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November 7, 2007

Downunder Daily

Downside Risks Go Up

The downgrades to growth keep coming – and the downside risks increase. Morgan Stanley U.S. economists Richard Berner & David Greenlaw, who were already on the low side of consensus, have reduced their through-the-year 2008 US GDP forecast to 1.7% from 2.1%. At the start of the year, they were expecting 3.0% growth for 2008.

As important as the point forecast, in my view, is Dick and Dave's sense of the risks around their base case. They now see a 40% risk of a recession. For details, see *The Credit Recession*, 5 November. (As an aside, the current forecast points to top-down 'book' profits falling by 4.2% next year, compared with a 4.4% rise forecast at the start of this year. Over the same period, the consensus S&P EPS forecast has *increased* from 9.9% to 13.0%.)

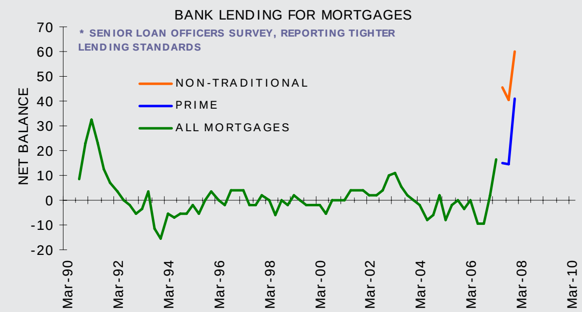
Eric Chaney, our chief European economist, is likewise thinking of the downside risk. His base-case forecast for Europe is GDP growth of 2.0% in 2008, down from 2.6% forecast for 2007. But if oil moves to US$100/bbl, the euro to US$1.50, and credit conditions are tightened – none of which is far away from where we are now – then GDP growth would likely slow to 1½% next year. For details, see *Oil at $100, € at 1.5, Credit Crunch: The Bill*, 5 November.

There are a few points to note about this:

First, it confirms the point that the world – or at least the developed parts – has shifted from a four-year cycle of persistent growth upgrades to a cycle of downgrades.

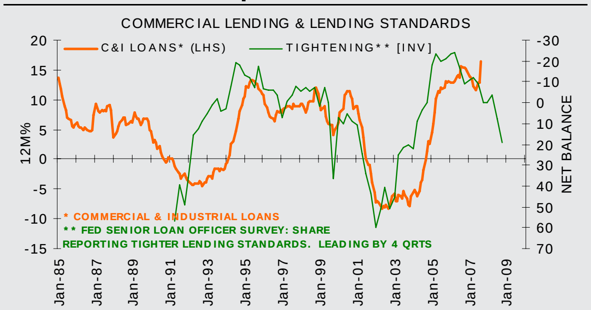
Second, there is absolutely no sense of this shift in economic momentum apparent from looking at overall equity pricing. Indeed, the contrast between rising growth-orientated equities (led by emerging markets and the developed-world sectors that are linked to those markets) and downgrades to developed world growth implies either growing confidence in economic decoupling or the view that soft landings are good for equities, or short-sightedness.

Exhibit 1
Banks Tighten Mortgage Lending…



Source: Federal Reserve; Morgan Stanley Research

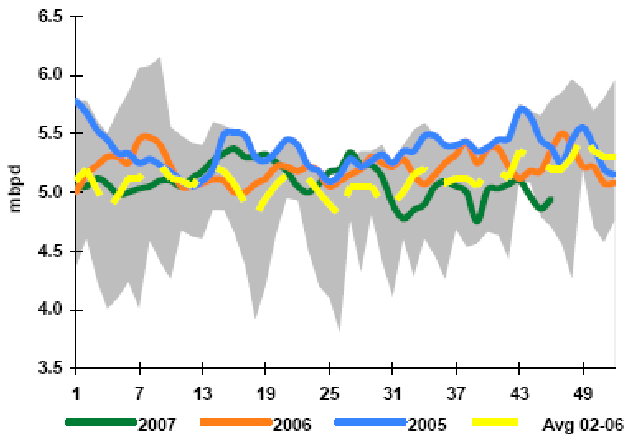
Exhibit 2
…and Also on Corporate Loans



Source: Federal Reserve; Morgan Stanley Research

Third, while equity investors probably could live with the current set of economic forecasts, it seems clear that the world is more vulnerable to an adverse shock now than it has been in 5-6 years.

