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US Economics and Rate Strategy

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FOMC Reaction: Year-End Focus

Chair Powell expressed increased optimism in the outlook while again placing the onus on inflation outperforming in order to raise rates. The Fed is focused on year-end funding. Strategists suggest buying UST 2y and 5y notes, while staying neutral on breakevens.

US Economics

- At its December meeting, the FOMC voted to hold the federal funds rate target range unchanged at 1.50%-1.75%. The statement remained neutral by swapping "uncertainties...remain" for monitoring "global developments and muted inflation". Chair Powell's presser then delivered increased optimism around the outlook, while reaffirming that the Fed would need to see, "A significant move up in inflation that is also persistent for raising rates to address inflation concerns.

- The Fed on hold through next year. For inflation forecasts, the bar for hiking rates will not be met prior to mid-2021.

- Economist will follow the incoming data for signs that downside risks to the outlook increase or abate. The path for inflation remains highly uncertain while binary risks around trade remain live. The result is a Fed that is hamstrung until a more clear sign on the direction of economic activity emerges.

US Rates and FX Strategy

- Investors continue to suggest buying UST 2y and 5y notes. Investors appear to think risks to monetary policy in 2020 skew asymmetrically to rate cuts over rate hikes terms of: (1) timing, (2) size, (3) pace, and (4) destination. The Fed is focused on year-end funding: if needed, the Fed will increase the amount of repo operations it is providing.

- In TIPS, the FOMC's guidance to be on hold for 2020 is likely to keep real yields stable in the near term. Investors see breakevens continuing to lead the moves in nominals within the range.

- A high bar to hike in response to improving US data should blunt any USD strength, though the timing and magnitude of the selloff will depend on how quickly global growth improves and fiscal expansion kicks off. Potential December 15 tariffs remain a key short-term risk.

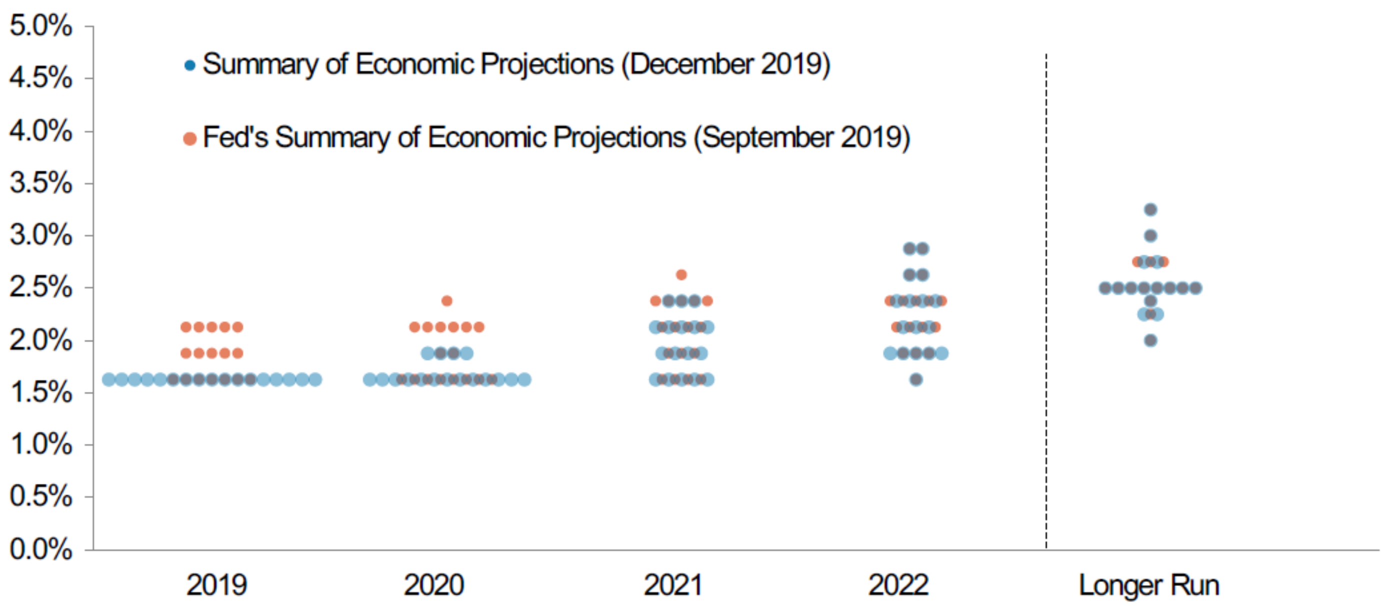
US Economics:

