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Global Macro Strategist | Global

Down the (Jackson) Hole We Go

Six species of rabbits are native to Wyoming. So central bankers will have plenty of rabbit holes to go down at the Jackson Hole Economic Symposium. Meanwhile, concerns should grow over the August 31-September 2 shutdown of the Nord Stream 1 pipeline. Pay top USD to reduce EUR risk.

Global Macro Strategy

We discuss how maintenance of the Nord Stream 1 pipeline, the Jackson Hole Economic Symposium, and easier financial conditions in the US may keep EUR/USD moving lower, USD/JPY moving higher, and the US yield curve flattening. We also discuss long-end UST valuations.

Interest Rate Strategy

We maintain 1s10s flatteners and short the June FOMC contract (FFN3). We keep EUR 10y10y swap paying trade and long EUR 5y5y inflation. We roll our Sep 149/147/146 Bund broken put fly into an October 147/145/144 one. We keep our EUR 10s30s swap steepeners, but roll our EUR 2s5s10s swap fly in the German cash fly. We enter tactical 30s50s OAT steepeners. We close our tactical OAT ASW trade, and maintain our short 5y Spain vs France and our short 30y BTP vs OAT. We maintain our short in UKT 1T 57 as high inflation and market liquidation weigh on gilts. We extend targets on both the long 5y RPI swap (5.75%) and the long OATei24 BE (5%). We maintain JGB 10s20s steepener and TONA OIS 5s20s steepener. We also enter long 10y JGB ASW to prepare for a potential duration sell-off.

Currency & Foreign Exchange

Bid-ask spreads may remain at historically wide levels amid uncertainties. Financial conditions have loosened 100bp despite 150bp of Fed rate hikes since June. Sticky inflation and strong data suggest a re-tightening may be necessary, supporting USD. Stay short EUR/USD. We still see downside risks for GBP as more rate hikes accelerate the growth slowdown.

Inflation-Linked Bonds

We maintain long 1y1y CPI swaps. We examine the strong 30y TIPS auction and the steepening of the 5s30s breakeven curve, as well as more evidence that markets are pricing sticky inflation in the coming years.

Short-Duration Strategy

We examine the drivers behind 2y UST notes trading "special" in bilateral funding markets as well as the impact that this has on SOFR and curve shape. Following the recent tightening in FRA/€STR basis, we updated our model, and think that recent setback is an opportunity to add long basis trades. We keep our long June 23 FRA/€STR basis widener.

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IDEA

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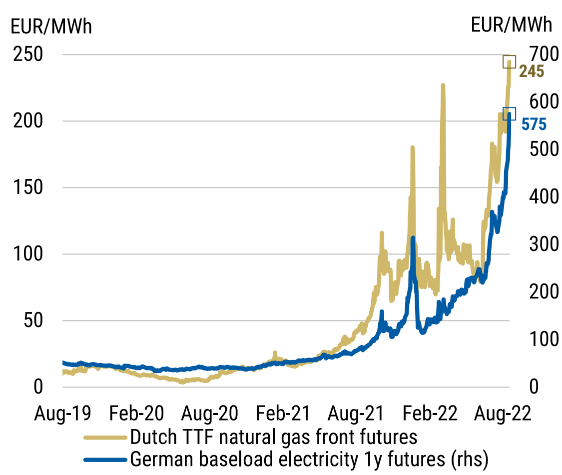
Paying Top USD to Reduce EUR Risk

This past week, investors began discussing the Jackson Hole Economic Symposium. At the same time, they exported capital out of Europe and into the US as energy prices in Europe rose significantly (see Exhibit 1). The euro fell over 2% against the US dollar, MSCI Europe equity index declined 4% while MSCI US ended the week unchanged, and 10y Treasuries outperformed 10y German Bunds by 10bp.

Increasing concerns about a complete European gas shutoff received a boost on Friday when Gazprom - a Russian majority state-owned multinational energy corporation - announced that natural gas flows via the Nord Stream 1 pipeline from Russia to Germany will be halted between August 31-September 2 for maintenance.

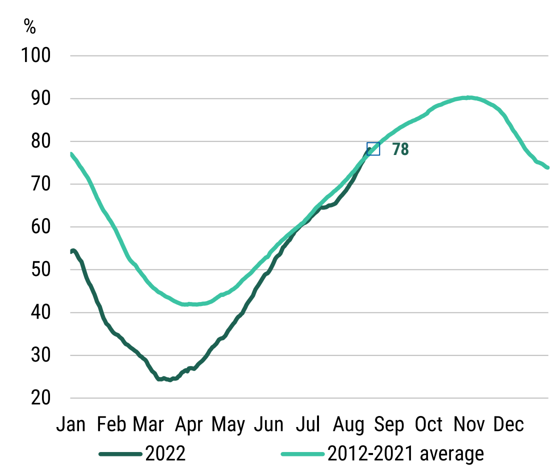
The release mentioned that flows will be restored at 33 mcm/d - the current level - “upon work completion and absence of technical malfunctions of the turbine”. So far this year, Europe - and Germany in particular - has made significant progress in building up natural gas inventories for the winter heating season (see Exhibit 2). Nevertheless, investor concerns about a complete shutdown remain.

Exhibit 1: Dutch TTF natural gas and German baseload electricity futures prices



Source: Morgan Stanley Research, GIE, Bloomberg

Exhibit 2: Germany gas storage % full



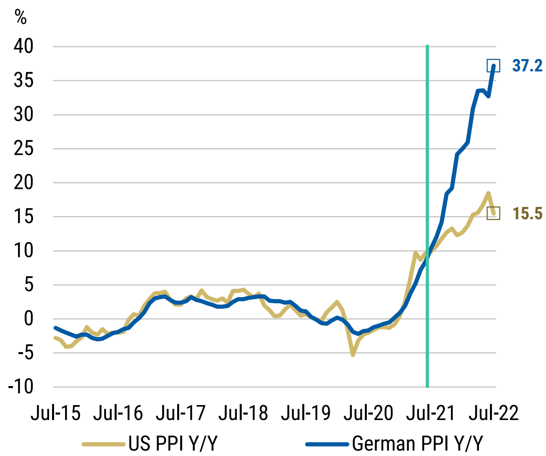
Source: Morgan Stanley Research, GIE, Bloomberg

In this event, our economists see a more negative impact on the Eurozone economy than in their current bear case. They see the euro area entering into recession for the following few quarters even under the most conservative estimates of the impact of a cutoff (see Gauging the Economic Impact of Potential Russian Gas Cutoff).

They note, however, that the ultimate impact "would be very much dependent on the scope of a cutoff, i.e. whether it would affect only natural gas, or oil too, and the ability of households, firms and governments to mitigate the impact via reduced consumption or substitution with other energy sources."

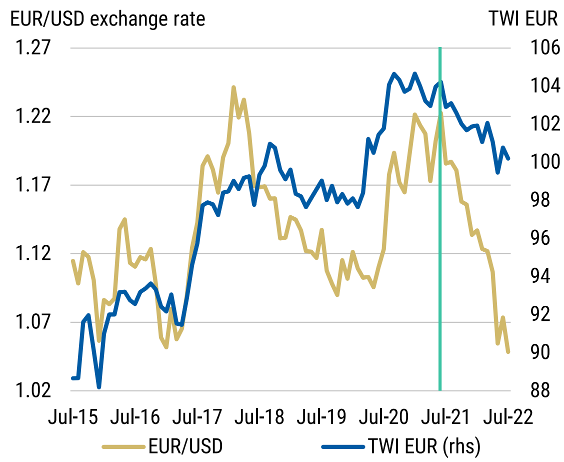
The energy situation facing Europe has weighed on the euro since mid-2021. As Dutch TTF natural gas prices made new highs in July 2021, producer prices in Germany began to diverge from those in the US (see Exhibit 3). This coincided with EUR/USD peaking around 1.22, and the trade-weighted euro moving it lower (see Exhibit 4).

Exhibit 3: Producer price indexes Y/Y: US vs. Germany



Source: Morgan Stanley Research, BLS, GFSO, Bloomberg

Exhibit 4: EUR/USD exchange rate and trade-weighted EUR index



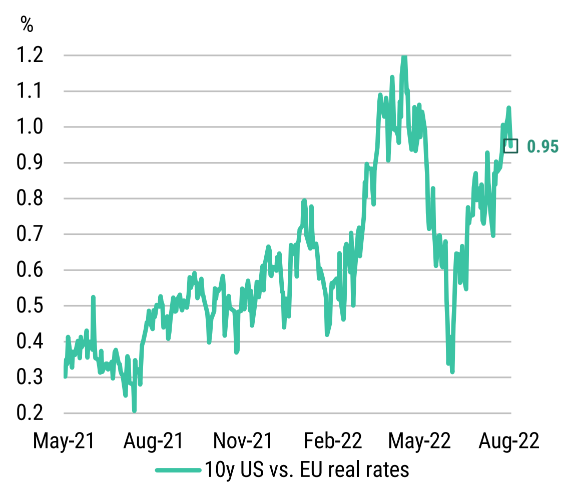
Source: Morgan Stanley Research, Bloomberg

At the same time, real rate differentials between Europe and the US began to widen. We flagged this eventual real yield divergence theme in August 2021 (see Europe's Real Rates Get Revenge). And now, once again, as energy prices rise dramatically in Europe, real rate differentials have widened sharply again (see Exhibit 5 and Exhibit 6).

Exhibit 5: 10y real rates (using OIS and CPI swaps): US vs. Europe

Source: Morgan Stanley Research, Bloomberg

Exhibit 6: 10y real rate spread between US and Europe

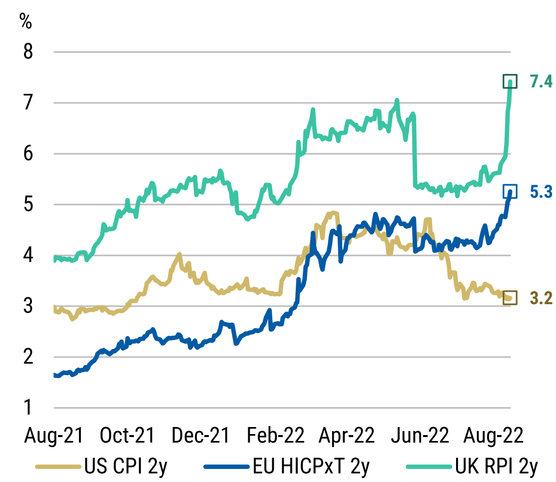


Source: Morgan Stanley Research, Bloomberg

The rising wedge between real rates in the US and Europe has been helped by (1) the behavior of breakeven inflation rates in each region, as well as (2) the divergent pricing of central bank reaction functions. Breakeven inflation rates in Europe and the UK jumped over the past month, while those in the US have moved sideways (see Exhibit 7).

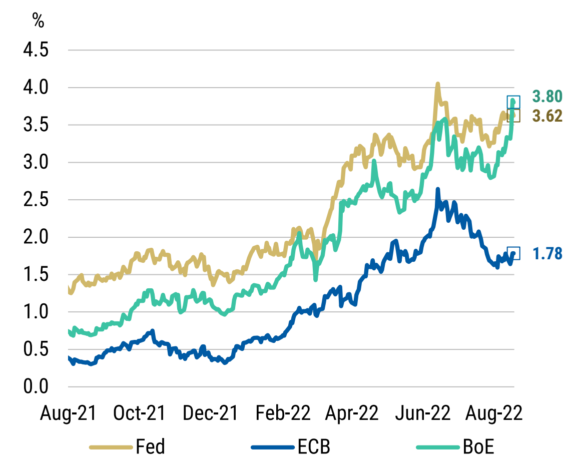
At the same time, markets priced a lower terminal (peak) rate from the ECB, a higher rate by the BoE, and a stable rate by the Fed (see Exhibit 8). Rising breakeven inflation rates in Europe coupled with the pricing of less hawkish ECB policy has put downward pressure on real yields in Europe, outright and relative to the US.

