
Bubble Trouble or Goldilocks ?

David Greenlaw, Chief U.S. Fixed Income Economist

May 2007

Forecast at a Glance

	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007e</u>	<u>2008e</u>
GDP Growth⁽¹⁾	3.4	3.1	3.1	2.1	3.1
Core CPI Inflation⁽¹⁾	2.1	2.1	2.7	2.4	2.1
Budget Surplus (% of GDP)	-3.6	-2.6	-1.9	-1.3	-1.1
Fed Funds Rate⁽²⁾	2.25	4.25	5.25	5.25	4.75
10-Year Note Yield⁽²⁾	4.24	4.39	4.71	4.90	4.75

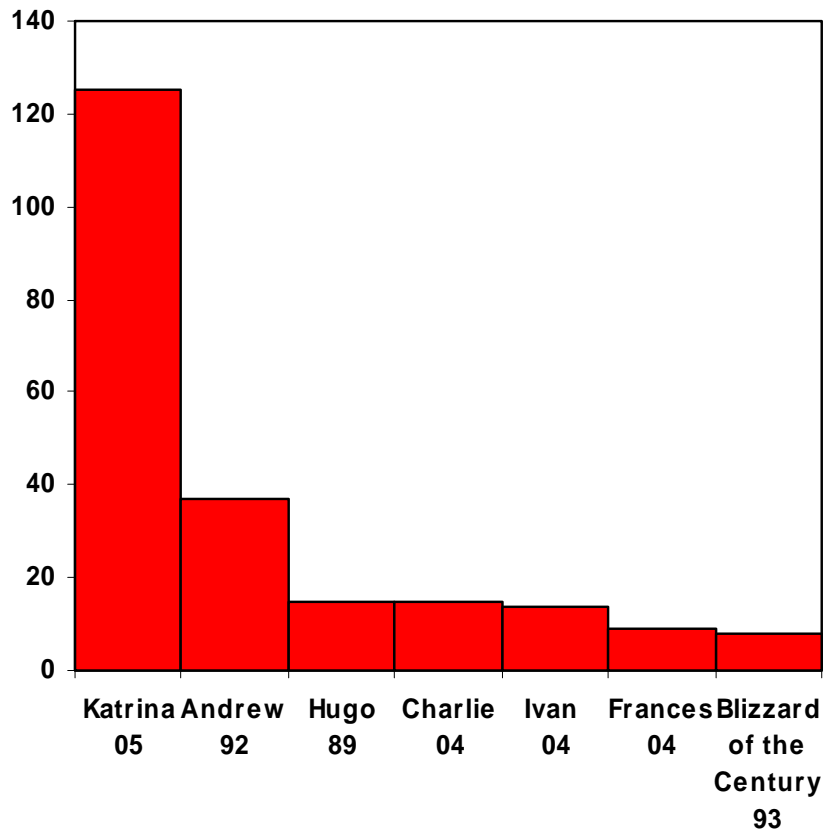
Notes: (1) Q4/Q4 Percent Change

(2) End of period

e = Morgan Stanley Estimate

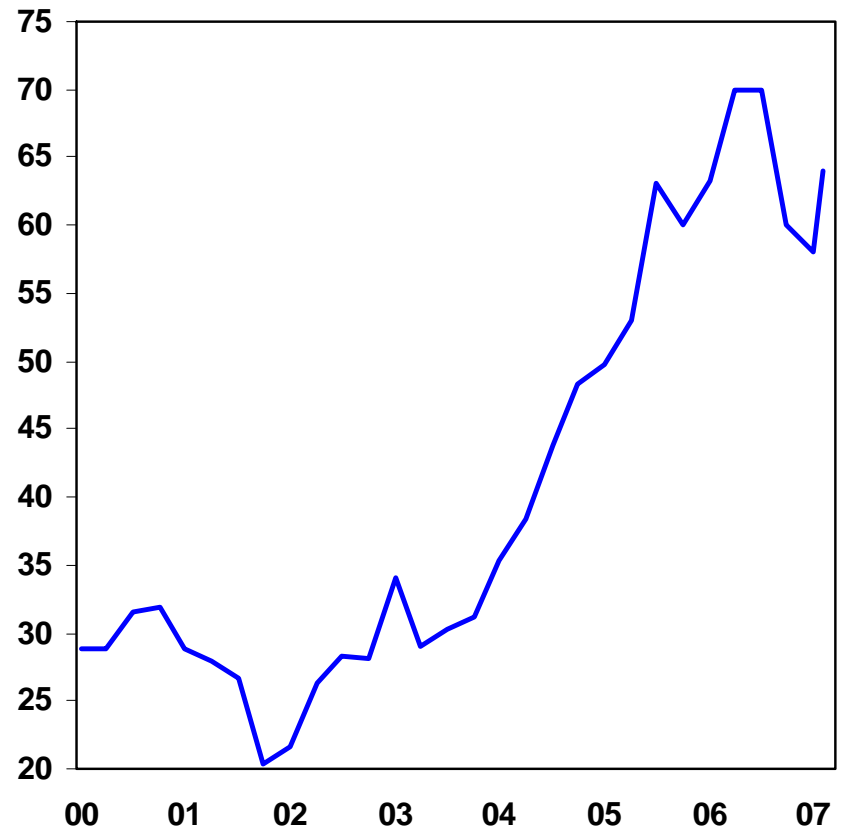
The US Economy Has Demonstrated Impressive Resilience

Estimated Damage Caused By Major Weather Events, 1980 – 2005 (Billions of 2005\$)



Source: National Climatic Data Center and Risk Management Solutions

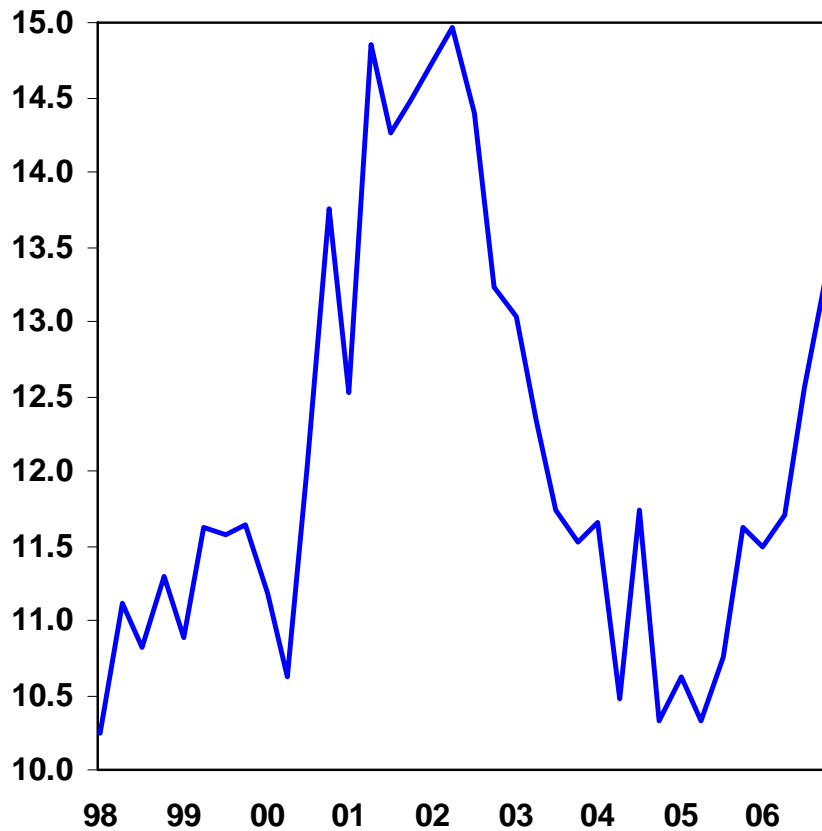
Crude Oil Prices (WTI \$/bbl)



Source: Haver

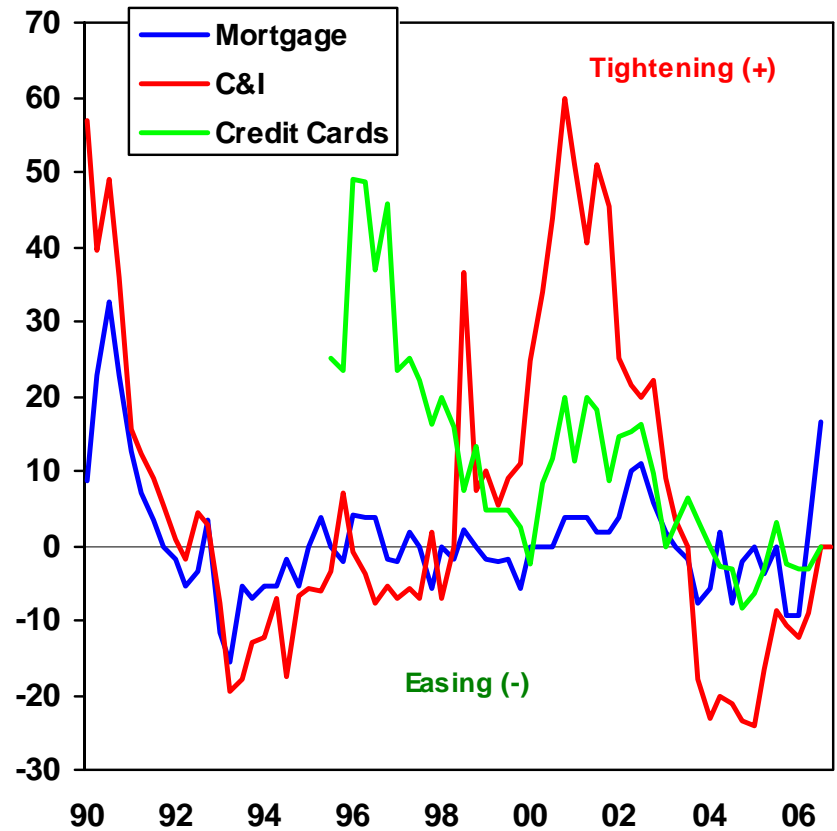
The Latest Hurdle for the Economy

Subprime Mortgage Delinquency Rate (Percent)



