Morgan Stanley

INVESTMENT MANAGEMENT

2017 Was More About Beta, While 2018 May Be More About Alpha

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Key investment theme for 2018: Sourcing alpha opportunities from idiosyncratic factors, being selective, which can favor active versus. passive management.

- **U.S. Federal Reserve (Fed)/Federal Open Market Committee (FOMC) Minutes:** The Fed still expects a gradual pace of tightening (three hikes in 2018) although risk is growing for a fourth hike. A March hike is 65% priced into the market. Market pricing is for 2.2 hikes in 2018 vs the Fed forecast of 3 hikes. The market is pricing the terminal fed funds rate at 2.20% versus the Fed at 2.75%. THE RISK IS THE FED HIKES FASTER (i.e., 4 hikes in 2018).

- **Important: The Fed Is not Tightening**. They are just removing excess accommodation. Their objective is reach "neutral," not tighten. Thus EASY FINANCIAL CONDITIONS, WHICH IS POSITIVE FOR ASSET PRICES.

- **A Positive for 2018**. We expect a slow upward growth trajectory globally (3.9%). "Slow" is good because it extends the market cycle, keeps the economy from overheating and central banks from hiking too quickly.

- **BUT THE RISK** is that we get faster-than-expected growth. Consensus calls for 2018 growth at 2.5% but then a fall to 2.1% by 2019. What if growth is revised higher for 2019?

- **Inertia versus Mean Reversion.** The risk is that growth is upgraded for 2019 and the narrative changes from mean reversion to lower growth to one of upside surprises. It could come from tax reform and business investment that leads to higher expectations on productivity. Potential growth could shift higher. This is not our base case but it is not a negligible risk either. The market has little appreciation for this risk.

- Another risk is a stronger USD.

- Basically, anything that challenges the prevailing narrative of low rates and low volatility is the risk case.

Where and How to Invest

- The initial conditions in the market suggest that U.S. Treasury 10-Year is likely to stay in a range between 2% and 3%. We are agnostic in that range and believe fixed income can have positive returns in that space.

- **Idiosyncratic versus Systemic Positioning.** It will not be sufficient to just own index exposure (systemic). It will be more important to be selective, to seek to construct a portfolio handpicked with more durable assets, as well as to construct hedges (idiosyncrasies). We believe a greater portion of ones fixed income allocation should be in active strategies.

- We believe the highest source of returns will come from select emerging markets and in the non-agency mortgage space and tactical positioning of duration, curves and foreign currency (FX). We will not be surprised to see a correction in credit spreads but view it as a buying opportunity.

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