

Point of View

## Fed and ECB Meetings: The Consensus and 2019 Surprises

**FIXED INCOME** | GLOBAL FIXED INCOME TEAM | MACRO INSIGHT | 2017

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.<sup>1</sup>
- 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.”<sup>1</sup>
- But then growth is expected to fall back in 2019, to 2.1% in the U.S. and 1.9% in Europe.<sup>1</sup>
- Both Central Banks see an upward drift in inflation.<sup>1</sup>

### 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.

AUTHOR



**JIM CARON**

*Managing Director  
Global Fixed Income Team*

<sup>1</sup> 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.

## RISK CONSIDERATIONS:

### Diversification does not eliminate the risk of loss.

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 fund will decline and that the value of fund shares may therefore be less than what you paid for them. Accordingly, you can lose money investing in this Portfolio. Please be aware that this Portfolio may be subject to certain additional risks. Investing involves risks including the possible loss of principal.

**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 the current rising interest rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. Longer-term securities may be more sensitive to interest rate changes.

In a declining interest rate environment, the portfolio may generate less income.

**Mortgage- and asset-backed securities** 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 Strategy, such as those issued by Fannie Mae and Freddie Mac, are not backed by the full faith and credit of the U.S. It is possible that these issuers will not have the funds to meet their payment obligations in the future. **High yield securities** ("junk bonds") are lower rated securities that may have a higher degree of credit and liquidity risk. **Public bank loans** are subject to liquidity risk and the credit risks of lower rated securities. **Foreign securities** are subject to 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. **Sovereign debt securities** are subject to default risk. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks. **Restricted and illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk).

## IMPORTANT DISCLOSURES

### Past performance is no guarantee of future results.

The views, opinions, forecasts and estimates expressed are those of the portfolio manager as of the date presented and are subject to change at any time due to market, economic or other conditions. 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 and are not intended to predict the future performance of any specific Morgan Stanley Investment Management product.

This material is a general communication, which is not impartial and all information provided has been prepared solely for informational and educational 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. 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.

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.

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.

### DISTRIBUTION

This communication is only intended for and will be only distributed to persons resident in jurisdictions where such distribution or availability would not be contrary to local laws or regulations.

**United Kingdom:** Morgan Stanley Investment Management Limited is authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA. **Dubai:** Morgan Stanley Investment Management Limited (Representative Office, Unit Precinct 3-7th Floor-Unit 701 and 702, Level 7, Gate Precinct Building 3, Dubai International Financial Centre, Dubai, 506501, United Arab Emirates. Telephone: +97 (0)14 709 7158). **Germany:** Morgan Stanley Investment Management Niederlassung Deutschland Junghofstrasse 13-15 60311 Frankfurt Deutschland (Gattung: Zweigniederlassung (FDI) gem. § 53b KWG). **Italy:** Morgan Stanley Investment Management Limited, Milan Branch (Sede Secondaria di Milano) is a branch of Morgan Stanley Investment Management Limited, a company registered in the U.K., authorised and regulated by the Financial Conduct Authority (FCA), and whose registered office is at 25 Cabot Square, Canary Wharf, London, E14 4QA. Morgan Stanley Investment Management Limited Milan Branch (Sede Secondaria di Milano) with seat in Palazzo Serbelloni Corso Venezia, 16 20121 Milano, Italy, is registered in Italy with company number and VAT number 08829360968. **The Netherlands:** Morgan Stanley Investment Management, Rembrandt Tower, 11th Floor Amstelplein 11096HA, Netherlands. Telephone: 31 2-0462-1300. Morgan Stanley Investment Management is a branch

office of Morgan Stanley Investment Management Limited. Morgan Stanley Investment Management Limited is authorised and regulated by the Financial Conduct Authority in the United Kingdom. **Switzerland:** Morgan Stanley & Co. International plc, London, Zurich Branch | Authorised and regulated by the Eidgenössische Finanzmarktaufsicht (FINMA). Registered with the Register of Commerce Zurich CHE-115.415.770. Registered Office: Beethovenstrasse 33, 8002 Zurich, Switzerland, Telephone +41 (0) 44 588 1000. Facsimile Fax: +41 (0) 44 588 1074.

