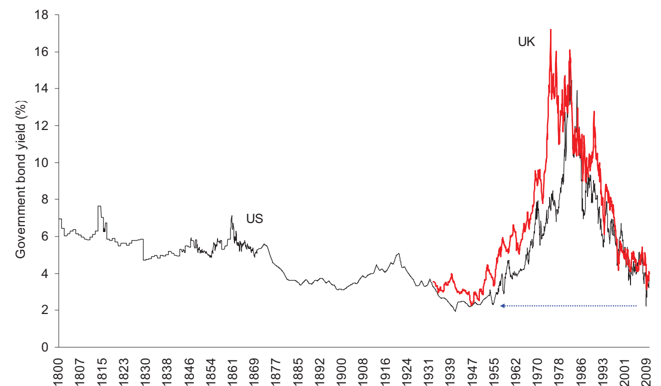
EU banks need to roll over >€1 trillion of debt in the next two years – and at a higher cost. In its latest note, *Elevated Sovereign Funding Costs and European Banks* (February 16), our Banks team downgraded its sector view to Cautious and highlighted that the European banking sector needs to roll over in excess of €500 billion of bank debt in 2010, with a similar amount in 2011. The cost of capital for the banking sector is likely to rise for three reasons, in our view: Higher funding costs for sovereigns; a move toward longer-duration debt (many banks shortened their funding duration during the crisis and are now keen to reverse this); and a move away from government-guaranteed debt to non-guaranteed debt – in 4Q09 we estimate the latter was approximately 40 bp more expensive than the former.

Higher funding costs for sovereigns and banks will feed through to corporates and consumers. With funding costs set to rise for governments and banks, we assume that this will move further up the food chain, affecting the availability and cost of credit for corporates and households. In its latest survey on company access to finance, the ECB noted that conditions for access to bank credit are stationary at very tight levels, which means that credit contraction/deleveraging is continuing in the corporate sector.

Consumer credit costs have been rising for a year. In the consumer sector, the demand for credit is likely to remain low as households look to de-lever. Nevertheless, with credit availability likely to remain subdued (as banks de-lever and shrink loan books), a rise in the 'risk-free' rate implies a higher cost of capital for all. Over the past year, consumer credit costs have been rising despite unchanged policy rates. This trend has accelerated in recent months. Put simply, a lack of credit availability suggests to us that consumers are likely to be price takers rather than price makers.

Are the authorities losing control of effective interest rates? Somewhat more contentiously, we'd also argue that the ability of authorities to control effective interest rates through the system is becoming impaired. This could be one interpretation of the current record steepness of government yield curves, with the other being that we are about to see a sharp and sustained economic recovery.

Exhibit 1
The risk free rate hit a generation low in this cycle



Source: Datastream, Global Financial Data, Morgan Stanley Research

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Investment implications of a higher cost of capital:
(1) Asset allocation – prefer equities over fixed income on a 12-month view. An increase in government bond yields usually leads to a de-rating in equities. In a UK strategy report, *Bond yields are key focus for 2010* (January 7, 2010), we highlight that the P/E of the UK equity market has a 90% probability of falling in the year after a structural trough in gilt yields. Although rising earnings can offset the P/E contraction, equities tend to suffer in periods when bond yields are rising and leading indicators are rolling over. But with corporate bond performance likely to be undermined by a structural rise in government bond yields, equities remain our preferred asset class for the long term (see our report *Prefer non-financial equities over credit*, February 15, 2010).

(2) Sectors & countries. Higher government yields tend to be bad for Financials and bond proxies and relatively good for Industrials, commodity-related sectors, and some defensives. In this cycle the linkage between higher bond yields and fiscal retrenchment pressures also suggests that Consumer Discretionary stocks should struggle. On consensus 2010 data, the sectors with the highest net debt to equity ratio are: Utilities, Transportation and Telecoms. The countries with the highest corporate leverage are Portugal, Spain, Italy and Greece. This analysis also supports many of the positions within our European Model Portfolio – for example we are overweight Consumer Staples, Pharmaceuticals, Energy and Materials and underweight Utilities, Financials and Consumer Discretionary.

(3) Stocks. A sustained rise in the cost of capital is likely to hurt those companies with the weakest balance sheets and those whose business models are reliant on regularly refinancing or rolling over short-term debt instruments. These stocks have actually been significant outperformers over the last year, but we expect this to reverse in 2010. We highlight three screens to identify stocks that may be perceived as vulnerable to balance sheet concerns:

Our anti-LBO screen – Stocks rated Underweight on this screen are Enterprise Inns, Brisa, Celesio, Heineken, Kemira and DSGI.

Piotroski analysis – Stocks with a high Piotroski score are now outperforming those with a low score. Our screen of stocks with a low Piotroski score includes 15 Underweight-rated stocks, including Acerinox, Lonmin, Michelin, ThyssenKrupp, Brisa, Daimler, Gas Natural and Volvo. Four stocks in our European Model Portfolio appear in our high Piotroski score screen: Wood Group, AstraZeneca, Danone, Nestle.

Net debt to equity ratios – Underweight-rated stocks with a high net debt to equity ratio include Northumbrian Water, Pennon, Brisa, Heineken, Daimler, Bunzl and Iberdrola. There are 8 Overweight-rated stocks with a net cash position on their balance sheet: Acergy, Balfour Beatty, Bwin, EADS, ENRC, Inditex, Invensys and Vestas.

Exhibit 2

Sector performance in periods of rising real rates

	Ann'd Relative Perf. In Months when US 10Y BY is RISING		Ann'd Relative Perf. In Months when US 10Y BY is FALLING	
	Average	*Hit Ratio*	*Average*	*Hit Ratio*
MSCI Europe (Absolute, Since 1958)	**9.2**	**64**	**4.7**	**61**
MSCI Europe (Absolute, Since 1973)	**7.6**	**63**	**5.4**	**62**
Industrials	**3.7**	**57**	-2.8	48
Telecommunication Services	**8.8**	**55**	-0.1	49
Energy	**6.1**	**55**	-0.7	48
Materials	**4.8**	**54**	-1.5	47
Health Care	**2.1**	**54**	7.2	58
Consumer Staples	**0.1**	**52**	3.7	49
Consumer Discretionary	**2.4**	**52**	-3.9	44
Information Technology	**2.8**	**48**	-1.0	47
Utilities	**-3.6**	**46**	5.0	54
Financials	**-6.3**	**39**	2.3	53

Note: Data looks only at months in the top & bottom tertile of movements in the Real US 10Y Bond Yield since 1958 (Monthly average). Sector performance only goes back to 1973 due to data limitation. Hit ratio is the probability of the sector to outperform in different regimes.
Source: MSCI, FRB, Datastream, Morgan Stanley Research

Exhibit 3

Consensus 2010 net debt to Equity

Consensus 2010 net debt to equity (%)	
Portugal	189
Spain	141
Italy	85
Greece	82
Belgium	73
Netherlands	62
Austria	54
France	52
Ireland	51
Germany	46
Norway	44
United Kingdom	39
Denmark	38
Finland	30
Sweden	26
Switzerland	21
Europe ex UK	**58**

Source: FactSet, Worldscope, IBES, Morgan Stanley Research

Prices: Enterprise Inns 106p, Brisa €6.07, Celesio €21.15, Heineken €36.12, Kemira €12.37, DSGI 31p, Acerinox €12.76, Lonmin 1815p, Michelin €50.87, ThyssenKrupp €23.18, Daimler €31.25, Gas Natural €13.49, Volvo SKr 60.5, Wood Group 362p, AstraZeneca 2817p, Danone €43.21, Nestle SFr 52.8, Northumbrian Water 271p, Pennon 523p, Bunzl 675p, Iberdrola €5.90, Acergy NKr 97.85, Balfour Beatty 271p, Bwin €41, EADS €15.05, ENRC 1025p, Invensys €318, Vestas DKr 281, Inditex €42.31.

Strategy and Economics

February 19, 2010

Equity & Credit Derivatives Strategy

Resetting Tail Risk Hedges – Contagion vs. Differentiation

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For details see our *Derivatives Across the Capital Structure* report of February 19, 2010. Pricing reflects initial publication of this report, unless otherwise noted.

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Note: Phanikiran Naraparaju and Ashley Musfeldt are Fixed Income Research Analysts and they are not opining on equity securities. Their views are clearly delineated.

In the past month credit and equity markets reset quite dramatically, driven by European sovereign concerns, liquidity tightening in China, and potential financial-reform regulation in the US and Europe. While sovereign concerns have proven to be a bigger headwind for European risk assets — particularly European bank equities — the concern has moved market correlations higher, and US risk assets have been affected as well, though to a lesser extent, mainly on the equity side. Credit markets, on the other hand, have underperformed equities, especially in the US, where the negative price performance of CDX HY has been slightly worse than that of equities. We also see this in the volatility space, where option-implied credit volatility has risen more relative to equities — with European vol being better bid than US.

We have been advocating tail risk hedging since the beginning of this year (see *Investment Perspectives,* "Time for Tail Risk Hedges," January 13, and "Cyclical Sector Hedging," January 27), and today investors remain focused on this, though the market has repriced lower and there have been associated moves in volatility. We have revisited our hedging themes and trade ideas across credit and equity in both Europe and the US. Given the recent strength in most markets, we believe our small-tail and large-tail scenarios from early January still hold.

Credit reset more dramatic than in equities. In credit, we have seen a complete reset of the hedging landscape. Volatility surfaces have re-priced, with SOVX and iTraxx Main being affected the most. In equities, the move has been less dramatic, as we effectively rolled down the skew curve. However, cyclical sectors in US equities have seen more of a reset higher.

Europe weaker than US. While investment-grade credit vol in Europe has repriced dramatically relative to credit vol in the US, the same differentiation is less evident in the high yield or equity markets, and we like hedges on European equities as a result. In contrast, we like playing the contagion theme through CDX IG options.

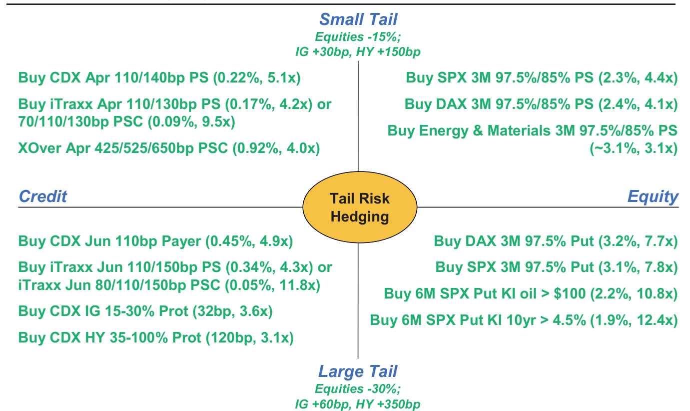
Long-dated vs. short-dated expiries. Recent price moves provoked less demand for short-dated options and gamma than we would have expected. In both markets, the near-term nature of the sovereign issues and other risks is not reflected in the pricing between long- and short-dated options.

Small-tail hedging. For our small-tail hedging scenario — equities down 15%, IG credit spreads wider by 30 bp, and HY/loan spreads wider by 150 bp — we like put spreads on the S&P 500. While we previously liked outright puts in some cyclical sectors, volatility and skew have repriced higher, consistent with our expectations, and we now prefer put spreads here as small-tail hedges. In credit we like puts and put spreads on IG CDX, and put spreads and put spread collars on iTraxx, XOver, and high yield given higher volatilities.

Large-tail hedging. For our large-tail scenario (equities fall 30%, IG spreads widen 60 bp, and HY/loans widen 350 bp), we like slightly out-of-the-money puts on the S&P 500 as well as over-the-counter puts on the DAX for Europe-based investors. We also like contingent puts in equities that are only active if oil or rates move up significantly. In credit we think outright puts on IG CDX offer the best risk reward, and we also like shorts in senior and super-senior tranches as market hedges.

Exhibit 1

Tail Risk Hedging Strategies



Note: Numbers in parenthesis indicate upfront premium for trade and the ratio of the max P/L in each scenario to initial cost. Source: Morgan Stanley Research

Strategy and Economics

Short-dated hedges offer best value. Our discussions with credit investors suggest that few had longer-term hedges coming into the new year, and the demand for longer-dated hedges has kept term structures from inverting fully during the sell-off. In equities, short-dated at-the-money vol has risen more than their long-dated counterparts, but much of this move was due to steeper near-term skews and rising volatilities as spot prices fell. In a worsening environment, we see room for more curve inversion and believe being long the front-end of the curve offers the best value from an option buyer's perspective. This is particularly true in credit, where short-dated options appear cheaper than in equities.

There are other reasons to keep hedges short-dated as well. (1) Many of the risks we care about (or know about) are in the near term: Greece/other sovereigns, China tightening, and the end of quantitative easing. (2) Long-dated options remain expensive given the general level of implied volatility, so we prefer cheaper, shorter hedges where the premium loss is less in a market rally. (3) A rolling strategy can potentially benefit from lower option prices in the future as volatility falls and provides opportunity to reset strikes.

Credit vol repricing more than equity. For US and European credit the downside skew, or payer skew, has moved higher since mid-January. In US equities, downside skew is steep (90th 3-year percentile), reflecting hedging demand, but has not changed much over the past month. Upside skew has steepened though, as calls became cheaper during the sell-off, indicating to us that the market is not pricing in a quick or large rebound (despite stocks' recent bounce). For the European equity markets both the downside and upside skews look relatively flat versus history (SX5E and DAX 90-110 skews are in the 25th and 8th percentiles, respectively), and are also flatter than the SPX on an absolute basis. Furthermore, they have not moved higher over the past month, another reason to like OTM DAX puts as a large-tail hedge.

Looking at skew can also give us insight into how much the market is re-pricing volatility, driven by the supply and demand for options, or merely accounting for lower asset prices by "rolling down the skew" to higher implied volatility levels — i.e., today's ATM volatility was yesterday's OTM put volatility (see "Learning from the VIX," *Investment Perspectives,* November 11, 2009, for details).

We find that the entire move in ATM S&P 500 and DAX volatility over the past month was attributable to a reset higher in the level of volatility itself (i.e., 1100 strike volatility on February 19 and on January 19 are nearly the same). This supports the notion that equity investors, at least at the market level, were relatively well hedged or complacent during this downturn.

Exhibit 2

Cyclical Volatilities Reset More than for Indices

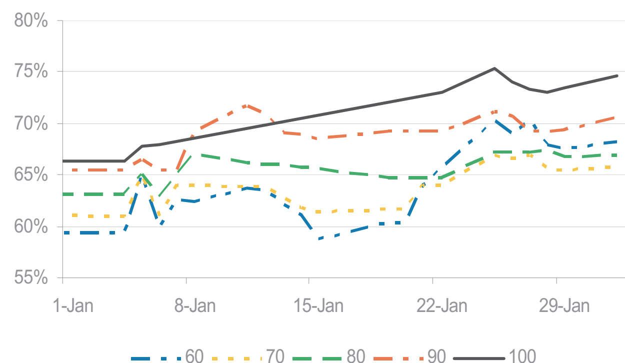
Sector / Index	Change in 3M ATM Vol	Change due to Reset in Volatility Surface	Change in 90-110 Skew
Healthcare	2.7%	1.4%	0.6%
Energy	4.2%	1.4%	0.4%
Materials	3.8%	1.2%	1.4%
Industrials	3.2%	0.7%	0.2%
Staples	1.5%	0.6%	0.4%
Utilities	2.8%	0.5%	0.3%
Tech/Telecom	2.2%	0.0%	0.4%
Discretionary	1.8%	-0.2%	0.6%
Financials	2.4%	-0.2%	2.7%
S&P 500	2.7%	-0.4%	0.8%
DAX Index	1.9%	-1.4%	-0.5%

Source: Morgan Stanley Research

Individual US equity sectors have moved quite differently than the S&P 500 though, with protection buying in cyclicals — Energy, Materials, and Industrials — driving a volatility increase over and above what one would expect from rolling down the skew alone. This shift in pricing makes sense to us, and we had previously recommended buying puts outright on cyclicals given low volatility and flat skew.

Exhibit 3

Fixed Strike Volatility Rising in Credit (iTraxx)



Source: Morgan Stanley Research

In contrast to equities, the entire vol surface has reset wider in SovX and to a lesser extent in iTraxx Main, with the current iTraxx ATM volatility trading well wider than the OTM vol seen in early January (see Exhibit 3). At that point the skew was largely non-existent, but we now see a significant differentiation between ATM and OTM options vol in iTraxx Main. The re-pricing is less obvious in CDX IG. however. In XOver/HY as well, the magnitude of the move (5% in price vol terms) has been such that mere rolling up the skew cannot explain the change in ATM volatility.

Strategy and Economics

February 12, 2010

Exchange-Traded Funds

Average Tracking Error Rose Meaningfully in 2009

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Tracking error may be a concern to ETF investors. ETFs are designed with the objective of providing access to and replicating the performance of specific indices. One of the primary goals of ETF portfolio managers is to minimize tracking error, which we define as the difference in total return between an ETF's net asset value (NAV) and its underlying index. Therefore, tracking error can indicate to us how well managers have met their objectives. Factors such as fees and expenses, diversification requirements, portfolio optimization (holding a representative sample as opposed to a full replication), and index turnover may cause an ETF's performance to deviate from its underlying index.

For 2009, average and weighted average tracking error for all US listed ETFs were 125 and 113 basis points, respectively. This reflected a significant increase of 73 bps in the average tracking error as well as a meaningful increase in the weighted average tracking error from 2008 levels of 52 and 39 bps, respectively. Exhibit 1 (next page) displays the tracking error for each major market segment.

The combination of portfolio optimization and the outperformance of smaller index constituents were the primary drivers of increased tracking error for many ETFs. Despite market volatility, ETFs that fully replicated their benchmarks were able to closely track their underlying indices.

Within US Equity, tracking error increased to an average of 84 bps in 2009 from 50 in 2008. We note that all US Equity ETF market segments saw meaningful increases in their averages. For example, in 2009 US style ETFs exhibited average tracking error of 54 bps, up from 19 in 2008. On a weighted average basis, tracking error performance was mixed among US Equity ETFs, with US Style experiencing the largest Y/Y percentage increase and 52 of the 57 ETFs within the category exhibiting higher tracking error than the 2008 weighted average of 6 bps. Despite the increase, US style still had the lowest tracking error of the market segments.

ETFs based on international indices exhibited the largest absolute level of tracking error in our study. In 2009, average and weighed average tracking error for international ETFs were 194 and 232 bps respectively, versus the 65 and 92 bps observed in 2008. International also accounted for 28 of the 54 ETFs with 2009 tracking error greater than or equal to 300 bps (all of which trailed their respective indices). Noteworthy, in our view, is the relatively large tracking error exhibited by some ETFs tracking Emerging Markets equity indices. Seven of the nine international ETFs with the highest 2009 tracking error are based on EM indices and, on average, the seven trailed their respective underlying index by 836 bps. We attribute this primarily to optimization, which may increase tracking error, particularly when smaller index constituents have wide performance disparities from the broader index.

Tracking error in the fixed income ETF market segment increased for the second consecutive year. Tracking error in 2009 was 75 bps greater than 2008. We attribute much of this increase to the higher levels of tracking error observed for three high yield funds, which ranged from 378 to 1,299 bps. The three preferred stock ETFs experienced the second highest tracking error among fixed income ETFs (343 bps). In our view, optimization, illiquidity, and diversification requirements all contributed to the above-average tracking error.

We analyzed ETF tracking error by market segment from 2002 to 2009. In general, US Equity market segments such as US major market and US style ETFs track their indices more closely due to lower expense ratios and easier/cheaper to access underlying markets, which typically leads to lower fees and less optimization. Conversely, international and global ETFs are more likely to experience higher levels of tracking error as these ETFs continue to penetrate markets that are more difficult to access, which typically leads to a greater need for optimization and increases idiosyncratic risk. Finally, we note that the fixed income ETF market segment, which typically had minimal tracking error between 2003 to 2006, now ranks as only ninth-best. Prior to 2008, US fixed income ETFs in our study included just seven ETFs, five of which were primarily or entirely Treasury/Agency. Our 2009 data includes 54 ETFs from market segments that also include high yield, international debt, mortgages, and municipal bonds. In addition to higher fees, many of the more recently issued ETFs are more likely to optimize, which, in many cases, results in higher tracking error.

Historically, tracking error by ETF provider was more easily explained by expense ratios, with lower-fee managers exhibiting smaller deviations. During the period from 2002 to 2009, Vanguard consistently ranked among the top performers in terms of tracking error and had the lowest average

Strategy and Economics

Exhibit 1

2009 ETF Tracking Error by Market Segment

	US Major Market	US Dividend	US Custom	US Asset Allocation	US Style	US Sector / Industry	International	Global	Fixed Income	Commodity	Currency
Average (bps)	63	100	97	84	54	104	194	158	144	108	91
Weighted Avg (bps)	18	23	69	125	19	58	232	109	125	95	35
Median (bps)	49	54	96	17	33	76	118	86	64	92	114
Low (bps)	0	4	7	3	1	1	1	0	3	19	12
High (bps)	334	374	201	350	345	1,709	1,070	1,368	1,299	282	147
0 to 25 bps (%)	40	42	7	71	44	16	11	13	26	7	33
26 to 50 bps (%)	13	0	4	0	21	16	12	13	17	7	0
51 to 75 bps (%)	12	17	14	0	5	19	10	11	13	33	0
76 to 100 bps (%)	15	8	36	0	14	15	9	22	15	7	0
> 100 bps (%)	20	33	39	29	16	33	57	41	30	47	67
Average Exp Ratio	36	46	61	41	33	47	57	60	27	79	80
ETFs w/ TE <= Exp Rat (%)	33	42	11	71	32	22	21	31	24	47	33
Number of ETFs	60	12	28	17	57	123	140	54	54	15	3

Source: Morgan Stanley Research, ETF Providers and Trustees, Bloomberg, Tracking Error displayed as an absolute value. Expense ratio figures are in bps.

expense ratio each year. However, in this study, PowerShares DB Commodity Services and US Commodity Fund exhibited the fourth- and sixth-lowest average tracking error (based on providers with at least five ETFs), despite having higher average fees. In our view, this shift is a result of the continued evolution of the ETF industry. While many lower-fee providers have been adversely affected by SEC diversification requirements on select ETFs, some newer providers, with higher average fees, have come to market with products based on indexes that can be more fully replicated. Importantly, forced optimization resulting from diversification mandates tends to be more common on narrower indices, which also tend to have fewer assets. As a result, there can be dramatic differences between average and weighted average tracking error. Most notably, compared to a straight average, weighted average tracking error was 54 and 80 bps lower for Vanguard and State Street, respectively.

We found a broader range and magnitude of tracking error in 2009 versus 2008. In 2009, the range of tracking error jumped 520 bps to 1709 bps (excluding 3 ETFs, the range of tracking error would have been 610 bps narrower). Moreover, we observed more cases of high tracking error in 2009 than in 2008. In 2009, 9.6% (54/563) of the ETFs included in this study exhibited tracking error that equaled or exceeded 300 bps. This compares with less than 1% (4/505) of the ETFs we analyzed in 2008. Conversely, in 2009 just 3.9% (22/563) of the ETFs included in this study exhibited tracking error less than or equal to 5 bps versus 12.9% (65/505) in 2008. As a result of greater absolute and relative tracking error in 2009, ETF tracking error averaged 6.3% of index returns, which is almost double the 2008 level of 3.6%. We also highlight that just 27% of ETFs in 2009 had tracking error less than or equal to their respective expense ratios compared to 69% in 2008.

For select ETFs, a major source of tracking error relates to SEC diversification requirements. Most index-linked ETFs are registered under the SEC Investment Company Act of 1940. This act sets diversification requirements such that, at a rebalancing, no ETF can invest more than 25% of its assets in any single issue. In addition, securities that have a weighting of 5% or more cannot compose more than 50% of total fund assets. As the weighting of some securities within many indices are higher than these thresholds, several ETFs statistically optimize their holdings.

As an alternative to optimizing, providers can base ETFs on indices customized to comply with diversification requirements. For example, one telecom ETF tracks the DJ Telecom "Select" Sector Index, as opposed to the more traditional DJ Telecom Sector Index. The "Select" index is modified such that it is compliant with the ETF diversification requirements. By tracking the "Select" index, the ETF is able to fully replicate its benchmark index. While this practice will reduce "tracking error" it also highlights the importance of fully understanding the index methodology as the "Select" Index has very different weights from the more traditional index.

While some optimization may be necessary, select ETFs optimize more aggressively with the goal of reducing trading spreads and creating more liquid underlying portfolios. The largest EM ETF is relatively heavily optimized (exposure to 689 stocks out of the 767 stocks in the MSCI Emerging Markets Index). It had tracking error of 671 bps net of expenses in 2009. Interestingly, the second-largest EM ETF, which fully replicates the same index, had tracking error of just 10 bps net of expenses in 2009.

Tracking error experienced by investors may be higher than our observed values. The actual performance that investors achieve may be affected by commissions, small premiums or discounts, and bid/ask spreads. Each of these may contribute to differences in market performance relative to NAV performance and the performance of an ETF's underlying index.

Opinion Changes

February 17, 2010

SanDisk
Upgrade to Overweight on Attractive Risk-Reward

Morgan Stanley & Co. Incorporated

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We have upgraded SNDK to Overweight from Equal-weight with a new price target of $37, representing 35% potential upside. While the stock has roughly tripled from its trough last year, we believe consensus estimates do not fully reflect potential upside to NAND flash product margins — amid a backdrop of stable pricing and favorable supply-demand fundamentals — and should be revised higher through the year. Our recent industry checks suggest NAND pricing to decline modestly in 1Q or down 10% Q/Q. Our prior Equal-weight rating was based on a much steeper pricing decline of down 20-30%. Our updated proprietary capex model suggests memory capex is skewed more toward DRAM this year, boosting our confidence in disciplined NAND supply.

