US Economics and Rate Strategy

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Binary Outlook Binds the Fed

Based on the Fed's recent rhetoric, the odds of the next rate move being up or down look closer to balanced. Analysts expect the Fed to remain on hold for longer to guard against downside risks, removing expectations for a December hike. Strategists expect UST 10y yields to end the year at 2.25%.

- The Fed's move to a median of zero hikes this year was a surprise. Analysts and the markets underestimated Chair Powell's appetite to deliver a preemptive strike against downside risks to the outlook. At the same time, the Committee has moved to wait-and-see mode, backing away from any hints about what further policy adjustments may be necessary down the road.

- Based on this more fluid reaction function, analysts have removed the December hike, leaving the Fed on the sidelines for the year. Having the Fed on the sidelines into next year lowers subjective probability of a recession starting in 2020 from 30% to 20%. The longer the Fed is on hold, the more slack is reduced and inflationary pressures build, drawing the Fed back into the hiking cycle in 2020.

- Oddly, the Fed's dovish turn has helped drive the yield spread between the 3m T-bill and the on-the-run 10y Treasury note negative, inconsistent with economic fundamentals. We have to get past a noisy quarter that is shaping up to be quite sluggish, but more recent data, on balance, point to a rebound in 2Q. Market concerns about recessions can be self-fulfilling, however, and can sway the Fed for that reason.

- What if analysts are wrong and instead we are moving not through a trough in growth, but into a downturn? Expect Chair Powell to act decisively and aggressively, buying insurance against hitting the zero lower bound by cutting rates 50bp. Consider it another preemptive strike.

- Strategists now see the 10y Treasury note yield ending the year at 2.25%, down from 2.35% previously. Real rates do the heavy lifting as nominal yields decline on the forecasts. Analysts see real yields ending the year back around pre-tax reform levels – consistent with the fiscal impulse fading completely.

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Neutral Is Purgatory

The Fed's move to a median of zero hikes this year was a surprise to us as well as the markets that underestimated Chair Powell's appetite to deliver a preemptive strike against what the Committee saw as building external downside risks to the outlook. At the same time, the Committee sees the outlook as calling for minimal further policy adjustments at this stage. The Chair appears comfortable with this assessment, so **analysts have removed expectation for a December hike, leaving the Fed on the sidelines for the year**.

Gauging the Fed's reaction function feels like trying to hit a moving target. With no strong bias toward the timing or direction of the Fed's next move, **even small deviations in the data can create large disturbances in financial markets**. With its December hike, the Fed has moved into what New York Fed President Williams has called the third phase of policymaking—managing rates around neutral. But neutral is really just purgatory, a temporary stop on the way to either heaven (continued expansion), or hell (a recession). When the policy rate is very low or very high, the direction of the next move is much more clear compared with trying to calibrate appropriate policy to keep the economy growing at potential, which never happens for very long.

Nevertheless, Chair Powell believes that with the economy in a "good place" there is nothing to do except, "be patient and watch and wait and see how things evolve...The data are not currently sending a signal that we need to move in one direction or another." In the same vein, Atlanta Fed President Bostic: "We may move up; we may move down." And Chicago Fed President Evans, "policy may have to be left on hold—or perhaps even loosened." The incoming data since the Fed's January policy pivot have been foggy, **whipsawing the 1Q GDP tracking estimate from as low as 0.4% to 1.0%** as of the January PCE and February new home sales data released on March 29. Job growth paused in February, but it came on the back of an unusually large increase in January jobs. December retail sales tanked, followed by a comparatively meager rebound in January. The University of Michigan's consumer sentiment measure moved up in March, but the Conference Board's consumer confidence measure moved down. The incoming data includes undeniably good prints as well—capex plans in the MSBCI survey point to a rebound in investment; regional manufacturing surveys also look better, on balance, and suggest an increase in the March ISM is in train. Jobless claims also continue to run very low.

