Morgan Stanley

INVESTMENT MANAGEMENT

Where Are Bond Yields Going?

It depends on what part of the curve you are asking about.

FIXED INCOME | GLOBAL FIXED INCOME TEAM | MARKET PULSE | May 12, 2020

AUTHOR

JIM CARON

Managing Director
Portfolio Manager
Global Fixed Income Team

Liquidity versus Solvency

The goal of the Fed's policy response function is to prevent the liquidity crisis brought on by Covid-19 from becoming a solvency crisis. This is achieved by keeping interest rates low in the short- and intermediate-term segments of the yield curve, providing corporations with the opportunity to refinance debt at lower costs and have ongoing access to affordable capital. The ultimate goal is to minimize funding risks and keep companies solvent.

As such, the main focus of the Fed is to keep rates managed lower for maturities of *less than* 10 years. On the other hand, maturities *greater than* 10 years are at risk to rise and have their curves steepen.

Will the Fed succeed? Perhaps. Part of the answer relies on whether it can force the private sector to participate in the market. There is often some skepticism at the onset of Fed purchase programs and the risk that the private sector may not follow. But in that case we reiterate that the Fed will do "whatever it takes" to achieve their goals, and we do not think it wise to "fight the Fed" and end up on the wrong side of this trade.

In the end the impact of the Fed ultimately depends on the lingering impact of the coronavirus and the path and pace of the reopening of the global economy.

Supply and Demand: It's all about the math

There is a massive amount of supply in the markets. The question is whether it can be effectively matched by demand.

Supply

The refunding of U.S. Treasuries (UST) was slightly larger than expected and skewed towards longer maturities:

- On the yield curve we saw a modest steepening for maturities *less than* 10 years and a more pronounced steepening for those *greater than* 10 years

    - UST 2-10-year peaked at 265bps in 2013, bottomed at -5bps in Aug 2019 and are now starting to re-steepen at 54bps, a **20% retracement**.

    - UST 10-30-year peaked at 125bps in 2013, bottomed at 10bps in July 2018 and are now at 71bps, roughly a **50% retracement.**

    - The supply of corporate bonds is currently estimated at $1 - $1.5 trillion in 2020 (and we expect it closer to $1.5 trillion as we are already at $840 billion YTD). This compares to $1 trillion in 2019.[1]

- Negative interest rates? Fed Chair Powell says no! He stated in an interview with the Peterson Institute on May 13, 2020:

    - The current Fed tools are working, and it does not see it necessary to move to negative rates.

    - The Fed has seen mixed results on negative rates, no clear evidence that they work.

    - The risk of using negative rates is that it impacts the bank intermediation process, i.e. it impedes its ability to extend credit to the real economy.

    - We think that a move to negative interest rates would also mean serious structural and legal considerations, including a review of Dodd-Frank and prime and money market funds.

Demand

Demand is primarily a function of the Fed and their Quantitative Easing program. As of today, most of QE is focused on maturities of less than 10 years. Beyond that, the Fed has indicated they will keep policy rates at 0% for "as long as it takes," perhaps until 2023.

[1] Bloomberg, 2019

- Mathematically this keeps front-end, and to a large degree, intermediate-term rates anchored.
- Longer-term rates tend to be less impacted by near-term policy expectations.

A note on credit risk

The Fed purchase program is designed to support Investment Grade debt, but not most of High Yield. As we like to say at MSIM, High Yield is “outside the tent” and will not benefit from the Fed’s monetary policies. In the end the Fed cannot eliminate credit risk, an important consideration for active managers.

Reopening global economies

The pace and the path of the reopening of global economies is a linchpin of the Fed’s market outlook

- When the economy opens, it is assumed it will it stay open. But will it?

- Does consumer confidence return? It is our view that this depends on medical developments, including therapeutics (a vaccine?) and improved preparedness of the healthcare system.

- A reopening of SMALL BUSINESS is absolutely critical, as small businesses account for roughly 65% of job creation. We recommend that investors pay attention to the NFIB small business confidence survey (released on the second Tuesday of each month at 6 AM EST). The survey is akin to the ISM or PMI, but for small businesses, and is the most underappreciated economic data point we receive each month.

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 portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this portfolio. Please be aware that this portfolio may be subject to certain additional risks. **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 a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. **Longer-term securities** may be more sensitive to interest rate changes. 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).

Past performance is no guarantee of future results.

The views, opinions, forecasts and estimates expressed of the author or the investment team as of the date of preparation of this material 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.

Certain information herein is based on data obtained from third-party sources believed to be reliable. However, we have not verified this information, and we make no representations whatsoever as to its accuracy or completeness.

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.

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.

DISTRIBUTION

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.

