INVESTMENT MANAGEMENT

Morgan Stanley

Jim Caron on CNBC:

Bond Markets Ahead – What to Watch For at the Fed Meeting

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The Trump rally: What's pressuring bonds, is it irrational exuberance and will it fade?

Trump rally: Trump's policies focus on fiscal stimulus and regulatory reforms that are designed to drive: Capital Expenditure (Cap-ex) ⇨ Business Investment ⇨ Productivity. The economy has been missing the knock-on effects in this linkage to drive organic growth and drive a healthy increase in inflation expectations.

Yield driver?: The rise in bond yields reflects a shift from the prior regime of Secular Stagnation (shared misery) to Shared Optimism – an environment where markets are driven by economic prospects rather than Federal Reserve (Fed) dependencies.

Irrational exuberance?: No, in our opinion. 'Irrational' would mean UST bond yields are at unreasonable levels. Bond yields are still low respective to how other assets have performed YTD as of December 12, 2016: equities +11%, high yield +17%, emerging market bonds +15%, investment-grade corporate bonds +5%, UST Index +0.5 – +1%.[1] BONDS ARE NOT in a BEAR MARKET yet.

Will the Trump rally fade? This is conditional on: 1) How much, how fast and the quality of fiscal stimulus; 2) The pace and design of regulatory reform; 3) The risk of possible missteps on trade; protectionism polices. We believe there is the possibility of more upside to be captured, but the market is pricing in a healthy degree of fear that Trump will fail. The degree to which this maybe mispriced (in either direction) is the key to determining how long this rally will last.

Looking forward: Fed expectations, Fed metrics, key issues to watch and our yield outlook

Fed expectations: Our current expectations are that we will see a 25-bp interest rate hike in December 2016, two hikes in 2017 and three hikes in 2018. This would push the terminal rate to approximately 2.00% versus the Fed rate which would be at approximately 3.00%.

Fed metrics: Inflation, wage levels and overall economic productivity, are important metrics provided by the Fed. We believe they are currently showing evidence that weakness in economic growth is cyclical, and not structural.

[1] Equities are represented by the S&P 500 Index, high yield by the Bloomberg Barclays U.S. Corporate High Yield Index, emerging market bonds by the JP Morgan Emerging Markets Bond Global Index, investment-grade corporate bonds by the Bloomberg Barclays U.S. Corporate Index and UST Index by the Bank of America/Merrill Lynch 1 Year U.S. Treasury Note Index.

Key issues: The Fed "dot plot," which shows each member of the Fed's interest rate expectations, has been WRONG at times in the past and the expectations have moved to be more in line with the market's expectations. BUT is the Fed now RIGHT and the market wrong? Maybe the big change will be a shift in the market's rate expectations, and no move in the Fed's expectations.

Yield curve management: We expect the yield curve to steepen and inflation expectations grow.

Yield outlook: We see UST 10-year yield being fairly valued around 2.75% - 3.00%. The overshoot risk is if Trump is successful and economic growth for 2017 reaches +3.0% versus consensus expectations of 2.2% versus potential output of 1.5%

The USD is a key player for 2017

Historically, a strong USD is good for the U.S. economy. But it matters why the USD strengthens. If the USD rises in reflection of higher potential U.S. growth, which increases world growth, then that should be good for the U.S. economy. If the U.S. grows in isolation and the rest of world weakens, then USD strength will likely feed back to weakness.

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