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Morgan Stanley Strategy Forum

Global Economics

Spillovers versus Linkages

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The global economy continues to be faring well in the face of a downshift in the US. Has the long-awaited decoupling — with the rest of the world untethering itself from the US — finally occurred?

It is premature to conclude that the world has faced a legitimate decoupling test. America's deceleration has been concentrated in one of the least globalized pieces of the US economy – homebuilding activity. It takes internal spillovers to drive external cross-border linkages.

America's downshift will have global implications only if there are spillovers between housing and consumption demand.

Recent IMF research confirms the growing dependence of the rest of the world on the US, warning of a still synchronous global downturn if the US slowdown broadens and deepens. Canada, Mexico, China, and the rest of Asia ex Japan would be especially hard hit.

Market implications. I continue to believe that the American consumer will falter – taking the lead engine of the global growth train off the tracks, with the rest of the world quick to follow. That would be a major shock to financial markets, which are still discounting relatively sanguine prospects for global growth in 2007-08.

Risks. If the US labor market continues to display extraordinary staying power as it did in March, I would be the first to concede that the overly-indebted, saving-short American consumer will squeak by – and so, too, will the rest of a still-coupled world.

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GEM Equity Strategy

Approaching Our Target

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Emerging markets have rallied strongly since early March, with MSCI EM now at record levels around 950, approaching our 2007 target of 980. EMs have outperformed the average developed market and the S&P 500 in particular.

Decoupling of EMs from developed markets shows EMs' alpha tendency. Reflecting the strong improvement in EM fundamentals in recent years, we find that emerging markets have become a source of incremental alpha, not just beta. We have demonstrated this through extensive regression analyses, as discussed in our recent note ("More Than Just a Beta Play").

Keep an eye on commodity prices. The LME metals index has closely tracked the MSCI EM in recent years and has now reached new highs, confounding the expectations of many market observers. As the LME and MSCI EM continue to climb, we plan to keep a close eye on markets and would consider raising cash as the MSCI EM moves past our target, possibly in the next few weeks.

Room for multiple expansion. The MSCI EM index is trading at 12.6 times 2007 consensus estimates, in line with historical averages, while ROE continues to be close to highs. EMs are trading cheap relative to prior peaks.

US Equity Strategy

Tweaking 2007 and Peering Into 2008

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Macro tension focuses on extent of slowdown. Our view is that as the US economy slows, international growth will be sufficiently robust that certain cyclical stocks can still do well. If Steve Roach is correct and the slowdown is worse than we expect and global growth also stumbles, we would be wrong to be overweight energy and capital goods. So this is an important question to debate.

Interest rates are key to our valuation call. Right now our COV model shows the S&P trading in the middle of its recent range at 19%. If interest rates backed up above 4.90%, that would materially worsen the valuation case, whereas if rates declined from here, the market would look cheap.

Reiterating 2007e EPS of $91.00, but modifying mix towards lower multiple sectors: Our estimate implies year/year earnings growth of just 3.3%, below both the bottom-up consensus of 6.5% ($93.80) and the top-down consensus of 5.2% ($92.65). Probably more important, we have modified our earnings mix assumptions to reflect greater contribution from low-multiple commodity sectors and less contribution from high-multiple consumer sectors.

Introducing 2008 S&P 500 EPS estimate of $97.50, near the low end of the Street: The resounding message we hear from company managements and the analyst community is that 1H07 should mark the mid-cycle trough, while one should expect a decisive reacceleration next year. Our work points to a much slower resolution and a mid-cycle trough that does not arrive until sometime around mid-year 2008.

US Economics

The Employment Conundrum

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We've marked down our forecast for growth, reflecting still-higher energy prices, a deeper housing recession, and additional weakness in capital spending. Over the first three quarters of 2007, we now see growth at a 1.8% annual rate compared with 2.6% in our March update. With growth below trend and operating leverage fading, margins are flattening and earnings growth will be weaker. And once again, reflecting higher prices for energy, food, imports, and medical care, we've marked up our outlook for headline and to some extent core inflation.

The mix of growth and inflation has again turned less favorable. And the dichotomy between weak output and firm labor markets raises critical questions about the outlook: Will job and income gains sustain consumer outlays? Has potential output growth declined? If so, will it prolong the whiff of stagflation? And will slowing growth and rising unit costs squeeze profit margins?

Forecast at a Glance

	2006E	2007E	2008E
Real GDP	3.3%	2.0%	3.9%
Inflation (CPI)	3.2	2.5	1.9
Unit Labor Costs	3.1	3.0	2.7
After-Tax "Economic" Profits	22.5	1.1	5.3
After-Tax "Book" Profits	19.4	1.1	2.6

Source: Morgan Stanley Research E = Morgan Stanley Research Estimates

Consumer retrenchment is unlikely although the housing recession is far from over**.** Strong global growth should sustain both output and employment. Amid uncertainty about productivity's trend, we still think inflation has peaked, but inflation risks are rising again. Margin compression implies that profit growth likely will stall in 2007.

Market Implications: This mix likely will reinforce the Fed's conviction that they must wait patiently for inflation to decline. Rising uncertainty about the outlook and reduced forward-looking guidance from the Fed imply that term and other risk premiums will rise further, the yield curve will steepen irregularly, and TIPs may outperform.

Risks: The risks for investors are rising with crosscurrents swirling around the outlook for growth, inflation, profits, and monetary policy. That markets have defied these uncertainties lately does not give us comfort because we see neither a rapid improvement in growth, a quick decline in inflation, nor relief from the Fed.

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The following analysts hereby certify that their views about the companies and their securities discussed in this report are accurately expressed and that they have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report: Henry McVey, Jonathan Garner

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(as of March 31, 2007)

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