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US Economics & Global Macro Strategy | North America

FOMC Preview: June Meeting

We expect the Fed to hold the policy rate steady at 5.1% while maintaining a tightening bias. We think the data will not meet the bar for a July hike, and the Fed remains on extended hold until the first cut in 1Q24. Our strategists stay neutral on US Treasuries, and maintain long USD positions.

Key expectations

- The FOMC holds the policy rate at 5.1% in June, where we see the peak rate of the tightening cycle. Banking conditions are stable, but the impact of tighter credit conditions is still uncertain, as are policy lags. Current conditions should reflect the Beige Book's assessment that economic activity has stagnated, but job gains remain robust and inflation elevated.

- The statement continues to show the Fed is on a tightening bias. The FOMC reaffirms that it will continue to reduce its holdings of longer-term securities according to plan. SEP projections are little changed, with the exception of a downward revision to the unemployment rate.

- We see a very high bar for the Fed to resume hiking post-June and continue to expect it to be on extended hold before making the first 25bp cut in 1Q24.

- Our rates strategists see limited scope for markets to price any higher terminal rate or fade any of the current rate cuts at the upcoming FOMC meeting. They stay neutral tactically, waiting for the CPI print next week.

- Our FX strategists recommend long USD positions to hedge against tail risks, given USD's negative correlation to risk appetite and attractive carry.

- On the agency MBS side, our strategists maintain their long mortgage index versus rates position.

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June FOMC

We expect the Fed to forego a hike in June, maintain a tightening bias, and leave forecasts little changed outside of a downward revision to the unemployment rate. While the center of the Committee has described the June meeting as an appropriate place to pause, more hawkish participants have described it as a skip. Regardless, should the data unfold in line with our expectations, the bar to start hiking again gets higher over time, and we continue to expect the Fed to remain on extended pause before first cutting in 1Q24.

The Summary of Economic Projections (SEP) produced by the FOMC each quarter is just a rough guide to how the median Fed participant is thinking about the appropriate path for policy based on the median outlook.[1] In reality, only the statement provides the consensus view on the Committee and the guidance as of the May FOMC is that it will "take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments" to determine the "extent to which **additional policy firming** may be appropriate...". *[emphasis added]*

The statement set forth a tightening bias and clearly left the door open to further rate increases – a prudent stance given the uncertainty about how the outlook will evolve. So, even as the March SEP showed a median peak policy rate of 5.1% – and matches our own expectation – the statement makes no assertion that the Fed reached peak at the May meeting. Maintaining the tightening bias in the statement even as the Fed hits the pause button is precisely why we think gaining consensus on a pause at the June meeting will be easy.

Current conditions

The Federal Reserve's Beige Book prepared ahead of the June FOMC meeting noted that growth in the economy was "little changed" overall in April and early May. **The Beige Book helps to inform the current conditions paragraph of the FOMC statement and underscores that overall growth in the economy has been stagnant in 2Q23.**

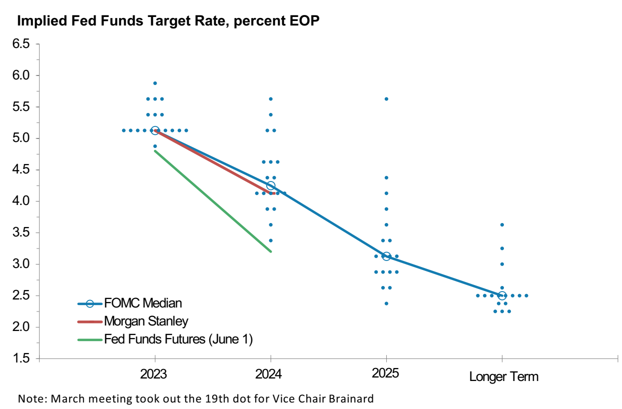
Overall the labor market is cooling and inflation is lower, but remains stubbornly elevated. Of particular interest was the revelation that "Several Districts noted greater price sensitivity by consumers than in the prior report", which ties into our view of a slowdown in consumption this year that helps to bring down inflation, and corroborates what our retail equity analysts are seeing on the ground. The comments around inflation are encouraging, but until this is reflected more clearly in the as-reported data, the Fed will treat it as anecdotal evidence for policymaking purposes.