Exhibit 7: 2y inflation swaps: US CPI, EU HICPxT, UK RPI



Source: Morgan Stanley Research, Bloomberg

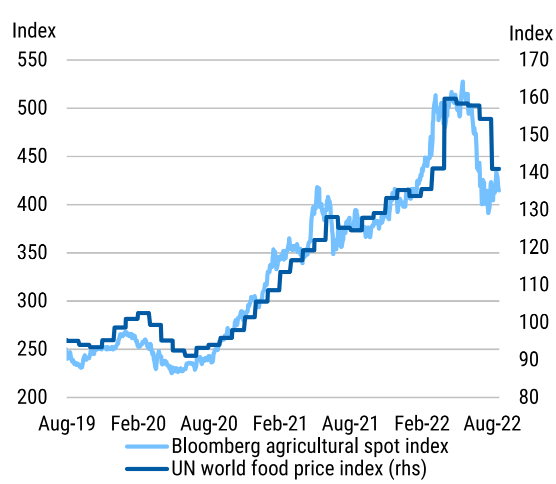
Exhibit 8: Market-implied peak policy rates: Fed, ECB, BoE



Source: Morgan Stanley Research

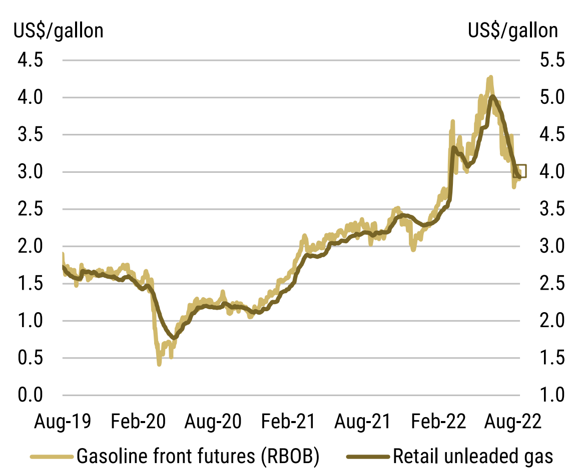
Over the next two weeks, concern is likely to build over whether Gazprom's Nord Stream 1 pipeline maintenance period might be extended beyond September 2. Meanwhile, heading into Chair Powell's Jackson Hole speech on Friday, August 26, we think investors will remain nervous about a hawkish performance. The combination should keep EUR/USD moving lower, and USD/JPY moving higher into month-end.

Exhibit 9: Bloomberg agricultural commodity index and UN world food prices



Source: Morgan Stanley Research, United Nations, Bloomberg

Exhibit 10: RBOB gasoline front futures and daily US national average gasoline prices



Source: Morgan Stanley Research, American Automobile Association, Bloomberg

Finally, with food and US gasoline prices having fallen back to pre-Ukraine invasion levels (see Exhibit 9 and Exhibit 10), real incomes in the US might improve on the margin - supporting consumption and growth. If US growth data rebound into year-end, the Fed may have to adjust higher its vision for the peak policy rate. We think risk-reward favors the market pricing a higher terminal rate in the US, so stay in US 1s10s flatteners.

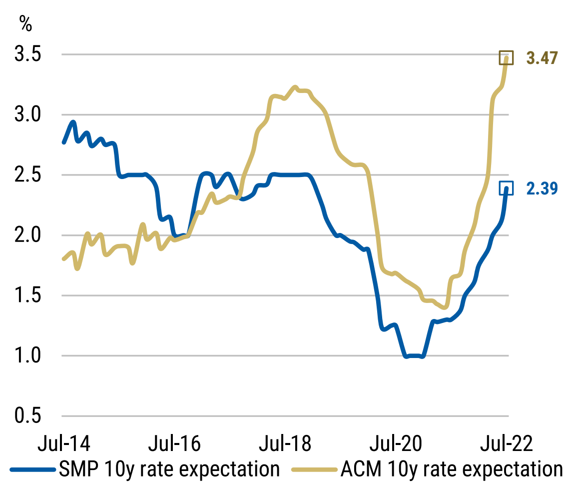
Looking at Long-Term US Treasury Valuations

The day after the Fed releases the FOMC minutes, the NY Fed releases the results of its Survey of Market Participants (SMP) and Survey of Primary Dealers (SPD). The NY Fed asks market participants to estimate both the longer run target fed funds rate and the average target rate over the next 10 years.

We use these survey-based estimates as a guide to valuations in the Treasury market for both 10y Treasury notes and the longer end of the curve. We start with an observation we have made before: the survey-based measure of the average target rate over the next 10 years is wildly different than a model-based approach.

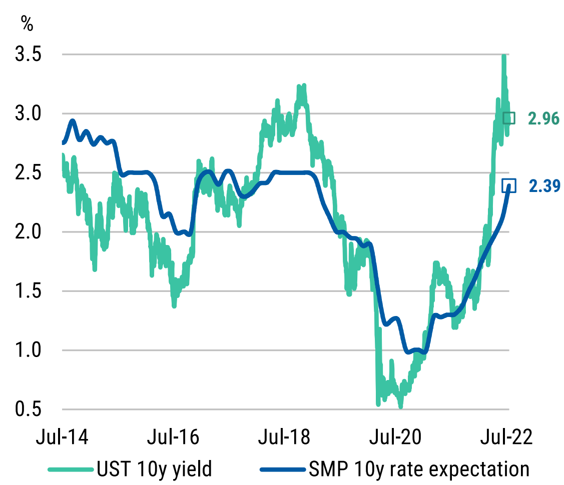
Exhibit 11 compares the median response to the SMP with the output from the NY Fed's ACM term structure model. A model-based approach, using market prices that represent average outcomes, suggests the target rate over the next 10 years will average 3.5%. The median response to the survey suggests it will average 2.4%.

Exhibit 11: Average fed funds rate over the next 10 years: SMP vs. ACM model



Source: Morgan Stanley Research, FRB New York

Exhibit 12: SMP average fed funds rate over the next 10 years vs. UST 10y yields



Source: Morgan Stanley Research, FRB New York

This discrepancy is large and meaningful because it can affect the estimate of term premium in the market. And term premium is one important measure of value. The prices of Treasury notes and bonds, like all market prices, reflect both investor expectations and risk premiums around those expectations.

In the case of government bonds, we use estimates of expected average short term rates, i.e., rate expectations, to tease out estimates of term premiums. Because market prices, or yields, incorporate both, we can estimate term premiums by comparing market yields to rate expectations, as shown in Exhibit 12.

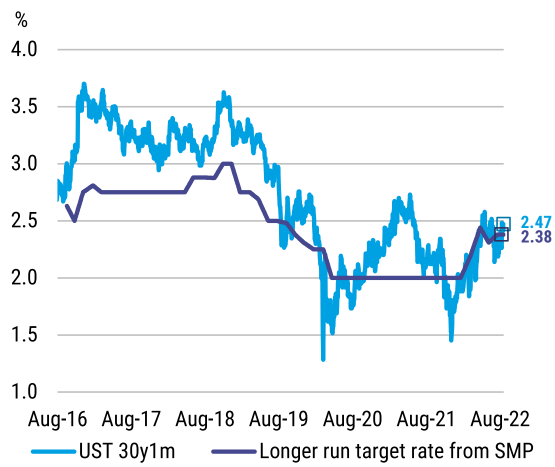
With the 10y Treasury yield near 3.0% today, the embedded term premium is either negative ~50bp – if the ACM model is correct – or positive 50bp – if the SMP is correct. For a medium to long-term investor, that 100bp on a bond that yields 3.0% is a meaningful amount of yield. The truth probably lies somewhere in between.

Another approach to measuring value, which also uses the SMP, compares the median response for the "longer run" target rate to the market price that most closely reflects this idea, i.e., the 1-month rate in 30 years time (see Exhibit 13).

Exhibit 14 shows the difference between the two series, one a market price and one a survey median of expectations. The difference reflects, in theory, a term premium. This analysis suggests term premium in the long end of the curve is currently near zero.

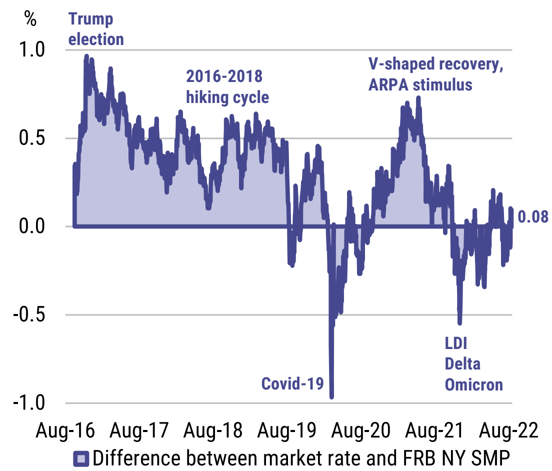
Putting it all together suggests that US Treasuries still don't offer enough positive term premium on enough metrics to warrant an overweight stance. As such, we continue to suggest a neutral stance toward Treasury market duration, even though we remain more defensive on duration in European government bonds.

Exhibit 13: UST 30y forward 1m rate vs. the longer-run target rate from the SMP



Source: Morgan Stanley Research, FRB New York

Exhibit 14: UST 30y forward 1m rate less the longer-run target rate from the SMP



Source: Morgan Stanley Research, FRB New York

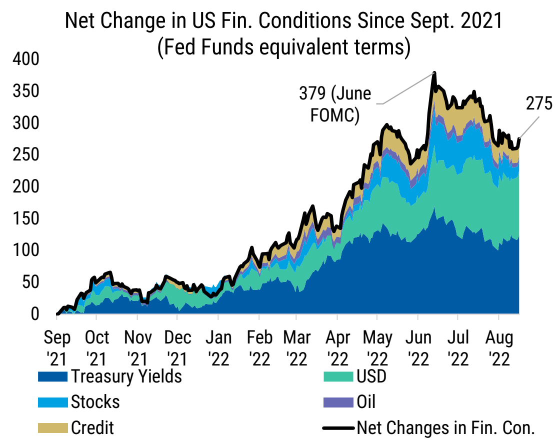
Have Financial Conditions Loosened Too Much?

A few months ago we analyzed how financial conditions in the US had evolved. In this note, we update our analysis to see how financial conditions (FCI) have evolved since May. See more here: USD | How much looser are financial conditions?

Financial conditions had tightened nearly 400bp in fed funds-equivalent terms from September 2021 to June 2022, consistent with the Fed's pullback in asset purchases and rate hikes (see Exhibit 15).

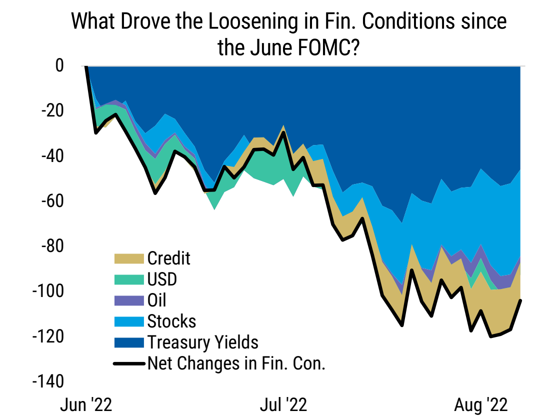
However, since the June FOMC, despite the Fed hiking rates by an additional 150bp, financial conditions have eased roughly 100bp, explained chiefly by the decline in Treasury yields and the rise in US equities (see Exhibit 16).

Exhibit 15: Financial conditions tightened to the equivalent of nearly 400bp of rate hikes from September 2021 to June 2022...



Source: Bloomberg, Morgan Stanley Research

Exhibit 16: ...but have loosened roughly 100bp since June 2022

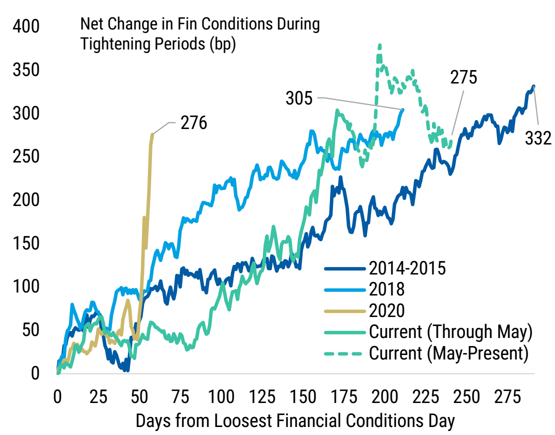


Source: Bloomberg, Morgan Stanley Research

Since our original analysis in May comparing the current FCI tightening to previous episodes, the loosening in financial conditions has brought the net change in financial conditions back roughly in line with previous episodes, a net tightening of 275bp (see Exhibit 17).

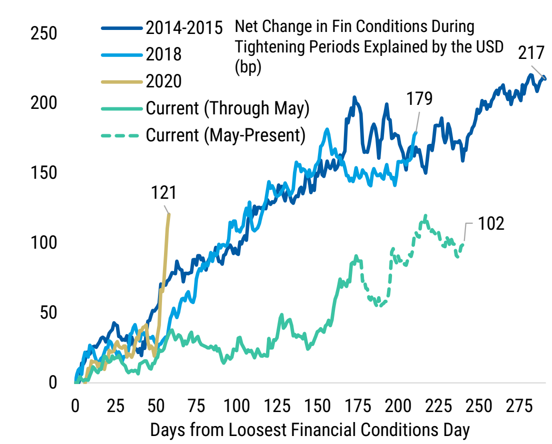
However, unlike previous episodes, USD continues to do far less of the "heavy lifting" than it has in previous episodes (see Exhibit 18). We see several implications:

Exhibit 17: The net tightening in financial conditions has returned to levels similarly seen in previous periods...



