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Downunder Daily

A Get-Out-of-Jail-Free Card

This time is not different – at least not in terms of the initial investor response to an unexpectedly aggressive Fed rate cut. But I'm not convinced that the Fed's move makes a material difference to the risk of recession, which is the decisive issue for medium-term investors. A few thoughts:

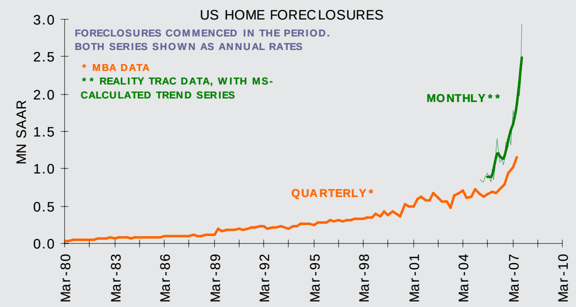
First, rate cuts are like tequila shots: You rarely have just one. Morgan Stanley US economist Richard Berner expects the FOMC to ease by a cumulative 100 basis points. The prospect is underlined by the second-round collapse in housing indicators. For example, Reality Trac reported overnight a substantial jump in housing foreclosures in August (Exhibit 1).

Second, equities usually perform well in the initial stages of a Fed easing cycle. Morgan Stanley European strategist Teun Draaisma has provided a nice summary of past equity performance around the first Fed cut (see *Striking Statistics*, 17 September). Teun notes that historically the first rate cut may only stabilize markets, while better returns follow the second easing. Rightly, however, Teun notes that it's not a stretch to argue that the discount rate cut was the first easing in this cycle.

Third, equities are a sell in extended Fed easing cycles. That's because extended easing cycles usually occur in recessions, and recessions are always bad for equities. But even within recession-driven bear markets, Fed rate cuts can provide a short-term boost for the market, particularly if they are unexpected. Amidst the TMT rout of 2000-03, the NASDAQ jumped 14% on the day of the first (surprise) Fed cut in 2001. Of course, in a bear market, it pays to sell such bounces.

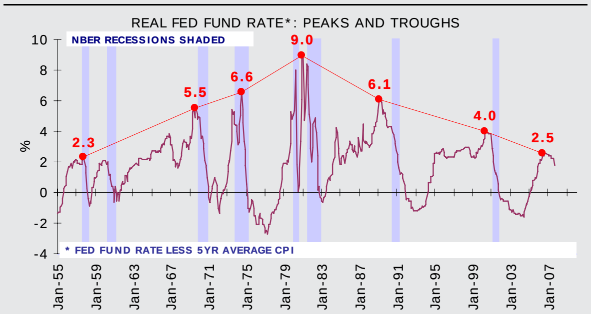
With the daily run of economic data soft, but not providing compelling evidence of recession, my base case assumption is that the Fed easing will provide support for equities in the next quarter or so. For medium-term investors, however, the key issue remains simple: Is the US heading into recession?

Exhibit 1
Exploding Foreclosures



Source: MBA, Reality Trac; Morgan Stanley Research

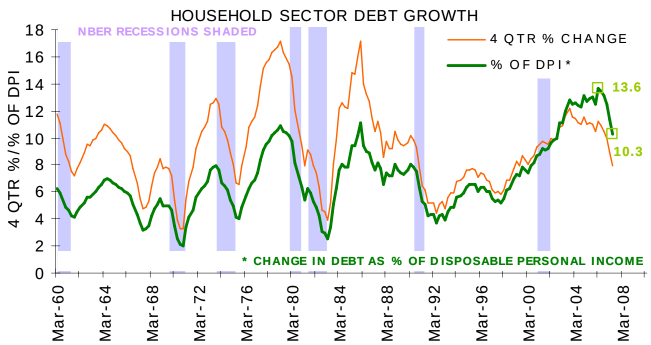
Exhibit 2
Another Lower Low



Source: Federal Reserve, BLS, NBER; Morgan Stanley Research

A few comments on that big-picture issue. First, I think it's noteworthy that having now marked the top of the tightening cycle that started in 2004, the funds rate has followed the pattern of lower lows/lower highs evident since 1980 (Exhibit 2). To me, this is important evidence that in a world of rising leverage, monetary policy packs a bigger punch. More to the point, the profile of successively lower lows in nominal rates suggests to me that the rate cuts in this cycle will extend further than most expect.

