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Downunder Daily

Decoupled but in Synch?

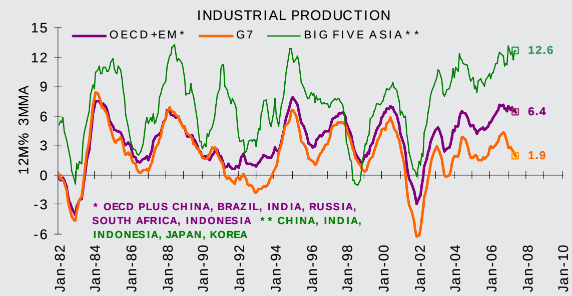
There are tentative signs of developed-economy slowdown outside the US. Those signs may not reflect the transmission of US weakness to the rest of the world; instead, growth may be slowing independently, due to tighter policy in other important economies. In other words, this may not be a matter of economic coupling, but the major developed economies may continue to be synchronized. A few thoughts:

First, I continue to believe that for investors (as distinct from economists), the coupling/decoupling debate is a sideshow: Regardless of the economic linkages, the recent correction has again demonstrated that markets remain highly coupled. As a result, if there is a US recession that leads to a bear market in US assets, then risk assets everywhere would suffer whether or not the economies prove to be coupled.

Second, while the evidence for now supports the view that the emerging economies have been able to decouple from slower US growth, the decoupling hurdle would be significantly higher if growth started to slow in Europe and Japan. In that scenario, the issue would be whether the emerging economies can decouple from a broad-based OECD slowdown.

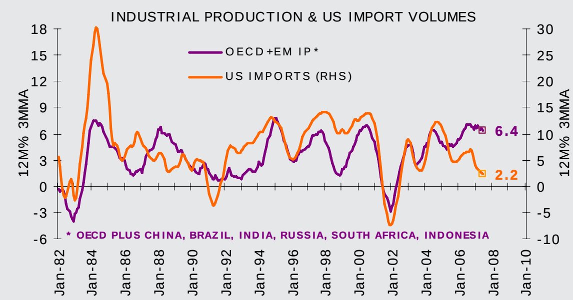
Admittedly, the rest of the world has coped well so far with slower US growth. While overall OECD industrial production is growing at a moderate pace, production in the major emerging economies remains at cycle highs (Exhibit 1). More impressively, production has remained strong in the face of a material slowdown in US import demand (Exhibit 2). It's also notable that for the first time in 20 years, Asian exports have accelerated at a time when US manufacturing orders have slowed (Exhibit 3).

Exhibit 1
Decoupling Here…



Source: OECD; Morgan Stanley Research

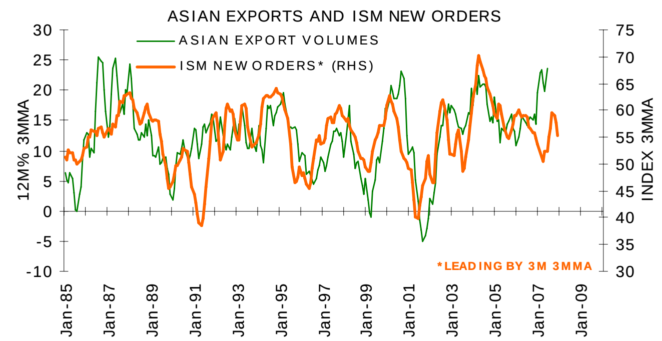
Exhibit 2
…And Here



Source: OECD, BEA; Morgan Stanley Research

Third, the main reason to expect a synchronized slowdown is that we have seen synchronized policy tightening. As I see it, investors risk making the mirror image of the mistake many made (myself included!) in 2002-03: forgetting about those famously long and variable lags between monetary policy changes and real economy responses. In 2002-03, global central banks had put in place extraordinarily loose policy, yet risk assets remained in a funk and growth was lackluster. Obviously, that all changed. Now, with risk assets buoyant, it's seemingly forgotten that there has been a significant tightening in policy, not just in the US, but throughout the OECD.

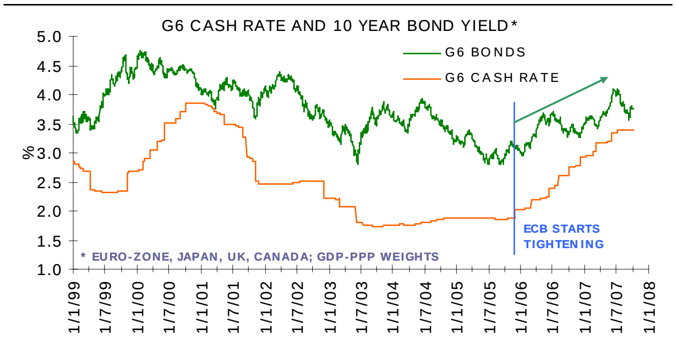
Exhibit 3
There Are Lags Involved



Source: ISM, IMF; Morgan Stanley

Exhibit 4 shows long and short rates in the G6 (that is, the G7 excluding the US). Although short rates are not as high as in 2000 – which was tight enough to precipitate a mild recession – my hunch is that they are now high enough to trigger a material slowing in activity.

Exhibit 4
And Policy Has Been Tightened



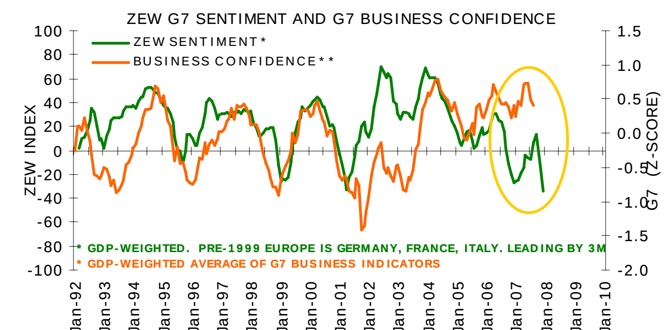
Source: Bloomberg; Morgan Stanley Research

Moreover, not captured here are two other factors. The first is the willingness or otherwise of lenders to provide finance.

The recent tightening in standards – reflected in part by wider credit spreads – adds to the general restrictiveness of official rates. The second is currency changes. Globally, currency changes are zero-sum; but with the US$ falling sharply, it's clear that currency changes must be adding to restraint in the rest of the world. That's particularly true for Europe. Overnight, the European purchasing managers' index fell to a two-year low. Eric Chaney, Morgan Stanley's chief European economist, is now pointing to clear signs of slowdown in Europe, and no longer rules out a cut as the next move in European Central Bank policy (see *The Economy Is Cooling*, 28 September).

Certainly, the ZEW indices – which capture financial analysts' expectations – have now turned pessimistic. As with monetary policy, this expectations series has a history of long and variable lead time over business confidence (Exhibit 5).

Exhibit 5
Confidence Past Its Peak?



Source: OECD, ZEW; Morgan Stanley Research

My view is that, at a minimum, after four years of persistent upgrades to growth and earnings expectations, we are about to enter a period of downgrades. Time will tell how severe those downgrades are, but the shift will make it even less likely that global asset markets can decouple from a bear market in the US, if that is what ultimately unfolds.

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