Source: Bloomberg, Morgan Stanley Research

Exhibit 18: ...but USD's contribution to the tightening remains far below previous trends



Source: Bloomberg, Morgan Stanley Research

Looser FCI today means more Fed hawkishness tomorrow: The market is underestimating the stickiness and persistence of inflation, the Fed's resolve in tackling it, and the difficulty the Fed may have in achieving this goal.

Tighter financial conditions is the mechanism by which tighter monetary policy transmits to the real economy, and slowing demand and loosening the labor market may be required to achieve this. Thus, the FCI loosening we've observed is counterproductive, and the Fed may have to do more in response to re-tighten FCI.

USD has more work to do tightening FCI: The net FCI tightening seen so far has been chiefly explained by rates and risk assets, with a more muted-than-average USD contribution compared to the past. This suggests that there may be more scope for USD to "catch up" to amplify the tightening in FCI, particularly given the recent deterioration in Chinese data and the worsening eurozone growth outlook.

We maintain our core EUR/USD short recommendation: The market may be underestimating the Fed as well as the challenges Europe faces. Water and power shortages in Europe are likely to crimp production and may limit just how hawkish the ECB can be become, contrasting with an underpriced Fed.

Trade idea: Maintain short EUR/USD at 1.004 with a target of 0.970 and a stop of 1.050
Trade idea: Maintain US 1s10s flatteners

Our Current Stance On Markets

In global rates markets, we maintain 1s10s flatteners and short the FFN3 contract. We maintain long July '24 TIPS BE vs. short July '23 TIPS BE, and long 1y1y ZCIS. We continue to suggest selling 3m10y ATM SOFR straddles and buying +/-50bp OTM SOFR strangles as a way to play the range. In addition, we continue to recommend 2y2s30s curve floor spreads struck ATMF/ATMF-75bp, and 6m5s30s conditional bull-steepeners as a cheap hedge to our delta view.

In the euro area, we close our September 149/147/146 Bund broken put fly, EUR 2s5s10s swap fly, and our tactical short OAT ASW. We enter October 147/145/144 Bund broken put fly, 2s5s10s German fly (using Sep 22 CTDs), and a 30s50s OAT steepener (long OAT May 50 vs May 72). We maintain short SPGB Jan 27 vs. FTFR Feb 27. We maintain our tactical EUR 10s30s swap steepener, our OATei24 BE, and our conditional Bund ASW widener. We continue to recommend long June 23 FRA/€STR positions, short 30y BTP vs. OAT, and keep our short duration through the EUR 10y10y paying trade and the long EUR 5y5y inflation swap.

In the UK, we maintain short UKT 1T 57. We continue to recommend rec Sep'22 SONIA MPC meeting, long 5y UK RPI Swap, and long UKT 1E 39 vs. UKT 0H 61.

In Japan, we enter long JB367 ASW. We maintain our TONA OIS 5s20s steepener. We maintain JGB 10s20s steepeners (DV01 2:1), TONA/SOFR basis 2s10s20s fly, long 20y JGB ASW vs. ESTR compound, and ZTIBOR-OIS 5s20s flattener.

In dollar bloc, we maintain long BAZ2 - BAZ3 Steepeners.

In foreign exchange markets, we exit short EUR/NZD. We maintain long NOK/SEK (target 1.09, stop 1.04) and short EUR/USD (target 0.970, stop 1.05). In FX options, we maintain long 3m USD/JPY seagulls (initially priced 25-Apr-22 0.69%).

Interest Rate Strategy

United States

Growth and labor-market-centered data have done better than feared in the last two months – as reflected in the economic surprise indices. Consistent with that, the market has faded the 2023 rate cuts as while moving 2023 and 2024 forwards higher - and the markets have pushed up the short-run neutral rate assessment.

In the near term, markets pricing a higher short-term neutral rate means the intermediate forwards like 6m1y , 1y1y, and 2y1y will lead the way. Said differently, the path to further inversion and flattening of the yield curve might go through some intermediate rise in yields in parallel or even some bear steepening. That's why we have suggested investors maintain both the 1s10s flattener alongside with short the June FOMC contract - so that the combination works well when both short-term neutral and terminal rates rise.

While the Jackson Hole comments will be widely watched next week, the July FOMC minutes have been seen reinforcing the Fed's dovish approach. However - it is not clear that the minutes were as dovish as market reaction implies. As an example, participants noted that elevated inflation is a “significant risk” while overtightening is “also a risk”. The use of the word "significant risk" vs. "also a risk" suggests the Fed sees a higher risk of entrenched inflation instead of overtightening. Similarly, all participants saw the risk of entrenched inflation, but "many" (less than all) saw the risk of over-tightening. Finally, on the neutral rate too, some participants acknowledged that the Fed is below short-run neutral, which might keep these participants open to a 75bp hike in September.

Finally, looking at inflation expectations data, a few are notable: 1) The recent behavior of short-term inflation expectations shows resilience, even as oil prices have declined, 2) The latest paper from the SF Fed that argues that short-term inflation expectations do have an important role in setting wage inflation - increasing the risk of a wage-inflation spiral, and 3) Powell's inflation model shows an inflation persistence coefficient close to 1, suggesting inflation begets inflation. Ultimately, these data points suggest that the underlying inflation dynamics are very strong, and will likely require substantial cooling off the economy to control inflation.

Euro area

The stronger UK inflation data was the catalyst for a return of 10y Bund yields above 1.00%. We believe that this signals the resumption of the Bund bear market on i) a repricing of the ECB terminal rate due to a higher path for 2023 inflation and ii) a normalisation of the current premium versus a rising fair value for Bunds. A return to 1.50% seems a first credible target for September 1, in our view. We keep our EUR 10y10y swap paying trade and the long EUR 5y5y inflation swap. We roll our September Bund broken put fly into a new one, October 147/145/144.

On the curve, steepening pressures on the 1s2s slope should persist with the sell-off in the near term. The valuation of the belly of the curve has not been corrected so far. With the belly of the German cash curve being more out-of-line than the swap curve, we prefer switching from the EUR 2s5s10s swap fly into the German cash fly (short 5y). At the very long-end of the cash curves, we fade the expensiveness of 50y OATs through a 30s50s OAT steepening trade. The new downward trend on swaption volatility should push the fair value even higher. We keep our EUR 10s30s steepeners.

On EGBs, most of the mispricing of 10y German ASW was corrected with the decline in ASW and the rise in fair value due to wider peripheral spreads. A bottoming is likely. Accordingly, we prefer closing our tactical short OAT ASW. Non-core EGBs have cheapened back and we retain our bearish stance. The 10y BTP/Bund spread should retest the 230/235bp area over the coming weeks. Spain - especially the belly of the curve - underperformed but remains rich. We keep our short 5y Spain vs France and our short 30y BTP versus OAT.

United Kingdom

This week's market moves have been exceptional in several ways. We suspect that the broad strength of the UK RPI print has pushed various market participants to re-consider their macro thesis. From a technical aspect, September tends to be one of the weakest months for gilts and this emboldens us to be short duration, ideally through UKT 1T 57.

In UK inflation, we think that the market will have to price in more of a near-term high inflation story. While this has been ongoing, 2y3yRPI is still cheap relative to levels that we experienced a few months ago. Hence, we extend our 5y RPI swap target to 5.75%. 1y RPI swaps have risen by about 400bp since the beginning of the month and this seems to be an ongoing story.

At the end of this week, around £1.67bn of coupons go ex-div. We suspect that if they are reinvested in front-end gilts, not only will they lead to richer spreads, but they could also trigger even more stop outs. So the coupon event is likely to be more relevant for spreads and market stability than for duration.

Japan

We discuss the possibility that pension funds' rebalancing flows also contributed to the recent outperformance in long-end JGBs. MoF International Transactions in Securities data show Japanese investors making net acquisitions of foreign bonds in each of the past two weeks, despite the UST yield remaining low, while selling off foreign equities, suggesting that funds are being reallocated out of the latter asset class into the former.

Indeed, our own estimates suggest that pension funds will have increased their portfolio allocations to foreign and domestic equities through mid-August. We believe that the subsequent rebalancing into domestic/foreign bonds has perhaps partially contributed to recent bull-flattening of the JGB yield curve.

That said, we expect such flows to prove comparatively short-lived, given the risk of overseas yields trading higher if positioning for a more dovish Fed is dialed back. The resultant tightening of financial conditions could bring a temporary halt to the rebalancing out of equities into bonds. We would also expect JGB shorting to be heaviest in the super-long sector given that the BoJ seemingly remains determined to enforce its +0.25% ceiling over the 10y JGB yield.

We therefore continue to envisage a steepening bias, with life insurers—admittedly a potential game changer—looking likely to maintain a wait-and-see approach for at least the time being. We maintain JGB 10s20s steepener and TONA OIS 5s20s steepener. We also enter long JB367 ASW to position for a potential yield sell-off.

United States | Were the FOMC minutes really dovish?

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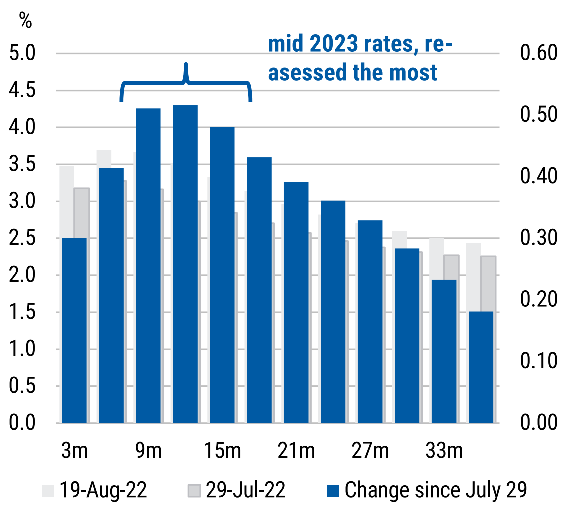
	Duration	Curve	Inflation
VIEW	NEUTRAL ON LONG END BEARISH ON SHORT END	FLATTENING BIAS	BULLISH SHORT-TERM INFLATION HIGHER REAL YIELD BIAS
Remarks	75bp hikes can be priced in September, higher terminal rate	High terminal and neutral rates, global recession risks, and pension bid	Markets underestimate inflation persistence;
Trades	Short FFN3 contract	1s10s flatteners	Long 1y1y CPI swaps

Markets assessing a higher short-term neutral rate?

In the last two weeks, we have discussed the possibility of markets pricing a higher short-term neutral rate (see Are we discovering a higher neutral rate?) and pricing out the rate cuts in 2023 (see Are those rate cuts in 2023 justified?). Our assessment has been based on growth and labor market economic data remaining strong, while inflation data continues to reflect the sticky inflation problem.

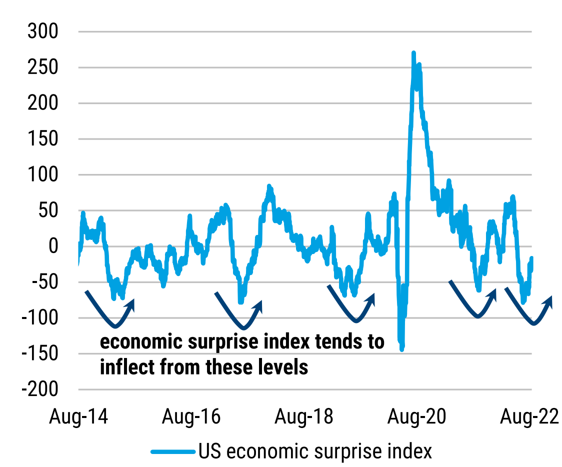
Growth and labor-market-centered data have done better than feared in the last two months – as reflected in the economic surprise indices (see Exhibit 20). Consistent with that, the market has faded the 2023 rate cuts as while moving 2023 and 2024 forwards higher (see Exhibit 19).

Exhibit 19: Change in Eurodollar strips



Source: Bloomberg, Morgan Stanley Research

Exhibit 20: US economic surprise index in the last eight years



Source: Bloomberg, Morgan Stanley Research

It is important to draw a distinction between the short-term and long-term neutral. We think emergence of strong growth data, as well as high and sticky inflation, raises the possibility of a higher short-term neutral rate, whereas the long-term neutral rate depends on secular trends such as demographics, Fed's ultimate success on inflation targeting, and productivity trends.

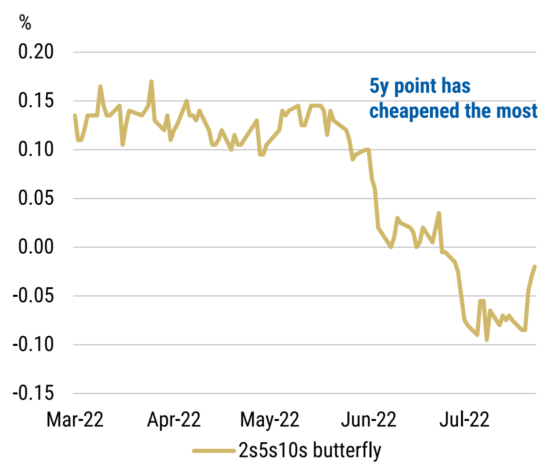
The FOMC minutes acknowledged that the current Fed funds rate may be below the short-run neutral, implying that the short-run neutral could be 3% or higher (more on this below).

