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Downunder Daily

The Confidence Trick

The risk is obvious, but my sense is that a US recession is not seen as a *fait accompli* by all investors, nor is it fully priced into markets. Indeed, some recent price action – rising commodity prices, higher bond yields, out-performing cyclicals – is consistent with a cycle turn. Moreover, while the flow of economic news has worsened, not every lead indicator is in recession territory.

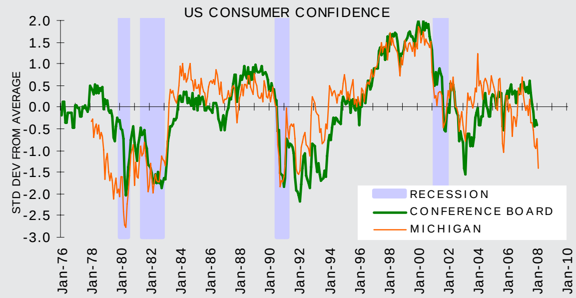
The one set of data that is uniformly bleak is confidence. Consumer confidence is now at the lowest levels since the early 1990s recession (Exhibit 1). Business confidence has collapsed (Exhibit 2 shows an average of the headline readings from the ISM surveys for manufacturing and services, the NAHB survey of homebuilders, and the NFIB small business index). If confidence is self-fulfilling, then a recession is on the way (or has started).

Markets, as usual, are forward-looking. The decline in leading indicators has seen risk assets under-perform. Exhibit 3 shows the under-performance of equities versus bonds has matched the deceleration in the OECD's leading index.

So is recession in the price? I've spent the past two notes arguing that equities are not cheap – that is, a recession is not in the price – despite the lure of relative value arguments. But a simpler test of what's in the price is this: how does the market react to incoming news? If the recession is in the price, then you'd expect equities would be able to shake off poor macro news.

Exhibit 1

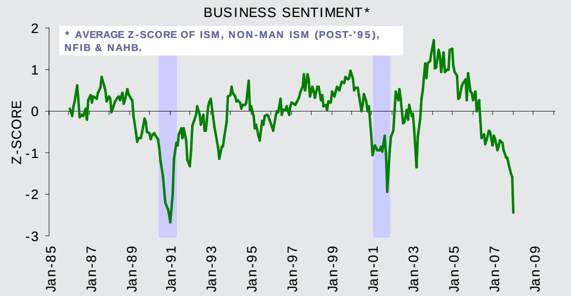
Consumers Lose Confidence…



Source: University of Michigan, Conference Board, NBER; Morgan Stanley Research

Exhibit 2

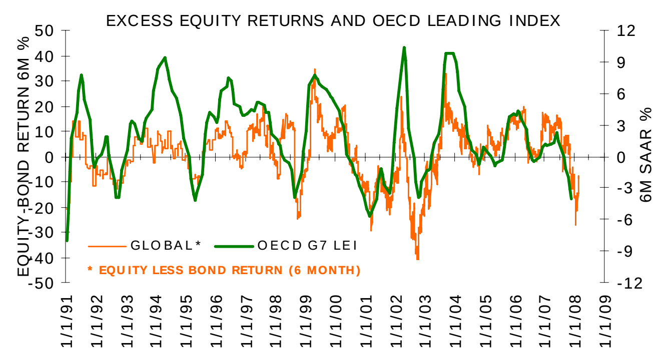
…And So Do Business



Source: ISM, NFIB, NAHB, NBER; Morgan Stanley Research

Exhibit 4 shows the short-term change in the S&P500 versus the 'surprise' in the macro data (that is, whether statistics are falling on the strong or weak side of fore-casts). The recent resilience of equities could be because the macro data have been mixed (in fact, on this surprise index, slightly more releases have been stronger than expected). It would be important sign of at least a tactical bottom if Wall Street were able to shrug off weak numbers. For now, that prospect is untested.

