

Morgan Stanley

INVESTMENT MANAGEMENT

The Fed's Conundrum

FIXED INCOME | GLOBAL FIXED INCOME TEAM | MARKET PULSE | May 2, 2019

In their May 1 statement, the Federal Open Market Committee (FOMC) was upbeat on growth and downbeat on inflation. The U.S. Federal Reserve (Fed) is now left with a conundrum on how to boost inflation, but avoid creating an asset bubble.

State of the Fed

The risk of low inflation. The recent year-over-year core personal consumption expenditures (PCE) price index of 1.6% was lower than expected. The risk of low inflation is that it forces the Fed to keep policy rates lower than ordinary in good economic times, leaving it less room to cut rates to stabilize the economy during periods of economic weakness. This is the risk concept of the "Zero Lower Bound," a time when it is difficult to lower nominal rates much below zero and effectively stimulate an economy.

Will there be a pre-emptive rate cut? We believe it unlikely we'll have a pre-emptive rate cut to boost inflation. The Fed sees low inflation as transitory, at least for now, based on other measures such as the Dallas Fed's Trimmed Mean measure of inflation which is just under 2%.

Is the economy overheating? The Fed does not see an overheating economy. They see asset prices as "not extremely elevated," leverage in the household sector "under control," e.g. mortgage default rates are very low, and non-financial sector leverage as high, but funding costs remaining low.

Fed cut to interest on excess reserves (IOER) just a technical signal. The Fed announced a cut to IOER by 5 basis points to 2.35%. This is a technical adjustment to keep the price of Fed Funds within its target range of 2.25%-2.50%. This is not meant to be a dovish policy signal.

State of the Markets

China stimulus is having an impact. Global growth is finding a bottom, but not accelerating, largely due to the China stimulus program gaining traction in 1Q19. The U.S. economy was impacted the most and first. We expect a boost

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for Europe and emerging markets with a 3-6 month lag and an expected resurgence in late 2Q/3Q19.

A weakening U.S. dollar would signal that China stimulus is positively impacting the global economy as a whole. Until then, we are likely range bound at a 2.25%-2.75% yield on the 10-year U.S. Treasury.

Market Opportunities.

Securitized assets. Non-agency mortgage-backed securities is our highest conviction sector. The consumer is strong, default rates are low and home prices are steadily appreciating.

Emerging markets. We expect the global economy to rebound in the 2H19 and emerging markets should benefit the most. Stable to low interest rates in developed markets and buoyant commodity prices should help emerging market assets. Even if the U.S. dollar weakens modestly, as we expect, this would provide incremental support to the asset class.

Credit spread product. High yield is attractive as we think U.S. economic growth will remain robust and keep default rates low. We like investment grade for the same reasons. However, since spreads have significantly tightened already this year, carry is likely to be the biggest source of return for the remainder of the year.

Market Risks

There is the potential for geo-political risks: U.S.-China Trade, European Area Elections and BREXIT. We don't see any of these as being imminent though. Other risks include a disinflationary shock to the U.S. and global economy, a stronger U.S. dollar and/or a failure of global growth to stabilize.

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DEFINITIONS

PCE Price Index is released monthly and reflects changes in the price of goods and services purchased by consumers in the United States.

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