A reassessment toward a higher short-term neutral ultimately translates to a high terminal rate and ultimately a flatter curve. In the near term, markets pricing a higher short-term neutral rate means the intermediate forwards like 6m1y , 1y1y, and 2y1y will lead the way - and the 5y point will cheapen on the curve (see Exhibit 21). Similarly, one would expect rate expectations to lead the move higher with a higher neutral rate (see Exhibit 22).

Said differently, the path to further inversion and flattening of the yield curve might go through some intermediate rise in yields in parallel or even some bear steepening. That's why we have suggested investors **maintain both the 1s10s flattener alongside with short the June FOMC contract - so that the combination works well when both short-term neutral and terminal rates rise.**

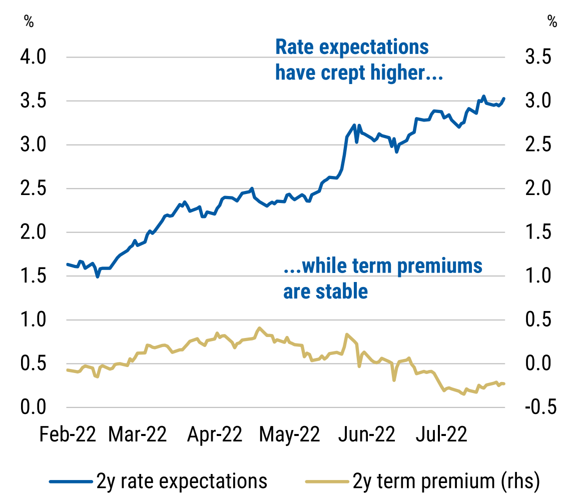
In addition to near term neutral rate re-adjustment, there are some technical near term steepening risks, we are cognizant of. The front-end could be strong driven by short covering impulse in the front-end (see United States | Feeling special). And there is seasonality for the curve to steepen in the first half of September - something our colleagues in Europe have pointed out. However, we do not see much value in tactically exiting the flattener, and instead suggest keeping the flattener on as a medium-term trade - even if the path to flattening could go through some steepening in the near term.

Exhibit 21: 5y yields on 2s5s10s butterfly



Source: Bloomberg, Morgan Stanley Research

Exhibit 22: Rate expectations vs. term premiums at the 2y point



Source: Bloomberg, ACM model, Morgan Stanley Research

Were the FOMC minutes really that "dovish"?

The main event for the next week is likely going to be Fed chair Powell's remarks at the Jackson hole symposium. With financial conditions having eased, the key question is whether Powell would want to affirm the current status quo, or push-back against market pricing, what investors might call another "hawkish pivot".

While comments from Fed officials have been mixed, the July FOMC minutes were seen as dovish by the market - with risky assets rallying, curve steepening and yield declining. Some headlines suggested that the Fed was focused on the risk of "over-tightening", which lent a dovish interpretation, but which we think is mis-characterization of the Fed's risk-assessment. Our economists rightly point out that the overall tone of the FOMC minutes was balanced, which doesn't square with the market's reaction.

In fact, there are some elements of the FOMC minutes that can also be interpreted as being hawkish. Consider the part in which FOMC participants discuss the risks around their monetary policy approach (text below). Participants noted that elevated inflation is a “significant risk” while overtightening is “also a risk”. The use of the word "significant risk" vs. "also a risk" suggests the Fed sees a higher risk of entrenched inflation instead of overtightening.

Importantly, the use of the words "participants" without any qualifier suggests all participants acknowledged the significant risk of entrenched inflation, whereas "many" participants - but not all - see the risk of overtightening policy.

Finally, even on the neutral rate discussion, some participants acknowledged that the fed funds rate was below the short-run neutral rate after the July hike, suggesting the neutral rate is above the ~2.50% level, likely closer to the 3% level that SF Fed President Mary Daly has cited. If FOMC participants believe that they have not reached the short-run neutral, when they meet for the September FOMC meeting, they may be more likely to hike rates by 75bp instead of 50bp.

FOMC minutes on risk management: *Participants judged that a significant risk facing the Committee was that elevated inflation could become en-trenched if the public began to question the Committee’s resolve to adjust the stance of policy sufficiently. If this risk materialized, it would complicate the task of returning inflation to 2 percent and could raise substantially the economic costs of doing so. Many participants remarked that, in view of the constantly changing nature of the economic environment and the existence of long and variable lags in monetary policy’s effect on the economy, there was also a risk that the Committee could tighten the stance of policy by more than necessary to restore price stability.*

FOMC minutes on neutral rate: *Participants observed that, following this meeting’s policy rate hike, the nominal federal funds rate would be within the range of their estimates of its longer-run neutral level. Even so, with inflation elevated and expected to remain so over the near term, some participants emphasized that the real federal funds rate would likely still be below shorter-run neutral levels after this meeting’s policy rate hike.*

The rising role and resilience of inflation expectations

Inflation expectations continue to be an important and widely watched data point for the market and the Fed. To that end, there is often a debate whether short-term or long-term inflation expectations matter more.

We discussed whether short-term or long-term inflation expectations matter more in our publication last year - concluding that generally short-term inflation expectations matter more in changing consumer behavior compared to long-term inflation expectations.

Our discussion was based on the paper from Jeremy Rudd that disagreed with the role of inflation expectations in informing policy decisions. However, the paper offered the following premise:

> **Jeremy Rudd's paper on inflation expectations:** One development to watch for would be any evidence that a renewed concern with price inflation was starting to affect wage determination—either in statistical form….or in the form of anecdotes. To the extent possible, we might also try to determine whether quit rates were starting to rise in a manner that was less tied to the state of the labor market...

To that end, there are two notable points:

1. The recent behavior of short-term inflation expectations shows resilience, even as oil prices have declined, and

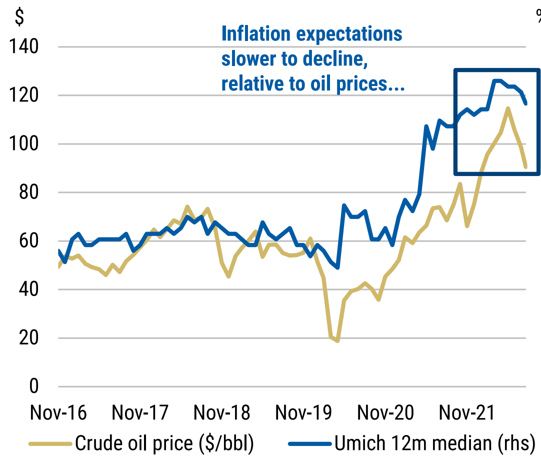
2. The latest paper from the SF Fed that argues that short-term inflation expectations do have an important role in setting wage inflation.

Looking at University of Michigan data for 12m ahead inflation expectations, it is notable that inflation expectations in the near term have not decreased at a pace commensurate with the decline in oil (gas) prices (see Exhibit 23). While the survey data can be volatile month to month, if the level of short-term inflation expectations holds up, it would suggest that inflation expectations have truly shifted in a more structural manner than just reacting to near-term moves in oil and food.

Another notable data point here is the blog from SF Fed, which argues that short-term inflation expectations have a strong contribution to wage inflation dynamics, and the recent rise in short-term inflation expectations increases the upside risk to wage inflation, and ultimately a wage-inflation spiral.

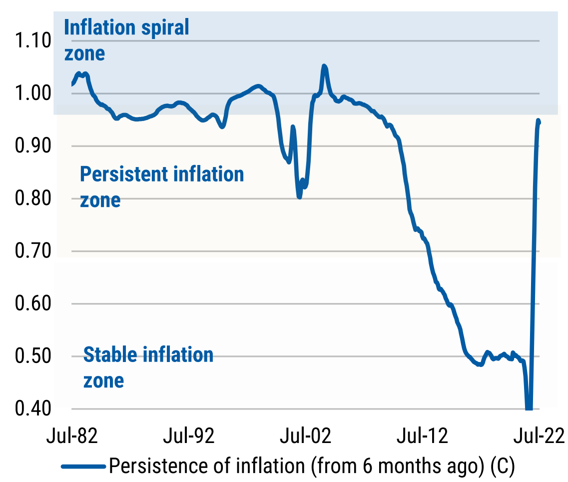
Finally, we update the inflation persistence coefficient in Fed Chair Powell's inflation model that he introduced in 2018, and find that inflation persistence continues to be near 1 (see Exhibit 24), which means past inflation begets future inflation. The resilience of short-term inflation expectations, their role in wage inflation, and the high persistence coefficient of inflation together suggest that the underlying inflation dynamics are very strong, and will likely require substantial cooling off the economy to control inflation.

Exhibit 23: University of Michigan 12m ahead inflation vs. crude oil prices



Source: Bloomberg, Morgan Stanley Research

Exhibit 24: Inflation persistence coefficient from Powell's inflation model



Source: Bloomberg, Morgan Stanley Research

Trade idea: Maintain 1s10s flatteners at -26bp

Trade idea: Maintain short FFN3 at 96.40

Euro area | Bye bye 1%, hello 2%

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Exhibit 25: Summary of our views

1-month horizon	Duration	Curve	Inflation	ASW	EGB spreads
Macro	Bearish	Flatter	Higher	Tighter	Wider
Net supply after QE	Neutral	Steepeners 2s10s			
Valuation	Bund 30bp rich vs Aug. FV	EUR 10s30s swap around FV	EUR 10y10y swap 27bp rich	Bund ASW only 2bp above FV	2y BTP only 17bp cheap vs Bono
Seasonality	Bund bearish seasonal on 31 Aug - 80%	EUR 2s10s and 10s30s steepening on 31 Aug		Bund/OAT ASW tightening from d5	
Technical analysis	2-months bullish channel broken				
Market positioning	CTAs increased longs	2s5s/2s10s flatteners	Long 2y to 5y maturities		Short OATs
Preferred trades	Structural short	**Roll EUR 2s5s10s swap fly into German cash**	Long EUR 5y5y inflation	**Close short OAT ASW**	**Sell 50y OAT vs 30y**
	Roll Sep broken put fly into October	Paid EUR 10s30s swap			Short 5y Spain vs France
	Pay EUR 10y10y swap	Long June 23 FRA/€STR basis			Short 30y BTP vs OAT
Our view	**Bearish**	**10s30s in range -25/0 range**	**Higher**	**Normalisation almost done**	**Wider non-core spreads**

Source: Morgan Stanley Research

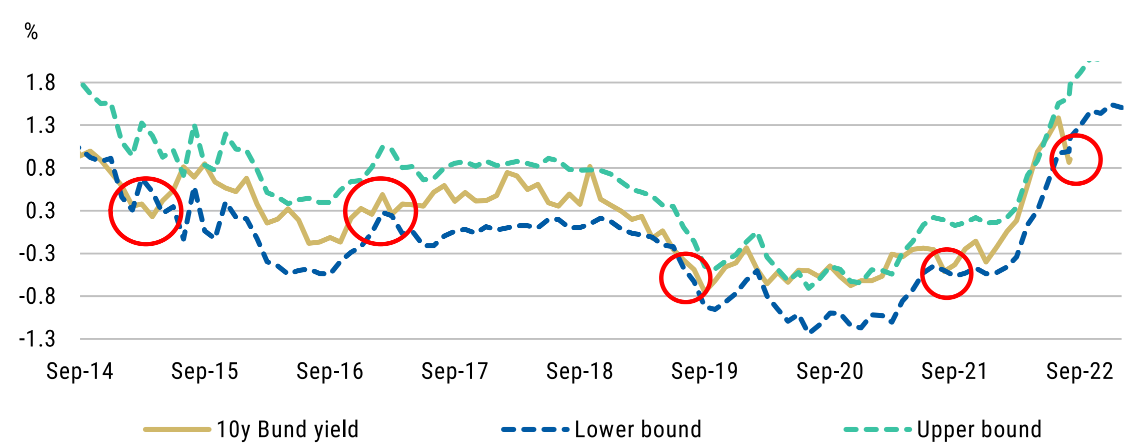
Duration

We have provided a long list of headwinds for Bunds, which has argued in favour of the resumption of the bear market, but we needed a catalyst for a downside break of the 155.00 level, which we have mentioned as the technical factor that would provide the required bearish signal. The release of the stronger-than-expected UK inflation data was the catalyst for the overdue resumption of the bear market. We see a return to 1.50% as a first target for the coming weeks - our central scenario remaining a rise above 2% in 4Q22 - for the following reasons:

- As Exhibit 26 below illustrates, the 10y Bund yield, which went temporarily below the lower side of its theoretical corridor derived from our long-term model (i.e. the fair value +/- 1.5 standard deviations) in late July, is still rich. The fair value in August should be 1.42%, and could rise to 1.75% by October, implying that the 10y Bund yield is still 30bp rich even after the sell-off from early August.