Summary of Economic Projections

Incoming data on the economy and inflation are tracking closely with the 2023 median forecasts laid out in the March SEP. As such, we expect little-to-no change to growth and core inflation forecasts in the June SEP. Nearly halfway through the year, the unemployment rate stands at 3.7% compared with the Fed's end-2023 median forecast of 4.5%. A near percentage point increase in the unemployment rate in the second half of this year would imply a sudden, very deep recession in the US, an outcome policymakers are not calling for. **In the updated June SEP, we expect the median forecast for the unemployment rate in 2023 to be revised materially lower to around 4.0%, in line with our own view (Exhibit 1).**

Some FOMC participants will point to the downward revision in the unemployment rate to highlight that policy may not yet be in restrictive territory, while others may see it as further evidence that inflation can recede without the need to radically increase unemployment. **While tweaks to the policy path are likely to show through in some minor adjustment to the dots, ultimately we think the end-year medians for the federal funds target remain unchanged (Exhibit 2).**

Exhibit 1: Projected and market-implied fed funds path



Source: Federal Reserve, Morgan Stanley Research forecasts; Note: FOMC projected path reflects the March Summary of Economic Projections.

Exhibit 2: Expected changes to June Summary of Economic Projections

Changes to the Summary of Economic Projections	2023	2024	2025	Longer Run
Real GDP (% 4Q/4Q)				
MS Forecast	0.4	1.3	NA	1.7
FOMC March SEP	0.4	1.2	1.9	1.8
FOMC June SEP Est.	0.4	1.2	1.9	1.8
Unemployment Rate (4Q Avg)				
MS Forecast	4.0	4.4	NA	4.0
FOMC March SEP	4.5	4.6	4.6	4.0
FOMC June SEP Est.	4.0	4.5	4.6	4.0
Core PCE Inflation (% 4Q/4Q)				
MS Forecast	3.4	2.2	NA	-
FOMC March SEP	3.6	2.6	2.1	-
FOMC June SEP Est.	3.6	2.6	2.1	-
Fed Funds Target				
MS Forecast	5.1	4.1	NA	2.5
FOMC March SEP	5.1	4.3	3.1	2.5
FOMC June SEP Est.	5.1	4.3	3.1	2.5

Source: Federal Reserve, Morgan Stanley Research forecasts

July should prove June was not a skip

Once the Fed pauses at the June meeting, we think that the hurdle to resume hiking only increases. Exhibit 3 provides an illustrative roadmap of data releases ahead of the

July meeting, alongside our subjective view on the Fed's data-dependent action. It shows potential thresholds of the incoming data on jobs and core inflation that could move the Fed to hike in July after pausing in June. Between the June and July meeting, we get June CPI inflation, which we expect to show deceleration in core-core services (core services inflation ex-medical, ex-housing) on both a MoM basis and 3M annualized trend basis. We also look for a slowing in June payrolls to 180k, resuming a slowdown in the 3M moving average.

Data in line with our expectation would not embolden policymakers to hike in July. The thresholds we show in Exhibit 3 reflect what we see as an extraordinary hurdle rate that would show a reacceleration in inflation and jobs, and most likely warrant action. It would take a 0.7%M increase in June core-core services for the trend pace to reaccelerate, and similarly a June payroll print greater than 200k.

Exhibit 3: Roadmap for incoming data ahead of the July FOMC

%M	Core PCE	Core PCE 3M AR	Core CPI	Core CPI 3M AR	Core Core Services*	Core Core Services 3M AR	NFP	3M MA NFP	Assessment:
Dec-22	0.37	3.71	0.40	4.25	0.40	5.99	239	284	
Jan-23	0.55	4.69	0.41	4.58	0.72	6.65	472	334	
Feb-23	0.35	5.23	0.45	5.17	0.91	8.44	248	320	
Mar-23	0.31	4.96	0.38	5.11	0.71	9.78	217	312	
Apr-23	0.38	4.25	0.41	5.10	0.20	7.54	294	253	
May-23	**0.29**	**3.99**	**0.30**	**4.48**	**0.34**	**5.11**	339	283	June FOMC: 0bp expected. Core Core Services> 0.4 -- 25bps
Jun-23	**0.21**	**3.58**	**0.22**	**3.81**	**0.29**	**3.36**	**180**	**271**	July FOMC: 0bp expected. NFP>200k & Core Core Services > 0.7 -- 25bps
Jul-23	**0.18**	**2.75**	**0.16**	**2.76**	**0.26**	**3.63**	**160**	**226**	

