Morgan Stanley

INVESTMENT MANAGEMENT

Uncertainty, Politics and Fundamentals

FIXED INCOME | GLOBAL FIXED INCOME TEAM | MARKET PULSE | March 7, 2018

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What matters for fixed income is the pace and path of interest rates. A robust global economy suggests the path for yields should be higher, but the pace may be slowed by political uncertainties with regard to trade and protectionism.

Political uncertainty (e.g., U.S. trade policy, Italian elections) creates a headwind for rising yields and may keep them sustained below 3.00% near term. But the risk is these headwinds subside and U.S. 10-year yields rise modestly above 3.00%. Whether we stay above 3.00% will depend on further economic strength and rising inflation risks.

Gary Cohn's resignation from the National Economic Council to the president adds to political uncertainty and makes the market worry that the U.S. may adopt more protectionist trade policies going forward.

That said, Cohn has already done the heavy lifting with respect to policy, i.e., he was instrumental in getting tax reform passed in 2017. 2018 will be about trade and tariffs, and it's unlikely that Cohn could influence the president on those matters, thus his resignation may not have materially affected the outcome of policy beyond what was already mostly priced in the market with respect to U.S. trade policy. Cohn's resignation may therefore be more noise than signal with respect to market prices.

Europe: The European Central Bank (ECB) meeting on March 8 may be a prelude to opening discussions on the winding down of the asset purchase program expected to begin the end of September and on rate hikes that are not expected to begin until 1H19. The ECB will mark to market euro area economic performance.

Powell: The March 21 Federal Reserve (Fed) meeting will likely see a rate hike of 25 basis points. The question is if the dots in the Fed's dot plot will shift to four versus three hikes for 2018. The market is pricing 3.5 hikes in 2018 and about two hikes in 2019.

U.S. yield curve: The question remains, if the Fed keeps hiking rates, are they willing to flatten and invert the yield curve? Fed models do not factor the shape of the curve into their models—they see it as noise, while the market sees it as a signal for a recession. Who is right? We believe the market is right and the Fed may alter their course of rate hikes if the yield curve becomes too flat.

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