Bear in mind that in the sharp sell-off in June, the Bund valuation moved up to 80bp cheap, on fears of the ECB selling its holdings of Bunds to buy BTPs, which highlights a potential risk to Bunds in September and October with the resumption of EGB supply.

Exhibit 26: Bund theoretical corridor will keep on rising over the coming months



Source: Bloomberg, Morgan Stanley Research

- A few ECB members' comments regarding developments on the inflation front have also highlighted the ECB's rising concerns about the inflation path. It is worth noting that the June 23 CPI fixing rose above 7% this week, which is a 220bp rise since late July. Accordingly, we think that additional hawkish comments from ECB members are likely, which would fuel a repricing higher of October and December 22 ECB meetings and a rise in Bund yields.

- Moreover, as Exhibit 27 shows, the 10y both in the US and EUR tend to underperform the 2y with a bear steepening observed 87% of the time in the first two weeks of September during the 2007-2021 period.

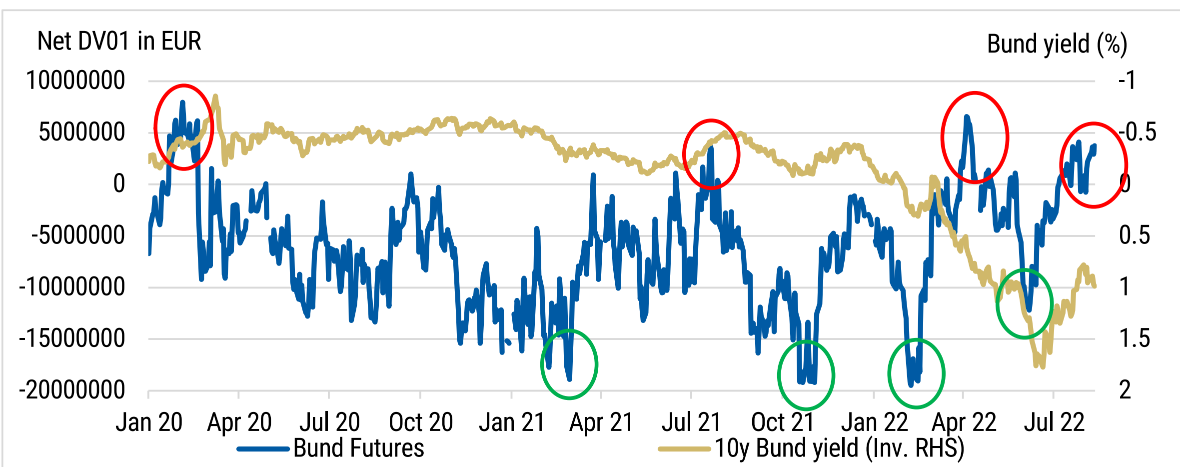
Exhibit 27: 10y underperforms the short-end going into September EG supply

EUR 2s10s swap: Seasonal steepening patterns								
Period	Length	Average move	Av. Steepening	Obs. Prob	Max	Min	St.dev.	Av. move/St. Dev.
February	8	3.2	5.5	80%	17.0	-7.9	6.3	0.5
September	11	8.2	11.0	87%	29.8	-17.9	11.0	0.7
October	5	3.6	4.8	87%	16.9	-6.1	5.5	0.6
November	14	4.8	6.8	80%	15.0	-6.3	6.5	0.7
EUR 2s10s swap: Seasonal flattening patterns								
Period	**Length**	**Average move**	**Av. Flattening**	**Obs. Prob**	**Max**	**Min**	**St.dev.**	**Av. move/St. Dev.**
February from d8	9	-3.9	-6.4	80%	9.4	-15.2	6.4	0.6
April	11	-1.8	-3.5	80%	7.8	-7.6	4.3	0.4
June from d16	19	-3.6	-7.3	80%	15.6	-14.5	9.1	0.4

Source: Bloomberg, Morgan Stanley Research

- Finally, regarding market positioning, according to Eurex statistics, final investors (CTA, real money, hedge funds) actually added to their net long on the Bund future during the sell-off observed last week, to the tune of a net EUR 3m DV01, something observed three times since January 2020.

Exhibit 28: Final investors* added new longs on the Bund future last week



Source: Eurex, Morgan Stanley Research, * CTA, real money, hedge fund

With the expiry of the September Bund options being only in one week's time and with the longer-than-expected summer rally, we prefer rolling our long September 149/147/146 broken put fly into the October 147/145/144 broken put fly, which has thirty five days before expiry. That longer horizon will allow investors to benefit from the likely acceleration of the sell-off in September with the resumption of EGB supply, which has fuelled a sell-off 80% of the time during the 2007-2021 period.

Trade idea: we roll our September 149/147/146 broken fly into the October 147/145/144 one.
Trade idea: we maintain our EUR 10y10y swap paying position.
Trade idea: we keep our long EUR 5y5y inflation swap

Curve

The duration sell-off following the stronger UK inflation data fuelled a further bear steepening of the EUR 1s2s slope this week. However, those steepening pressures did not trigger a major normalisation of the belly of the swap curve versus our model – the swapped KFW 5y issuance could have explained the 5y swap strength. Indeed, although the EUR 2s5s10s swap fly rose, the mispricing versus our model barely moved and even increased at one stage. As Exhibit 29 shows, among the EUR 6m, ESTR, and German cash 2s5s10s flies, the cash one is the most dislocated - by 8bp. We believe that the initial phase of the sell-off will be consistent with a further bear steepening of the 1s2s slope, which will push the fair value of those three flies higher - making the current levels even more out of line.

With the resumption of EGB supply in less than two weeks, we would expect the current mispricing on the belly of the cash curve to be corrected. Accordingly, while we keep our view regarding a normalisation i.e., higher 2s5s10s fly level, we think that it makes sense to switch from the swap into the German cash fly.

Exhibit 29: German 5y is the most out-of-line among EUR 6m, ESTR, and the German cash 2s5s10s flies

	Eur 2s5s10s (vs 6m)	vs Estr	Eur 2s5s10s (vs €STR)	German fly	2s5s10s German fly
Observed 2s5s10s fly (bp)	-3.5	Observed EUR 2s5s10s fly (bp)	-6.7	Observed EUR 2s5s10s fly (bp)	-9.2
Fair value	0.4	Fair value	-3.1	Fair value	-1.5
Gap to Fair Value (bp)	**-3.9**	**Gap to Fair Value (bp)**	**-3.6**	**Gap to Fair Value (bp)**	**-7.7**
Z score (Gap to Fair Value)	-0.8	Z score (Gap to Fair Value)	-0.7	Z score (Gap to Fair Value)	-1.6
Std Dev (bp)	5.0	Std Dev (bp)	4.9	Std Dev (bp)	4.7

Source: Morgan Stanley Research

Trade idea: we switch our EUR 2s5s10s swap fly into the German 2s5s10s cash fly, using Sep 22 CTDs
Trade idea: we maintain our EUR 10s30s swap steepeners

Core/semi-core ASW

We underscored the excessive level of core/semi-core ASW two weeks ago (see Global Macro Strategist: Bad is Good is Back) and the start of the seasonal ASW tightening period ahead of the September supply. It led us to recommend entering a tactical short OAT ASW targeting 40bp. The expected tightening has occurred.

However, the rewidening of the 10y BTP/Bund spread (one of the five factors in our model with German repo, equity volatility, excess liquidity and ECB gross weekly purchases) has also pushed German ASW fair value higher (see Exhibit 30). In the case of the Bobl and Bund ASW, the gap to fair value which was still at 12bp and 10bp respectively one week ago, fell to 5bp and 2bp. A 7bp widening of the BTP/Bund spread would push the Bund ASW fair value to the current market level.

Exhibit 30: Bund ASW almost fully normalised versus our model

	Schatz	Bobl	Bund	Buxl
Observed (bp)	92.6	89.2	88.5	51.3
Fair Value (bp)	**81.4**	**84.1**	**86.5**	**43.7**
Gap to Fair Value (bp)	11.1	5.0	2.1	7.6
Z score (Gap to Fair Value)	2.3	1.1	0.5	1.2
Implied BTP/Bund compression	26	17	7	
Std Dev (bp)	4.9	4.5	4.2	6.1

Source: Morgan Stanley Research

As we mentioned in the last Global Macro Strategist, we think that the 10y BTP/Bund spread has found a floor in the 195/200bp range, and should widen back ahead of the BTP supply and the September elections in Italy. We are not fundamentally bearish BTPs, rather we consider that the 10y BTP/Bund spread repricing from last October ahead of the end of the PEPP and APP has occurred, and we forecast now a trading range in the 10y spread of perhaps 195/235bp as the ECB TPI has removed the tail risk.

We calculated the likely fair value in German ASW under the scenario of a 10y BTP/Bund spread back to 235bp. Exhibit 31 provides the new fair value per bucket under the scenario of a 10y BTP/Bund spread at 235bp - we assumed excess liquidity unchanged and a small rise - 3 points - in eurostoxx volatility. The change in fair value on 2y to 10y ASW is quite impressive, around 7/8bp. It would imply a Bund ASW actually trading below its fair value by 6.5bp.

Exhibit 31: German ASW and new fair value with a BTP/Bund spread back to 235bp

Central Scenario: BTP/Bund spread back to 235bp							
Variables	**Input**						
GC vs ester (bp)	-10	**ASW**	**New Fair value**	**Chg in FV**	**Obs. vs new FV**	**New z-score**
Eurostoxx Vol (%)	25	Schatz	**90.0**	8.6	2.5	0.5
BTP-Bund 10y (bp)	235	Bobl	**90.9**	6.8	-1.8	0.6
Excess liquidity (€, bn)	4465	Bund	**95.1**	8.6	-6.5	0.6
ECB Gross Weekly Buying (€, bn)	5	Buxl	**44.9**	1.2	6.4	0.4
EUR 2y30y normal Vol	90					

Source: Morgan Stanley Research

Thus, while we acknowledge that German ASW are still in the tightening seasonality period, that period will end at Thursday's 25 August close if the 2007-2021 period is any guide.

With only a 2bp mispricing and the BTP/Bund spread likely to widen further, we think that the risk/reward for short core/semi-core ASW tactical positions ahead of the September supply is no longer attractive. The recent tightening move is an opportunity to unwind short positions. Hence, we prefer closing the tactical short OAT ASW trade.

Trade idea: we prefer to close our short OAT ASW tactical trade.

Long-end valuation: Enter into long FRTR 1.5% May 2050 vs short FRTR 0.5% May 2072

Bottom Line: We think that most of the mis-valuations in EGBs could still be found in semi-core curves, despite some of the correction seen since the end of 2Q22's extreme richness. We think that volatility at the long-end peaked concurrently with the start of the ECB's depo normalization, and the decrease in implied vol should help to drive the 50y point cheaper, particularly in semi core countries. We like to express this thesis via selling FRTR 0.5% May 2072 vs FRTR 1.5% May 2050.

I. EUR Curve 30s50s

From a valuation standpoint, EUR 30s50s in the ~ 29bp region is currently hovering around fair value. Since the end of July, when the 30s50s spread was deemed to be around 7bp rich vs our fair value estimates (see Exhibit 32), the expensiveness of the 50y point has been corrected with a rise in the observed level higher than the move in the fair value. The main drivers of this correction, in our opinion, were:

- **EUR 10s30s:** The re-steepening of 10s30s from the end of the July lows until recently helped in cheapening 50y point as, on average, every 10bp of steepening in 10s30s are worth around +2.2bp in 30s50s.

- **Swaption 2y30y Implied vol:** The 100bp mark on 2y30y implied vol, witnessed in mid-July, in our opinion, was a peak as it usually tends to lead the beginning of policy tightening. The 13bp decrease in normal vol on 2y30y implied helped in normalizing the richness in 50y. On average, the impact of a 10bp decrease on 2y30y implied vol is worth +2bp in isolation.

Exhibit 32: EUR 30s50s corrected most of its richness since mid-July

Source: Bloomberg, Morgan Stanley Research estimates

Given the resumption of the sell off in European duration, we think that on **(i)** range-bound EUR 10s30s and with **ii)** a further re-steepening in front-end rates (see curve section), EUR 30s50s as of now do not offer a compelling opportunity to engage into ultra long-end expressions on the EUR swap curve (see Exhibit 33Exhibit 33).

Exhibit 33: Estimated level on EUR 30s50s given central scenario assumptions

	Central Scenario: steeper EUR 2s1s and 10s30s, lower rates vol			
Current	**Variables**	**Input**	**Output**	
32	*ECB exp*	42	**Observed (bp)**	-28.7
23	*Eurostoxx Vol*	23	**Current Fair Value**	**-29.6**
-20	*EUR 10s30s*	-10	**New Fair Value**	**-26.3**
87	*EUR 2y30y normal Vol*	80	**Chg in FV**	3.2
			Obs. vs new FV	2.3
			New z-score	0.9

Source: Bloomberg, Morgan Stanley Research estimates

II. *Semi-Core 30s50s*

The premium on 50y semi-core EGBs has been corrected by around 50% since July but 50y remains expensive. Liquidity wise, this is particularly true for the on-the-run (hereafter OTR) OAT given the lower dirty price relatively to the off-the-run bond (see Exhibit 34Exhibit 34).