* Core core services: Core CPI ex. Medical & Housing. Bold numbers are MS forecasts.

Source: BLS, Morgan Stanley Research forecasts

Global Macro Strategy

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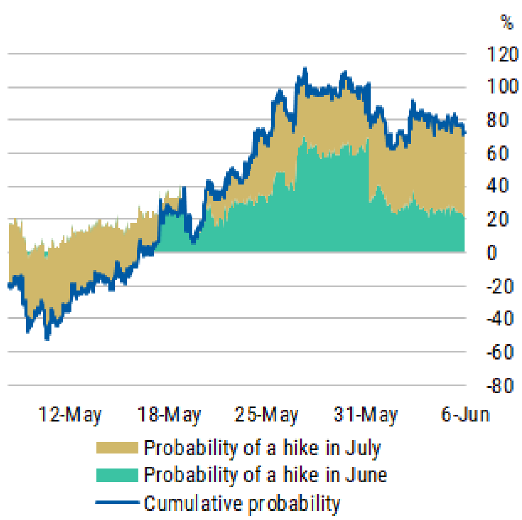
Max pricing?

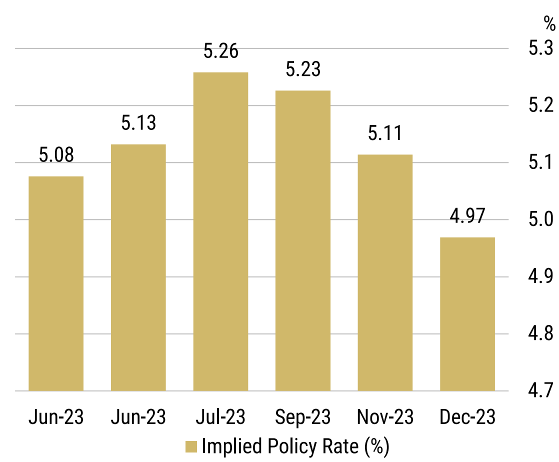
The rates market prices nearly a 75% cumulative probability of one hike by the July FOMC, currently split between a 25% chance in June and 50% in July. The use of the word "skip" instead of "pause" by some FOMC members has introduced the idea for markets that no hike in June could simply increase the probability of a hike in July (see Exhibit 4). Our economists expect no hike in June, which ultimately translates to an extended pause through 1Q24.

Exhibit 4: Probability of rate hike at June and July FOMC meetings



Source: Bloomberg, Morgan Stanley Research

Exhibit 5: Market-implied policy rate through December 2023

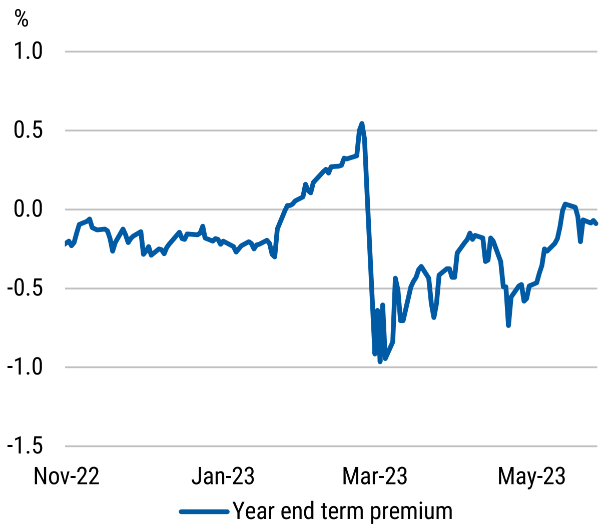


Source: Bloomberg, Morgan Stanley Research

Taking into account our economics team's view, markets are already over-pricing the prospects for a hike. Furthermore, our team thinks that economic data will slow down further, which will limit the case for a July hike. **Even if the case for one more hike builds over the coming weeks, that event is already 75% priced in – and we think that risk/reward to play for further hikes looks diminished.**