In addition, we think many investors view memory stocks purely as short-term "cyclical plays" and could be overlooking the longer-term secular drivers for NAND flash memory usage in smartphones, tablet-style portable devices, and solid-state drives (SSDs).

In addition, our updated proprietary capex model suggests memory capex is skewed more toward DRAM this year — i.e., 60-65% — which boosts our confidence in disciplined NAND supply. Our bullish outlook on NAND flash demand is also consistent with Morgan Stanley's Wireless Equipment Research team's recent forecast of above consensus 37% Y/Y smartphone growth over the next 2-3 years.

As a pure play on NAND flash supply-demand, SanDisk should benefit strongly from these positive market trends over the next 12 to 18 months by supporting (1) moderate price declines for SanDisk's retail card and OEM component products, (2) 35% or better product gross margins on cost reduction from transition to 24nm technology, and (3) modest investment in capex and joint ventures to strengthen the company's balance sheet. We also think SanDisk's actions from last year to reduce captive wafer supply and develop a broader OEM channel should continue to move the company toward a less capital intensive and sustainably profitable model over future cycles.

Stock Rating: Overweight	Reuters: SNDK.O	Bloomberg: SNDK US
Price target		$37.00
Shr price, close (Feb 16, 2010)		$27.34
Mkt cap, curr(mm)		$6,321
52-Week Range		$32.08-7.53

Fiscal Year ending	12/08	12/09	12/10e	12/11e
EPS($)**	(1.97)	1.85	3.10	3.90
Prior EPS($)**	-	-	2.00	-
ModelWare EPS($)	(2.25)	1.52	2.66	3.44
Prior ModelWare EPS($)	-	-	1.57	-
P/E	NM	19.0	10.3	7.9
Consensus EPS($)§	(2.42)	1.84	2.32	2.26

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

Price Performance

Source: FactSet Research Systems Inc

Company Description
SanDisk designs and markets NAND-flash based data storage cards and peripheral products. The company's proprietary memory and controller technologies are implemented in various form factors for data, image, and audio storage applications. A manufacturing joint venture agreement with Toshiba provides a major portion of SanDisk's wafer needs.

Industry View: Cautious — Semiconductor Capital Equipment
We expect fundamental indicators like chip utilization and equipment orders to peak in 1H10. Semi cap stocks are up ~100% off the bottom and have outperformed the market by ~3:1 on YTD basis. We believe stocks typically start underperforming the market ~6 months in advance of a peak in fundamentals.

Valuation looks attractive on revised estimates and recent pullback. SNDK has declined ~17% YTD on expectations reset of seasonal demand weakness. The risk-reward looks attractive (at ~1:2 at current levels) with $48 as our Bull Case and $18 as Bear Case. SNDK currently trades at 9x our revised C2010 EPS estimate of $3.10, significantly below its five-year historical range of 12–25 times. We arrive at our new price target of $37 by applying a 12x multiple, the low end of SNDK's historical trading range and the average for our global memory group, as we think lower royalty revenues from new Samsung agreement and persistent concerns on oversupply imply the low end of the range is appropriate.

Opinion Changes

Exhibit 1

Our F2010/11 Estimates Are 30-50% Above Consensus

	FY2010E			FY2011E		
	Rev	EPS	GM*	Rev	EPS	GM*
MS (Old)	$3,888	$2.00	36.7%	NA	NA	34.4%
MS (New)	$4,706	$3.10	39.7%	$6,038	$3.90	38.7%
Consensus	$4,350	$2.32	37.3%	$4,789	$2.26	35.9%

Combined royalty and product gross margin
Source: FactSet, Morgan Stanley Research Estimates

Key Debates

1. Is NAND memory in over- or undersupply this year?
Market's view: Supply and demand will be balanced.
Our view: We see moderate undersupply due to lack of new NAND capacity and demand upside from smartphones, tablets, and SSDs.

2: Are product gross margins over 30% sustainable?
Market's view: No. Lower royalty revenue stream and use of non-captive supply will cap margin upside.
Our view: Yes. Undersupply and transition to 24nm technology gets us to 35% product gross margins in 2H10.

3: Is SNDK's valuation still attractive after strong run-up?
Market's view: No, market is already pricing in balanced supply/demand and management guidance.
Our view: Guidance appears conservative and our estimates are above the Street. Based on historical valuation data, SNDK currently trades below the five-year average on P/E, Price/Book, and EV/Sales metrics.

Current stock price implies a growth assumption well below our forecast. According to Morgan Stanley ModelWare's "What's in the Price" tool, consensus forecasts imply a terminal growth rate (post-2012) of 4%, at the low end of our long-term growth outlook of 4–6% for SanDisk. To yield a 5% implied terminal growth rate — the mid-point of our expected range — the tool suggests the stock would be fairly priced at $31. Moreover, using Morgan Stanley's three-year estimates, the implied terminal growth rate is negative 6.7%, well below our expected range; to generate a 5% implied terminal growth rate, the tool suggests the stock would be fairly priced at $42 and is therefore significantly undervalued.

Exhibit 2

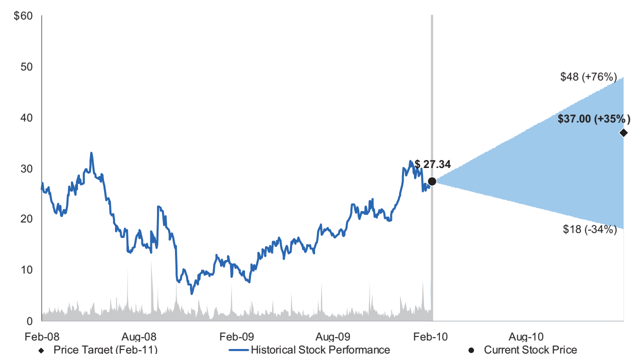
Summary of 'What's in the Price' Analysis

	EPS FY1	EPS FY2	EPS FY3	Implied Terminal Growth Rate	Price to Yield 5% Growth Rate	Implied Upside
Consensus Estimates	$2.32	$2.26	$2.52	3.94%	$31	13%
MS Estimate	$3.10	$3.90	$4.16	-6.73%	$42	53%

Source: FactSet, Morgan Stanley Research

Exhibit 3

SNDK: Risk-Reward Looks Attractive Here



Bull Case $48	12x our Bull Case C2010 EPS of $4	**NAND undersupply throughout 2010, demand upside from smartphone adoption, stable prices.** • Better than expected smartphone growth of 45%+ • Undersupply of 10% on limited capacity additions in 2010 • Stable prices of down 10-20% • Cost reduction of 40% - 50% in 2010 from faster transition to 24nm (nanometer) technology • SNDK bit growth of 80%-90% • Bit demand growth of +100% • Product gross margins of +35%
Base Case $37	12x our Base Case C2010 EPS of $3.10	**NAND undersupply in 2H10, demand upside from smartphone adoption, moderate price decline.** • Smartphone growth of 37% • Undersupply of 3% on disciplined 15-20% tier 1 NAND capacity additions in 2H10 • Moderate price decline of ~30%Y/Y • Cost reduction of 40% from planned transition to 24nm technology • SNDK bit growth of 70% • Bit demand growth of 80% - 90% • Product gross margins of 34% - 35%
Bear Case $18	1.0x C2010 book value per share	**Further deterioration in consumer spending spoils 2010 NAND supply-demand recovery.** • Lower than expected smartphone growth ~10% on consumer spending concerns • Oversupply of 10% on aggressive tier 1 NAND capacity additions in 2H10 and/or below 70% bit demand growth • Severe price decline of ~50% - 60%

Source: FactSet, Morgan Stanley Research

Risks include faster-than-expected NAND supply or more aggressive pricing by Tier I NAND makers. SanDisk has little control over price decline if competition decides to add more supply or b) becomes aggressive on pricing in 2010.

New Coverage

February 18, 2010

MasTec

Overweight — Diverse Customer Base Provides High Visibility with Upside Potential

Morgan Stanley & Co. Incorporated

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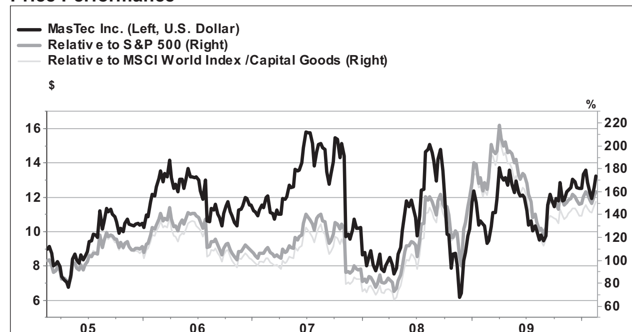
Stock Rating: Overweight	Reuters: MTZ.N Bloomberg: MTZ US
Price target	$17.00
Shr price, close (Feb 17, 2010)	$12.85
Mkt cap, curr(mm)	$1,080
52-Week Range	$14.00-8.91

Fiscal Year ending	12/08	12/09e	12/10e	12/11e
ModelWare EPS($)	1.01	0.90	0.92	1.08
P/E	11.5	13.9	14.0	11.9
Consensus EPS($)§	1.00	0.87	0.93	1.12
Div yld(%)	0.0	0.0	0.0	0.0

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

Price Performance



Source: FactSet Research Systems Inc

Company Description
MasTec is a diversified specialty contractor provides construction, installation, and maintenance services to the wireline, wireless, satellite TV, electric, wind, solar, oil and gas industries throughout the US.

Industry View: In-Line — Business Services
Economic sensitivity is a general undercurrent for Business Services. High international exposure may add to volatility and uncertainty especially if FX rates fluctuate widely. Strong balance sheets and positive free cash flow are a positive across much of the space. Beyond these traits, however, our numerous subsectors have little in common as evidenced by substantial price divergence over time, and thus our overall industry view is In Line. We have identified our most and least favorite groups, and in general, we prefer companies with defensible business models, exposure to niche, high-growth markets, and reasonable valuations.

Initiating at Overweight: Strategic M&A has set the stage for strong growth, margin expansion. A reputation for quality work combined with recent acquisitions has positioned the company for highly visible growth in 2010 and strong long-term exposure to federal government spending. Stimulus dollars aimed at rural broadband, renewable energy and the electrical grid offer upside potential, as do untapped end markets such as home security, a contract win with Verizon Wireless, and TV installation for Wal-Mart. The business model features a high mix of recurring service revenues and low capital intensity, and MasTec's balance sheet is strong.

Key debates surround potential step function growth drivers and margin expansion. With multiple new, potentially powerful growth drivers, the chances are high that at least one comes through to spur better-than-expected growth in coming years. We assume no new sources of growth, but still find valuation attractive given the high visibility into existing streams. On the margin front, we see MasTec benefitting from growing scale advantages, cost synergies, and the cessation of recent M&A.

Fifteen-month backlog, attractive valuation. Our model calls for 25%-plus growth this year (12% organic growth) even without modeling potential step function growth drivers. MasTec has exclusive long-term contracts with DirecTV and AT&T and is already working with more than 15 natural gas companies. The company is fairly agnostic to changing consumer behavior, serving wireline, wireless, satellite, fiber and copper customers. Similarly, the company caters to multiple segments within the energy market. Within our 26-stock coverage universe, MasTec has one of the most compelling growth profiles and also one of the most attractive valuations.

We believe that MTZ's valuation is compelling, even with conservative modeling that assumes limited growth beyond 2010 and which could ultimately bring our Bull Case model more into focus. The stock is trading at 5.7x our 2010 EBITDA estimate, which is below the peer group average and a discount to expected growth. At 14.0x our 2010 earnings estimate, MasTec again trades at a discount, despite cash tax savings, which, in our view, makes the attractive FCF yield of 11% more relevant. Our DCF analysis, which includes assumptions we believe are reasonable (WACC: 10.2%; terminal multiple: 6.5x; perpetual growth rate: 3.5%), suggests significant upside, while Morgan Stanley ModelWare's "What's in the Price" analytical tool calculates that MasTec's current market price implies a modest 6% terminal growth rate post-2011 — fourth-lowest of the 26 stocks within our coverage universe.

New Coverage

Summary of Key Investment Debates

1. **Will new opportunities materialize to drive outsized growth in coming years?**
Market view: Growth will moderate now that M&A has run its course. The 15%-plus growth in 2009 was partially non-organic and nothing to get excited about.
Our view: We see powerful growth through 2010 at a minimum, even without new growth drivers. After speaking with Morgan Stanley's Telecom, Cable/Satellite, and Natural Gas analysts, we believe the outlook is strong for fiber deployment, wireless network upgrades, DirecTV installations, and greater investment in natural gas. Wind power also appears poised for strong growth. We look for 25% top line growth this year, 12% organic. Potential sources of unmodeled upside include the $7 billion in federal stimulus for rural broadband and $4 billion for the electrical grid. Other opportunities include a wireless contract with Verizon, Sprint or Clearwire, TV installation for Wal-Mart and/or Sam's Club, or performing home security system and at-home solar installations.

2. **Can margins continue to climb?**
Market view: Margin expansion is bound to taper off after a 250 bp rise in two years. A growing mix of revenues from utilities should help margins, but there's little else to further drive profitability.
Our view: The company has been in rapid growth mode, and can at last focus on operational efficiency. The wind power segment generates the highest margins for MasTec and is also the fastest growing. Pricing power should improve given the rapidly changing supply / demand dynamic within wind. Improved economic conditions should help labor utilization rates. Most importantly, MasTec's growth should slow as M&A moderates, helping management focus on its new found scale to drive efficiencies.

3. **Will management focus turn from M&A toward shareholder friendly execution and organic growth?**
Market view: Four acquisitions in two years make MasTec a serial acquirer. Two of the recent deals were outside the core business and of significant size. M&A helps growth, but integration risk will be a constant if the diversification-through-acquisition approach continues.
Our view: Acquisitions made sense, but are now complete. MasTec's current appetite for M&A is low. A competitor recently bought a smaller player for 11x EBITDA, driving valuations out of reach. We note that management has been disciplined with its acquisitions, paying only ~4x EBITDA for its last two deals. This will be a year of organic growth with a focus on execution.

MTZ Key Debate: Will New Growth Drivers Kick In as Margins Continue Climbing on Rising Scale, Synergies?

Price Target $17		Derived from base case, utilizing DCF analysis that assumes a WACC of 10.2% and a terminal EBITDA multiple of 6.5x, implying long-term perpetual growth of 3.5% which we believe is reasonable.
Bull Case $24	8.0x 2010e EBITDA	**Accelerated stimulus spending, meaningful contribution from new customers** (WMT, VZ, S, CLWR, home security, home solar), with margins driven by synergies, pricing power and mix. CAGR: 8.1%, EBITDA margin 12.1% by 2012, 2010 EPS of $1.14 with FCF of $141 million.
Base Case $17	6.8x 2010e EBITDA	**Gradual increased spending by existing customers, limited stimulus boost, modest margin expansion on renewed management focus.** 2010-13 revenue CAGR: 5.9%, EBITDA margin 10.8% by 2012, 2010 EPS of $0.92 with FCF of $111 mn.
Bear Case $8	5.4x 2010e EBITDA	**Weak economic environment impacts satellite and telco installations and energy investment. Margin expansion illusive.** 2010-13 revenue CAGR: 1.3%, EBITDA margin 8.6% by 2012, 2010 EPS of $0.59 with FCF of $65 million.

e = Morgan Stanley Research estimates Source: Morgan Stanley, FactSet

Investment Risks

- Competitors could encroach into MasTec's AT&T or DirecTV regions, though we view this as unlikely.
- Customer workforces are partially unionized, as is MasTec's.
- Significant family ownership and voting influence at 30%.
- Further delays in the spending of US economic stimulus dollars.
- Wireline and electric distribution remain exposed to housing weakness.
- Major customers DirecTV, AT&T and Verizon may slow deployment.

Morgan Stanley is currently acting as financial advisor to Verizon Wireless with respect to the proposed acquisition of certain of its wireless assets by AT&T, Inc. and Atlantic Tele-Network, as required by the conditions of the regulatory approvals granted for Verizon Wireless' purchase of Alltel Corporation earlier this year. The proposed acquisitions are subject to customary regulatory approvals, as well as other customary closing conditions. Verizon Wireless has agreed to pay fees to Morgan Stanley for its financial services. Please refer to the notes at the end of the report.

Morgan Stanley
alphawise
proprietary research

Industry Analysis

February 17, 2010

Media
Third Annual Local Ad Survey Points to Improving Trends

Morgan Stanley & Co. Incorporated

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Relative to our 2009 survey, local advertisers are more bullish on budgets, according to our third annual local ad survey. The findings support our bullish view of advertising growth in 2010 and, in particular, our view that local advertising could surprise to the upside. Specifically, the percentage of those surveyed that indicated budgets would be flat to up over the next six months increased 1,100 basis points. In addition, the percentage of those that expect to pay equal or higher Y/Y advertising rates over next six months increased 700 basis points from last year's survey (led by local TV and radio). We take these results as additional evidence of an improving local advertising environment.

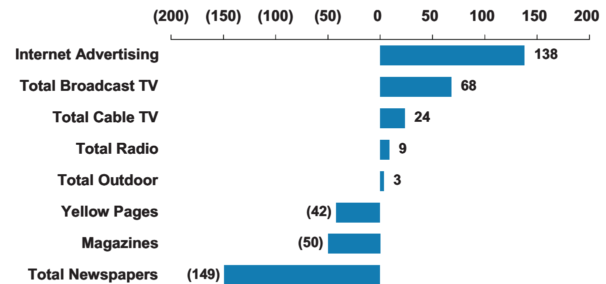
Continue to see Auto as a leading indicator. Auto advertising continues to represent a key category for a local advertising recovery. We view auto as a leading growth category in 2010 (with respect to both timing and magnitude), and our survey results indicate auto advertisers are the most bullish among surveyed verticals. Specifically, 97% of auto advertisers see budgets flat to up compared to 86% for the overall survey group. Auto is particularly important for local TV and radio and was a big contributor to the 20-25% declines in 2009 for both.

Expected budget allocations similar to prior surveys — out of print and into online: While those surveyed spend 35-40% of their advertising today on print (newspapers and yellow pages), budgets are clearly shifting online. Internet advertising accounted for ~22% of respondent budgets over the last 12 months. We do note, however, that this shift appears to be slowing. This year's survey shows ~920 basis points of spending share expected to shift online over the next two years relative to two years ago. These expected budget share gains, which come primarily from print platforms, moderated in last year's survey and did again this year.

Exhibit 1

We Expect Internet and TV to Be the Primary Market Share Gainers in 2010

2010 Share Shift by Advertising Medium



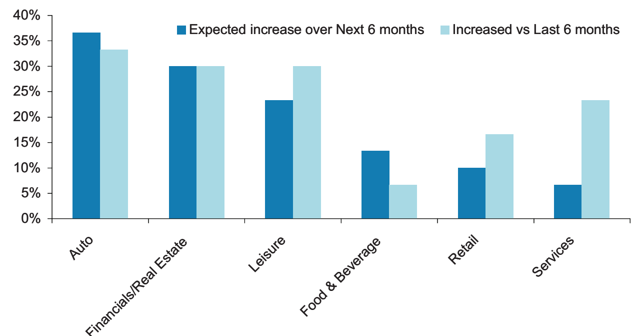
Source: Morgan Stanley Research

Exhibit 2

Auto Category Most Bullish Among Survey Respondents

Positive for Local TV and Billboard Assets – Categories that Over-index to Auto

Change in Budget Among Respondents



Source: Morgan Stanley Research

Survey Conclusions

Spending Expectations:

- 86% of survey see ad budgets flat to up over next six months, versus 75% in 1Q09 survey.
- Second consecutive year highlighting importance of economy on local ad budgets, as ROI and CPM (cost-per-thousand impressions) both receive greater focus.
- 13% of respondents expect their ad budget to decrease over the next six months, a decrease from 25% a year ago.

Industry View: Attractive — Media
We believe that macroeconomic indicators and easing comparisons suggest 2010 could surprise the market with respect to overall advertising growth, and that there is likely upside to current consensus estimates in the event of a steady advertising recovery in 2010.

Industry Analysis

Ad Pricing:
- Respondents expect to see a generally firmer pricing environment relative to 2009 survey across all media — with 77% of respondents expecting pricing over the next 6 months to be flat to up vs. 70% last year.

Ad Effectiveness
- Internet advertising is viewed as the most effective.
- ROI and targetability remain the most important factors in local ad buying

Budget Shifts
- Survey respondents expect ad budgets to continue to shift from print to internet advertising.
- Expected share shift to online has slowed through history of survey.
- Other net share winners are direct mail and TV.

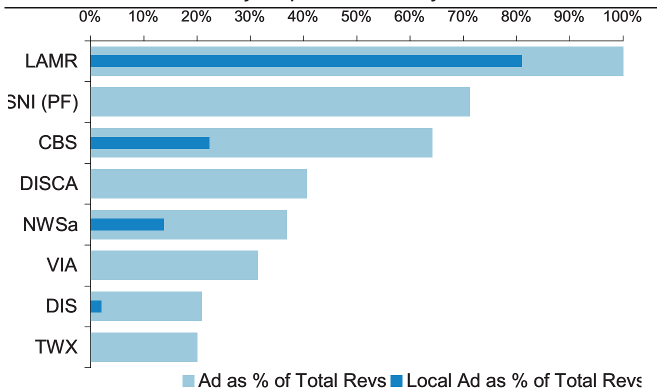
Category Results
- Auto respondents most bullish on advertising budgets, with 37% of auto respondents expecting budget increases over the next 6 months, and no respondents expecting budget declines over that same time period.

Stocks mentioned: CBS Corporation (CBS, $13.27, Overweight), Lamar Advertising (LAMR, $29.86, Equal-weight), and Walt Disney (DIS, $30.47, Overweight).

Exhibit 3

Stock Implications: LAMR, CBS Most Locally Exposed

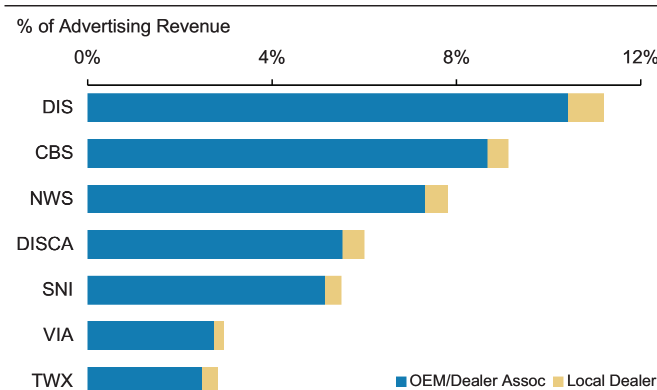
Lamar is most locally exposed, followed by CBS; News Corp. Less Than 20% Locally Exposed, Disney Less Than10%



Source: Morgan Stanley Research

Exhibit 4

Disney is Most Exposed to Automotive Advertising



Source: Morgan Stanley Research, TNS Media Intelligence, Company Filings

Industry Analysis

February 19, 2010

Oil Services, Drilling & Equip.

Shifting Our Focus to Offshore Drillers; We Favor ESV, NE, and RIG

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Jackup recovery underway. Tendering activity for offshore rigs is picking up, led by a surge in jack-up demand. If recent demand trends hold up, we see utilization of the globally marketed fleet at 85% by mid-year and as high as 95% by year-end. This compares with current utilization of just under 80%.

We expect deepwater slack to be gone by late summer. We do not subscribe to market concerns that inexperienced drilling contractors will put any lasting pressure on rig rates. While next few contracts may test the low-$400,000s per day, we expect demand to yet again outpace available supply as we look into the back half of 2010. We would not be surprised to see a national oil company take a slew of uncontracted rigs just as the majors and supermajors start to prepare for increased activity (as supported by recent increases in tendering activity), putting renewed upward pressure on rates.

Ensco, Noble, and Transocean are our top picks within the space. We are broadening our focus by becoming incrementally positive on the space, following recent underperformance relative to North American natural gas levered small caps and land drillers. Ensco, Noble, and Transocean are our top picks within the space, while Seadrill should continue to do well if it can continue to leverage its premium valuation and superior management skills to deliver value-enhancing M&A transactions or asset acquisitions.

We believe Seadrill shares offer the most compelling way of playing the variable dividend growth story, while our work indicates that NE, RIG and ESV could offer the most upside if they were to adopt a dividend strategy similar to Seadrill's or Diamond Offshore's (i.e., less dynamic — no asset acquisitions using shares).

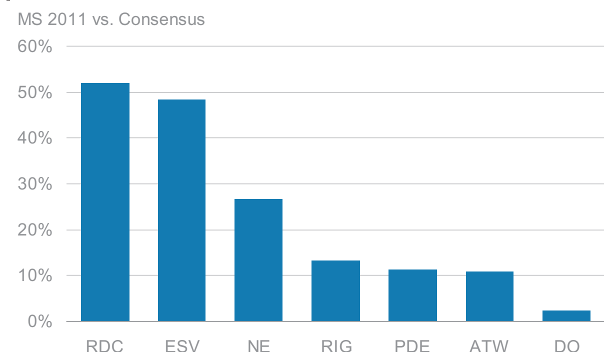
We are further above consensus for jackup names Rowan, Ensco, and Noble vs. our estimates for deepwater names. We believe that the Street is not discounting an increase in rates or utilization for jackup players. Indeed, we believe that consensus numbers are discounting jackup rates for 2011 to remain at current levels of $85,000–115,000 per day and utilization near current levels of 80%. We believe that these expectations are unrealistic given the tightening trend for crude fundamentals.

Jackup demand, like many aspects of our industry, is highly dependent on the strength and sustainability of crude prices. The Street appears to be constructive on crude price expectations and the contango of the forward curve suggests that market expectations are positive. Therefore, we see the consensus view that jackups will not recover by 2012 as a major inconsistency with the market's positive view on crude.