Exhibit 34: Semi core 30s50s on-the-run and off-the-run valuations

	OATs 72s50s	OATs 66s50s	OLOs 71s50s	OLOs 66s50s
Observed (bp)	-5.5	3.9	-8.0	-1.7
Fair Value (bp)	0.4	6.5	-2.3	2.2
Gap to Fair Value (bp)	**-5.9**	**-2.6**	**-5.7**	**-3.9**
Z score (Gap to Fair Value)	-1.8	-1.2	-1.6	-1.9
Std Dev (bp)	3.4	2.1	3.6	2.0

Source: Bloomberg, Morgan Stanley Research estimates

With the summer duration rally over, we think that there is a risk of seeing further normalization on 50y EGBs. As stated previously, the peak on swaption volatility with the start of the ECB depo normalisation should be supportive for a push higher in 30s50s fair values. On the margin, profit taking in 50y could also lead to a reversal.

Moreover, for both the OTR OATs and OLOs, the beta of front-end rates to 30s50s is positive, i.e. any re-steepening of EUR 2s1s (proxy for white/reds Euribor) should drive OTR 30s50s cheaper. This exposure, for both countries, is worth on average 8bp for every 10bp steeper in EUR 2s1s.

We are wary that issuance considerations may go against this view because:

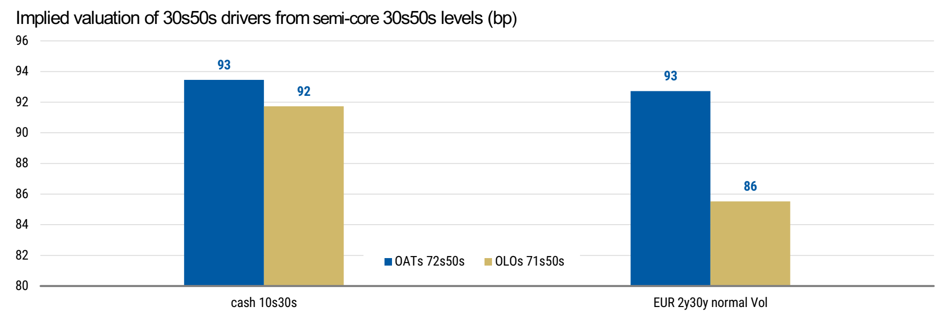
- AFT is likely to conduct a long-end syndication as we approach the resumption of September's issuance (see 2022 state financing). The syndication should happen in the 20y-30y tenor range, as per AFT guidance, and we estimate that it could be worth around € 3.5-4bn.

- The Belgian Debt Agency (BDA) could tap the BGB 0.65% June-2071 in H2. We estimate that total long-end issuance for OLOs until YE could be worth around € 2.5bn. So far this year, at the longer end of the maturity spectrum, whilst the BDA tapped both the BGB 2.5% June 2057 on Aug. 4th and the BGB 2.15% June 2066 on May 16th, they have not served the 2071 yet. We think that the 50y tap could be worth around € 0.5-0.6 bn based on previous instances.

- Both OATs and OLOs OTR 30s50s have a negative beta exposure to their respective 10s30s segment (i.e., 30s50s flattens as 10s30s steepens). This directionality is worth 2bp of richening on the 50y tenor for every 10bp steepening in 10s30s semi core, on average.

However, the estimated dislocations (5.9bp for OATs 72s50s and 5.7bp OLOs 71s50s) and current semi core 30s50s traded levels imply the following valuations on 30s50s drivers like semi-core 10s30s and 2y30y implied vol. as showed in Exhibit 35.

Exhibit 35: 10s30s semi core and 2y30y implied vol levels implied by 30s50s semi core traded levels



Source: Bloomberg, Morgan Stanley Research estimates

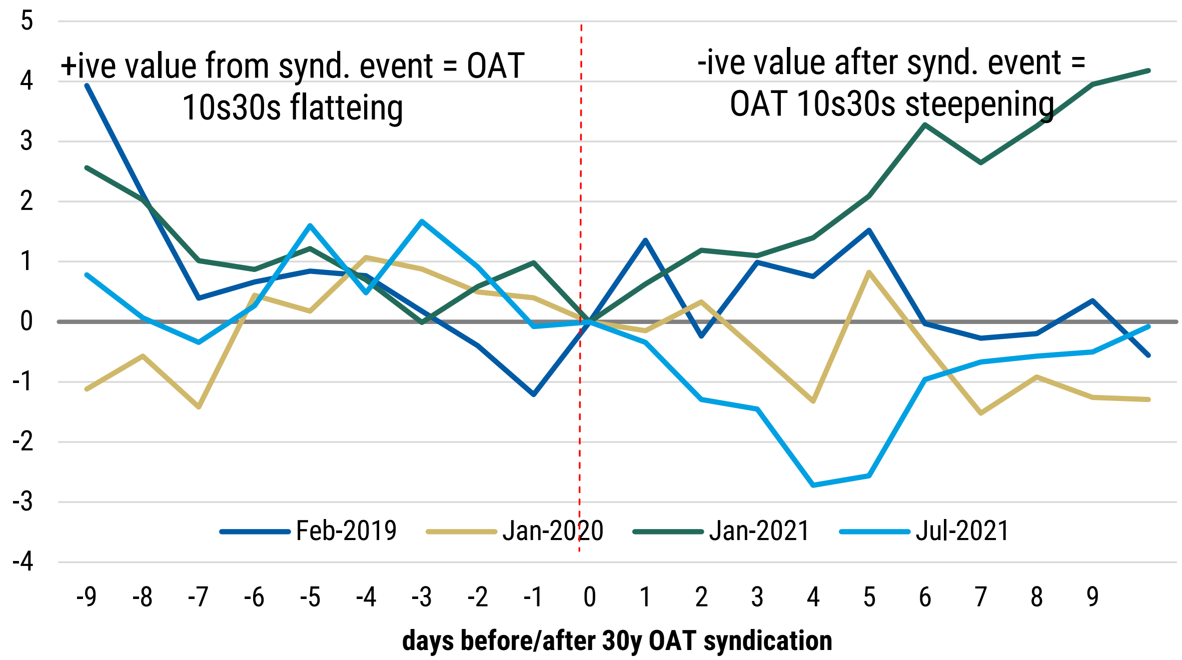
This means that on OATs, for example, as long as OAT 10s30s do not re-steepen by 30bp from current levels or 2y30y swaption vol does not spike towards July's highs, is likely that market level converges towards FV estimates and not the other way around. It also provides a sizeable cushion for the trade to be profitable, improving the prospects of its realization, in our view.

Historical precedents usually tells us that is very unlikely that a 30y syndication is worth 30bp+ of re-steepening in OATs 10s30s. This is showed in Exhibit 36where we studied previous price actions on OAT 10s30s before and following a nominal 30y OAT syndication over the last 3yrs. The max. steepening in the 2w before a 30y syndication was worth 4bp, observed in Feb 2019.

All in all, this is to say that macro considerations (i.e., EUR 2s1s re-steepening and stabilization/lower long end vol) will outweigh issuance dynamics, in our opinion.

On a **(i)** 10bp re-steepening in 10s30s OAT to account for the possible 30y syndication impact, **(ii)** lower to stable long-end volatility, and **(iii)** a re-steepening on front-end rates to price in the prospects of a more aggressive ECB, the move in 30s50s OAT should be worth 11bp on a full normalisation (Exhibit 37).

Exhibit 36: OAT 10s30s px action before/after a nominal 30y syndication*



Source: Morgan Stanley Research* *working days*

Accordingly, we enter into a long FRTR 1.5% May 2050 vs short FRTR 0.5% May 2072 currently at -6.2bp. target 6bp, stop -10bp.

The risk to the trade is that the cheapening of 30y OAT due to the expected September syndication would outweigh our core thesis of a re-steepening in front-end rates and stable-to-lower long-end vol.

Exhibit 37: Estimated level on OAT 30s50s given central scenario assumptions

OATs 72s50s	Central Scenario: steeper EUR2s1s and OATs 10s30s. Lower rates vol			
Current	**Variables**	**Input**	**Output**	
32	*ECB exp*	42	**Observed (bp)**	-5.5
22.7	*Eurostoxx Vol*	23	**Current Fair Value**	**0.4**
62	*OAT 10s30s*	70	**New Fair Value**	**5.5**
-14	*6mth QE change*	-14	**Chg in FV**	5.1
87	*EUR 2y30y normal Vol*	80	**Obs. vs new FV**	-11.0
			New z-score	-3.3

Source: Bloomberg, Morgan Stanley Research estimates

III. Non-core 30s50s

Regarding 50y non core, what we're seeing from a valuation standpoint is a complete normalization of the expensive SPGB 2071 since touching peak richness vs our fair value model around mid May, while in BTP, both OTR and OFT 50y remain rich (see Exhibit 38).

Exhibit 38: Non-core 30s50s estimated fair value

	SPGBs 71s50s	SPGBs 66s50s	BTPs 72s50s	BTPs 67s50s
Observed (bp)	23.3	26.9	-14.6	2.7
Fair Value (bp)	25.6	27.2	-4.5	10.2
Gap to Fair Value (bp)	**-2.3**	**-0.3**	**-10.1**	**-7.5**
Z score (Gap to Fair Value)	-0.4	-0.1	-1.5	-1.0
Std Dev (bp)	5.5	4.8	6.5	7.3

Source:Bloomberg, Morgan Stanley Research estimates

In the BTP case, one could decide to fade the expensiveness of the OTR 30s50s as an interesting trade, or at least as an "higher beta" alternative to the OATs 72s50s previously mentioned. This is because:

- The Italian Treasury could likely offer a long-end BTP via syndication in 2H.
- BTPs 72s50s are directional with the 10s30s curve. On average, the estimated cheapening on 30s50s OTR is worth 8bp for every 10bp of 10s30s steepening.

Nevertheless, when assuming the same impact on OTR BTPs 30s50s as we previously did in the semi-core case, we find that the expected fair value of -4.5bp should converge towards market levels, unlike OATs (see Exhibit 39).

Exhibit 39: Estimated level on BTPs 30s50s given central scenario assumptions

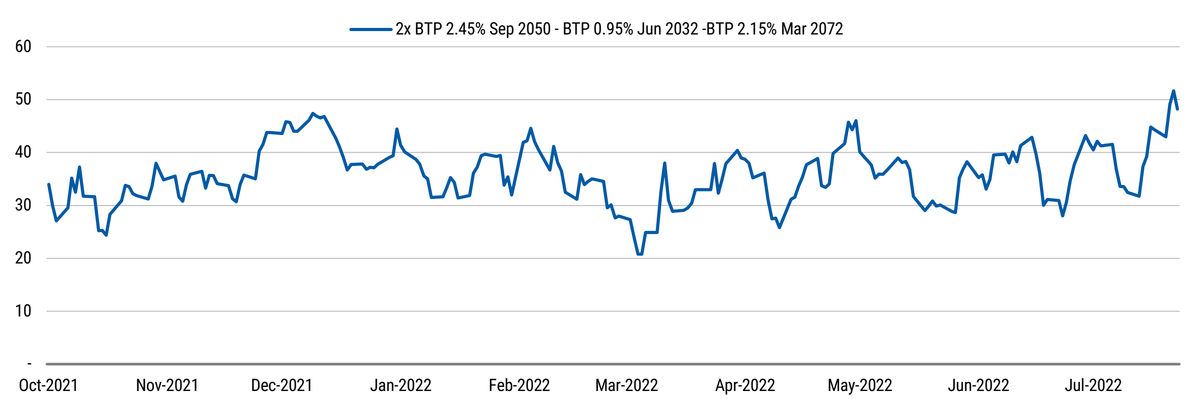
BTPs 72s50s	Central Scenario: Steeper EUR 2s1s and BTPs 10s30s. Lower rates vol			
Current	**Variables**	**Input**	**Output**	
33	*ECB exp*	42	**Observed (bp)**	-14.6
22.8	*Eurostoxx Vol*	23	**Current Fair Value**	**-4.5**
10	*BTP 10s30s*	20	**New Fair Value**	-15.2
-14	*6mth QE change*	-14	**Chg in FV**	-10.7
87	*EUR 2y30y normal Vol*	80	**Obs. vs new FV**	0.6
			New z-score	0.1

Source: Bloomberg, Morgan Stanley Research estimates

From an RV stand-point, given traded levels, we don't think that is even worth to play the cheapening of 30y BTP on a 10s30s50s fly as a way to minimize rates directionality and leveraging the possible syndication impact.