Further out the curve, beyond the pricing for the June and July rate hikes, markets only price about 28bp below the peak rate – i.e., about one rate cut by the end of 2023 (see Exhibit 5). At the same time, our economics team thinks that the Fed will likely leave the median dots unchanged in the June dot plot – similar to March.

Exhibit 6: Market-implied term premium versus end-2023 dot



Source: Bloomberg, Morgan Stanley Research

We think that the market prices a high amount of term premium by end-2023 (see Exhibit 6) for the fact that the market already expects to see one hike more than the Fed's current dot plot. Said differently, markets appear too sanguine about the potential negative impacts of the incremental rate hike that it expects above the June dot plot, especially given that our economists expect inflation to come in below the Fed's forecast. Additionally, the risk premium of only one cut by the end of the year underestimates the non-linear risks that still lurk in the banking system.

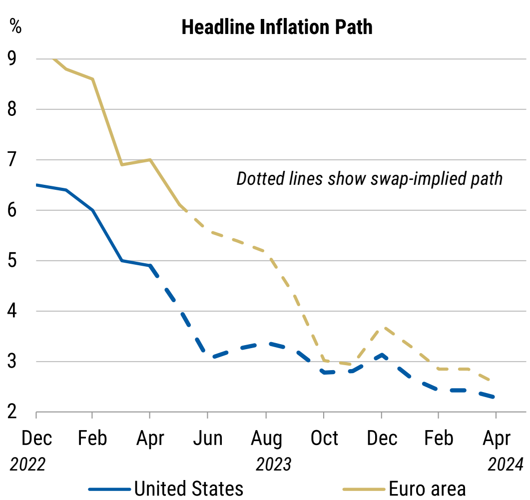
Overall, we see limited scope for markets to price any higher terminal rate or fade any of the current rate cuts at the upcoming FOMC meeting. We stay neutral tactically, especially as we wait for the CPI print next week. We think that the market is ripe for a bullish turn in the medium term (see our rates outlook) but prefer to go past CPI to evaluate the next trades in the rates market.

USD outlook

We continue to recommend long USD positions against EUR and AUD. Our bullish USD view reflects our belief that markets appear to have priced optimistic outcomes in the US (inflation declines, Fed cuts) and abroad (growth remains supported), and that USD will gain as tail risks become increasingly priced.

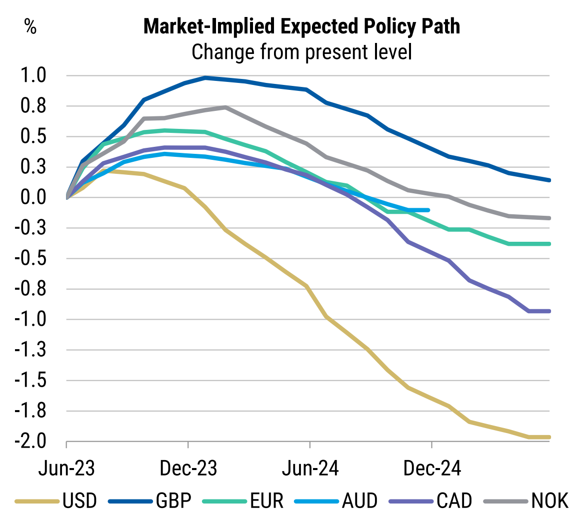
Inflation swaps imply that US inflation falls quickly (see Exhibit 7). As inflation is expected to fall swiftly, market pricing implies that the Fed will cut rates more and more quickly than other G10 central banks (see Exhibit 8).

Exhibit 7: Swap pricing implies that US inflation will decline more quickly than in the euro area



Source: Morgan Stanley Trading, Morgan Stanley Research

Exhibit 8: The Fed is priced to cut far more than other G10 central banks



Source: Morgan Stanley Trading, Morgan Stanley Research

These market-implied paths for inflation and rates strike us as assigning too low a probability to tail risks.

