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MORGAN STANLEY RESEARCH
ASIA/PACIFIC

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February 7, 2008

Downunder Daily

The Weakness Spreads

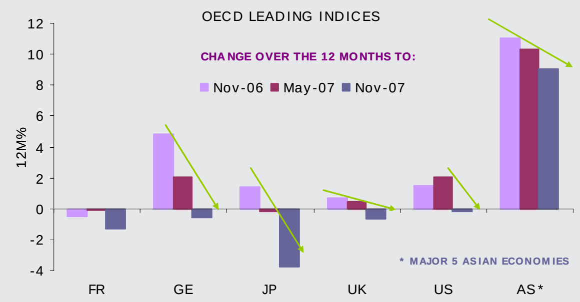
Just as it becomes clear the US is entering recession, there are more signs of softer growth elsewhere. In other words, it seems that economic weakness will not be ring-fenced to the US, so investors will face softer conditions in many markets.

Exhibit 1 shows the 12-month change in the OECD's leading indexes for a range of economies, as at November (latest available), six months prior, and 12 months prior. All are decelerating. There are outright declines in the developed economies (although that does not imply GDP contraction). The Asian leading index is also slowing, although it remains very strong by Western standards. Incoming Asian data had consistently surprised on the upside through the second half of last year, supporting the view that economic decoupling was occurring. However, the data are now falling short of forecasts (Exhibit 2).

It's important to emphasize that the weakest signals are coming from the developed world, where our economists now acknowledge the risks are slanted to the downside. The risk of recession is rising in the UK and Japan (although it is not yet our base case – see, for example, David Miles, *The UK Economic Outlook*, 6 February). Our emerging market team see their economies as better placed to withstand a developed economy downturn than has been the case in many years – and the data continue to support that view. However, it is clear (as our team has noted) that growth in the emerging economies would be affected by either a US recession or a broader OECD slowdown.

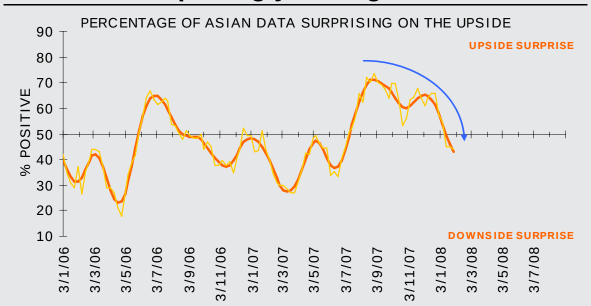
For investors, the trend is clear: What started as a sub-prime problem in the US has now morphed into a US recession, which, in turn, seems to be pointing to a fairly broad-based, if uneven, slowdown in global economic activity.

Exhibit 1
Leading Indicators Weaker Everywhere



Source: OECD; Morgan Stanley Research

Exhibit 2
Asia Was Surprisingly Strong…

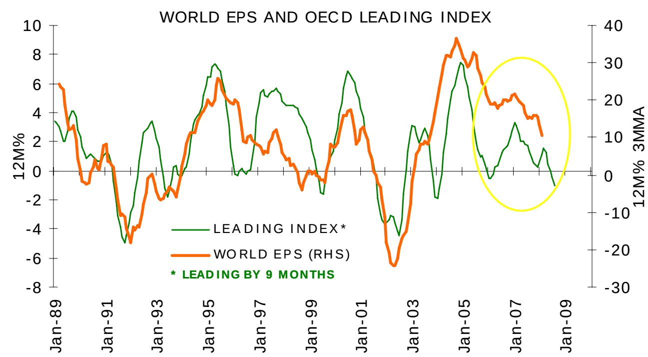


Source: Westpac; Morgan Stanley Research

It's not clear how severe that slowdown will be, but any slowdown will have several ramifications:

First, the Fed will not be the only central bank to respond. This is likely to be a year of widespread policy easing – "the great monetary easing of 2008," as Joachim Fels, our chief global fixed income economist, has called it (see Joachim's report of that name, 3 January 2008).