The cheapness of the BTP 2.45% Sep 2050 vs BTP 0.95% June 2032 and BTP 2.15% Mar 2072 in reality suggests otherwise (see Exhibit 40) or at least suggests eventually fading further 30y cheapening post-syndication on the fly, something that we will continue to monitor in the future.

Exhibit 40: BTP 10s30s50s fly



Source: Bloomberg, Morgan Stanley Research

A cheaper 30y BTP is also flagged from a seasonality standpoint as it usually tended to steepen 82% of the time since 2007 vs Bunds on the 10s30s box, with the average move being worth around 9.5bp (see Exhibit 41)

Exhibit 41: 10s30s BTP/Bund seasonality (2007-2021)

BTP/Bund 10s30s box: Seasonal widening patterns								
Period	Length	Average move	Av. Widening	Obs. Prob	Max	Min	St.dev.	Av. move/St. Dev.
January	6	2.9	5.1	67%	9.5	-2.6	4.2	0.7
August from d8 (Ex. 2011)	19	5.7	9.5	82%	23.2	-9.0	10.1	0.6

Source: Bloomberg, Morgan Stanley Research estimates

Currently, we have exposure towards a cheaper Italian long-end via selling 30y Italy vs OAT.

Trade idea: Enter into long FRTR 1.5% May 2050 vs short FRTR 0.5% May 2072 currently at -6.2bp, target 6bp, stop -10bp
Trade idea: Maintain long 30y OAT vs BTPs

United Kingdom | Bearish duration, long inflation

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Exhibit 42: Summary of GBP rates views

1-month horizon	Duration	Curve	ASW	Inflation
Macro	Bearish	Steeper		Bullish
Net supply	Neutral	Steeper		
Valuation		GBP 2s5s10s swap fly 8bp rich		
Seasonality	Gilt bearish on 31 Aug - 80%	GBP 2s5s flattening for 8d in Aug - 86%	Tighter from d14 in August- 80%	
Technical analysis	2-months bullish channel broken			
Market positioning	CTAs turned long			
Preferred trades	Short UKT 1T 57			Long 5y UK RPI swap
		Rec Sep 22 MPC meeting		
Our view	**Bearish**	**Steeper curve**	**Neutral on spreads**	

Source: Morgan Stanley Research

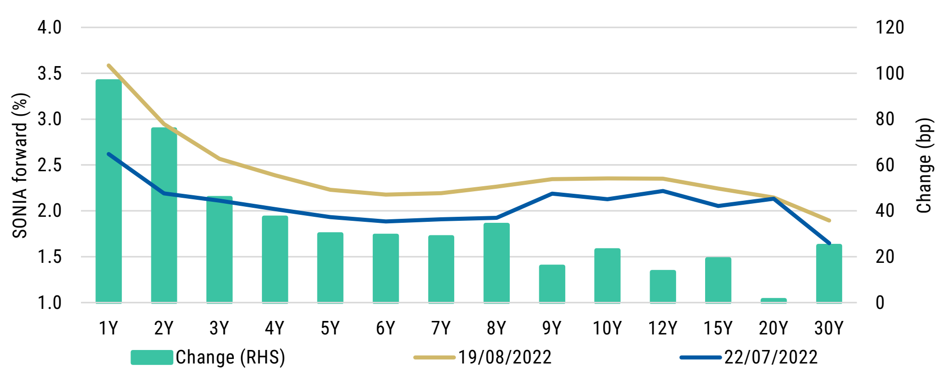
Maintain bearish stance - Vol induced rates shock

This week's market moves have been exceptional in several ways. We suspect that the broad strength of the UK RPI print has pushed various market participants to re-consider their macro thesis. Among others, our UK economist is now expecting a 50bp hike at the Sep meeting followed by 25bp hikes in both Nov and Dec (see here). So while our UK economist is clearly more dovish than the current market pricing in the SONIA market it will be hard for the market to price out the hikes at the front-end of the curve.

The key problem is inflation: PMI data are released on 23 August but barring an exceptionally weak number, the market will continue to respond to inflation rather than growth news. And with inflation pressures being broad based, the BoE will have to stay at the restrictive end of the spectrum.

Exhibit 43 shows changes in the pricing of 1y SONIA rates at different forward points. Basically the curve inversion has become more acute with the residual paying at the front-end being more linked to stop-outs rather than genuine, fresh paying positions. However, we continue to think there is more potential from being short the long-end of the curve. Despite little issuance, gilts not only sold off in the last week, but they also underperformed other FI markets. This all happened despite a weaker currency. At the end of this week, around £1.67bn of coupons go ex-div. We suspect that if they are reinvested in front-end gilts, not only they will lead to richer spreads; they could also trigger even more stop outs. We reiterate our short position in UKT 1T 57, entered on 12 August.

Exhibit 43: Changes across the SONIA term structure over the last 2 months



Source: Morgan Stanley Research

From a technical aspect, September tends to be one of the weakest months for gilts (Exhibit 44). As mentioned in previous editions of the Global Macro Strategist, some of that may be priced ahead of the beginning of the month but in any case we do not think that investors should be long duration now, and with the coupon reinvestments coming from short gilts, the support on the curve is likely to be minimal.

Exhibit 44: Seasonality turning less supportive for 10y gilts

Gilt 10y: Seasonal rally patterns								
Period	**Length**	**Average move**	**Av. Rally**	**Obs. Prob**	**Max**	**Min**	**St.dev.**	**Av. move/St. Dev.**
February from d8	13	-6.4	-14.8	73%	29.5	-24.6	15.9	0.4
March	21	-7.9	-14.0	73%	17.4	-40.5	14.7	0.5
April from d17	6	-2.9	-6.9	73%	14.3	-18.4	8.3	0.3
June from d15	18	-11.6	-15.7	87%	19.4	-48.9	15.9	0.7
August	14	-11.3	-19.5	80%	29.8	-53.2	20.4	0.6
November from d9	12	-8.3	-17.2	60%	8.5	-54.6	16.3	0.5
Gilt 10y: Seasonal sell-off patterns								
Period	**Length**	**Average move**	**Av. Sell-off**	**Obs. Prob**	**Max**	**Min**	**St.dev.**	**Av. move/St. Dev.**
January	16	5.0	16.5	66.7%	35.2	-25.7	18.9	0.3
February	7	5.4	10.9	73.3%	29.9	-16.8	13.3	0.4
May	8	5.1	10.7	73.3%	34.7	-17.8	13.4	0.4
June	6	6.4	13.5	66.7%	25.4	-17.8	12.2	0.5
September	**15**	**10.3**	**17.4**	**80.0%**	**35.0**	**-35.5**	**17.5**	**0.6**
October	15	7.5	12.7	80.0%	32.1	-25.9	15.0	0.5

Source: Morgan Stanley Research

With this in mind, the picture is simple: we maintain our short in UKT 1T 57 while taking minimal curve of butterfly risk.

Trade idea: Maintain sell UKT 1T 57: entry 2.45%, stop loss 2.25%, take profit 2.85%

Market dynamics and technicalities: visually rich 5y SONIA and risks from fading it

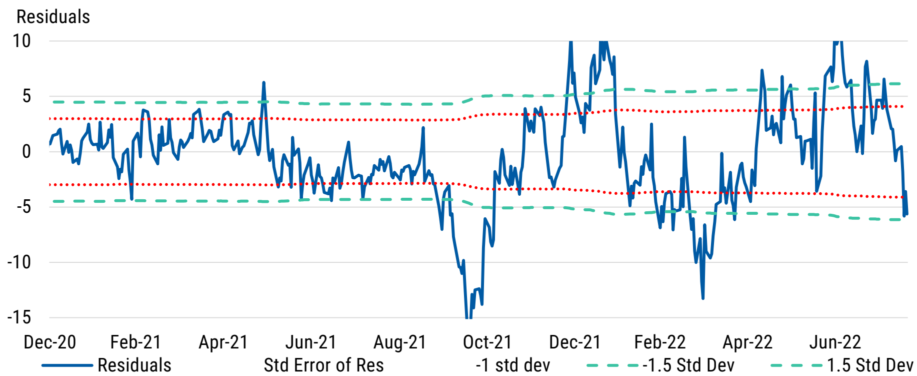
We envision the market oscillating for the rest of the year between two states: 1) normalisation, and 2) market capitulation. In this environment, normalisation trades are any trades that are **short near-term inflation or long carry,** for example: short BEs, gilt bull steepeners, short swaptions, short front-end gilts on ASW and long duration. The converse holds for the market capitulation regime. We think that in the near term the market will remain in the **latter camp**, i.e., market normalisation trades will struggle to perform. The reason is simple: the July'22 RPI print has triggered generalised risk reduction, primarily on inflation and slope trades. While the Jackson Hole symposium is usually an opportunity to calm markets, it is less clear whether this year it will deliver. The market's main problem is inflation, and it seems too early for Central Bankers to signal a pause to their restrictive stance on inflation. With this in mind, we expect the traditional August illiquidity to ensure high delivered volatility and a reduction in carry trades. This also means that market dynamics may continue to look stretched, at least relative to historical standards.

For example, one market dynamic that seems particularly stretched is the shape of the SONIA curve. Exhibit 45 shows the residual of the 2s5s10s SONIA fly vs 1s2s SONIA, the 2s5s10s USD fly along with 1y-into-30y normal vol.

Based on the model, the fly is about 5bp too rich, and paying the fly would allow investors to enter a carry-positive position by 6.3bp/month. So this would be an attractive normalisation trade for anyone who believes that the post-RPI market liquidation is over.

The challenge with this trade is that the ongoing paying at the front-end (2y) of the curve could continue. For example, re-mortgaging from deals that were established right as we exited the pandemic would cause further 2s5s flattening. And as the summary table in Exhibit 44 shows, seasonal patterns support 2s5s flattening in August. Moreover, it is less clear whether mortgage paying flows continue to take place at the 5y point or they shift to the front-end in general. And when the market will be able to price recession risks, then the 5y point could rally.

Exhibit 45: Rich 2s5s10s fly relative to the model



Source: Morgan Stanley Research

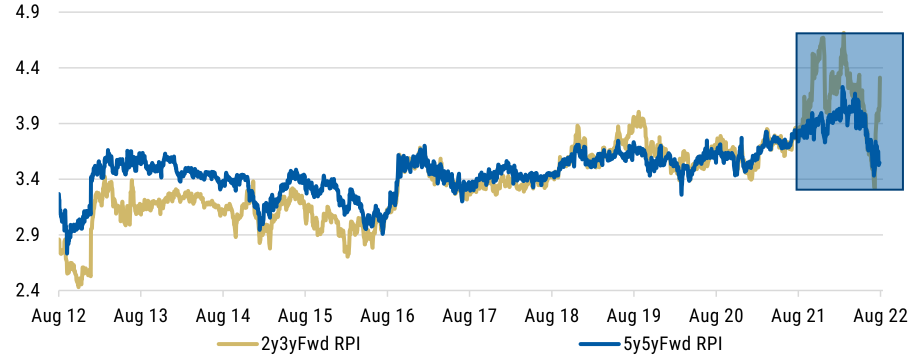
Parts of the following section were previously published here

Extending the 5y RPI swap target to 5.75%

The word "unprecedented" has been used several times during the pandemic and during exceptional event risk. Right now it applies to the state of the UK RPI market given daily moves to the upside. About two months ago we added a long position in RPI swaps, given several cheap RPI forwards (see here). We think that the market will have to price in **more** of a near-term high inflation story. While this has been ongoing (Exhibit 46) 2y3yRPI is still cheap relative to levels that we experienced a few months ago. And inflation worries have definitely accentuated since then, with the simplest proof being the need for the BoE to hike faster.

Why 5.75%? Setting a target lies between art and science so it is hard to pinpoint a precise number, but we will explain our rationale. We expect to move to a different regime with higher inflation swaps and a flatter curve. Using estimates of 1y at 9.7%, 1y1y at 4.5% and 2y3y at 4.9%, we end up with a valuation of 5.75%. This is in line with the aforementioned regime, with RPI forwards above previous levels. We think that the market will have to overshoot first and then stabilise at a structurally wider level for BEs and RPI swaps.

Exhibit 46: Gradual rise in 2y3y RPI but still far from previous highs

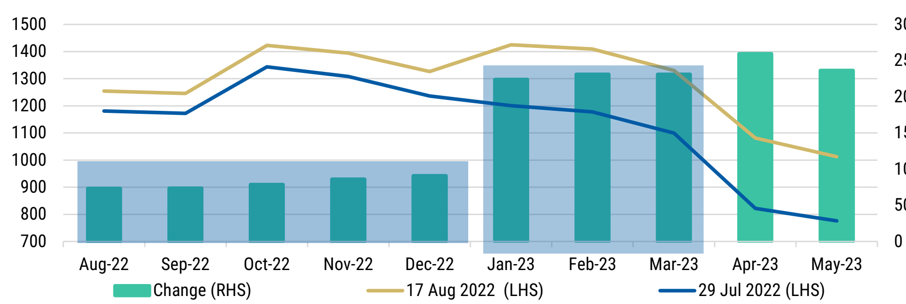


Source: Morgan Stanley Research

Fixings – higher for longer, 250bp in four weeks: Front-end RPI fixings had to reprice because of the upside surprise in the July 2022 RPI print and the broad nature of the increase. We expect RPI fixings going forward to trade largely in triplets, reflecting the timing of Ofgem cap increases. We see that some of those fixings have risen by about 250bp within a span of four weeks and the increased numbers will keep the summer heat in the UK inflation market even during meteorologically colder months of the year.

