INVESTMENT MANAGEMENT

Morgan Stanley

Jim Caron on Bloomberg

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Jim Caron, Managing Director
Global Fixed Income Team

The U.S. Federal Reserve (Fed) June Announcement

The release details on the Fed's plan to normalize its balance sheet was HAWKISH, but their projected pace to normalization remains DOVISH.

- The level of detail on the Fed's path to balance sheet normalization was very specific, except for the start date. But the level of detail they provided signal that these changes could come as soon as September, a **HAWKISH** stance.
- The balance sheet targets were set at $6 billion in U.S. Treasury and $4 billion in mortgage-backed securities (MBS) to start. There is also a cap at $50 billion per month and $600 billion per year in purchases, with a little over 3 years to reach a normalized level of balance sheet exposure of $3.3 trillion. This is a relatively slow pace, a **DOVISH** stance.
- We don't expect any of this policy to be disruptive to markets.
- The policy indicates that the Fed is looking at the recent string of weak inflation as technical/transitory.
    - The Fed's Summary of Economic Projections (SEP) estimates core inflation has decreased from -0.2%, which leaves core inflation at 1.7% for 2017. The long-term target inflation of 2.0% is still unchanged and targeted to be achieved in 2018.
    - Their SEP estimate for gross domestic product (GDP) in 2017 is up +0.1% to 2.2%.
    - Their SEP estimate of the unemployment rate was lowered to 4.3% for 2017 and 4.2% for 2018, with the non-accelerating inflation rate of unemployment (NAIRU) decreasing by -0.1% to 4.6%.

A Strong Technical: Fund managers holding high cash – looking to 'buy a dip'

- High levels of cash are a key factor keeping volatility levels low. Global fund managers are holding ~1% more cash than normal, which represents ~$700 billion in assets that could be purchased.[1] This is a very strong technical.

How to Play it?: Investment Ideas

- Carry is still king, while the rates market is expected to be range bound.
- Top 3 Picks: assets with winning characteristics[2] for the current market environment

    1. **Non-agency residential mortgage-backed securities (RMBS)**: strong fundamentals and technicals to support this market; yields are still attractive. 4-6% returns YTD.[3]
    2. **Emerging markets (EM)**: highest real yield spread vs developed markets, attractive! See opportunities in Latin America, Poland, Mexico and Brazil. Local EM returns has been 11% YTD[4] and external EM returns have been 7% YTD.[5]
    3. **High-yield (HY)**: Have had 4.8% returns YTD with +5% yields.[6] We believe cyclical GDP sectors have the opportunity to perform well in this market environment: housing, builders, transports, manufacturing.

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[1] Global Fund Manager Survey, Bank of America Merrill Lynch, May 16, 2017.
[2] These investments may be subject to additional risks. See risk disclosures on next page for more details.

[3] Source: Bloomberg Barclays U.S. Mortgage Index. Data as of June 14, 2017.
[4] Source: JP Morgan Emerging Market Bond Index Global. Data as of June 14, 2017.
[5] Source: JP Morgan Global Bond Index. Data as of June 14, 2017.
[6] Source: Bloomberg Barclays U.S. High Yield Index. Data as of June 14, 2017.

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