Global Insights

When Doves Cry and Hawks Screech

Coordinated global central bank action helped stave off the worst effects of last year’s pandemic-induced recession. As a result, global composite purchasing manager index levels are healthy, showing that the global economy is finally on the mend. As we move into the second year of the recovery, many investors are rushing to shore up portfolios against monetary-policy-related risks.

- The Federal Reserve has come under fire recently, but we don’t see the central bank increasing its target rate anytime soon. However, they are closer to discussing tapering economic support by scaling down asset purchases on the open market. Past experience has demonstrated that stocks fall when central banks remove excess liquidity. However, we still prefer stocks over US Treasuries during the midcycle transition.

- The European Central Bank (ECB) is expected to expand its asset purchasing program at its June meeting. The ECB maintains an ultra-dovish stance because Europe is considerably earlier in its economic recovery than other regions, which benefits European equities. Lower relative bond yields in Europe make fixed income less attractive. However, German Bund yields rising to 0% by June 2022 is a positive sign for the European economy and investors in the region.

- The People’s Bank of China (PBOC) is now the most hawkish central bank among major economies. China’s solid cyclical rebound from COVID-19 has encouraged the government to reallocate economic resources to long-term structural priorities such as financial sector derisking. The central bank’s desire to control risk in the financial system could put pressure on equities, while higher US Treasury yields and increased currency volatility have made Chinese bonds less appealing to foreign investors.
The Fed. To meet its dual mandate of stable prices and full employment, the Fed has pledged to maintain a dovish policy stance. We see a Fed increasingly focused on outcomes versus outlooks, wanting to see more evidence of progress toward its goals. Although Fed officials have reiterated that they are not yet prepared to remove support for the economy, investors fear that stronger-than-expected economic data could spark a quick reversal in policy.

Even though the Fed has faced sharp criticism recently, we don’t see officials increasing the target rate any time soon. Based on the MS & Co. M1KE Index, which captures the market’s expected timing of rate hikes, traders don’t see the Fed moving away from low-interest rate policy until the first quarter of 2023, which is generally in line with the Fed’s forecast.

The Fed has indicated that it will keep the short-term rate pegged near zero until it sees full employment and inflation averaging 2%. Currently, we see evidence that neither is imminent. For example, the labor market is still missing about 7 million jobs from before the pandemic. Additionally, the 61.6% participation rate in May is below the 63.3% pre-pandemic level, implying that there is still plenty of slack in the labor market.

On the inflation front, the data is more mixed, and uncertainty around how inflation will play out has led to bouts of volatility during the past couple of months. First, 10-year breakeven rates, a market-based measure of inflation expectations, have climbed 130 basis points in the past 12 months, which is at the 95th percentile for the 20 years ending in May. Second, the Consumer Price Index for April leaped 4.2% from a year earlier due to a combination of pent-up demand, supply chain issues and base effects. Finally, wage growth, a “sticky” component of inflation, is at 3.2%, according to the Atlanta Fed Wage Growth Tracker—a level that is not yet alarming. Taken together, the inflation measures seem to point to an economy running hot, but we expect to see a lot of noise in the inflation data over the coming months. As a result, we think that the Fed will be purposefully patient.

At April’s FOMC meeting, committee members acknowledged that rapid improvement in macroeconomic data could upend their cautious approach to policy normalization. If conditions do change materially, we see a Fed prepared to reduce the pace of its $120 billion per month asset purchase program. Ellen Zentner, Morgan Stanley & Co.’s chief US economist, expects committee members to finally provide guidance at its September 21-22 meeting. We don’t think the Fed will rush a decision to taper its balance sheet, and note that MS & Co. economists expect the Fed to begin to reduce the pace of asset purchases next April.

The recent rise in US inflation expectations, a component of bond yields, suggests that the market is pricing the removal of emergency measures. As a result, US bond investors should maintain below-benchmark portfolio duration. Although past experience has demonstrated stocks fall when central banks reduce easy money policy, we still prefer stocks to US Treasuries during the midcycle transition.