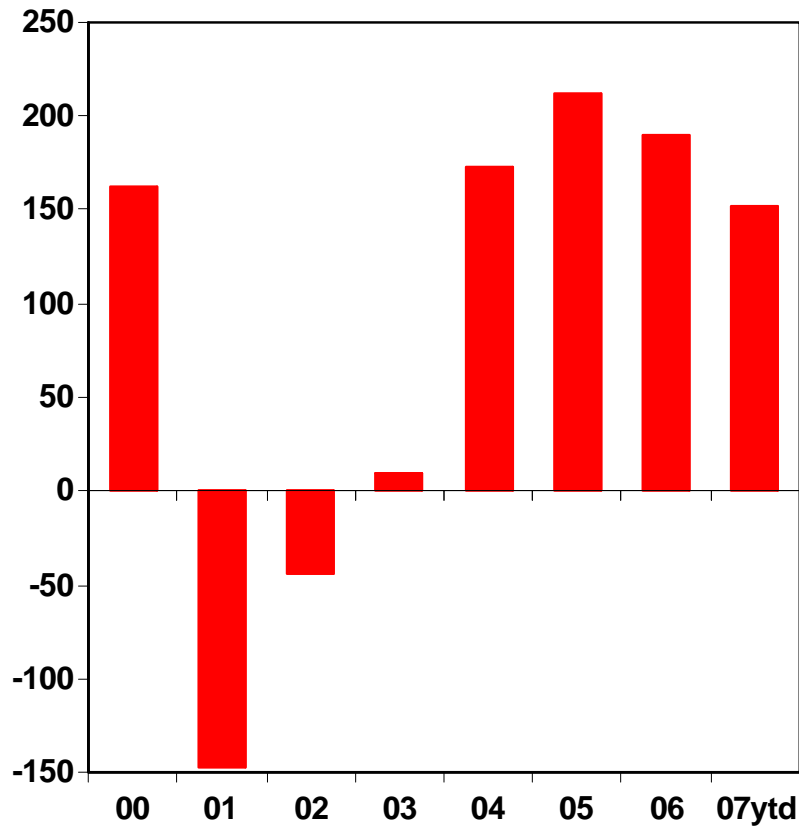
Source: Mortgage Bankers Association (data through Q4)

Lending Standards (Net Percentage of Institutions Reporting a Tightening)



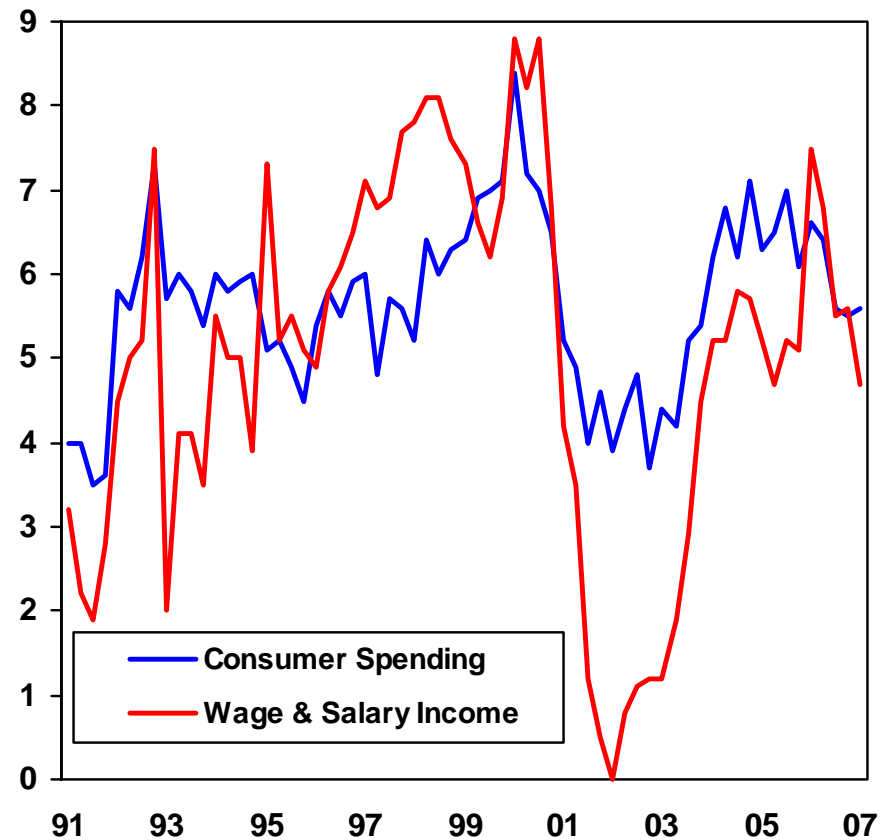
Source: Federal Reserve, Senior Loan Officer Survey. Latest data point is from the January 2007 survey.

Job Growth
(Average Monthly Payroll Change, Thousands)



Source: BLS

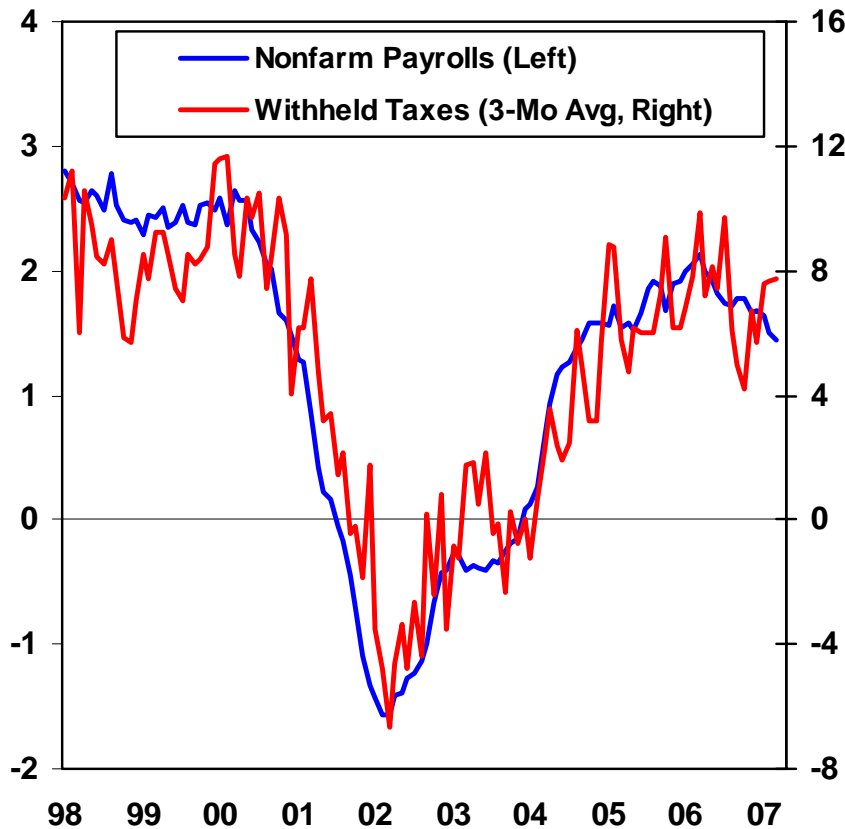
The Link Between Income and Spending
(Year/Year Percent Change)



