Morgan Stanley

Monthly Musings

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The Benedict-McLoughlin Group @ Morgan Stanley

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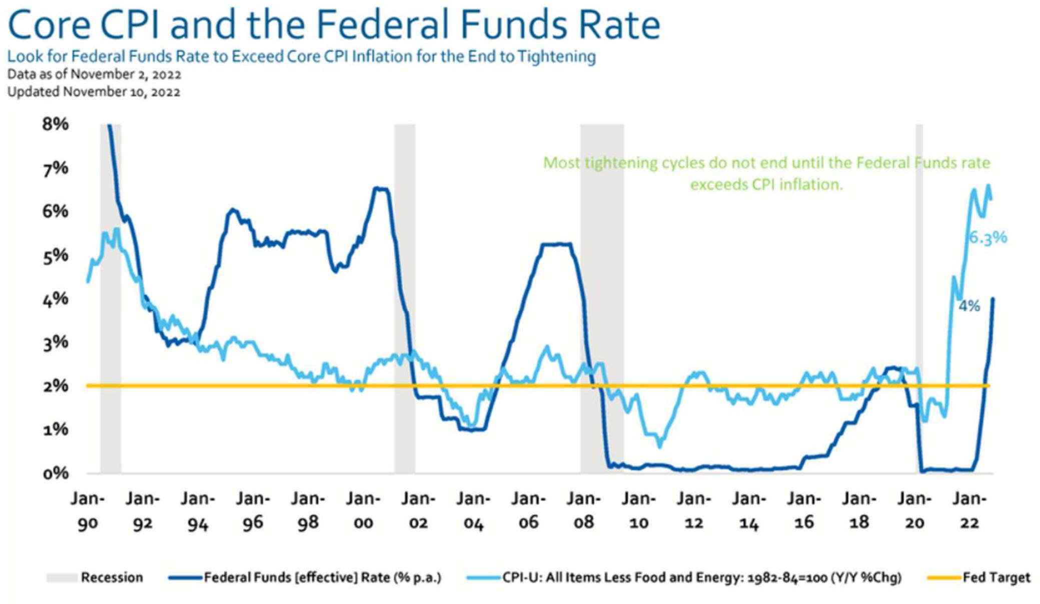
The Interest Rates Edition

2022 has been a year of "welcome back to normal" monetary policy…and global stock and bond markets have spent the greater part of it downwardly adjusting to this reality. Arguably, the fed kept rates at 0% for too long, which, by itself, had created many market distortions. But, when you combine this with the unprecedented fiscal policy that accompanied it, the resulting decades-high inflation effectively forced their hand to move aggressively and the consensus is that they have a "behind the curve" mindset.

Although inflation may have, in fact, peaked already, the U.S. Federal Reserve appears determined to bring it back towards their 2% target. Their aggressive hikes of the federal funds rate so far this year are solid evidence of their resolve (see graph below). As you can see, the federal funds rate is at 15-year highs, well off the zero bound we enjoyed since the Global Financial Crisis. However, we are still well below the peaks seen in the 1980's and 1990's…interestingly, this period was the last time we saw inflation rates like we're experiencing currently.

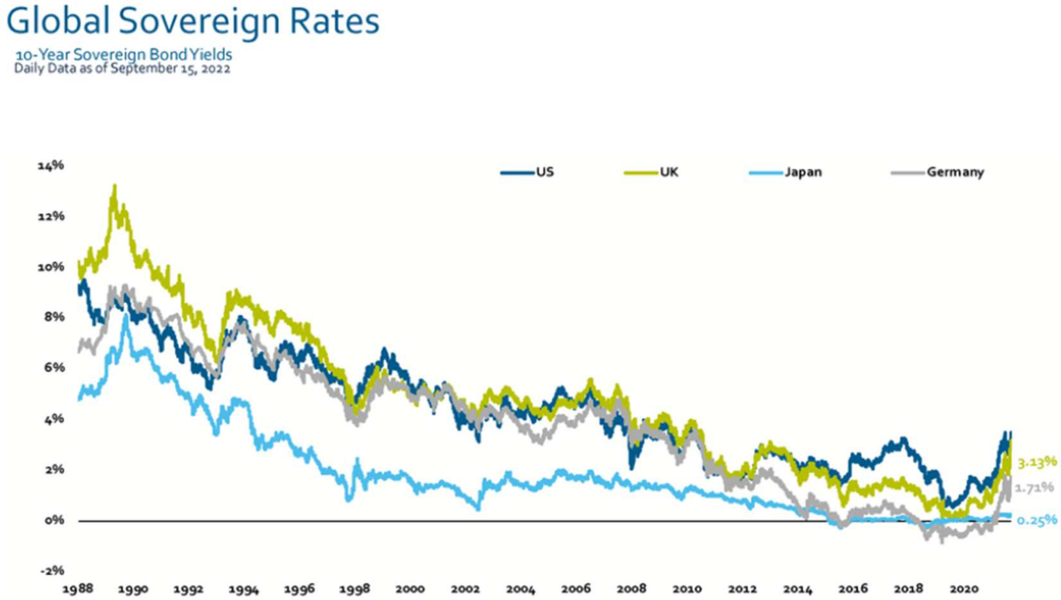


Source: Morgan Stanley ChartBook (See disclosures below)