In our view, markets should assign a higher probability to the tail risk that US inflation remains high and sticky. As our US rates strategy colleagues note here, 3m, 6m, and 12m core CPI are all close to 5%Y, which we think suggests that recent inflation has been sticky near 5%Y.

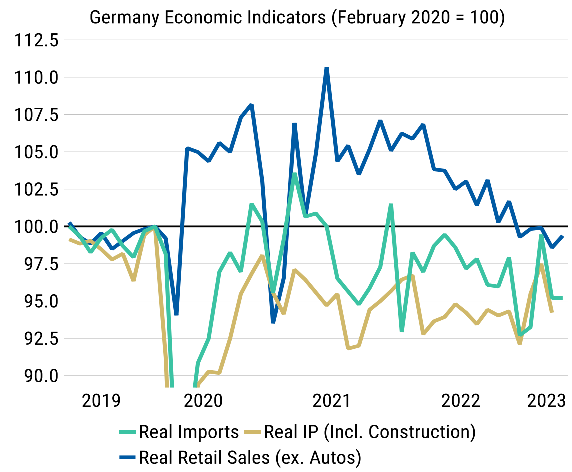
We also think that markets should assign a higher probability to the tail risk of a sharp global growth slowdown.

Coincident data from the OECD suggest that growth outside the US has slowed to around the low levels seen in 4Q22. Chinese growth data have been surprisingly weak, raising questions about the shape and timing of potential further policy support.

Exhibit 9: Growth remains slow outside the US

Source: OECD, Macrobond, Morgan Stanley Research

Exhibit 10: German activity metrics have remained below pre-Covid levels

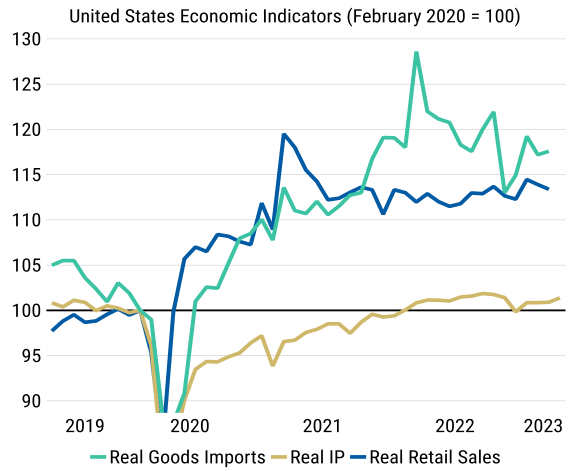


Source: Bloomberg, Macrobond, Morgan Stanley Research

Meanwhile, the European economic recovery from the Covid pandemic has been lackluster. Demand and production data from Germany indicate that activity remains below pre-Covid levels in real terms (see Exhibit 10).

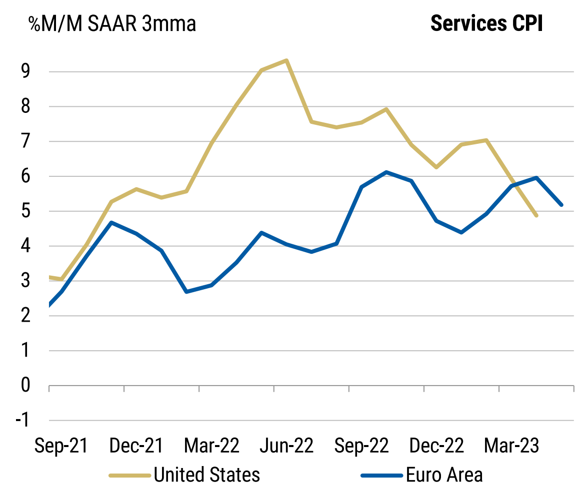
That sluggish economic momentum contrasts with similar metrics in the US. Demand data suggest that price pressures remain well above pre-Covid levels (see Exhibit 11).

