US Economics and Rate Strategy

March 5, 2019

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Growth Is Troughing Now, Fed Comes Off Hold in December

The tightening in financial conditions, growth correction, and Fed pivot we expected this year came two quarters early. All three of these factors have happened in 1Q. GDP growth is moving through a trough now and we expect the Fed to come off the sidelines to hike at its December meeting.

Key Highlights

- The US is moving through the trough in GDP growth now, with 1Q tracking at just 0.5%. Thereafter, a sizeable rebound to 2.3% in 2Q is then followed by average growth of 2.1% in the back half of the year.
- The Fed has set a high bar for hiking and average growth of 1.4% in 1H19 is not strong enough to convince the Fed that inflationary pressures will rise. Above-trend growth in 2H19 and core inflation rising above its forecast prompt the Fed to hike in December.
- Steady inflation then keeps the Fed on hold in early 2020. Only by mid-year is inflation accelerating more noticeably, driving further rate hikes in June, September, and December.

US Rates Strategy

- A Fed on hold and subdued inflation through most of the year will make it difficult for Treasury yields to rise: Without the two hikes our economists and the median FOMC participant were projecting by December, Treasury yields should fall a bit further than we expected previously, while the yield curve should be a bit steeper. We forecast the 10y yield to end the year at 2.35% from 2.45% previously.
- We think the degree of growth our economists forecast (2H19: 2.1%) will not be enough to justify the hike in investors' eyes. Also, if the Fed begins to hike at the first signs of inflation moving above its 2% goal, investors will discount the Fed's commitment to its symmetric inflation goal, especially if growth is near its vision of potential.
- With our economists suggesting even more patience from the Fed, we think real rates will come down further. We see 10y real rates ending 2019 at 45bp, moving towards levels last seen in 2017 before fiscal stimulus had been put into place.

US Economics: Updating GDP and the Fed Call

US and Global Growth Are at the Trough

We are moving through the trough in US GDP growth now (as is growth globally), with 1Q tracking at just 0.5%. Thereafter, a rebound to 2.3% growth in 2Q is followed by 2.1% growth in the back half of the year. Core PCE inflation moves above of the Fed's target in the second half, eventually convincing a patient Fed that a December rate hike is warranted. Core PCE inflation then stabilizes until mid-2020 before moving up to 2.5% in the second half, leading even a patient Fed to hike an additional three times. With this update we have adjusted the quarterly profile for GDP and removed two hikes from the rates path through 2020 because of changes in the Fed's reaction function towards greater tolerance of an inflation overshoot.

That was then: In our 2019 year-ahead outlook we envisioned a Fed that continues to hike gradually into 2019, but hits a wall by September when financial conditions ratchet tighter and growth sputters at 1.0% in 3Q. That outlook has unfolded much more quickly than we had anticipated—financial conditions tightened severely over the turn of the year, GDP growth is tracking just 0.5% in 1Q, and the Fed has moved to the sidelines and set a high bar for resuming its hiking path (see US Economics: 4Q18 GDP & 1Q19 Tracking (28 Feb 2019), US Economics: FOMC Minutes: A Chapter Closes With Details Still To Be Written (20 Feb 2019), and US Economics & Rates Strategy: FOMC Reaction: Switching Off Autopilot (31 Jan 2019)).

Bowing to the data... Originally due for release on December 20, but delayed by the government shutdown, the Bureau of Economic Analysis (BEA) finally released its estimate of 4Q18 GDP on February 28. The data confirmed the economy grew by 3.1% on a 4Q/4Q basis in 2018. But that is old news. Economic activity weakened sharply in the final month of the year, with personal consumption clocking its largest monthly decline (-0.5%) since 2009 (see US Economics: Personal Income & Spending (1 Mar 2019)). The utter lack of momentum coming into the year has helped to level set 1Q19 at 0.5%.