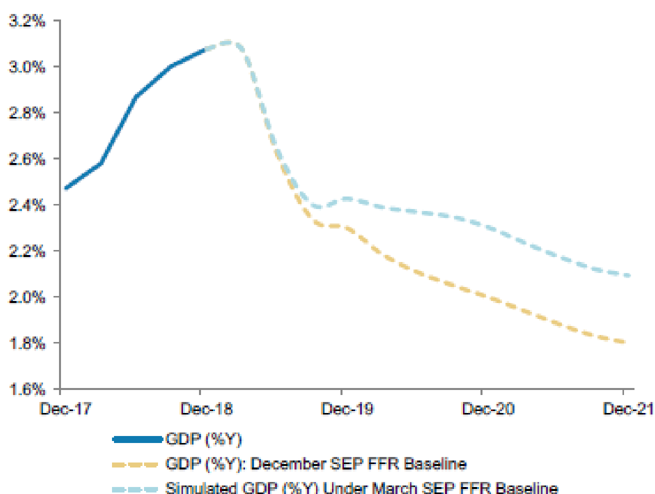
The markets are acting as if the Fed's new patient, dovish stance is the harbinger of a recession. **The yield spread between the 3m T-bill and the on-the-run 10y Treasury fell almost 10 basis points on the March FOMC announcement and is now negative, but is in no way consistent with economic fundamentals.** Market behavior can become self- fulfilling, even all the way to a recession. This could sway the Fed for that reason. The shape of the yield curve reflects market expectations for economic growth in the US and abroad, as well as the Fed's decisions on balance sheet policy, which took a dovish turn in March as the FOMC announced ending dates for its balance sheet runoff, while choosing to reinvest across the Treasury curve rather than in T-bills.

If the yield curve inversion persists and looks like it might be generating enough concern about a recession that it does indeed become self-fulfilling, the FOMC may need to consider whether its balance sheet plan is flattening the yield curve in a risky way. Either way, the Committee has indicated it will revisit its reinvestment plan "in connection with its deliberations regarding the longer-run composition of the SOMA portfolio."

The inverted yield curve is puzzling since **the forward-looking data are shaping up for a growth rebound**. The Fed's median path now delivers only one hike through the end of 2021, two fewer hikes than in its December Summary of Economic Projections (SEP). Using the Fed's own macro model, FRBUS, simulations indicate that between 2019 and 2021, the lower fed funds path embedded in the March SEP should have lifted growth expectations by 15-30bp in each year (see The Fed, Financial Conditions, and The Data, March 21, 2019). Instead, they were lowered by 10-20bp in 2019 and 2020 (Exhibit 1). This provided another murky message from the Fed that suggested it saw significant downside risks to the outlook such that a much shallower path would not be enough to stem the slowdown in growth.

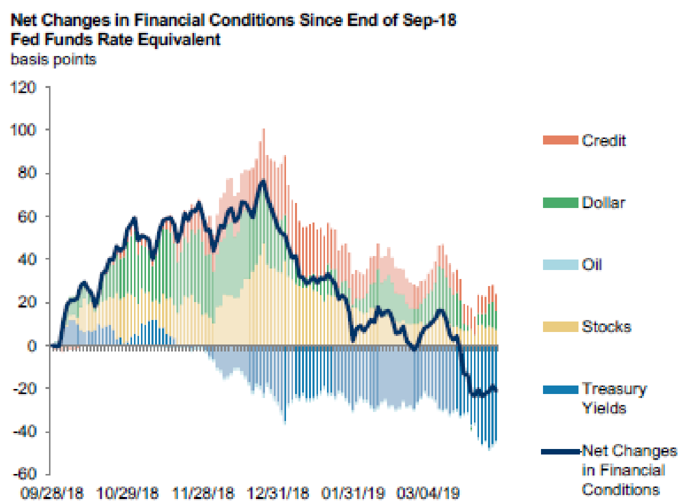
In addition, going into the March FOMC meeting, financial conditions were the easiest they've been since September last year (a reflection of the Fed's January pivot) and following the meeting they eased further, led by the Treasury yields, the dollar, and (to a lesser extent) stocks (Exhibit 2). Indeed, **financial conditions have eased the equivalent of nearly a 25bp rate cut since September**.

Exhibit 1: Downward shift in the path for the Fed funds rate should have lifted growth expectations



Source: Federal Reserve, Morgan Stanley Research

Exhibit 2: Financial conditions had already eased considerably, and eased even more after the March FOMC



Source: Morgan Stanley Research

Better incoming data and more support for the economic backdrop from easier financial conditions are one way to avoid a self-fulfilling yield curve recession prophecy.