Source: BEA

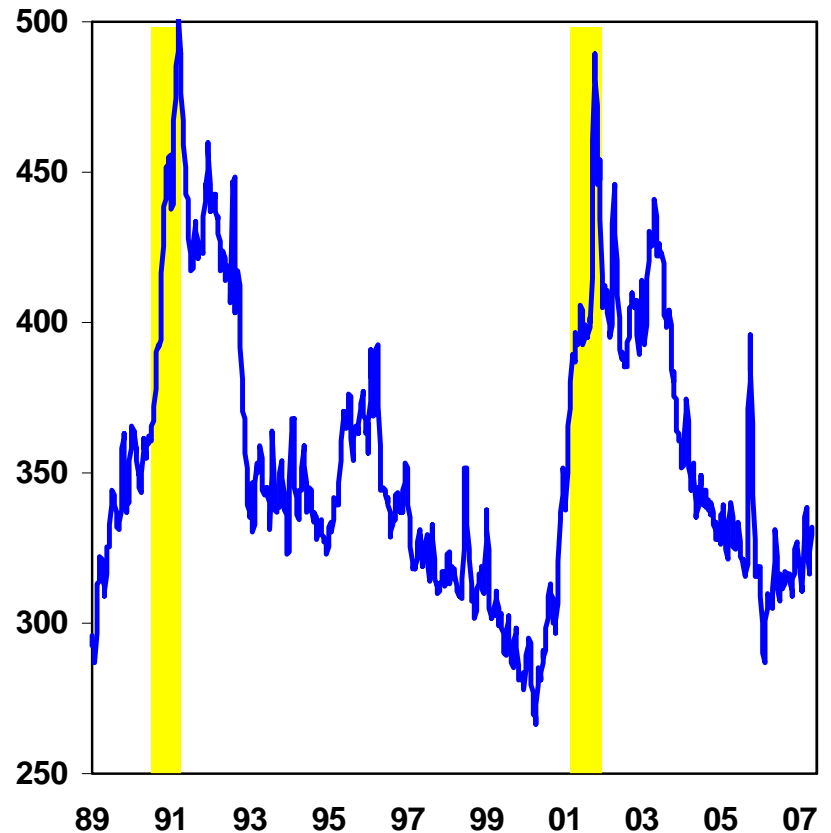
The Labor Market Still Looks Healthy

Employment and Tax Collections
(Year/Year Percent Change)



Source: BLS and Daily Treasury Statement.

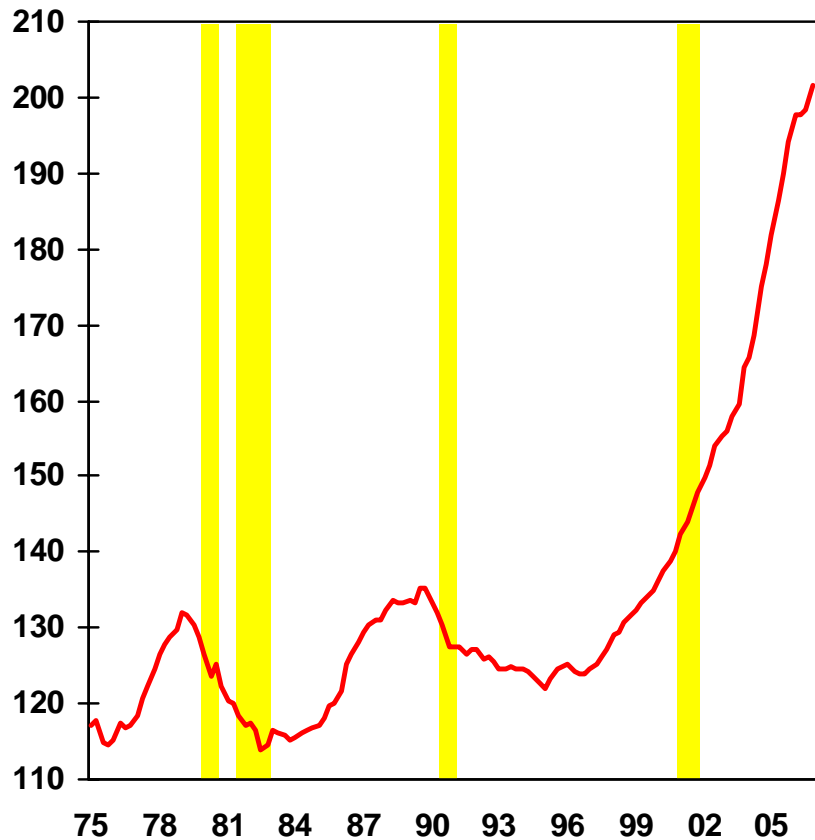
Jobless Claims
(4-Week Average, Thousands)



Source: Department of Labor
Note: Shaded areas indicate recessions.

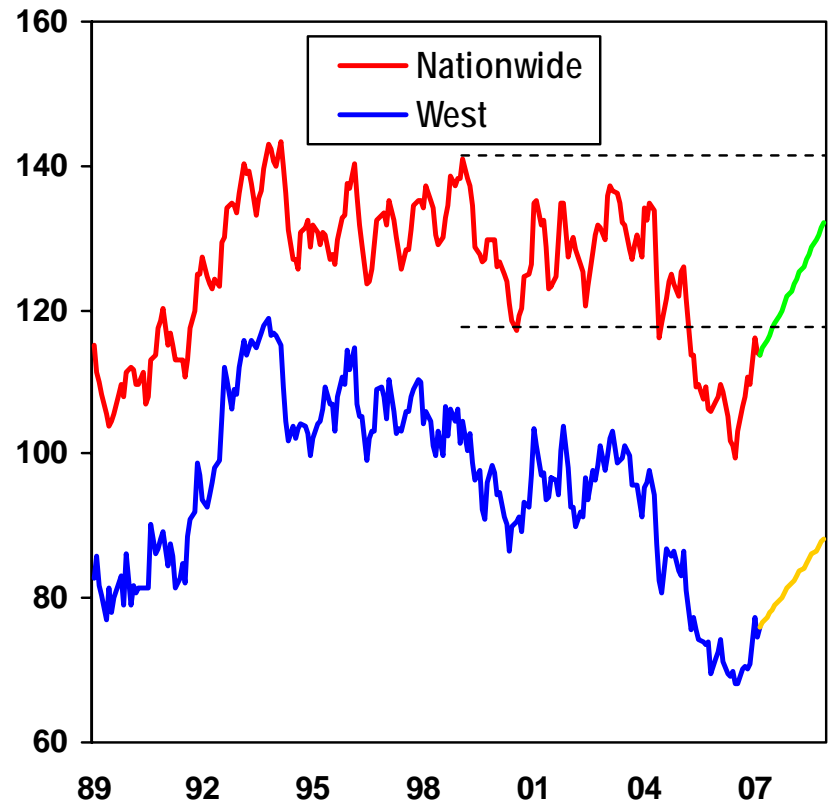
Bubble Trouble in the Housing Market?

Home Prices and the Business Cycle
(OFHEO Index Adjusted for CPI Inflation)



Source: OFHEO and BLS. Shaded Areas indicate recession

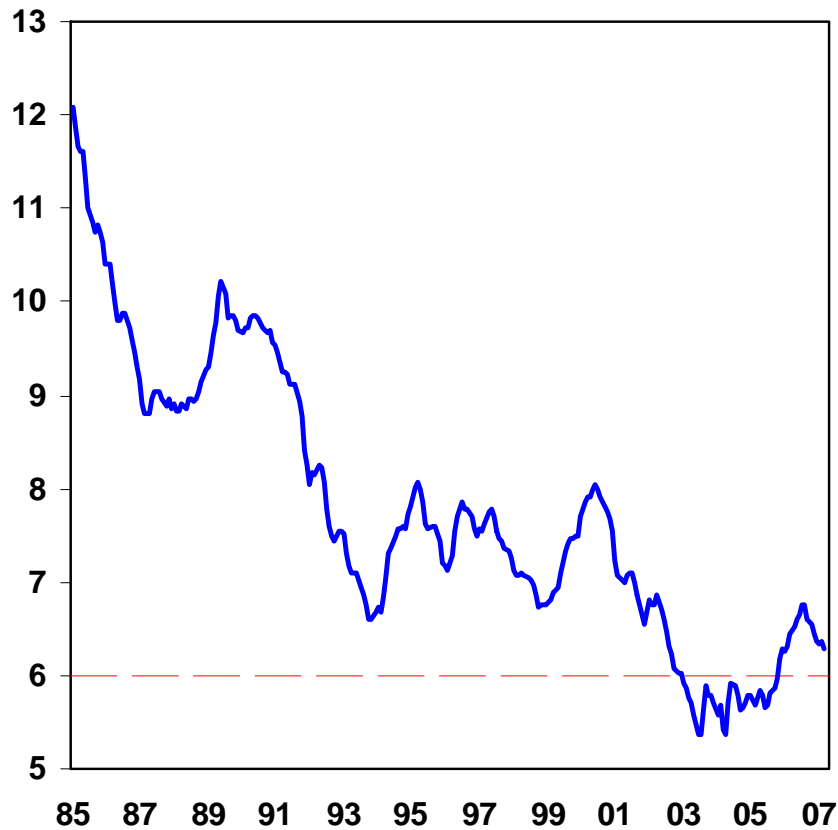
Housing Affordability Index
(Index, Base=100)



Source: National Association of Realtors w/ MS calculations.
Note: Actual series plotted through March with estimates through the end of 2008 assuming a 5% decline in home prices.

