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Morgan Stanley Australia Limited+
Gerard Minack
Gerard.Minack@morganstanley.com
+61 2 9770 1529

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Downunder Daily

From a Credit Scare to a Growth Scare

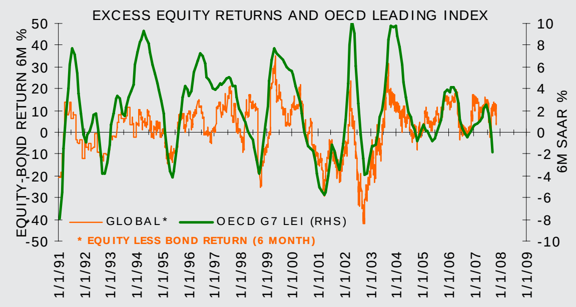
Last Friday (*Another Stumble*), I argued that markets were in another buy-the-dip setback to the global risk trade. I thought it would be buy-the-dip because the focus was on credit, rather than growth. Taking a second look, however, there are signals that growth is starting to become an issue. If these signs intensify, it would bode ill for equities. Indeed, it would increase the risk that the end-October highs mark the peak for the bull market.

Our strategists are also more cautious. Toby Walker went neutral Australian equities on 30 October (*Moving to Neutral Australian Equities)*; Jonathan Garner clipped his Overweight in emerging markets on 8 November (*2008 Outlook: Reducing Equities OW to 2%)*, and Teun Draaisma went neutral European equities on Monday (*Too Much Uncertainty – Taking Profits in Equities)*.

What are the signs of growth concerns? One is that the OECD's leading index for G7 production is now at its weakest level since the last recession (on a six-month change basis). This is noteworthy because historically this index has been highly correlated with excess equity returns (that is, equity returns above returns on sovereign bonds).

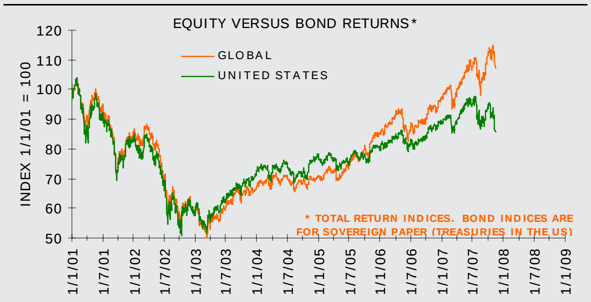
Exhibit 1 shows that bonds could now outperform equities for a period. Indeed, that is already happening in the US: Exhibit 2 shows equity returns relative to bond returns for the US and for developed markets. Bonds (Treasuries) are now out-performing equities (S&P 500) on a year-to-date basis in the US.

Exhibit 1
A Proper Growth Scare



Source: OECD, MSCI, JP Morgan; Morgan Stanley Research

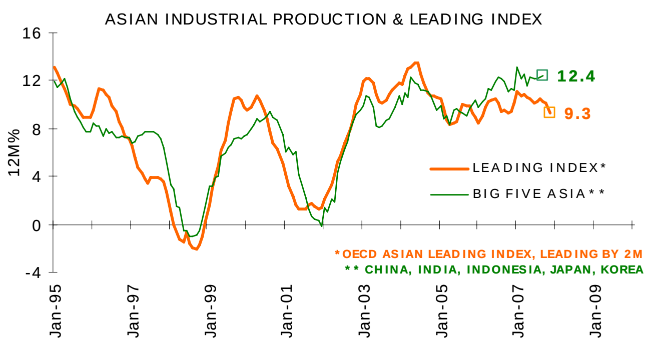
Exhibit 2
Better to Be Safe?



Source: MSCI, JP Morgan; Morgan Stanley Research

Warning signs in the emerging economies are less worrisome, but the risk of slowdown would clearly rise if, as I expect, we see ongoing downgrades to growth forecasts throughout the G7. The OECD's leading index is signaling a moderate slowdown in Asian production, although admittedly it has been doing so for some time (Exhibit 3).