ESV has the most upside to our price target among its peers, given its leverage to a jackup recovery and potential deepwater catalysts over the next few months. The Street appears to be expecting jackup rates to remain flat and utilization to stay depressed. This is reflected in the markedly lower consensus estimates for 2011/12. We believe consensus estimates fail to reflect the recent uptick in jackup tendering and fixtures. Ensco also has strong leverage to potential upcoming deepwater catalysts, as three of the company's newbuilds do not have contracts. Since these rigs were ordered at lower cost relative to those of its peers, the company is able to bid competitively when looking for work. Ensco is also not exposed to the risks that could arise from a potential decline in 3G/4G floater demand, a concern for several of its competitors.

Exhibit 1

Our 2011 EPS Estimates Remain the Furthest Above Consensus for Jackup Names



Source: FactSet, Morgan Stanley Research

Industry View: Attractive — Oil Services, Drilling & Equipment
We expect the following sequence of events: A positive inflection in crude, followed by a positive inflection in jackup rates, followed by a positive inflection in deepwater rates. Stocks usually rebound at signs of the most leading indicator, which in this case is the price of crude, and we'd expect all of our names to deliver absolute gains.

Industry Analysis

Investment Debates Summary

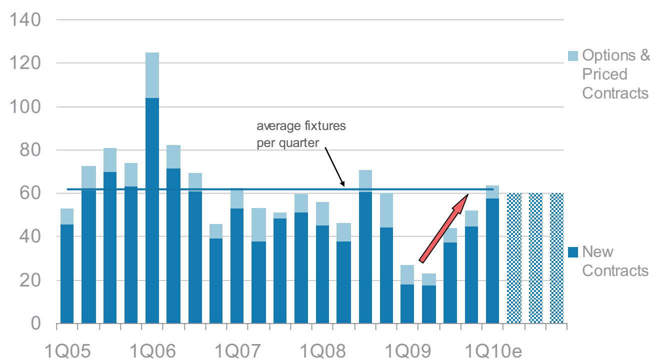
(1) Will the jackup market tighten?

Market's view: Jackup market will remain oversupplied over the next few years given close to 100 uncontracted jackups, coupled with 70-plus more jackups under construction. Consensus estimates appear to be discounting dayrates and utilization to remain flat at current depressed levels.

Our view: Jackup utilization above 85% should permit firmer pricing, driving positive earnings revisions. Recent acceleration in jackup fixtures to normal levels, faster than anticipated, can bring jackup utilization to 85% by mid-year and 95% by year-end.

Exhibit 2

Surge in Fixtures to Drive Utilization Higher



Source: ODS-Petrodata, Morgan Stanley Research.
E = Morgan Stanley Research estimates.

(2) Will drilling contractors with uncontracted deepwater newbuilds sell or contract their rigs at a major discount?

Market's view: The market is concerned that many uncontracted deepwater rigs scheduled to *be delivered* over the next year would pressure rig owners to buckle and sell rigs on the cheap or contract their rigs at a major discount.

Our view: We believe that once operators see a few strong contracts, they will spark a 'contracting rush.' Many operators are waiting for ultra-deepwater dayrates to soften; however, that is unlikely to happen given increased tendering activity, market inquiries and improved sentiment.

(3) What role do dividends play on valuation and who is most likely to benefit?

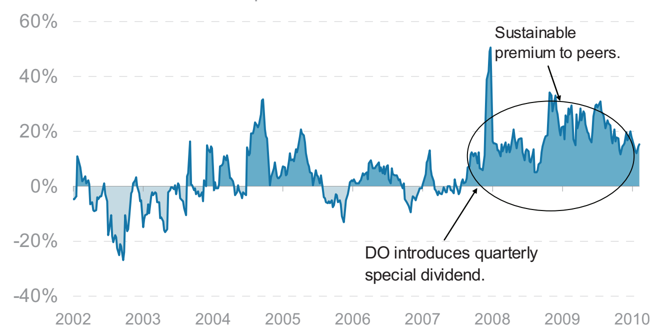
Market's view: The market does not place value on stocks that are more likely to pay a dividend; valuations only re-rate after the fact.

Our view: We believe that a high-payout quarterly dividend has a positive impact on valuation, and believe certain stocks have a more compelling bull-case scenario given their ability and likelihood of paying dividends.

- *We believe Noble is the most likely to increase its dividend to a higher payout,* as the company had already shown interest in doing so two years ago, while the recent implementation of a dividend is supportive of this view.
- *We expect Transocean to generate significant FCF and is becoming too big to grow meaningfully by expanding its fleet.* While historically the company has favored repurchases, the company recently announced that the board has authorized a $3.2 billion share repurchase program and a $1 billion dividend program. While this translates to just over $3 per share, compared to an estimated dividend capacity of over $10 per share, we see this as a solid start.
- *Ensco pays a small dividend and may choose to increase its payout after more of its newbuilds are delivered,* creating a more stable earnings stream. However, the company may prefer to build more rigs using its free cash flow, as channel checks suggest that the company may be in discussions with Keppel to build more semis.

Exhibit 3

Quarterly Dividends Tend to Earn a Premium Valuation



Source: Company data, Morgan Stanley Research. E = Morgan Stanley Research estimates.

Exhibit 4

Stocks Mentioned

Company (Ticker, Price)	Rating	Analyst
US Oil Services, Drilling & Equipment: Attractive Industry View		
Ensco (ESV, $41.97)	Overweight	Ole Slorer
Noble Corp. (NE, $42.62)	Overweight	Ole Slorer
Rowan (RDC, $24.65)	Equal-weight	Ole Slorer
Transocean (RIG, $83.32)	Overweight	Ole Slorer
Europe Oil Services: Attractive Industry View		
Seadrill (SDRL.OL, NKr124)	Equal-weight	Martijn Rats

Source: Morgan Stanley Research

Company Analysis

February 18, 2010

Adobe Systems
Moving Beyond Cyclical — The Story Is Set to Accelerate

Morgan Stanley & Co. Incorporated

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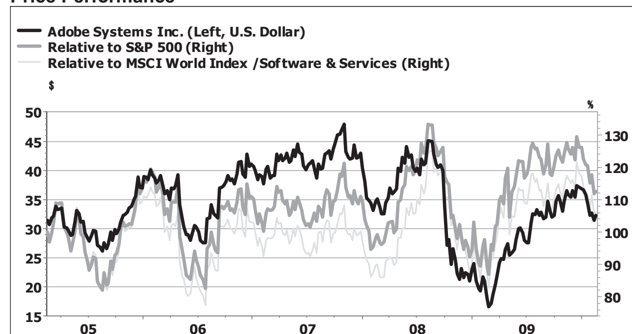
Stock Rating: Overweight	Reuters: ADBE.O	Bloomberg: ADBE US
Price target		$42.00
Shr price, close (Feb 17, 2010)		$32.33
Mkt cap, curr(mm)		$17,101
52-Week Range		$38.20-15.70

Fiscal Year ending	11/09	11/10e	11/11e	11/12e
ModelWare EPS($)	0.93	1.58	1.85	2.05
EPS($)**	1.54	1.79	2.08	2.31
P/E**	22.8	18.1	15.5	14.0
Consensus EPS	-	1.80	2.08	2.27

** = Based on consensus methodology
* = GAAP or approximated based on GAAP
e = Morgan Stanley Research estimates

Price Performance



Source: FactSet Research Systems Inc

Company Description
Adobe is one of the largest software companies from its content and productivity software platforms. With the Macromedia acquisition, Adobe has Rich Internet Applications.

Industry View: In-Line — Software
As we move beyond the early cycle phase of the economic recovery into the growth phase, there may be more relative upside from here in mid-cycle Technology groups. We still believe our group holds some absolute upside, but stock-picking will become more important.

Management meetings and field checks make us more bullish on the prospects for Creative Suite 5 (CS5). We recently met with a number of Adobe's leaders, including CEO Shantanu Narayen, CTO Kevin Lynch, Creative Solutions leader Johnny Locaino, and former Omniture CEO Josh James. We have also been breaking apart the model, doing field work, looking at comScore and NPD data, and starting our checks. We are now more optimistic about the prospects for CS5, Acrobat 10, Flash as a revenue driver, and Omniture. We still believe that CS5 will be a successful product for Adobe and that Flash usage will continue to grow, with monetization improving, while potential improvements in demand for Acrobat, LifeCycle and Omniture are not yet in expectations. In addition, we do not think that the threat from Apple and/or HTML 5 is as significant as the stock's recent move might suggest.

We're buyers of ADBE — undervalued growth, both cyclical and secular. While the stock has been drifting around the February quarter as we expected, we maintain that Adobe is now entering a multi-quarter period of product and financial catalysts. With the stock at 15.5 times our F2011 EPS estimate, we'd argue that the market is undervaluing both the cyclical and the secular growth stories, and we're buyers.

CS5 can still surprise… Beyond the increasingly visible drivers for CS5 around pent-up demand, improving ad spend, a PC upgrade cycle, the move to 64 bit, and others, we are more comfortable that Adobe can drive up average selling prices (ASPs) with CS5, a lever that is not fully appreciated, and we are likely to see more SKUs than with CS4. We also now believe that CS5 will hold much deeper product level integration with Omniture than we first thought, including integration with Omniture's Test & Target and substantially improved Flash analytics.

…and the Flash ecosystem is expanding… Despite noise around HTML 5, Flash could see an inflection as a revenue driver in C2010 as Adobe expands to new users (Flash Catalyst bridges designers and developers), new business models (offering "try and buy" with Shibuya), into the enterprise (providing rich front ends for enterprise apps), and with a fully configured mobile version for the first time (19 of the top 20 handset OEMs support Flash 10.1).

…but there's more to the story than Flash and CS5, in our view. Flash and CS5 capture the bulk of investor attention, but Acrobat, LiveCycle and Omniture are added opportunities for growth as IT spending returns. Acrobat should benefit from PC refreshes and a growing collaboration story, while LiveCycle should benefit from renewed server growth and Flash emerging as a front end. We model 4% F2010 revenue growth in Business Productivity (Acrobat & LiveCycle), but we think growth could be 10%-plus. In addition, Omniture may be tracking ahead of plan on revenue and costs, helped by transaction growth, with its mobile business accelerating.

Company Analysis

Exhibit 1

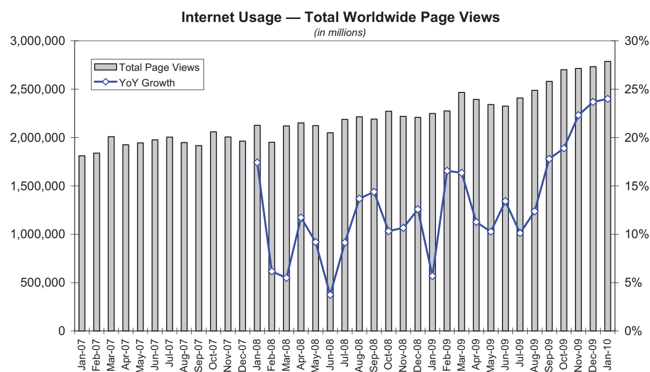
Rising ASP Has Been a Primary Driver Behind Creative Solutions Revenue Growth

	FY07	FY08	FY09
Change in CS Rev	32%	9%	-18%
From 10-K			
ASP Commentary	Increased	Increased	Consistent
Unit Commentary	Slight Decrease	Stable	Down
Implies			
Change in ASPs	35%	9%	0%
Change in Units	-2%	0%	-18%

Source: Company data, Morgan Stanley Research

Exhibit 2

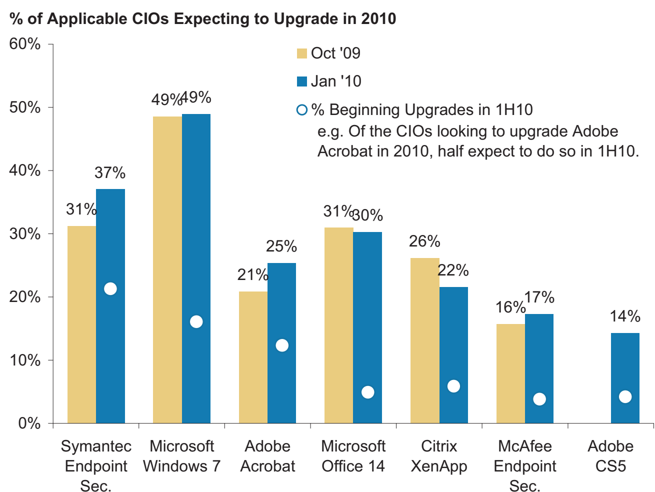
Worldwide Page View Growth Accelerated Through C2009, and Should Be a Tailwind for Omniture



Source: comScore, Morgan Stanley Research

Exhibit 3

25% of Surveyed CIOs Expect to Upgrade Acrobat in 2010

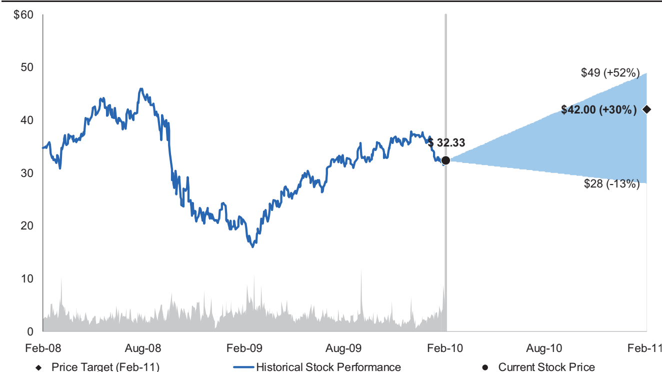


Source: Morgan Stanley January 2010 CIO Survey

Our proprietary job tracker recently showed a pick-up in active job postings on Adobe's Web site. Until the past two weeks, Adobe had kept the number of job openings relatively low, with the increase in December largely stemming from the inclusion of Omniture openings. We believe that this uptick in hiring could be a leading indicator of Adobe's outlook for revenue growth in F2010.

Exhibit 4

ADBE: Secular Growth and Product Cycles Favor Reward



Bull Case $49	C2011 P/E = 21x (4-yr avg. multiple of FY2 EPS)	**Product cycles drive segment growth.** The CS5 product cycle comes on strong while a healthy recovery in IT spending and a robust PC replacement cycle drive top-line growth to 24% in F2010 and 14% in F2011. The Omniture integration is better-than-hoped and Adobe realizes some revenue synergies from the combined product offering. Expenses start to tick back up, but op. margin still expands to 37.0% in F2011, resulting in $2.37 of F2011 EPS.
Base Case $42	C2011 P/E = 20x (3-yr avg. multiple of FY2 EPS)	**Macro impacts bottom in F2009, with some recovery in 2010.** Creative Solutions revenue benefits from a modest recovery in ad spending and a good CS5 product cycle, while overall revenue gets a boost from better IT spending and a rebound in corporate PCs. The Omniture acquisition contributed to revenue and profits, but with few revenue or cost synergies. Total revenue grows 20% in F2010 and 11% in F2011 while the company keeps a tight rein on hiring, allowing operating margins to expand to 36.2% in F2011, resulting in F2011 EPS of $2.08.
Bear Case $28	C2011 P/E =16x (1-yr avg. multiple of FY2 EPS)	**Product cycles disappoint.** CS5 and Acrobat 10 product cycles disappoint and CS rev. is flat in F2010 and only grows 6% in F2011 while KW declines 1% in F2010 and F2011. Omniture adds to revenue, but Adobe is unable to generate any synergies from the merger while competitive pressure from GOOG and other analytics vendors limits Omniture's top-line growth. Management cuts costs as revenue declines, but operating margins still contract to 34.2% resulting in F2011 EPS of $1.71.

Source: FactSet, Morgan Stanley Research

Risks: Push-out of CS demand in advance of the CS5 launch in spring 2010; CS revenue declines steeply due to economic weakness and a deceleration in ad spending; beyond Acrobat and CS, other product areas are small; and Omniture merger integration risk.

Company Analysis

February 17, 2010

Avago Technologies
Multiple Product Cycle Play: Resume at Overweight

Morgan Stanley & Co. Incorporated

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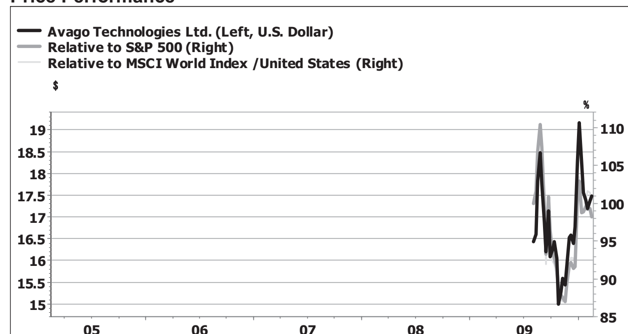
Stock Rating: Overweight	Reuters: AVGO.O	Bloomberg: AVGO US
Price target		$20.00
Shr price, close (Feb 16, 2010)		$17.48
Mkt cap, curr(mm)		$3,872
52-Week Range		$19.55-14.33

Fiscal Year ending	10/09	10/10e	10/11e	10/12e
ModelWare EPS($)	0.61	1.35	1.54	1.68
Prior ModelWare EPS($)	-	1.17	1.34	1.46
P/E	24.6	13.0	11.3	10.4
Consensus EPS($)§	0.61	1.17	1.42	1.46

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

Price Performance



Source: FactSet Research Systems Inc

Company Description
Avago Technologies makes optoelectronics, radio frequency and microwave components. It also makes application-specific integrated circuits. Its products are used in a wide range of applications including mobile phones, consumer electronics, enterprise networking gear and aerospace systems.

Industry View: Cautious — Semiconductors
Our EPS estimates have gone from 25% above consensus in spring 2009 to below consensus today, and EPS, gross margins, utilization, and growth metrics tell us we are in the final innings of the semi cycle.

We have resumed coverage on Avago with an Overweight rating. Three key drivers make us want to get ahead of strong potential upside in AVGO stock:

(1) Evidence that management is in the early stages of monetizing its portfolio of ~5,000 US and foreign patents;

(2) a focus on custom parts with predictable lead times; and

(3) Strong product cycle positioning in wireless and wireline (70% of revenues) should enable it to outgrow the industry.

Within our Cautious industry view, we are Overweight stocks for which we see secular trends and reputations for execution. For the industry as a whole, we are concerned that extended lead times are leading to double-ordering and perhaps an inventory build; and while Avago isn't immune, we think the company has the right product mix and its lead times have stayed within norms (4-8 weeks).

Wireless product cycles should drive outsized growth. Over the past four quarters, Avago's wireless revenues (46% of total revenues) have outgrown its pure play competitors, given its higher relative exposure to 3G. Furthermore, we believe that the company will ramp new wireless products for new revenues of ~$125 million for F2010.

Wired product growth (24% of revenues): Our checks convince us that new wired products (fiber interconnects, and custom SerDes chips) could generate $40-70 million in revenues for F2010.

Demonstrated ability to execute. The evidence is compelling that Avago has successfully started the process of focusing its ~5,000 US and foreign patents and patent applications it had developed over the past 40 years into markets that are more commercially attractive than the ones it had pursued in the past. Since 2006, the management team cut headcount by 50%, drove gross margins up by 800 bps, and increased operating margins by 1,000 bps. However, it did not cut at the expense of its share. Avago outpaced the growth of its broad-based peers by 1,000 bps in 2008, and is on track to outgrow them by 800 bps in 2009. We think that it will do so again in 2010 by at least 100 bps.

Avago's 'factory-lite' business model suggests low capex and high free cash flow. For C2010, we forecast free cash flow yield of 7%, above the 5% of our coverage universe.

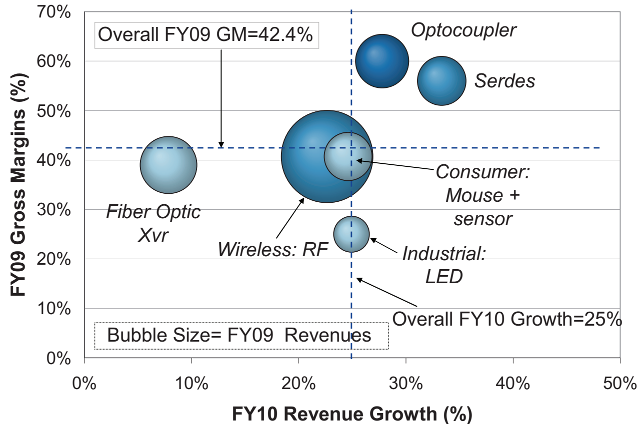
Our $20 price target assumes that Avago will trade at a discount to its diversified, broad-based peers on both P/E (we assumes 14x C2010e EPS) and EV/Sales (we assume 2.5x). Further, AVGO's FCF yield of 7% on our C2010 estimates is higher than the average 5% of our coverage space.

Risks: Lower-margin businesses could put a cap on multiple expansion; stock overhang as sponsors exit their positions (see below); competitive threats in 3G power amplifiers from larger competitors like Skyworks and RF Micro Devices; weaker product mix driven by LEDs; and double-ordering risk, with an ensuing inventory build in the supply chain.

Company Analysis

Exhibit 1

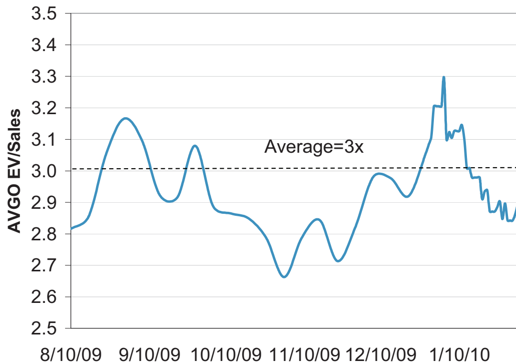
Portfolio Analysis - Gross Margin vs. Growth: Expect Higher Margin Products to Grow Faster



Source: Company data, Morgan Stanley Research E = Morgan Stanley Research Estimates

Exhibit 2

Avago's EV/S of 2.5x Is Below Its Average to Date

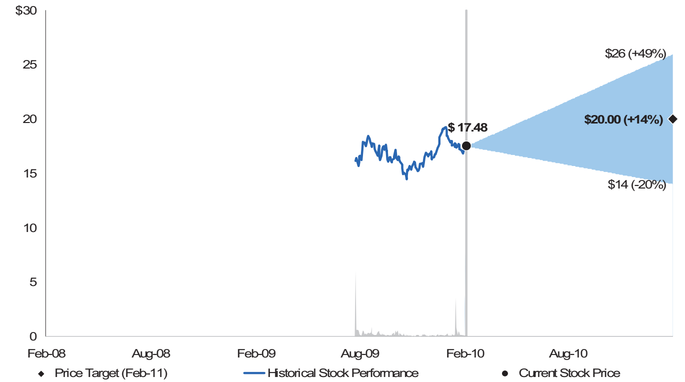


Source: FactSet, Morgan Stanley Research

Private equity firms own almost 68% of the firm. The holders of ~160 million shares have signed a 90-day lock-up agreement, which is set to expire on April 27, 2010. Of these, ~159.3 million shares are subject to a management share-holders agreement (MSA) set to expire five years from the IPO. Following the lockup expiration, all shares are eligible to be sold according to Rule 144, under which existing shareholders are restricted from selling during any 3-month period, which cannot exceed the greater of 1% of outstanding shares (~2.4 million shares) or the average weekly trading volume 4 weeks preceding the notice of sale. Since the sponsors can only sell a limited number of shares (~2.4 million) every 3 months using the method above, compared to what they own (159 million), we think that they would sell their shares through a registered filing.

Exhibit 3

AVGO: Product Cycles to Drive Above-Average Growth



Price Target $20		Derived from our base case, which assumes a P/E of 14x on C2010e EPS of $1.41. A 14x multiple is below the analog average PE of 19x on our C2010 estimates. Our DCF-based intrinsic value calculation is $21, and is based on a risk free rate of 3.6%, an equity risk premium of 4%, a long-term growth rate of 4.0% and a cost of equity of 9.1%.
Bull Case $26	16x Bull Case C2010e EPS of $1.65	**Gains share in 3G FEMs, multiple product cycles across all segments, strong growth in SerDes and Optocouplers.** Strong growth across all segments, and C2010 revenues increase by 27%. Operating margins expand in the low 20% range and gross margin in the 45-48% range. PE multiple expands as a result.
Base Case $20	14x Base Case C2010e EPS of $1.41	**Product cycles in Wireless and Wired Infrastructure drive growth, expand SerDes and Optocoupler share.** 22% increase in C2010 revenues, and gross margins expand by 100 bps exiting C2010. Achieves target model of GM=44-46% and OM=17-20% through C2010. PE of 14x is below the analog average PE of 19x on our C2010 estimates.
Bear Case $14	13x Bear Case C2010e EPS of $1.10	**Delayed Enterprise spending, slow turn around in Industrials, share loss in 3G FEMs.** Muted product cycles and weakness across all segments drive C2010 revenue growth of 17%. Operating margins below target in model and gross margins remain flattish. Share loss in 3G FEM and pricing pressures on optical components affect product mix. P/E multiple compresses to 13x.

Source: FactSet, Morgan Stanley Research

Potential Catalysts

- Better-than-expected cost reduction efforts resulting in improved operating leverage.
- Expanded market share in 3G front-end modules (FEMs).
- Potential 2H10 enterprise spending increases.
- Continued strength of the Industrial segment.
- Shares gains with Optical Finger Navigation
- Transition to laser mice.

