Morgan Stanley

INVESTMENT MANAGEMENT

Market Gets Surprised by an Unsurprising U.S. Federal Reserve

FIXED INCOME | GLOBAL FIXED INCOME TEAM | MARKET PULSE | SEPTEMBER 21, 2017

AUTHOR

JIM CARON

Managing Director

Global Fixed Income Team

Market participants were expecting a more dovish statement from the U.S. Federal Reserve (Fed). The surprise was that the Fed did exactly as they advertised and in that sense was unsurprising – from their perspective.

The Fed did what they said they were going to do…

- **Action:** Fed keeps rates unchanged but leaves the door wide open for December with 12 of 16 members voting for a rate hike.
- **Action:** Fed maintains a view for three hikes in 2018 (11 of 16 Fed member votes), but two hikes in 2019 (down from three) and a long-term terminal rate of 2.75% (down from 3.00%).
- **Action:** Balance sheet unwind to begin in October: $10Bn U.S. Treasuries and mortgage-backed securities (MBS) per quarter until it reaches a $50Bn per quarter pace, or $600Bn per year.
- **On the economy:** Modest upgrade to gross domestic product (GDP) and labor market. However, the **Fed looked past recent weakness in inflation**, and instead focused on inflation returning to the 2% target. That is to say, low inflation is transitory and they still believe in the Philips Curve in which a low and falling unemployment rate will cause inflation to rise.

…the surprise came from investor expectations that the Fed would be more dovish.

- Market expectations were pricing a long-term Fed policy rate of 1.75% to 2.00%; no hike in December and 2-3 hikes by end of 2019. **Versus** the Fed's current stance of staying with one hike in December and three hikes in 2018 and two in 2019.
- However, there **will be several new members of the Fed** in 2018 including the possibility of a new chairperson. This creates doubt amongst investors that the Fed will increase rates as currently prescribed.
- **Bottom line:** Financial conditions may become less easy, but are unlikely to tighten.

What the market may extrapolate from today's Fed decision

- Taken at their word, the Fed may be **more** on a pre-set course to hike interest rates and unwind the balance sheet and **less** data dependent.

- **Mispricing along the yield curve.** Based on the Fed's forecasted path of policy rates, the federal funds rate will be 2.25% by the end of 2018, which is close to where the U.S. Treasury 10 year yield is today. Either the Fed is trying to engineer a very flat curve (which we think is unlikely) or back-end rates are too low.

- **The Fed's creates its own dilemma – a Catch-22.** The Fed expects inflation to rise, but at the same time they plan to hike rates to stay ahead of inflation. In which case, inflation is less likely to rise. So, the Fed either has a preference for inflation to rise to target, or they'd rather be on a pre-set course to hike rates. It's unlikely they can have it both ways.

Highest conviction areas to invest: Own carry assets but hedge with an underweight in duration

- **Emerging markets (EM):** From a valuation perspective we like EM best. Fundamentals align with strengthening global growth, stable/rising commodity prices, better balanced economies than historically, low global inflation and the gap between real yields in EM still historically wide versus developed markets (DM). We expect U.S. rates to rise slowly thus keeping the USD weaker, or not strengthening as fast as ordinary. Thus keeping the EM asset class an attractive investment.

- **Non-agency residential mortgages:** We still believe both fundamentals and technicals are aligned for this asset class: strengthening economy and labor metrics, home prices appreciating, low default/delinquencies, historically low supply of housing, to name only several. Yields still attractive for this product relative to the risk.

IMPORTANT DISCLOSURES

This material is for use of Professional Clients only, except in the U.S. where the material may be redistributed or used with the general public.

Past performance is no guarantee of future results.

The views, opinions, forecasts and estimates expressed are those of the portfolio manager as of date presented and are subject to change at any time due to market, economic, or other conditions. Furthermore, the views will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring, after the date of publication. The views expressed do not reflect the opinions of all portfolio managers at Morgan Stanley Investment Management (MSIM) or the views of the firm as a whole, and may not be reflected in all the strategies and products that the Firm offers.

Forecasts and/or estimates provided herein are subject to change and may not actually come to pass. Information regarding expected market returns and market outlooks is based on the research, analysis and opinions of the authors. These conclusions are speculative in nature and are not intended to predict the future performance of any specific Morgan Stanley Investment Management product.

This material is a general communication, which is not impartial and all information provided has been prepared solely for informational and educational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The information herein has not been based on a consideration of any individual investor circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision.

RISK CONSIDERATIONS: There is no assurance that a Portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the fund will decline and that the value of fund shares may therefore be less than what you paid for them. Accordingly, you can lose money investing in this Portfolio. Please be aware that this Portfolio may be subject to certain additional risks. Investing involves risks including the possible loss of principal.