The obvious questions for investors are when and at what rate will they stop raising rates. Fed Funds futures currently predict a peak rate of just under 5% in May 2023.[1] Interestingly, the upper band could be very close to this level next week if they continue their streak of 0.75% hikes. In my opinion, the futures market provides a pretty reasonable outlook, as the Fed will likely only do a 0.50% hike on 12/14 and follow that up with a 0.25% hike in February and maybe another one after that. So, for those investors looking out for “peak Fed”, it appears to be in sight…but, does that mean that intermediate and longer term rates have peaked?

Is There a Fundamental Value Level for the 10-Year US Treasury Yield?

During periods of normal monetary policy (i.e., pre-2008), investors typically required a real rate (after inflation) of between 1% - 3% for the 10-Year US Treasury Note. Using the current inflation rate of 6.3% (Core CPI), that would give us a hypothetical yield of 7.3% – 9.3%, a long way from the current 10-Year level of 3.57%.[2] But, even if we assume inflation does moderate down towards the 3% level, we would expect to see a yield on the 10-Year of between 4% – 6%. The yield did get above 4% briefly in October but, I would expect it to go back above again if we are truly getting back to a normal interest rate regime…and history has shown us that going above 5% is also very possible, even if inflation eases (see graph below).



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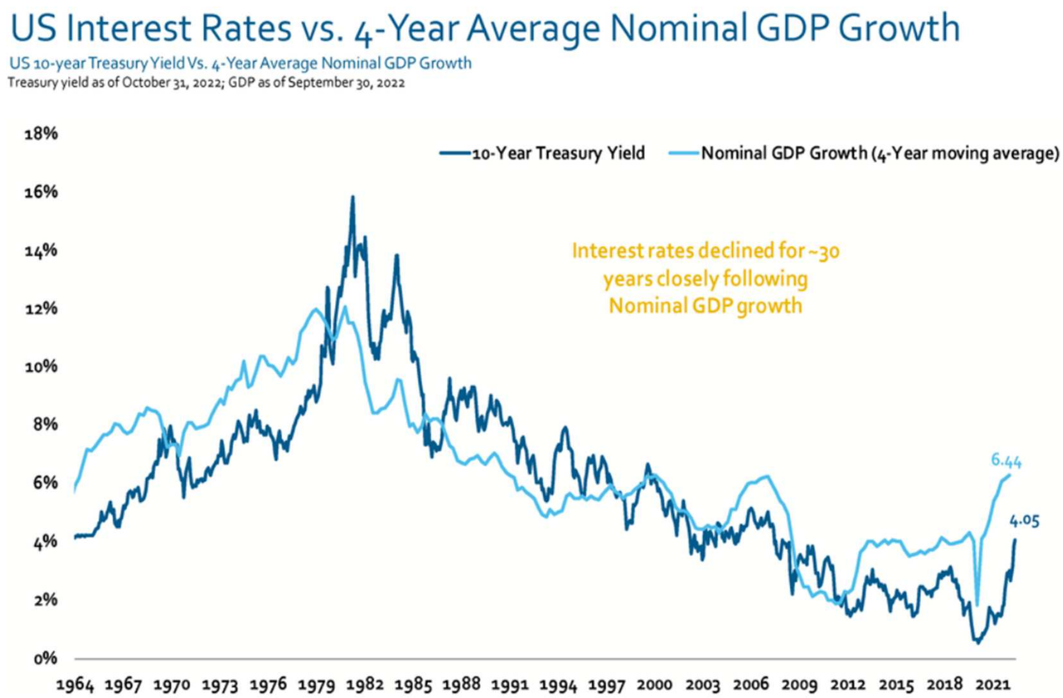
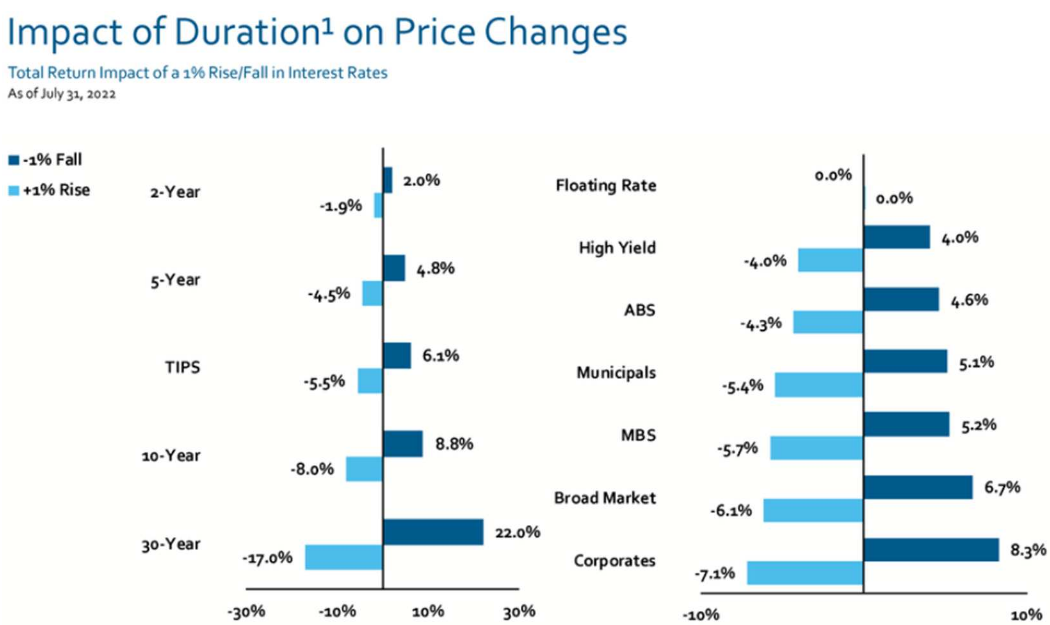


