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Downunder Daily

The Slow Slowdown

I have to admit that the slowdown is coming slower than I was expecting. But I still think it's right to be bearish on growth, particularly in the US. Moreover, it may be that the cycle decline from here will speed up – that is, become more normal – due to the accelerating pace of house price declines, the recent sharp rise in oil prices, and the prospect of accelerating job losses (although the rebates will work against this speed-up).

For now, however, the fact is that growth in the US has proved to be resilient outside residential construction and consumer discretionary. Exhibit 1 shows that US growth excluding autos and residential construction was a not-too-shabby 3.8% over the year to March. That, in large part, explains the resilience of corporate earnings outside financials, homebuilders, and consumer discretionary.

Morgan Stanley US economist Richard Berner has likewise noted the resilience, but still thinks that the growth risks remain slanted to the downside – something not priced into risk markets. See Richard Berner, *Pushback*, 19 May.

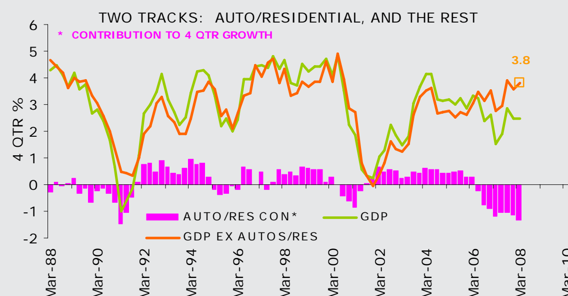
Several factors have contributed to this resilience:

First, there were fewer excesses in several important sectors. In particular, there hasn't been the over-build in investment spending that we saw in the last downturn. Moreover, inventories are being held in check. As important, the shrinking importance of manufacturing means that even when inventories do adjust sharply – as in 2001 – the impact on GDP is more muted than in prior cycles (Exhibit 2).

Second, net exports have provided an offset to domestic softness. This is partly export strength, due to buoyant trading partner growth. Export growth contributed 1.1 percentage points to GDP over the year to March, compared with 0.7 point over the year to March 2007. Softer imports have also been important.

Exhibit 1

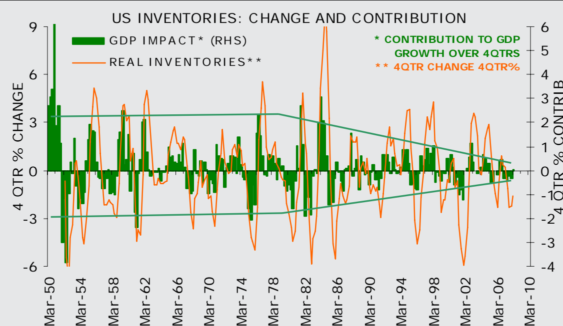
Ex-Housing and Autos Still Respectable



Source: BEA; Morgan Stanley Research

Exhibit 2

Inventories Swing – But Impact Less



Source: BEA; Morgan Stanley Research

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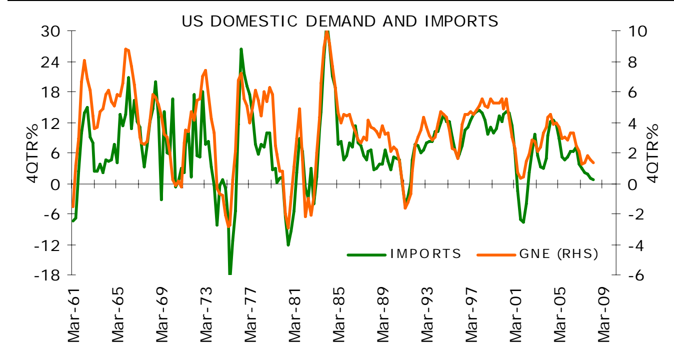
Imports subtracted just 0.1% from GDP growth over the year to March, down from 0.6% in the prior year. Imports have been weaker than implied by the usual 3:1 link to domestic demand (Exhibit 3).

