It is well understood that the recent ‘everything bubble’—in which valuations for most major financial assets have reached historical extremes—is predicated on low real rates and the perception of their sustainability. Low real rates have also been viewed as an important driver of newly emergent trends, including U.S. dollar weakness and a bullish outlook for commodities. Any interruption to this low real rates regime could threaten valuations, and thus represents a major risk to the current market environment.

We believe a further moderate back up in real rates is possible later in 2021 in the context of the strong U.S. economic growth that we expect this year. However, over the medium-term, that is over the next 2-3 years, this increase in real rates may prove fleeting as longer-term budgetary and debt dynamics will likely require real rates to be even lower than they are today (see Display 1).

The U.S. 10-year TIPS (Treasury inflation-protected securities) yield, at -65 basis points today, is only moderately above its level in the third quarter of 2020, despite a substantial improvement in global growth which has historically been an important driver. Today’s global composite PMI reading of 52.9, for example, would suggest that the U.S. 10-year real yield should be about +34 basis points, or about +100 basis points above current levels (see Display 2). The current break with the historical relationship between global growth and real yields to a significant degree reflects an altered perception of economic policy, future constraints of budget and debt dynamics, as well as a downward reassessment of trend growth.

The change in policymaker attitudes has been pronounced and is at this point well-known. Policymakers are focused on fighting the low growth and low inflation that marked the post-Global Financial Crisis recovery and expansion (with falling neutral real rates as a consequence). The Federal Reserve (Fed) is seeking to overshoot its inflation target and has committed to begin a liftoff of the policy rate only when inflation has reached and exceeded its

**Display 1:** Real U.S. 10-Year Yields Trend to Remain Depressed Going Forward

Real U.S. 10-Year Yields (3-Year Moving Average)


Forecasts/estimates are based on current conditions, subject to change, and may not necessarily come to pass. The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. Past performance is no guarantee of future results.
target, with a lag, as opposed to reacting to anticipated inflation based on the Phillips curve framework. With fiscal tightening having been blamed for anemic growth following the Global Financial Crisis, premature fiscal consolidation—which would measurably impact growth—appears unlikely.

Display 2: Real Yields Too Low Relative to Current Growth
U.S. 10-Year TIPS Yields vs. PMI

Forecasts/estimates are based on current conditions, subject to change, and may not necessarily come to pass. The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. Past performance is no guarantee of future results. See Disclosure section for index definitions.

However, a substantial increase in real rates may temporarily occur if inflation breaks out sustainably above its target, probably above 3.0% to 3.5%. With nearly $2 trillion of savings amassed by U.S. consumers, and additional stimulus measures in the works, we expect U.S. GDP growth could be +7.5 to 9.5% in 2021, such that the output gap could be positive—between +3% and +5%—by the end of 2021. Conventional analysis suggests a muted inflation outlook. But an output gap of this magnitude and current money supply growth (M2 growth at +26%) would both be near the highest levels ever (or since data began in 1949 and 1910, respectively). Supply side disruptions in the services sector may lead to prices accelerating this year as the economy reopens, in the same way inflation went up in segments of the goods sector that experienced bottlenecks in 2020. Given the ongoing highly stimulative policy setting (again, we expect fiscal consolidation to be difficult to achieve and the Fed to be reactive rather than anticipatory), an inflation outburst is likely to occur eventually. The Fed will be required to step in to tighten policy, and this may cause real rates to rise significantly.

To assess how big such a cyclical back-up in rates might be, besides assessing various cyclical drivers behind it, it is useful to consider what the neutral level of real rates might be. We consider the following factors in determining this: potential GDP growth, aggregate debt growth—which we have found influences the relationship between neutral interest rates and GDP growth and, most importantly, debt sustainability. Taking each of these factors into consideration, we expect debt sustainability to dominate and over time severely depress real rates.

The Congressional Budget Office (CBO) and Organization for Economic Co-operation and Development (OECD) estimate potential U.S. GDP growth to be around 1.6%, which could be optimistic. In the past their potential growth estimates tended to be closely linked to growth experienced in the previous 6 to 8 years, and their current estimates are not an exception. Their current projections imply productivity growth of 1.3%, close to the average of 2010-2020. This may prove overly optimistic given the outlook for tighter regulation, compared with the deregulation experienced during 2017-2020, and it may overlook the drag on growth from substantially higher debt; but for the sake of argument we will use 1.6% as potential U.S. growth.

We have found historically that the pace of debt growth (best measured as the growth in the ratio of debt to GDP), along with past inflation, has been predictive of the gap between potential GDP growth and interest rates. Based on the CBO’s projections of federal debt growth and assuming private sector debt growing in line with GDP, real 10-year rates should be 0.10% today (-150 basis points below trend real GDP growth of 1.6%), implying somewhat higher real rates than today.