Source: Morgan Stanley ChartBook (See disclosures below)

The other negative for bond prices (i.e., higher rates) is the combination of continued budget deficits and the unwinding of Quantitative Easing (QE), otherwise known as Quantitative Tightening (QT). The Fed can shrink its balance sheet by almost $100 billion per month but, still has an enormous job ahead of it given that the Fed has approximately $8.6 trillion of assets.[3] For reference, the

Fed's balance sheet was around $4 trillion just before the pandemic response and $1 trillion prior to the 2008-2009 crisis. This effective increase in bond supply coupled with the $1.4 trillion budget deficit in the most recent fiscal year points to lower bond prices and higher interest rates, in my opinion.[4]

So, how should investors position themselves in the fixed income sector? Given that investors were harshly reminded this year that you can lose money in bonds, it's important not to venture too far out the maturity curve, in my opinion. The graph below shows that even a relatively benign 1% move in rates can lose you 8% in a 10-year bond and 17% in a 30-year bond. If I am right and the Fed Funds will peak in 2023 while intermediate and longer-term rates continue to normalize higher, then, the 2 – 4 year maturity range looks like the sweet spot to me currently. As far as which sectors, most look reasonable, including certain international areas, given the rise in interest rates this year…So, It really depends on an investor's risk tolerance. That said, I would avoid going too far down the quality ladder in the high yield sector given the likelihood of slower economic growth in 2023.



Source: Morgan Stanley ChartBook (See disclosures below)

See My Previous Investment Commentaries here:
https://advisor.morganstanley.com/benedict-mcloughlin-group

***Tactical Allocation Tilts in my Global Growth and Global High-Income Model Portfolios (as of 12/1/22):**

Overweight	**Underweight**

Global Value Equities, Long/Short Equity Strategies, Quality Dividend Paying Global Equities, Emerging Market Consumer Equities, Total Return Strategies, Shorter-term Corporate Bonds	High P/E technology/growth stocks, U.S. Treasuries, Long-Term Fixed Income

* These weightings do not consider each client's unique profile, preferences and/or constraints and therefore may not be applicable to you.

The Benedict-McLoughlin Group always strives to use sound judgment…at every decision point.

We bring experience, credentials, and tenacity which we expect to continue to enable us to help achieve our clients' goals over time.

Regards,
Chris

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Alternative Investments Director

The Benedict-McLoughlin Group – *"Institutional Caliber Portfolio Management, Customized to Your Personal Situation"*

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NMLS #1278939

Notes:

1. Bloomberg Markets, 12/1/22
2. Bloomberg Markets, 12/5/22
3. www.federalreserve.gov, 12/5/22
4. www.treasury.gov, 12/5/22

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Chartbook Source: FactSet, Morgan Stanley Wealth Management GIC. (1) The cyclically adjusted P/E ratio (CAPE), also known as Shiller P/E ratio, uses a 10-year average of inflation-adjusted earnings to value the stock market. Historically, cyclically adjusted price-earnings ratios have led subsequent returns with a 10-year lag. Recent price earnings levels suggest equity returns could be better going forward than they have been over the recent past, assuming the statistical relationship holds. Standard deviation (volatility) is a measure of the dispersion of a set of data from its mean. Past performance is no guarantee of future results. Estimates of future performance are based on assumptions that may not be realized. This material is not a solicitation of any offer to buy or sell any security or other financial instrument or to participate in any trading strategy. Please refer to important information, disclosures and qualifications at the end of this material.

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