

January 6, 2008

Downunder Daily

The Year of the Bear

The US is now approaching – possibly already in – a recession. This will be the only thing that will matter for investors over the next few quarters. As a result, the bear market in risk assets, which in hindsight started two months ago, has much further to run, in my view. In short, it's time to sell.

I've continually pointed to employment as the single most important indicators for investors to watch. The labour market now appears so weak that it would be extraordinary for the US to avoid recession. Annual payroll growth has fallen to 1.0%. US employment growth has not fallen this low outside a recession period since the early 1950s (Exhibit 1). In soft landings growth has held above 1.6%.

Unlike the August payroll report, which initially was reported as -4K (but has since been revised to +93K), the weakness in December fits with other labour market indicators, such as the rise in jobless claims and the fall in the employment components of employer surveys.

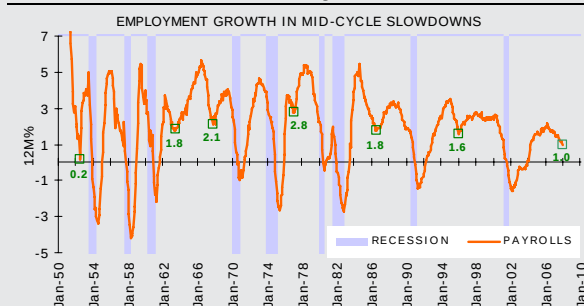
Moreover, the employment report continued the run of data hinting at a material loss of momentum. Housing remains in a deep funk, there is now evidence of spillover to non-residential construction, business sentiment is souring and capex indicators are weak, and consumer confidence is falling. All this is occurring against a backdrop of a developed-world credit crunch and signs that growth elsewhere in the OECD is slowing. Summary indicators of US activity are around recession levels (Exhibit 2).

A few points to note about this:

First, recessions are always bad for risk assets generally and equities specifically. I do not expect the apparent cheapness of equities – either in an absolute sense or relative to, say, Treasuries – will prevent a bear market.

Exhibit 1

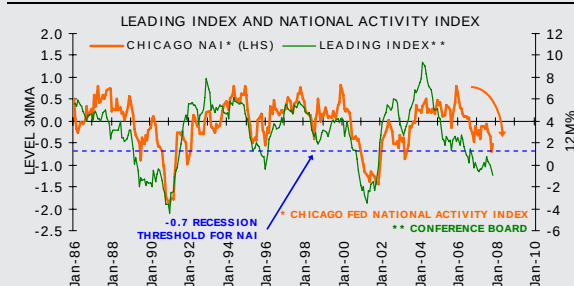
Too Weak To Be A Mid-cycle Slowdown



Source: BLS, NBER; Morgan Stanley Research

Exhibit 2

On The Brink



Source: Chicago Federal Reserve, Conference Board; Morgan Stanley Research

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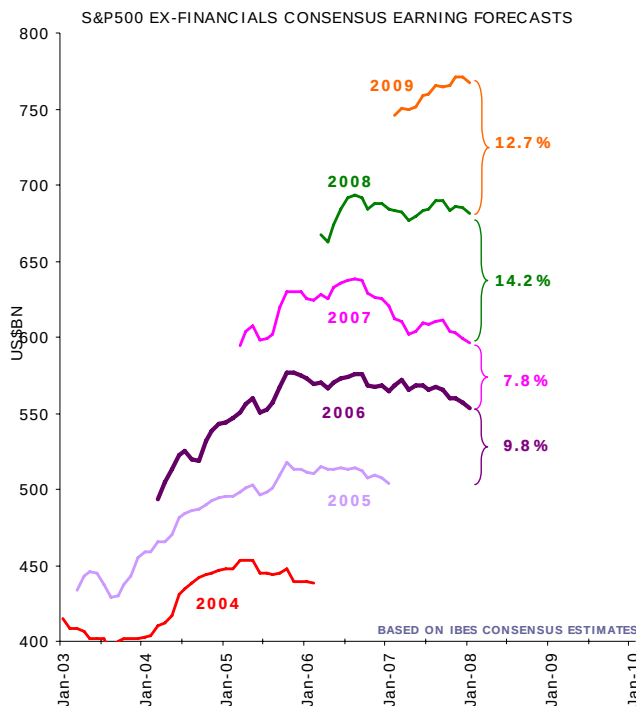
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Strategy and Economics