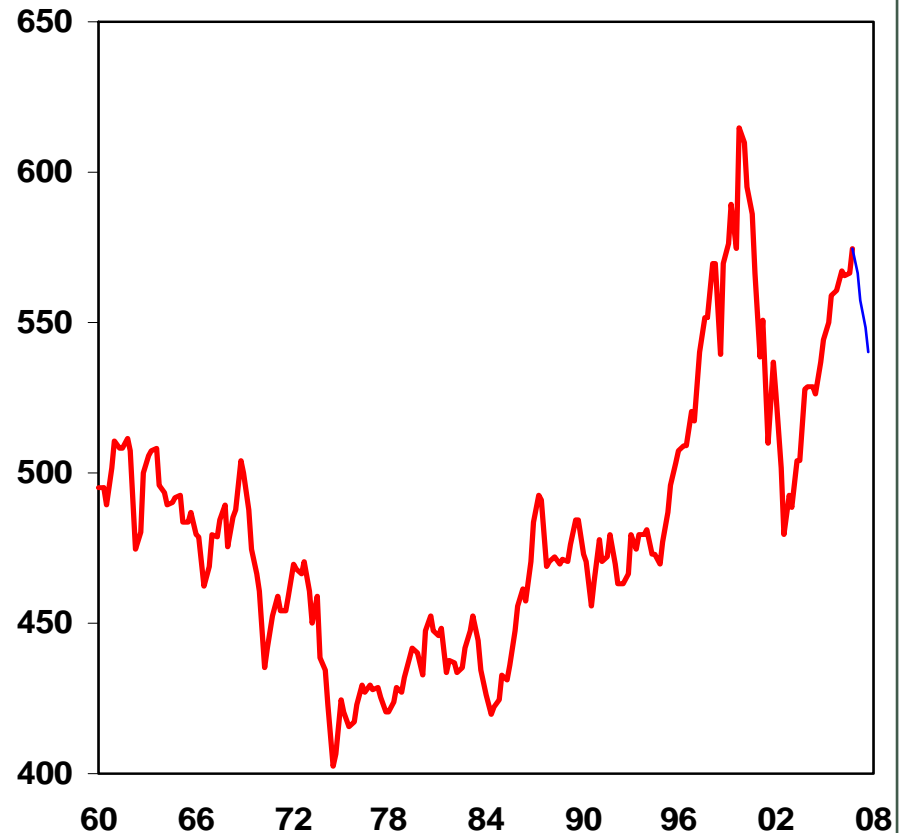
How Big is the Wealth Effect?

Average Contract Rate on All New Mortgage Loans Closed (Percent)



Source: Federal Housing Finance Board. Data plotted through March.

Household Net Worth (Percent of DPI)



Source: Federal Reserve

Note: Actual series plotted through 2006 Q4, with estimates for the ensuing year based on a 5% drop in home prices and a flat equity market.

Wealth Effect

- **Household Real Estate Assets = \$20 trillion.**
- **Assume Home Prices Drop 5%.**
- **“Standard” Wealth Effect implies a \$40 bil (or 0.4%) hit to consumer spending. ^{1/}**

Energy Shock

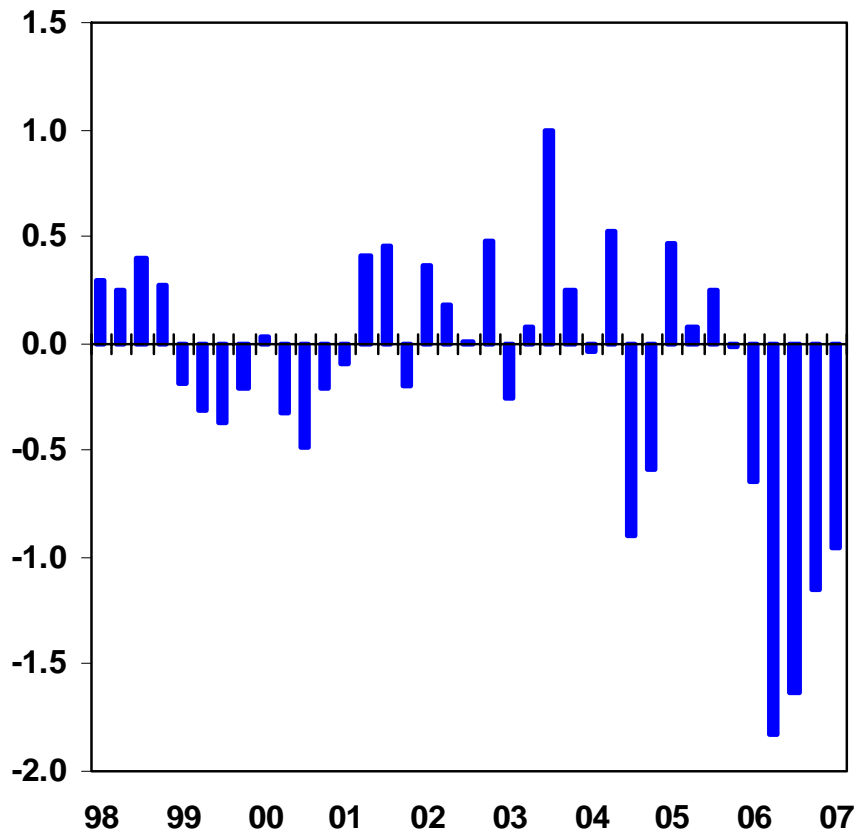
- **Gasoline and fuel oil account for about 4% of total consumer spending. ^{2/}**
- **Assume Gasoline Prices Decline from \$3/gal to \$2.25/gal.**
- **This adds \$90 bil (or 1.0%) to discretionary spending power.**

^{1/} *The wealth effect of 4 cents per dollar of change in wealth is based on the econometric model of the US economy that is used by the Federal Reserve Board. Recent research suggests that the housing-specific wealth effect may be even smaller. See “The Decline in Household Saving and the Wealth Effect” by Juster, Lupton, Smith and Stafford.*

^{2/} *Does not include household fuels such as natural gas.*

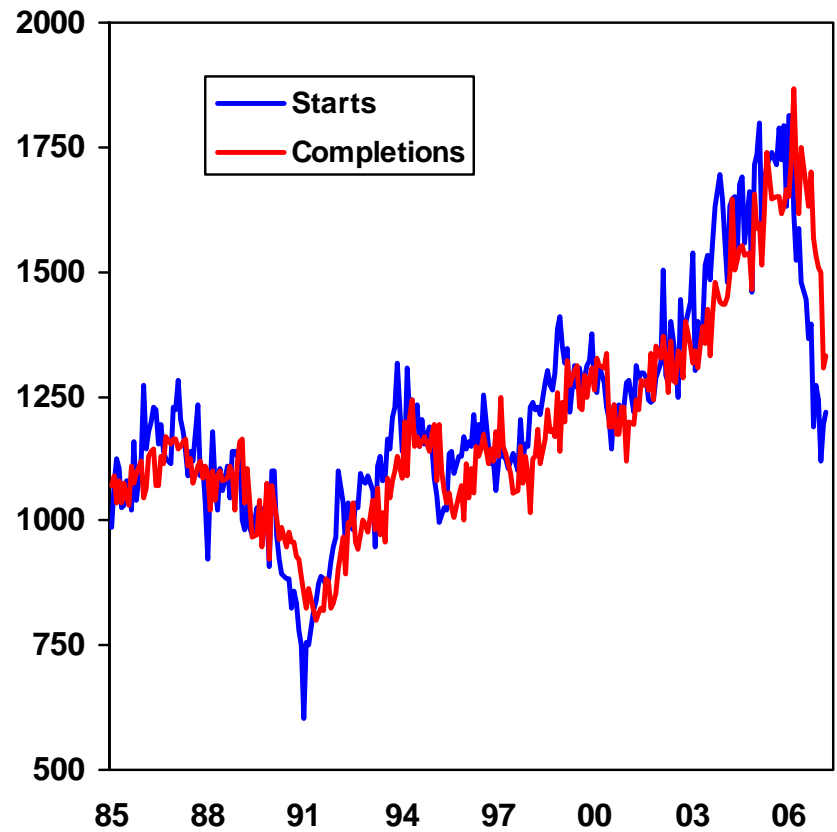
A Correction In Residential Construction Is Well Underway

Residential Investment (Percentage Point Contribution to Quarterly GDP Growth)