Fixed-income securities are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In the current rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. Longer-term securities may be more sensitive to interest rate changes. In a declining interest-rate environment, the portfolio may generate less income. **Mortgage- and asset-backed securities** are sensitive to early prepayment risk and a higher risk of default and may be hard to value and difficult to sell (liquidity risk). They are also subject to credit, market and interest rate risks. Certain **U.S. government securities** purchased by the Strategy, such as those issued by Fannie Mae and Freddie Mac, are not backed by the full faith and credit of the U.S. It is possible that these issuers will not have the funds to meet their payment obligations in the future. **High yield securities ("junk bonds")** are lower rated securities that may have a higher degree of credit and liquidity risk. **Public bank loans** are subject to liquidity risk and the credit risks of lower rated securities. **Foreign securities are** subject to currency, political, economic and market risks. The risks of investing in **emerging market** countries are greater than risks associated with investments in foreign developed countries. **Sovereign debt securities** are subject to default risk. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks.

Restricted and illiquid securities may be more difficult to sell and value than publicly traded securities (liquidity risk).

This communication is not a product of Morgan Stanley's Research Department and should not be regarded as a research recommendation. The information contained herein has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.

This communication is only intended for and will be only distributed to persons resident in jurisdictions where such distribution or availability would not be contrary to local laws or regulations.

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market. Prior to investing, investors should carefully review the strategy's / product's relevant offering document. There are important differences in how the strategy is carried out in each of the investment vehicles.

EMEA:

This communication was issued and approved in the United Kingdom by Morgan Stanley Investment Management Limited, 25 Cabot Square, Canary Wharf, London E14 4QA, authorized and regulated by the Financial Conduct Authority, for distribution to Professional Clients only and must not be relied upon or acted upon by Retail Clients (each as defined in the UK Financial Conduct Authority's rules).

Financial intermediaries are required to satisfy themselves that the information in this document is suitable for any person to whom they provide this document in view of that person's circumstances and purpose. MSIM shall not be liable for, and accepts no liability for, the use or misuse of this document by any such financial intermediary. If such a person considers an investment she/he should always ensure that she/he has satisfied herself/himself that she/he has been properly advised by that financial intermediary about the suitability of an investment.

U.S.:

A separately managed account may not be suitable for all investors. Separate accounts managed according to the Strategy include a number of securities and will not necessarily track the performance of any index. Please consider the investment objectives, risks and fees of the Strategy carefully before investing. A minimum asset level is required. For important information about the investment manager, please refer to Form ADV Part 2**.**

Please consider the investment objective, risks, charges and expenses of the fund carefully before investing. The prospectus contains this and other information about the fund. To obtain a prospectus, download one at morganstanley.com/im or call 1-800-548-7786. Please read the prospectus carefully before investing.

Morgan Stanley Distribution, Inc. serves as the distributor for Morgan Stanley funds.

NOT FDIC INSURED | OFFER NO BANK GUARANTEE | MAY LOSE VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A DEPOSIT

HONG KONG:

This document has been issued by Morgan Stanley Asia Limited for use in Hong Kong and shall only be made available to "professional investors" as defined under the Securities and Futures Ordinance of Hong Kong (Cap 571). The contents of this document have not been reviewed nor approved by any regulatory authority including the Securities and Futures Commission in Hong Kong. Accordingly, save where an exemption is available under the relevant law, this document shall not be issued, circulated, distributed, directed at, or made available to, the public in Hong Kong.

SINGAPORE:

This document should not be considered to be the subject of an invitation for subscription or purchase, whether directly or indirectly, to the public or any member of the public in Singapore other than (i) to an institutional investor under section 304 of the Securities and Futures Act, Chapter 289 of Singapore ("SFA"), (ii) to a "relevant person" (which includes an accredited investor) pursuant to section 305 of the SFA, and such distribution is in accordance with the conditions specified in section 305 of the SFA; or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. In particular, for investment funds that are not authorized or recognized by the MAS, units in such funds are not allowed to be offered to the retail public; any written material issued to persons as aforementioned in connection with an offer is not a prospectus as defined in the SFA and, accordingly, statutory liability under the SFA in relation to the content of prospectuses does not apply, and investors should consider carefully whether the investment is suitable for them.

AUSTRALIA:

This publication is disseminated in Australia by Morgan Stanley Investment Management (Australia) Pty Limited ACN: 122040037, AFSL No. 314182, which accept responsibility for its contents. This publication, and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act.

Morgan Stanley Investment Management is the asset management division of Morgan Stanley.

