Morgan Stanley
INVESTMENT MANAGEMENT

Have Policy Rates Peaked?

MARKET INSIGHTS | GLOBAL LIQUIDITY TEAM | September 2023

Federal Reserve Board[1]

After the Federal Open Market Committee (FOMC) increased the federal funds target rate by 0.25% to a range of 5.25% to 5.50% in July, the committee was able to observe incoming data in August as no meeting was held. Whispers from the Fed suggest additional evidence of progress in reducing inflation is necessary while "above-trend growth" potentially warrants further tightening. Market participants view a pause in September as the most likely outcome, but continue to remain highly attentive to incoming data.

European Central Bank[1]

The European Central Bank (ECB) increased the ECB deposit rate by 0.25% to 3.75% in July and maintained its data-dependent approach. The Governing Council is committed to reducing inflation and believes the rate hikes have had an impact. The ECB forecasts inflation to decline the rest of the year, but remain above its 2% target. There was no policy meeting in the month.

Bank of England[1]

The Bank of England (BoE) Monetary Policy Committee (MPC) voted 6-3 to increase the Bank Rate by 0.25% to 5.25% at its August meeting. Two dissenting members preferred to increase the rate 0.50% to 5.50% while another dissenting member preferred to keep the rate unchanged at 5.00%. The BoE forecasts consumer price index inflation to end 2023 around 5.0%, then ultimately fall to the 2% target by the second quarter of 2025. MPC members noted that the labor market is starting to show signs of "loosening," although it currently remains "tight." The June 12-month inflation data came in below expectations at 7.9%. MPC members remain committed to reducing inflation and "will ensure that Bank Rate is sufficiently restrictive for sufficiently long to return inflation to the 2% target sustainably."

DISPLAY 1
Monthly Interest Rate Summary
As of 8/31/2023

US TREASURY RATES	YIELD (%)	MOM CHANGE (%)
1M UST	5.36	0.02
3M UST	5.44	0.04
6M UST	5.50	0.05
12M UST	5.38	0.01
2Y UST	4.86	(0.01)
5Y UST	4.25	0.08
10Y UST	4.11	0.15
30Y UST	4.21	0.20

Source: Bloomberg

Portfolio Strategy

GOVERNMENT/TREASURY STRATEGY

As the Fed approaches its terminal rate for this hiking cycle and inflation showed gentle signs of cooling, we added some duration via 6-month Treasury bills as well as a callable agency bond from Federal Home Loan Bank (FHLB). We still have ample room within our duration boundaries, as we continue to be cautious of elevated supply and a firm labor market. Consensus expects a "hold" in interest rates at the

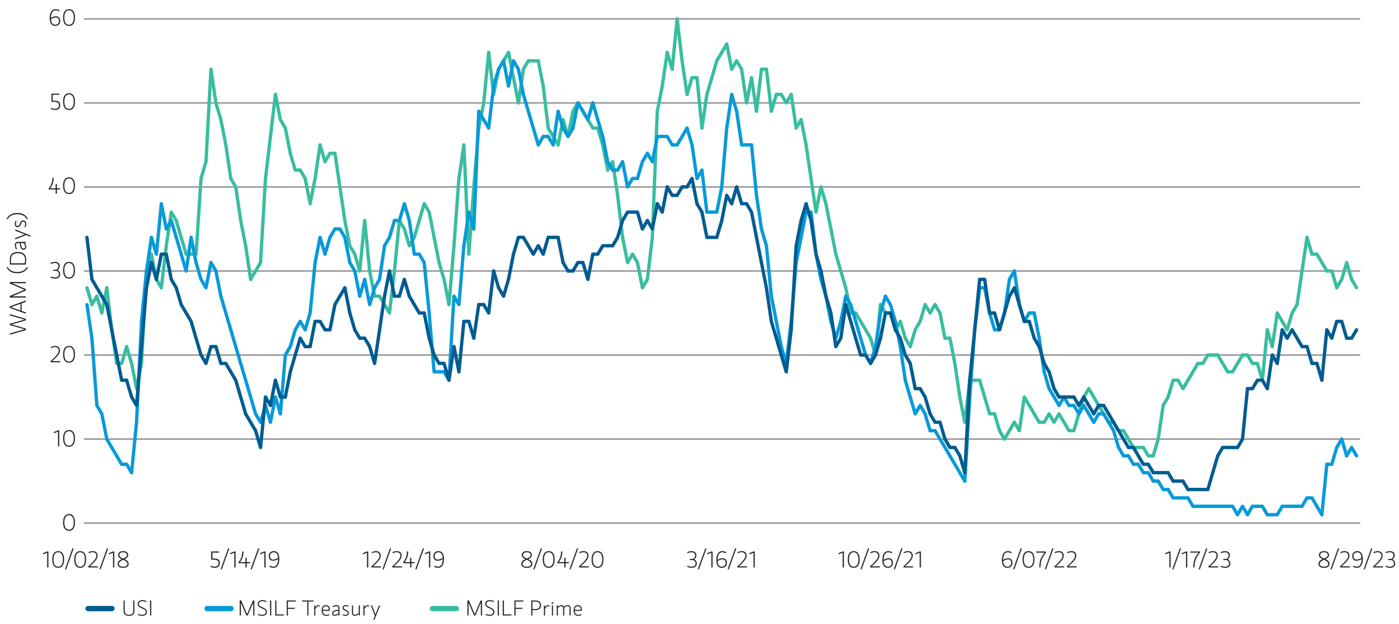
[1] Source: Bloomberg.