Company Analysis

February 21, 2010

Bucyrus International
Raising Price Target — Consensus Still Under-Appreciates Deal

Morgan Stanley & Co. Incorporated

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Stock Rating: Overweight	Reuters: BUCY.O	Bloomberg: BUCY US
Price target		$75.00
Shr price, close (Feb 19, 2010)		$62.64
Mkt cap, curr(mm)		$4,743
52-Week Range		$68.57-10.62

Fiscal Year ending	12/08	12/09e	12/10e	12/11e
ModelWare EPS($)	3.10	4.12	3.61	5.35
Prior ModelWare EPS($)	-	4.04	3.03	5.08
P/E	6.0	13.7	17.3	11.7
Consensus EPS($)§	3.10	4.12	3.44	4.12
Div yld(%)	0.5	1.1	1.5	2.2

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

We have raised our 2010 and 2011 estimates and our price target after the 4Q09 results by Bucyrus, and after a number of capex announcements by large miners. Our previous estimates had assumed more margin degradation off the 2008–09 peak. Our 2010 estimate of $3.61 includes purchase accounting charges of around $0.40 (a rough estimate), and would be $4.00 excluding those charges, in line with the 2009 peak.

The Street underappreciates strategic benefits and financial accretion of the purchase of Terex's mining assets, in our view. With global mining investment headed back toward peak as soon as 2010, we estimate the acquisition will prove to be at least 50% accretive to EPS. Our EPS estimates are 27% ahead of consensus in 2011 and 47% ahead in 2012.

Our thesis is supported by our global mine-by-mine analysis of Terex's and Bucyrus's fleets, which indicates that: (1) there is significant potential for cross selling/revenue synergies (not included in Bucyrus's estimates), and (2) projected cost synergies look reasonable. Our work shows that Bucyrus has substantially improved its strategic position by diversifying into higher-growth hydraulic excavators, and diversified its mineral exposure relative to competitor Joy Global. The one negative we hear in the channel is US coal, but Bucyrus's revenues rely less and less on that market.

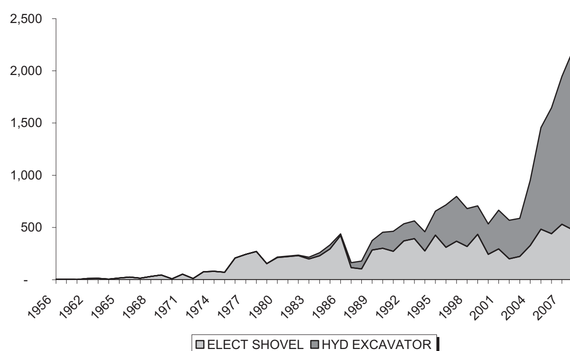
Price Performance

Source: FactSet Research Systems Inc

Company Description
Bucyrus is a world leader in the design and manufacture of high productivity mining equipment for the surface and underground mining industries. Bucyrus' surface mining equipment is used for mining coal, copper, iron ore, oil sands and other minerals.

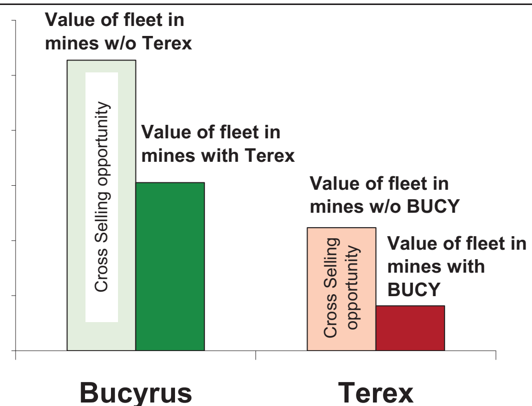
Industry View: Attractive - Electrical Equip. & Industrial Conglom.
We believe that fundamentals have surpassed multiples that have contracted recently to highly attractive levels. Stronger-than-expected order books provide visibility through 2010 and into 2011 on a sustainable industrial upcycle that we expect to exceed consensus views.

Exhibit 1
Hydraulics Are Taking Share/Growth Globally



Source: Parker Bay, Morgan Stanley Research

Exhibit 2
Revenue Synergies Understated: Half of Bucyrus's Installed Base Is in a Mine without a Terex Machine

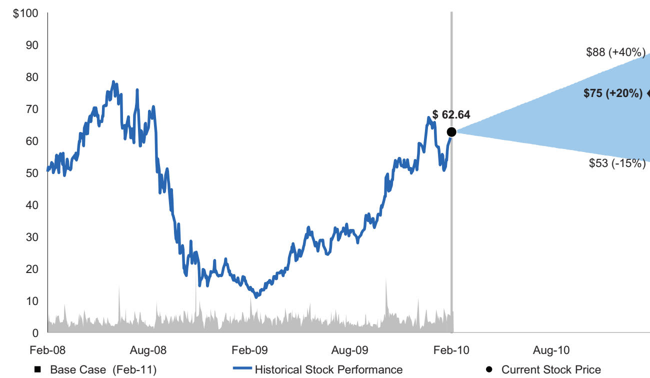


Source: Parker Bay, Morgan Stanley Research

Company Analysis

Exhibit 3

BUCY: Acquisition of Terex Assets Underappreciated



Valuation		Our $75 price target is based on 14x our 2011 earnings estimate. The multiple is slightly above a “normal” multiple for Bucyrus, we expect growth over the next several years, however, on strong mining fundamentals and on continued synergies benefit. Risks include merger execution, lower margins on price/materials and the threat of competition from China.
Bull Case $89	14x Bull Case 2011e EPS of $6.27	**Synergies achieved on schedule and margins on base business remain at high 2008-2009 levels.** China’s infrastructure push along with a slow global recovery pushes mines to resume investment in 2010, capturing production slots towards the end of the year. Terex mining revenues back to peak in 2011 and $300 million ahead in 2012.
Base Case $75	14x Base Case 2011e EPS of $5.35	**Successful integration and capture of synergies, with revenue outlook strong.** Margins contract 100-200 bps from peak despite the strong orders environment. Synergies total $70 mm in 2011 and $100 mm in 2012, with a bit of revenue synergies starting in 2012. Terex Mining revenues near peak in 2011, and ~$150 million ahead in 2012.
Bear Case $53	18x Bear Case 2011e EPS of $2.94	**Mining capex improves globally, but only modestly, Terex’s trucks prove to be non viable, and Bucyrus earnings suffer on weak volumes and margins.** We see the Terex truck as the largest risk in Bucyrus’s new portfolio, especially with the ongoing launch/ramp of CAT’s electric drive mining truck Our bear case does not assume a steep global double dip.

Source: FactSet, Morgan Stanley Research

Key Potential Catalysts

- Coal prices
- Synergies/aftermarket progress
- China investment in power

Investment Risks

- Success of underground products after large early wins
- Coal price volatility
- Chinese competition longer term

Caterpillar (CAT, $58.25, Overweight)

We think Caterpillar could earn as much as $8-10 per share this cycle. The company rolled out a more useful segment reporting structure in its 2009 10K, released February 19, which gives a three-year look under the new reporting structure. What stands out: We think CAT dramatically “under-earned” in some key businesses at peak, and some embedded/less visible businesses appear to be highly profitable, and likely substantially underestimated by the market. Our take is that CAT has a chance to earn $8-10 per share this cycle; we think a close look at the margins in some of these under earning businesses supports that view:

- CAT made a 13-15% margin in its mining business at peak in 2007–08, about the same as Terex. CAT has an exceptionally strong competitive position in this business, with share above 50% in large trucks, probably far higher in bulldozers, and price leadership across the board. We estimate that EPS likely could have been ~$1 higher at peak on this business alone.

- Building Construction Products (BCP) was a marginally profitable business close to peak despite better than average pricing: CAT’s small construction equipment business made a –4.2% accountable margin in 2007. At that time Bobcat, the industry leader in the US, was making 15% margins.

- Non-reported businesses have been a strong profit driver: Maybe the biggest surprise in the 10K is that CAT’s “all other” businesses generated the equivalent of 30-40% of operating profit in 2007–08. There are a lot of businesses in this bucket, many of which we don’t typically focus on when evaluating CAT’s earnings power.

Company Analysis

February 19, 2010

Comerica
Better Credit, Stronger NIM, and a Solid Capital Position Support Overweight Thesis

Morgan Stanley & Co. Incorporated

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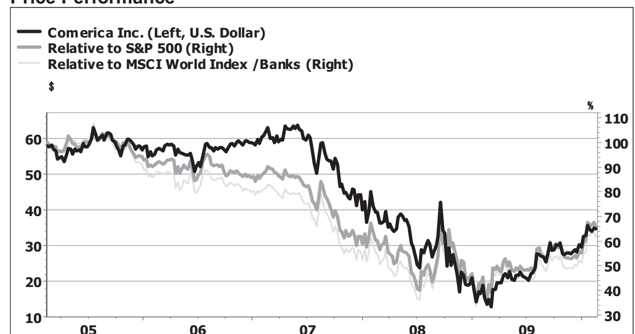
Stock Rating: Overweight	Reuters: CMA.N Bloomberg: CMA US
Price target	$45.00
Shr price, close (Feb 18, 2010)	$34.76
Mkt cap, curr(mm)	$5,267
52-Week Range	$37.31-11.73

Fiscal Year ending	12/09	12/10e	12/11e	12/12e
ModelWare EPS($)	(0.88)	(0.26)	2.27	3.96
Consensus EPS($)§	(0.78)	(0.43)	1.79	3.65
BV/shr($)	45.16	42.92	45.69	47.84
P/BV	0.7	0.8	0.8	0.7
Tang BVPS($)	31.16	29.37	31.67	33.64
P/tang BV	0.9	1.2	1.1	1.0

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

Price Performance



Source: FactSet Research Systems Inc

Company Description
Comerica, which has banking units in Michigan, Arizona, Florida, and California, provides traditional retail, corporate, investment and trust banking services.

Industry View: Attractive — Midcap banks
We expect lower provision expenses to drive strong earnings im-provement in 2010. Favorable trends include flat nonperforming asset balances, rising net interest margin, and a slowdown in the pace of loan balance contraction. As credit continues to stabilize, it should lead to an upward revaluation of midcap bank tangible book multiples.

We continue to recommend Comerica as one of our top Overweight-rated stocks. Our thesis is that it will benefit from improving credit quality, given declines in both watch list loans and NPA inflows and is well positioned for solid NIM expansion given its asset sensitivity, both of which will drive solid core pre-provision earnings growth and should lead to multiple expansion off its current price-to-tangible book multiple of just 1.1x (well below the group at 1.5x). We hosted a conference call with the management of Comerica on Feb 18, including Beth Acton, CFO, John Killian, CCO, and Paul Burdiss, Treasurer.

TARP repayment still a focus, but the question is does CMA raise capital? We believe the consensus view that it will need to raise 50% of its $2.25 billion of TARP is unlikely, given its current 8.2% tier 1 common ratio, although some equity raise is possible. If so, we would look for sizable share buy-backs, but could see stronger loan growth or FDIC-assisted deals instead.

Option #1: Reach an 8.0% tier 1 common ratio. If we assume banks need to get to a tier 1 common ratio of 8.0% to repay TARP, Comerica would not need to raise capital. To us, this seems the most fair because it focuses on capital adequacy, but we understand regulators may see the world slightly differently.

Option #2: Raise equity equal to some portion of TARP. If we assume regulators want higher capital ratios regardless of the starting point, the question then becomes how much is necessary. In Exhibit 1, we show the resulting increases to tier 1 common from different levels of capital raise, as well as the impact on normalized 2012 EPS. However, we cannot in good faith assume Comerica keeps a 10%+ tier 1 common ratio, so we have also assumed buybacks to get back down to 8.5%.

Exhibit 1
TARP Repayment Scenario Analysis

Scenario	Capital Raised	2012 T1C	Incremental Buybacks (mil shrs)	2012E EPS	Price/ 2012 EPS
Base Case	**$0**	**8.5%**	**7.5**	**$3.96**	**8.8x**
25% (no buybacks)	$563	9.4%	0.0	$3.58	9.7x
25% (incl. buybacks)*	$563	8.5%	16.3	$3.76	9.2x
50% (no buybacks)	$1,125	10.3%	0.0	$3.27	10.6x
50% (incl. buybacks)*	$1,125	8.5%	32.3	$3.58	9.7x

* Assumes incremental buybacks beyond our base case scenario to bring the T1C ratio to 8.5% in 2012 Source: Company data, Morgan Stanley Research

The worst case, in our view, is that Comerica raises 50% of its TARP and does not repurchase any additional shares beyond what we have already built into our model — the stock would then be trading at 10.6x normalized EPS of $3.27, slightly

Company Analysis

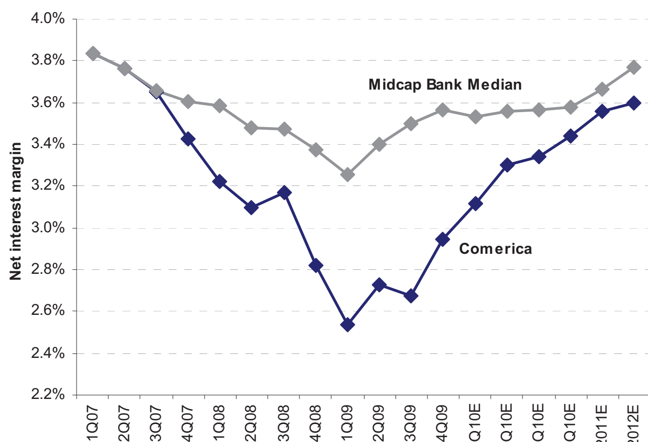
above the group at 9.5x, with a tier 1 common ratio at the end of 2012 of 10.3%. We do not think this is very likely.

NIM expansion a key positive: As one of the most asset-sensitive banks in our universe, Comerica is very well positioned to benefit from higher rates in our view. 80% of its loans are variable rate, and of those, just 9% are at their interest rate floors. We expect NIM to exceed management's guidance, given expected fed rate hikes, with NIM reaching 3.56% by 2011 (up 62 bps from 4Q09).

As shown in Exhibit 2, we expect Comerica's NIM to improve much more rapidly in 2010 than its peer group, given the reduction in its excess liquidity and asset sensitivity. We expect NIM to average 3.30% in 2010 improving to 3.56% in 2011. Longer term, how quickly it can return to a 4% NIM will depend on several factors including loan and deposit mix, loan spreads, and its hedging program. But according to management, *"getting well into the 3%s is very doable."*

Exhibit 2

Expect Strong NIM Expansion



Source: Company data, Morgan Stanley Research

Improving credit: Management's tone regarding its credit outlook seemed quite positive. Comerica was one of the few banks in our coverage universe to report an improvement in every credit metric in 4Q09. NCOs and provision expense have declined two quarters in a row, while watch list loans were down 6% Q/Q. Most of the company's credit problems have been concentrated within its construction portfolio, which we believe has largely been addressed at this point. With construction NCOs likely to decline further and C&I losses being at or near peak, we expect credit costs for the company to continue to improve going forward.

Exhibit 3

CMA: Risk-Reward View

Price Target: $45	Our price target is based on the residual income model.	
Bull Case: $55 **Sharp Recovery**	2010E EPS: $0.63 NCO Ratio: 174 bps Provision Expense: $684 mil	Net Interest Income: $1738 mil Expense Ratio: 63.0%
Base Case: $45 **Slow Recovery**	2010E EPS: -$0.26 NCO Ratio: 193 bps Provision Expense: $840 mil	Net Interest Income: $1694 mil Expense Ratio: 64.4%
BearCase: $25 **W-Shaped Recovery**	2010E EPS: -$2.24 NCO Ratio: 251 bps Provision Expense: $1294 mil	Net Interest Income: $1607 mil Expense Ratio: 67.1%

Source: FactSet, Morgan Stanley Research estimates

Valuation Methodology

Our price targets are derived using the residual income model, although we continue to apply a higher-than-normal discount rate assumption to our valuation given the fundamental weakness in the group. We expect the market will start to value banks off longer-term, normalized earnings as nonperforming loans continue to decline into 2010. Our bull case intrinsic values are based on normalized earnings and multiples, while our bear case intrinsic values are based on trough price-to-tangible book value plus reserves. For Comerica, we assume a 10% cost of equity.

Risks to Our Price Target

We define risks to our price targets as the possibility of stock price falling below our price targets. General risks include slower-than-expected economic growth, which would drive slower commercial credit growth and higher net charge-offs (NCOs) than we are forecasting.

For Comerica specifically, risks include significant further deterioration within its C&I and CRE loan portfolios, as well as prolonged subdued commercial loan demand, which will negatively impact balance sheet growth and net interest income.

Company Analysis

February 23, 2010

Echo Global Logistics
Remaining Overweight, but Looking Like a 2H10 Story

Morgan Stanley & Co. Incorporated

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Stock Rating: Overweight	Reuters: ECHO.O	Bloomberg: ECHO US
Price target		$17.00
Shr price, close (Feb 22, 2010)		$11.41
52-Week Range		$15.32-10.18

Fiscal Year ending	12/08	12/09	12/10e	12/11e
EPS($)**	0.23	0.18	0.41	0.69
Prior EPS($)**	0.20	0.23	0.45	0.77
P/E**	61.9	68.9	28.1	16.6
Consensus EPS($)§	-	0.19	0.47	0.77
Nom PEG, 1-yr	4.0	0.6e	0.3	0.3
Nom PEG, 3-yr	1.6e	1.0e	0.5	-
Return on avg NOA(%)	-	5.3	12.0	19.5

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

Company Description
Echo Global Logistics is a third-party logistics company providing technology enabled business process outsourcing (BPO) for transportation and logistics. The company's core logistics services include pre-engagement freight analysis, rate negotiation, shipment execution and tracking, carrier management, routing compliance, freight bill audit and payment and performance management and reporting.

Industry View: Attractive — Freight Transportation
4Q09 should mark the end of negative data trends — an inflection that we believe is under-appreciated by the Street. Y/Y comps are becoming easier, and we've seen no sign of a post-holiday slowdown in freight. Moreover, with inventories low across the system, restocking could provide additional upside. Within this context of a surprising recovery, we prefer names with greater leverage to volume — rails and parcel.

Not yet in harvest mode. Echo reported a sequential deterioration in operating margins as a large hiring effort and higher G&A costs related to the IPO offset improving gross profit trends. But what is more important, in our view, is that ECHO plans to continue hiring and investing for growth in 1H10, which should limit the pace of margin expansion. A slowdown in G&A growth and a recovery in less-than-truckload (LTL) pricing look unlikely in the near term. As a result, investors looking for impressive earnings growth and operating leverage may need to wait at least until 2H10. ECHO's valuation and compelling long-term fundamentals keep us Overweight, but the lack of 1H margin expansion coupled with the risk of technical selling pressure related to the lock up expiration could keep the stock range bound for the near term.

Estimates and price target reduced. Echo reported 4Q09 EPS of $0.15 vs. our estimate and consensus of $0.07. However, this included a large tax benefit that wasn't in our estimates. Net-net, operating income fell short by 1-2 cents as higher G&A costs and gross margin contraction more than offset better volumes. We have lowered our 2010 estimate to $0.41 from $0.45 (in line with the low end of guidance) and 2011 to $0.69 from $0.77 on the miss. We have also reduced our year-end 2010 price target to $17 from $18.50.

Negative mix effects weighing on gross margin. We recently noted that ECHO's gross margins may be more stable than C.H. Robinson Worldwide's (see our February 17, 2010 note), but we also listed a number of potential sources of margin pressure. All of these negative factors converged on Echo in 4Q09, but it's important to note that the majority of the margin pressure is the result of negative mix. We estimate that Echo's rapid growth in TL (where gross margin is lower, but contribution is higher) and the signing of two large enterprise accounts were responsible for at least 100bps of gross margin deterioration. While these factors will remain a Y/Y drag until lapped in mid-2010, the underlying gross margin stability story may still have some merit.

The next major event will likely be the lock-up expiration on March 31. Short interest has been building in anticipation of potential technical selling pressure.

Although procurement costs are clearly rising, the negative surprise in Echo gross margins is mostly attributable to mix. A shift in revenue towards lower margin Truckload and Enterprise revenue weighed on gross margins. As we look into the balance of 2010, the gross margin pressure should continue until ECHO laps the acquisition of Ray-Trans (a TL broker acquired in mid-2009). However, we don't see much incremental margin pressure from mix effect without a material acquisition. Management believes transactional revenue should grow faster than enterprise revenue, which will help to mitigate margin pressures. Moreover, faster growth in TL may continue, but the relative outperformance vs. LTL is likely to subside without another acquisition.

Our year-end 2010 price target of $17.00 per share is derived from a residual income analysis assuming a required return of 17.38% (we assume an 8.25% equity risk premium with a Beta of 1.50 on top of the company's 5.00% average cost of debt). We explore risks to our price target in our Bull and Bear Cases.

Company Analysis

Exhibit 1

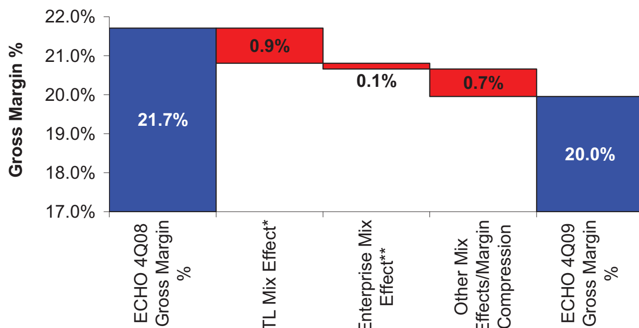
ECHO Gross Margins: Puts and Takes

Potential Sources of Margin Pressure	Potential Mitigating Factors
1. Demand recovery raises the cost to procure capacity	1. Unlike CHRW, Echo contracts tend to float with carrier rates (cost plus)
2. Plans to increase exposure to TL market (where GM is lower) could result in a negative mix shift	2. ECHO has a much smaller TL concentration which is where CHRW saw the most extreme margin pressure
3. Signing any large enterprise accounts where gross margin is lower (although op margin is similar)	3. Larger cash balance allowing for better payment terms to carriers and greater discounts
All three negative factors were apparent in 4Q09	4. As revenue and scale grow, bulk purchasing power increases
	5. Faster growth in higher margin transactional shipments is a positive for mix

Source: Morgan Stanley Research

Exhibit 2

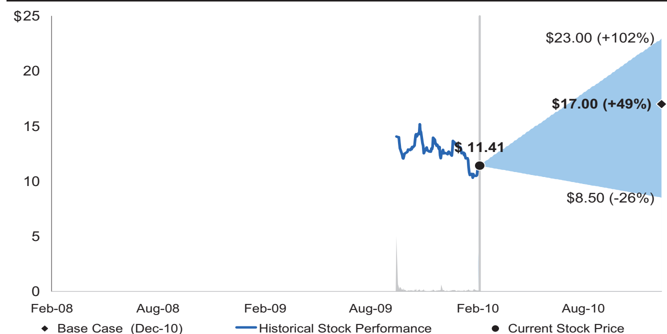
ECHO 4Q09 Gross Margin Analysis: Mix Effects Account for Over Half the Margin Compression.



Note: Morgan Stanley Estimates. *TL Mix Effect Assumes 11% margin differential vs. LTL applied to % of revenue shift Y/Y. **Enterprise mix effect assumes 11% differential between Enterprise and Transactional Revenue. Source: Company data, Morgan Stanley Research

Exhibit 3

ECHO: Powerful Growth, but May Need to Wait for 2H to See Material Leverage



Bull Case $23.00 — **25.5x Bull Case 2011e EPS of $0.90**

Surprising growth causes market to pay up. Strong recovery supports add'l share gains and volume recovery w/ existing customers. Accretive acquisitions add to growth. Tighter capacity creates more demand for brokers, but better payment terms and mix limit erosion in GM %.

Assumptions	2008A	2009A	2010E	2011E	2012E
Gross Revenue	112.5%	28.0%	56.7%	42.9%	38.0%
GP Margin %	21.2%	21.4%	20.0%	19.2%	19.1%
Op Margin % of GP	88.5%	89.5%	78.0%	71.5%	66.4%
EPS	**$0.23**	**$0.18**	**$0.53**	**$0.90**	**$1.42**
YoY Chg	22.7%	-18.9%	187.5%	70.8%	56.8%

Base Case $17.00 — **24.5x Base Case 2011e EPS of $0.69**

Modest recovery; share gains continue. Slow but sustainable recovery. Modest recovery in pricing and volumes w/ existing customers as GDP begins to improve. Recent acquisitions and greater sales effort support share gains. Top-line growth drives margin expansion.

Assumptions	2008A	2009A	2010E	2011E	2012E
Gross Revenue	112.5%	28.0%	42.0%	34.9%	33.6%
GP Margin %	21.2%	21.4%	19.8%	19.4%	19.5%
Op Margin % of GP	88.5%	89.5%	81.5%	74.9%	69.8%
EPS	**$0.23**	**$0.18**	**$0.41**	**$0.69**	**$1.06**
YoY Chg	22.7%	-18.9%	120.6%	69.7%	54.3%

Bear Case $8.50 — **20.5x Bear Case 2011e EPS of $0.41**

The margin squeeze is on. Momentum slows. Supply-led recovery squeezes margins w/o add'l volume. GM expansion strategy fails to resonate with carriers. Sales struggles to gain traction in TL market. Acquistions are limited. Slowing growth leads to significant

Assumptions	2008A	2009A	2010E	2011E	2012E
Gross Revenue	112.5%	28.0%	27.9%	24.6%	27.3%
GP Margin %	21.2%	21.4%	18.8%	17.9%	18.0%
Op Margin % of GP	88.5%	89.5%	84.5%	80.9%	76.3%
EPS	**$0.23**	**$0.18**	**$0.30**	**$0.41**	**$0.63**
YoY Chg	22.7%	-18.9%	62.3%	38.8%	51.1%

Base Case = year-end 2010 Price Target. E= Morgan Stanley Research estimates.
Source: FactSet, Morgan Stanley Research

Investment Risks

- Gross margin pressure from tighter capacity and negative mix effects (faster TL growth)
- Microcap, limited float, and potential technical selling on March 31 lock up expiration limit appeal
- Intense growth strategy results in less flexibility vs. peers in a slowdown.
- Macro weakness could alter growth trajectory.

