Morgan Stanley

INVESTMENT MANAGEMENT

2021 Market Outlook

The More Rates Stay the Same, the More Things Change…

The New Year's celebration this year took on a different meaning, as many looked to turn the page on 2020 and put the global pandemic-induced struggles of the past year behind them. The new year holds the promise of improved economic conditions, but challenges remain for cash investors as the current course of monetary policy and short-term rates is unlikely to change.

JONAS KOLK
Chief Investment Officer
Global Liquidity

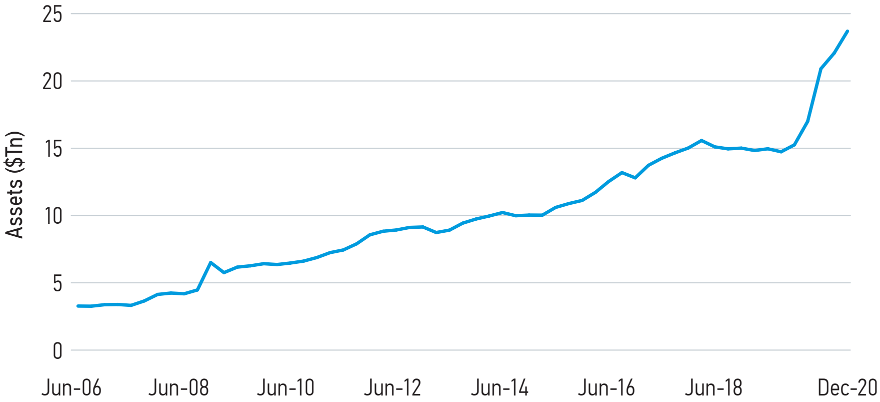
BRIAN BUCK
Executive Director

BOB LEGGETT
Executive Director

In this outlook, we will review the impact an economic recovery might have on rates and central bank policy and what steps investors can take to find opportunities—and mitigate risk—in their liquid portfolios.

DISPLAY 1

Central Bank Balance Sheets



Accommodative Central Banks for the Foreseeable Future

KEY QUESTIONS:

- What is the expected path of interest rates?
- What are the risks to the outlook?

Central banks across developed markets globally are running parallel accommodative monetary policies to help economies recover from the pandemic. These policies go far beyond low rates. Depending on the specific central bank, there have been asset purchase programs, liquidity facilities, lending schemes, extended forward guidance, and in some cases, all of the above. The conversation now is not about whether we will see a reversal in these policies in 2021, but rather to follow progression of policy over the next few years as it evolves from crisis to vaccine implementation to recovery.

The stimulative central bank policies are being paired with elevated levels of fiscal stimulus. Whether this comes in the form of stimulus checks or programs aimed at bolstering employment, these efforts are adding to the foundation laid by monetary policy. There is also tremendous optimism with approval of COVID-19 vaccines. The idea is that these monetary and fiscal packages will support the economy and build a bridge to the recovery when the vaccine is widely distributed.

The base case for accommodative central bank backstops are well documented. But what is the risk to the outlook? There is certainly downside risk with the spread of the virus proliferating or with delays or others issues with the vaccine. The ripple effects of this are fairly straightforward and will mean extended periods of accommodative policy. It is perhaps a more interesting exercise to investigate the opposite end of the spectrum.

With all of this stimulus in place, global growth consensus expectations in 2021 are north of 5%. Morgan Stanley Research is even more optimistic, estimating 2021 global growth at 6.4%. If this plays out and employment and inflation rebound quickly, central banks might have to reconsider their policies to keep rates at extremely low levels. All of that being said, before rates can be increased in any of these major economies, crisis-era liquidity and lending facilities will have to be rolled back and quantitative easing programs will need to be tapered. So even if growth does accelerate beyond current expectations, it will take time to peel back the accommodative central bank policies that are currently in place. This is a major reason why the market is expecting rates to be at current low and even negative levels for the next several years even in the face of a global synchronized recovery.

Faster growth in 2021 could lead to rising long-term rates, but given current central bank policy forecasts, short rates are anchored close to zero. Until rates expectations change materially, the interest rate curve for short-term fixed income securities will remain flat and investment yields will remain challenged.