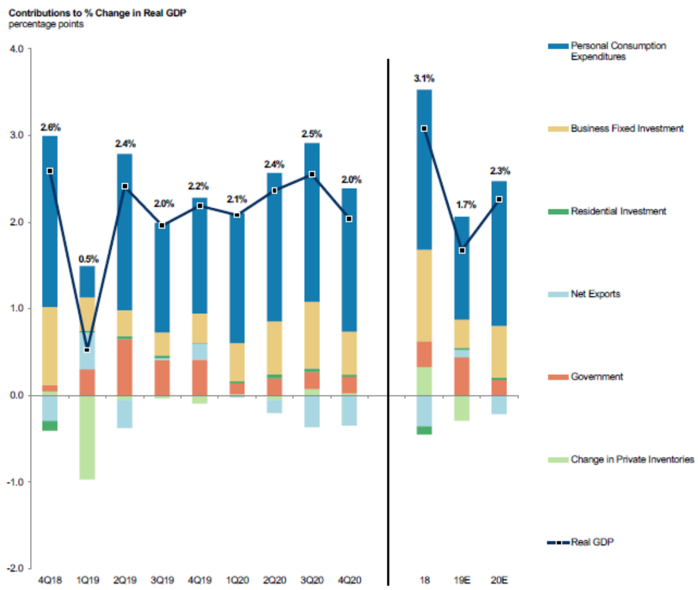
Additionally, transitory factors weighing on growth such as a large inventory drawdown, the 35-day partial government shutdown, the Polar Vortex, and a rattled consumer combined to depress growth at the start of the year, but importantly set up the economy for a strong rebound in the second quarter.

...and a shift in the reaction function at the Fed: In response to the severe tightening in financial conditions over the turn of the year and a laundry list of downside risk factors, the FOMC pivoted to a 'patient' policy stance and removed any bias on whether the next rate move will be up or down. In light of these factors, some policy-makers had "nudged down" their growth estimates since December, pointing to a likely downgrade to the median growth forecast in the March Summary of Economic Projections. We expect this forecast revision to pass through into the expectation for rate hikes this year, where we think the dots will fall to a median of one hike in 2019.

Muted inflation pressures also played an important role. The statement noted that "market-based measures of inflation compensation have moved lower in recent months", and explicitly offered "muted inflation pressures" as a key reason alongside global economic and financial developments as a reason to be cautious on further interest rate increases in the near term. Chair Powell reiterated this point in the press conference, noting that amid muted price pressures, “the case for raising rates has weakened somewhat”. This follows a downgrade to the December FOMC inflation projections, and means that developments in the inflation data over the coming months will be a crucial driver of the outlook for Fed policy decisions.

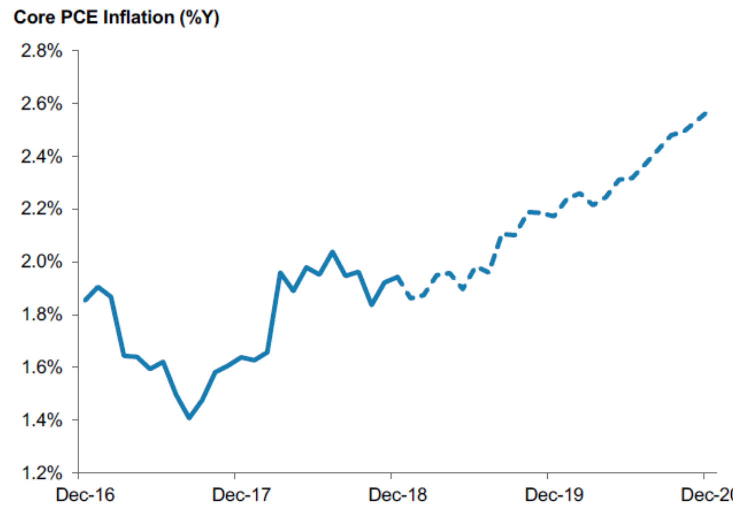
Forecast at a glance: Exhibit 1 and Exhibit 2 detail our updated quarterly forecast profile for GDP growth, and reiterate core inflation, where our forecasts have remained unchanged. On an annual 4Q/4Q basis we continue to look for GDP of 1.7% in 2019 and 2.3% in 2020, and for core PCE inflation to end this year at 2.2%, rising further to 2.5% by end-2020.

