Morgan Stanley

INVESTMENT MANAGEMENT

Background Noise Moves to the Foreground

FIXED INCOME | GLOBAL FIXED INCOME TEAM | MARKET PULSE | 7 December 2018

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Looking toward the peak … for most of 2018 markets looked past U.S.-China tensions and the consistent increase in the U.S. Federal Reserve (Fed) policy rate, mainly because gross domestic product (GDP) growth and earnings were rising toward a peak. As a result, these risks were viewed as nothing more than background noise.

… vs. now, looking toward the trough. Peak earnings and growth are now behind us and the market is looking toward the trough. What was once the background noise of rising policy rates and U.S.-China tensions has suddenly moved to the foreground.

It's the delta that matters. Full year growth for 2018 is expected to be ~3.2%, BUT 4Q19/4Q18 growth falls to nearly half that to an expected ~1.7%.[1] This is a big delta. The market is debating whether we stay at that level or lower for an extended period (hard landing), or if we quickly rise from the trough to a pace back above 2% (soft landing). This uncertainty is being reflected in market prices in the form of higher risk premia.

Managing the landing: soft, bumpy or hard. Fed policy actions have a role to play and may become more apparent at the December 19 Federal Open Market Committee (FOMC) meeting. What we can expect to learn from this meeting is as follows. First, the Fed may lower their growth forecast for next year to 2.3% from 2.5%. Next, they may also signal a reduction in the expected number of rate hikes in the upcoming year. Even though changes to their forecast in their *Summary of Economic Projections* may become less hawkish only at the margin, it's the route taken towards a dovish signal that matters most.

Managing expectations. In 4Q18, market Fed expectations have shifted wildly. Market pricing of Fed funds expectations shifted from nearly three hikes in 2019 from early 4Q18 to roughly one hike in 2019 today. Respectively, in nominal terms, this is a change of market expectations of policy rates in 2019 from 3.25-3.50% to 2.75-3.00%. Volatility!

Labor working toward a slower Fed. Today's labor report does not stand in the way of the Fed reducing its growth and policy forecasts at the December FOMC meeting. This is the key takeaway. The headline release of payrolls came in weaker than expected at 155,000 vs 198,000. Wages came in as expected at 3.1%. Counterintuitively, the slightly weaker tone to the non-farm payroll report may be a positive in that it provides a reason for the Fed to tilt more dovish from their September forecasts.

[1] Source: Morgan Stanley Research. Data as of December 6, 2018.

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