Morgan Stanley

INVESTMENT MANAGEMENT

Powell's Testimony and Where the Markets May Be Headed

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Powell Testimony

- Powell's comments left the market wondering if he wanted to change the baseline expectations for Federal Reserve (Fed) hikes in 2018 from three hikes to four.
- The confusion stems from:
  - His comments that the Fed's core personal consumption expenditures (PCE) price index target should be '"sustained" around 2%, which implies he may tolerate some overshoot. Bond yields rose and the curve flattened. *Fodder for the four-rate-hike camp.*
  - However, if inflation were to overshoot 2% it would require the Fed to not tighten too aggressively. *Fodder for the three-rate-hike camp.*
- The market interpreted his comments as hawkish, or, more importantly, NOT as DOVISH as many expected.
- Overall, Powell's comments do not strongly suggest a deviation from the course Yellen had set.

Market Price Action/Investing

- The market had expected more dovish comments from Powell. Equities rose and bond yields fell on Monday, but after Powell's comments on Tuesday were not as dovish as the market expected, we saw the reverse action of equities falling and bond yields rising.
- We expect U.S. Treasury 10-year yields to peak in the 3.00%-3.25% area. This peak may happen during 2Q, but we may ultimately end the year lower than that in yield.
- This is because political event risks, including the U.S. mid-term elections, will play an active role in market volatility. In 3Q, risk markets may falter until political event risks pass, but fixed income should perform well, as it will likely stabilize yields or even cause them to fall.
- Broadly, we have an optimistic economic outlook. Our top bond asset allocation picks are:
  - Non agency mortgages
  - Emerging markets
  - High yield
- We expect the USD to remain weak, although it may technically correct in the near term, as a large short base has been built.

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