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ASIA/PACIFIC

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November 9, 2007

Downunder Daily

Another Stumble

Another stumble in equity markets so, as a big-picture bear, I have to ask: is this it, the start of a bear market? My answer is 'no'. I expect this will be another buy-the-dip opportunity. Here are some thoughts:

First, markets seemed ripe for a bout of profit-taking after the electrifying recovery from the August lows. Our Emerging Markets team has noted that corrections are likely when the MSCI emerging markets index is 20% above its 200-day moving average – last week the index was almost 30% above that average (Exhibit 1).

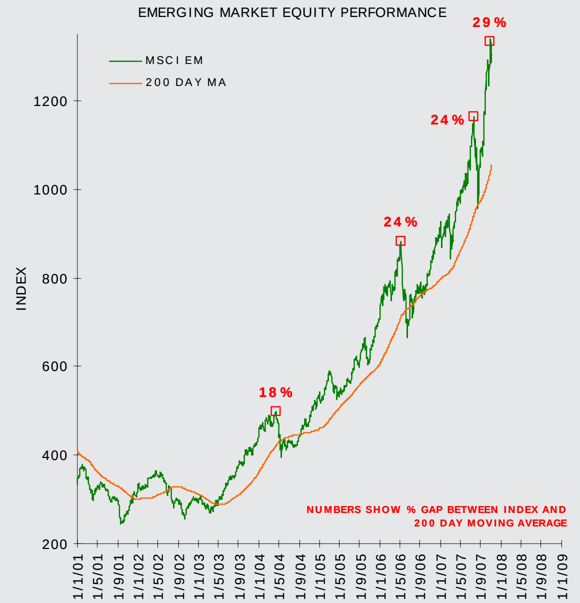
Second, it's noteworthy that recent gains had run ahead of earning forecasts in most markets (particularly EM). That meant that PE ratios were rising. Average valuations are not stretched by late 1990s standards, but they are now high compared to recent history. Exhibit 2 shows how stock prices have out-paced consensus earnings forecasts for the global ex-US MSCI index. (The chart is drawn so when the lines intersect the index is on a prospective PE of 15x.)

Against that backdrop, renewed concern about credit markets has, as in August, provided the trigger for an equity market set-back.

But what's important is what we haven't seen. We haven't seen a material change in the consensus outlook for growth and earnings. That is important because, as I keep insisting, equity markets have rallied on the back of an earnings (E) bubble, in contrast to the PE bubble of the late 1990s. While a PE bubble is vulnerable to rising rates, an E-bubble is vulnerable to falling GDP and earnings forecasts.

Exhibit 1

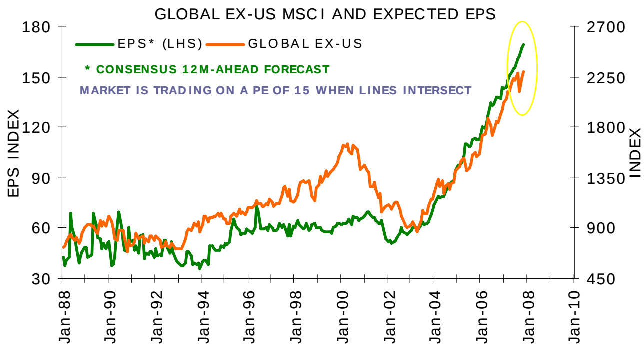
Too Far, Too Fast?