Powell on the yield curve:
Dallas Fed Q&A (11/28/18):

One of the many [considerations] to setting a long-term interest rate is an assessment of what the longer-run neutral short-term rate is. So if the yield curve is inverted, that may mean that current policy is or is expected to be tight, which is to say higher than – that rates – you know, that you have rates that are actually higher than the neutral rate, so you're deliberately slowing the economy. So that's what it is.

NABE Conference (10/2/18):

A lot of things go into long-term rates…if you can sort of pull out of them an expectation of the longer-run neutral rate, then you can ask yourself whether policy is tight. By those measures, policy is not tight at this moment.

Press conference following September FOMC Meeting (9/26/18):

The point of it is to see whether policy is tight or not. So the risk in monetary policy is that you tighten too much, that's one of the risks, and tightening too much would mean that you've got the interest rate higher relative to what a neutral policy would be. So you look at the long rate and you say there's some sense of it in there of what the longer run neutral is. You look at the short rate and if it's higher than that then maybe policy is too tight.

Q&A before the House Financial Services Committee (7/18/18):

I think the whole point of the yield curve conversation is that you can decompose that and in that whatever the long-term rate is… but there's also sort of the market's estimate of a long-run neutral rate. So it's telling you something and we're listening. You've got to kind of do a decomposition to pull that out and then that tells you what the stance of monetary policy is so you know whether a policy
is accommodative or whether it's restrictive and that's the important question, not the shape of the yield curve.

Q&A before the Senate Banking Committee (7/17/18):

I think what really matters is what the neutral rate of interest is. And I think people look at the shape of the curve because they think that there is a message in longer run rates—which reflect many things—but that longer run rates also tell us something, along with other things, about what the longer run neutral rate is. That's really I think why the slope of the yield curve matters.
If you raise short-run rates higher than long-term rates, then maybe your policy is tighter than you think, or it's tight. The shape of the curve is something we've talked about quite a lot…I think about it as really the question being what's that message from the longer-run rate about neutral rates.

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Press conference following June FOMC Meeting (6/13/18):

I think that that discussion is really about what is appropriate policy and how do we think about policy as we approach the neutral rate…when people are talking about the slope of the yield curve, that's really what they're talking about.
We know why the yield curve is flattening—it's because we're raising the federal funds rate.
Ultimately, what we really care about is what's the appropriate stance of policy. There may be a signal in that long-term rate about what is the neutral rate, and I think that's why people are paying attention to the yield curve.