Source: BEA

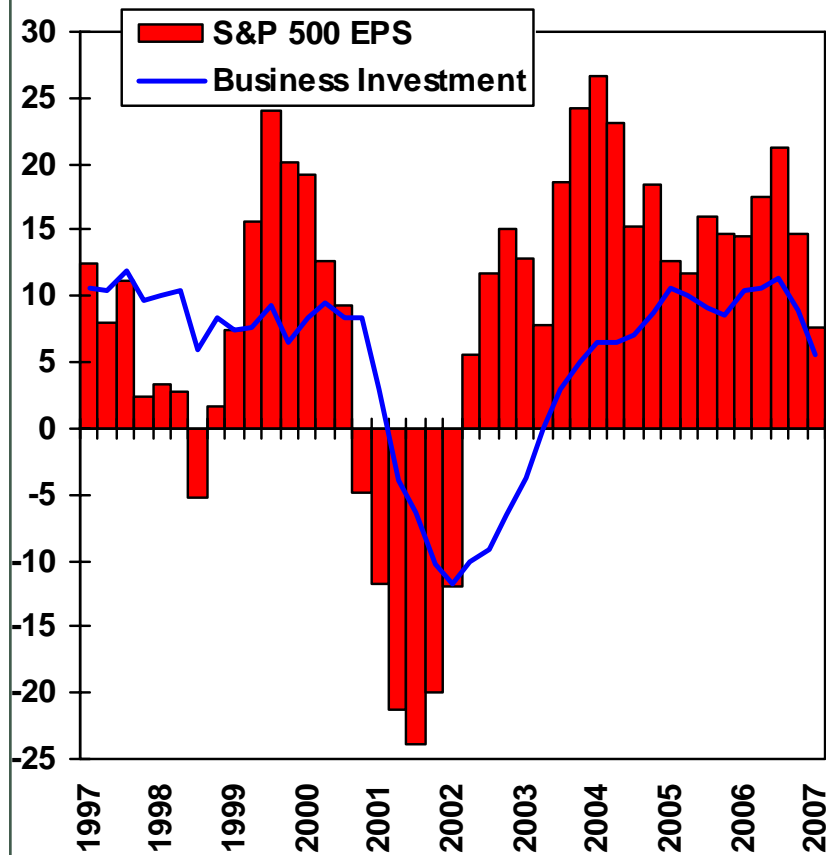
Single-Family Housing Starts & Completions (Thousands, SAAR)



Source: Census Bureau

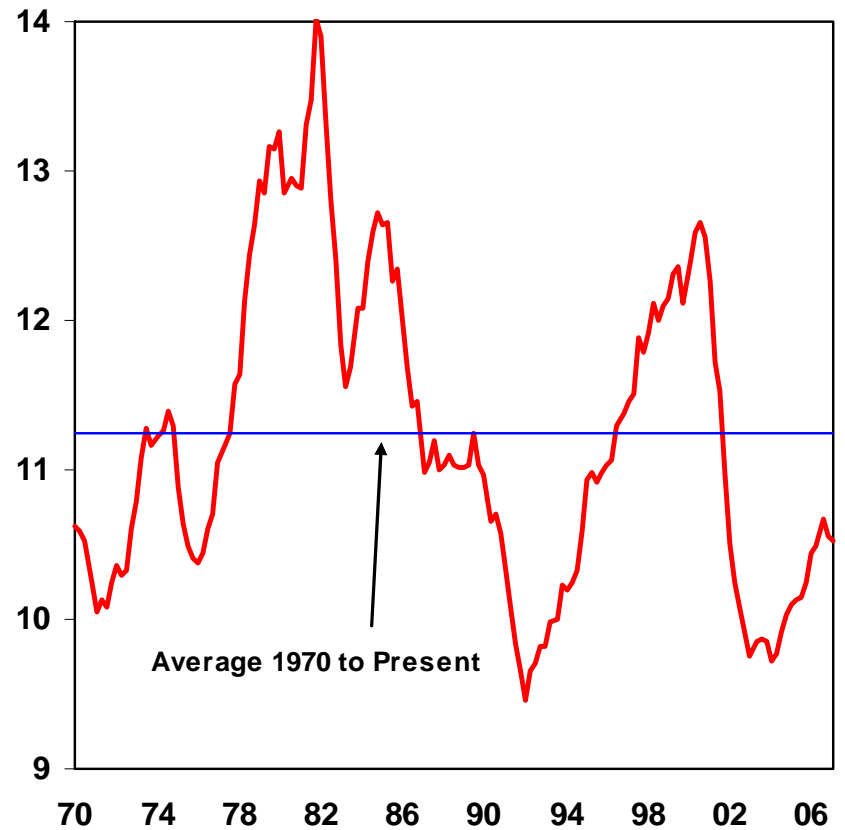
The Cap-ex Mystery

Corporate Profits and Capital Spending
(Percent Change From Year Ago)



Source: S&P and BEA (note: capital spending series is nominal business fixed investment).

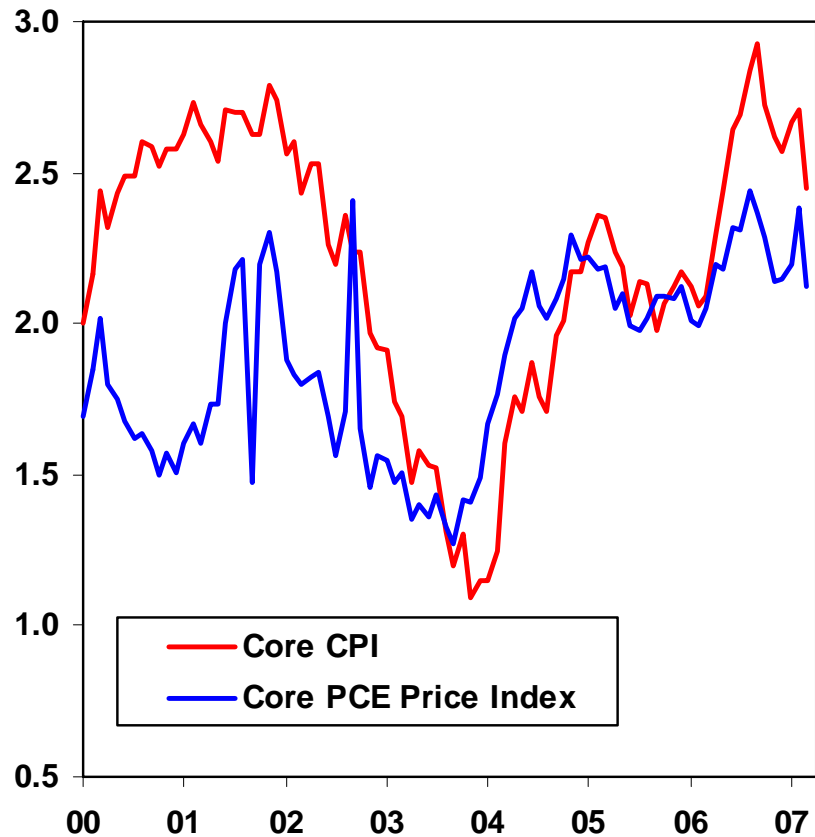
Business Investment as a Share of GDP
(Percent)



Source: BEA

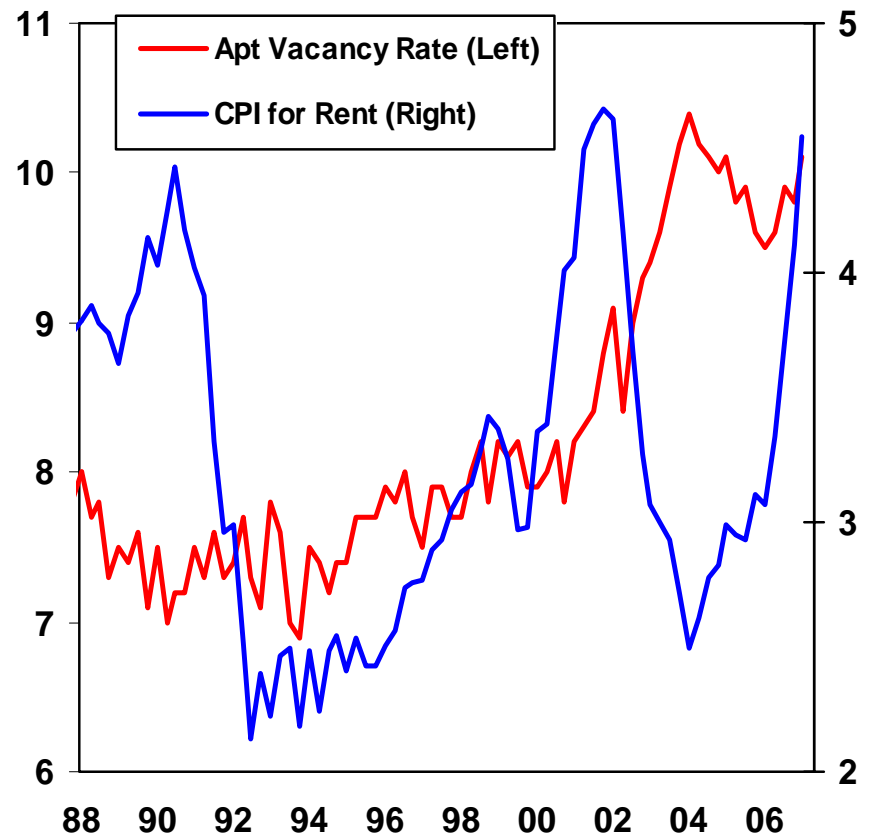
Still on the Inflation Watch

**Core Inflation
(Percent Change From Year Ago)**



Source: BEA and BLS (note: PCE data plotted through February)

