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Downunder Daily

A Bernanke Bounce?

There should be no more uncertainty about one important issue: Mr. Bernanke seems as willing to cut rates on signs of cycle weakness as Mr. Greenspan. He signaled more easing to come in an overnight speech; our US team now looks for the FOMC to lower the funds target by 50 basis points at its 30 January meeting (see David Greenlaw, *Bernanke Speech More Dovish Than Expected)*. Markets are now pricing a decline in the funds target to 2¾% by year-end, from 4¼% now (Exhibit 1).

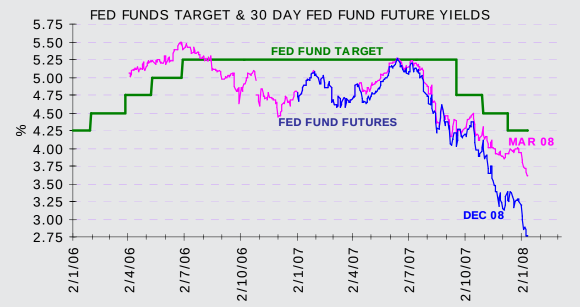
A few comments:

First, the change in tone underlines the importance of employment as a cycle indicator. There is no more powerful driver of Fed policy than unemployment, and it seems the decisive change in the Fed's thinking was the rise in unemployment reported for December. Historically, the relationship is broadly 2:1: the fund rates move 2% for every 1% change in unemployment (Exhibit 2).

Second, it is likely that a 50-point cut would provide some short-term relief for equities. Faith in the Fed remains high, and investors have had 25 years of Pavlovian training: just as you can train a dog to salivate when you ring a bell, investors will buy stocks when the Fed cuts rates.

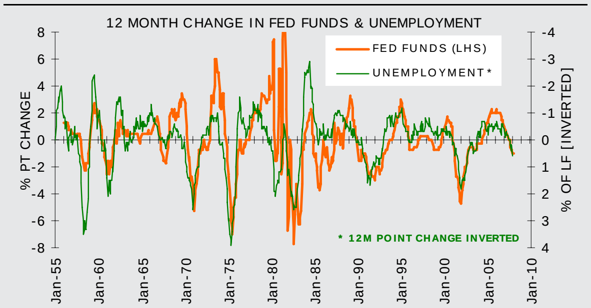
But that bounce is typically short-lived in recessions. The NASDAQ bounced 13% on the day of the first Fed rate cut in the last cycle – but then fell 33% over the following three months. If you share our view that the US is heading into recession, then Fed-inspired bounces are, at least at this early stage of the downturn, selling opportunities.

Exhibit 1
More Fed Easing…



Source: Bloomberg; Morgan Stanley Research

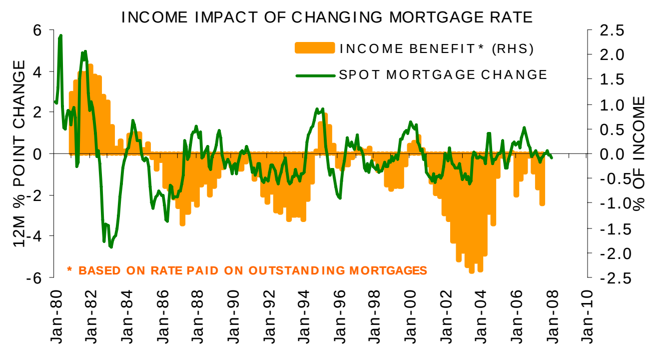
Exhibit 2
…As Bernanke Follows The Usual Pattern



Source: BLS, Federal Reserve; Morgan Stanley Research

Third, the decision on when to stop selling Fed-driven bounces will depend critically on how deep the recession proves to be. And that, in turn, will depend on how effective Fed rate cuts are in moderating the downturn. This, as I've noted before, is not an issue I think investors need to focus on for a couple of quarters: in the initial slide into recession, caution is the appropriate strategy. If, however, by mid-year it's become clear that the recession will be fairly mild – as our US team expects – then risk assets may do better through the second half.

