Morgan Stanley

INVESTMENT MANAGEMENT

Markets Recalibrate as Central Banks Stay the Course

MARKET INSIGHTS | GLOBAL LIQUIDITY TEAM | March 2024

Federal Reserve Board[1]

The Federal Open Market Committee (FOMC) held the federal funds target rate at its current range of 5.25% to 5.50% in March. The press release was effectively unchanged aside from one minor adjustment suggesting job growth has "remained" strong, versus the previous characterization that job gains "moderated since early last year, but remain strong". While Chair Powell and the FOMC have noticed some evidence that inflation is moving toward its target, they'd like to see more progress materialize before making a policy rate change. Prior to the start of the new year, market futures forecasted six or so rate cuts in 2024. However, projections have swiftly repriced since then, now suggesting roughly two rate cuts.[2]

The March FOMC meeting included an update of the Federal Reserve's (Fed) summary of economic projections. The Fed's dot plot showed officials' median projection for the benchmark rate at the end of 2024 was unchanged at 4.6%. The 2024 median gross domestic product (GDP) growth projection was increased by 70 basis points to 2.1%. The 2025 GDP growth forecast increased 20 basis points to 2.0%. The 2024 unemployment rate estimate decreased marginally to 4.0%. The 2024 core PCE projection increased 20 basis points from the December forecast to 2.6%.

DISPLAY 1

Monthly Interest Rate Summary

As of 3/31/2024

US TREASURY RATES	YIELD (%)	MOM CHANGE (%)
1M UST	5.36	(0.03)
3M UST	5.36	0.03
6M UST	5.32	0.07
12M UST	5.02	0.26
2Y UST	4.62	0.37
5Y UST	4.21	0.37
10Y UST	4.20	0.32
30Y UST	4.34	0.31

Source: Bloomberg

European Central Bank[1]

The European Central Bank's (ECB) Governing Council left the deposit rate unchanged at 4.00% at the conclusion of its policy meeting on March 7. Economic projections were revised, with inflation projections now at 2.3% and 2.0% in 2024 and 2025, respectively. The ECB has also lowered its projections for growth, expecting 0.6% and 1.5% in 2024 and 2025, respectively. The Governing Council remains "data-dependent" and is focused on returning inflation to 2%. Subsequently, the Governing Council began hinting that market projections forecasting an initial rate cut in June were starting to be relatively in line with their current thinking.

Bank of England[1]

The Bank of England (BoE) Monetary Policy Committee (MPC) voted 8-1 to hold the Bank Rate steady at 5.25% at the conclusion of its March meeting. The only dissenting member preferred to decrease the rate 0.25% to 5.00%. U.K. GDP is expected to resume growth during the first half of the year.

[1] Source: Bloomberg.

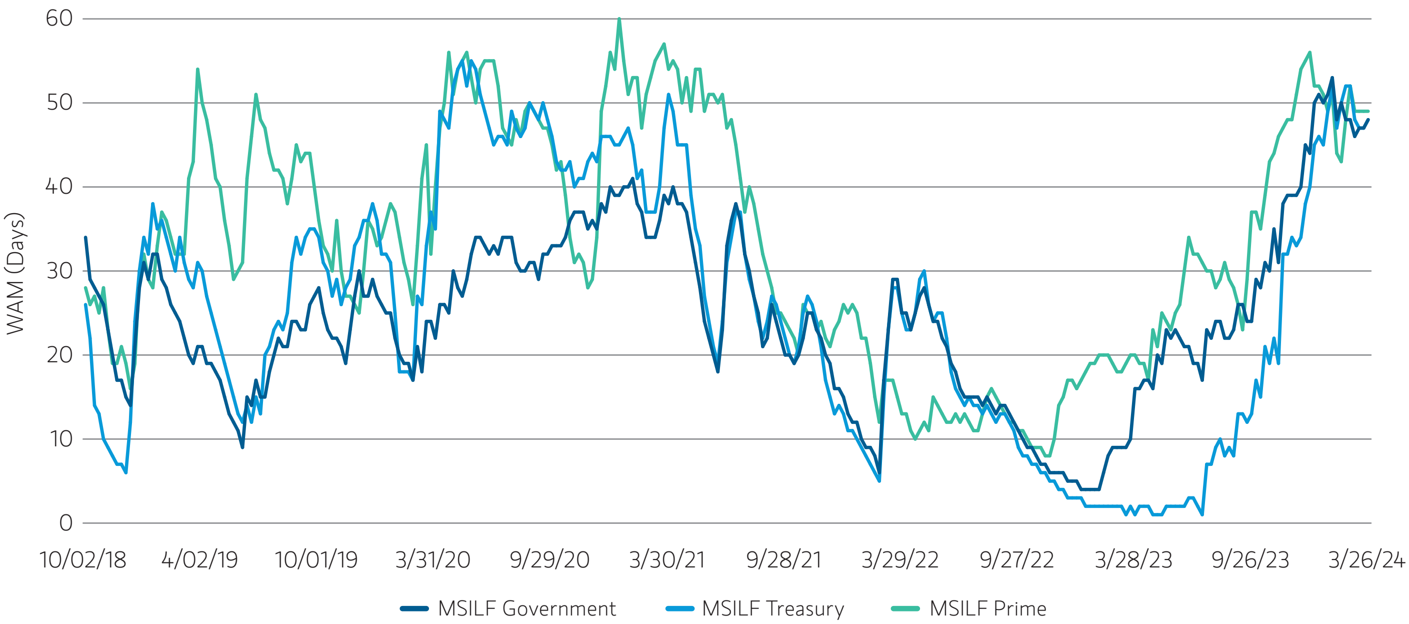
[2] As of April 15, 2024.

