Morgan Stanley

INVESTMENT MANAGEMENT

Jim Caron on Bloomberg:
The Fed, The Markets & The Counterfactual

FIXED INCOME | GLOBAL FIXED INCOME TEAM | MARKET PULSE | JULY 27, 2017

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The Fed: Recent statement as expected

- **Expect balance sheet reductions in 2017**
  The U.S. Federal Reserve (Fed) is still on track to announce balance sheet reductions at the September Federal Open Market Committee (FOMC), September 20 (i.e., "relatively soon"); reductions may start as early as October.
- **Interest rate hikes expected at a "slow pace"**
  Jobs are running at a better pace, inflation is sluggish.
- **The Fed seems unconcerned about recent string of weak inflation reports**
  Nothing in their statement suggests otherwise. (The next inflation report is the Consumer Price Index (CPI) on August 11.)
- **Market versus the Fed**
  Market pricing is well below the Fed's "dot plot", their projected path of fed funds rate. The Fed still sees terminal value at 3.00% versus market at ~1.75%.

Note: The US dollar (USD) has fallen 7% YTD as determined by the Fed's Broad Trade Weighted Dollar Index. Analysis from the Morgan Stanley economic team reveals that based on the FRB/US Model, the Fed's largescale macroeconomic model for the U.S. economy, each -2% decline, when run through the FRB/US is roughly the equivalent of a 25 basis points cut in terms of how a weaker USD translates into stimulus for the U.S. economy. Given that the trade weighted dollar has fallen 7%, it effectively erases the past three hikes in this cycle. Thus financial conditions remain easy amid a growing economy. This is bullish for riskier assets and carry strategies.

The Markets: Still supportive of asset prices and still a carry environment, but there are risks

- **A benign positive economic climate**
  We are witnessing both global and U.S. growth at a modest pace, a pace slow enough that rising rates do not pose a grave risk and default rates remain low. In our view, spread products and carry strategies are still likely to perform.

- **High correlations, but low volatility**
  Both bond and equity performance has been positively correlated. This is rare, but it is explained by easy financial conditions created by central banks in many developed markets.
- **Causality & correlation can cut both ways**
  The cause for this high correlation, we believe, is the low rate and low inflation environment. If rates rise, then both bonds and equities may both decline together – correlation can cut both ways.
- **Risks**
  The market has grown complacent that the benign/low rate environment will persist. The bar has been set very low for a surprise; rates may push higher, perhaps it may come on the August 11 release of the CPI inflation report.

<u>The Counterfactual</u>: Explaining the market's strength—the bull case is if the bear case does not materialize

- **Counter facts may be explaining the market's current strength**
  - It may be more important that oil and some commodities, such as copper, are NOT falling and less important that they are rising;
  - More important that data from China is not declining and less important that it is rising/stabilizing;
  - More important that spreads are not widening and less important that they are narrowing/remaining stable
- **Bottom line**
  The environment is such that financial conditions remain easy, despite the Fed and European Central Bank hiking/tapering and planning to taper/hike. Effectively, global policy remains easy and focused on removing excess accommodation; policy is NOT tightening on a global aggregate basis.

<u>Assets We Like*</u>

- **Securitized assets/non-agency residential mortgage-backed securities**
  More upside potential, good carry and valuations are comparatively good.
- **Select emerging markets**
  Valuations look attractive (high real yields versus developed market real yields), global growth and rising commodities.
- **High yield (HY)**
  See opportunity in select areas of the HY market. It is offering good carry, default risks that are likely to stay low, but it is nearly fully valued.
- **Hedge trade**
  Buy USD/JPY. The USD is currently underowned and the USD/JPY position is the shortest it has been since 2013 based on International Monetary Market data. The Bank of Japan is likely to stay easy and the bar is low for a reflation surprise. A spike in USD/JPY may surprise many.

*See important disclosures for risks associated with these assets.

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