Stagnant Rates Should Not Mean Stagnant Cash Investment Plans

KEY QUESTIONS:

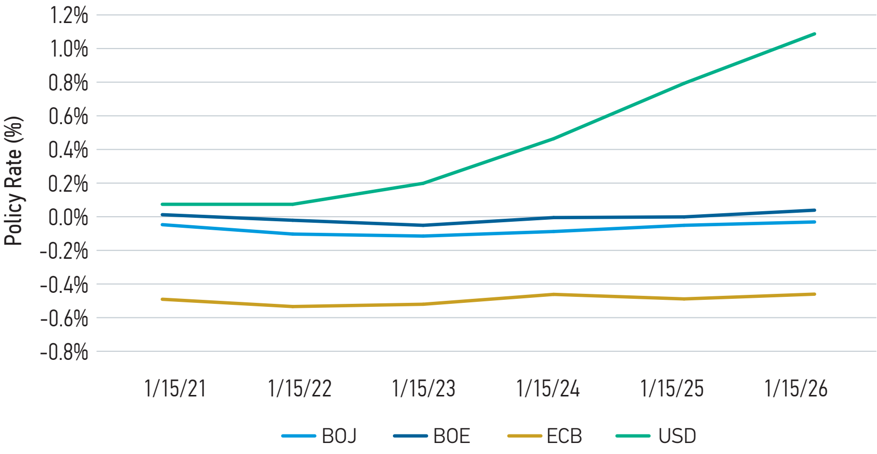
- How do you ensure efficient cash management across deposits and traditional investments?
- What is the value of an extra basis point in yield to you?
- Have you embraced new ideas for your cash management with regard to product or technological innovations?

For many treasury professionals and cash investors, 2020 was characterized by reactionary measures to a challenging market environment. Many investor emerged from 2020 with elevated levels of cash, and that presents a unique challenge given the record low rates globally. As we move into 2021, market functioning and sentiment has largely recovered. The harsh reality for cash investors lies in the fact that major global central banks are unlikely to raise rates anytime soon.

This fact, while painful, gives investors what could be a period of stable rates where they can focus on new ideas and emerging trends within the cash management space. First and foremost, evaluate your portfolio and make sure that your current investments reconcile with your goals and time horizon, especially if your cash balances increased substantially in 2020. Ask yourself if you would change anything if you knew rates were going to be on hold for the next two to three years. Some investors might stand pat with their investments but others might realize that more stable cash balances will allow them flexibility to consider a broader set of investments. Investor decisions come down to efficient cash management as well as determining the value of an extra few basis points in yield and what it might take from a duration or credit perspective to get there.

DISPLAY 2

Global Central Bank Forward Curves



As of January 15, 2021.

Secondly, a year of calmer interest rates could allow you to focus on some emerging investment trends. For some, these trends could come in the form of adding an element of environmental, social and governance (ESG) or socially conscious considerations to your investment portfolio. These themes have come to the forefront recently and could help in aligning cash portfolios with an organization's mission statement or overall goals and objectives. Alternatively, emerging ideas can be realized in the technology space with the advancement of integrated investment portals that contain innovative monitoring and analytics tools that can increase treasury efficiency and transparency. While interest rates may be on hold, the cash investing landscape is very much in motion.

Conclusion

As we begin 2021, cash and liquidity investors should first acknowledge that accommodative monetary and fiscal stimulus. The below checklist should keep investors on track with current investing themes as they continue to evolve:

- **TAKE CARE OF THE BASICS.** Make sure your cash is managed efficiently with your goals, time horizon, and liquidity needs aligned with your investment solutions.
- **UNDERSTAND THE RISKS OF SEEKING OUT HIGHER PORTFOLIO YIELDS.** Review your current investments and maximize your banking relationships, including monitoring deposit and earnings credit rates
- **CONSIDER THE EMERGING TRENDS IN CASH AND LIQUIDITY MANAGEMENT.** ESG or social-conscious investment themes could help align your investments with organization-wide goals. Technology enhancements could also help your treasury efficiency and transparency

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. 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 these portfolios. Please be aware that these portfolios may be subject to certain additional risks and general market liquidity (market risk). **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. **ESG Strategies** that incorporate impact investing and/or Environmental, Social and Governance (ESG) factors could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. As a result, there is no assurance ESG strategies could result in more favorable investment performance.

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