Exhibit 1: Outlook for GDP growth: 2019 and 2020



Source: Bureau of Economic Analysis, Morgan Stanley Research forecasts

Exhibit 2: Outlook for inflation: 2019 and 2020



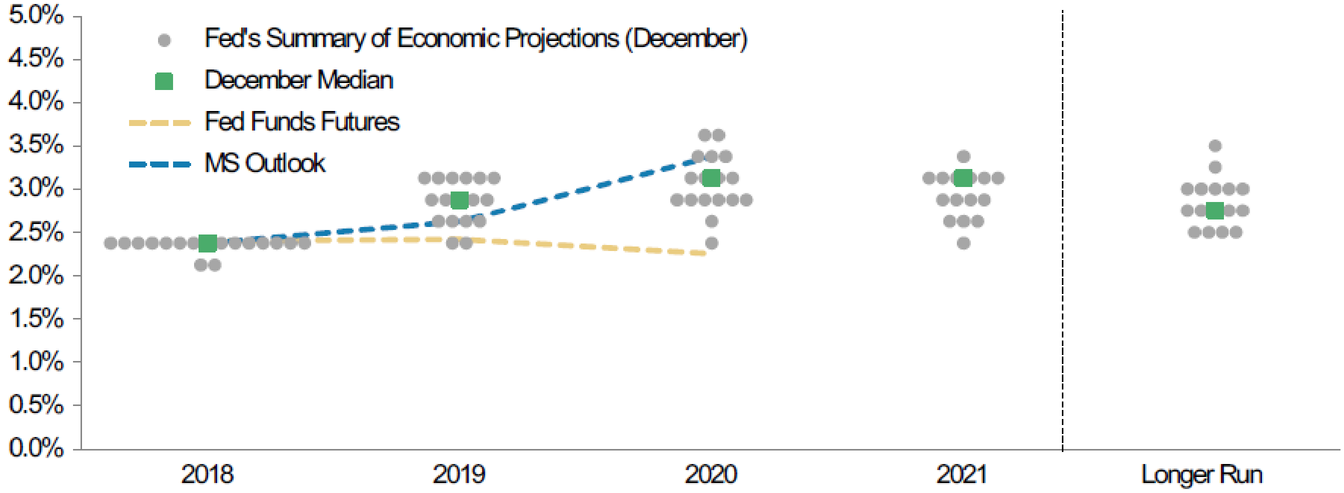
Source: Bureau of Economic Analysis, Morgan Stanley Research forecasts

Forecast details: Although we forecast the economy to be treading water in the first quarter, the good news is that 2Q19 GDP growth is expected to rebound to 2.3%, as many of the factors holding down 1Q growth either neutralize or turn more positive (the inventory drawdown lessens, severe weather effects are absent, and the direct effects of the government shutdown come off). Indeed, the US is moving through its trough in growth now. What's more, as our Global Chief Economist Chetan Ahya has noted, easing in global financial conditions supports our view that 1Q19 will mark the trough in this mini-cycle globally. Still, that puts 1H19 growth in the US on track to average 1.4%—growth that is too sluggish for the Fed to expect inflationary pressures to build. To be sure, core inflation moves sideways in the first half of the year, oscillating between 1.9- 2.0%.

The second half of the year in the US now looks much stronger, and we forecast an average 2.1% in 2H19 (3Q19 growth at 2.0% and 4Q growth at 2.2%), presaging the reacceleration in annual growth we expect for 2020. With growth sustaining above potential, we also forecast core inflation to begin breaking above 2.0% in August, and ending the year at 2.2%—a few notches above the Fed's expectation. Together these draw the Fed off the sidelines to deliver a hike at its December meeting.

Steady inflation thereafter keeps the Fed on hold in early 2020. Inflation begins to accelerate more noticeably coming into mid-year, driving further rate hikes in June, September, and December. Exhibit 3 maps out our expectation for rates hikes compared with the Fed's December SEP as well as that implied by current market pricing.