MORGAN STANLEY
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Company Analysis

February 17, 2010

Hewlett-Packard
Back to a 'Beat and Raise' Story

Morgan Stanley & Co. Incorporated

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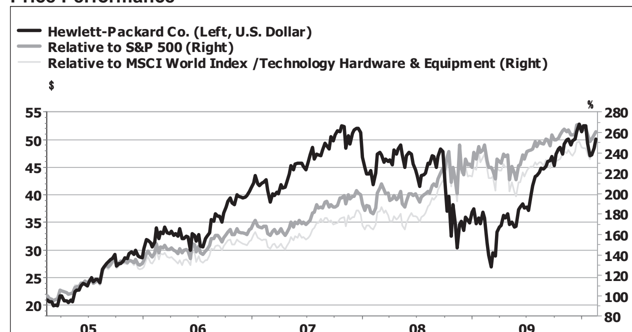
Stock Rating: Overweight	Reuters: HPQ.N Bloomberg: HPQ US
Price target	$62.00
Shr price, close (Feb 17, 2010)	$50.12
Mkt cap, curr(mm)	$121,292
52-Week Range	$52.95-25.39

Fiscal Year ending	10/08	10/09	10/10e	10/11e
ModelWare EPS($)	3.63	3.90	4.48	4.94
Prior ModelWare EPS($)	-	-	4.46	4.90
Consensus EPS($)§	3.62	3.85	4.34	4.76
P/E	10.6	12.2	11.2	10.2
EV/rev	0.9	1.0	0.9	0.8
EV/EBITDA	6.9	6.6	6.0	5.0
Div yld(%)	0.8	0.7	0.6	0.6

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

Price Performance



Source: FactSet Research Systems Inc

Company Description
Hewlett-Packard is a global provider of computing and imaging solutions as well as services for the business and the home. Its chief divisions include imaging and printing; computing systems; personal systems; and IT services.

Industry View: Attractive — Systems and PC Hardware
We expect enterprise hardware earnings to normalize in 2010 on the back of a return to revenue growth and related operating leverage that we believe is currently underappreciated in consensus estimates.

We continue to see both earnings per share and multiple upside as HPQ becomes a 'beat and raise' story again. Our thesis of a stronger-than-expected recovery in Hewlett-Packard's server and printing segments partially played out in the January quarter and we expect to see more evidence throughout 2010.

We see three sources of potential earnings upside from here:

- Guidance prudently assumes no/modest improvement in EMEA demand, services revenue, software/storage execution, and corporate PC sales;
- Imaging and Printing Group (IPG) growth should continue to accelerate, especially in higher margin supplies and laser hardware;
- Low channel inventory and the company's strong position in growth markets, like China, point to relatively normal seasonal trends in PCs and servers this year, which alone could drive 2% revenue growth and $0.10 in earnings per share to our already above-consensus forecast.

Hewlett-Packard beat our above consensus revenue and EPS forecast by 2% on the back of strong PC and server sales. The January quarter beat appears sustainable given low DSOs exiting the quarter, stronger-than-expected cash flow, normal/low channel inventory levels, and prudent assumptions around the rate of recovery in global IT spending.

Impact on other technology names: Strong x86 server sales should be sustainable into the April quarter in light of channel inventory tracking 0.5-1.0 week below normal levels. HP server sales should be flat to up slightly in the April quarter. We view this as a positive for QLogic (QLGC, $17.6, Overweight) which should outperform the market given its relative customer exposure (strong in x86/blades) and low inventory levels exiting December.

Hewlett-Packard is more than a cost-cutting story, in our view. Strong growth in the company's enterprise server and storage (ESS) segment combined with low printer channel inventories set up for strong revenue growth and operating leverage in F2010 and F2011.

We believe H-P's exposure to a server and storage spending recovery is underappreciated. While many investors view H-P's business as less transactional due to its Services/Printer exposure, we expect the ESS segment will account for nearly half of fiscal 2010's EBIT growth.

Our proprietary inventory data point to a potential rebuild. Hewlett-Packard's printer channel inventory has stabilized and could prove to be a strong earnings driver as high-margin printer supplies inventory increases.

Company Analysis

We see the following as upcoming catalysts:

- **Printer inventory rebuild –** Morgan Stanley publishes weekly proprietary data. Unemployment and GDP are also important indicators.
- **PC market momentum –** Monthly NB ODM shipments and official 2Q shipments in mid April.

Risks to our investment thesis and price target include:

- Muted enterprise IT spending rebound in C2010;
- Margin pressure in PCs from component costs and competition;
- Structurally lower growth in printing end markets.

Morgan Stanley is currently acting as financial advisor to Hewlett-Packard Company ("Hewlett-Packard") with respect to its proposed offer to acquire 3Com Corporation "3Com"), as announced on November 11, 2009. The proposed transaction is subject to the consent of the 3Com shareholders and other customary closing conditions. This report and the information provided herein is not intended to (i) provide voting advice, (ii) serve as an endorsement of the proposed transaction, or (iii) result in the procurement, withholding or revocation of a proxy or any other action by a security holder. Hewlett-Packard has agreed to pay fees to Morgan Stanley for its financial advice, including transaction fees that are contingent upon the consummation of the proposed transaction. Please refer to the notes at the end of the report.

HPQ: Multiple Paths to Our Bull Case – Underappreciated Enterprise Server Cycle and Printer Market Recovery

Bull Case $68	13x F11 EPS of $5.25	Multiple levers: We see multiple levers that could drive EPS towards $5.25+ in F11 including services billings, EMEA, corporate PC demand and a stronger server cycle. We apply a 13x multiple to our F11 bull case EPS of $5.25.
Price Target $62	12.5x F11 EPS of $4.94	**Cyclical recovery in servers and printers.** ESS revenue rises 16% in F10 driven by strong underlying demand and easy comps. A recovery in the printer market along with a rebuild of channel inventories drives IPG revenue up 6%. PC momentum continues driven by consumer and market share gains. Operating margins of 11.7% rise due to services restructuring and ESS leverage. We apply a 12.5x multiple (HP's 5-year historical relative PE) to our F11 EPS estimate of $4.94 to arrive at our $62 price target.
Bear Case $46	11x F11 EPS of $4.20	**Mild and protracted recovery.** IT spending remains subdued for the year and investments for growth mute margin improvements. We assume no multiple expansion from the current, below average, levels.

Source: FactSet, Morgan Stanley Research

MORGAN STANLEY
BEST IDEA

Company Analysis

February 24, 2010

The Home Depot
The Turn: Margins Above 9% in 2011 Looks Realistic

Morgan Stanley & Co. Incorporated

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Stock Rating: Overweight	Reuters: HD.N Bloomberg: HD US
Price target	$35.00
Shr price, close (Feb 23, 2010)	$30.75
Mkt cap, curr(mm)	$52,630
52-Week Range	$31.03-17.52

Fiscal Year ending	01/09	01/10e	01/11e	01/12e
EPS($)**	1.78	1.64	1.85	2.30
Prior EPS($)**	-	1.57	1.75	2.30
ModelWare EPS($)	1.75	1.60	1.81	2.25
Prior ModelWare EPS($)	-	1.53	1.72	2.25
P/E	12.3	17.5	17.0	13.6
Div yld(%)	4.2	3.2	3.1	3.4

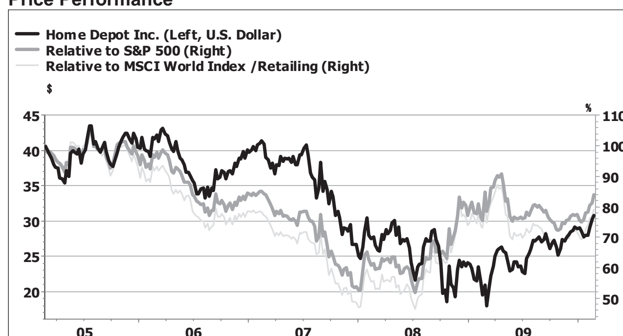
** = Based on consensus methodology
e = Morgan Stanley Research estimates

We remain optimistic about Home Depot's prospects as housing begins its recovery. We view HD's 4Q beat as a strong indication that 2010 will show progress on the path to recovery and 10% EBIT margins. HD showed continued EBIT margin improvement and big sequential improvements in comp largely driven by better-looking ticket. HD continues to "out-comp" Lowe's domestically, though the gap has narrowed. Credit and restructuring drove SG&A leverage, suggesting HD can leverage a leaner base when sales recover.

We found much to like in the quarter: traffic and ticket improvements, gross margin increase, SG&A discipline. Traffic improved, with US comp transactions growing 2.1%. The new credit agreement and cost cuts helped HD lever operating margins on sales down 0.3%. US comp ticket was down –3.2%, a sequential improvement. Baskets over $900 (20% of total) were down only 1%.

We continue to believe the market underappreciates 2011 margin expansion and potential for shareholder return. We project that with only 8% operating margins HD can generate $4 billion-plus in FCF, enough to fund the 3%-plus dividend yield and at least $2 billion in buybacks. As EBIT margins increase, HD should gain headroom to increase the

Price Performance

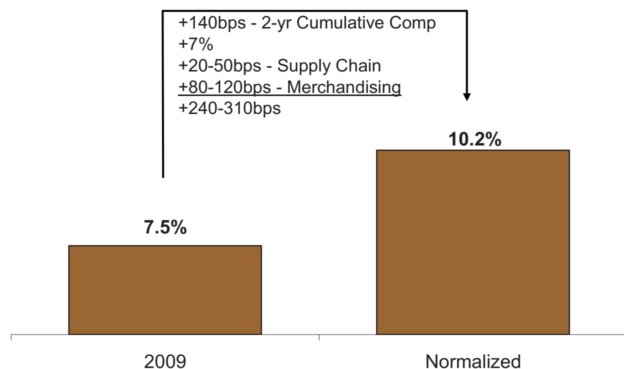


Source: FactSet Research Systems Inc

Company Description
The leading retailer in the home improvement industry, The Home Depot ranks among the 10 largest retailers in the US based on net sales volume. The company operates more than 2,000 stores in the US, Canada, Mexico, and China

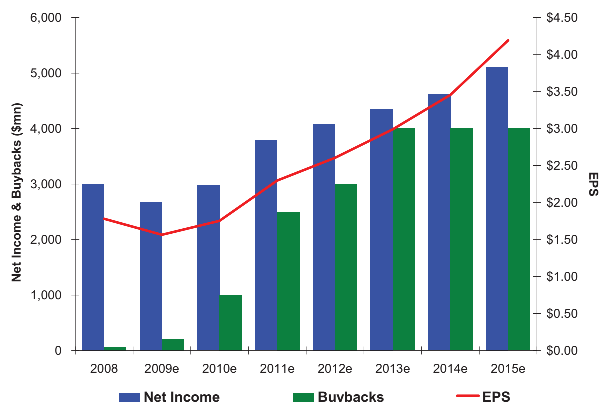
Industry View: In-Line — Retail - Hardlines
Valuations on Price/Sales and EV/Sales for many stocks have only recovered to where they were in late 2008. That suggests that if 2009 is the trough for retail, upside remains into 2010.

Exhibit 1
10%-Plus Margins Are Likely the Normal Run Rate



Source: Company Data, Morgan Stanley Research estimates

Exhibit 2
We Project HD Has Capacity to Buy Back One-Third of its Market Cap on Lower Capex and Store Growth



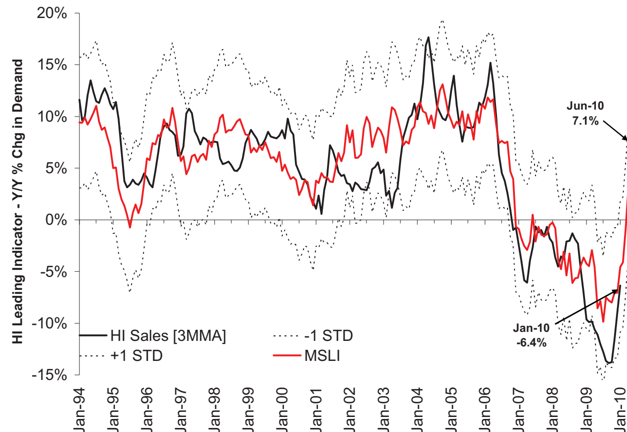
Source: Company Data, Morgan Stanley Research e = Morgan Stanley Research estimates

Company Analysis

Exhibit 3

Morgan Stanley Home Improvement Leading Indicator

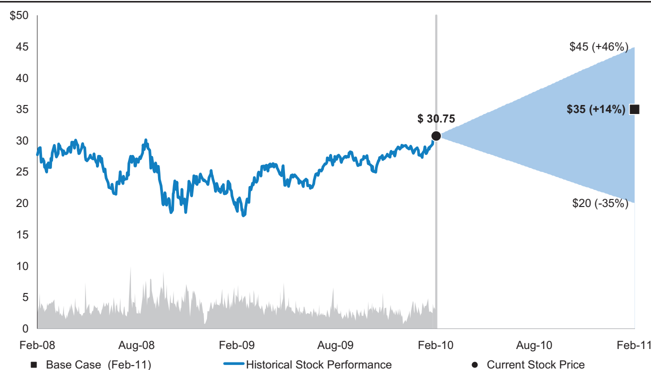
Our HILI has posted big gains for the last 3 months – an indication that the spring selling season could be robust



Source: Census Bureau, Morgan Stanley Research

Exhibit 4

Watch Our Lead Indicator for a Breakout in HD



Bull Case $45	17x Bull Case 2011e EPS of $2.65	**Quick recovery in 2010: Comps ramp pushing 2011 margins to 10%-plus.** US comps turn positive in 1Q10 and continue to build in 2010 as EHS jump 20%. Home prices are flat by 1Q. Comps recover to 5-6%, margins grow 200bp to 10%, EPS hits $2.65. Stronger than expected FCF generation provides for $4.5bn in buybacks and a 20% dividend increase.
Base Case $35	15.2x Base Case 2011e EPS of $2.30	**Positioned to win on recovery.** Slowing store expansion and focus on FCF and returns from 2007-2009 set HD up to thrive. Strong FCF generation supports $3.5 billion-plus in buybacks and a 12% dividend increase in 2010. SG&A levers 25bps per point of comp as gross margins expand 50bps+ on merchandising and distribution. Slower store growth helps the comp and FCF, but the multiple settles at 15x EPS, contraction from the current forward P/E.
Bear Case $20	11.5x Bear Case 2011e EPS of $1.75	**Double Dip: Stuck in housing purgatory, 7% is the new normal margin, interest rates surge to 7.5% in 2010.** Declining ticket fails to recover even as home prices stabilize. Traffic continues to drive the comp to 1-2%, but ticket never recovers and margins settle at 7%. Investors like the FCF story, but 7% margins and RNOA/ ROIC closer to 11–14% depresses the multiple. HD becomes the AZO of home improvement – good margin, low growth, high buybacks, but low multiple.

Source: FactSet, Morgan Stanley Research

dividend and buybacks again in 2011 (we estimate $3.5 billion in buybacks for 2010-11 and $20 billion returned to shareholders through 2015).

We believe that Home Depot has made the right investments to outperform retail on a recovery in housing… Since 2007, when the comps turned negative, HD has invested in the supply chain, improved merchandising, improved customer service, cut store growth, and increased FCF generation by $1.6 billion.

…so HD is well positioned to lever margins once sales start to come back, in our view. Improvements in distribution, merchandising, and customer service could help HD push normalized margins back to 9-10% as soon as 2011.

We believe that the turn in housing is real. Our proprietary Home Improvement Lead Indicator (HILI) has posted three straight months of gains for the first time since 2006, making us more confident that traffic and sales will start to come back in 2010. The increases in the Y/Y rate of Existing Home Sales (EHS) indicate traffic should continue to boost HD's comps into 2010. Further declines in home prices and the "glut" of foreclosures that many analysts expect to hit the market in 2010 remain obstacles to a recovery of ticket, but as shown by 4Q results from Whirlpool, Black & Decker, Stanley Works, Sherwin-Williams, and Fortune Brands, ticket is much less of a concern than it was 6 months ago. We think HD can continue to grow the top line and leverage the operating base to grow earnings even if ticket does not recover in 2010.

HD or Lowe's (LOW, $22.81, Overweight)? We say both. The macro trends are improving and both HD and LOW can succeed in 2010, in our view. HD has a better dividend yield and exposure to the "bubble markets" that could enable it to out-comp in 2010. We estimate Lowe's has 200-300 more stores it could build, which should provide some growth premium in the multiple.

Where the risks may remain: interest rates and multiple compression. Fed tightening could increase mortgage rates to the extent that it could slow the pace of existing home sale growth. The increase in the number of foreclosures that could enter the market this summer may make homeowners reluctant to continue large ticket investments in their properties. Multiple compression is a long-run risk given dialed back expansion plans — low square footage growth retailers typically do not hold growth multiples. That said, the housing stock is a fixed asset that is maintained and scrappage is generally low. Older houses require more spending, so we estimate the long-run growth for the industry will likely be 4-5%.

Company Analysis

February 22, 2010

Honeywell International
A 'Show Me' Story; Attractive Risk-Reward

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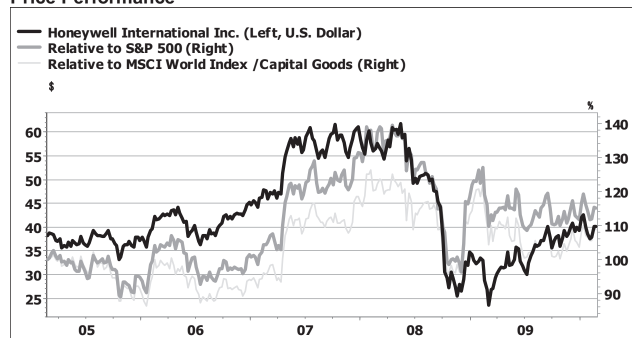
Stock Rating: Overweight	Reuters: HON.N	Bloomberg: HON US
Price target		$51.00
Shr price, close (Feb 22, 2010)		$40.15
Mkt cap, curr(mm)		$31,039
52-Week Range		$43.21-23.06

Fiscal Year ending	12/09	12/10e	12/11e	12/12e
ModelWare EPS($)	2.85	2.40	3.00	3.51
P/E	13.8	16.7	13.4	11.4
Consensus EPS($)§	2.85	2.38	2.90	3.51
Div yld(%)	3.1	3.3	4.1	4.9

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

Price Performance



Source: FactSet Research Systems Inc

Company Description
Honeywell is a $30 billion diversified global, multi-industry company split into four primary business segments: Aerospace Solutions (37% of sales), Automation and Control (34% of sales), Specialty Materials (12% of sales), and Transportation and Power (16% of sales). Each segment has various business units and product classes serving multiple end markets.

Industry View: Attractive - Electrical Equip. & Industrial Conglom.
We believe that fundamentals have surpassed multiples that have contracted recently to highly attractive levels. Stronger-than-expected order books provide visibility through 2010 and into 2011 on a sustainable industrial upcycle that we expect to exceed consensus views.

Is Honeywell a different company worthy of revaluation higher? We believe so, though some do not. As the stock is trading in the bottom half of the peer group on 2011e P/E, the market is clearly not convinced. We understand the market's skepticism but believe that the likely upcycle of the next 3-4 years will prove Honeywell's transformation. "Show me" stories are often the best performers into an upcycle.

We think the following dynamics will drive the stock:

- **New products and rate of change:** The perfect time to launch is into an upcycle, and Honeywell's new product launches have doubled vs. two years ago. We believe that Honeywell's best-in-class R&D spend will differentiate it in the upcycle for top-line growth, broad share gains for the first time in many years, and pricing power that should drive gross margins. If Honeywell outgrows peers and shows substantive gross margin expansion, the stock should follow.

- **Honeywell Operating System (HOS) rate of change in adoption:** Last cycle, there was limited HOS adoption; it's now 35% with a goal of 100% in four years. It took five years for the program to gain acceptance and is now broadly understood. What this means to us is that into an upcycle, Honeywell will show unprecedented productivity driving operating leverage well above peers. Honeywell's margins are 200-300 bps below its closest peers', signaling opportunity.

- **Other.** We maintain that: (1) Honeywell is the biggest beneficiary of energy efficiency trends in our coverage group; (2) Honeywell's cost-out in the downturn was excellent; (3) Honeywell is much better positioned in Emerging Markets now than five years ago; (4) Honeywell's cash reinvestment has been a positive surprise and provides upside; and (5) the pension noise is mostly behind us. All in, these represent solid upcycle tailwinds.

Where could Honeywell miss? We think the biggest risk is pace at which cost returns to operations. We think the best example comes from a recent 8K filing in which Honeywell rolled out its executive incentive compensation targets, which we think are set on a very low bar — assuming a macro recovery.

Even in a weak recovery, Honeywell's targets to pay out incentive comp look quite low. Honeywell's incentive comp was almost zero in 2009 — perhaps overly punitive for a company that executed at a high downcycle level and stayed ahead of the cost curve. However, we'd argue that the time to keep employees from leaving and keep morale up is now. This implies that Honeywell "over-earned" a bit in 2009 and labor costs will rise ahead of "normal" in 2010. It may be necessary, but could hold back margins.

Other risks to the HON story relate to macro/micro timing issues. The timing of recovery in commercial aerospace and

Company Analysis

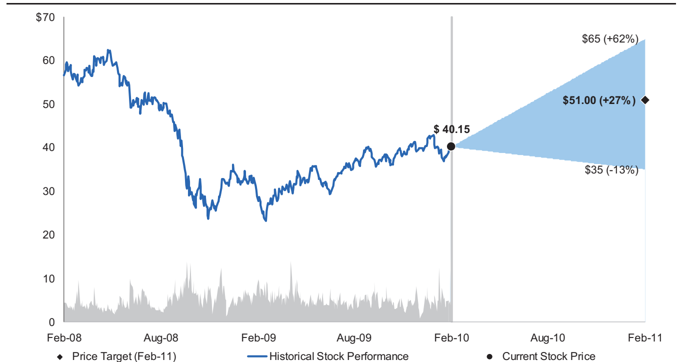
business jets aftermarket is important. The highest-margin businesses at Honeywell were down significantly (i.e. 30% or so) in 2009, and 2010 provides easy comps and opportunity for not only recovery but inventory rebuild. The timing is unknown, however. Our sense is that this risk will dissipate by mid-2010. Aerospace recovery signs and flight hour data are encouraging and, we think, sustainable.

Government risk: Honeywell is a big beneficiary of energy efficiency mandates, so it's a beneficiary of a more "active" government and policy makers. However, tax policy is a risk, as is healthcare policy. CEO Dave Cote's active engagement with government officials may help, however.

Other risks: Commercial construction exposure within Automation and Control Solutions (ACS); timing of turbo recovery in Europe is still a wildcard; the timing of recovery in the UOP division and the reload cycle are nearly impossible to forecast; rising materials costs at same time that labor costs are rising (an issue for all Industrials, including Honeywell). Honeywell has higher debt rates than the average industrial but also higher FCF generation, so debt reduction will be part of 2010 operating plan and take some cash away from potentially more productive endeavors for the year.

Pension risk: A sizeable pension expense headwind of 80 cents per share in 2010E has weighed on the stock for the last 6-9 months. An incremental headwind potential of ~10 cents in 2011 doesn't help. However, we'd argue that it all comes down to cycle activity. Improving macro conditions combined with debt crowding issues could bring higher interest rates and mitigate pension issues pretty quickly. Our back-of-the-envelope calculation shows that a 100bps rate increase would wipe out that incremental 2011 pension expense. Asset returns also a variable and it's too early for us to confidently forecast 2010. It is our view that peers will show incrementally higher pension liabilities over the next three years, whereas we estimate Honeywell that has already pretty much taken its hit.

HON: A 'Show Me' Story; Attractive Risk-Reward



Valuation		Our price target assumes a forward P/E multiple of 17X our 2011E of $3.00. Our price target multiple is in line with high-end peers.
Bull Case $65	18x Bull Case 2011e EPS of $3.63	**A return to positive core sales growth in 2010 with positive operating leverage.** 2011 EPS of $3.63 drives a share value of $65, with HON trading at a 18X multiple, in line with high-end peers — upside to this multiple on strong execution is also possible. This Bull Case could be increasingly likely if Honeywell were to get more aggressive with cash reinvestment or see greater margin expansion.
Base Case $51	17x Base Case 2011e EPS of $3.00	**Flattish core revenues in 2010 and a return to solid core growth in 2011, supported by pent-up demand**. Operating costs include an incremental ~$0.77 of pension costs in 2010e vs. 2009e. Aerospace and commercial construction end markets remain difficult in 1H but benefits from productivity initiatives drive margin expansion on flat revs. Additionally, rate of change at late cycle businesses is improving. Demand environment for Turbo and UOP also shows improvement. Our 2011e of $3.00 implies a stock value of $51 based on a 17X multiple. We consider this a conservative valuation with upside; our DCF implies higher levels.
Bear Case $35	14x Bear Case 2011e EPS of $2.50	**Another leg down in commercial construction and Aerospace end markets** with only modest recovery in 2011**.** In this scenario, 2011 EPS of $2.50 implies a share value of $35 with a lower multiple (14X) due to weaker than expected macro, lower EPS growth, and diminished management credibility.

Source: FactSet, Morgan Stanley Research

Risks to Price Target

Volatility in end-markets including aerospace, commercial construction, auto, energy, and automation. Pension risks if rates remain low or further decline and/or asset returns disappoint. Price/mix/costs becomes a bigger risk into 2010 for all Industrials.

Company Analysis

February 18, 2010

Life Technologies
Making Way for Capital Deployment to Drive Value

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Life Technologies' free cash flow is set to become a more important driver of the stock in 2011 and beyond… We have updated our model for the company's recent debt offering (less than 2% impact on EPS), but perhaps more importantly, the long-term debt reduces restrictions around the use of cash (under the term loans) helping to clear the way for capital deployment to create shareholder value as the story shifts away from the merger synergies over the next 12-24 months. As cash expenses related to integrating Applied Biosystems wane heading into 2011, we estimate Life Technologies will generate ~$800 million in FCF in 2011 (Exhibit 1).

