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Downunder Daily

The Bear's Other Claw

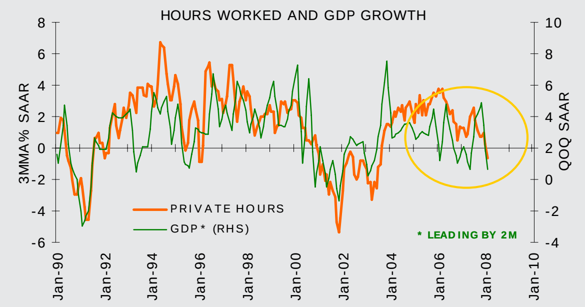
Mounting evidence of US recession – combined with signs of slowdown in other economies – could change the bear market. What has to date largely been a financial-sector sell-off could spread to sectors and markets driven by the growth cycle.

Friday's payroll report was further important evidence that the US is in, or heading towards, recession. Our US team expects outright declines in GDP in the current half year, which points to accelerating job losses (Exhibit 1). Business surveys paint a similar picture (Exhibit 2).

I do not think this is academic. I do not think recession is in the price. Recession is not factored into sell-side consensus forecasts, which continue to expect double-digit EPS growth outside the financial sector this year. Moreover, the day-by-day reaction of Wall Street – which typically falls on weaker-than-expected data – says that the investor community is not positioned for recession.

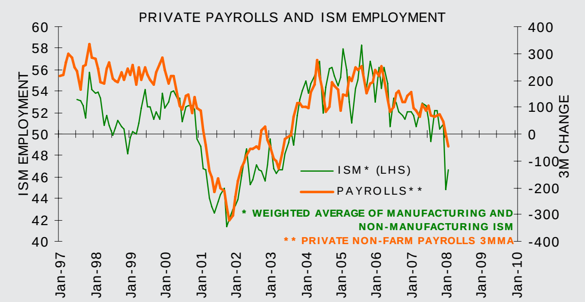
Growth disappointment may not just be a US issue – I think it will be a global theme this year. The OECD released its latest set of leading indicators on Friday, and they are rolling over throughout the developed world (Exhibit 3). The US leading index is now 1.2% below year-ago levels. Leading indicators are falling even faster in Japan (-1.8% yoy); France (-1.4% yoy) and the UK (-1.3% yoy). The OECD's leading index for the five big Asian economies is very strong (by western standards) but is decelerating (Exhibit 4).

Exhibit 1
Weaker Growth Leads to Weaker Jobs…



Source: BEA, BLS; Morgan Stanley Research

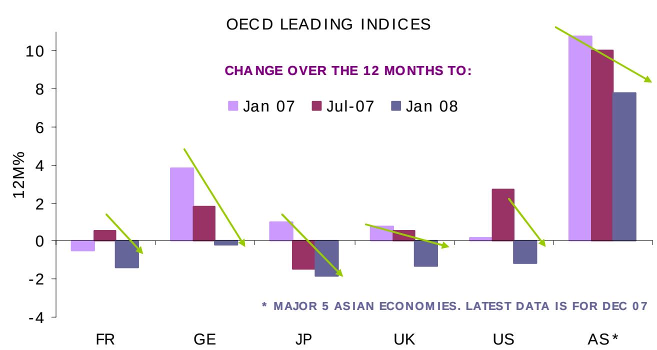
Exhibit 2
…With Worse to Come



Source: ISM, BLS; Morgan Stanley Research

None of this signals global recession. However, it may prove optimistic to think in terms of a soft landing for the developed economies. There now seems a reasonable chance of simultaneous recession in the US, Japan and the UK, with a material slowdown in Europe.

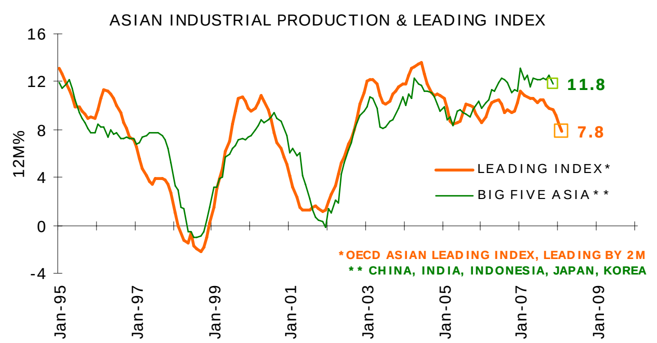
Exhibit 3
Deceleration Everywhere



Source: Federal Reserve; Morgan Stanley

The key point for investors is this: after four years of persistent upgrades to economic and earnings expectations, we are now entering a period where downgrades will dominate. Those downgrades could be quite severe for developed markets. My view is that the emerging markets will not escape unscathed.

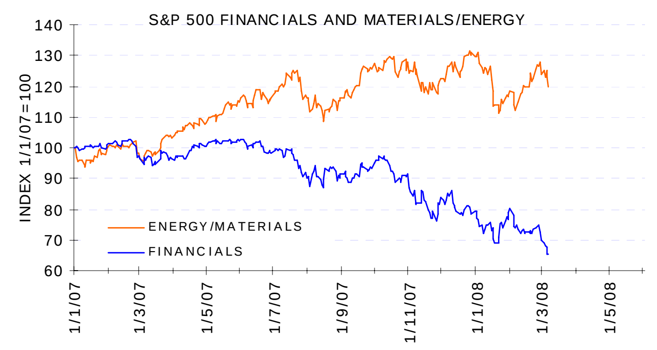
Exhibit 4
Cum Slowdown?



Source: OECD, Morgan Stanley Research

How much of this is factored into equity prices? My view is that very little is. Last year, broadly speaking, was a financial-sector bear market. Excluding financials, the S&P 500 was up around 6% in 2007. The non-financial sector started to weaken only as the growth news deteriorated. Global growth stocks have barely suffered at all. Exhibit 5 compares the performance of US financials and the combined performance of the energy and material sectors. The latter outperformed the former by 50% last year. Unsurprisingly, these globally orientated sectors have moved hand-in-glove with emerging markets (Exhibit 6).

Exhibit 5
The Bear Market So Far: Financials Only

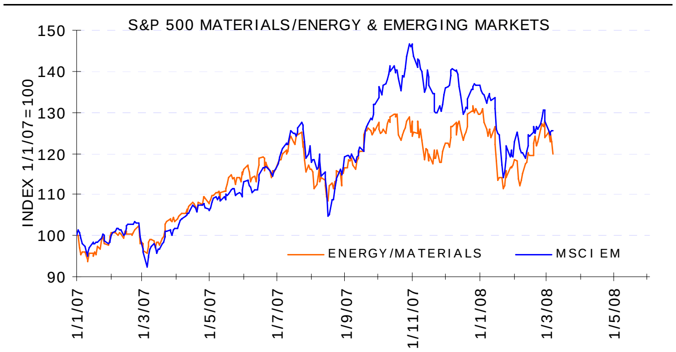


Source: Bloomberg; Morgan Stanley Research

The risk now is that as global growth expectations are pulled lower, the bear market spreads to the global sectors and markets. If there is a catalyst for a short-covering rally in financials (and the Fed announced new measures on Friday designed to inject additional liquidity into the sector), then there could be a sharp swing in the relative performance between financials and global stocks.

Don't misconstrue that as a bullish comment on financials. The bigger picture outlook remains fraught, in my view. But the balance of bad news may shift enough in the next month or two to trigger a temporary reversal of the relative performance.

Exhibit 6
The Next Bear Market?



Source: Bloomberg; Morgan Stanley Research

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