Exhibit 3
What Recession?



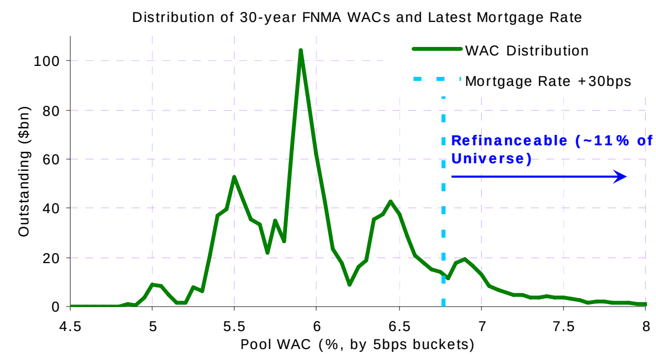
Source: Federal Reserve, BEA, NBER; Morgan Stanley

Second, in this cycle, the recession risks are centered in the household sector; last time it was the corporate sector. The household sector is now the highly indebted/cash-flow-negative sector. (And, as with the corporate sector in 2000, the household sector's balance sheet – at market values – now looks fine.) More than usual, consumer-related data will provide the clearest guidance on the recession risk.

Third, I believe that in this cycle the benefits of looser monetary policy will not be easily transmitted to the household sector. This is the reverse of the last recession. Uniquely, the household sector accelerated its borrowing through the 2001 recession: Exhibit 3 shows the change in household debt, both in four-quarter change terms and relative to disposable income.

The bulk of household debt is mortgage-related, most of which remains tied to long-end rates. The boom in borrowing through the last downturn reflected the fall in long-end rates and the willingness of households to refinance their mortgages. Ten-year Treasury yields hit their cycle low in June 2003 at 3.1%. That means, however, that the key to providing renewed monetary stimulus to households is getting long-end rates down to levels that make refinancing again attractive. To do that, long-end rates need to fall significantly from current levels (Exhibit 4). As it turns out, 10- and 30-year Treasury yields rose after the Fed cut last night.

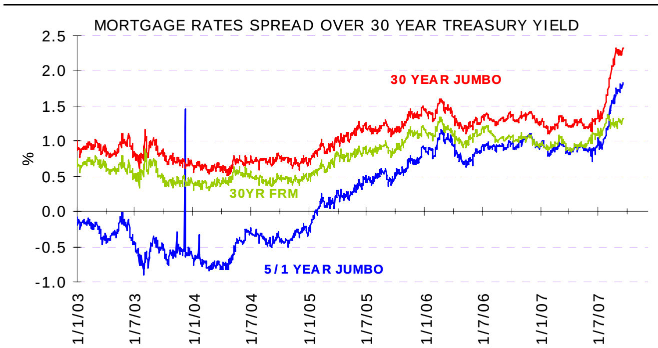
Exhibit 4
Where the Mortgages Lie



Source: Janaki Rao, Morgan Stanley Research

In this context, the important 'credit crunch' is not what is happening in the land of high finance, or commercial paper, but the tightening in mortgage lending. Exhibit 5 shows a selection of mortgage rates relative to long-end Treasury yields. Not captured here is the fact that mortgage finance is simply not available for a range of borrowers that did have access through the past few years. Also not captured here are the prospective mortgage resets that mean that, notwithstanding today's Fed rate cut, many borrowers face a material tightening in 'monetary policy' in coming quarters.

Exhibit 5
The Important Tightening



Source: Bloomberg, Bankrate.com; Morgan Stanley Research

In short, it's my view that this Fed easing cycle will have less impact than the usual cycle. Certainly, today's move does little to change what I consider the fairly high risk of recession in 2008. That, in turn, fits with my view that any near-term rally in stocks will be one that investors have to sell into on a 12-month view.

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