Exhibit 3: Outlook for Fed policy: FOMC versus fed funds futures versus Morgan Stanley outlook



Source: FOMC December 2018 Summary of Economic Projections, Bloomberg, Morgan Stanley Research forecasts

Is a 3.375% federal funds rate at the end of 2020 consistent with the recent signals from the Fed that it will be more tolerant of an inflation overshoot than it has been in the past? We think so. As we discussed in our 2019 year-ahead outlook, standard Taylor rules predict a federal funds rate of at least 3.75% in the circumstances we are projecting at the end of 2020, especially if accelerating growth and continued declines in the unemployment rate prompt FOMC participants to nudge the median longer-run neutral rate of interest up to 3% or higher. Setting the fed funds rate at a level below standard Taylor rules is consistent with greater tolerance of an inflation overshoot by the FOMC or with the FOMC placing some implicit weight on a price-level target.

US Rates Strategy: Marking Down Our Yield Forecasts Again

As a result of our US economists removing a rate hike from their 2019 forecast profile, we nudge lower our Treasury yield forecasts for 2019. Expecting only one hike in 2019, our economists are in line with where they think the median FOMC participant will be at the March FOMC meeting. If their expectations are met, the target fed funds rate range will end the year at 2.50-2.75%.

In forecasting Treasury yields further out the curve, our challenge lies in knowing what market participants expect from the Fed in 2020 and beyond. Also, we need to properly assess what amount of risk premium market participants will accept around those expectations and get the sign on that risk premium correct (positive or negative).

First, investors will focus on the drivers of the December 2019 rate hike: According to our economists, inflation above the Fed's projections (Morgan Stanley at 2.2% versus median FOMC participant at 1.9%) and a recovery in real growth (Morgan Stanley at 2.1% in 2H19 versus 1.4% in 1H19) cause the Fed to get back on the hiking train. How will market participants feel about this?

In our view, the type of growth forecast by our economists (2H19 at 2.1%) will not be enough to justify the rate hike in the eyes of investors. After all, the median FOMC participant's vision of potential growth is at 1.9%. In that sense, the Fed would be hiking with growth at potential (within a rounding error), not above it like growth was in 2018.

What about inflation? Much depends on the debate that will occur during the Fed's review of its policies and tools starting in June 2019. Still, if the Fed begins to hike at the first signs of inflation moving above its 2% goal, investors will discount the Fed's commitment to its symmetric inflation goal, especially if growth is at potential.

Second, investors will focus on the Fed's forward guidance that comes throughout the year: Given that the December 2019 hike would be in line with the dot-plot we envision being delivered in March, investors will focus much more on how the 2020 and 2021 dots evolve. Do those dots move above the longer-run dots as if to suggest that restrictive policy is appropriate? Or will those dots be in line with the longer-run dots as if to suggest that any further rate hikes would be to tighten policy tactically and would likely be reversed at some point?

Until then, however, a Fed on hold and subdued inflation through most of the year will make it difficult for Treasury yields to rise, to say the least. In fact, the opposite, in our view. Without the two hikes our economists and the median FOMC participant were projecting by December, Treasury yields should fall a bit further than we expected previously and the curve should be a bit steeper. Exhibit 4 displays our new Treasury yield forecasts for our base, bull, and bear cases.

Exhibit 4: US Treasury yield forecasts: Base, bull, and bear cases

	Quarter	2y	5y	10y	30y
	1-Mar	**2.55**	**2.56**	**2.75**	**3.12**
Base	2Q19	2.30	2.25	2.40	2.65
	4Q19	2.40	2.30	2.35	2.50
Bull	2Q19	2.15	2.00	2.20	2.50
	4Q19	1.80	1.70	1.90	2.15
Bear	3Q19	3.00	2.95	3.00	3.15
	4Q19	3.20	3.15	3.10	3.00

Source: Morgan Stanley Research forecasts

US real rates and breakeven forecasts: The driver of our nominal Treasury yield forecast adjustment is real rates. With our economists suggesting even more patience from the Fed, we think that real rates will come down further. We see 10y real rates ending 2019 at 45bp (Exhibit 5), moving towards levels last seen in 2017 before fiscal stimulus had been put into place.

Regarding breakeven inflation, we have left our previous forecasts in place. They imply a small decline in breakevens from current levels in the market – consistent with our view that investors will boo the Fed's decision to hike shortly after inflation peaks above 2%. Even though we see breakevens declining slightly on absolute levels, we see them outperforming their beta to nominals, a reflection of the dovishness of the Fed through 2019.

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