The ECB. Since the beginning of the COVID-19 pandemic, the ECB’s Pandemic Emergency Purchase Program (PEPP) has supported the 19 Euro-Zone economies through waves of infection and a double-dip recession. However, with the accelerated pace of vaccinations driving cases lower and economies poised to reopen, many investors wonder when the ECB will transition away from its support measures.

MS & Co.’s European economists do not expect the ECB to announce tapering of asset purchases at the June 10 meeting. In fact, they expect the program to expand as tighter financial conditions, weaker inflation expectations and risks to the European Commission’s 70% vaccination goal present headwinds. However, as the March 2022 deadline for the proposed end to PEPP draws near, we highlight some of the most significant items to watch. First, MS & Co.’s European economists expect the ECB to start communicating plans on what happens after PEPP at its Sept. 9 meeting. In the following months, the ECB will likely hint at changes, ultimately providing explicit details at its Dec. 16 meeting. At this meeting, the ECB will likely begin winding down PEPP and pivot to providing accommodation consistent with the medium-term outlook for inflation, which MS & Co.’s economists expect to be a flat target of 2%.

The program that is expected to replace PEPP is a revised version of the ECB’s Asset Purchase Program—a Quantitative Easing (QE) initiative that was introduced in 2014 and employed until 2019. MS & Co.’s economists expect this QE program to include a fixed component of €20 billion per month that can be reassessed on a quarterly basis. Notably, ECB is expected to be more proactive on climate change issues as part of their strategy review and begin to formally include them as part of their mandate. This recent development is likely to impact collateral eligibility and pricing, capital requirements and the composition of policy portfolios.

The ECB maintains an ultra-dovish stance because Europe is considerably earlier in its economic recovery than other regions. Such support should benefit European equities. Loose monetary policy, coupled with aggressive fiscal policy in the form of a €750 billion EU Recovery Fund, will provide ample liquidity and support to equities, especially reflation beneficiaries within Financials and Materials. Lower relative bond yields in Europe make fixed income less attractive, especially as the German Bund remains in negative territory. However, according to MS & Co. analysts, Bund yields rising to 0% by June 2022 should be another positive sign for investors in the region.
The PBOC. Now the most hawkish central bank among major economies, China's total credit growth slowed to 12.3% year over year in March, down from a high of 13.6% in October. Similarly, the new flow of total social finance (TSF), China's broadest credit metric, was 36% lower than in March 2020.

This round of tightening reflects more than just countercyclical policy. China's solid cyclical rebound from the COVID-19 recession has encouraged the government to reallocate economic resources from short-term emergency measures to long-term structural priorities such as financial sector derisking. Still, the question remains as to how hawkish their policies will be in the remaining months of 2021.

Investors are concerned that the PBOC, eager to normalize policy, will be forced to raise interest rates sooner than anticipated. We believe that those concerns are unfounded and that overtightening is unlikely. The sharp slowdown in March was primarily due to base effects rather than aggressive tightening, as the new TSF flow was still 12.8% higher than in March 2019. Moreover, CPI was unchanged in the first quarter of 2021 compared with the previous year, owing largely to a 12.5% year-over-year decline in food prices off of last year's high base. This would more than offset a modest increase in services prices as COVID fears fade.

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The Outlook for Central Banks