Ireland: Morgan Stanley Investment Management (Ireland) Limited. Registered Office: The Observatory, 7-11 Sir John Rogerson's, Quay, Dublin 2, Ireland. Registered in Ireland under company number 616662. Regulated by the Central Bank of Ireland. **United Kingdom:** Morgan Stanley Investment Management Limited is authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA. Dubai: Morgan Stanley Investment Management Limited (Representative Office, Unit Precinct 3-7th Floor-Unit 701 and 702, Level 7, Gate Precinct Building 3, Dubai International Financial Centre, Dubai, 506501, United Arab Emirates. Telephone: +97 (0)14 709 7158). **Germany:** Morgan Stanley Investment Management Limited Niederlassung Deutschland, Grosse Gallustrasse 18, 60312 Frankfurt am Main, Germany (Gattung: Zweigniederlassung (FDI) gem. § 53b KWG). **Italy:** Morgan Stanley Investment Management Limited, Milan Branch (Sede Secondaria di Milano) is a branch of Morgan Stanley Investment Management Limited, a company registered in the U.K., authorised and regulated by the Financial Conduct Authority (FCA), and whose registered office is at 25 Cabot Square, Canary Wharf, London, E14 4QA. Morgan Stanley Investment Management Limited Milan Branch (Sede Secondaria di Milano) with seat in Palazzo Serbelloni Corso Venezia, 16 20121 Milano, Italy, is registered in Italy with company number and VAT number 08829360968. **The Netherlands:** Morgan Stanley Investment Management, Rembrandt Tower, 11th Floor Amstelplein 1 1096HA, Netherlands. Telephone: 31 2-0462-1300. Morgan Stanley Investment Management is a branch office of Morgan Stanley Investment Management Limited. Morgan Stanley Investment Management Limited is authorised and regulated by the Financial Conduct Authority in the United Kingdom. **Switzerland:** Morgan Stanley & Co. International plc, London, Zurich BranchI Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered with the Register of Commerce Zurich CHE-115.415.770. Registered Office: Beethovenstrasse 33, 8002 Zurich, Switzerland, Telephone +41 (0) 44 588 1000. Facsimile: +41 (0) 44 588 1074.

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. This publication has not been reviewed by the Monetary Authority of Singapore. **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.

Japan: For professional investors, this document is circulated or distributed for informational purposes only. For those who are not professional investors, this document is provided in relation to Morgan Stanley Investment Management (Japan) Co., Ltd. ("MSIMJ")'s business with respect to discretionary investment management agreements ("IMA") and investment advisory agreements ("IAA"). This is not for the purpose of a recommendation or solicitation of transactions or offers any particular financial instruments. Under an IMA, with respect to management of assets of a client, the client prescribes basic management policies in advance and commissions MSIMJ to make all investment decisions based on an analysis of the value, etc. of the securities, and MSIMJ accepts such commission. The client shall delegate to MSIMJ the authorities necessary for making investment. MSIMJ exercises the delegated authorities based on investment decisions of MSIMJ, and the client shall not make individual instructions. All investment profits and losses belong to the clients; principal is not guaranteed. Please consider the investment objectives and nature of risks before investing. As an investment advisory fee for an IAA or an IMA, the amount of assets subject to the contract multiplied by a certain rate (the upper limit is 2.20% per annum (including tax)) shall be incurred in proportion to the contract period. For some strategies, a contingency fee may be incurred in addition to the fee mentioned above. Indirect charges also may be incurred, such as brokerage commissions for incorporated securities. Since these charges and expenses are different depending on a contract and other factors, MSIMJ cannot present the rates, upper limits, etc. in advance. All clients should read the Documents Provided Prior to the Conclusion of a Contract carefully before executing an agreement. This document is disseminated in Japan by MSIMJ, Registered No. 410 (Director of Kanto Local Finance Bureau (Financial Instruments Firms)), Membership: The Japan Securities Dealers Association, the Investment Trusts Association, Japan, the Japan Investment Advisers Association and the Type II Financial Instruments Firms Association.

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

IMPORTANT INFORMATION

EMEA: This communication has been issued by Morgan Stanley Investment Management Limited ("MSIM"). Authorised and regulated by the Financial Conduct Authority. Registered in England No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA.

The indexes are unmanaged and do not include any expenses, fees or sales charges. It is not possible to invest directly in an index. Any index referred to herein is the intellectual property (including registered trademarks) of the applicable licensor. Any product based on an index is in no way sponsored, endorsed, sold or promoted by the applicable licensor and it shall not have any liability with respect thereto.

MSIM has not authorised financial intermediaries to use and to distribute this document, unless such use and distribution is made in accordance with applicable law and regulation. Additionally, 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.

This document may be translated into other languages. Where such a translation is made this English version remains definitive. If there are any discrepancies between the English version and any version of this document in another language, the English version shall prevail.

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