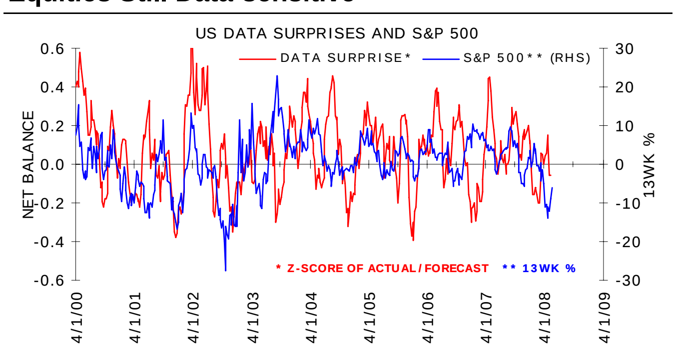
Exhibit 3
Forward-looking Markets Respond



Source: OECD, Bloomberg; Morgan Stanley

It's noteworthy how Treasuries have responded to incoming data: as Exhibit 5 shows, the fall in yields has been far more aggressive than would have seemed likely given the data flow. (And it's clear from comparing Exhibits 4 & 5 that historically the link between data surprises has usually been tighter for Treasuries than it has been for equities.)

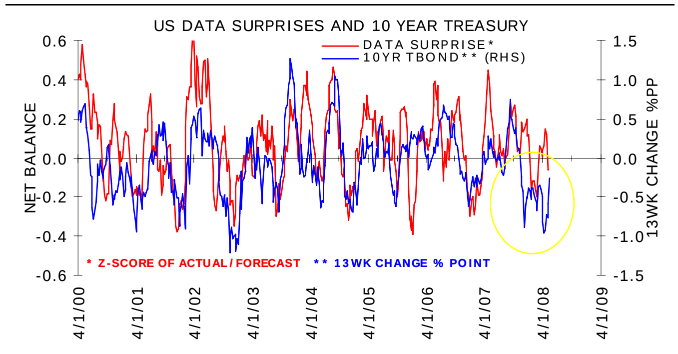
Exhibit 4
Equities Still Data-sensitive



Source: Bloomberg, Westpac; Morgan Stanley Research

The 'over-response' of Treasuries to soft data is either because Treasury investors are markedly more pessimistic than equity investors. Or, it's because the sharpest flight-to-safety flows have been from other debt asset classes. Or, it's because the Fed has been unusually aggressive in lowering short-rates in the face of what appears to have been mixed data flow.

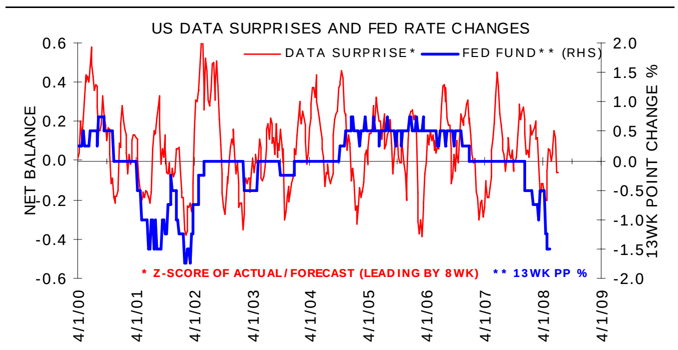
Exhibit 5
Treasuries Over-respond?



Source: Bloomberg, Westpac; Morgan Stanley Research

Exhibit 6 suggests that the Fed has aggressively responded to the data flow. This reaction may explain why Treasuries have likewise seen yield falls consistent with a worst data flow than actually seen. That, in turn, suggests that Treasuries may be closer to pricing in recession than equities – and if the economic news is mixed, rather than bleak, the bigger reaction will come from rate, not equity, markets. However, our US team expects more bad news, with next likely area of weakness being commercial construction (see Richard Berner, *US Economics: Recession Claims Its Next Victim: Commercial Construction*, 19 February).

Exhibit 6
Fed Rushes To Ease



Source: Bloomberg, Westpac, Morgan Stanley Research

I'm off marketing, largely in Asia, so the next DuD will be 3 March. GM

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