Source: MSCI; Morgan Stanley Research

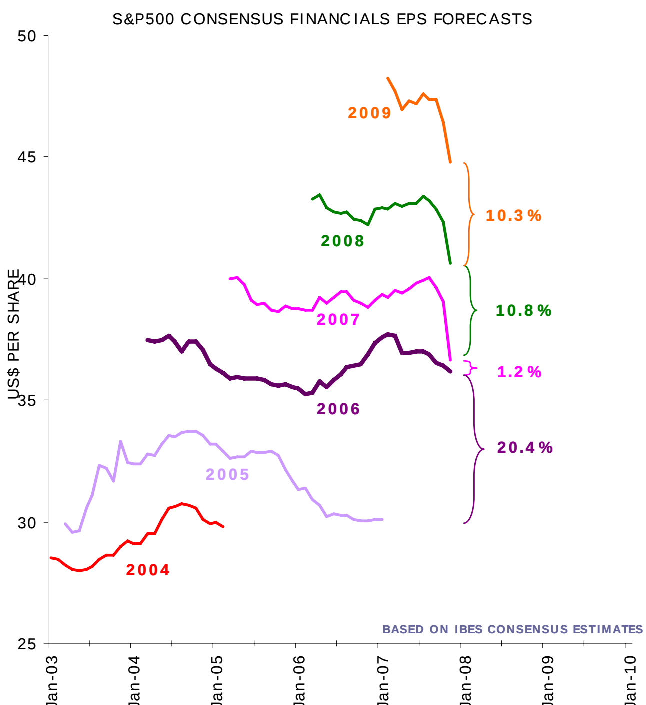
For now, only one major sector is experiencing those sorts of bubble-ending downgrades: Anglo financials. Exhibit 3 shows the sharp downgrades to consensus forecasts for US financials.

Exhibit 2
Run Ahead Of Earnings



Source: MSCI, IBES; Morgan Stanley

Exhibit 3
The One Earning Shock



Source: DataStream, IBES; Morgan Stanley Research

For now, however, this is seen as a sector-specific issue. Moreover, my sense is that most investors continue to think that either:

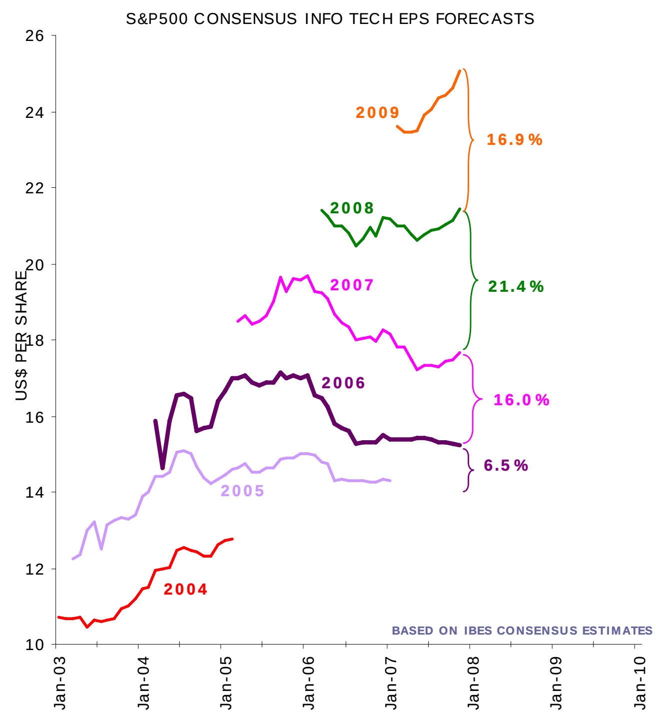
1) the spillover of financial sector problems to the real economy will be minimal; or

2) if it's not minimal, the Fed will cut rates to compensate; or

3) even if the Fed can't fully compensate for the credit-related weakness, the rest of the world can/has/will decouple from a softening US.

In that context, it is worth contrasting the downgrades to financials with the upgrades seen in a cyclical, globally-orientated sector such as information technology (Exhibit 4). If this story starts to sour – and I note that Cisco missed forecasts overnight – then the correction would take on a more serious tinge.

Exhibit 4
But Upgrades Here



Source: DataStream, IIBES; Morgan Stanley Research

I continue to be pessimistic on the big-picture, and continue to expect a bear market in 2008. But the most likely trigger for a bear market, in my view, is earnings and growth downgrades – something associated with recession fears. The best indicator to watch on that score is payrolls. When payrolls start falling, then it will likely be time to stop buying dips.

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