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ASIA/PACIFIC

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Downunder Daily

Sink in Synch

Slowing growth in 2008 is not just a US story. I'm skeptical about whether markets could decouple from US weakness, even if the economies could – but that increasingly looks like an academic debate as the growth slowdown broadens through the developed world.

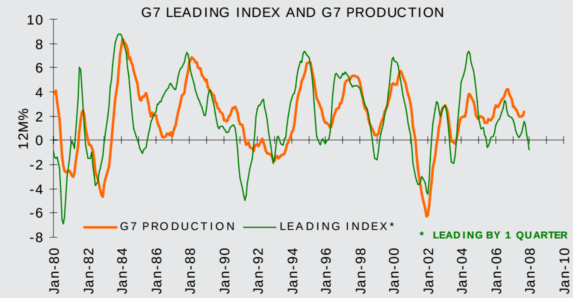
There are a couple of forces at work here. First, the US remains the world's largest economy, so weakness there will, unsurprisingly, have an impact on other economies, although often with a lag.

The second, more important (and under-appreciated) point is that economic coupling is more than just a follow-the-leader story: Cycles are synchronized because policy is often synchronized, business confidence is correlated, and financial flows tend to go through global mood swings. In other words, trade flows are not the only important transmission mechanism for economic coupling, and economies can be synchronized even if trade linkages are small.

These other links have been important in this cycle. Monetary policy has followed a similar pattern through the developed world: easing sharply in the aftermath of the TMT bubble bursting, and tightening over the past three years. Not every economy eased policy to the same extent, nor has policy been tightened to the same extent, but the fact is that just as the past few years reflected the generally easier policy of the 2001-03 period, 2008 is likely to reflect the generally tighter policy implemented over the past two years.

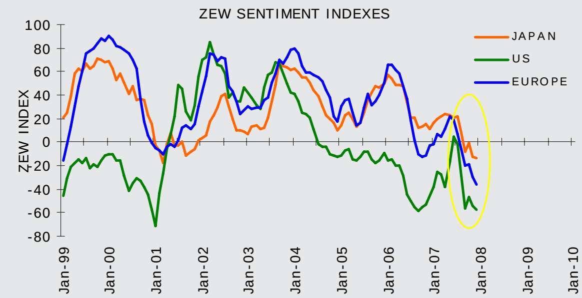
The turn in official monetary policy has been magnified by the swing in lending practices. The change in lender attitudes – and market pricing of credit risk – has clearly occurred throughout the developed economies.

Exhibit 1
The Outlook for the G7 Worsens…



Source: OECD; Morgan Stanley Research

Exhibit 2
…and It's Not Just a US Problem

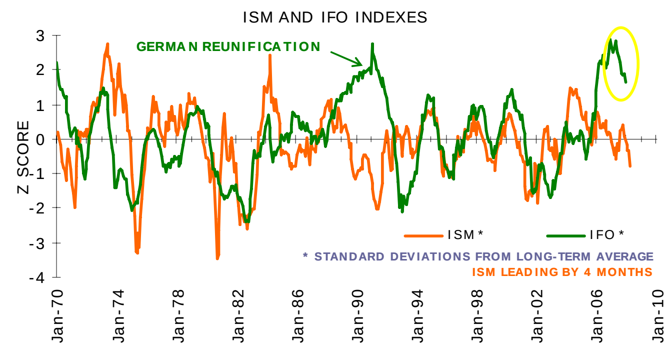


Source: ZEW; Morgan Stanley Research

The change in global credit conditions is one facet of what seems likely to be another synchronized swing, at least in the developed world: a turn in business confidence.

Finally, currency movements are by definition a zero-sum factor, but it's notable that dollar weakness over the past few years implies that currency movements are a headwind, in net terms, for other economies.

Exhibit 3
European Sentiment Historically Lags American



Source: ISM, IFO; Morgan Stanley

The signs of a synchronized turn in the developed world are starting to appear. The OECD's leading index is now signaling a period of contraction in developed world industrial production (Exhibit 1). The ZEW's survey of investor sentiment shows deterioration across the big three economies (US, Europe, and Japan – Exhibit 2). Business sentiment is likewise starting to decline (albeit from very high levels in some surveys). Exhibit 3 shows manufacturing sentiment in the US and Germany.

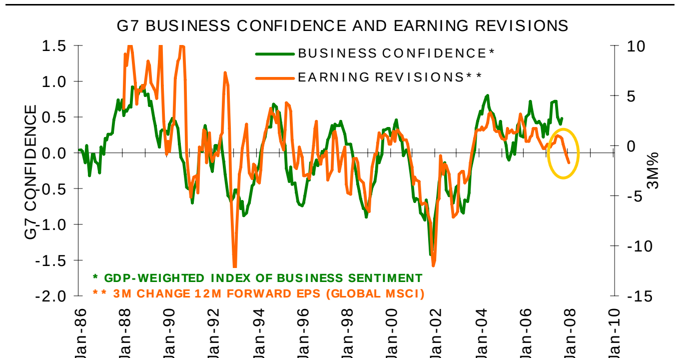
Exhibit 4
Asian Exports Historically Lag US Orders

Source: ISM, IMF; Morgan Stanley Research

All this points to a synchronized slowdown in the developed world. Our economists, for example, are forecasting a material slowdown: US GDP growth slowing by 2½% over the four quarters to September 2008 from the prior four quarters; by almost 1½% in Europe over the same period; and by almost 1% in Japan.

What remains unclear is the degree of spillover to the emerging economies. They are unlikely to be unscathed. Exhibit 4 shows how Asian exports, as one example, tend to follow new orders, as reported in the US ISM survey. Our economics team is forecasting developing world GDP to slow by over 1½% (to 6¼% on a four-quarter change basis).

Exhibit 5
Global Earnings Getting Downgraded



Source: OECD, DataStream, IBES, MSCI; Morgan Stanley Research

For investors, the important message from all this is that growth downgrades lead to earning downgrades – and downgrades will not be a US story only. Exhibit 5 shows that consensus earnings for the global MSCI index are now being downgraded for the first time since the bull market commenced in 2003. Our European strategy team expects an earnings recession in Europe (see Teun Draaisma, *Earnings Recession Guidebook*, 7 January.)

A synchronized global slowdown doesn't imply that the cycle downswing will be of uniform amplitude. While I think this downturn threatens to be a structural turning point for several developed economies – broadly, the Anglo economies – I agree with our emerging market teams that it will likely prove to be a run-of-the-mill cyclical setback elsewhere. Even cyclical setbacks can lead to bear markets, however, and that seems to be the story for the next few quarters.

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