…which we believe the market is undervaluing. Moreover, comparing LIFE to the peer group on normalized FCF yield in 2011 suggests the market is not giving the stock credit for the cash generation potential of this business. In our model, FCF yield will increase from ~6% in 2010e (in-line with the group) to ~8.5% in 2011e, roughly 150bps above the median for the tools group at ~7% (Exhibit 2). Closing this gap implies a fair value of $60 per share, although diluted share count will grow from the convertible debt going forward.

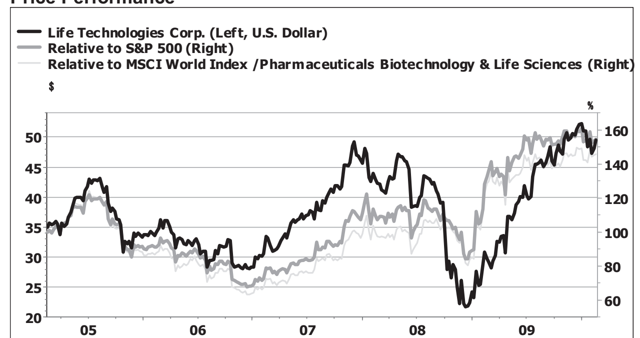
Tuck-In acquisitions make sense, but not large deals, we believe. Given Life's history as a serial acquirer, the refinancing raised investor concern that with the balance sheet settled with long-term debt, management was positioning for the next large acquisition. While we acknowledge past missteps, we believe the refinancing is more opportunity than risk. We view smaller, tuck-in deals to leverage a strong distribution channel and augment growth as a core strategy for Life over the next few years. However, the refinancing has raised investor concern about another large acquisition. This seems unlikely, in our view, as (1) management is beginning to discuss ROIC goals, (2) the remaining logical markets with an instrument-related consumables stream favoring smaller assets (e.g., flow cytometry, microarrays), and (3) few oppor-

Stock Rating: Overweight	Reuters: LIFE.O Bloomberg: LIFE US
Price target	$57.00
Shr price, close (Feb 17, 2010)	$49.50
Mkt cap, curr(mm)	$13,806
52-Week Range	$53.35-26.55

Fiscal Year ending	12/09	12/10e	12/11e	12/12e
ModelWare EPS($)	3.04	3.43	3.76	4.11
Prior ModelWare EPS($)	-	3.44	3.82	4.24
P/E	17.2	14.4	13.2	12.0
Consensus EPS($)§	3.04	3.38	3.73	4.10

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

Price Performance

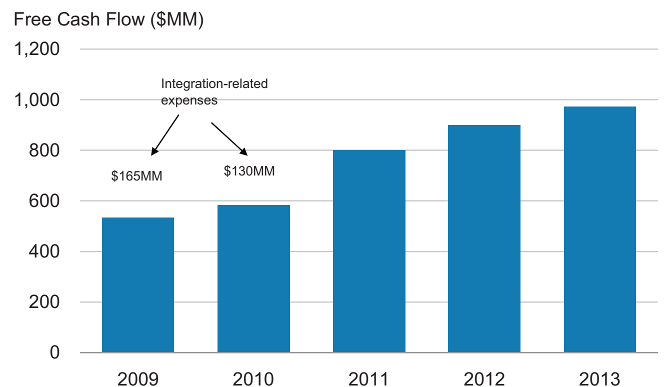


Source: FactSet Research Systems Inc

Company Description
Life Technologies, created by the combination of Invitrogen and Applied Biosystems, is a global biotechnology tools company.

Industry View: Attractive — Medical Technology
Analysis of previous recessions shows: (1) Healthcare multiples tend to initially price in deeper revisions than warranted by fundamentals, creating opportunities for outperformance; (2) Med Tech returns beat the S&P 500 going into recession and beat both the S&P and the Healthcare sector as a whole coming out.

Exhibit 1
Free Cash Flow Inflection in 2011e



Source: Company data, Morgan Stanley Research estimates

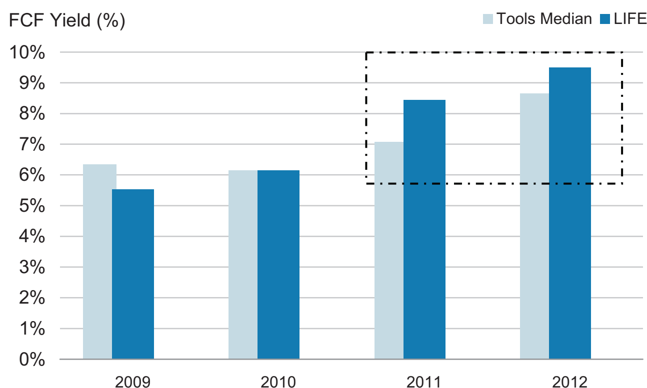
Company Analysis

tunities to increase scale materially in life science consumables given a highly fragmented landscape.

Buybacks a potential positive as well. Buybacks to return capital to shareholders and offset convert related dilution are a plausible use of cash going forward that does not appear to be in current Street numbers. We estimate that each $100MM buyback would add $0.02 to EPS at a share price of $50-$55.

Exhibit 2

FCF Yield to Be ~150bps Above the Group in 2011e



Source: Company data, Morgan Stanley Research estimates, ModelWare, Morgan Stanley estimates for LIFE, TMO, WAT, MIL, and ILMN and FactSet consensus estimates for PKI, SIAL, MTD, BRKR, DNEX, BIO. Based on current market capitalization

Exhibit 3

We Estimate Each $100 million of Repurchases Would Add $0.02 to EPS

Base Case - 2011			
Net Income	**$736**	**Buybacks in Model**	$51
Share Count	**196**	**Interest on Cash**	**1.5%**
EPS	**$3.76**	**Tax**	29%

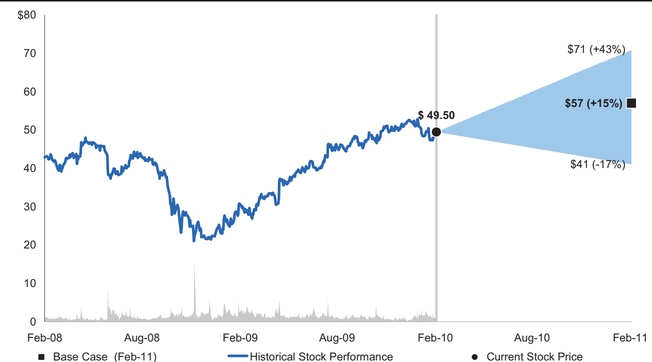
Incremental Impact to EPS

		Buyback Amount					
		100	200	**300**	**400**	500	600
	65	0.01	0.03	0.04	0.05	0.06	0.08
	60	0.01	0.03	0.04	0.06	0.07	0.08
Share	**55**	0.02	0.03	**0.05**	**0.06**	0.08	0.09
Price	**50**	0.02	0.03	**0.05**	**0.07**	0.09	0.10
	45	0.02	0.04	0.06	0.08	0.10	0.12
	40	0.02	0.04	0.07	0.09	0.11	0.13
	35	0.03	0.05	0.08	0.10	0.13	0.16

Source: Morgan Stanley Research estimates

Exhibit 4

LIFE: Upside if Revenue Synergies Materialize; Downside if Poor Execution, End-Market Deterioration



Price Target $57		Our price target is derived from our base case. This multiple is in-line with the life science tools group, which trades at 15-16x as Life's growth premium is balanced with execution risk from the integration and faster than expected instrument deceleration
Bull Case $71	18x Bull Case 2011e EPS of $3.96	**Consumables Revenue Synergies and Instruments Hang In,** with ~8% organic growth: • **Pricing optimization and Invitrogen's larger distribution channel** drives upside to AB's consumables business beyond our expectations. • **Instruments** manage modest growth as the capital spending environment proves more benign than we expect. • **Cost synergies** as in our base case.
Base Case $57	15.25x Base Case 2011e EPS of $3.76	**Realization of cost synergies drives stock:** • **Conservative 2010 revenue estimate given potential upside benefits:** 7% organic growth and 8% reported growth from 1% currency benefit. • **Cost synergies upside:** operating expenses growth of 5%, slower than revenue growth 8% y/y despite royalty headwinds. • **Currency:** +1% benefit revenue impact at current levels.
Bear Case $41	12x Bear Case 2011e EPS of 3.41	**Execution Missteps and/or Macro Deterioration.** • **Execution shortfalls** cause downside to EPS and multiple contraction. • **End-market pressures beyond our expectations** as pharma, biotech, and academia slow instrument and consumables purchases more than we expect, with organic growth of 5%.

Source: FactSet, Morgan Stanley Research estimates

Key Risks

- Trends in AB's instrument business
- Integration given past stumbles and especially as integration moves past low-hanging fruit
- Currency: Each 500bps move in the US$ = $0.10 of EPS, we estimate

Potential Catalysts

- Details on timing of federal stimulus package
- Evidence of execution on integration cost synergies in the coming quarters

Morgan Stanley

Company Analysis

February 23, 2010

Newell Rubbermaid.
Bear Arguments Appear to Be More Than Priced Into Valuation

Morgan Stanley & Co. Incorporated

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The five key investor concerns we have heard are more than discounted into NWL's valuation, we believe. Since we upgraded the stock to Overweight on February 8, 2010, we have heard bear arguments covering themes such as Newell's subpar product portfolio, muted SG&A top-line leverage, and limited pricing power. We believe Newell's risk-reward is compelling here, as the market has more than priced the bear arguments into valuation. We argue that the market is not giving Newell enough credit for an improved business mix after de-commoditizing its portfolio through divestitures and acquisitions, and re-investment behind the business to drive long-term growth, a potential macro-driven top-line rebound going forward, and potential Newell market share gains with recent strategic SG&A spending increases are additional positive factors supporting our thesis.

Attractive risk-reward: Our $18 price target implies 30% upside to our Base Case. Moreover, our Bull and Bear Cases also offer an asymmetrically positive risk-reward, as we think Bear Case downside is protected by limited potential multiple compression given NWL's already peer-low valuation. We view NWL's valuation as attractive with a 12% 2011e free cash flow yield, as well as a 6.7 times 2011 EV/EBITDA, at a significant 19% discount to peers.

The stock price implies negative terminal EPS growth beyond our three-year forecast period, according to Morgan Stanley's "What's in the Stock Price" analyzer — we believe this is too low based on Newell's prospects for rebounding category growth with improving macros and continued market share gains with increased strategic SG&A.

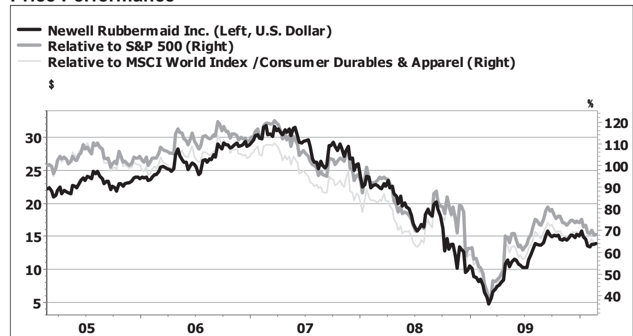
…and the options market implies only a 15% probability that NWL exceeds our price target and 5% probability that NWL exceeds our Bull Case scenario, which we also view as way too low.

Stock Rating: Overweight	Reuters: NWL.N Bloomberg: NWL US
Price target	$18.00
Shr price, close (Feb 22, 2010)	$13.84
Mkt cap, curr(mm)	$3,904
52-Week Range	$16.09-4.51

Fiscal Year ending	12/09	12/10e	12/11e	12/12e
ModelWare EPS($)	1.31	1.44	1.65	1.79
P/E	11.5	9.6	8.4	7.7
Consensus EPS($)§	1.31	1.42	1.60	1.73
Div yld(%)	1.7	1.4	1.4	1.4

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

Price Performance



Source: FactSet Research Systems Inc

Company Description
Newell Rubbermaid is a global manufacturer and marketer of consumer products in three business groups: Home & Family (key product lines include Graco baby and parenting products, Calphalon cookware, and Rubbermaid consumer products), Office Products (key product lines include Sharpie and Paper Mate writing instruments, and Dymo label makers) , and Tools, Hardware & Commercial Products (includes Lenox/Irwin hand tools and power tool accessories, Rubbermaid commercial products, and Technical Concepts hygiene systems). Products are distributed via discount stores, warehouse clubs, home centers, hardware stores, office superstores, toy stores and contract stationers.

Industry View: In-Line — Household & Personal Care
Relative valuations look low, but we believe that near-term results and the prospects for stock outperformance will be limited by fundamental pressures — a heightened promotional environment, consumer trade-down, and an increasing retailer focus on private label products.

Exhibit 1

Options Market Ascribes Too-Low Probability to NWL Exceeding our Base and Bull Case Valuations

The probabilities of our Bull, Base, and Bear case scenarios playing out were estimated with implied volatility data from the options market as of Feb 19,2010. All figures are approximate risk-neutral probabilities of the stock reaching beyond the scenario price in one-year's time.

Source: Morgan Stanley Research

Company Analysis

Key Market Concerns

How Much Pricing/Commodity Cost Risk?

Market View: Skeptical about Newell's ability to fully pass on re-inflating commodity costs through higher pricing, as Newell has the highest raw material exposure in the group, commodity costs are re-inflating, and historically Newell has shown limited pricing power in fully passing on commodity costs.

Our Take: Risk is there but is lower than is generally perceived. We agree with the market that the net pricing/ commodity cost gap is a risk factor for Newell, but we believe Newell's pricing/cost risk has become less pronounced, due to (1) price increases by competitors, (2) low competitive risk from P&G (Newell has negligible exposure to P&G categories), (3) promotional activity in Newell's categories has stabilized, (4) in-line 4Q pricing, and (5) lower resin exposure.

Does NWL Have an Inferior Product Portfolio?

Market View: Newell's product portfolio is inferior to that of its household products peers, given its product categories are generally slower-growth with less brand equity, and more macro-sensitive than typical household products categories.

Our Take: We believe the market is not giving Newell enough credit for its improvement in business mix over the last few years as half of Newell's business mix has changed since 2002. We agree with the market that Newell has a subpar product portfolio, but we think this is clearly already understood by the market and more than priced into valuation.

Will Strategic SG&A Increases Limit Margin Expansion?

Market View: Limited top-line payback, as Newell's revenue trends have been muted despite higher SG&A.

Our Take: We think concerns about Newell's historic SG&A spending increases are overblown, given: (1) overall operating margins have been increasing as Newell has reinvested gross margin upside into SG&A, (2) a large part of the SG&A increase has been driven by mix, and (3) a muted sales payback has been limited by the weak macro conditions in 2008 and 2009, which should reverse as growth rebounds.

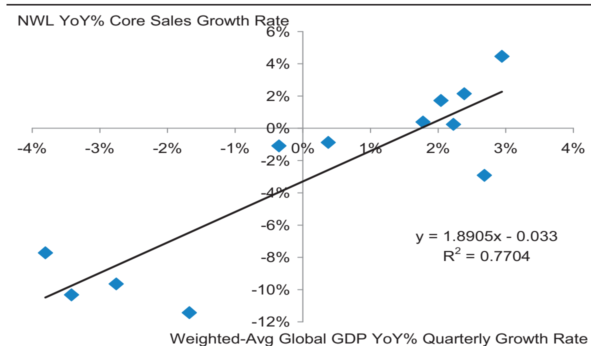
Will Newell experience a significant macro benefit?

Market View: Skeptical that Newell will benefit from a late-cycle rebound — NWL's valuation is at the low end of peers.

Our Take: We believe Newell will experience a greater benefit from improving macros than the market is pricing into valuation. Our analysis indicates Newell was the most macro-sensitive name in our coverage universe during the downturn. Further, our forecast for a Newell sales growth rebound is in line with our Retail team's forecasts in key divisions.

Exhibit 2

Newell Core Sales Growth Highly Correlated to GDP Growth



Source: Company data, Morgan Stanley Research

Exhibit 3

NWL: Macro Rebound Drives Favorable Risk-Reward

Bull Case $25	13.5x Bull Case 2011e EPS	**Revenue upside on improving macro trends and additional cost cutting drives multiple expansion**: Macro trends and market share gains drive 250 basis points of top-line upside and Newell cuts an additional 1% of its total cost base, driving multiple expansion to 13.5x 2011e EPS.
Base Case $18	11x Base Case 2011e EPS	**Macro recovery and market share gains:** Average organic sales growth of 3% in 2010-2011 on improving macros and continued market share gains. Valuation expands to 11x 2011e EPS, in line with NWL's 11x NTM P/E average over the past 3 years.
Bear Case $12	8x Bear Case 2011e EPS	**Pricing risk and weak macros limits results:** A weaker than expected macro recovery drives a 100 basis point top-line miss and weak pricing hurts top line by another 100 basis points, compressing Newell's 2011e EPS multiple to 8 times.

Source: FactSet, Morgan Stanley Research

Risks include organic sales volatility given Newell's macro sensitivity. We also estimate each 10% change in the resin price affects 2010e EPS by 3.6%. Newell has said it expects to boost strategic SG&A spending toward 8% long term, versus about 6% in 2009; each 100 basis point variation vs. our forecast would be worth 9.7% of 2010e EPS. We expect Newell to take price increases in 2010 to offset higher commodity costs, with each 100 basis points of pricing impacting 2010e EPS by 9.7%. Finally, currency has an impact, as 32% of sales are outside the US.

MORGAN STANLEY
BEST IDEA

Company Analysis

February 22, 2010

Oracle
Customer Demand Inflects Post-Sun Close

Morgan Stanley & Co. Incorporated

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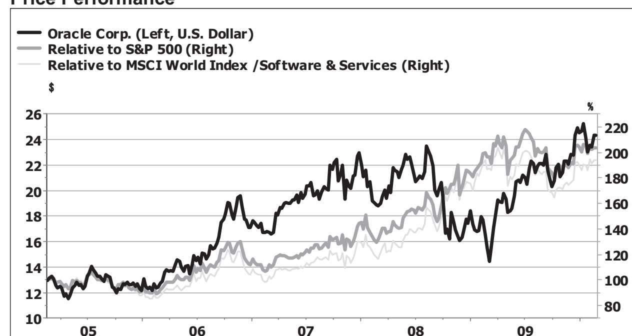
Stock Rating: Overweight	Reuters: ORCL.O	Bloomberg: ORCL US
Price target		$31.00
Shr price, close (Feb 19, 2010)		$24.32
Mkt cap, curr(mm)		$123,132
52-Week Range		$25.64-13.80

Fiscal Year ending	05/09	05/10e	05/11e	05/12e
ModelWare EPS($)	1.34	1.45	1.79	2.15
EPS($)**	1.44	1.60	1.94	2.28
P/E**	14.4	16.6	13.4	11.2
Consensus EPS($)§	1.39	1.58	1.83	2.00
Revenue($mm)**	23,252	26,809	35,544	37,813

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

Price Performance



Source: FactSet Research Systems Inc

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
As we move beyond the early cycle phase of the economic recovery into the growth phase, there may be more relative upside from here in mid-cycle Technology groups. We still believe our group holds some absolute upside, but stock-picking will become more important.

Sun and core Oracle revenues should surprise favorably in F2011; we remain aggressive buyers of ORCL stock, based on a strong potential for upside to conservative F2011 expectations and a significant valuation discount to our large-cap coverage, even with currency representing a head-wind (see our sidebar comment on the next page).

Sun hardware is back in the game: Deal should be a positive for Oracle's hardware and software revenues, according to our survey of IT managers. We gathered data from 45 C-level IT executives at Sun customers and the data point to materially improved demand for Sun post close, as well as a strengthening outlook for core Oracle. We surveyed 34 joint customers of Oracle and Sun both before and after the closing of the transaction. Additionally, we held in-depth conversations with another 11 CIOs on their spending intention with the two vendors.

While Oracle's F2011 revenue target of $9.6 billion for Sun assumes next to no growth versus the company's September 2009 run-rate, our survey finds both improving spending intentions for Sun hardware and a significant skew toward increasing spending with the combined company. With Oracle's $1.5 billion F2011 operating income target for Sun driven largely by cost synergies, any revenue growth in Sun likely represents upside to both our merger model and consensus expectations.

CIOs expect to increase spending on SPARC servers and storage hardware. According to our survey, 35% and 29% of CIOs look to increase spending on SPARC servers and Sun Storage, respectively — far more than the 18% and 12% looking to decrease spend. Additionally, 35–38% of respondents look to increase spending on Oracle apps, middleware, and database as a result of the merger vs. 0–3% looking for a decrease. Compared to our November survey, nearly twice as many CIOs reported expectations of increasing spend on the above areas in our February survey. This would suggest Oracle has significant momentum in its push to be a provider of integrated software/hardware solutions and that the deal close has comforted customers.

Most CIOs see value in Oracle's push to offer integrated appliances — 82% of CIOs surveyed see value in appliances that integrate software and hardware.

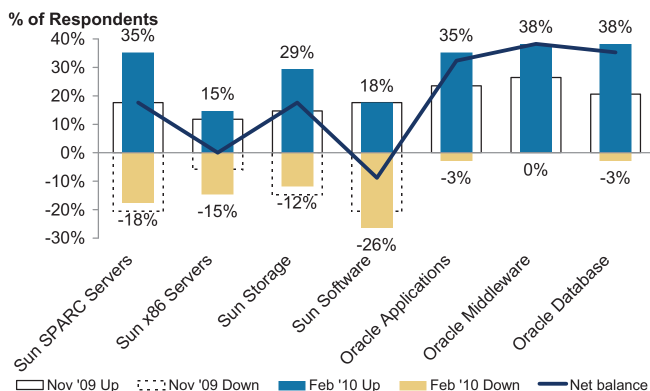
Near-term, 21% of CIOs reported pent-up demand post-merger, suggesting upside to May quarter estimates, where we look for just $1.2 billion in Sun hardware revenue contribution. Longer term, Oracle intends to add ~2,000 employees to its sales force as it shifts towards selling Sun products directly to its top 4,000 customers. Our checks suggest that Sun may have less than 500 enterprise salespeople,

Company Analysis

Exhibit 1

CIOs Expect to Increase Spending on Sun Hardware, as well as Oracle Software, Post Merger

How do you think the merger will impact your spending on the two vendors' technologies going forward?

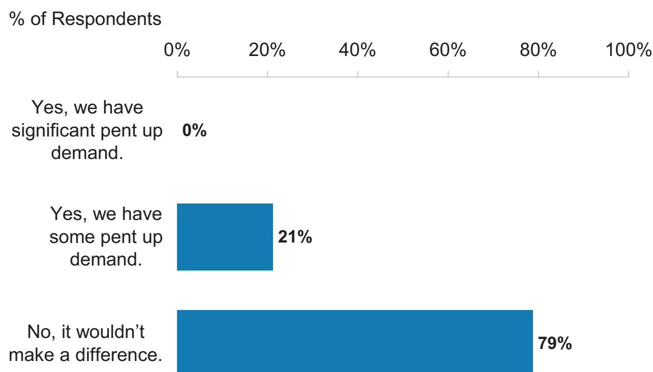


Source: Company data, Morgan Stanley Research
Note: Bars show % of respondents who expect to increase/decrease spend in each product category. For example, in the current survey, 35% of CIOs expect to increase spend on SPARC servers, vs. 18% who expect to decrease spend, and the net balance is nearly 18%. The unshaded bars show results from our last survey (in which no respondents said they would decrease spend on Oracle software).

Exhibit 2

21% of CIOs See Some Pent-Up Demand Post Merger

Does Oracle's closure of Sun and commitment to SPARC/Solaris and other platforms release any 'pent up' or delayed projects?



Source: Company data, Morgan Stanley Research

so Oracle would be expanding distribution five-fold. Given the positive indications on potential revenue synergies in our survey, new distribution should have a measurable impact on revenues in the first year.

Maintenance is a potential multi-billion-dollar opportunity. Our checks also suggest that maintenance was a largely untapped opportunity under Sun, with less than 30% attach rates. However, 56% of the CIOs we surveyed would be willing to pay maintenance on hardware and software where appropriate, while we found a surprisingly significant amount of third-party maintenance in the base. We expect Oracle to aggressively pursue maintenance opportunities with Sun, which we think is a multi-billion revenue opportunity.

Valuation and Risks

Our $31 price target is based on 15x C2011e EPS of $2.09 (a slight premium to average hardware vendor P/E).

Risks: We model a $17 Bear Case where a multi-year global recession drives high-single digit declines in organic constant-currency license revenues in C2010, severely limiting EPS growth, despite the strong recurring contribution of the customer base. In this scenario, we assume ORCL's forward P/E stays at its 10-year trough of ~10.

Stronger US dollar hurts ORCL, but the impact looks manageable. With over 50% of revenues generated overseas, a strengthening US dollar creates headwinds for Oracle's fundamentals. However, management's conservative expectations for both its core business and the potential accretion from the Sun deal should make these impacts manageable, and we believe that Oracle can meet/exceed our F2011 EPS even with a currency headwind. The US dollar's appreciation since Oracle's F2Q10 earnings call represents an impact of less than 1% to February-quarter revenues and less than a penny to EPS, by our estimates.

Further, over the past 2 years, moves in the S&P 500 have tracked in line with the inverse of the US dollar index — we calculate a 0.81 R^2 value. While this represents Beta risk, the correlation between ORCL's stock price and the inverse USD index showed an R^2 of only - 0.42 — although it was higher, 0.60, over the past year. Additionally, looking at price moves on a Q/Q basis, there is very little correlation — R^2 = 0.21.