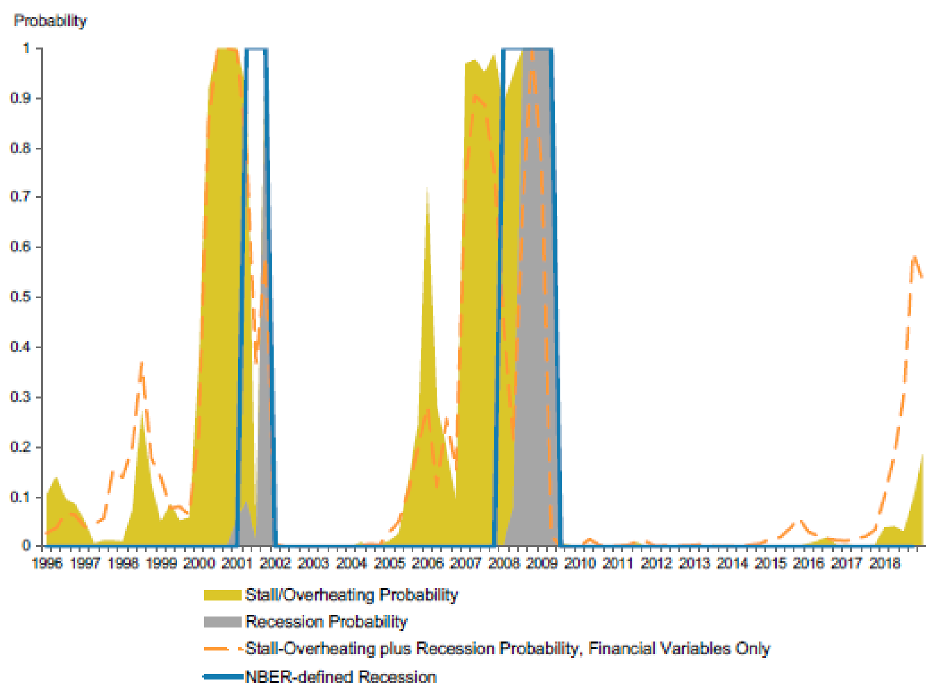
Recession Probability

Comments such as those from Dallas Fed President Kaplan in a *Wall Street Journal* interview on March 27 suggest his level of concern about the yield curve inversion is still low: "I'd need to see an inversion [of the yield curve] of some magnitude and/or some duration, and right now we don't have either." Kaplan went on to say an inversion would need to go on for months and that "we're not there yet." Indeed, **we may look back on this time and see that the inversion of the 3m-10y curve was a false-positive**.

The recession probability model sees only a modest probability of recession over the next year. Exhibit 3 shows the full-model probability that the economy has entered the stall/overheating phase of the business cycle has moved up close to 20%. Once the economy enters this phase, a recession follows, according to the model, although the timing is uncertain. This 20% stall probability translates into a 13% probability that the economy is already in or will enter recession over the next year, by 1Q20.

The probability estimates are constructed using 11 cyclically sensitive non-financial and financial variables, including the slope of the yield curve. Exhibit 3 also shows probabilities the economy has entered either a recession or the stall/overheating phase computed from financial variables alone over the last four quarters. This probability is currently higher, over 50%, which translates into 33% probability the economy is already in or will enter recession over the next year. However, those forecasts perform less well than those from the full model. It bears repeating that the extensive expansion of central banks' balance sheets in this cycle has likely flattened the yield curve more than was the case in prior expansions—which might increase the chance of false signals and an overstatement of recession risks from just looking purely at financial variables.

Exhibit 3: Real-Time Probabilities of Stall/Overheating and Recession



Source: Morgan Stanley Research

Despite the gloom from financial markets, **we can't ignore the substantial easing in financial conditions the Fed has provided** through its communications and actions. Statistical analysis says inflation-driven Fed tightening determines the timing of most recessions, so the Fed being on hold through the early part of 2020 is important in tamping down recession risk. These steps have lowered subjective assessment of recession risk as easy policy underpins the growth backdrop more materially. Specifically, while analysts have kept 2019 recession probability estimates unrevised at 15%, **they have lowered the probability of a recession starting in 2020 from 30% to 20%.**

If Not Recession, Then What?

Analysts have contended that recessions are preceded by a period of overheating. Is it possible, then, that in 2018 when GDP grew by 3% on a 4Q/4Q basis and the Fed hiked four times we were moving through the period of overheating and are now headed into a downturn? The full recession probability model presented above says no, that did not happen. But the version using only financial variables suggests that is a possibility.

But if recession is not in the cards, as analysts believe, then the appropriate question is if not recession, then what? Despite the projections shown in the Fed's March SEP, there is no such thing as a soft landing. No unicorn. No pot of gold at the end of the rainbow. The longer the Fed is on hold, the more slack is removed from the economy, the more positive the output gap grows, and the more inflationary pressures build. **The Fed will be drawn back into a hiking cycle before long as the costs to being patient tilt toward the increased financial stability and inflation risk** of leaving rates too low for too long in an environment where financial markets conflate patience with a no-rate-hike path. This is what analysts envision in 2020.

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Buying Insurance

In his risk management approach **Chair Powell likes to buy insurance**. When the expansion was moderately rolling along and inflation remained benign, the Chair still chose to move cautiously, raising rates gradually as sitting by and doing nothing would risk the economy overheating, prompting catch-up hikes that could precipitate the next downturn. Those gradual moves were akin to buying insurance against overheating.

What if the baseline, that the Fed's easy stance allows the wheels of the economy to grip the road and take off again, is wrong? If instead we are moving not through a trough in growth, but into a downturn? **Expect Chair Powell to act decisively and aggressively, buying insurance against hitting the zero lower, bound by cutting rates 50bp.** Consider it another preemptive strike.

Just be sure to not get carried away with a one-sided view. Chair Powell and the FOMC were quick to pivot on the material downside risks posed by slowing global growth, financial market turmoil and frozen credit markets at the turn of the year. Just as quickly the Fed can pivot back to take into account financial stability concerns should its extended hold lead to runaway animal spirits in markets.