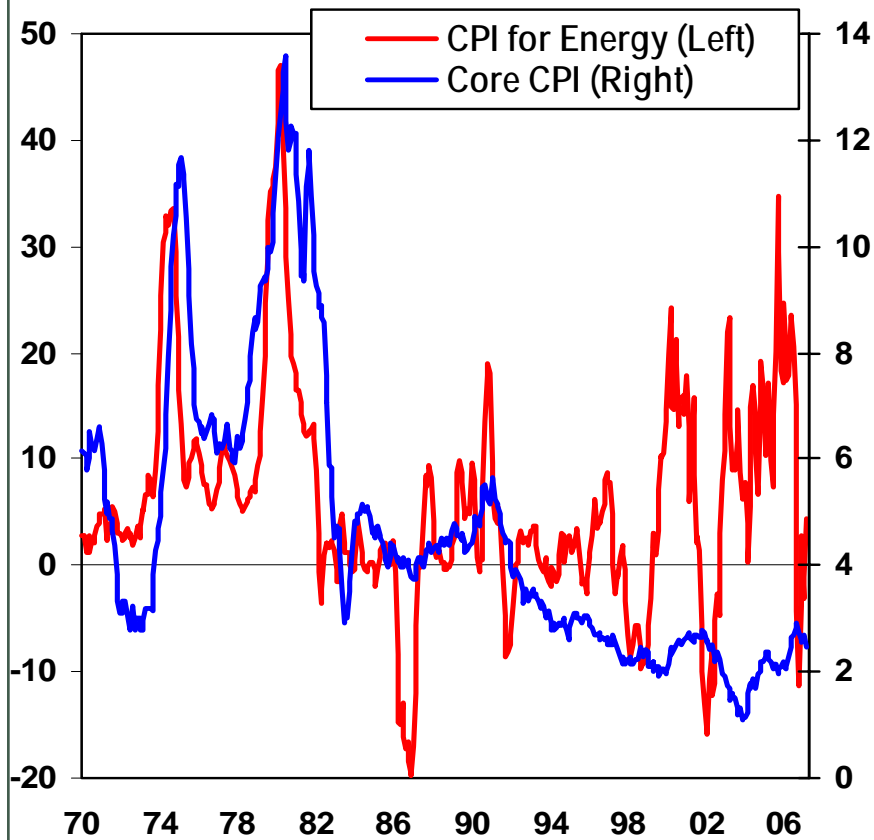
**Rent Increases May Be Peaking
(Percent)**



Source: Census Bureau and BLS

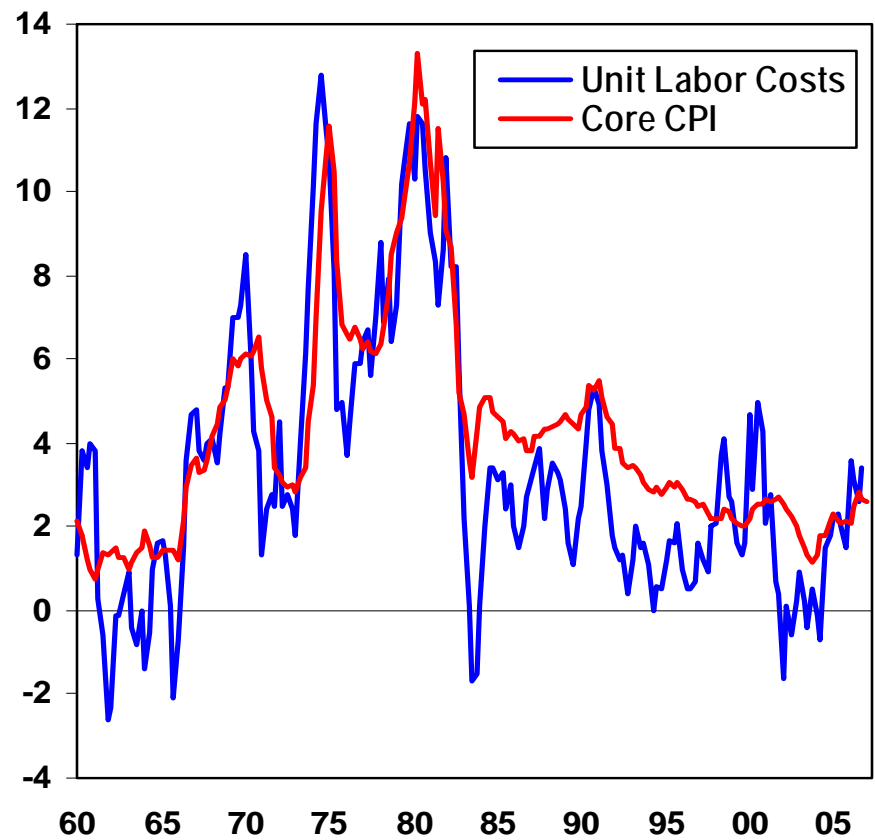
Labor Cost Pressures Are Building

A Mixed Track Record
(Percent Change From Year Ago)



Source: BLS

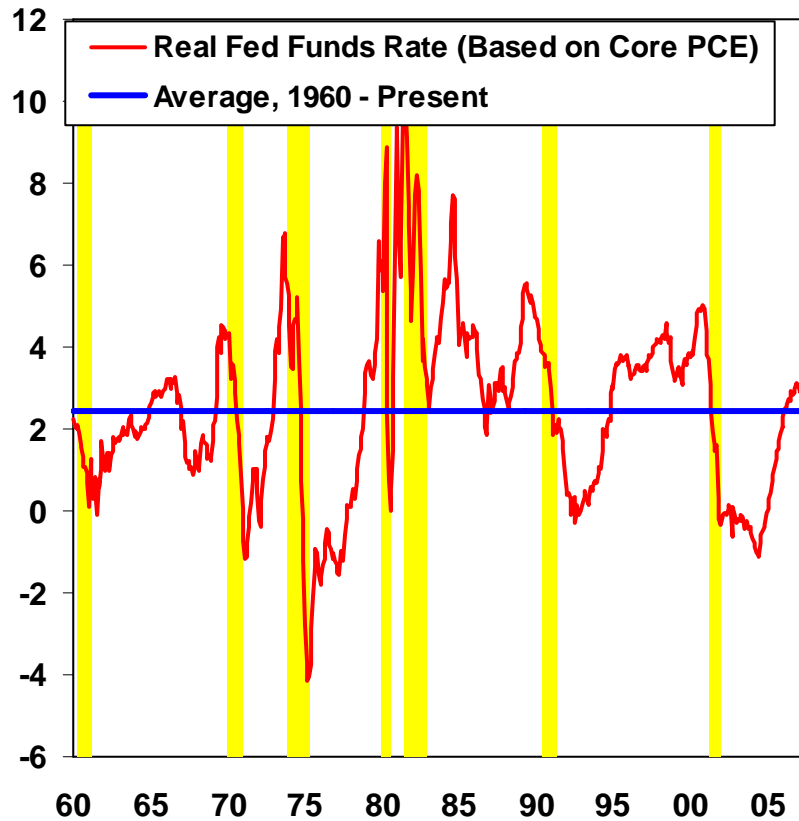
Unit Labor Costs and Inflation
(Year/Year Percent Change)



Source: BLS

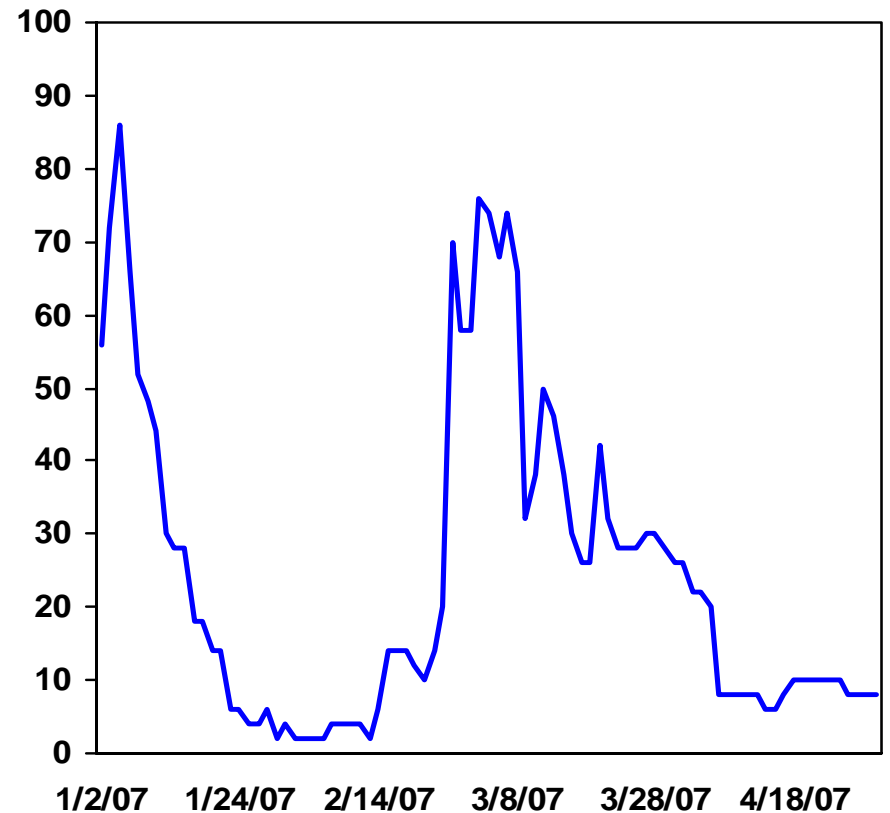
Where are the Bond Market Vigilantes?