The FOMC held rates steady at its December meeting, and maintained that there is a fairly high hurdle for rates to move either up or down from here. While the statement and accompanying economic projections appeared more constructive about the growth outlook, the bulk of Chair Powell's remarks in the press conference tied the outlook for interest rate policy to the evolution of inflation, indicating that without a "significant and persistent" rise in inflation, the FOMC would be unlikely to raise interest rates anytime soon.

The economic projections presented at the December FOMC meeting were broadly stable—the median policymaker continues to expect growth will stabilize around 2.0% next year, but even with steady economic growth and a 3.5% unemployment rate, policymakers continue to project low inflation will persist next year, with core PCE inflation expected to pick up from 1.6% in 2019 to 1.9% in 2020.

Against this economic backdrop, the majority of policymakers see no catalyst on the horizon for a change in interest rate policy. The median FOMC participant sees interest rates unchanged next year at 1.625%, and has penciled in a 25bp rate hike in 2021 and another 25bp rate hike in 2022, leaving policy below the long-run neutral rate at the end of the forecast horizon. That's a somewhat notable downshift from the September dot plot (Exhibit 1)—for example, there were 10 dots above 2% in the September dot plot, but now there are 8, while the dispersion of the dots in 2022 remains high

Exhibit 1: A Downshift in the Dot Plot



Source: Federal Reserve, Morgan Stanley Research

Chair Powell provided more context on these projections in his press conference remarks when he reiterated that policymakers would need to see "a significant move up in inflation that is also persistent" in order to argue for raising interest rates to address inflation concerns. With a more uncertain outlook for inflation—indeed, economists preliminary estimate for November core PCE inflation is for a decline to 1.5%Y from 1.6%Y—the bar to raise interest rates for at least the next 12 to 18 months appears almost insurmountable for now.

Economists found it notable in that regard that Chair Powell downplayed the significance of a sustained period of low unemployment. The unemployment rate is expected to average 3.6% in 4Q19 and is expected to fall to 3.5% in 4Q20. That's 60bp below the median estimate of the long-run unemployment rate, but Chair Powell explicitly refrained from calling the labor market "tight". The labor market is certainly "strong", but to call the labor market "tight" policymakers need to see greater wage pressures and also need to see those wage pressures translating to higher price pressures. And as Chair Powell emphasized early in his press conference, policymakers view the influence of slack on inflation as incredibly modest, indicating that even with low unemployment, the upward pressure on prices may be only very modest.

Trade policy and global developments remain important for Fed policymakers, but Chair Powell indicated that a marked improvement in the global outlook or in trade policy uncertainty would not necessarily be a catalyst for a significant shift in the Fed's policy stance. Removing trade policy uncertainty would be a "positive for the economy" but on its own would not necessarily meet the bar for a return to rate hikes.

On the other hand, Chair Powell reiterated that a "material reassessment" of the outlook would catalyze an appropriate policy response. In other words, if trade policy or global developments get worse and that spills over into a material weakening in US economic activity, the Fed could cut interest rates further—i.e., even if, on their own, they would not be a catalyst to hike, trade and global developments could be a catalyst to cut.

In this regard, the FOMC reiterated the asymmetric skew toward cutting at least for the next year. It appears unlikely that the bar for hikes will be met by the end of 2020, but it is certainly more conceivable that downside risks could play out in a way that could trigger cuts.