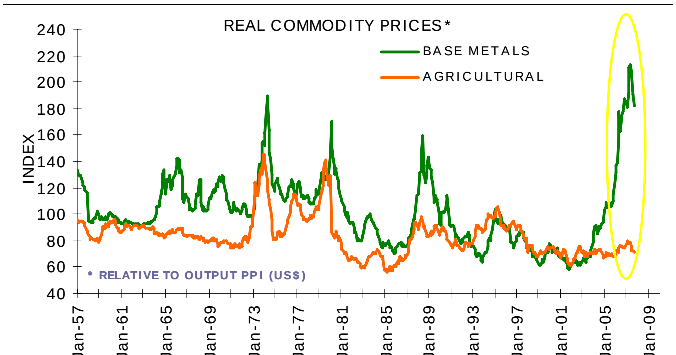
Exhibit 3
A Moderate Headwind (For Now)



Source: OECD; Morgan Stanley

As importantly, market-based indicators suggest (or reflect) growing concerns about growth. Metal prices have now seen the most significant pullback since the mega-bull market commenced in 2001 (Exhibit 4). Of course, prices remain very high by historical standards.

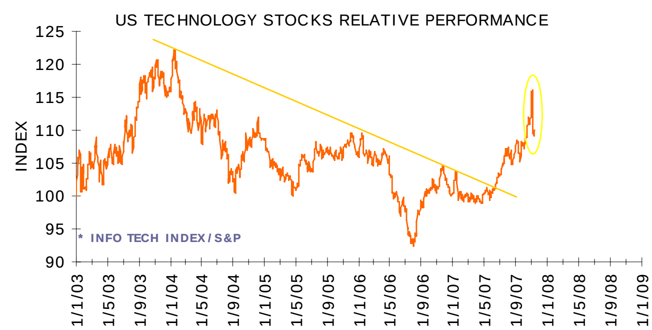
Exhibit 4
The First Setback for Metals



Source: IMF, BLS; Morgan Stanley Research

The poor performance of the technology sector is worth noting. In my *Another Stumble* comment, I noted the resilience of earnings forecasts outside financials, with technology seeing upgrades. But investors typically move before consensus earnings forecasts, and the setback to the technology sector last week is a warning sign that at least some in the market are becoming more concerned about the growth spillover of credit issues. Contrast last week with the out-performance of technology stocks through the August correction (Exhibit 5). (However, the under-performance of technology through the first three years of the bull market shows that it is not always an accurate reflection of growth sentiment.)

Exhibit 5
US IT Sees a Setback



Source: Bloomberg; Morgan Stanley Research

So where to from here? I am bearish big-picture, and I think what will end the bull market is a material deterioration in growth and earnings forecasts. I think those signs will first appear in the US. I've usually pointed to non-farm payrolls as the single most important indicator, the one that signals a shift from the soft-landing to the hard-landing scenario in the US – and the indicator that, as far as I can tell, would do most to shake the consensus view that remains for a soft landing.

However, I've also argued that if I'm going to get my timing wrong, I'd rather be late than early. That's because late-cycle rallies can be particularly fast, so the cost of getting out too early can be large in performance terms. I also expect that the bear market will be an elongated (and, in the Anglo world, deep) affair, as markets fall in line with earnings. On that basis, being too early to sell equities may be more costly than being too late.

In my view, that suggests even now waiting for more evidence of the turn in growth and profits before flicking the switch to structural bear. My best guess remains that that evidence to turn strategically bearish will come to hand in the first half of next year.

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Morgan Stanley

The Americas
1585 Broadway
New York, NY 10036-8293
United States
Tel: +1 (1) 212 761 4000

Europe
25 Cabot Square, Canary Wharf
London E14 4QA
United Kingdom
Tel: +44 (0) 20 7 425 8000

Japan
4-20-3 Ebisu, Shibuya-ku
Tokyo 150-6008
Japan
Tel: +81 (0) 3 5424 5000

Asia/Pacific
Three Exchange Square
Central
Hong Kong
Tel: +852 2848 5200