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<th>Central Bank</th>
<th>Commentary</th>
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<td>Federal Reserve</td>
<td>The Fed has pledged to maintain a dovish policy stance until the economy reaches full employment, has made clear that it is largely unconcerned about forward-looking market-based measures of inflation, and has reiterated a willingness to let the economy run hot. FOMC members will continue to discuss tapering through the end of the year, but will ultimately hold off on doing it until 2022.</td>
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<td>European Central Bank</td>
<td>Despite Europe's improving economic outlook, the presence of tighter financial conditions, weaker inflation and risks to the post-pandemic recovery mean that the ECB will wait until at least the fall to announce decreasing asset purchases. However, the March 2022 deadline to end the Pandemic Emergency Purchase Program (PEPP) means that the ECB should start communicating post-PEPP plans in September, followed by explicit details in December. MS &amp; Co. economists expect a revised Asset Purchase Program to be announced, containing a fixed component of €20 billion per month, as well as a robust climate change mandate.</td>
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<td>People's Bank of China</td>
<td>China's solid recovery has encouraged the government to reallocate economic resources to structural priorities. However, because growth has likely peaked, policy rate increases by PBOC are not required to cool the economy further. We believe a rate change is unlikely this year.</td>
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<td>Bank of Japan</td>
<td>The BOJ will continue with Quantitative and Qualitative with yield curve control, aiming to achieve the CPI target of 2%. It will continue to support financing and market stability through the Special Program to Support Financing in Response to COVID-19; purchases of Japanese government bonds; and purchases of exchange-traded funds and Japanese real estate investment trusts. It expects short- and long-term policy interest rates to remain at current or lower levels.</td>
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<td>Bank of England</td>
<td>The BOE will likely use its full Asset Purchase Facility in 2021. At the current pace, the £875 billion will be completed by the end of this year. As activity returns to normal, the BOE will signal tightening. We forecast a 15 basis-point hike in August 2022 and one more in 2023.</td>
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<td>Bank of Canada</td>
<td>The BOC's April meeting was relatively hawkish as it began to taper its asset purchases from C$4 billion to C$3 billion per week. The BOC had also substantially upgraded its growth forecasts, as well as pulling forward the expected timing of the closing of the output gap, which is tied to the timing of forward guidance of interest rates. As such, MS &amp; Co. economists expect the BOC to gradually reduce the pace of asset purchases until its January 2022 meeting, and deliver its first rate hike in the third quarter of 2022 followed by hike in the fourth quarter.</td>
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<td>Bank of Australia</td>
<td>The RBA is focused on the labor market and has flagged full employment as a priority. We believe the RBA will extend its policy support at its July 6 meeting, with another A$100 billion of QE purchases. Despite the strong recovery, slack in the labor market will lead to a more modest inflation pickup, underpinning the expectation of a continuation of support.</td>
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Please refer to important information, disclosures and qualifications at the end of this material.
The PBOC intends to keep liquidity adequate and interbank rates low in the face of rising pressures in the corporate bond market. Market rates have remained relatively stable around their policy benchmarks. Because growth has most likely peaked, policy rate increases are not required to cool the economy further. Therefore, we believe policy rate hikes is unlikely this year.

Importantly, the central bank's desire to control risk in the financial system is the main upward risk for short-term interest rates. When interbank leverage becomes too high, the PBOC frequently introduces rate volatility to temper it.

As a result, Chinese equities are expected to underperform in 2021. The shift in macroeconomic policy should also lower Chinese government bond yields. However, higher US Treasury yields and increased currency volatility have made Chinese bonds less appealing to foreign investors. In currency markets, slowing capital inflows will ease upward pressure on the renminbi, whose effective exchange rate is already too strong relative to its fundamentals.
Charts You Can't Miss

European Financials Benefit From Rising German 10-Year Bund Yields

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of June 2, 2021

Real Fed Funds Rate Sits Deep in Negative Territory

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of June 3, 2021

Overtightening Is Unlikely Given a Turn in China’s Credit Growth

Source: Bloomberg, Haver Analytics, Morgan Stanley Wealth Management Global Investment Office as of March 3, 2021

The Federal Reserve Balance Sheet Has Expanded by $3.7 Trillion Since the Recession Started

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of May 26, 2021
Current Readings From Our Quantitative Framework

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Ongoing Development Spotlight

**Investors Fear Taper Tantrum, But This Time it’s Different**

Federal Reserve chairman Ben Bernanke triggered a bond market sell-off in 2013 when he told Congress that the Fed would reduce the volume of its bond purchases. Fixed income investors were caught off-guard when US Treasury volatility spiked 40% and the 10-year yield climbed 100 basis points in a four-month period. We think that this time will be different. We expect the Fed to announce tapering in September, and start in April 2022. The Fed is being extremely transparent on its policy stance, which should help to dampen market volatility.

*Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of March 31, 2021*
Disclosure Section

Risk Considerations

Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond’s maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.

Rebalancing does not protect against a loss in declining financial markets. There may be a potential tax implication with a rebalancing strategy. Investors should consult with their tax advisor before implementing such a strategy.

Because of their narrow focus, sector investments tend to be more volatile than investments that diversify across many sectors and companies. Technology stocks may be especially volatile.

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