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Downunder Daily

To the Rescue

The usual Pavlovian reaction: Hopes for easier Fed policy have again lifted equities. Of course, perhaps not all the bounce can be attributed to Wednesday's signal from Donald Kohn that the Fed may ease at the forthcoming FOMC meeting. The S&P 500 index had been sitting on technical support, the rally had started the day before the speech (after news of ADIA's investment in Citigroup), and short-end futures had for some time been confidently pricing in a Fed cut (and, as a result, were basically unmoved by the Fed comments – see Exhibit 1).

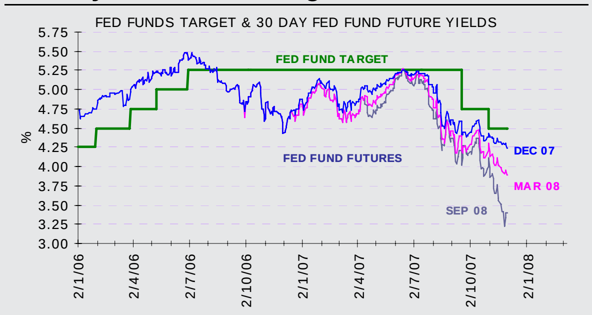
Nonetheless, I'll take the past 48 hours as confirmation of what I in any case sense anecdotally: Most investors still expect the US to land softly, and see the combination of softer US growth and lower US rates as broadly supportive for equities in 2008 – particularly Asian equities. A few comments on this:

First – and this is a statement of the obvious – a few rate cuts may be good for equities, but a lot are bad. There are lots of rate cuts in a recession, but in a recession, earnings drive equities down. There's a reasonable link between Fed rate changes and the change in prospective earnings (Exhibit 2). Historically, the Fed cutting by more than 1% over a 12-month period has coincided with outright declines in forecast earnings (compared with what was forecast a year earlier) – and those sorts of earning declines are usually accompanied by bear markets.

Second, notwithstanding the jitters of the past few weeks, equity markets do not appear to me to be pricing in anything worse than a soft landing. Financials have been hammered, but there's little evidence that analysts are factoring in much (or any) second-round effects for non-financials. Exhibit 3 shows consensus earnings forecasts for the S&P 500 non-financial sector: 2008 forecasts have held up, while 2009 forecasts have been revised higher.

Exhibit 1

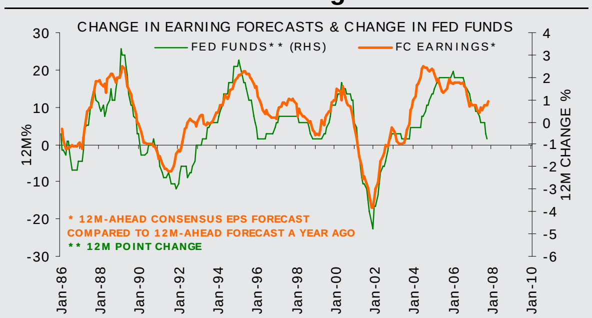
Already Priced In Easing…



Source: Bloomberg; Morgan Stanley Research

Exhibit 2

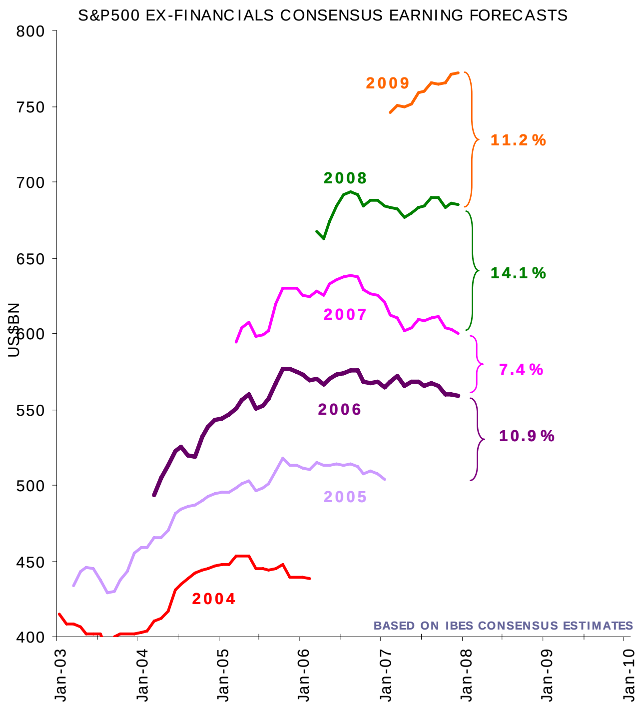
Too Much of a Good Thing?