Exhibit 11: US demand is well above pre-Covid levels



Source: Bloomberg, Macrobond, Morgan Stanley Research

Exhibit 12: Services inflation in Europe may decelerate relative to the US



Source: Bloomberg, Macrobond, Morgan Stanley Research

Relatively muted demand in the euro area raises risks that services inflation decelerates in Europe as it has in the US (see Exhibit 12).

A higher market-implied probability of these risks (stickier-than-expected inflation in the US, a sharp global growth slowdown, or a deceleration in euro area services inflation) would likely support USD.

- **Trade idea: Maintain short EUR/USD at 1.0692 with a target of 1.0300 and stop of 1.1350**
- **Trade idea: Maintain short AUD/USD at 0.6671 with a target of 0.62 and stop of 0.70**

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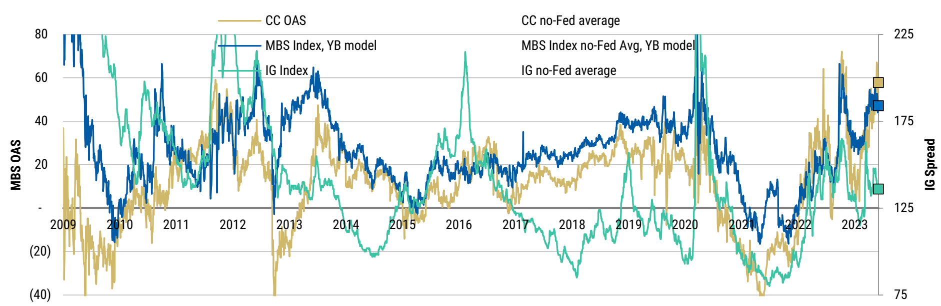
On trend with the past few months, fewer eyes are on the Fed as mortgage investors continue to digest FDIC sales and navigate the new regime for bank assets. The main challenge for mortgages now is the shift to a market in which the two largest mortgage holders are likely reducing their holdings for the foreseeable future; but at this point, we think mortgages have priced that in with additional room to spare. We are constructive on mortgages, though given recent tightening, we think excess returns will be weighted more towards carry than spread compression.

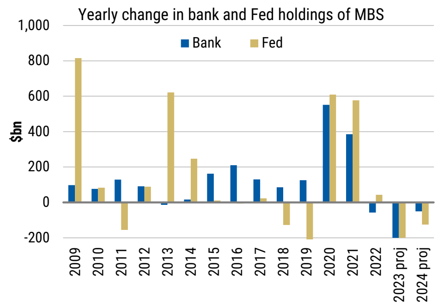
Exhibit 13: After accounting for vol, both the index and current coupon are near post-GFC level wides, while cash credit is not



Source: Yield Book, Bloomberg, Morgan Stanley Research

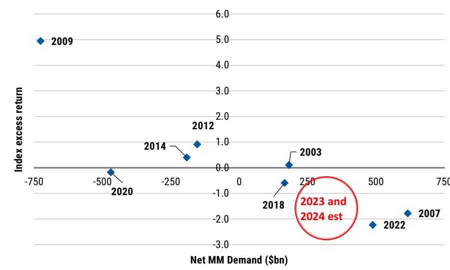
The demand challenges facing mortgages shouldn't be understated – 2023 and 2024 are likely to be the first two years since the GFC that neither banks nor the Fed will net buy MBS (see Exhibit 14). Our economists expect that: 1) QT will continue when the Fed does cut, and 2) When QT ends, MBS will get reinvested back into the bills market, which means continued reduction in MBS holdings. We are forecasting that the Fed will reduce MBS holdings by $225 billion this year, and approximately $175 billion next year. In terms of bank demand – given that banks have already reduced mortgage holdings by over $150 billion year to date, we think the year will end with a $200 billion aggregate net reduction, followed by another $50 billion net reduction from banks next year. This means we're relying on money managers to be the largest buyers of mortgages; and since money managers have alternative investment opportunities to compare mortgages against, they have historically required wider spreads to net add mortgages on underperformance (see Exhibit 15).

