Morgan Stanley

INVESTMENT MANAGEMENT

The Fed Needs to Lead, Not Follow

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The U.S. Federal Reserve (Fed) can lead or follow. But today, we firmly believe they need to be proactive and lead, and not be reactive, in order to get ahead of this relative global decline in policy rates.

- If they follow we believe they will continue to be behind the curve and yields will likely continue to decline.
    - Why? Because the market believes the slower the Fed reacts today, the more they will need to cut in the future.
- If the Fed leads by cutting rates proactively (sooner and by more), then the market will restore term premia and confidence in its future outlook for economic growth.
    - This can potentially slow, and even reverse, the long-term decline in yields.

- Success for the Fed would be reflected by a steeper yield curve and a weaker U.S. dollar (USD), according to the market.

- The USD is an important risk barometer, as a stronger USD is a significant headwind to global growth and financial conditions in general.
    - The Chinese yuan (CNY) fixing is a key metric to watch, but as long as the USD/CNY fixing continues to trend higher, yields will trend lower because it shows a continuation of market stress.
    - This fixing is also an indicator of U.S.-China trade risk

- Other important macroeconomic factors:
    - Fiscal stimulus becoming hip and fashionable again (Germany is warming to it).
    - U.S. is headed in the same direction (easier to pay for it with 50-year and 100-year bonds, which has been hinted.).

- Globally, countries are less worried about spending, given how low rates are.
- All this talk about fiscal stimulus could stabilize markets for the time being. U.S.-China trade is the key.

Investment Themes

- We remain long duration and high on quality
  - **High yield:**
    - Likes – Building materials, transports, select retail. BB rating bias.
    - Concerns - Energy, healthcare, Bs, CCCs.
  - **Investment grade:**
    - Likes – Financials, utilities, communications.
    - Concerns – Healthcare, pharmaceuticals
    - Risk – Pace of delevering is slowing as low interest rates make refinancing more attractive.
  - **Emerging markets:**
    - Opportunities – Brazil (reforms, rate cuts), Central and Eastern Europe/Poland (European Central Bank play, central banks have room to ease), Mexico (cutting rates but still political risks), South America (high-beta emerging market, similar to Mexico).

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