Morgan Stanley

INVESTMENT MANAGEMENT

Global Rates, Trade, the USD & the Yield Curve

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Japan

- Japan (Bank of Japan ((BoJ): Media reports suggest that the BoJ may consider reducing easy policies, which include:
  1. Adjusting yield-curve-control (YCC) to allow long term rates to drift higher above the de facto target range of 0bps-10bps.
  2. Operational changes to BoJ purchases of government bonds and ETFs.

- Why the change? Acknowledgement of a buildup of negative side-effects from too easy policy for too long.
  1. Mainly pressures on financial institutions from an extensively period of a low-rate environment.
  2. Market distortions and adverse technical impacting liquidity of some parts of the market.

- Key Point: The Butterfly Effect - Japan (BoJ) policy is the proverbial butterfly flapping its wings.
  - o Japan is a global anchor for policy rates (next to the U.S .and Europe).
  - o The ‘direction’ not the ‘magnitude’ of JGB yield moves is most important.
  - o A small move higher in JGB yields has compounding ripple effects for ALL global yields (butterfly effect).

U.S.

- Shape of the Yield Curve: It’s NOT different this time but some differences do matter.
  - o Flatter curve sends a weaker signal than previously about the future of economic activity. Why? Because:
    1. The Fed is not currently tightening; they are ”removing excess accommodation”. The curve flattening sends a stronger signal about future economic weakness when the Fed is actually tightening policy and actively trying to slow the economy. The Fed is currently moving to ’neutral; they are not tightening, so the signaling effect of curve flattening about the future is weaker today.
    2. QE has reduced term premia by approximately 40bps, we estimate. As a result, if we make a comparison about the slope of the yield curve today to draw conclusions about the future, we need to add ~40bps to the slope of the curve. So, of the 2-10yr yield curve (for example) is 30bps today, then we need to add 40bps to adjust for QE, which puts the QE adjusted curve at 70bps. This is still flatter than average but less alarming.

Summary Outlook : The Laggards of 1H18 may be the Performers of 2H18

We expect the second half of 2018 to rebound in performance from the first half. When we started the year, spreads were tight and many assets were expensive. Since then, we adjusted to the event risks surrounding trade, tariffs and a sharp rebound in the U.S. dollar, which hurt EM assets most. In addition, interest rates rose in 1H18 which hurt performance of-higher quality interest rate -sensitive assets like investment grade credit.

We believe these assets that got hurt most in the first half of 2018, will perform best in second half of 18. This is because economic fundamentals are still strong globally and will likely reassert its influence on asset prices that may have sold off too much from previously expensive levels. The entry point to add exposure to EM and IG is attractive to us.

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