US Economics and Rate Strategy

January 15, 2019

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Patiently Pushing Out Hikes

Despite continued economic strength, sharply tighter financial conditions have the Fed concerned about its outlook. Emphasis on patience makes a March hike unlikely, so we move the two hikes we expect this year to June and December. We lower our yield forecasts. 10y USTs to end the year at 2.45%.

Key Highlights

- We were early last year to call for just two hikes in 2019, initially placing them in March and June.
- With "patience" returning to Fed policymakers' communications due to recent financial market developments and emerging downside risks to the global economy, we believe the FOMC's message is clear: policy is on hold for at least the next three months until the implications for real economic activity are discernible.
- While our base case of two hikes remains appropriate in our view, we are adjusting our expectations on the timing of those hikes. We now expect the FOMC to raise interest rates in June and December.
- In the interim, policymakers will continue their internal and external conversations on the Fed's balance sheet normalization process and its impact from the perspectives of both technical policy implementation considerations and its effects on financial conditions.

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- We lower our below-consensus 2019 Treasury yield forecasts further. We now see the 10y Treasury yield ending 2019 at 2.45% (down from 2.75%, which was also our forecast for year-end 2018).
- We still forecast an inverted curve in 2019, given our economists' projection of a rate hike in June and another in December. If the Fed is unable to deliver these hikes, the yield curve might not invert.
- The early end to balance sheet normalization we forecast should contribute to the curve inversion and to lower Treasury yields.
- With a patient Fed, we see real rates now moving lower through 2019, to levels last seen before fiscal stimulus was enacted in 2018. We see 10-year real rates ending 2019 at 55bp. We see 10-year breakevens recovering a bit, and ending 2019 at 190bp.

US Economics: Patiently Pushing Out Hikes

Risk management kicks in

A shift in communication from Fed policymakers since the turn of the year has highlighted a need for the FOMC to remain 'patient' in further adjustments to monetary policy in light of a recent substantial tightening in financial conditions and pickup in market volatility. This message received in public comments from policymakers was affirmed in the minutes from the December FOMC meeting, which noted that "especially in an environment of muted inflation pressures, the Committee could afford to be patient about further policy firming." In particular, "participants expressed that recent developments, including the volatility in financial markets and the increased concerns about global growth, made the appropriate extent and timing of future policy firming less clear than earlier."

Policymakers' use of the word 'patient' is important because the word has institutional significance at the Federal Reserve. It first appeared in 2004 as policymakers were cautiously preparing to begin the rate hiking cycle, and then returned to the FOMC lexicon in December 2014 as policymakers were moving away from language in the FOMC statement that interest rates would be maintained at zero for a 'considerable time'. At the time of this language change, then Chair Yellen confirmed at the December 2014 FOMC press conference that 'patient' meant "the Committee considers it unlikely to begin the normalization process for at least the next couple of meetings." Asked by a reporter what a 'couple' meant, Yellen referred observers to the dictionary when she said "'a couple'—I believe the dictionary probably says, "a couple" means two. So, 'a couple' means two."

With patience now returning to Fed policymakers' communications in light of recent developments in financial markets and the emergence of downside risks to the global economy, we believe the message from the FOMC is clear: policy is on hold for at least the next three months until the implications for real economic activity in the US are discernible. In other words, in our view a March rate hike is now off the table.

Consequently, we are revising our expectation around the timing of Fed policy changes in 2019. While our base case of two hikes remains appropriate in our view, we are adjusting our expectations on the timing of those hikes. We now expect the FOMC to raise interest rates in June and December, whereas we expected rate hikes in March and June previously.

We expect the FOMC will be prepared to raise interest rates again in June because at that point, while tighter financial conditions will have no doubt weighed on spending and growth, we believe countervailing factors will have supported economic growth, namely solid real disposable income growth boosted in no small part by lower gasoline prices and by abnormally large tax refunds (see 2019 US Economic Outlook: Managing Neutral (25 Nov 2018)). On net, we expect real GDP growth to continue to run above trend in the first half of the year. Moreover, aided by the considerable economic momentum heading into the year, the unemployment rate will likely continue to trend down in the first half of 2019 to around 3.5%, while wage growth rises by 3.5%, leading to renewed concerns among policymakers about potential overheating in the economy (see 2019 US Economic Outlook: Managing Neutral, November 25, 2018).