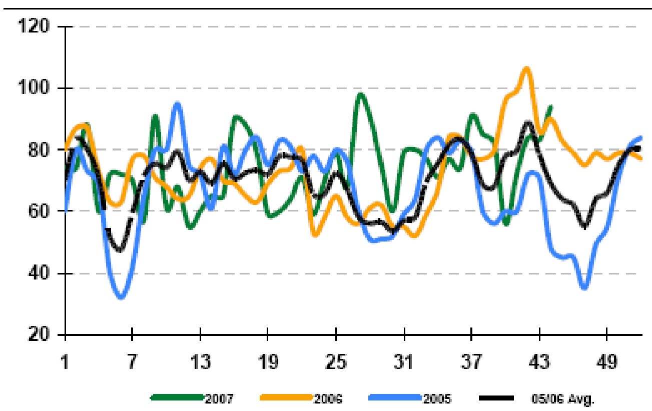
Exhibit 3
Oil Shipped West from the Middle East



Source: Ole Slorer, *Commodity Shipping: A Phantom OPEC Hike*, 4 November; Norwegian Energy; Morgan Stanley

Looking ahead, there are two obvious shock candidates. The first is that credit tightening bites harder than now generally expected. The Federal Reserve's latest survey of senior loan officers, released yesterday, signaled another material tightening in lending standards, for both mortgages (Exhibit 1) and corporates (Exhibit 2).

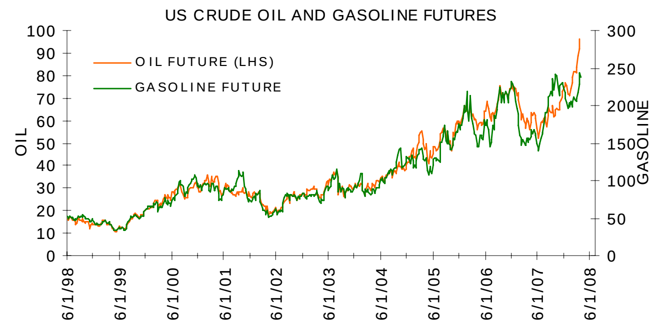
Exhibit 4
Lots of Tankers Are Available



Note: Chart shows availability (in numbers) of VLCC (very large crude carriers).
Source: Ole Slorer, *Commodity Shipping: A Phantom OPEC Hike*, 4 November; Norwegian Energy, Lorentzen & Stemoco; Morgan Stanley

A second risk is oil prices. For many investors, oil has lost its sting. That's because growth concerns triggered by oil climbing from US$20/bbl in the last recession, through $30 (in mid-2003), $50 (mid-2004), and higher, have proved to be unfounded. In that context, there's nothing magic about oil breaking $100/bbl. In fact, rising oil (like other commodity prices) has been a symptom of economic strength, not a threat to it.

Exhibit 5
Gasoline Prices Lagging (Rising) Crude Prices



Source: Bloomberg; Morgan Stanley Research

However, it may be that oil price increases from here do start damping growth. That's for a very simple reason: There's evidence to suggest that the world has hit its short-term supply limit for oil, so any increase in demand from, say, Asia, will have to push oil prices to levels high enough to destroy demand elsewhere. The current tightness in supply is highlighted in a note from our global shipping team, led by Ole Slorer (*Commodity Shipping: A Phantom OPEC Hike*, 4 November).

The point is simple: There is no pick-up in shipping flows out of the Middle East – despite a plentiful supply of tankers and rising prices – which suggests that for all practical purposes there is zero spare capacity amongst oil suppliers. Exhibit 3 shows westbound ship movements from the Middle East, which are now at a five-year low. This is not due to a lack of ships: Exhibit 4 shows the availability of large oil tankers, which is at a seasonally high level. The apparent extreme tightness of supply is important as the northern winter approaches. In the US, gasoline (petrol) prices are lagging the pick-up in spot crude prices (Exhibit 5).

This is a setting where retail-level prices could move sharply higher. Sharp upward moves haven't had a material impact over the past few years, but as our Economics team makes clear, the US is now more vulnerable to shock than it has been at any stage in this cycle. Higher oil and tighter credit could now be enough to tip the US into recession.

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