

June 10, 2009

Downunder Daily

The Tightening Question

One stronger-than-expected payroll report, and short-rate markets are focused on the prospect of a Fed tightening. A few thoughts:

First, short-end rates remain at very low levels, despite the post-payroll jump. The two-year note, for example, lifted from under 1% to over 1.4% by Monday's close (Exhibit 1). Jim Caron, our head of rates strategy, believes that the spike has been exacerbated by profit-taking on curve steepening positions: the 2-10 year spread reached a record earlier last week.

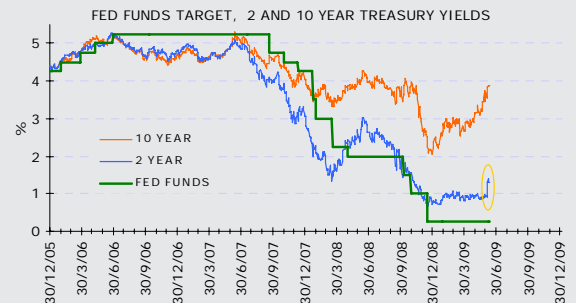
Second, a rise in short-end yields was to be expected as markets normalize: just as long-end yields were unlikely to remain too far under 3% once there was a sniff of recovery, likewise, short rates were going to speculate when policy-makers would temper the current extraordinarily loose policy. In other words, the key question for rates, as for equities, is no longer when the recession ends, but the nature of the recovery.

Our US team's view is that the market is already too hawkish on the likely turn to tighter Fed policy. Admittedly, there are many uncertainties. Markets, like policy-makers, have little or no experience judging the effectiveness of the non-conventional policy tools used in this cycle – or judging the impact of their removal. Even if it were totally clear how the recovery would progress, the pace and sequence of removing or tightening these policies is not clear.

The more important call, however, is on the nature of the recovery. Dick Berner and Dave Greenlaw expect that the recession will end by mid-to-late (northern) summer, but the recovery will be gradual. Our team has nudged its near-term GDP numbers higher (expecting GDP will fall by 1½% through this year, versus -1.9% previously), but full-year growth of 2¼% in 2010 is an anemic bounce given the depth of the downturn. (See *Recession Ending But Recovery Will Still Be Gradual*, June 8.)

Exhibit 1

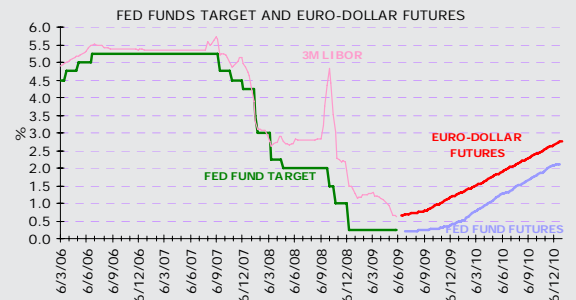
Now The Short-end Sees Recovery...



Source: Federal Reserve, Bloomberg; Morgan Stanley Research

Exhibit 2

...And Prices in a Tighter Fed



Source: Federal Reserve, Bloomberg; Morgan Stanley Research

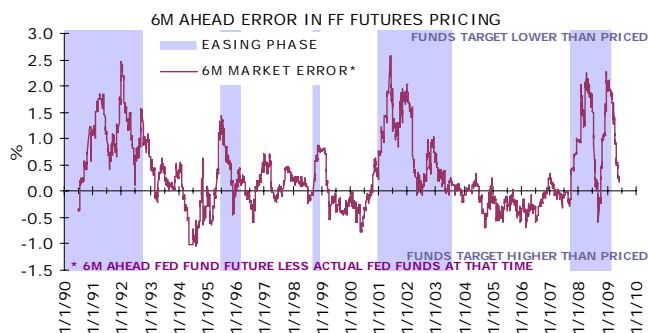
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Given that outlook, we think markets are pricing in tighter policy too soon (Exhibit 2). Dick and Dave don't expect the Fed to lift its funds rate target until the September 2010 quarter. In contrast, the futures market is pricing in a rate hike this year, with a move to around 1¼% by mid-2010, and almost 2% by end-2010.

