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Downunder Daily

Hiccup Warning

Calling short-term market moves is not my forte, but several on the Morgan Stanley team now see the chance of a short-term consolidation/correction in equity markets. Note, however, that none of these colleagues is bearish on the medium term, and all see any near-term pullback as a chance to reload for further gains.

The common theme is that after the recent sharp gains, a pause is warranted:

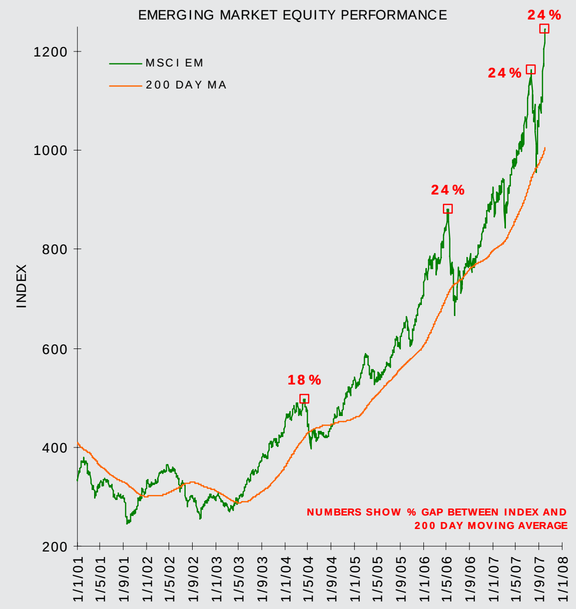
Jonathan Garner, our Emerging Market strategist, has clipped his recommended overweight to his markets. The global MSCI emerging market index has gained 33% from its intra-day low on 17 August. Jonathan notes that emerging market corrections have typically come when the market is 20% or more above the 200-day moving average. The index is now 24% above that average (Exhibit 1).

Wiktor Bielski, our global head of mining research, likewise sees the prospect of a pullback in mining stocks. This sector has bounced in line with the emerging market indexes. It's notable, in my view, that stock prices have run far harder than metal prices over the past few weeks (Exhibit 2).

Finally, Paul Ruddlestone and Paul Keohane, our Global Market Trading Strategy team, noted on Tuesday that two important indices, the Hang Seng and the NASDAQ 100, had hit the strategists' target level for this year, and hence could see a pullback.

Market corrections aren't always connected to fundamental news, but Friday's non-farm payroll report is an obvious catalyst. Depending on how the data print, the report may reveal how much the recent equity rally has relied on the prospect of lower rates versus the view that the worst is past for the US growth scare.

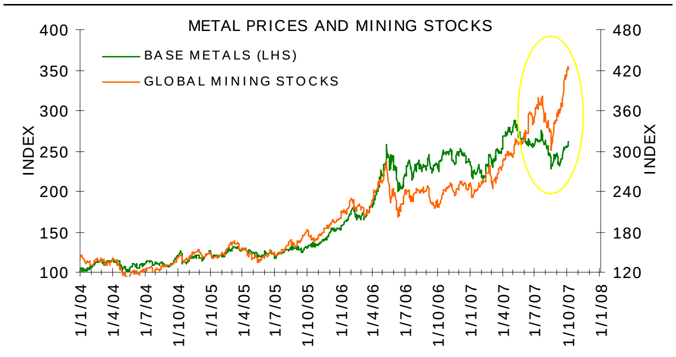
Exhibit 1
Time for a Rest?



Source: MSCI; Morgan Stanley Research

Our US economics team is forecasting a rise of 125,000, while consensus is expecting 98,000. Either way, an increase of that order would confirm that the August decline was an aberration, and, more importantly, provide support for the view that the US is heading for a soft landing. (I'm not implying that I would be persuaded by it!) More to the point, it would also likely reduce the perceived chance of a rate cut at the 31 October FOMC meeting.

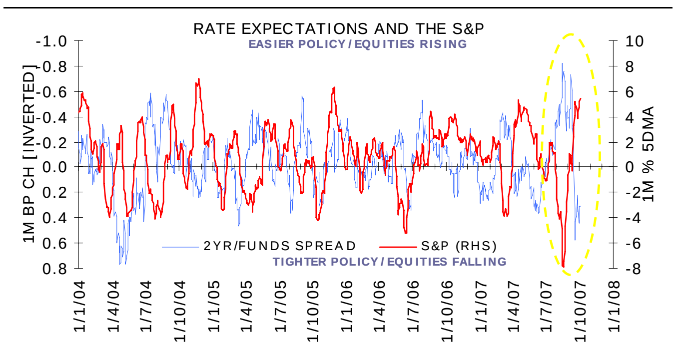
Exhibit 2
Stocks Leave Behind the Spot



Source: Bloomberg; Morgan Stanley

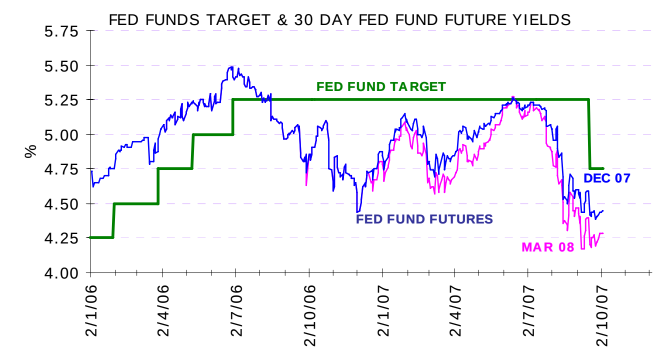
Usually, short-term swings in interest rate expectations are correlated with short-term swings in equity market performance: Hopes for easier policy lead to stronger equities, and vice versa. This link breaks down in periods of stress, such as we've just seen, but should be restored if markets behave normally (Exhibit 3). Short-end futures are now pricing in one rate cut by December, and two by March 2008 (Exhibit 4). It may be that a robust payroll report – one that reduces the perceived chance of a near-term easing – could trigger a setback in stocks.

Exhibit 3
Will the Market Miss a Rate Cut?



Source: Bloomberg; Morgan Stanley Research

Exhibit 4
Two Cuts by March



Source: Bloomberg; Morgan Stanley Research

This is all short-term stuff. Keep in mind a bigger picture point: This is an earnings bubble, as opposed to a TMT-style P/E bubble. I think that makes a big difference for what matters to investors. A P/E bubble is much more likely to be popped by higher rates. Such was the case with the TMT bubble: 6½% Fed funds rate was a contributing factor to the NASDAQ peaking, while the recession didn't start until a year later. An earnings bubble, however, is more likely to be vulnerable to growth and earnings downgrades, and less sensitive to interest rates. Seventeen consecutive Fed rate hikes didn't turn Wall Street.

That suggests that strong growth news and rising interest rate expectations are not important hurdles for equities. In that context, I agree with my colleagues than any correction that follows strong growth news is a dip to buy. Softer growth and earnings data would threaten to seriously damage this market. That, in my view, will have to wait until early next year. It may also be that a soft landing – implying earnings downgrades but also lower rates – may not be a particularly beneficial mix for Wall Street.

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