Company Analysis

February 22, 2010

PG&E Corporation
Risk-Reward Favorable Ahead of Next Week's Analyst Conference

Morgan Stanley & Co. Incorporated

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Investors are nervous ahead of the analyst day, but we believe that PG&E's guidance is achievable. 4Q09 EPS were modestly better than forecast and management reaffirmed 2010/2011 EPS guidance of \$3.25–3.50 and \$3.65–3.85. Lower rate base projections for 2009–11 have brought into question whether PG&E can do better than the low end of those ranges and/or the earnings quality of expected guidance at the March 1 analyst meeting. We believe that PG&E's aspirations are still achievable, but have modestly lowered our forecast.

The stock has lagged its regulated peers year-to-date. These above issues are more recent. Coupled with general concern regarding the regulatory environment given PG&E's pending base rate case, the shares have declined 6% YTD vs. –2% for other large cap regulated utilities and flat for the S&P 500. While PG&E does have regulatory risk, with a pending base rate case at the California Public Utilities Commission (PUC), many of its peer companies have profiles with equivalent risk — but trade at premiums.

Risk vs. reward appears favorable. We chalk up PCG's valuation discount in part to its lower dividend payout ratio, despite the fact that the company offers equivalent if not superior total return as measured by yield plus earnings growth. We believe the March 1 analyst day will partly validate PG&E's ability to achieve consistent earnings growth with relatively low structural risk, as the regulatory scheme decouples revenues from demand and allows ROE adjustments due to changes in market driven cost of capital.

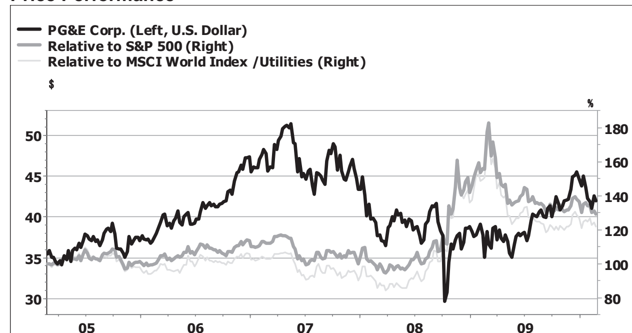
Beyond management needing to re-assure investors on March 1 that the capital investment plan, balance sheet and cash flow profile support current EPS growth aspirations, investors will need to get comfortable that the political and regulatory backdrop in CA still provides the opportunity for a constructive rate case outcome later this year. We like the shares in part because we think they already discount this risk.

Stock Rating: Overweight	Reuters: PCG.N Bloomberg: PCG US
Price target	\$46.00
Shr price, close (Feb 22, 2010)	\$41.98
Mkt cap, curr(mm)	\$15,533
52-Week Range	\$45.79-34.51

Fiscal Year ending	12/09	12/10e	12/11e	12/12e
ModelWare EPS(\$)	3.21	3.40	3.75	3.90
Prior ModelWare EPS(\$)	3.20	3.45	3.80	4.00
P/E	13.9	12.3	11.2	10.8
Consensus EPS(\$)§	3.17	3.40	3.69	3.78
Div yld(%)	3.5	4.3	4.6	4.8

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

Price Performance



Source: FactSet Research Systems Inc

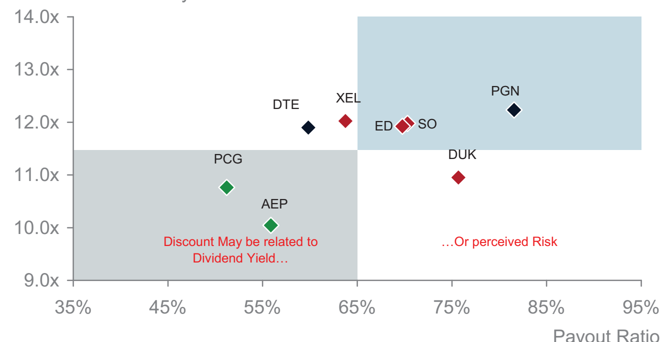
Company Description

PG&E's Pacific Gas and Electric serves about 4.3 million electric customers and 3.6 million gas customers in California. PG&E also markets energy commodities wholesale and has a stake in a fiber-optic network.

Industry View: In-Line — Electric Utilities/Regulated
Regulated utilities are capital-intensive and tend to earn slim but predictable regulated returns over their cost of capital. Investors generally believe that regulateds typically outperform in recessions but do not generate alpha in a recovery, yet our work shows that in all but two of the past 20 years, it was possible to outperform the market through stock selection.

Exhibit 1

Cheap vs. Peers Due to Yield Despite Comparable Projected Total Return Outlook



Source: FactSet, Morgan Stanley Research

Company Analysis

Exhibit 2

PCG: Relatively Tight Set of Earnings Outcomes, Limited Downside Risk: A Low-Risk Adjusted Return Story

Price Target $46		P/E target multiples are derived using our proprietary DDM.
Bull Case $48	12.0x Bull Case 2012 EPS of $4.00	**2010 rate decision supports cap spending plan; multiple reflects 9% rate base growth and 12% long-term ROE.** 60% of relief requested is passed and 11.7% earned ROE achieved on a 52% equity ratio. $600 mn of equity in 2011/12 and $30 mn of energy efficiency incentives.
Base Case $46	11.8x Base Case 2012 EPS of $3.90	**2010 rate decision cuts back cap spending aspirations; multiple reflects 8% rate base growth and stable ROE.** 55% of relief is passed and 11.7% ROE achieved on 52% equity layer. $400 mn of equity in 2011 and $21 mn of energy efficiency incentives.
Bear Case $41	11.0x Bear Case 2012 EPS of $3.70	**2010 rate decision cuts cap spending aspirations, multiple reflects reduced rate base growth and long term ROE.** 40% of relief passed on 52% equity. ROE trends to 11.0%, $400 mn of equity in 2011, no energy efficiency incentives.

Source: FactSet, Morgan Stanley Research

Investment Thesis

- Since January 4, 2010 PCG has declined 6% vs. –2% for other large cap regulated utilities and flat for the S&P500. We think concern over the general state of the California economy, coupled with some regulatory news flow and a lower rate base growth forecast, has driven fear of increased regulatory risk and lower earnings growth.
- We believe the March 1 analyst day will validate our earnings forecast, the relatively tight risk-reward offered by the stock at current levels, and our view that over the next 12 months the stock is one of the better positioned large cap regulated utilities in our universe.
- PCG has a 53% payout ratio and yields 4.3%, below the large cap regulated group average 70% payout and 5.4% yield. However, with EPS growth expected to be 6-7% over the next several years it offers a comparable projected total return at a 7% discount, while doing so with less regulatory risk.
- PG&E is growing its rate base by more than 8% annually & can fund its capital budget with utility debt, internally generated funds and equity DRIP in 2010 but will need some external equity ($400 million annually) in 2011/12.
- Resolution of PG&E's rate case this year should validate their growth aspirations regardless of economic conditions due to the regulatory scheme in California, which decouples revenues from demand and allows for adjustments to authorized returns due to changes in the cost of capital.

Investment Risks

- PG&E filed its 2011 General Rate Case (GRC) on December 21, 2009, requesting a $1.05 billion rate increase (6.5%) for rates effective January 1, 2011. A high level of opposition evident at the CPUC, were it to arise over the next several months, would further impact perception of the regulatory backdrop and compress the valuation.
- A final CPUC decision in this proceeding is expected in December 2010.

Company Analysis

February 18, 2010

TD Ameritrade
Re-affirming Ameritrade's Net New Assets Potential, Discounting a Price War

Morgan Stanley & Co. Incorporated

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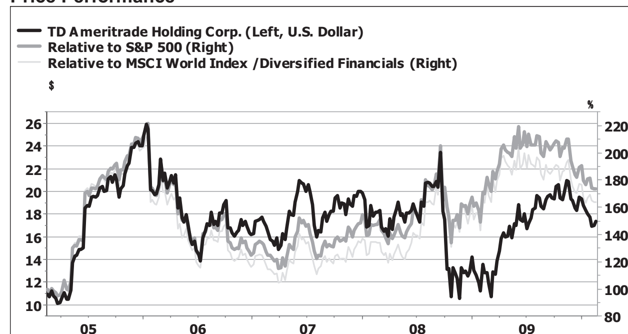
Stock Rating: Overweight	Reuters: AMTD.O	Bloomberg: AMTD US
Price target		$28.00
Shr price, close (Feb 16, 2010)		$17.33
Mkt cap, curr(mm)		$10,342
52-Week Range		$21.30-10.09

Fiscal Year ending	09/09	09/10e	09/11e	09/12e
ModelWare EPS($)	1.10	1.13	1.72	2.32
Prior ModelWare EPS($)	-	1.13	1.71	2.31
P/E	17.9	15.4	10.1	7.5
Consensus EPS($)§	1.10	1.16	1.54	1.88
Div yld(%)	0.0	0.0	9.9	13.9

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

Price Performance



Source: FactSet Research Systems Inc

Company Description

TD Ameritrade is a leading provider of securities brokerage services and technology-based financial services to retail investors and business partners. The company provides services predominantly through the Internet, a national branch network and relationships with independent registered investment advisors (RIAs).

Industry View: In-Line — Diversified Financials

We see greater upside to our Base Cases, on average, vs. Morgan Stanley's strategy team's expected 8% for the S&P 500 in 2010; however, our In-Line view is driven more by the disparate group of companies we cover than by the relative outlook.

'Price war' concerns are just noise and TD Ameritrade's asset growth opportunity is underappreciated, in our view. The biggest resistance we get on our Overweight call on AMTD revolves around (1) concerns that a price war that would greatly impact revenue, asset growth, and in turn, earnings power, is upon us; and (2) investors questioning Ameritrade's ability to continue to grow assets at a reasonable rate. We believe our assumptions for growth in Ameritrade's net new assets (NNA) are conservative, with room for upside from both retail and registered investment advisor (RIA) segments.

We do not believe a pricing war is upon us…. Fidelity, Schwab, and E*Trade had charged drastically higher prices when inclusive of "per share" charges, which by eliminating, likely helped customer satisfaction levels. Further, we do not see a couple of dollars difference in commissions as a major driver of customers moving from one broker to another (if that were the case, Scottrade might have much greater market share, as its pricing has been $7.00 for some time). Our RIA survey (which admittedly is different from retail) indicated that RIAs view technology and service as much more important factors than price when choosing a custodian; further, a 2009 J.D. Power and Associates study of 5,000 self-directed investors concluded that price isn't always the most important factor. At Morgan Stanley's US Financials conference, Ameritrade management reiterated that it has no plans to match the price cuts but will monitor account transfers (ACATs), calls in from clients, and other business fundamentals to gauge impact. We note that many of Ameritrade's active traders pay significantly less than the $9.99 list price already.

…but even with pricing pressures, we are still comfortable with our Overweight rating. Our positive view on Ameritrade is driven by our above-consensus forecast of asset growth, and the inherent strength of the business model in a normalized interest rate environment, the extent of which we don't think is reflected in the stock price.

Moreover, the changes that Ameritrade's competitors have made have been for non-active traders, and while some have priced below Ameritrade's list price, Ameritrade's active traders are mostly already trading on a negotiated pricing structure. We already assume Ameritrade lowers 50% of its trade commissions by $1 (a conservative assumption, in our opinion, because we believe more that 50% of trades are by active traders and options represent ~20% of trades); this impacts Ameritrade's EPS by $0.01 per quarter, we estimate.

In our Bear Case scenario, we assume Ameritrade lowers its trade commission list price $2 further than our estimate (down to $6.99 from $9.99) so that it has the lowest commission of the major online brokers. The change would reduce our price target to $26 from $28, all else equal.

The last time Ameritrade changed its pricing structure was in April 2006. Trading revenue declined significantly the next quarter and didn't recover for 12 months. AMTD's stock price

Company Analysis

declined significantly post-announcement. However, the lowering of the commission price coincided with the integration of TD Waterhouse. Management acknowledges flaws in service and technology at that juncture, which likely was a drag on valuation.

Looking at the impact on Schwab after its various price cuts, we see that while trading revenue often waned, overall revenue — and the company's stock price typically responded positively over time (Exhibit 2). Perhaps more importantly, it was difficult for us to see any correlation between NNA growth and price changes; asset growth was not impacted by price changes, a concern of investors regarding Ameritrade.

We are strong believers in Ameritrade's asset gathering ability and think the Street under appreciates the growth here. We expect NNA growth to come from three sources: new retail accounts, wallet share expansion, and growth in Ameritrade's RIA business. In addition, our RIA survey (published February 1, 2010) implied Ameritrade should be able to at least maintain its market share, even before it began new initiatives. We continue to expect market recovery/the company's growth to lead to new accounts/greater wallet share.

Ameritrade's partnership with TD Bank to be TD's US wealth management solution is a promising opportunity, in our view, one that should help drive strong NNA growth. According to Ameritrade, two-thirds of TD's brokerage referrals in Canada come from the bank; if Ameritrade and TD can make it work (which we don't reflect in our estimates), the 1,000-plus TD branches in the US could be an important driver for Ameritrade down the road. Note 7% of new bank branches in US are TD Bank's and TD estimates it controls 45–50% of the Canadian online brokerage business.

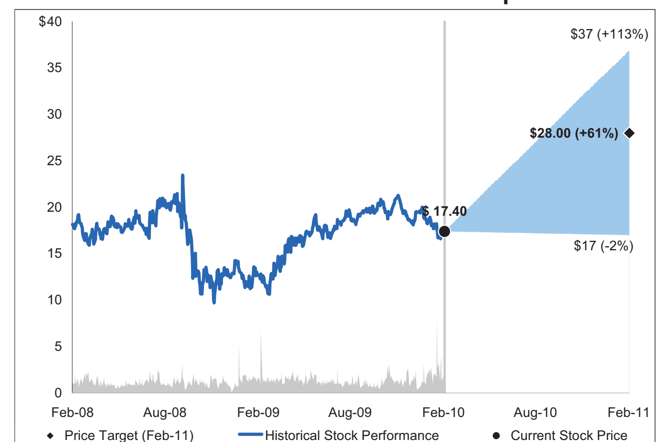
We recognize there are some risks to Ameritrade's asset gathering ability. There is the question of how much (if any) of the company's strong NNA growth over the past year was driven by its simple pricing and the lack of per-share fees. In the same vein, if pricing is a differentiator, is Ameritrade's platform strong enough to overwhelm price/fees for new customers? Ameritrade management also noted that it has seen a significant increase in marketing spend from its competitors over the past month. Ameritrade significantly outspent its competitors in 2009; how much was it contributing to growth?

Our $28 price target is based on the net present value (NPV) of Ameritrade's projected free cash flow, assuming an 11% cost of equity and terminal year growth of 1%.

Risks: We believe the Street underestimates the drag on net interest from IDA (insured deposit account) balances invested at low interest rates. Ameritrade's NNA growth may not be sustainable long term. There is no guarantee online brokers will continue to take share of advisory assets from wirehouses. Regulatory risks exist as well (e.g., potential transaction tax, fiduciary duty legislation).

Exhibit 1

AMTD: Client Asset Growth Should Drive Upside



Bull Value $37	18% three-year client asset growth; 2010 DARTs: 470k; Fed begins raising rates in March 2010 quarter, 2.00% at 9/30/10
Base Value $28	14% three-year client asset growth; 2010 DARTs: 408k; Fed begins raising rates in September 2010 quarter, 0.50% at 9/30/10
Bear Value $17	7% three-year client asset growth; 2010 DARTs: 303k; Fed doesn't raise rates until C2011

Source: Morgan Stanley, FactSet

Exhibit 2

Schwab Price Performance Post-Commission Pricing Changes

		Stock Performance				Trading Revenue			Revenue			NNA Growth		
Event	Date	Close	+ 1 Week	+ 30 Days	+ 180 Days	Quarter	+ 1Q	+ 2Q	Quarter	+ 1Q	+ 2Q	Quarter	+ 1Q	+ 2Q
Started $9.95 commissions for $1million+ clients and expanded $14.95 and $19.95 access to more clients	5/25/04	-2.9%	-1.0%	4.6%	7.7%	-27.7%	-48.8%	-39.6%	-6.7%	-11.0%	-4.3%	2.7%	5.2%	6.7%
Lowered online equity comm. from $29.95 to $19.95, expanded access to $9.95 comm. based on activity	10/4/04	-1.6%	-5.7%	3.0%	13.3%	17.8%	11.9%	1.1%	7.5%	7.4%	10.2%	6.7%	6.0%	4.2%
Eliminated account service fees on accounts for clients with at least $25k at Schwab	1/13/05	-2.2%	-0.4%	-4.1%	11.1%	-5.0%	-14.2%	-14.2%	-0.1%	2.5%	7.4%	6.0%	4.2%	8.5%
Lowered online equity commissions from $19.95 to $12.95	2/4/05	-3.0%	0.7%	2.1%	28.5%	-5.0%	-14.2%	-14.2%	-0.1%	2.5%	7.4%	6.0%	4.2%	8.5%
Lowered options contract trading rate	3/22/05	-1.9%	-2.4%	-3.6%	38.2%	-5.0%	-14.2%	-14.2%	-0.1%	2.5%	7.4%	6.0%	4.2%	8.5%
Eliminate account service fees and order handling fees	9/15/05	-1.2%	-3.1%	-9.4%	17.0%	0.0%	5.9%	21.4%	4.7%	-11.3%	-3.0%	8.5%	7.9%	10.0%
Lowered online equity commissions from $12.95 to flat $8.95	1/7/10	-0.4%	-0.9%	-6.7%	N.M.	N.M.	N.M.	N.M.	N.M.	N.M.	N.M.	N.M.	N.M.	N.M.

Source: Morgan Stanley Research; FactSet

Company Analysis

February 22, 2010

Visa
'Go World' Isn't Just a Slogan

Morgan Stanley & Co. Incorporated

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We continue to prefer Visa's shares to MasterCard's in the near term as we have a higher degree of confidence that Visa's analyst day on March 11 and its F2Q earnings call will be positive catalysts; and we expect less share-price volatility than for MA. At some point this year, we expect the reversion trade will be the right call, but at this point, we favor V slightly over MA ($224.24, Overweight).

We did a quick West Coast payments tour last week and came away more optimistic about the growth prospects in the industry. Our primary conclusions:

(1) There is more to the Visa and MasterCard value proposition than just pricing — we reiterate our view that the two are not in a pricing war.

(2) Opportunities in emerging markets and new products should enable growth to be sustained further into the outer years than consensus currently expects.

(3) The two main threats to the Visa and MasterCard stories are irrational pricing decisions and disintermediation (we think both are unlikely).

(4) The Visa analyst day on March 11 should be a positive catalyst for the stock (driven by new product introductions and greater detail about Visa's growth strategy).

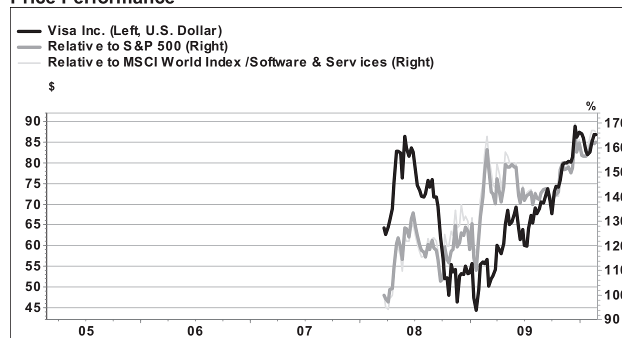
Visa's growth strategy is the key to the story, in our view. With cost reduction becoming less of a contributor over time, the sustainability of relatively high valuation levels will depend on each company's ability to maintain high revenue growth rates. The two main areas we are focused on are emerging markets (Exhibit 1) and new or existing products that are less mature and have yet to ramp. In Asia, China and India show substantial promise, and in Latin America, we view Brazil, Mexico, Argentina, and Colombia as the primary growth opportunities. In many of these markets, V and MA will have to carefully navigate large issuing banks as their ownership stakes in local networks and/or processing entities may create barriers to entry and/or opportunities for partnerships and alliances.

Stock Rating: Overweight	Reuters: V.N Bloomberg: V US
Price target	$120.00
Shr price, close (Feb 22, 2010)	$86.91
Mkt cap, curr(mm)	$64,821
52-Week Range	$89.69-48.74

Fiscal Year ending	09/09	09/10e	09/11e	09/12e
ModelWare EPS($)	2.80	3.69	4.31	5.00
P/E	24.7	23.6	20.2	17.4
Consensus EPS($)§	2.92	3.76	4.53	5.32
Div yld(%)	1.0	1.0	1.0	1.0

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

Price Performance



Source: FactSet Research Systems Inc

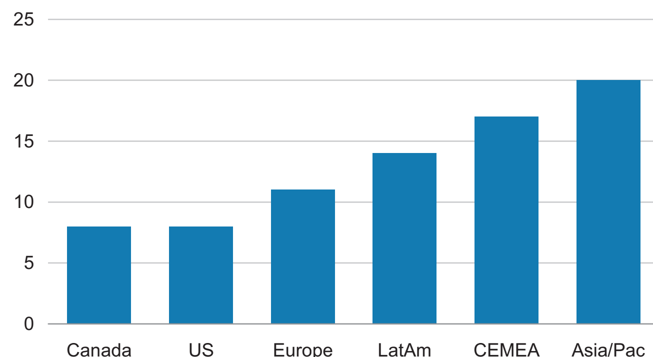
Company Description
Visa operates consumer electronic payment networks. It provides processing services and payment product platforms, including consumer credit, debit, prepaid and commercial payments which are offered under the Visa, Visa Electron, Interlink, and Plus brands.

Industry View: In-Line — Computer Services & IT Consulting
Over the next 2 years, the potential for improved business models and fundamentals could empower the sector to regain investor mindshare. "Growth" is our central insight, as its potential is not fully understood or properly discounted in some cases, and overestimated in others.

Exhibit 1

Emerging Markets Are Where the Growth Is

Industry transaction growth by region (2006-12e CAGR)



Source: Visa, Inc and The Nilson Report

Company Analysis

From the product side, key priorities remain (1) deeper and broader penetration within the affluent market across the globe, (2) increasing debit usage at the point of sale (POS), and (3) the four new primary product initiatives including ecommerce, prepaid, mobile, and money transfers/P2P.

'Right Click' sounds like it's 'right on.' Visa expanded a little bit on its recent beta-test of its "Right Click" product. To us, the inaugural version appears to be as a combination consumer wallet that can accommodate multiple payment drivers (e.g., MasterCard, AmEx, PayPal, etc.). This tool is already in Beta testing and will likely improve a shopper's online experience by offering things like form-filling data, "Wish List" (with constantly updated pricing), shipping status for outstanding purchases, and special offers when you use a Visa payment product. We think this is a very well thought-out and effective strategy to maintain/augment Visa's already solid ecommerce market share (high 40%s) as it puts Visa next to the consumer at the point of entry (POE) to the Web, as opposed to the point of check-out (POC), where the payment choice can be more random.

We view the mobile opportunity as greater in regions where it already exists (i.e., Japan, some Nordic areas, etc.) and in emerging markets where the build-out of traditional acceptance infrastructure would be costly and take several years (i.e. decades) to accomplish. In the US, we view the mobile opportunity as more material as it applies to eCommerce, with an eventual increase of usage in P2P applications, and maybe at some point (very far) down the road, at the actual point of sale.

What could derail the stories?: Irrational pricing and disintermediation (both of which we think are unlikely). While we do think there will be occasional "portfolio swaps" between Visa and MasterCard, we do not see either one behaving irrationally and in ways which would be detrimental to either company's business model. On the disintermediation front, while it's conceivable that banks could come together and form their own network, or the wireless networks could get into the consumer commerce area in more meaningful ways, we don't think either of these scenarios are viable in the near or medium-term.

Visa's evolving P&L: Slower revenue growth, but also slow fixed cost growth — still 50%-plus margin target. While revenue growth has slowed materially with the global economic slowdown, guidance still calls for operating margin to reach the mid to high 50% range in F2010 and for EPS growth to exceed 20% in F2010 and F2011. In terms of costs, we think there are still some efficiencies to be realized as a result of the reorganization prior to the IPO, most of the low hanging fruit appears to be gone, and we maintain that in order to save money, Visa will likely have to spend a little up front. But outside of purposeful increases in discretionary investments in areas like R&D, product development, and A&M, we do not expect Visa's fixed costs to meaningfully increase over the next few years.

We believe that Visa should break out R&D and product investment costs to allow investors to get a better feel for how management is allocating resources.

We estimate Visa has enough leverage on the tax expense line, and enough cash, to buy back stock to at least partially mitigate any operating margin decline on its reported EPS growth if its expenses were to increase to a certain degree.

Valuation and Risks

Our $120 price target reflects a gradual rebound and P/E multiple in line with its two-year average (a blend of 22 times C2011 EPS and our DCF, which assumes a WACC of 7.9%, 10.5% revenue growth through 2020, and 4.5% terminal growth).

Key Risks: Margins stop expanding (or even settle back) and revenue growth does not rebound materially (impact on P/E); Competition intensifies in emerging markets or in product areas targeted for investment; Consumer savings rates continue to climb and US credit growth rates continue to be muted; Headline risk regarding interchange reform and/or speculation about potential outcomes of pending litigation.