Chair Powell’s Fed is fluid.

US Rates Strategy

A minor tweak at the end of a major shift

With economists changing their perspective on the Fed and removing the December 2019 rate hike from their projections, we lower Treasury yield forecasts slightly. Exhibit 4 displays base, bull, and bear case forecasts through year-end 2019. Analysts now see the 10y Treasury note yield ending the year at 2.25%, down from 2.35% previously. Bull and bear cases have also been updated to reflect the lower distribution of possible outcomes, per analyst views.

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

	Quarter	2y	5y	10y	30y
	29-Mar	**2.26**	**2.23**	**2.41**	**2.81**
Base	2Q19	2.25	2.25	2.40	2.80
	4Q19	2.05	2.05	2.25	2.70
Bull	2Q19	2.05	1.90	2.10	2.40
	4Q19	1.70	1.60	1.80	2.05
Bear	3Q19	2.60	2.65	2.70	2.95
	4Q19	2.75	2.75	2.75	3.00

Source: Morgan Stanley Research

As displayed in Exhibit 5 real rates do the heavy lifting as nominal yields decline on the forecasts. Analysts see real yields ending the year back around pre-tax reform levels – consistent with the fiscal impulse fading completely, per economists' growth forecasts.

Exhibit 5: Morgan Stanley US real yield and inflation breakeven forecasts: Base case

	Breakevens			Real Yields			Nominal Yields		
	5y BE	10y BE	30y BE	5y Real	10y Real	30y Real	5y	10y	30y
29-Mar	**1.79**	**1.88**	**1.91**	**0.44**	**0.53**	**0.90**	**2.23**	**2.41**	**2.81**
2Q19	1.85	1.85	1.90	0.40	0.45	0.90	2.25	2.30	2.80
4Q19	1.85	1.90	1.90	0.20	0.35	0.80	2.05	2.25	2.70

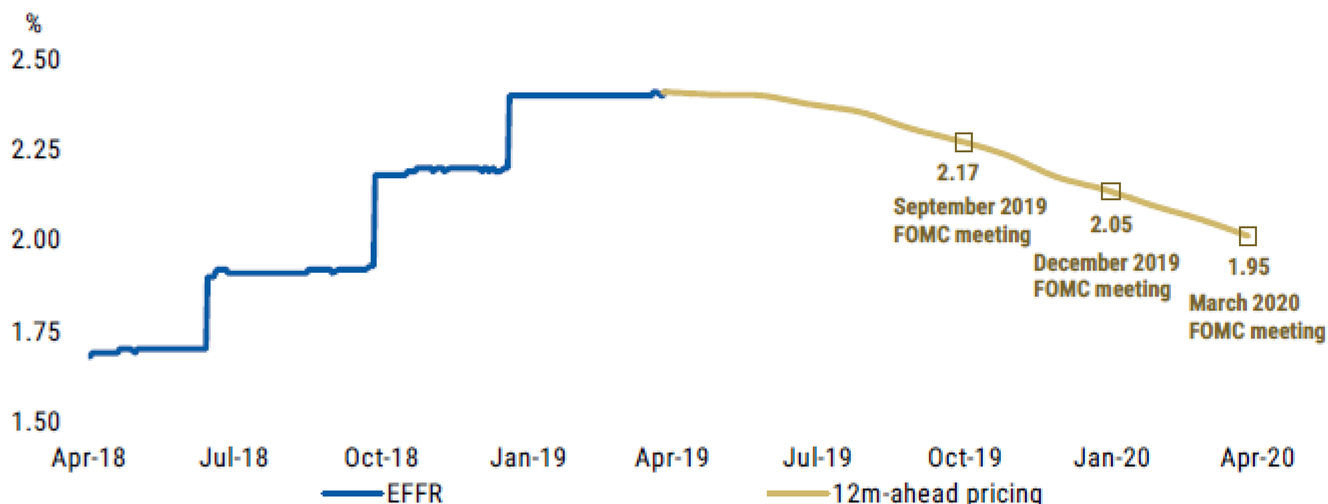
Source: Morgan Stanley Research

Why do forecasts imply rate cuts when economists aren't calling for them?

