

January 26, 2009

Downunder Daily

Early Days

Remember that the global downturn is just one quarter old. Yes, the financial crisis is several quarters old, and investors have been fretting about global growth for some time, and worried about US growth for even longer. But the global recession has just started. Whether there would be a recession was a live debate just 3-4 months ago. It was only in the December quarter that growth, sentiment and earning indicators fell sharply (Exhibit 1). It may feel like the recession is well advanced, but it's not.

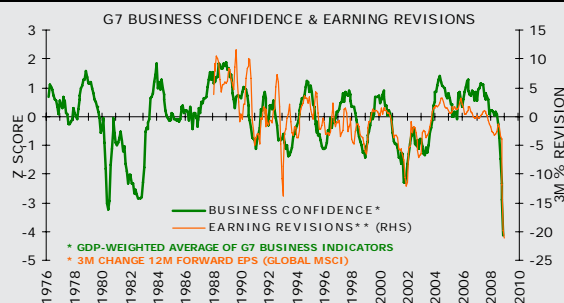
This matters. A key issue for investors is when the cycle will trough and growth and profit indicators pass an inflection point. The consensus seems to be that the cycle will bottom in the June quarter – that is, in the third quarter of the global downturn. That would be plausible if this were a vanilla cycle. However, there are many signs that this will be a deeper, longer cycle than average. Moreover, the fact that the downturn started just a handful of months ago has a number of important implications.

First, it means that the global policy response is not very progressed. The Anglo-economies – notably, the US – are an exception, arguably because the Anglo-economies are at the epicenter of this crisis. Even so, Anglo-policy rates peaked as recently as September, and the aggressive rate cuts only commenced in October. Outside the G7, my simple average of policy rates peaked in mid-November (Exhibit 2).

Monetary policy, famously, works with long and variable lags. Even if this were a normal cycle – and, clearly, it's not – then it would be far too early to expect a response to easier policy in the current quarter, or even next quarter. Monetary policy typically takes 3-4 quarters to have a notable impact. Fiscal policy is likewise affected by lags. Colleague David Greenlaw highlights Congressional Budget Office estimates that less than 20% of the planned US fiscal stimulus will be spent this year, including only 7% of the infrastructure spending.

Exhibit 1

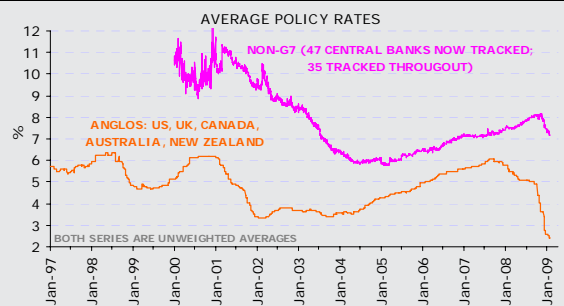
It Was Only In Q4 When Growth Stopped...



Source: IBES, MSCI, DataStream, CBI, ISM, IFO, Ivey, BoJ; Morgan Stanley Research

Exhibit 2

...And Policy-makers Responded



Source: Bloomberg; Morgan Stanley Research

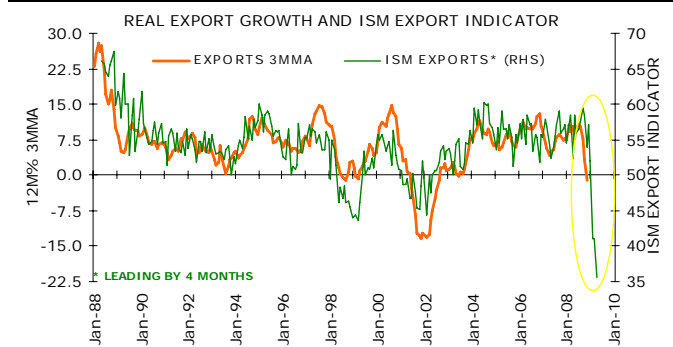
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Second, the second-round effects of the global slowdown are yet to become clear. Richard Berner, our chief US economist, emphasizes how the global slowdown will feed back to dampen US growth. This is just starting. The ISM export indicator, for example, is signaling a precipitous fall in US export growth (Exhibit 3). These second- and third-round effects take time to occur. Most of them are yet to come.