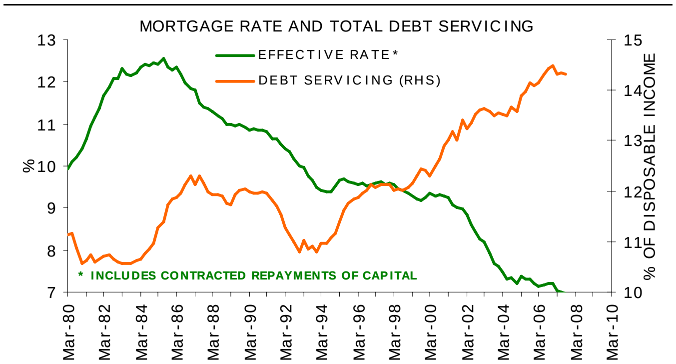
Exhibit 3
Last Cycle's Massive Assist From Lower Rates



Source: Federal Reserve, BEA; Morgan Stanley

Fourth – and given the prior comment, this is a point that will matter in a couple of quarters – I'm not sure Fed policy will be as effective in this cycle as it has been the past. The consumer is at the epicenter of this recession. In the last cycle, the consumer received a massive benefit from lower rates. The benefit was so big because of two reasons: long rates fell, and the household sector has a lot of debt (falling rates matter less if you have no debt).

Exhibit 4
High Debt Service With Low Rates



Source: Federal Reserve, BEA; Morgan Stanley Research

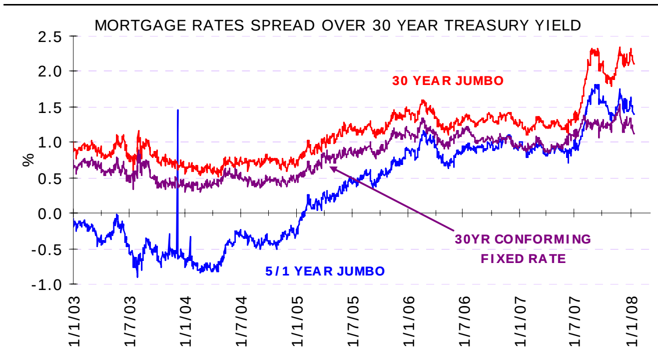
Exhibit 3 shows my estimate of the benefit (as a percent of income) of falling mortgage costs. Debt service burdens didn't actually fall that much, because the household sector decided not to keep leverage constant and benefit from lower rates, but instead to lift leverage. In fact, they accelerated their borrowing so much that the debt-service ratio rose even as rates fell. On top of that, the effectiveness of monetary policy was enhanced in the last cycle by the willingness of financiers to lend.

But there are a couple of critical follow-on points from this. First, the rates that matter for household are long-end rates, because most household debt is mortgage debt. The stimulus last cycle came as much (if not more) from the drop in long-end yields as from lower Fed rates. Second, because the household sector responded by lifting leverage, we are now in a situation where the household sector has a debt servicing burden at an all-time high when the average cost of mortgage debt is at an all-time low (Exhibit 4).

That now points to three problems for monetary policy in this cycle, in my view. First, the greater difficulty in getting rates – and in this context, the key rate is the mortgage rates – to a level that provides fresh stimulus. Second, the risk that households have simply reached the limit of their debt-load carrying capacity. Third, lenders are now tightening standards. Exhibit 5 shows the blow-out in spreads between mortgage rates and long-end Treasury yields.

All this suggests that Fed policy will be far less effective in easing the recession strains. If I'm right on that point, then investors should keep fighting the Fed for some time.

Exhibit 5
Wider Spreads



Source: Bank Rate.Com, Bloomberg, Morgan Stanley Research

I'm conferencing and marketing in the US for a while. The next DuD will be 4 February. GM

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