Additionally, we expect that some of the key downside risk management considerations that Fed policymakers (and financial market participants) are now accounting for will have dissipated by the end of 2Q19, or at least we'll have more clarity on those factors. In particular, the government shutdown should hopefully be behind us, the Brexit outcome should be known, and we should have more clarity on China-US trade negotiations.

Assuming the Brexit and US-China trade negotiation outcomes are not unduly negative, as they are not in our base case, the reduction in uncertainty about these tail risks should be enough to shift the balance in policymakers' risk management calculus back towards a June rate hike. Following another lengthy pause after June we expect financial conditions to support a rebound in growth in the final quarter of the year that prompts the second hike in December.

In the interim, policymakers will continue their internal and external conversations on the Fed's balance sheet normalization process and its impact from the perspectives of both technical policy implementation considerations and its effects on financial conditions (see US Economics and Fixed Income Strategy: Insight into the Balance Sheet (11 Jan 2019)). We continue to expect that further signaling towards the ultimate end of balance sheet normalization in September 2019 will play out in the months ahead, beginning with the Fed's annual organizational meeting on January 29-30 where we expect potential adjustments to the FOMC's Policy Normalization Principles and Plans document to include more information on its expectation of how it will gradually reduce the monthly caps as the balance sheet approaches its optimal size.

Gradual is out; patience is in — recent quotes from Fed policymakers:

December FOMC minutes: Against this backdrop, many participants expressed the view that, especially in an environment of muted inflation pressures, the Committee could afford to be patient about further policy firming.

Kaplan (1/3/19): I would be an advocate of taking no action and, for example, in the first couple of quarters this year, if you asked me my base case, my base case would be take no action at all. That could change if things improve but my own view right now is we should be patient.

Mester (1/4/19): We can take time. We don't have inflation running ahead, we don't see it accelerating.

Powell (1/4/19): There is no preset path for policy. And particularly, with the muted inflation readings that we've seen coming in, we will be patient as we watch to see how the economy evolves. But we're always prepared to shift the stance of policy and to shift it significantly if necessary.

Bostic (1/9/19): To me, the appropriate response is to be patient in adjusting the stance of policy and to wait for greater clarity about the direction of the economy and the risks to the outlook.

Rosengren (1/9/19): Recent data from China's economy, the potential for increased trade tensions, and heightened volatility all counsel for policy to be both flexible and patient. ...
The Federal Reserve's current monetary policy seems appropriate for now, and can patiently observe future economic developments.

Powell (1/10/19): I think we're actually in a good place. I think where that leaves us, particularly with inflation low and under control, is we have the ability to be patient and watch patiently and carefully as we see the economy evolve and figure out which of these two narratives is going to be the story of 2019. ...

We're in a place where we can be patient and flexible and wait and see what does evolve. I think, for the meantime, we're waiting and watching. ...

You should anticipate that we're going to be patient and watching and waiting and seeing.

Evans (1/10/19): Because inflation is not showing any meaningful sign of heading above 2 percent in a way that would be inconsistent with our symmetric inflation objective, I feel we have good capacity to wait and carefully take stock of the incoming data and other developments.

Clarida (1/10/19): With inflation muted, I believe that the Committee can afford to be patient as we see how the data evolve in 2019 and as we assess what monetary policy stance is warranted to sustain strong growth and our dual-mandate objectives

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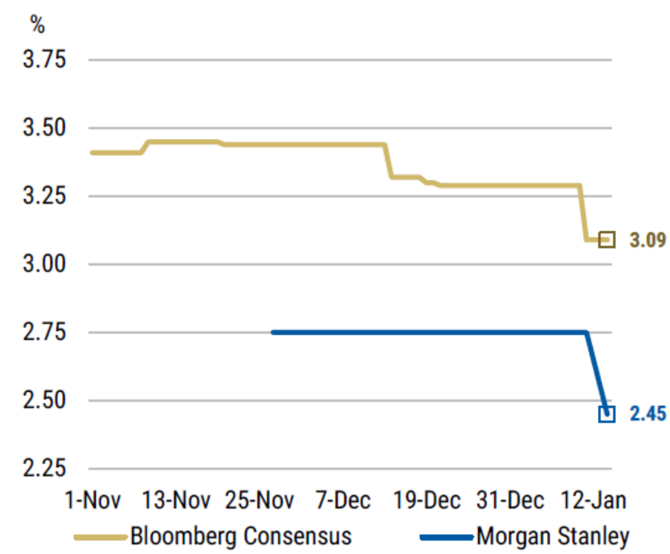
One jump ahead of the slowpokes

