INVESTMENT MANAGEMENT

Morgan Stanley

Jim Caron on CNBC:

Market Pricing vs. Fed Projections

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Market Pricing vs. Fed Projections: Is the Fed Making a Policy Mistake?

- **IMPORTANT!**
  We believe the market will learn the answer in the course of 2H17.

- **U.S. Federal Reserve (Fed) & Market at Odds – A Mispricing of Risk.**
  Median Fed 'dot' for 2018 & 2019 are 2.125% & 2.875% respectively. If the Fed blindly follows its models and stays on this policy path, then when compared to 1-year and 2-year forward pricing of UST 10-year yields, it suggests a flat to possibly inverted yield curve. **Mistake!**

- **What's at Stake? Risk of Recession.**
  Very flat yield curves are historically precursors to significant economic slowing and possibly a recession.

- **What signal is the yield curve sending?**
  The UST yield curve, as measured by the spread between the 10-year yield minus the 2-year yield, has been flattening and currently resides at 82 basis points as of June 19, 2017. The average yield curve spread is 125 basis points based on Bloomberg data going back to 1992. We have observed when yield curves flatten below 75 basis points what follows is a significant slowing of economic activity.

  In the past, the slowing of economic activity was induced by a tightening of policy rate hikes designed to slow an overheating economy as was the case around the 1994 and 2004 periods. Today, the economy is neither overheating, nor is the Fed actually tightening. The Fed, instead, is removing excess accommodation and trying to reach a prescribed neutral policy rate of 3% for which the market is at odds with and believes the Fed may only reach 2%. Long-end yields are thus falling because inflation appears to be faltering.

  Nevertheless, the yield curve still sends a signal about credit creation and its cost. In the current environment the yield curve is flattening as investors reach for yield at longer maturities. Eventually, if yields and credit spreads continue to compress, then investors (i.e. lenders) will be reluctant to invest and lend money to the real economy. Effectively, this could create a 'tightening' of credit that will squeeze economic growth prospects.

  This may happen when the spread in the UST 2-10yr segment of the yield curve falls below the 50 to 60 basis points threshold. We are not there yet, but this is a signal from the yield curve to watch closely.

- **Resolution.**
  Unless we see fiscal policy stimulus, higher productivity and rising inflation, we'd expect the Fed to adjust the projected terminal Fed Funds rate closer to the low 2% area than 3% as the Fed projects.

- **Investment Consequence.**
  For now, yields are likely to remain in a range, if they rise it will be slowly. Carry strategies are still king in our opinion. However, we are watchful for signs of a tightening of financial conditions that could be a headwind to our strategy.
    - **Top Picks**
        - Non-Agency mortgage-backed securities (MBS)
        - Emerging-market (EM) debt & EM foreign currency (FX) vs USD
        - Select high-yield

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