

October 1, 2007

Downunder Daily

The Phony War

Take your pick: equity markets are either behaving as if the worst is over for credit and housing problems or they remain convinced that the Fed can offset whatever bad news may unfold. The end result is the same: the consensus remains solid that the US will soft-land and that rates will head lower – which is seen as a marvelous combination for equity assets, not just in the US but globally.

This phony war can last a little longer, in my view. Until there are casualties – and, in an economic sense, that means sustained job losses – investors will remain confident in a Fed-engineered soft-landing. While ever that remains the case, equity markets are likely to continue to follow the recent pattern: 'soft growth = Fed cuts = equities rally'.

However, the view that the worst is over is dead wrong in my opinion. Certainly, the residential construction recession has been evident for some time, but even so it seems set to run well into next year, based on our US team's forecast. But the bigger issue – the important issue for investors – has always been the extent of the knock-on to consumer spending, and then the labour market. I expect the knock-on to come through several routes:

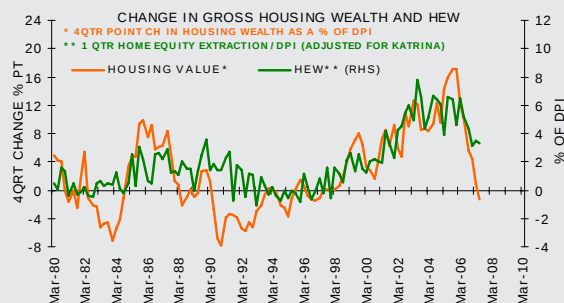
First, the household sector continues to draw substantial equity from its dwelling wealth – equivalent to 3½% of household income over the year to the June quarter. There is a close relationship between home equity extraction and the change in housing wealth, so it seem likely that extraction will fall in coming quarters (Exhibit 1).

Second, as is well known, the mortgage reset wave is yet to crest. Exhibit 2 is from colleague Janaki Rao, showing estimated resets.

Third, potential borrowers have to cope with a material tightening in financial conditions. One gauge of that

Exhibit 1

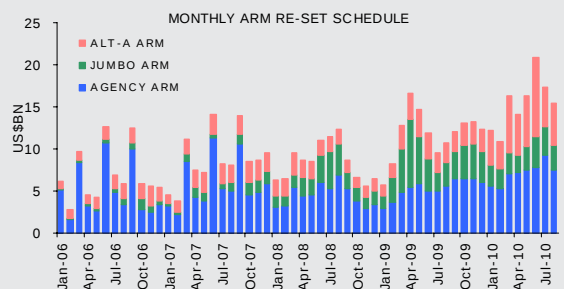
Awaiting The Extraction Contraction



Source: Federal Reserve; Morgan Stanley Research

Exhibit 2

Reset Wave Yet To Crest



Source: Janaki Rao; Morgan Stanley Research

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October 1, 2007
Strategy and Economics

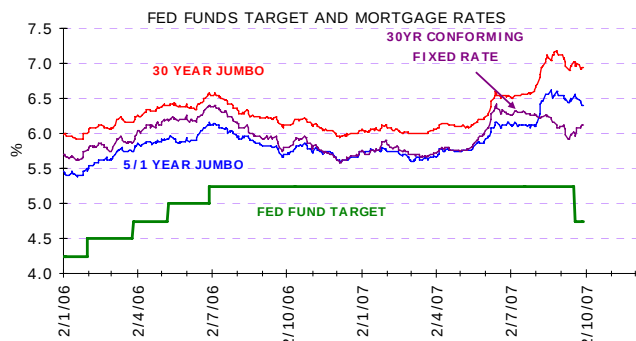
tightening is the rise in mortgage rates. Despite the Fed's rate cut, mortgage rates are now at or near cycle highs (Exhibit 3).

More difficult to gauge, however, is the tightening in lending standards. As I've noted before, over US\$2 trillion was lent to sub-prime borrowers over the past four years; they will not have anywhere near that credit on offer going forward, regardless of what happens to rates.

Finally, these prospective events will likely compound each other. Mortgage resets will likely lead to rising foreclosures and hence forced property sales, which in turn will depress prices (Exhibit 4), which will compound the likely decline in home equity extraction.

Exhibit 3

Rates Go Higher, Not Lower



Source: Bloomberg, Bankrate.com; Morgan Stanley

Easier Fed policy seems likely to do very little to change the transmission of weakness from housing to broader consumer spending.

Remember, the key to the Fed easing monetary conditions for the household sector is getting long rates down. Long rates have not come down: in fact, there is a hint that the Greenspan conundrum – the unexpected decline in long rates in the face of tighter Fed policy – has been supplanted by a Bernanke conundrum, rising long-rates as the Fed eases. Admittedly, I don't expect this to last: if growth weakens as I expect, then Treasury yields will come down. But the simple point for now is that the Fed rate cut did not lead to an easing in what in this cycle is the most important interest rate: the mortgage rate.

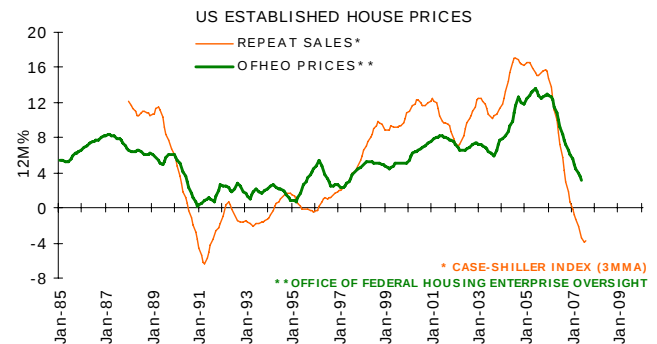
Taking this a second step, it is important to understand the limitations of Fed policy in this cycle. A common view

seems to be that the Fed has 'reloaded' the monetary policy shooter. Yes, the funds rate target, which was cut in the last cycle downswing from 6½% to 1%, was returned to 5¼%. But from a household sector perspective, short rate bullets are blanks: what matters is the long rate. The average effective interest rate on the stock of mortgage debt is now 6.3%, only marginally above the 2004 low of 6.1%. That is in part because the wave of mortgage refinancing that occurred in 2002-03 – as the long-end Treasury yield fell towards 3% – has locked in mortgages at what are now well-below market rates.

To stretch the metaphor, the Fed's reloaded the pistol but its rifle is empty. Yes, those mortgages will be able to be refinanced if Treasury yields head back towards 3% (or, more realistically, below 3% given the widening spread between mortgage rates and Treasury rates). But if we do see Treasury yields below 3% (and ultimately I do expect that) I believe that it will be because the US is already in recession.

Exhibit 4

Prices Will Fall Further



Source: OFHEO, Standard & Poor's/Case-Shiller; Morgan Stanley Research

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