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Downunder Daily

Action–Reaction

There was always going to be a policy reaction to signs of economic weakness and market distress. But the response over the past fortnight has been more aggressive than I expected, forcing investors to confront a crucial issue sooner than I thought. That issue is simple: how effective will policy be in moderating the downturn and promoting recovery?

The first point to note is that recession is still likely (indeed, the arbiters at the NBER may subsequently tell us that it's already started). That means markets still face the broad-based earning downgrades and rising credit defaults that always come with recession. But investors will be much more able to cope with that bad news if they are confident that the policy response will lead to a relatively mild recession.

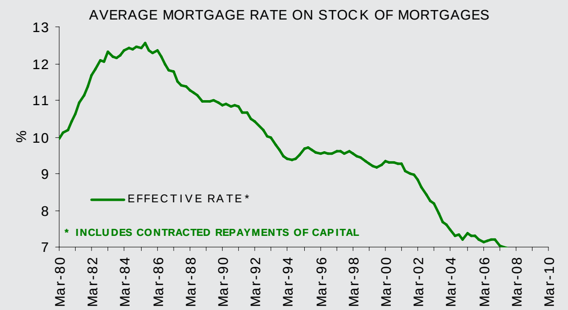
My view, however, is that policy will be much less effective in moderating this recession than is usually the case, and notably less effective than in 2001-02.

Policy will struggle to gain traction because the two sectors in most distress are the financial sector – the transmitter of monetary policy changes – and the household sector, which provided the most vigorous response to policy stimulus in the last recession.

Moreover, policy makers have less room to move in this cycle. The starting point for fiscal policy in the last downturn was a budget surplus of around 2% of GDP; now the deficit stands at 1½% of GDP. The funds rate peaked at 6½% in 2000, this time the starting point was 5¼%. More importantly, the average interest rate on the stock of outstanding mortgages was 9¼% in 2000, now it is 7%. As Exhibit 1 shows, the average mortgage rate remains at cycle lows. In short, there was no 're-loading' of the policy holster in terms of what is arguably the single most important interest rate.

Exhibit 1

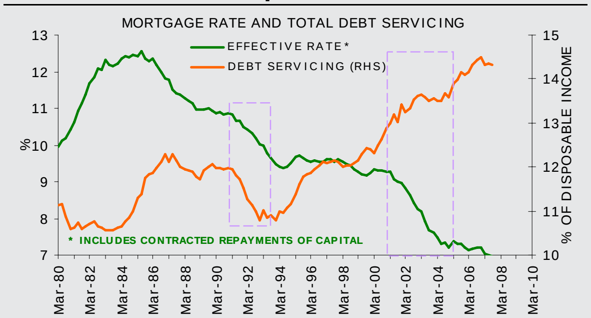
Starting With Very Low Rates



Source: BEA, Federal Reserve; Morgan Stanley Research

Exhibit 2

2 Recessions, 2 Responses



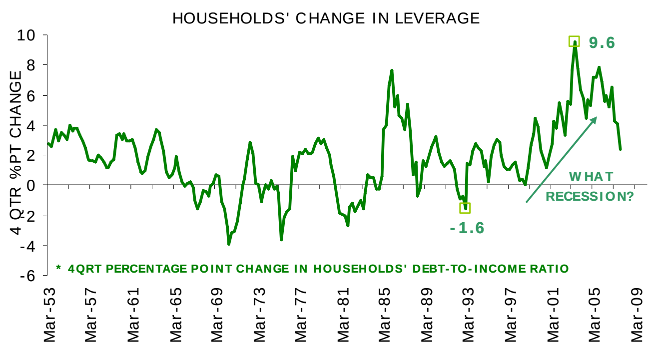
Source: BEA, Federal Reserve; Morgan Stanley Research

To calibrate the likely response of households consider this: when interest rates fall (and here I'll focus on the key rate for households, the mortgage rate), borrowers have three options. First, they can refinance their mortgage, but not change their debt, and so reduce their debt service burden (the ratio of interest payments to income). Alternatively, they can keep their debt service burden steady, and lift their leverage commensurate with the fall in effective mortgage rates. Finally, they can increase their debt service burden as rates fall, implying a sharp rise in leverage.

Exhibit 2 shows the household sector's response in the past two recessions. In the early 1990s, households took the first option: they reduced their debt service burden. In the last recession they took the third option: lifting the debt service burden as rates fell. In the early 1990s recession household leverage (debt-to-income) fell, while in the last downturn it increased. In fact, as Exhibit 3 shows, through the last recession the household sector increased leverage at the fastest pace in at least 50 years.

Exhibit 3

From De-leverage To Re-leverage

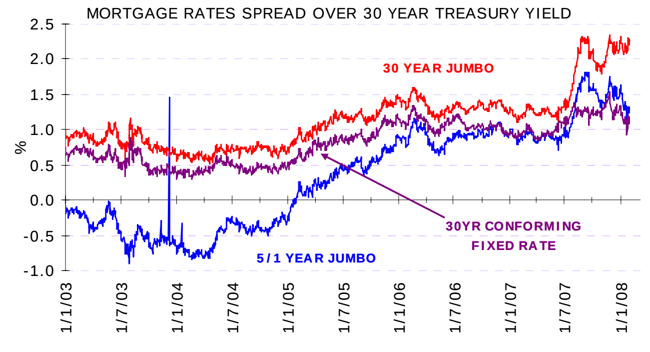


Source: Federal Reserve, BEA; Morgan Stanley

My view is that the household sector's response this time will be more like the early 1990s – in fact, I suspect we will see even more aggressive de-leveraging than seen in that cycle. The reason for this is simple: households are already defaulting on mortgages, despite the fact that rates are low and, until recently, unemployment was low. I think they're defaulting simply because they have too much debt. Moreover, house prices, which the household sector's principal store of wealth – and, as importantly, its key piece of collateral – are now falling.

Exhibit 4

Wider Spreads



Source: Bloomberg, Bankrate.com; Morgan Stanley Research

All this suggests that households will be much less willing to respond to easier monetary policy in this cycle than has been the case in the last two downturns. In fact, given leverage is at an all-time high, debt service at all time highs, and nationwide house prices are falling for the first time in living memory, I think the response will be more muted than seen in decades.

The prospective ineffectiveness of monetary policy is not just a demand-side issue. The financial sector is in distress, and credit standards are being sharply tightened. One simple indicator is the spread between published mortgage rates and the long-end Treasury yield, shown in Exhibit 4. The standard 30 year mortgage is now being offered at more than 100 basis points over the 30 year Treasury, compared to under 50 points over in 2004. The spread on other mortgage products are even wider.

What the spread chart doesn't capture, of course, is that there is entire class of borrower – sub-prime – who had funding thrown at them last cycle, but will likely get nothing this time.

It will of course take time to assess how effective the policy response will be. But if my view is right, then the positive investor reaction to the aggressive policy response already seen will be mistaken. Secondly, if the initial policy response proves ineffective, then there will be a second round. As I've noted before, since 1980 every cycle low for official rates has been lower than in the prior cycle. If policy is as ineffectual as I think it will be, then that pattern of lower-lows is likely to be repeated this time.

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