On the back of a more patient, cautious approach by FOMC participants, our US economists changed their expectation for when the Fed would deliver the two rate hikes they had projected. Instead of hiking in both March and June 2019, the Fed's patient approach should lead to a hike in June followed by one in December. The former view, for a couple of front-loaded hikes, had led us to project the 10y Treasury yield at 3.00% by midyear. Now, however, we see no such move higher in yields.

Instead, we lower our already below-consensus Treasury yield forecasts. We now forecast the 10y Treasury yield to end 2019 at 2.45% after ending the first half of the year at 2.55%. While the number of forecasted rate hikes remains the same, a more patient approach to hiking rates will make an underweight allocation to bonds a more painstaking decision, given the opportunity cost of the coupon income.

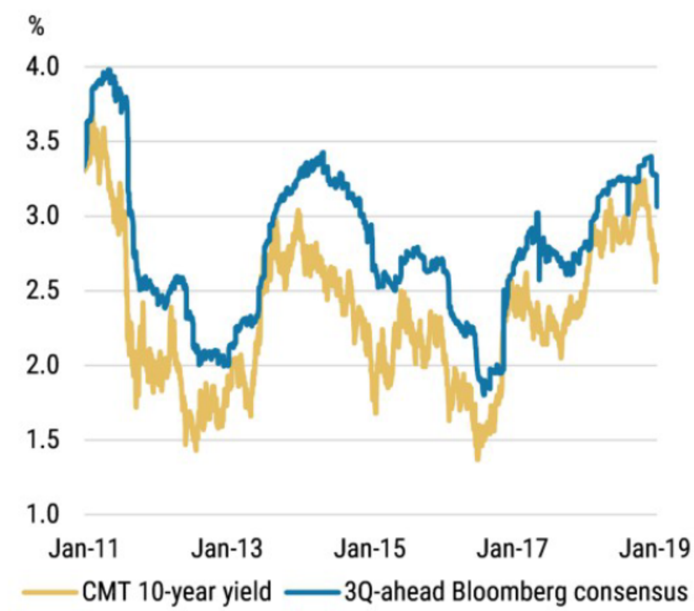
At the time we published our 2019 global rates outlook, our call for a 2.75% US Treasury 10y yield at the end of 2019 was 70bp below the Bloomberg consensus. With consensus forecasts having fallen since, our revised forecasts are now 65bp below consensus (see Exhibit 1). It's common for consensus bond yield forecasts to be higher than actual yields at the time the forecast is made (see Exhibit 2). In that sense, the forecast from our year-ahead outlook went against the grain: our 2.75% forecast was 30bp below the market yield at that time.

Exhibit 1: Morgan Stanley vs. Bloomberg consensus forecasts for 10y Treasury yields in 4Q19



Source: Morgan Stanley Research, Bloomberg

Exhibit 2: CMT 10y yield vs. 3 quarter-ahead Bloomberg consensus



Source: Morgan Stanley Research, Bloomberg

It's not just the more patient approach from the Fed that matters. It's also our out-of- consensus view that the Fed's balance sheet will stop shrinking earlier than most expect (see A Surprisingly Early End to Balance Sheet Normalization and Insight into the Balance Sheet). This would likely lead to much less Treasury supply that market participants currently expect. As investors lower their expectations for Treasury supply, Treasury yields should fall.

In terms of the curve shape, the more patient approach to rate hikes should make it more difficult for the yield curve to invert quickly, but the rate hikes we forecast weigh on the curve nevertheless. As a result, we have the yield curve inverting by midyear as both the June rate hike and the June announcement of a 3-month drawdown of the balance sheet reinvestment caps should help intermediate-sector Treasuries outperform.