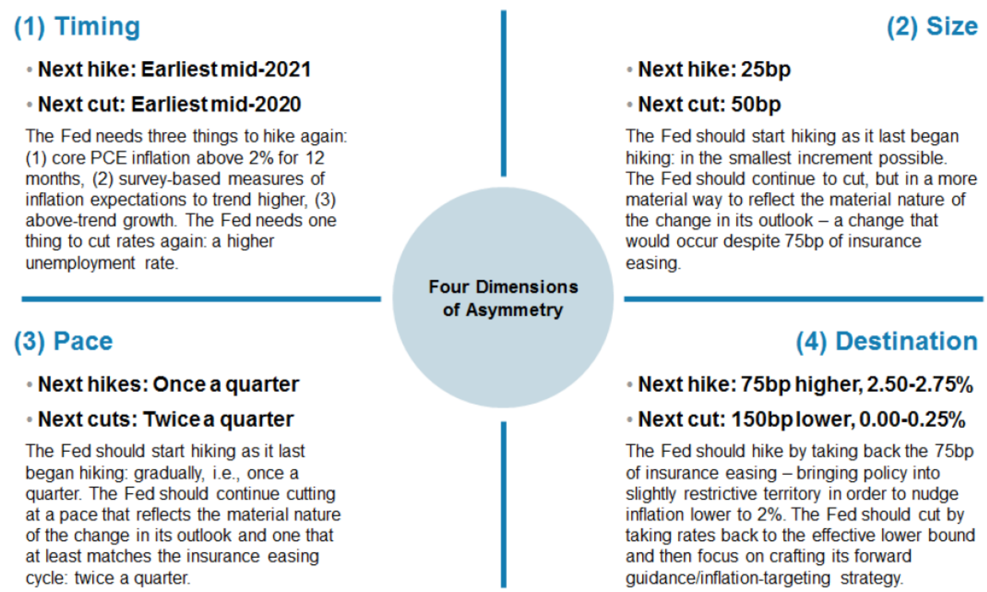
Economists continue to see the Fed on hold through next year, and the consensus among FOMC participants is solidly in agreement. Economists will follow the incoming data for signs that downside risks to the outlook increase or abate. The path for inflation remains highly uncertain while binary risks around trade remain live. The result is a Fed that is hamstrung until a more clear sign on the direction of economic activity emerges.

US Rates Strategy:

A higher premium required for a dovish Fed in 2020

The FOMC meeting outcome and press conference did not change our view. Economists see the risks to the Fed's next policy move as skewed dovish to a considerable degree. Economists think risks skew asymmetrically to rate cuts over rate hikes in the four dimensions of rate policy: (1) timing, (2) size, (3) pace, and (4) destination. Economists perspective on each dimension in our 2020 Global Rates Outlook: United States - An Asymmetric Fed Reaction Function, and include a visual framework in Exhibit 2.

Exhibit 2: Risks to the next Fed rate move are asymmetric, skewed dovishly



Source: Morgan Stanley Research

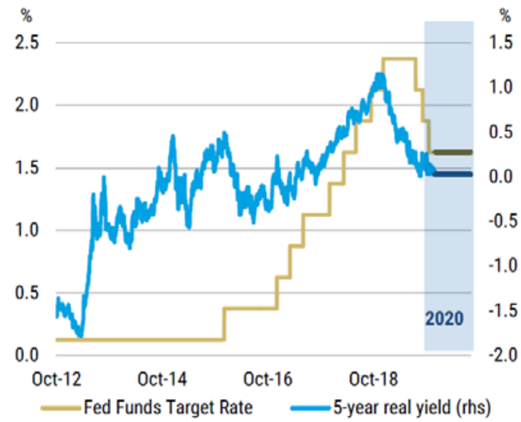
This means the pricing of Fed policy should incorporate a risk premium for lower, rather than higher, policy rates, i.e., a negative term premium, relative to expectations. And with expectations for unchanged Fed policy next year, the market should price in some degree of rate cuts in 2020 (again, even if the base case is for the Fed to remain on hold). The next question is, how much should the negative risk premium be?

Economists assign a 60% chance that the Fed remains on hold next year, a 5% chance the Fed raises rates by 25bp, and a 35% chance the Fed lowers rates to zero. Given these probabilities and the extent of the moves, economists think the market should price in 50bp of rate cuts for 2020, more than the ~25bp priced in.