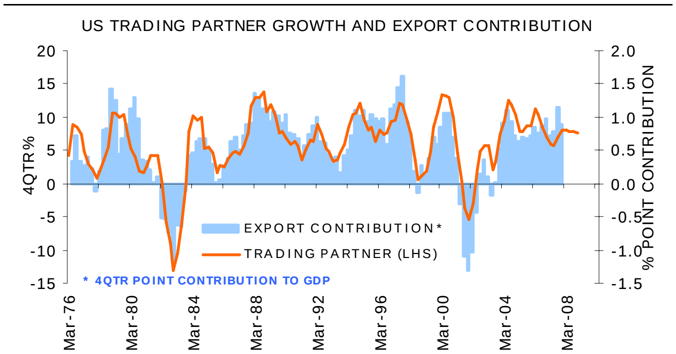
Exhibit 3
Global Earnings: High-Beta



Source: OECD, FTSE; Morgan Stanley

Second, earnings everywhere will be affected (Exhibit 3). Profits are a high-beta variable, in part due to the corporate sector's operational leverage. You do not require a GDP recession to get an earnings recession, and my hunch is that the relative GDP resilience expected for many economies will not translate into earnings resilience.

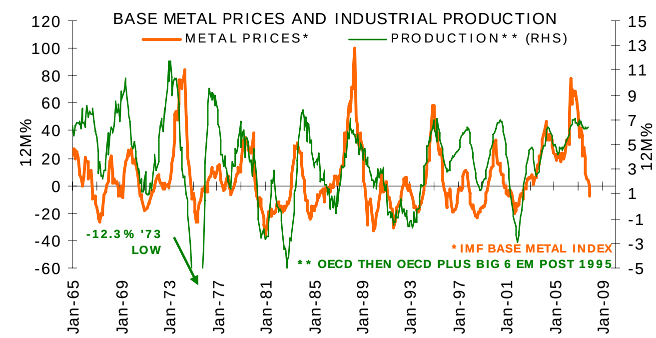
Exhibit 4
Moderating Support



Source: BEA, OECD; Morgan Stanley Research

Third, the spread of weakness beyond the US will compound America's own downturn. America's export growth is driven by growth in its trading partners (Exhibit 4). The OECD remains America's largest trading group.

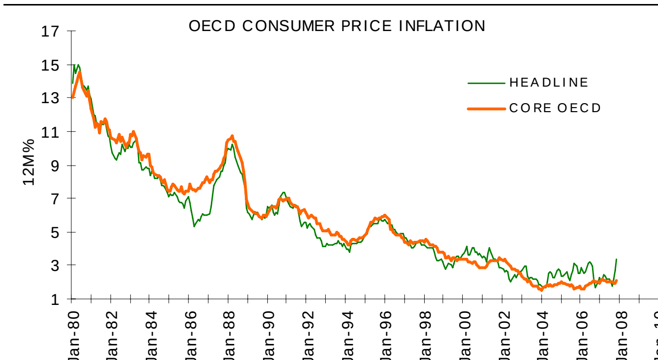
Exhibit 5
Easier Commodities



Source: IMF, OECD; Morgan Stanley Research

Fourth, regardless of the likely resilience in Asia generally or China specifically, I think significantly slower developed-economy growth will weaken commodity prices. Indeed, the surprise over the past year has been the softness in base metals against a backdrop of what appeared a robust global economy (Exhibit 5). I'd expect significant price weakness as the US falls into recession, Japan and the UK come close, and continental Europe softens.

Exhibit 6
The Inflation 'Problem' Will Fade



Source: OECD, Morgan Stanley Research

Finally, this is a global outlook that will very likely douse the cyclical inflation threat. As I've commented before, the big surprise over the past year has been how low inflation has been – and that the inflation pressures still are largely centered on commodity prices (Exhibit 6). If commodity prices fall, headline inflation rates will likewise quickly turn. Free capacity in manufacturing will provide additional disinflation force. Inflation will not, in my view, stop sharp policy easing – nor continued strength in safe-haven debt instruments.

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(as of January 31, 2008)

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