Morgan Stanley

INVESTMENT MANAGEMENT

Market Insights

Key Takeaways From the Fed's December Rate Hike

LIQUIDITY | GLOBAL LIQUIDITY TEAM | MARKET INSIGHT | December 19, 2018

In a move widely expected by the markets, the Federal Open Market Committee (FOMC) increased the federal (fed) funds rate by 0.25% at its December meeting.

FOMC Meeting Summary[1]

- Monetary policy decisions
  - The FOMC unanimously voted to increase the target range for the fed funds rate by 0.25% to 2.25-2.50%
  - The Fed raised the interest on excess reserves by 20 basis points to 2.4%
- Rates outlook
  - FOMC member consensus projects there will now be two rate hikes in 2019, versus the three that were expected at the September meeting. As a result, the median fed funds rate forecast for 2019 dropped to 2.9% from 3.1%
  - Median rate forecasts indicate the Fed believes there will be one additional hike in 2020, bringing the median fed funds rate projection to 3.1%
  - The median of the longer-run neutral rate decreased slightly to 2.8%, down from 3.0% in September
- Assessment of economic conditions
  - One notable change in the statement was adding the word "some" before "further gradual increases" to describe the trajectory of future rate increases
  - GDP projections were revised slightly downward from the FOMC's September meeting, with 2018 projections now at 3.0% and 2019 at 2.3%
  - Core inflation remains around the FOMC's 2% target, and is expected to reach 2.0% in 2019 and remain at target levels through 2021
  - The unemployment rate is expected to decrease to 3.5% in 2019 and tick up by 0.1% in 2020 to 3.6%
  - Chair Powell stated that financial conditions have tightened, which are less supportive of growth

In summary, while slightly decreasing the future path of rates, the Fed has not fundamentally altered its outlook as a result of recent market volatility. FOMC members modestly lowered their growth forecasts for 2019 and beyond, but reiterated that current economic indicators such as unemployment and GDP remain strong.

[1] Source: FOMC December 19, 2018 Statement.

Morgan Stanley Global Liquidity Solutions Fund Positioning

As monetary policy continues to tighten, albeit at a slower pace going into 2019, we believe that active management of interest rate risk is critically important. Our conservative, yet opportunistic portfolio management strategy will position us to help capitalize on opportunities that present themselves in the market.

Prime Portfolio Strategy

Leading up to the December FOMC meeting, where a 25 basis point interest rate hike was widely expected by the market, both one-month and three-month London Interbank Offered Rate (Libor) rose to recent highs, with a December 19 setting of 2.48 and 2.79 percent respectively.[2] As yields moved higher in recent weeks, we opportunistically added 3 month fixed rate securities to the portfolio that we felt priced in expectations of an upcoming interest rate hike. The weighted average maturity (WAM) of the portfolios touched a three month low, as fixed rate maturities approached their final maturity date and floating rate notes approached their reset date. With the Fed dot-plot signalling two rate hikes in 2019, we continue to manage our portfolios from a conservative positioning standpoint, maintaining our emphasis on high levels of weekly liquidity and structuring our portfolios to respond to changes in monetary policy.

Government and Treasury Portfolio Strategy

Our strategy for the portfolios continued to focus on minimizing interest rate risk and maintaining high levels of liquidity. As the December FOMC meeting approached, we added investments in fixed-rate agency and treasury debt as market yields moved higher in anticipation of today's interest rate hike. The duration metrics of the portfolios moved higher due to these term investments. We continued to place significant maturities near the next quarterly FOMC meeting date. This type of positioning in the portfolios allows for interest rates to reset immediately following FOMC meetings. In 2019, the current FOMC expectation is for two rate hikes and we will continue to manage the portfolios to be responsive to changes in market conditions and interest rate levels.

Please reach out to your Morgan Stanley relationship manager with any questions, or visit www.morganstanley.com/im for more information.

[2] Source: Bloomberg. As of December 19, 2018

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Government and Treasury Portfolio
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Prime Portfolio
FLOATING NAV FUNDS

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