Getting to Neutral
(Percent)



Source: Federal Reserve and BLS
Note: Shaded areas indicate recession.

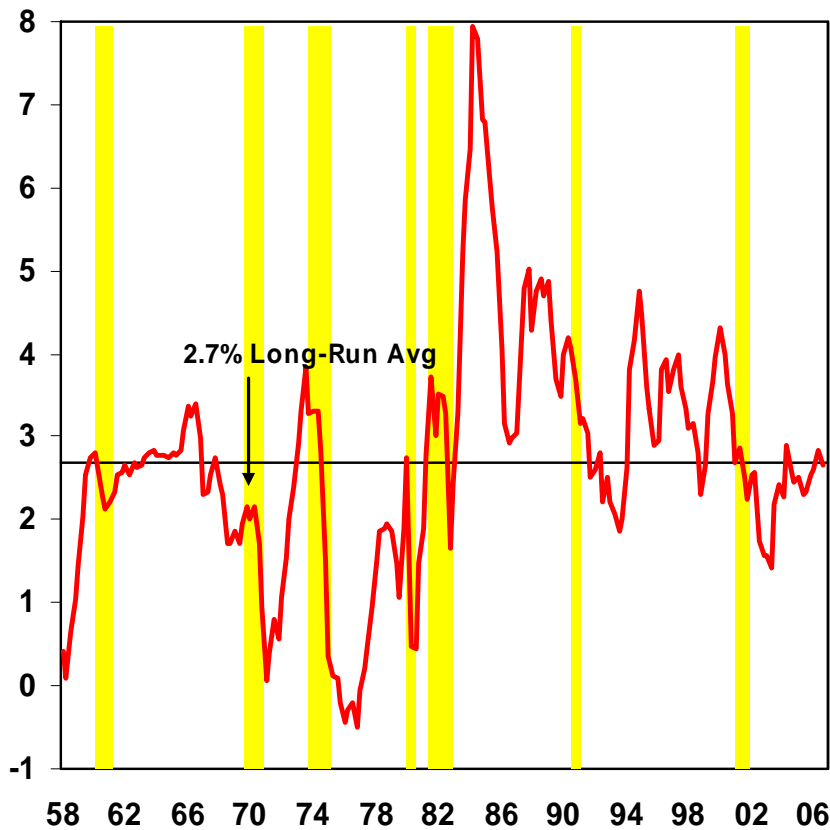
Market Pricing of a Rate Cut by June
(Implied Probability Based on July 07 Fed Funds Futures)



Source: CBOT

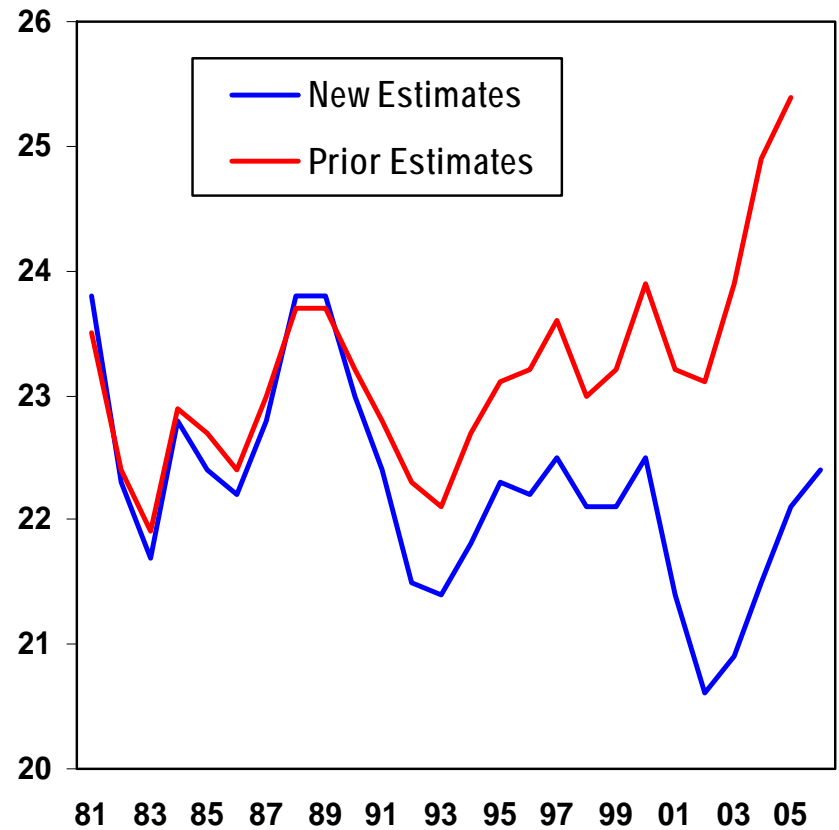
Is There Still a "Conundrum"?

Real 10-Year Treasury Note Yield
(Nominal Yield Less 3-Yr Weighted Average Core CPI)



Source: Federal Reserve and BLS with Morgan Stanley calculations.

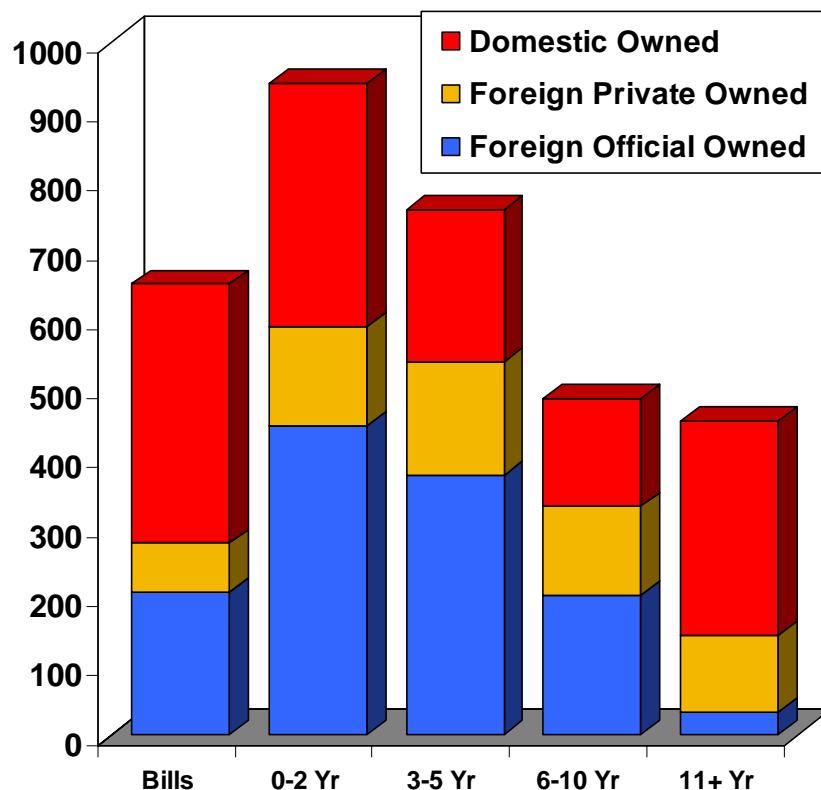
Global Savings Rate
(Percent)



Source: IMF

The Dominant Role of the Foreign Investor

Foreign Ownership of Treasuries, by Maturity (Billions of Dollars)



Note: Data as of June 2005. Excludes Fed holdings.
 Source: Morgan Stanley calculations based on US Treasury Dept data.

Financing the U.S. Budget Deficit

Cumulative Budget Deficit, FY 2002-06 **\$1516 billion**

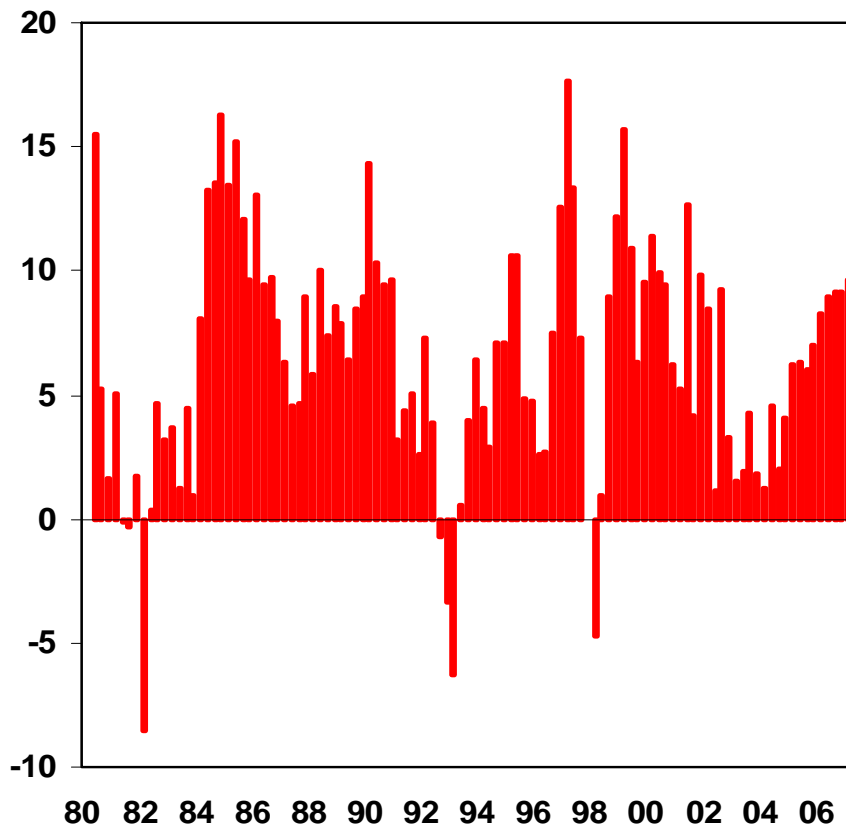
Net Purchases of Treasuries, FY 2002-06

Federal Reserve	\$225 billion
Foreign Central Banks	\$438 billion
Private Foreign Investors	<u>\$846 billion</u>
Total	\$1509 billion

