Morgan Stanley

INVESTMENT MANAGEMENT

The Year Ahead for the U.S.: Fundamental Challenges Exist, but Policy Will Prevail

FIXED INCOME | GLOBAL FIXED INCOME TEAM | MARKET PULSE | December 2, 2020

Over the past few weeks we have laid out our expectations for the path of interest rates and their drivers. From a macro perspective, the debate on future growth and the path of rates is now spilling over into credit default rates, and whether or not we experience a second wave of defaults. Let me say upfront that I am optimistic about a procyclical recovery (explained at the end), but let me first lay out the challenges and risks currently in front of us.

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The narrative in the market

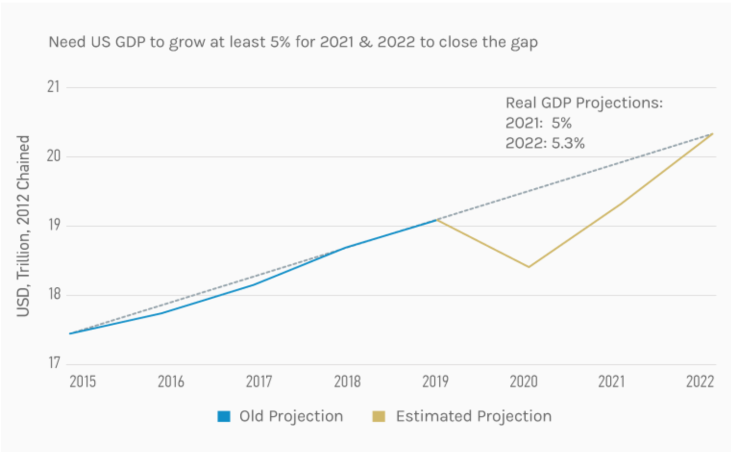
The current market narrative is that we will see a sharp rebound in growth next year, a viable vaccine will become widely available, yields will rise and all will quickly return to normal – in essence, a reflation view. While I generally agree with this narrative, it's a coin flip as to whether it is, in fact, actually correct. Here's the rest of the story.

The quandary

In order for the reflation view to be correct, we need to close the output gap by fully restoring lost aggregate demand, i.e. the shortfall in GDP growth relative to trend, in order to generate sustainable reflation. Making up that shortfall requires approximately 5% growth in 2021 and 2022 (*Display 1 – following page*). And how likely is this? Not very. That is the quandary the market needs to solve to square with the narrative.

Display 1

It will take time to close the output gap in the U.S.



Source: Haver, Morgan Stanley Investment Management. As of December 2, 2020
Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass

Market expectations for growth

What is the market expecting for growth? Blue Chip Consensus Economics surveyed 49 economists and consensus growth for 2021 is 3.8% as of Nov. 30, 2020. Closer to home, the Morgan Stanley forecast for 2021 GDP is more bullish at 6.0%, but compare this to the 3.4% forecasted at one of our major competitors. But here's the real kicker … 2022 GDP forecasts are 2.7% for Morgan Stanley and 3.3% for that competitor. The point here is that, based on these forecasts, the US economy falls short of averaging 5% growth over the next two years and will ultimately struggle to close the output gap.

This indicates that the reflation trade may not materialize as quickly as the market narrative suggests. The implication is that bond yields will rise, but real inflationary pressures will build very slowly as it may take more time to close the output gap - think 2023, but more likely 2024. In addition, a slow return of aggregate demand (i.e. cash flow) makes credit default risk more prominent than what the current narrative might be suggesting.

Why the optimism?

What is laid out above is an economic fundamental argument. What is missing is the technical data from policy support, *and I think that matters more*. Remember that asset prices in 2020 were driven mainly by policy, not fundamentals, and this will likely continue to be true in the years ahead. Whether it be fiscal policy, monetary policy helping to keep rates low, Fed backstops, "animal spirits", etc., any and all can help to push asset prices higher. So, once again, incorporation of the impact of the policy response function, which we expect will still be accommodative alongside a recovery (i.e. procyclical), may dominate asset prices. This is why I am optimistic about the future of asset prices and performance despite challenging economic fundamentals.

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