Exhibit 14: 2023 and 2024 are likely to be the first two years since the GFC that neither banks nor the Fed net bought MBS



Source: eMBS, Federal Reserve, Morgan Stanley Research forecasts

Exhibit 15: Years where money managers have net changed their holdings by at least $150 billion have coincided with inverse excess returns for the mortgage index

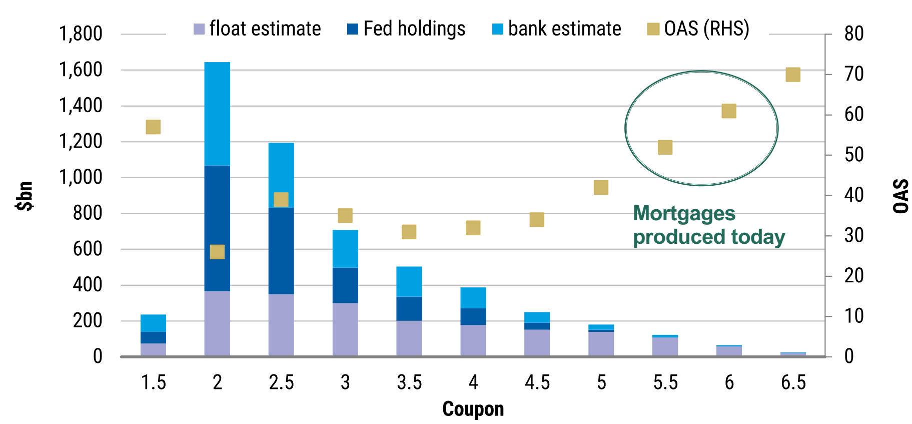


Source: Bloomberg, Morgan Stanley Research forecasts

Clearly, the story for mortgages isn't all that positive. However, when we first double-upgraded to an overweight view, current coupon ZV was at the wides since November 2008, while current coupon OAS and valuations on the index were also the widest portion of their ranges. Though we think that the equilibrium spread on mortgages should be biased wider than historical averages to account for lack of buying from both banks and the Fed, we really don't think that spreads should be near GFC levels. At this point, we are also through the bulk of the FDIC sales and far less concerned about regional banks and the debt ceiling; we could see vol coming down even more with the Fed on hold through 1Q24.

An interesting dynamic we do want to point out is the supply-demand context for discounts. Discounts have been directly impacted by the FDIC selling ~$30 billion in pools, with another $30 billion to come. Valuations will likely be further weighed down by $13 billion of project loan sales and $20 billion of CMOs. Once FDIC sales are complete, however, there's no natural supply of these discount mortgages. Lower coupons make up the largest portion of the index, but represent a much smaller portion of the float. If indexed investors are the largest mortgage buyers in the near term, we think that there are few catalysts for lower coupons to widen after FDIC sales are complete.

Exhibit 16: Mortgages getting produced today are much wider than discounts, but the float versus index weights support discount performance



Source: eMBS, Morgan Stanley Research

Ultimately, we continue to think that the mortgage basis will perform well. In terms of additional ideas, we do like production coupon G2/FN swaps – we think that issuance trends should balance out and see a reduction in Ginnie supply, and historically wide valuations should bring in buyers. We also continue to recommend long IIO lightly hedged as an expression of our macro view for bull steepening, lower vol, and tighter lending standards.