The views and opinions expressed are those of the Portfolio Management team as of March 31, 2024 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[3]

As of 3/31/2024



Source: iMoneyNet

At 3.4%, February's headline 12-month inflation data came in below both January and December readings. The MPC notes that the labor market continues to "loosen," but remains "relatively tight." The Bank of England expects inflation to arrive at its 2% target in the second quarter. While much progress has been made, committee members noted that the BoE's current policy is "restrictive," and they will need to see further evidence before making a policy pivot.

Portfolio Strategy

GOVERNMENT/TREASURY STRATEGY

Weighted average maturities (WAMs) for our portfolios fluctuated through the month between 40 and 50 days, as we navigated both tax season flow technical patterns and choppy data releases. Where attractive, we added duration in the 6-month and 1-year sectors, while shedding duration in the 3- to 4-month buckets as sentiment for the May and June FOMC meetings grew more uncertain. From a floating-rate securities standpoint, we continue to prefer SOFR (secured overnight financing rate) floating-rate exposure, and added to it selectively during March. SOFR spreads have tightened meaningfully, however, and therefore we have been less aggressive in adding large new exposure at these richer levels.

Bond markets remain on the edge of an inflection point—feeling that the next Fed move will be a rate cut but highly uncertain on the timing of it. Economic momentum and inflationary data lately have been stronger than anticipated at times, but weaker at other times. This choppiness in the data trends has caused the market to push back expectations for the first rate cut to June or July, but has not yet caused the market to abandon the expectation for cuts to occur this year. We feel this is fair, and given the FOMC's consistent reminder on data dependence, the market will likely continue to gyrate meaningfully on every data print. Given the FOMC is predicting three cuts this year, the next two months of payrolls and inflation data will be exceptionally crucial.

[3] **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.

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Treasury and agency auctions have continued to be orderly. As we are now heading into tax season, we note that auction sizes have started to be reduced and the supply pattern will be more technically driven from here. We will also be on the lookout for any Treasury cash management bill announcements as we approach April 15. We have no concerns or issues to raise with respect to Treasury bill liquidity.

PRIME STRATEGY[4]

As wholesale maturities picked up throughout the month of March, spreads widened off their recent lows. Coupled with a sell-off in interest rates due to expectations for the timing of the first rate cut being pushed back to the July FOMC meeting and the magnitude of rate cuts for the entirety of 2024 lower than previously expected, we opportunistically added duration in the 6- and 9-month tenors, locking in coupons and avoiding reset risk associated with floating-rate notes. We continue to find value in secondary bonds that trade cheap relative to their wholesale equivalents, targeting maturities across the entire money market curve. We have no current concerns about market liquidity, which remains strong and dealer balance sheets remain unconstrained heading into the second quarter.

[4] The Portfolio will be required to price and transact in their shares at a floating net asset value ("NAV").

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One basis point = 0.01%

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