Finally, the rate hike our economists now project in December would further weigh on longer-end Treasury term premiums, pushing the curve even more inverted. Of course, as we approach the end of 2019, investors and markets will increasingly focus and price in the outlook for 2020. We'll explore those dynamics more in our midyear outlook. For now, our revised Treasury yield forecasts support our view to be long US Treasuries (and Canadian government bonds) against core Europe (Germany and the

Exhibit 3: US Treasury yield forecasts: Base, bull, and bear cases

	Quarter	2y	5y	10y	30y
	15-Jan	**2.52**	**2.51**	**2.70**	**3.06**
Base	2Q19	2.60	2.50	2.55	2.75
	4Q19	2.60	2.40	2.45	2.55
Bull	2Q19	2.45	2.40	2.50	2.75
	4Q19	1.85	1.90	2.15	2.50
Bear	3Q19	3.05	3.00	3.05	3.30
	4Q19	3.20	3.15	3.20	3.45

Source: Morgan Stanley Research

US real rates and breakeven forecasts

In keeping with the spirit of our economists' adjustment to the Fed's rate path for 2019, we adjust our real rates forecast lower as well. We had expected the first half of 2019 to be a period of rising real rates and falling breakevens, a sign that the Fed was going to be hawkish in early 2019. With our economists now suggesting that the Fed will be emphasizing patience, we think current real rates are too high, and we see them moving lower. We see 10-year real rates ending 2019 at 55bp (see Exhibit 4), moving towards levels last seen in 2017, when fiscal stimulus had not been enacted.

Exhibit 5: Morgan Stanley real yield and breakeven forecasts

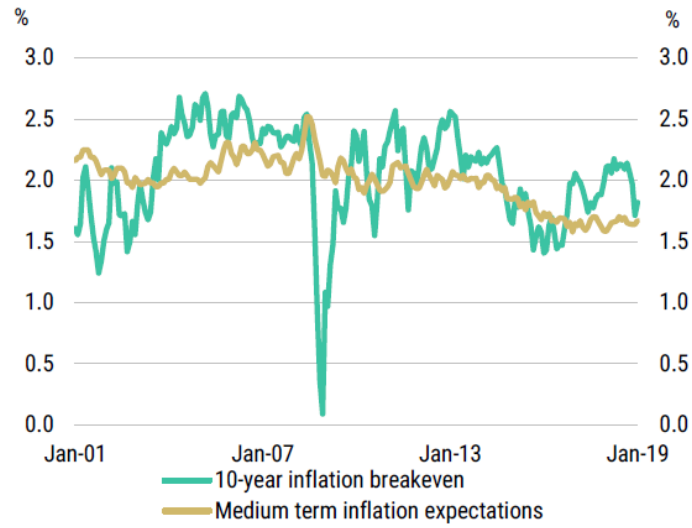
	Breakevens			Real Yields			Nominal Yields		
	5y BE	10y BE	30y BE	5y Real	10y Real	30y Real	5y	10y	30y
1-MAR	1.87	1.96	2.00	0.69	0.79	1.12	2.56	2.75	3.12
2Q19	1.85	1.85	1.90	0.40	0.55	0.75	2.25	2.40	2.65
4Q19	1.90	1.90	1.95	0.40	0.45	0.55	2.30	2.35	2.50

Source: Morgan Stanley Research forecasts

Similarly, we believe breakevens are too low at the current levels and should widen, but stay below 200bp to end 2019. We think 220bp on 10-year breakevens was the peak in this cycle – akin to the 270bp peak in the previous cycle. We think this new peak is 50bp lower than the previous cycle, given that inflation expectations, once justifiably anchored around 2%, have moved much lower in the last few years where the Fed has persistently missed its inflation target from below.