Source: Bloomberg, IBES, DataStream; Morgan Stanley Research

Third, while I concede that the spillover from housing and credit stress to the rest of the economy has happened more slowly than I expected, say, a year ago, I still think that spillover will occur (as I discussed yesterday). The most important signal that spillover is occurring will be when (if?) payrolls start to decline.

Exhibit 3
No Problems outside Financials

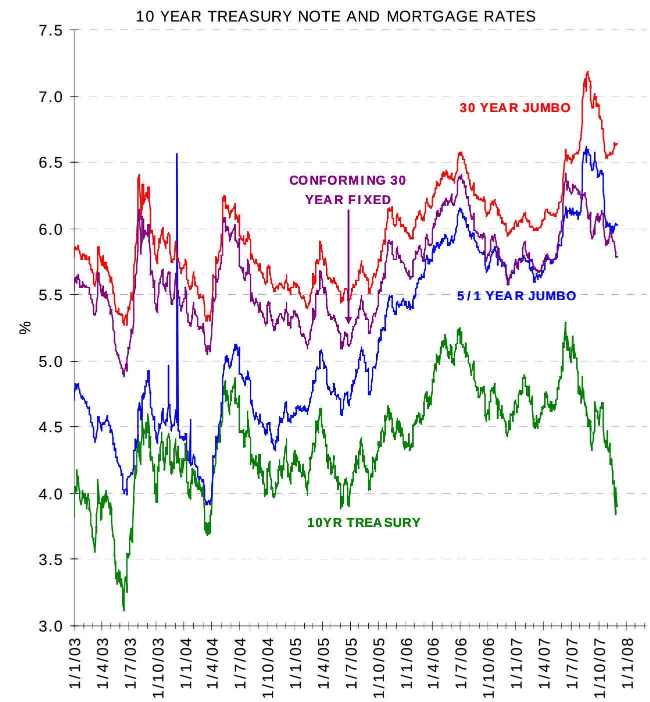


Source: IBES, DataStream; Morgan Stanley Research

Fourth, and perhaps most importantly, easier Fed policy is likely to be less effective than usual precisely because the problems are centered in the financial system. The financial system is the transmitter of Fed policy to the real economy. If the problem is in the financial system, the transmission is less effective.

That is easy to see in a number of areas. Exhibit 4, for example, shows how mortgage rates have remained at elevated levels despite the tumble in Treasury yields seen since June. The same is true of corporate bonds.

Exhibit 4
No Flow-through



Source: Bloomberg; Morgan Stanley Research

Finally, it may be that we are embarking on another bounce in equities. All the factors I noted in the opening paragraph – together with the bearish short-term sentiment indicators and some end-of-year short covering – suggest that a Fed-inspired December rally could be in the offing. Given the correlation between risk assets, that would presumably coincide with a recovery in credit markets. Neil McLeish, Morgan Stanley's head of European credit, believes that we could likewise see a rally in credit – despite his bearish medium-term view on the credit cycle. (Please see Neil McLeish, *Widespreads Revisited*, 28 November.)

But as the economic signs worsen, my view is that this would be the get-out-of-jail-free chance to sell risk assets ahead of what is likely to be an uncomfortable 2008.

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