Third, the credit crunch is taking time to filter into the real economy. This is arguably the most important delay factor. Remember one of the unusual features of this cycle: Usually, an economic downturn causes credit problems; this time the credit problems are a key reason to expect an economic downturn. But credit tightening – like monetary policy – can spread to the real economy with a long and variable lag.

Exhibit 3

Import Demand Falls

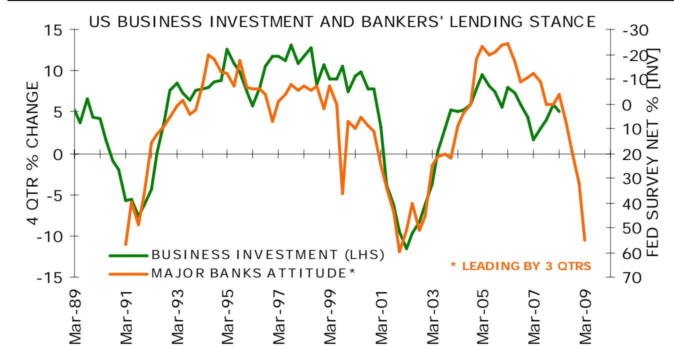


Source: BEA; Morgan Stanley Research

Exhibits 4 and 5 show how the lag between credit changes and real economy variables can be quite extended – but the message remains that changed credit conditions will still have a significant impact on the real economy.

Exhibit 4

A Turn in Lending Attitude Takes Time…

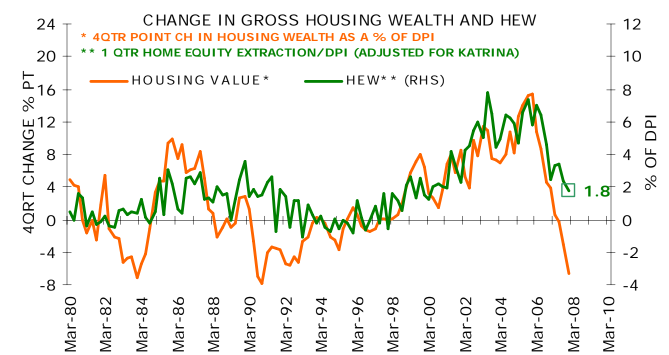


Source: BEA, Federal Reserve; Morgan Stanley Research

Exhibit 4 shows the lead-lag between business investment spending and bankers' lending attitude to business. Historically, investment has followed changes in bankers' stance, but with a three-quarter lag. The relationship points to a significant business slowdown ahead.

Exhibit 5

The Turn in Housing Takes Time to Damp HEW



Source: Federal Reserve, Morgan Stanley Research

Likewise, Exhibit 5 shows the change in ratio of housing wealth to household income, as well as home equity extraction. Extraction rose as wealth increased, and now the cycle has gone into reverse. Even so, households extracted the equivalent of almost 2% of income from their housing wealth last year. It seems highly likely that that extraction will disappear this year.

As Dick notes, not only will the credit crunch filter through to the real economy, the prospect of slower growth outside the US may take the edge off US exports. A slowdown in Europe would be particularly important, not just for GDP, but also for earnings. Our US strategy team estimates that 8% of US corporate earnings are sourced from Europe (see Abhijit Chakrabortti, *Double Trouble – Europe Joins the Slowdown*, 12 May).

Domestically, the decline may accelerate as the downturn becomes more 'normal'. Certainly, house price declines are accelerating – the Case-Schiller house price index is now 14.4% below year-earlier levels – which may intensify adverse wealth effects and credit conditions. Secondly, the sharp fall in business confidence measures (ISM is now the notable exception) may signal a phase of accelerating labour retrenchment.

I expect a second leg down in risk markets to be driven by weaker growth and earnings. To get that second leg will require that the recession broadens from what, so far, has been a narrowly based downturn.

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