On March 27 and 28, the 10y yield hit the previous year-end forecast of 2.35%. The levels that 10y Treasury yields reached also coincided with the market pricing in almost a full 25bp rate cut at the September 2019 FOMC meeting and another 25bp rate cut by the March 2020 meeting (see Exhibit 6).

If the 10y Treasury yield ends the year around these levels, or even lower per forecasts, won't the market still be pricing in rate cuts? The answer is yes. The market can still price in rate cuts in 2020 and 2021 even though the rate cuts priced in for 2019 will not have materialized, on economists' projections.

Exhibit 6: Effective federal funds rate and the most dovish year-ahead fed funds futures pricing on Wednesday, March 27



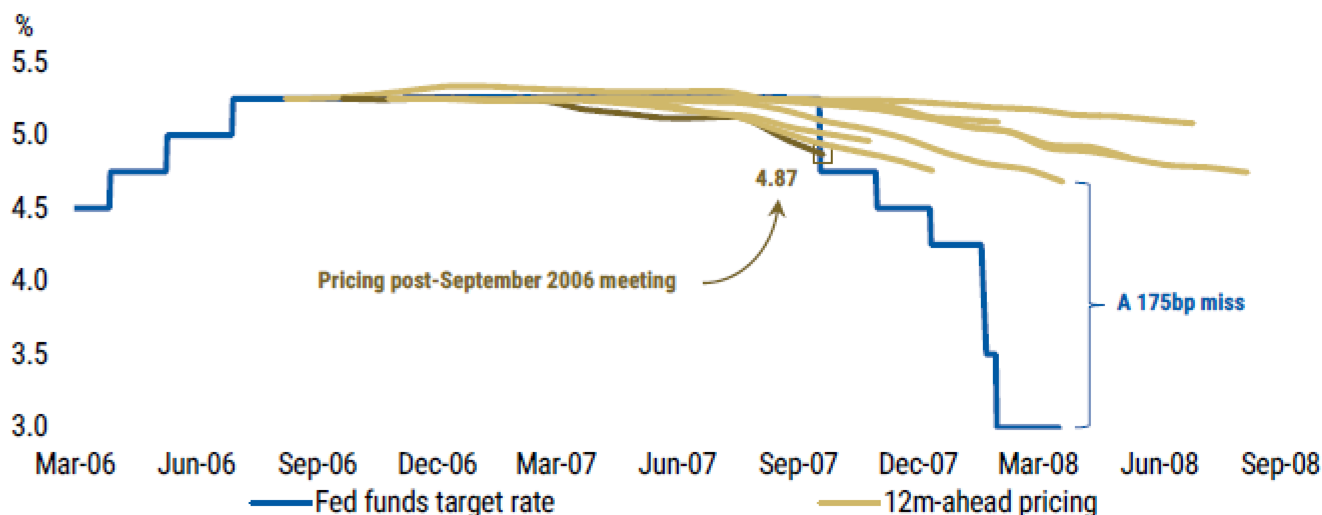
Source: Morgan Stanley Research, Federal Reserve, Bloomberg

Is it reasonable for the market to price in cuts as time passes? As discussed, on average the Fed first cut rates 169 business days (about eight months) after the 3m/10y curve first inverted with the target rate at its peak for the cycle. A rate cut in line with this average would arrive in December 2019, given the 3m/10y curve inverted first on Friday, March 22.

But even if a rate cut doesn't materialize in December 2019, the market can continue to price cuts beyond that point, as shown by looking at the 2006-2007 period. Exhibit 7 looks at how, after the Fed stopped hiking rates in June 2006, markets priced the path for policy extending out a year. After the September 2006 meeting (equivalent to the March 2019 meeting), fed funds futures were pricing nearly 50bp of rate cuts by September 2007.

And even as the Fed remained on hold through September 2007, the market continued to price in rate cuts beyond that. Even more notable, the market priced in those rate cuts even as the S&P 500 rocketed to new highs and financial conditions remained loose, the unemployment rate flirted with new lows, and core PCE inflation was above 2%.

Exhibit 7: Target fed funds rate and year-ahead fed funds futures pricing after each FOMC meeting from March 2006 to the end of the on-hold period



Source: Morgan Stanley Research, Federal Reserve, Bloomberg

As a result, analysts don't see an inconsistency between economists' projections for Fed policy through this year and year-end Treasury yield forecasts, which assume the market continues to price in rate cuts in the forward-looking period.