The Fed continued to suggest at the December FOMC meeting that rates are likely to be unchanged until further notice – and economists think this does not change our view from the 2020 inflation market outlook suggesting real rates are likely to be stable near current levels in 2020. In fact, as noted in Exhibit 3 below, 5-year real yields have stabilized near current levels as the guidance from the Fed has been for an unchanged stance since the October FOMC meeting.

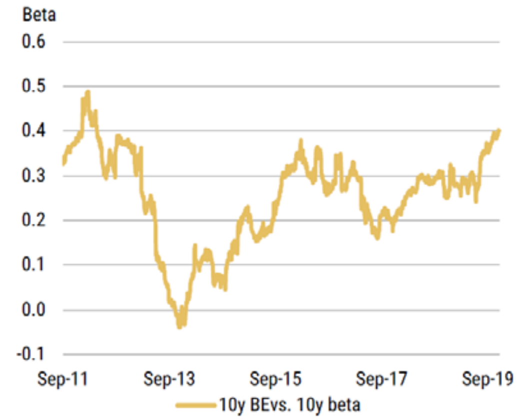
Additionally, economists see breakevens leading the range move in nominal yields, which investors have been playing from the long side within the range. The beta between breakevens is likely to stay high as it has been for the last few months (see Exhibit 4), with breakevens and nominals both reacting to the ebbs and flows of the news on the trade policy, and trade tensions between the US and China.

Exhibit 3: 5-year real yields vs. Fed funds target rate over the last decade



Source: Bloomberg, Morgan Stanley Research

Exhibit 4: Beta between breakevens



Source: Bloomberg, Morgan Stanley Research

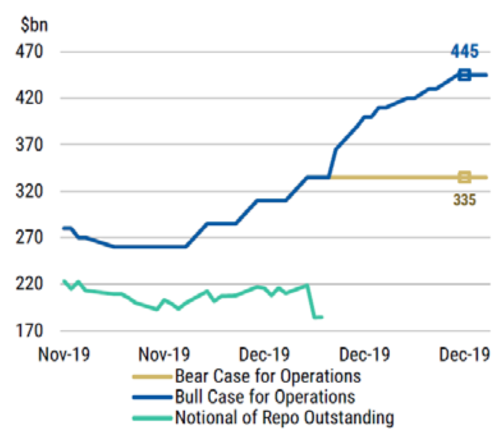
The key point economists noted from the press conference is how there continues to be pessimism in the prospects for higher inflation within the FOMC – it is notable that even with an unemployment rate below the long rate of unemployment for the economy, the FOMC participants hardly see any inflation overshoots in their forecast, reflecting a flat Phillips curve and well-anchored and sticky inflation expectations (see quote from Powell below).

The quote below from Powell suggests that the Fed is less likely to respond to an inflation uptick, unless it is persistent and significant. Economists do see an asymmetry in the Fed's reaction function to the dovish side as note above, which adds a long bias to real rates. However, given the negative carry in being long TIPS, economists stay neutral on real rate for now and continue to suggest being neutral on breakevens as well.

On repo, year-end, and the Standing Repo Facility (SRF)

The Fed reaffirmed its narrative surrounding the balance sheet. The Fed's priority remains permanent regrowth of reserves via T-bill purchases and temporary reprieve via TOMOs. When asked whether the Fed would consider purchasing short-dated coupons, which primary dealer balance sheets are flush with, chair Powell stated (our emphasis):

Exhibit 5: Different cases for amount of liquidity injected by the Fed via repo operations



Source: Federal Reserve, Morgan Stanley Research

Exhibit 6: Potential schedules for year-end repo operations

Operation Date	Maturity Date	Term	Bear Case ($bn)	Bull Case ($bn)
12/16/2019	1/13/2020	28-days	15	25
12/17/2019	12/30/2019	13-days	35	45
12/19/2019	1/2/2020	14-days	35	45
12/23/2019	1/7/2020	15-days	35	45
12/26/2019	1/9/2020	14-days	35	45
12/30/2019	1/14/2020	15-days	35	45
12/30/2019	1/6/2020	7-days	0	15
1/2/2020	1/16/2020	14-days	35	45
1/7/2020	1/21/2020	14-days	35	45
1/9/2020	1/23/2020	14-days	35	45
1/14/2020	1/28/2020	14-days	35	45