Valuation Methodology & Risks

Exhibit 17: Trade table

TRADE	ENTRY LEVEL	ENTRY DATE	RATIONALE	RISKS
Global Macro Strategy				
Short EUR/USD	1.0995	14-Apr-23	If US growth continues to slow meaningfully (and markets price increasing risks of a US recession), we expect spillovers to pricing for other central banks, including the ECB, as well as global growth. We believe the ECB may have to cut further than the Fed in the event of a global downturn. EUR/USD would likely move lower if 2y yield differentials move in the US's favor.	The key risk to the trade is that price pressures in the US decline sharply while they remain elevated in the euro area, leading yield differentials to move in Europe's favor
Short AUD/USD	0.6708	14-Apr-23	AUD looks uniquely attractive as an inexpensive risk hedge. AUD is one of the risk demand-sensitive currencies in G10 but also has a relatively low front-end. Meanwhile, Australian mortgage arrears have begun increasing as variable mortgage rates have risen dramatically. While house prices have shown some resilience, our economists expect prices to re-test the recent lows.	The risk to this trade is that inflation remains resilient in Australia, boosting RBA policy expectations and AUD.
Agency MBS				
TRADE	**ENTRY LEVEL**	**ENTRY DATE**	**RATIONALE**	**RISKS**
Long low payup loan bal and NY 5.0 and 5.5 specs on basis, converting to vs TBA over time if/as basis tightens		7-Jun-23	Spreads on specs are wide but technicals poor right now, over time as basis tightens trading cheap to TBA	Basis widens, heavy supply of specs, balance sheet trades poorly
Long MBS index for traditional investors, long current coupon for macro investors		30-May-23	CC nominal spreads at wides since Nov 2008, Index spreads near wides. Removed tail of debt ceiling or heavy FDIC selling-related widening	Still need money managers to go materially overweight, concerns around further bank challenges, macro-risks from the war in Ukraine, and debt ceiling resolutions
Long MBS outright for investors willing to take duration risk		30-May-23	Yields near highs since 2008, carry compelling	Fed prices in more hikes
Long IIO lightly hedged		22-Mar-23	Play for macro outlook of bull steepening and tighter lending conditions, low supply	Curve bear flattens, vol picks up
Long G2/FN 4.5, 5.0, 5.5	--	12-Mar-23	Swaps trading near lows adjusted for price, increased bank capital optimization, carry profile	Heavy supply in Ginnies, initial basis tightening in conventionals

Source: Morgan Stanley Research

Endnotes

1 This has led to a good deal of confusion at times because the Summary of Economic Projections is simply the median of the mode of ~19 different participants, and policymakers stress that it should not be taken as an indication of a consensus view on the Committee.

Disclosure Section

Mortgage Backed Securities (MBS) and Collateralized Mortgage Obligations (CMO)
Principal is returned on a monthly basis over the life of the security. Principal prepayment can significantly affect the monthly income stream and the maturity of any type of MBS, including standard MBS, CMOs and Lottery Bonds. Yields and average lives are estimated based on prepayment assumptions and are subject to change based on actual prepayment of the mortgages in the underlying pools. The level of predictability of an MBS/CMO's average life, and its market price, depends on the type of MBS/CMO class purchased and interest rate movements. In general, as interest rates fall, prepayment speeds are likely to increase, thus shortening the MBS/CMO's average life and likely causing its market price to rise. Conversely, as interest rates rise, prepayment speeds are likely to decrease, thus lengthening average life and likely causing the MBS/CMO's market price to fall. Some MBS/CMOs may have "original issue discount" (OID). OID occurs if the MBS/CMO's original issue price is below its stated redemption price at maturity, and results in "imputed interest" that must be reported annually for tax purposes, resulting in a tax liability even though interest was not received. Investors are urged to consult their tax advisors for more information. Government agency backing applies only to the face value of the CMO and not to any premium paid.
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(as of May 31, 2023)
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STOCK RATING CATEGORY	COVERAGE UNIVERSE		INVESTMENT BANKING CLIENTS (IBC)			OTHER MATERIAL INVESTMENT SERVICES CLIENTS (MISC)	
	COUNT	% OF TOTAL	COUNT	% OF TOTAL IBC	% OF RATING CATEGORY	COUNT	% OF TOTAL OTHER MISC
Overweight/Buy	**1357**	**37%**	**274**	**43%**	**20%**	**603**	**39%**
Equal-weight/Hold	**1661**	**46%**	**298**	**47%**	**18%**	**720**	**47%**
Not-Rated/Hold	**2**	**0%**	**0**	**0%**	**0%**	**0**	**0%**
Underweight/Sell	**612**	**17%**	**66**	**10%**	**11%**	**223**	**14%**
TOTAL	**3,632**		**638**			**1546**	

Data include common stock and ADRs currently assigned ratings. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months. Due to rounding off of decimals, the percentages provided in the "% of total" column may not add up to exactly 100 percent.

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Overweight (O). The stock's total return is expected to exceed the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
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