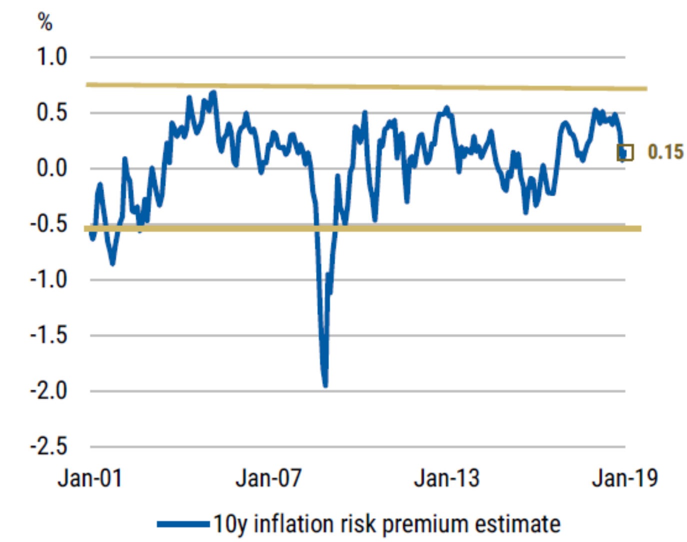
Exhibit 5 shows our estimate of inflation risk premium embedded in the 10-year TIPS breakeven. Exhibit 6 shows how the 10-year breakeven has evolved relative to the evolution of medium-term inflation expectations. We think inflation risk premium at current levels has moved to fair levels, and has some slight room for moving upwards. We see breakevens hovering around these fair levels through 2019.

Exhibit 5: 10-year breakeven vs. medium term inflation expectations



Source: Bloomberg, Morgan Stanley Research

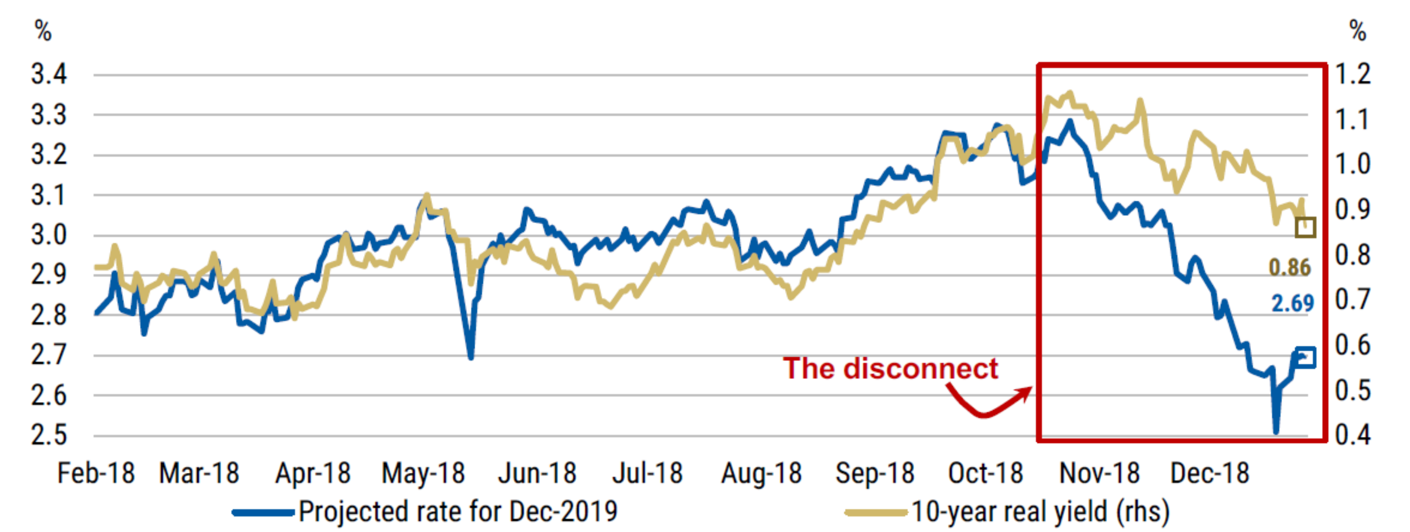
Exhibit 6: Inflation risk premium embedded in 10-year breakeven



Source: Bloomberg, Morgan Stanley Research

In the short term, we think real rates are high not just on an absolute level, but also on a relative level vs. other asset classes (see Exhibit 7). Notably, we see a clear inconsistency between the dovish pricing for the Fed path in EDZ9 vs. real rates which are at levels similar to when the Fed was expected to hike 3-4 times in 2019. In the short term, we like owning 10-year TIPS vs. going short EDZ9, something we suggested in our recent publication (Getting Real about Fed Pricing).

Exhibit 7: EDZ vs. 10-year real rates in the last 12 months



Source: Bloomberg, Morgan Stanley Research