MORGAN STANLEY
BEST IDEA

Company Analysis

February 22, 2010

Walt Disney
Estimates and Price Target Raised

Morgan Stanley & Co. Incorporated

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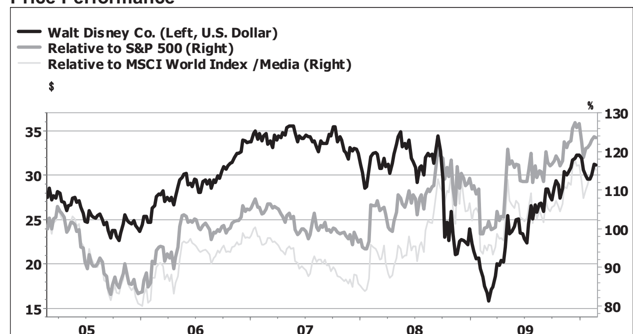
Stock Rating: Overweight	Reuters: DIS.N Bloomberg: DIS US
Price target	$37.00
Shr price, close (Feb 22, 2010)	$31.12
Mkt cap, curr(mm)	$58,599
52-Week Range	$32.75-15.14

Fiscal Year ending	09/08	09/09	09/10e	09/11e
EPS($)**	2.25	1.80	1.98	2.35
Consensus EPS($)§	2.27	1.82	1.97	2.26
ModelWare EPS($)	2.28	1.80	2.01	2.35
P/E	13.5	15.2	15.5	13.2
Div yld(%)	1.1	1.3	1.1	1.2

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

Price Performance



Source: FactSet Research Systems Inc

Company Description
Walt Disney is engaged in three main business areas: creative content, broadcasting, and theme parks and resorts.

Industry View: Attractive — Media
We believe that macroeconomic indicators in addition to easing comparisons suggest 2010 could surprise the market with respect to overall advertising growth, and that there is likely upside to current consensus estimates in the event of a steady advertising recovery in 2010.

We remain Overweight DIS and are raising estimates following strong 1Q10 results. Our view on DIS is based on 1) its leverage to an advertising and consumer recovery in 2010-2011, 2) its secular growth from key assets including ESPN, and 3) our view that consensus 2011 estimates underestimate the operating leverage DIS should show coming out of the current downturn.

Relative to our Overweight thesis, the 1Q results and 2Q advertising trends highlighted advertising strength at ESPN and the ABC stations. In addition, stronger than expected affiliate revenue growth from ESPNU also helped the cable networks segment, which saw 20%+ consolidated 1Q10 EBIT growth. Two other legs to our thesis — a consumer/theme park recovery and a creative cycle at the film studio — remain ahead of the stock. However, both segments saw stronger than expected cost management as margins were ahead for 1Q10.

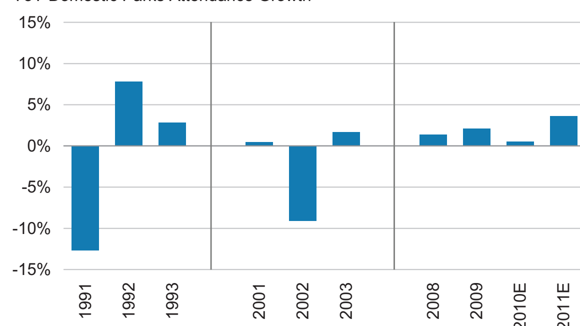
We are raising our 2010 and 2011 estimates to $1.98 and $2.35 respectively. Our new 2010 estimate reflects a faster recovery in broadcast advertising vs. our prior model at both the ABC network and the local TV stations. Film margins were also higher than expected in Q1; later quarters should benefit YoY from F2009's multiple film-write downs. We expect 8% ad growth and double-digit affiliate growth at ESPN.

The debate is shifting, following the strong advertising pacing for Disney and peers in the March quarter, with a greater focus on turn in theme parks and studio performance. Looking towards F2011, we expect a new debate to emerge, specifically the potential for ESPN to see meaningful increases to its already industry leading affiliate fee as it faces the expiration of a major distribution contract this Fall.

Cyclical drivers of advertising and theme parks augment strong secular growth from core ESPN: Among national cable networks, ESPN has more auto exposure at 15% of ad revenue. We expect auto advertising to grow 20% in 2010, which we believe is above consensus. We think the Street is also underestimating the theme park segment potential in 2011 as consumer recovers and the first of two new cruise ships launches.

Exhibit 1

Expect Parks Attendance Growth to Recover in 2011

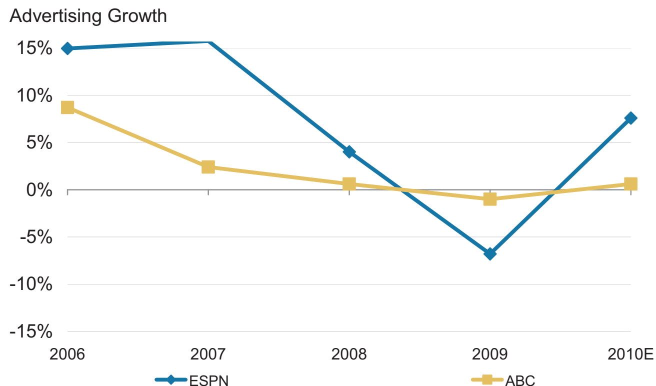


Source: Company data, Morgan Stanley Research E = Morgan Stanley Research estimate

Company Analysis

Exhibit 2

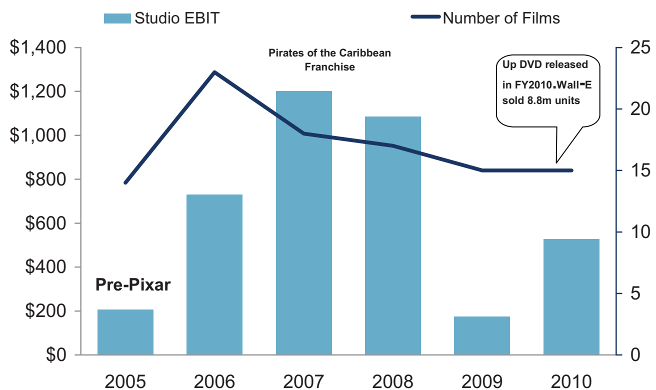
Expect High-Single-Digit Ad Growth at ESPN in 2010



Source: Company data, Morgan Stanley Research E = Morgan Stanley Research estimate

Exhibit 3

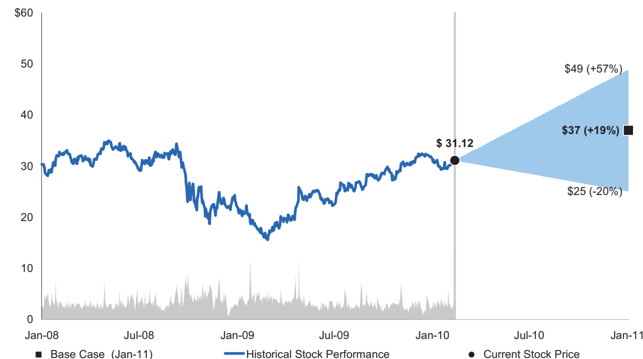
Upside to EBIT if Slate Performs Well; Focus on Smaller Number of Films Despite Marvel Deal



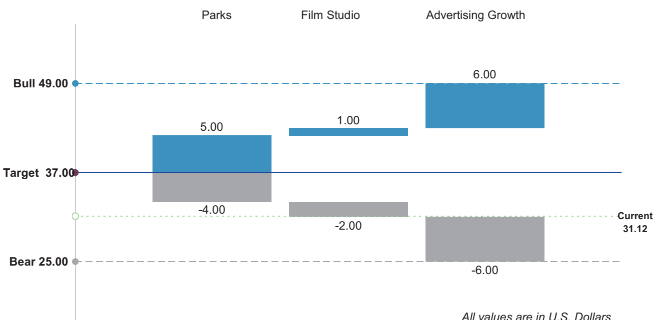
Source: Company data, Morgan Stanley Research estimates.
Wall-E DVD units are units sold to date per www.the-numbers.com

Exhibit 4

DIS: Earnings Upside Even if Parks Stay Depressed



Bull Case $49	18x Bull Case F2011e EPS	**V-Shaped Ad Recovery in 2010.** Advertising grows 8% buoyed by rising pricing and strong ratings at ESPN. Film EBIT is $590m vs. $175m in F202009. Parks attendance increases by 6%. Stock returns to recent five-year average fwd. P/E of 18x.
Base Case $37	16x Base Case F2011e EPS	**Steady Advertising Recovery in 2010.** Advertising grows 4% driven by ESPN advertising up 7.5%. Film EBIT is $550m vs. $175m in F202009. Parks attendance is flat versus up 2% in 2009 as discounting is pulled back.
Bear Case $25	13x Bear Case F2011e EPS	**Advertising Budget Cuts Continue in 2010** Advertising declines 2%. Film EBIT is $450m vs. $175m in F202009. Parks attendance is down 5% as economy double dips.



Source: FactSet, Morgan Stanley Research

Pivotal Investment Debate

- **Strong cyclical and secular growth drivers.** While the Marvel transaction is dilutive in 2010, we see 15-20% EPS growth annually from Disney in F2011-F2012. EPS growth will be driven by an advertising recovery in 2010 and a theme parks recovery in 2011.
- ESPN will begin a new round of distribution contracts in mid-2010 and we believe the market is missing the potential upside from higher affiliate fees.
- We think Disney returns to normalized EPS of $2.30-2.50 by F2011 which is above consensus, and that it can trade towards its recent historical average P/E of 18.x.

Potential Catalysts

- **Improving consumer:** Disney is more cyclical than its peers, given its advertising, theme park, and consumer products exposure.
- **Retransmission announcements:** While less exposed than peers, ABC stations and network have potential for upside from retransmission renewals.
- **Share repurchases:** After an absence from the market in the past year, we expect DIS to return to market for buybacks.

Risks

- If auto advertising remains depressed, our ESPN estimates could be high, although advertising is only one-third of ESPN revenues..

International

February 11, 2010

CITIC Pacific
Inexpensive Access to Commodity Boom — Overweight with 31% Upside Potential

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Stock Rating: Overweight	Reuters: 0267.HK Bloomberg: 0267 HK
Price target	HK$21.00
Upside to price target(%)	31
Shr price, close (Feb 5, 2010)	HK$16.06
52-Week Range	HK$24.25-7.18
Sh out, dil, curr(mn)	3,646
Mkt cap, curr(mn)	HK$58,559
EV, curr(mn)	HK$113,500
Avg daily trading value (mn)	US$17

Fiscal Year ending	12/08	12/09e	12/10e	12/11e
ModelWare EPS(HK$)	0.49	1.00	1.72	1.62
EPS, basic(HK$)*	(5.69)	1.53	1.72	1.62
Consensus EPS(HK$)§	(2.45)	1.39	1.39	1.68
Revenue, net(HK$mn)	46,420	47,034	57,013	72,298
EBITDA(HK$mn)	3,103	7,282	10,897	13,453
ModelWare net inc(HK$mn)	1,086	3,643	6,282	5,899
P/E	17.2	20.9	9.3	9.9

§ = Consensus data is provided by FactSet Estimates.
* = GAAP or approximated based on GAAP
e = Morgan Stanley Research estimates

Company Description
CITIC Pacific has diversified business interests focused on Hong Kong and China. In order of importance, the company is involved in: specialty steel manufacturing and iron ore mining, property investment and development, power generation, telecommunications, tunnel operation, auto distribution, and aviation.

China Multi-Industry
Industry View: In-Line
Companies within this industry group are exposed to broad business portfolios, which reflect basic trends in the China economy.

We have initiated coverage of CITIC Pacific with an Overweight rating and HK$21.00 price target. CITIC is the largest specialty steel producer in China, and we expect the current commodity up-cycle to drive 70% earnings CAGR in 2009-12. Valuation is appealing at a 36% discount to our estimated NAV, or 9x our 2010E EPS. From such levels, CITIC shares have historically outperformed the Hang Seng Index by 43% in the subsequent 12 months.

Where we differ: Our 2010 earnings forecast is 24% above the Street's, while our 2011 estimate is 4% lower.

Investment Positives

Valuation has reached historical low: CITIC is trading near the low end of its historical trading range, at a 36% discount to NAV, or 9x our 2010e EPS.

Earnings recovery not in the price: We expect ROE to recover to 12% in 2010, above the 9-10% achieved in 2004-2007, but the valuation is lagging at 1.1x P/B, compared with 1.2-1.3x during 2004-2007.

Steel division to stand out in 2010e: CITIC derives 26% of its NAV from the steel business, which we expect to deliver 80% earnings growth in 2010 on industry recovery and added capacity. We believe the current steel price uptrend is sustainable, given a solid global demand recovery.

Upside from iron ore project understated: While consensus has low expectations for the iron ore project, given CITIC's limited track record in this area, we expect the project to generate a decent annual return of around HK$3 billion, or a 12% internal rate of return, once it is fully operational in 2012.

Divestments remain a call option: Although we do not expect divestments in the near term, given CITIC's sufficient cash position, we expect them to remain a viable option should financing needs arise. On January 29, 2010, CITIC announced that it is considering selling a minority stake in Dah Chong Hong.

Investment Concerns

Heavy spending mode in 2010e: We expect CITIC to record negative free cash flow of HK$12 billion, or HK$3.3/share, in 2010. This could weigh on near-term stock performance, we believe, unless the company disposes of more assets.

Policy change a wildcard: The Chinese property industry is highly susceptible to policy risks. The government has reversed its supportive policy stance and is acting to calm down property prices via tighter liquidity and increased land supply. Draconian measures would hurt CITIC's property division, we expect.

High exposure to cyclical assets: Conglomerates have an advantage over other companies in terms of risk diversification through their exposure to both growth and cyclical assets; such exposure makes conglomerates defensive plays during

International

downturns. However, around 80% of CITIC's NAV and earnings are tied to cyclical businesses.

Key Investment Debates

1) How sustainable is the steel recovery?

Market view: The current recovery is due to restocking, which may not be sustainable.

Our view: We believe steel is firmly on a recovery path in 2010 due to improvement in net exports.

Where we could be wrong: If the global economy relapses into recession, steel demand could suffer.

2) Will soaring iron ore costs impair steel margins?

Market view: Soaring iron ore costs could squeeze steel margins going forward.

Our view: Following the completion of the Sino Iron project in 2011, higher iron ore price will be a driver of, rather than a drag on, the steel division.

Where we could be wrong: A significant project delay at Sino Iron could limit CITIC's ability to hedge iron ore cost hikes in the forecast period.

3) Is CITIC vulnerable to a China property downturn?

Market view: A China property downturn is negative for a property developer like CITIC.

Our view: We expect the company to withstand macro headwinds in the property industry, given its defensive portfolio – around 80% of the property NAV is in Shanghai, where supply is scarce.

Where we could be wrong: A shift in policy to a tightening mode could lead to a sharp decline in property prices.

4) Is CITIC financially stressed?

Market view: CITIC may run into liquidity stress with its heavy investment in iron ore and property.

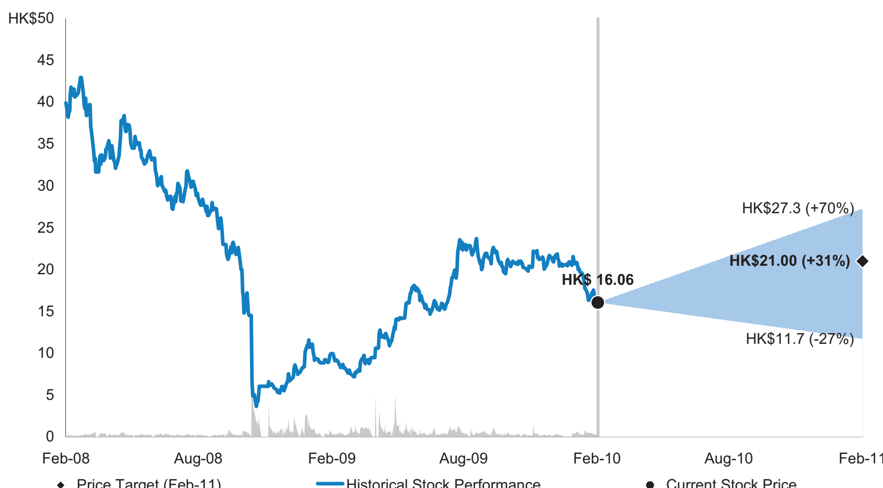
Our view: CITIC has cash and available facilities amounting to HK$26 billion as of end-2009e, sufficient to cover its HK$12 billion free cash outflow and HK$6 billion loan repayment in 2010e. It is also in the process of raising an additional HK$10 billion in debt to fund its operations in 2011-12.

Where we could be wrong: Capital spending on the Sino Iron project significantly above our estimates could result in cash constraints on CITIC.

Valuation: Our HK$21.0 price target is based on a sum-of-the-parts valuation analysis combining various methodologies. We use price/book value multiples to value CITIC's steel operations, discounted cash flow for its iron ore and property development businesses, and capitalized rental income stream for the investment property portfolio. We then apply a 15% target NAV discount to derive our price target.

Downside risks include lower-than-expected steel prices and declining property prices.

Risk-Reward View: Tilting to the Upside



Bull Case HK$27.3	**Higher materials and property prices as inflation heats up:** 2010e steel prices +23%; iron ore prices +30%; property prices +20%; rental up 10% annually in 2010/11e.
Base Case HK$21.0	**Commodity prices driven by solid demand; neutral outlook on property:** 2010e steel prices +12%; iron ore prices +20%; property prices flattish; rental up 10/5% in 2010/11e.
Bear Case HK$11.7	**Lackluster demand for materials on weaker than expected economy:** 2010e steel prices flattish; iron ore prices +15%, and 12-month delay for Sino Iron project; property prices -30%; rental up 5% annually in 2010/11e.

Source: FactSet, Morgan Stanley Research

International

February 17, 2010

Toyota Motor
J-Insight: Reiterate Overweight — Excessive Bearishness to Correct

Morgan Stanley Japan Securities Co., Ltd.+

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What's Changed	
Price Target	¥5,150 to ¥4,350
F3/11e Operating Profit	¥895.5bn to ¥734.8bn

Reiterate Overweight: Quality concerns have severely depressed the share price, but we believe the stock is highly undervalued on our revised F3/10-11e, which factor for market share loss. We lower our PT from ¥5,150 to ¥4,350. The stock trades at 4.3x, while P/B of 1.0x and P/Sales 0.55x are close to levels in early 2009, when visibility on the demand outlook was very poor.

Assume US market share of 14%, in line with F3/06: Recall-related newsflow will inevitably eat into the Toyota brand's US market share. Our base case is a fall to 14% in F3/11, matching F3/06 (2009: 17%). If the situation clears quickly we see a drop to 16% or so (our bull case). Our bear case entails brand image continuing to suffer and market share at 11% (F3/04 level), but the odds here are slim.

F3/11 forecast revisions: We cut our F3/11e OP from ¥895.5bn to ¥734.8bn. However, this ¥160bn downward revision is ¥350bn in real terms considering baseline earnings improvement in F3/10, and closely approximates to profit damage from loss of market share. We also allow for ¥110bn in added impact from forex rates and high raw materials prices, but expect lower recall costs and overhead cuts to offset this. We lower our NP forecast from ¥749.7bn to ¥645.7bn.

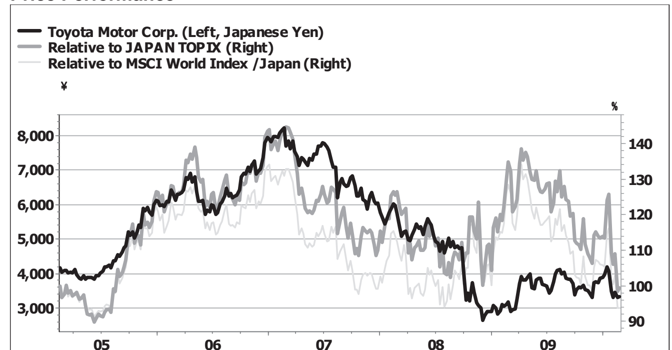
Communication from top management key to bridging gap with customers: The root of Toyota's troubles now is its distancing from customers, in our view. The vehicle faults and claims themselves are not of a level to threaten the Toyota brand. What has really upset customers is a tardy response that has created a vacuum for reports that the firm is at crisis point. Key to regaining customer trust rests with communication from top management.

Stock Rating: Overweight	Reuters: 7203.T Bloomberg: 7203 JP
Price target	¥4,350
Upside to price target(%)	29
Shr price, close (Feb 16, 2010)	¥3,380
Mkt cap, curr, basic(bn)	¥10,614.9
Div yld (03/10e)(%)	1.5

Fiscal Year ending	03/09	03/10e	03/11e	03/12e
Rev, gross(¥bn)	20,529.6	18,634.3	19,239.9	20,587.8
Operating profit(¥bn)*	(461.0)	(16.1)	734.8	1,339.4
PBT and eqty-method invstmnt inc(¥bn)	(560.4)	105.6	841.4	1,445.8
Net income(¥bn)*	(436.9)	86.8	645.7	1,059.4
EPS, basic(¥)*	(139.1)	27.6	205.6	337.3
Prior EPS, basic(¥)*	-	16.3	238.7	338.4
ModelWare EPS(¥)	(139.0)	27.6	205.3	336.9

* = GAAP or approximated based on GAAP
e = Morgan Stanley Research estimates

Price Performance



Source: FactSet Research Systems Inc

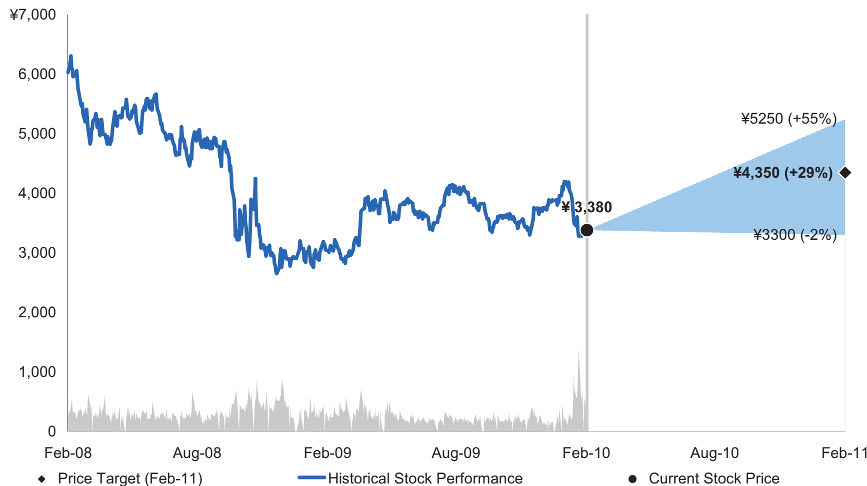
Company Description
Toyota is the largest automaker globally in terms of both production and sales units. Toyota Group umbrella also includes light vehicle/truck businesses. Building a vast lineup of models in every region globally. R&D capability of the Toyota Group, starting with its hybrid technology, is at the forefront of the industry. Current issue for management is regaining customer confidence in the aftermath of recalls in 2009-10.

Autos/Japan
Industry View: Attractive
Global auto demand is back to normal recessionary levels, and with automakers paring back overhead costs, earnings recovery in the auto industry is emerging. Our industry target EV/EBITDA is 6.0x our F3/11 estimates, based on the multiple during past earnings recoveries.

International

Risk-Reward Snapshot: Toyota Motor (7203.T, ¥3,380, OW, PT ¥4,350)

Risk-Reward View: Keys are faster recovery in N. American market, edge in environmental technology, premium brand recovery, FX



Price Target ¥4,350		Given potential for recall-related news to lengthen the time for the stock to reach our base case price, we set our PT at 6.6x EV/EBITDA (10% premium to our industry standard), a lower level than our base-case fair value (7.2x).
Bull Case ¥5,250	F3/11e OP ¥1.025trn, EV/EBITDA 7.2x	Here, FX rates are ¥95/$, ¥135/€. With other currencies this adds about ¥220bn to profit. N. American sales share only narrows about 1% from 17% in CY09 to 16%. The backlash to subsidies in Japan/Europe is milder than we foresee. Sales/mix adds another ¥250bn to profit, but rising overheads along with rising sales detract ¥180bn vs. our base case forecast. The positive surprise of limited loss of share boosts EV/EBITDA on our F3/11 estimates to 7.2x.
Base Case ¥4,630	F3/11e OP ¥734.8bn, EV/EBITDA 7.2x	We assume FX of ¥90/$, ¥125/€. In N. America, the firm lags overall demand recovery in F3/11 as the recall trims its share by 3% vs. CY09 to 14%, though shipment volume rises 5% with the end of inventory adjustments. For Japan and Europe we expect sales falls of 8% in both regions with the end of subsidies. For other regions (Australia, Latin America, etc.) we foresee a reflexive YoY rise of about 20%. We see a profit boost of ¥196bn from volume/mix, coupled with reduction in NUMMI closure costs. We also expect lower COGS to add ¥310bn, but high raw materials prices to pare ￥60bn. We foresee a ¥428bn boost to profit from reduction in overheads. As excessive concerns about recall damage ease, we expect the valuation to regain a premium over our standard for the autos industry (6.0x).
Bear Case ¥3,300	F3/11e OP ¥150bn, P/B 1.0x	The yen appreciates to ¥85/$ and ¥115/€, and with other currencies this pares about ¥220bn from profit. The slump in the firm's N. American share (11%) digs in and volume/mix factors pare ¥350bn. Growth in overheads is less than we expect, and this adds ¥80bn to profit, but F3/11 OP only reaches ¥150bn. As expectations of earnings recovery fade, the stock is valued at 1.0x F3/11e BPS.

Note: Share price as at Feb. 15, 2010, close
e = Morgan Stanley Research estimates
Source: FactSet, Morgan Stanley Research

Investment Thesis

- Product portfolio is defensive, with exposure to all segments.
- Stiffer competition in the hybrid segment could enhance recognition of Toyota's superiority.
- Sustainable cost reductions yield high operational leverage.
- We expect the firm to solidify a customer-centric management policy as it responds to the quality issues.

Key Value Drivers

- Sales recovery eradicates concerns about the worst-case scenario for loss of N. American share.
- Ongoing curbs on fixed costs lower the earnings breakeven point.
- Reversion to Toyota's normal 'pull marketing'

Potential Catalysts

- Response to the risk of medium-term slump in domestic demand in the form of consolidation of domestic sales channels
- Developments in technology alliance strategy focused on hybrid technology

Risk Factors

(1) FX movements (strengthening yen), (2) prolonged depression in N. American share, (3) drop in margins as the compact car segment is beefed up

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