Morgan Stanley

INVESTMENT MANAGEMENT

Cashing in on Fed 'Insurance' Rate Cuts

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Expectations for easier Fed policy are boosting asset valuations because it is lowering the interest rate their cash flows are discounted at. In addition, since potential rate cuts from the Fed are viewed as 'insurance' to stave off an economic downturn, then asset values get an added boost because lower policy rates are reducing the risk of recession that would typically increase default risk and put those cash flows at risk. Lower rates and reducing recession risk explains much of the upward repricing of riskier assets.

Our Investment Strategy

Most of the investment returns attributed to long duration in our portfolios have already been recognized for this year. We believe 'insurance' rate cuts from the Fed are mostly priced in, and returns attribution in fixed income may be generated by carry and spread narrowing for the remainder of the year. Our focus remains on the real economy and the strength of the consumer in both investment grade and high yield credit. Financials, building materials, gaming and delevering themes in communications remain key sectors for us. Our largest exposure remains in non-agency mortgages and asset-backed securities due to strong credit fundamentals in select areas within this asset class.

What is the Bond Market Telling Us? Well...

It depends which bond market you are talking about. The U.S. Treasuries (UST) market is pricing a recession in 12-months. Credit/high yield is pricing an extension of the economic expansion (low recession risk/low default risk). The bond market indicates that lower UST rates are increasing the valuations of riskier assets.

Where will UST yields level out?

If we take at face value the market expectation for rate cuts close to 100 basis points, then we believe the UST 2-year yield could fall to within a range of 1.50% - 1.75%. The yield curve should have some slope if these cuts serve as an insurance policy against rising recession risks, 2s10s 25-50 basis points. This leaves the UST 10-year yield in a range of 1.75% - 2.25%.

We believe these levels are fair and reasonable based on what we know right now. Lower yield expectations require a more negative economic outlook than is currently priced, and vice versa for higher yields.

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