Arguably, U.S. fiscal outlook and debt sustainability considerations are more important in determining the medium-term outlook for real interest rates and are likely to dominate other factors. Hypothetically, if 2020’s 13% cyclically adjusted primary deficit were to remain unchanged, the real 5-year interest rate required to maintain a stable debt-to-GDP ratio would need to be -11%, versus -1% today. Alternatively, to make debt sustainable at today’s level of real rates, the cyclically adjusted primary deficit would need to be cut by 10 percentage points. Such a drastic fiscal austerity program is unlikely to withstand political constraints, as its impact on growth and inequality would be unacceptably large. In the past, countries that experienced fiscal consolidations of a similar magnitude went through crushing recessions (Sweden in 1993; Ireland in 2009; Spain in 2009; to name a few). These episodes were accompanied by increasing monetary accommodation as interest rates were cut. Although fiscal consolidation of the early 2010s did manage to reduce the budget deficit from the -9% to -10% range in 2009-2010 to -2.8% in 2014-2016, this was at the cost of slow growth and low inflation, which, as discussed, policymakers view to have been a mistake that they have vowed not to repeat. In contrast to previous fiscal tightening episodes which usually were accompanied by monetary easing, room for additional monetary accommodation is at best limited today. According to research by the International Monetary Fund, fiscal consolidations in the past have tended to lead to rising inequality, which would be especially problematic today when concerns about this issue are being incorporated into economic policy goals. Due to increased policymakers’ concern with inequality, it seems likely that tax-based austerity measures would be more politically viable than spending based measures. We note that in the past tax-based fiscal consolidations have been more negative for growth than spending cut-based ones.

WHAT’S IN STORE FOR REAL RATES IN THE U.S.?

4% nominal GDP growth (a bit above potential) and half the fiscal consolidation of the 2010s (i.e. about 3-4% cumulative versus 6% in the 2010s), over the next 10 years, real 5-year rates would need to fall to -3% to stabilize debt in this fiscal scenario. Given this debt overhang, it seems that any back up in real rates on hawkish Fed repricing due to stronger GDP growth and higher inflation would be fleeting over the medium term.

The main risks to this prospect of lower real rates would be outright deflation, as policy rates would be unlikely to be cut into negative territory. But given policymakers’ commitment to supporting growth and the public’s lack of concern with debt and deficits, this outcome appears unlikely. A substantial improvement in trend productivity growth would have the potential to lead to higher rates too, but we do not currently anticipate it.

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. In general, equity securities’ values fluctuate in response to activities specific to a company. Investments in foreign markets entail special risks such as 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.

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 (MBS and ABS) 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 Portfolio, such as those issued by Fannie Mae and Freddie Mac, are not backed by the full faith and credit of the United States. It is possible that these issuers will not have the funds to meet their payment obligations in the future. The issuer or governmental authority that controls the repayment of sovereign debt may not be willing or able to repay the principal and/or pay interest when due in accordance with the terms of such obligations. Investments in foreign markets entail special risks such as 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. Real estate investment trusts are subject to risks similar to those associated with the direct ownership of real estate and they are sensitive to such factors as management skills and changes in tax laws. Restricted and illiquid securities may be more difficult to sell and value than publicly traded securities (liquidity risk). Derivative instruments can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the Portfolio’s performance. Trading in, and investment exposure to, the commodities markets may involve substantial risks and subject the Portfolio to greater volatility.

Nondiversified portfolios often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. By investing in investment company securities, the portfolio is subject to the underlying risks of that investment company’s portfolio securities. In addition to the Portfolio’s fees and expenses, the Portfolio generally would bear its share of the investment company’s fees and expenses.
DEFINITIONS

The Russell 1000® Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000® index companies with higher price-to-book ratios and lower forecasted growth values. The Russell 1000® Index is an index of approximately 1,000 of the largest U.S. companies based on a combination of market capitalization and current index membership.

The Russell 1000® Value Index is an index that measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

The S&P 500 Total Return Index is an index that consists of 500 stocks chosen for market size, liquidity and industry group representation. The S&P Index is a market value weighted index with each stock’s weight proportionate to its market value. The S&P Index is one of the most widely used benchmarks of U.S. equity performance. The performance of the S&P Index does not account for any management fees, incentive compensation, commissions or other expenses that would be incurred pursuing such strategy. Total return provides investors with a price-plus-gross cash dividend return. Gross cash dividends are applied on the ex-date of the dividend.

The S&P GSCI® is a composite index of commodity sector returns representing an unleveraged, long-only investment in commodity futures that is broadly diversified across the spectrum of commodities. The returns are calculated on a fully collateralized basis with full reinvestment. The combination of these attributes provides investors with a representative and realistic picture of realizable returns attainable in the commodities markets. Individual components qualify for inclusion in the S&P GSCI® on the basis of liquidity and are weighted by their respective world production quantities.

The Sharpe ratio was developed by Nobel laureate William F. Sharpe and is used to help investors understand the return of an investment compared to its risk. The ratio is the average return earned in excess of the risk-free rate per unit of volatility or total risk. Volatility is a measure of the price fluctuations of an asset or portfolio.

The S&P U.S. Treasury Bond Current 10-Year Index is a one-security index comprising the most recently issued 10-year U.S. Treasury note or bond.

The MSCI USA Energy Index is designed to capture the large and mid cap segments of the US equity universe. All securities in the index are classified in the Energy sector as per the Global Industry Classification Standard (GICS®).

The MSCI USA Materials Index is designed to capture the large and mid cap segments of the US equity universe. All securities in the index are classified in the Materials sector as per the Global Industry Classification Standard (GICS®).

The S&P GSCI Gold Index, a sub-index of the S&P GSCI, provides investors with a reliable and publicly available benchmark tracking the COMEX gold future.

Treasury Inflation-Protected Securities, or TIPS, provide protection against inflation. The principal of a TIPS increases with inflation and decreases with deflation, as measured by the Consumer Price Index.

IMPORTANT DISCLOSURES

The views and opinions are those of the author as of the date of publication and subject to change at any time due to market or economic conditions and may not necessarily come to pass. 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, may not come to pass 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 information 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.

Charts and graphs provided herein are for illustrative purposes only. Past performance is no guarantee of future results. 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. 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.

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.