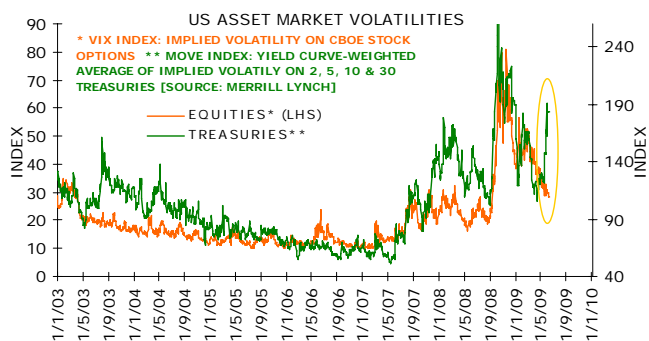
Exhibit 3
Market Is Not a Perfect Forecaster



Source: Federal Reserve, Bloomberg; Morgan Stanley Research

Third, the market is not a perfect seer. Exhibit 3 shows the forecast error on the six-month-ahead Fed funds target (that is, the gap between the funds rate priced in six months beforehand compared to the actual target rate). To be fair, short-rate markets are worse at forecasting easing cycles than tightening cycles. (I haven't adjusted for carry costs, so I'm being marginally harsh, but the errors are so large that that adjustment wouldn't significantly change the picture.) The error in the last cycle was fairly small – no doubt due to the Fed's clear signaling of imminent change. In prior cycles, however, short-rate futures got too hawkish, too soon.

Exhibit 4
Policy Uncertainty = Rates Volatility

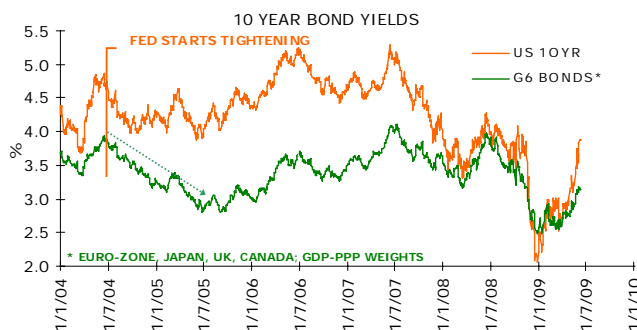


Source: Bloomberg; Morgan Stanley Research

Fourth, regardless of whether the market is right or wrong, it's clear that uncertainty is rising. Jim Caron has noted that the effect of the non-conventional policy measures was to limit the range of rate outcomes, therefore damping volatility. As those measures are relaxed, volatility will increase. This is now happening in the rates space. Exhibit 4 shows the sharp rise in the Move index, which is the Treasury counterpart to the Vix index. (For more details, see Jim Caron, *Bonds: A Bursting Bubble?* June 2.)

Fifth, while other developed-economy rates are correlated with US rates, the rise has been much less pronounced. Our European rates team thinks the market is right to price in the end of easing – but does not think that tightening is imminent. See Laurence Mutkin, *End of Easing: Implications*, June 5.

Exhibit 5
Global Rates Sniff Recovery



Source: Bloomberg; Morgan Stanley Research

Finally, for equity investors, the rise in Treasury yields combined with expectations of tighter Fed policy bring to an end the über-sweet spot enjoyed over the past three months: less bad macro data, a reversal of extreme positioning, low rates, and the expectation that policy would remain ultra-accommodative. Equities usually do cope well through the early stage of a tightening cycle: both policy-makers and equity markets are responding to the burgeoning economic recovery.

But this is not a normal cycle. Markets have run hard and are now, by my reckoning, increasingly priced for a sharp macro and profit recovery. Such a recovery still seems unlikely, at least within developed economies. The change in the rate environment may not singlehandedly stall the rally in equities, but in my view it is another indication that the risk-reward on equities is again tipping. I've nominated 950-1000 SPX as a likely region for the rally to peter out, with a stretch target of 1100. With rate markets now starting to shift, this still seems a reasonable upper bound for how far the current rally will travel.

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