### U.S.:

A separately managed account may not be suitable for all investors. Separate accounts managed according to the Strategy include a number of securities and will not necessarily track the performance of any index. Please consider the investment objectives, risks and fees of the Strategy carefully before investing. A minimum asset level is required. For important information about the investment manager, please refer to Form ADV Part 2.

Please consider the investment objective, risks, charges and expenses of the fund carefully before investing. The prospectus contains this and other information about the fund. To obtain a prospectus, download one at [morganstanley.com/im](http://morganstanley.com/im) or call 1-800-548-7786. Please read the prospectus carefully before investing.

Morgan Stanley Distribution, Inc. serves as the distributor for Morgan Stanley funds.

### NOT FDIC INSURED | OFFER NO BANK GUARANTEE | MAY LOSE VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A DEPOSIT

**Australia:** This publication is disseminated in Australia by Morgan Stanley Investment Management (Australia) Pty Limited ACN: 122040037, AFSL No. 314182, which accepts responsibility for its contents. This publication, and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act. **Hong Kong:** This document has been issued by Morgan Stanley Asia Limited for use in Hong Kong and shall only be made available to "professional investors" as defined under the Securities and Futures Ordinance of Hong Kong (Cap 571). The contents of this document have not been reviewed nor approved by any regulatory authority including the Securities and Futures Commission in Hong Kong. Accordingly, save where an exemption is available under the relevant law, this document shall not be issued, circulated, distributed, directed at, or made available to, the public in Hong Kong. **Singapore:** This document should not be considered to be the subject of an invitation for subscription or purchase, whether directly or indirectly, to the public or any member of the public in Singapore other than (i) to an institutional investor under Section 304 of the Securities and Futures Act, Chapter 289 of Singapore ("SFA"), (ii) to a "relevant person" (which includes an accredited investor) pursuant to Section 305 of the SFA, and such distribution is in accordance with the conditions specified in Section 305 of the SFA; or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. In particular, for investment funds that are not authorized or recognized by the MAS, units in such funds are not allowed to be offered to the retail public; any written material issued to persons as aforementioned in connection with an offer is not a prospectus as defined in the SFA and, accordingly, statutory liability under the SFA in relation to the content of prospectuses does not apply, and investors should consider carefully whether the investment is suitable for them.

### IMPORTANT INFORMATION

**EMEA:** This communication has been issued by Morgan Stanley Investment Management Limited ("MSIM"). Authorised and regulated by the Financial Conduct Authority. Registered in England No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA.

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.

The information contained in this communication is not a research recommendation or 'investment research' and is classified as a 'Marketing Communication' in accordance with the applicable European or Swiss regulation. This means that this marketing communication (a) has not been

**prepared in accordance with legal requirements designed to promote the independence of investment research (b) is not subject to any prohibition on dealing ahead of the dissemination of investment research.**

MSIM has not authorised financial intermediaries to use and to distribute this document, unless such use and distribution is made in accordance with applicable law and regulation. Additionally, financial intermediaries are required to satisfy themselves that the information in this document is suitable for any person to whom they provide this document in view of that person's circumstances and purpose. MSIM shall not be liable for, and accepts no liability for, the use or misuse of this document by any such financial intermediary.

This document may be translated into other languages. Where such a translation is made this English version remains definitive. If there are any discrepancies between the English version and any version of this document in another language, the English version shall prevail.

The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without MSIM's express written consent.

Morgan Stanley Investment Management is the asset management division of Morgan Stanley.

All information contained herein is proprietary and is protected under copyright law.

Explore our site at  
[www.morganstanley.com/im](http://www.morganstanley.com/im)