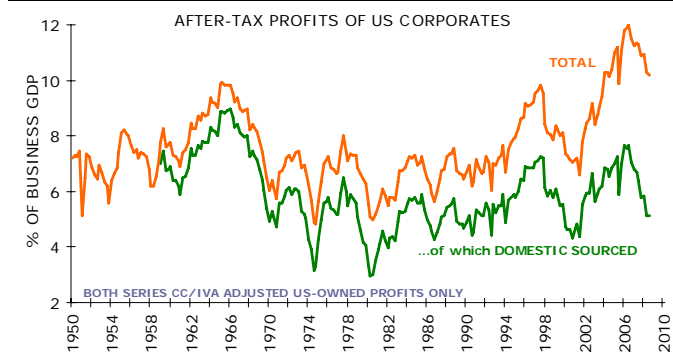
Exhibit 3
The Second-round Effects Start This Year



Source: BEA, ISM; Morgan Stanley Research

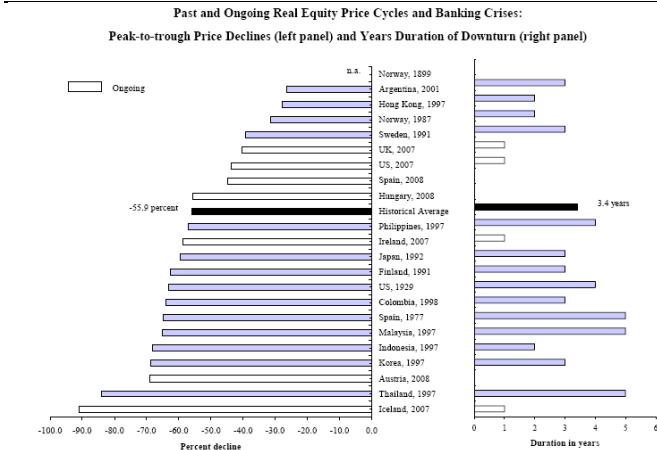
Third, with the downturn still young, the decline in operating earnings is likewise in its early stages. This is where it's important to distinguish the finance-focused asset write-down story from the prospective decline in operating profits from non-financial firms. While US-sourced profits have been declining relative to GDP for two years, and are now around their long-term average, total profits remain well above long-term average levels (Exhibit 4). The gap is explained by the still-high level of foreign-sourced profits. The sharp decline in foreign-sourced profits will come, but has barely started.

Exhibit 4
The Offshore Profit Decline Is Ahead



Source: BEA; Morgan Stanley Research

Exhibit 5
Recovery May Be Some Way Away



Source: Carmen Reinhart & Kenneth Rogoff, *The Aftermath of Financial Crises*, <http://www.economics.harvard.edu/faculty/rogooff/files/Aftermath.pdf>

If it is still early days for the downturn, how long is it likely to last? Standard downturns last 3-4 quarters. On that basis, passing an inflection point around mid-year (that is, 2-3 quarters after the downturn starts) would be a reasonable expectation. Downturns associated with financial crises historically last much longer. Research from Reinhart and Rogoff suggests that downturns associated with banking crises average 3½ years (Exhibit 5). To be fair, this is the length for which growth is running below trend, and on that basis this current crisis is now just over one year old. But the point remains that if this is a 'typical' banking crisis then it may be wrong to expect a bottom in the cycle in the current half year.

It remains a moot point what is priced into equity markets. Of course, investors are braced for the cycle and earnings to worsen in the current half year. However, as I noted last week, my sense is that the resilience of equities in the face of the horrible macro data of the past quarter is due to the view that the cycle will pass an inflection point around mid-year. A mid-year trough would justify the assumption that profits will be materially higher next year than this year. That, in turn, is permitting markets to look through the near-term tumble in earnings. If, however, that view of a near-term bottom and 12-month profit recovery is questioned, then equities will probably make substantial new lows.

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