The views and opinions expressed are those of the Portfolio Management team as of August 31, 2023 and are subject to change based on market, economic and other conditions. **Past performance is not indicative of future results.**

DISPLAY 2

Morgan Stanley Institutional Liquidity Funds (MSILF) Weighted Average Maturities (WAM) Summary[2]

As of 8/31/2023



Source: iMoneyNet

September FOMC meeting, while at this point a potential hike at the November meeting is in play, albeit slightly. We have seen that money market funds generally remained comfortable investing beyond the September FOMC date given this expectation.

The Fed remains highly data dependent—torn between improving inflation data and a firm jobs market. We feel the Fed is cautious about a resurgence of inflation, and Chair Powell reiterated this at his annual Jackson Hole symposium. Powell was careful to emphasize that specific areas of the economy have reacted to higher rates, while other areas are still too hot. We believe this leaves the policy committee in a wait-and-see approach where the bias is still favoring a hike or a hold in the future—with rate cuts simply not on the table.

Supply remains elevated and, as predicted, longer-dated auction sizes were increased this month. So far, this supply has been taken down quite well by the yield-seeking community of front-end investors. Currently, we have no concerns or issues to raise with respect to T-bill liquidity.

All eyes are still on inflation and jobs data – both of which will indicate just how close the FOMC is to a holding pattern. We certainly moved closer to the end of the hiking cycle, but a growing narrative surrounding the budget deficit and increasing issuance in years to come threatens to be a persistent headwind for fixed income.

PRIME STRATEGY[3]

After extending both weighted average maturity (WAM) and weighted average life (WAL) earlier this summer, we allowed the portfolios to organically shorten in August as summer technicals significantly decreased wholesale funding volumes. With the futures market priced mostly in line with Fed projections, indicating a 40% chance of another rate

[2] **Weighted Average Maturity (WAM):** Measures the weighted average of the maturities of the portfolio's individual holdings, taking into account reset dates for floating rate securities.

[3] The Portfolio will be required to price and transact in their shares at a floating net asset value ("NAV") and will be permitted to impose a liquidity fee on redemptions or temporarily restrict redemptions in the event that the Portfolio's weekly liquid assets fall below certain thresholds.

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hike by the November FOMC meeting and a hold thereafter, we continue to opportunistically add duration in the 5- to 9-month tenors when we feel the market is compensating it. We are also adding floating-rate notes with 2023 maturities that have coupons that will reset higher in the event the Fed raises rates sooner or reaches a peak rate higher than what the market anticipates.

The Fed continues to stress that it will remain data dependent and keep rates in restrictive territory until inflation returns to its 2% longer-run objective. We continue to use the June dot plot as our base case path for monetary policy, with one additional interest rate hike penciled in for the remainder of the year, before easing in 2024. With the futures market now pricing out all rate cuts in 2023—much more in line with Fed expectations—we remain comfortable purchasing both fixed- and floating-rate securities across the money market curve. We remain confident targeting floating-rate notes with 2023 maturity dates because they offer downside mitigation to the portfolio in the event the Fed has to tighten more than anticipated, but will also organically mature out of the portfolio by year-end when in all likelihood the Fed is done raising rates and the next move is lower.

Liquidity remains strong, and dealer balance sheets remain unconstrained as spreads have held mostly static over the past couple months. As we likely enter the final stages of this tightening cycle, we remain thoughtful about security selection, seeking to ensure we are purchasing the most liquid securities in the appropriate formats, while opportunistically adding duration when there is a dislocation in market pricing.

TAX-EXEMPT STRATEGY

The Bloomberg Municipal Short-Term Index[4] posted a +0.23% return for the month of August 2023, outperforming the broader municipal market. The Bloomberg U.S. Municipal Bond Index[5] returned -1.44% for the month.

With the minutes of the Fed's July meeting pointing to significant upside risks to inflation, which could require further tightening of monetary policy, and the U.S. government's ongoing rebuilding of its cash balances, we allowed the WAM and WAL on the portfolio to roll down, in anticipation of higher variable rate demand obligation (VRDO) rates. WAM on the portfolio was down 6 days to 13 days, while WAL moved lower by 7 days to 15 days.

The SIFMA Index,[6] which measures yields for weekly VRDOs, continued to experience volatility. The index moved as high as 4.47%, a new cycle high, then ultimately closed the month at 4.06%, 8 basis points higher than its July close.

[4] **Bloomberg U.S. Municipal Bond Index** is an index that covers the USD-denominated long-term, tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and pre-refunded bonds.

[5] The **Bloomberg U.S. Municipal Bond Index** is an index that covers the USD-denominated long-term, tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and pre-refunded bonds. It is composed of approximately 1,100 bonds.

[6] The **SIFMA Municipal Swap index** is a 7-day high-grade market index comprised of tax-exempt VRDOs reset rates that are reported to the Municipal Securities Rule Making Board's (MSRB's) SHORT reporting system.

One basis point = 0.01%

The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment.

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