Morgan Stanley

INVESTMENT MANAGEMENT

Point of View

Fed and ECB Meetings: The Consensus and 2019 Surprises

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The key takeaways from the U.S. Federal Reserve (Fed) and European Central Bank (ECB) meetings are really very simple: both central banks upgraded growth in 2018 but downgraded in 2019.

- The Fed upgraded growth in 2018 by 0.4%, from 2.1% to 2.5%, the main reason being fiscal stimulus from tax reform.[1]
- The ECB upgraded growth in 2018 by 0.5%, from 1.8% to 2.3%. Draghi describes the European economy in "expansion," no longer just "recovery."[1]
- But then growth is expected to fall back in 2019, to 2.1% in the U.S. and 1.9% in Europe.[1]
- Both Central Banks see an upward drift in inflation.[1]

Consensus view.

From the Fed and ECB perspective, consensus analyst forecasts for bond yields make sense. U.S. 10-year yields rise to 2.80%, but can't get much higher because of the expected slowing of growth in 2019. Thus increases in yield are likely capped, money is expected to remain cheap, the Fed will stop hiking rates once the neutral rate (r*) is reached (2.00%, 2.25%, 2.50%...?). The yield curve flattens.

[1] Source: U.S. Federal Reserve and European Central Banks as of December 14, 2017.

Where could we be surprised (a risk case)?

Contrary to our post-global financial crisis (GFC) experiences of perpetual growth downgrades, the surprise could come from an upgrade in growth expectations in 2019 and beyond. It could be that central bank stimulus and structural, regulatory and policy changes spur organic growth and kick-start a business cycle with plenty of easy money/liquidity to fuel it. Inflation risk premia and term premia along the yield curve could rebuild. Long-term yields could rise and the curve steepen. Positive trend growth is out of consensus. Why?

Since the (GFC), the economic bull case has never manifested; as a result it has been disregarded. Instead, we have been conditioned to believe current economic strength will be thwarted and give way to weakness. The bear case has come through more often. This has led to a confirmation bias causing analysts to persistently discount good economic news. And they've been right, except for 2017. Recall that consensus growth expectations for 2017 were about 2.2% with a fatter left-tail in the consensus actually pointing to sub 2.0% growth. Growth in 2017 may actually turn out to be slightly higher than consensus (at ~2.4%), but more importantly, **the fatter tail seems to be shifting rightward to more upside growth surprises than downside.** Of significance, this represents the first time since the GFC that the fatter-tail has changed trajectory toward upside surprises and shifted to the right.

Skipping ahead to 2019.

Consensus U.S. growth for 2019 is lower than 2018, at 2.1%, but if you incorporate our thesis for a fatter-right-tail, then 2019 growth could be subject to greater upside risk, even above 2018's expected growth levels, a risk we do not believe the market fully appreciates. Similar to the way consensus two-year-ahead growth in 2016 underestimated 2018 growth at 2.1%, versus what is now estimated to be 2.5%, we may also be underestimating 2019 growth today. We may therefore be able to apply this right-fat-tail risk to an upward surprise in 2019 consensus growth expectations.

If this were to occur through evolving events during 2018, it would dramatically change the current consensus narrative for yield levels and asset prices in 2018 and beyond. This could be the surprise, the Bull case. And if productivity rises from regulatory and tax reforms, we could see an upward shift in potential growth, which means, contrary to the post-GFC period, upside surprises to growth may become more frequent.

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