Source: Morgan Stanley Research

Although the Fed reserves the right to change its tactics, Chairman Powell made clear that the Fed has no intention of doing so at this point, particularly before year-end. In fact, if it needed to adjust anything around year-end, it would more likely increase the amount of repo operations it is providing. Exhibit 5 and Exhibit 6 show the amount of liquidity that economists expect the Fed could inject via repo operations.

Tomorrow, on December 12 around 3:00PM New York time, the Fed is releasing a new schedule for repo operations. Economists believe that it will continue offering overnight operations that are $120bn each in offering size, as well as 14-day term operations that are $35bn each in offering size. It is possible that the Fed increases the size of these operations as well, particularly the 14-day operations. If so, economists think it could increase them to $45bn each (see the blue line in Exhibit 5). It is also possible that the Fed introduces additional term operations covering the year-end turn.

With respect to year-end, Chairman Powell also acknowledged the normality of yearend repo volatility: "The purpose is not to eliminate all volatility in the repo market…. So, you asked about year end. Temporary upward pressures are not unusual around year end. Both of the operations are intended to mitigate the risks those pressures impose. We think that the pressures appear manageable and we stand ready to adjust the details of the operations as necessary to get the federal funds rate in the target range."

Therefore, as written in Outlook for 2019 Year-End, Economists continue to expect a year-end spike in repo to 3-4%, which is in line with current market pricing. While the risk remains to the topside, the Fed's main concern remains whether or not the fed funds rate trades within its target range, not whether repo volatility is avoided. So, economists believe volatility and wide rates should be expected.

In particular, economists think there could be some volatility next Monday, December 16, as there will be net settlements and corporate tax payments that draw down reserves by about $80-100bn in our estimate. In fact, Monday will be most similar to the set of circumstances that led to September's repo episode. While we expect modest cheapening of general collateral (~10bp) around this date, further stress could bear warning for a worse-than-expected year-end turn.

Looking ahead to more structural changes, Chairman Powell acknowledged that there are changes that could be made with respect to supervisory regulation that could encourage the more fluid flow of reserves in the system: "Your question on that is what we thinking about it -- we are more focused on the bill purchases, the year end, and the review of supervisory and regulatory issues. Because we think, these are structural things where you could, without sacrificing safety and soundness, allowing the liquidity that is already there to flow more freely perhaps by making fairly straightforward noncontroversial changes. We think there is some of that. We are working hard and fast. Those are things that will take notice of public rulemaking, which will take three months."

In the Outlook for the 2019 Year-End, economists discuss some of the regulation amendments that the Fed could make, or look to make, in the future. Namely, they may look to adjust G-SIB scoring mechanisms such that the binary behavior at year-end subsides. However, as Powell states, any review of regulation and supervisory constraints would need to maintain safety and soundness of the financial system.

Lastly, economists turn to a brief update on the standing repo facility (SRF). The repo facility is the gift that keeps on giving, as it is frequently discussed, but very little progress has been made. When asked about the facility, Powell emphasized that the priority is on rebuilding reserves via T-bill purchases and then on evaluating some of the structural changes that could be made to allow reserves to flow more easily. So, it appears that the SRF has fallen lower on the totem pole of Fed priorities. Once the Fed decides that the SRF is a priority, Chairman Powell explains that it will take time to develop: "The standing repo facility is something that it will take time to evaluate, create the parameters of and put into place. At the moment, we are focused on year end. I should mention that as the underlying level of reserves moves up because of bill purchases, as that happens there will come a time when it will become appropriate for overnight and term repo to gradually decline."

This last sentence suggests that as reserves increase, the need for a repo facility is seemingly obviated; this notion was one of the points emphasized in the SRF discussion in the October FOMC minutes. As such, economists believe that it seems unlikely that the SRF is introduced in 1H20.