Second, the key to equities in the bull market was rising earnings, and earning declines will likewise be the driver of the bear market. In the US, earning forecasts remain wildly optimistic in my view. As Abhijit Chakraborti, our US strategist, has noted, the resilience of earnings forecasts for the non-financial sector in particular looks odd (Exhibit 3). Cycle indicators, such as the ISM index, now point to imminent downgrades (Exhibit 4).

Exhibit 3

This Has To Change



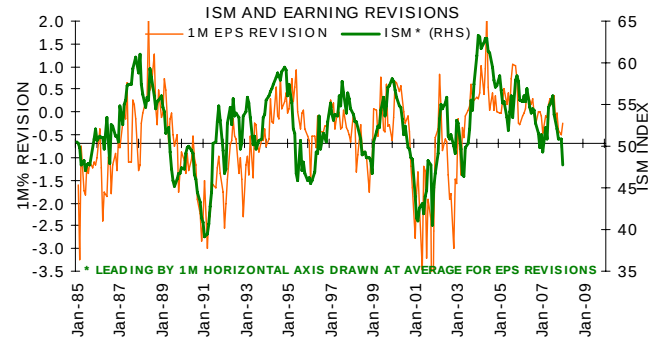
Source: DataStream, IBES; Morgan Stanley

Third, I continue to expect that a bear market in US risk assets will lead to a bear market in global risk assets. Global markets are simply too interconnected to expect that markets in the rest of the world – emerging markets in particular – can decouple from a bear market in the US.

Fourth, a turn in investor sentiment and the tightening in global credit greatly increase the prospect of financial accidents. Pinpointing when and where is very difficult. The sub-prime melt-down produced victims in unexpected places last year but that occurred with growth at robust levels and employment still rising. Now, a recession is coming, and with it a bear market in risk assets, in my view. Financial risk will increase dramatically.

Exhibit 4

Entering The Downgrade Phase

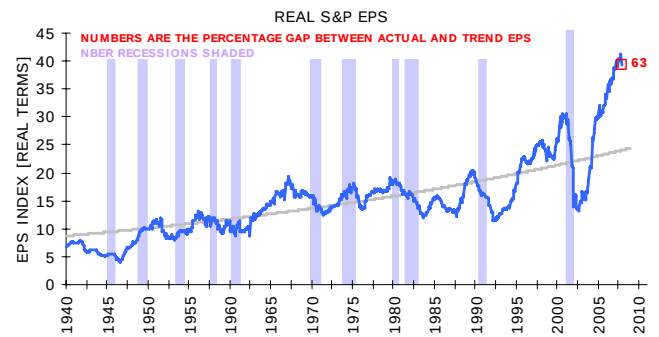


Source: ISM, DataStream, IBES; Morgan Stanley Research

Finally, at some stage, probably around mid-year, investors will have to decide what sort of recession is underway. Our US economics team is forecasting a relatively mild recession. My own view is that this could prove to be a very serious recession. For now, I don't think it matters what the recession will be like: risk assets will weaken in the near term. But by mid-year it will be important to make that call. If it's a major recession, it's likely to be accompanied by a very large fall in earnings. US S&P500 earnings for example, are now running 65% above the long-term trend (Exhibit 5). If this downturn leads to margins mean-reverting, then we are embarking on what will likely be a long and deep bear market, at least in developed economies.

Exhibit 5

Back To Trend, Or Below



Source: NBER, Standard & Poor's, BLS; Morgan Stanley Research

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