Source: Treasury Department, TICS Survey, Federal Reserve, and Morgan Stanley estimates

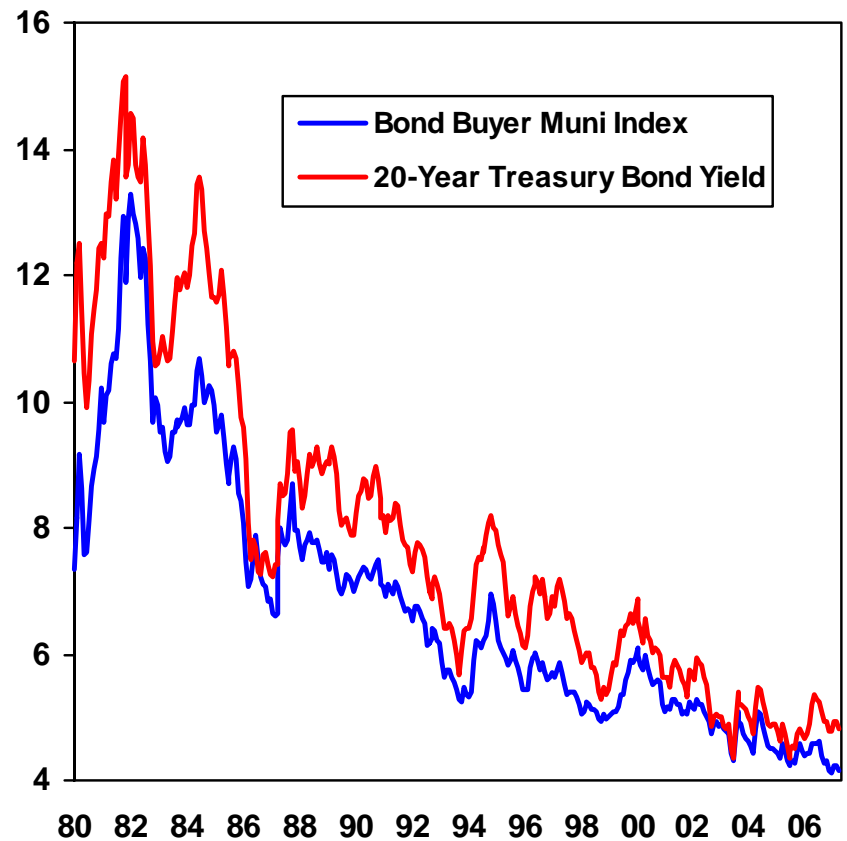
Infrastructure Spending Has Accelerated In Recent Years

State and Local Government Investment (Year/Year Percent Change)



Source: BEA

Muni Yields Tend to Track Treasuries (Percent)



Source: Federal Reserve

Important Disclosures

This material may contain information compiled by Morgan Stanley from transactions executed by Morgan Stanley in the securities/instruments, listed derivatives and over-the-counter foreign exchange markets with a portion of our global institutional and high net worth individual customer base; the data do not include, among other transactions, transactions effected with other dealers and market makers in these markets and transactions effected with retail customers of Morgan Stanley DW Inc. In compiling, interpreting and analyzing the data, Morgan Stanley makes certain assumptions, which may vary over time and by asset class, relating to the classification of an account as a customer (the entity/person that places the order) and the customer's jurisdiction, the inclusion and treatment of certain types of securities/instruments, and the classification of assets. The data have been aggregated, anonymized and otherwise compiled by Morgan Stanley so as not to identify the underlying transactions of any particular customer. Morgan Stanley compiles the data from its proprietary databases, is the sole owner of the resulting aggregated data and may use it for any purpose, including trading. No representation is made that the aggregated data are representative of trading patterns or trends in the asset classes or markets included in this material or of any particular type of customer. With respect to any asset class or market, Morgan Stanley's share of transactions executed for such asset class or market may not be significant. From time to time, Morgan Stanley may, but is not obligated to, make corrections or adjustments to data that have been previously reported that may result in such data being presented differently in future materials.

To our readers in Taiwan: Information on securities/instruments that trade in Taiwan is distributed by Morgan Stanley & Co. International Limited, Taipei Branch (the "Branch"). Such information is for your reference only. The reader should independently evaluate the investment risks and is solely responsible for their investment decisions. This publication may not be distributed to the public media or quoted or used by the public media without the express written consent of Morgan Stanley. Information on securities/instruments that do not trade in Taiwan is for informational purposes only and is not to be construed as a recommendation or a solicitation to trade in such securities/instruments. The Branch may not execute transactions for clients in these securities/instruments.

To our readers in Hong Kong: Information is distributed in Hong Kong by and on behalf of, and is attributable to, Morgan Stanley Dean Witter Asia Limited as part of its regulated activities in Hong Kong. If you have queries concerning this publication, please contact our Hong Kong sales representatives.

Certain information in this material was sourced by employees of the Shanghai Representative Office of Morgan Stanley Dean Witter Asia Limited for the use of Morgan Stanley Dean Witter Asia Limited.

THIS PUBLICATION IS DISSEMINATED IN JAPAN BY MORGAN STANLEY JAPAN LIMITED; IN HONG KONG BY MORGAN STANLEY DEAN WITTER ASIA LIMITED; IN SINGAPORE BY MORGAN STANLEY DEAN WITTER ASIA (SINGAPORE) PTE., REGULATED BY THE MONETARY AUTHORITY OF SINGAPORE, WHICH ACCEPTS RESPONSIBILITY FOR ITS CONTENTS; IN AUSTRALIA BY MORGAN STANLEY DEAN WITTER AUSTRALIA LIMITED A.B.N. 67 003 734 576, A LICENSED DEALER, WHICH ACCEPTS RESPONSIBILITY FOR ITS CONTENTS; IN CANADA BY MORGAN STANLEY CANADA LIMITED, WHICH HAS APPROVED OF, AND HAS AGREED TO TAKE RESPONSIBILITY FOR, THE CONTENTS OF THIS PUBLICATION IN CANADA; IN GERMANY BY MORGAN STANLEY BANK AG, FRANKFURT AM MAIN, REGULATED BY BUNDESANSTALT FUER FINANZDIENSTLEISTUNGSAUFSICHT (BAFIN); IN SPAIN BY MORGAN STANLEY, S.V., S.A., A MORGAN STANLEY GROUP COMPANY, WHICH IS SUPERVISED BY THE SPANISH SECURITIES MARKETS COMMISSION (CNMV) AND STATES THAT THIS DOCUMENT HAS BEEN WRITTEN AND DISTRIBUTED IN ACCORDANCE WITH THE RULES OF CONDUCT APPLICABLE TO FINANCIAL RESEARCH AS ESTABLISHED UNDER SPANISH REGULATIONS; IN THE UNITED KINGDOM BY MORGAN STANLEY & CO. INTERNATIONAL LIMITED, AUTHORISED AND REGULATED BY THE FINANCIAL SERVICES AUTHORITY; AND IN THE UNITED STATES BY MORGAN STANLEY & CO. INCORPORATED AND MORGAN STANLEY DW INC., WHICH ACCEPT RESPONSIBILITY FOR ITS CONTENTS. IN AUSTRALIA, THIS REPORT, AND ANY ACCESS TO IT, IS INTENDED ONLY FOR "WHOLESALE CLIENTS" WITHIN THE MEANING OF THE AUSTRALIAN CORPORATIONS ACT. NOT FOR DISTRIBUTION TO PRIVATE CUSTOMERS AS DEFINED BY THE UK FINANCIAL SERVICES AUTHORITY.

The trademarks and service marks contained herein are the property of their respective owners. Third-party data providers make no warranties or representations of any kind relating to the accuracy, completeness, or timeliness of the data they provide and shall not have liability for any damages of any kind relating to such data.

This material may not be sold or redistributed without the written consent of Morgan Stanley.

Morgan Stanley research is disseminated and available primarily electronically, and, in some cases, in printed form.

Additional information is available upon request.

© 2005 Morgan Stanley