In brief, we envision a higher inflation peak and RPI staying high for longer. Both are supportive for any long position at the front end of the curve. We also think that positioning is likely to go long UK RPI swaps. It is an asset class which tactical accounts have historically sold. But right now and with the ongoing uncertainty on gas prices, it pays off to be long, in our view.

Exhibit 47: Rise across RPI inflation fixings over the last four weeks



Source: Bloomberg, Morgan Stanley Research

Trade idea: Maintain long 5y UK RPI swap, entered at 4.26%, stop 3.8%, with a target at 5.75%

Parts of the following section were previously published here Gilt Roll to Cheapen

We estimate that the roll is currently 10 cents rich versus our forward-implied fair value estimates. Some of that is structural but we recommend longs to roll early ahead of a likely cheaper roll.

Exhibit 48: Key metrics for the gilt September-December roll

	Front Contract	Back Contract
Contract	G U2 Comdty	G Z2 Comdty
Current CTD	UKT 4.25 06/07/32	UKT 4.25 06/07/32
Isin	GB0004893086	GB0004893086
Cusip	EC256595 Corp	EC256595 Corp
Coupon (%)	4.25	4.25
Conversion Factor	1.020	1.020
Current Price	112.940	111.860
CTD Price	115.697	115.697
Repo to Delivery	130	156
Delivery Date	30/09/2022	30/12/2022
Days to delivery	31	133
Accrued Coupon to Delivery	0.36	1.55
Fwd Price	115.46	114.81
Converted Fwd price	113.20	112.60
Rich/Cheap (€)	-0.260	-0.737
Current Trading Status vs "Fair Value"	*Cheap*	*Cheap*

Source: Morgan Stanley Research

Optionality and net basis – High: There is a high degree of optionality on both rolls. We assign a 32% probability of CTD switch in the front-month contract and another 42% chance of a CTD switch in the back-month contract. In summary, given the small additional probability of a CTD switch in G Z2, we struggle to justify its cheapness.

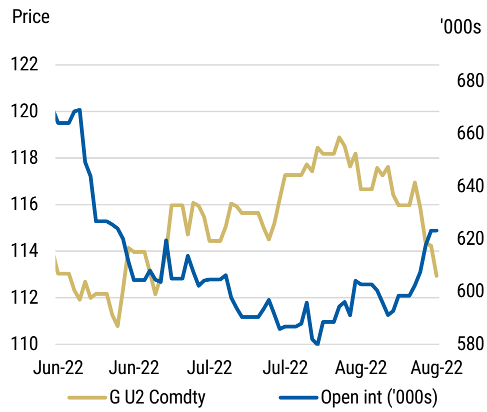
We understand that futures will have to be cheap vs cash because of the embedded optionality in both contracts. But we do not think the back-month contract should be that cheaper, i.e., we estimate the structural FV cheapness to be around -0.41 (as opposed to -0.73).

Positioning – Long: In Exhibit 49, we examine the price of the front contract versus open interest. In Exhibit 50, we report G U2 net longs to net shorts ratio positions as a percentage of open interest. This ratio is computed over a 30-day rolling period.

- We can clearly see that tactical positioning is pointing to a significant reduction in shorts (see July price action) along with tactical longs.

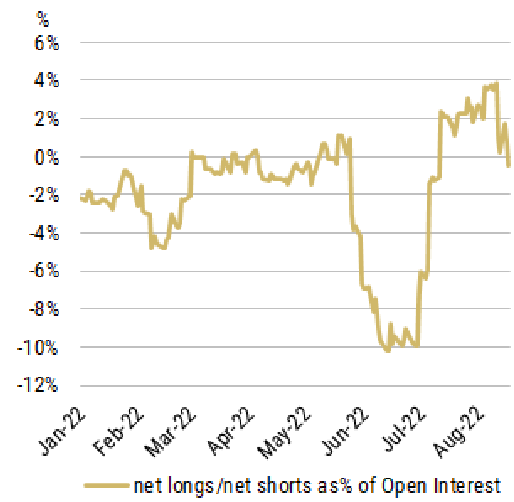
Recent roll cycles – Neutral: In Exhibit 51 we can see that current open interest is fully in line with the open interest of the previous ten rolls. Exhibit 52 shows that current activity in the contract is not too distant from its mean over the 10 previous cycles.

Exhibit 49: G U2 open interest vs. price



Source: Morgan Stanley Research, Bloomberg

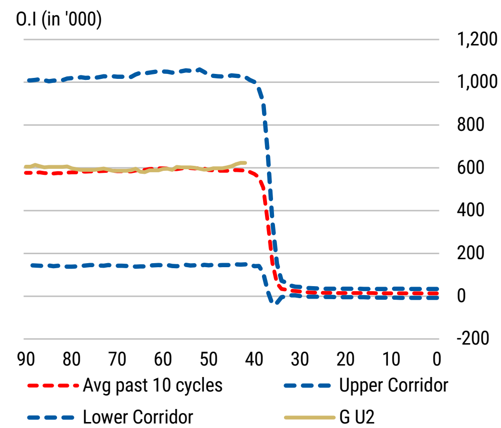
Exhibit 50: G U2 net longs to net shorts ratio as % of open interest (one-month rolling)



Source: Morgan Stanley Research, Bloomberg

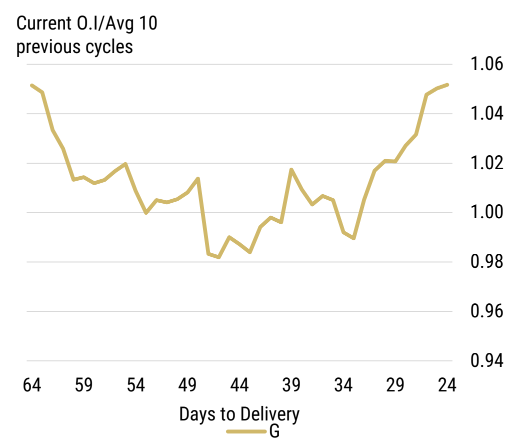
Verdict: We think that at current pricing the roll is rich and hence longs should roll early out of G U2 and into G Z2.

Exhibit 51: G U2 open interest versus previous 10 cycles



Source: Morgan Stanley Research, Bloomberg

Exhibit 52: Current G U2 current open interest over OI average from the 10 previous roll cycles



Source: Morgan Stanley Research, Bloomberg

Japan | Preparing for the potential sell-off

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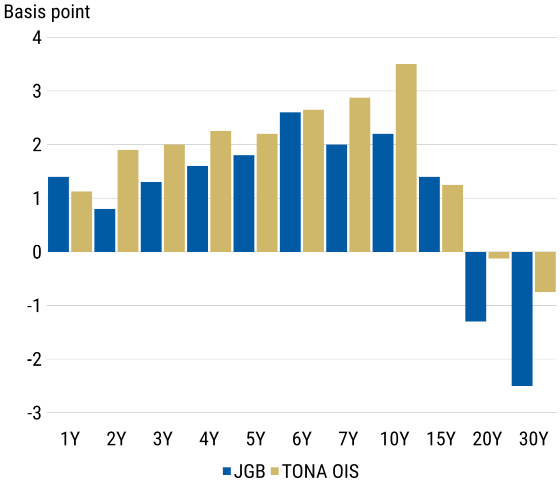
Portfolio rebalancing might affect the outperformance of long-end JGBs

The super-long portion of the JGB yield curve has continued to flatten in August with a general lack of catalysts (see Exhibit 53), suggesting that investors may have started to be attracted by relative cheapness now that overseas interest rates look to have stabilized. As discussed in "How Might The JGB Market Be Impacted As Special COVID-19 Operations Are Wound Down?", with trading volumes once again thinning out (and liquidity deteriorating) as many participants take their summer vacations, we consider it unlikely that domestic life insurers have switched wholeheartedly into buying (rally-chasing) mode.

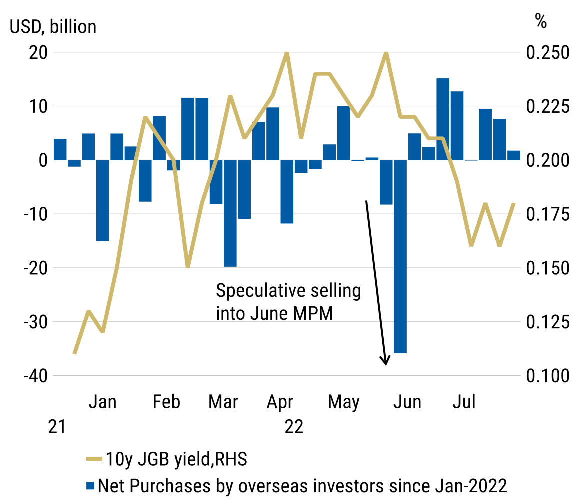
Recent flattening may have reflected some combination of short-covering by overseas investors and portfolio rebalancing by domestic pension funds. MoF International Transactions in Securities data show Japanese investors making net acquisitions of foreign bonds in each of the past two weeks, despite the UST yield remaining low, while selling off foreign equities (see Exhibit 54), suggesting that funds are being reallocated out of the latter asset class into the former.

Exhibit 53: Weekly changes on JGB and TONA OIS curve



Source: Morgan Stanley Research, Bloomberg

Exhibit 54: Japanese investors' weekly foreign assets investment

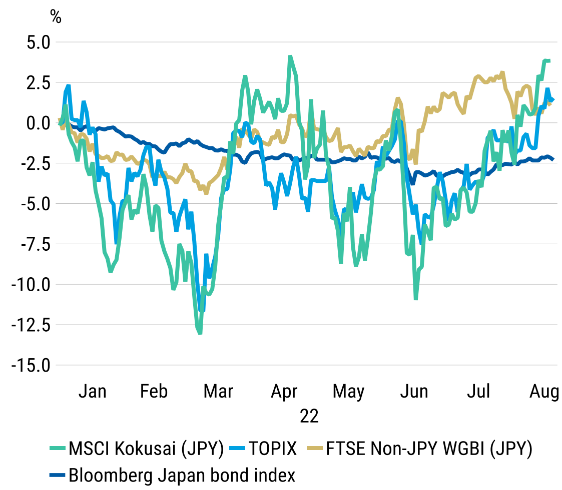


Source: Japan Mof, Morgan Stanley Research

We attribute this to equities having outperformed so markedly since the July FOMC meeting as financial conditions have improved significantly (see Exhibit 55) amid speculation that incoming economic data might cause the Fed to ease back on its rate hike cadence.

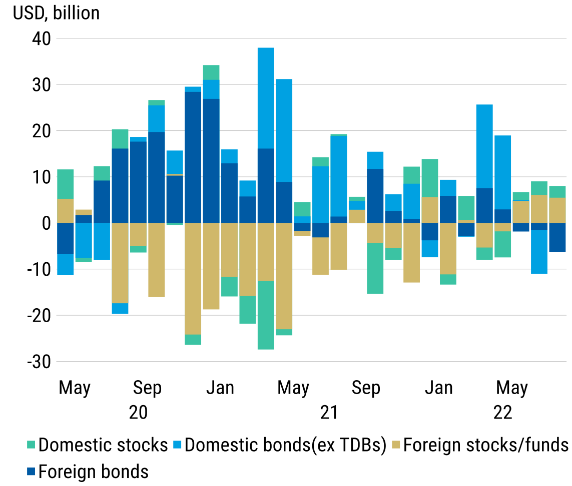
As of July there had been some expectation that "risk off" sentiment might necessitate a rebalancing out of bonds into equities (see Exhibit 56), but money actually appears to have flowed in the opposite direction due to the post-FOMC improvement in risk asset performance.

Exhibit 55: Benchmark equity and bond indices performance



Source: Morgan Stanley Research, Bloomberg

Exhibit 56: Trust accounts' monthly asset investment.



Source: JPX, JSDA, Japan MoF, Morgan Stanley Research Estimates. Note: domestic bond data as of end-July is not available as of writing

Our own estimates suggest that pension funds will have increased their portfolio allocations to foreign and domestic equities through mid-August (see Exhibit 57), with subsequent rebalancing into domestic/foreign bonds perhaps having partially contributed to recent bull-flattening of the JGB yield curve.

In any case, demand from domestic real money investors does appear to have been a factor behind sharp declines in super-long JGB yields as liquidity has dried up during the usual summer down-period. We see scope for further flows out of equities into bonds if stock prices and interest rates keep rising with support from looser monetary conditions.

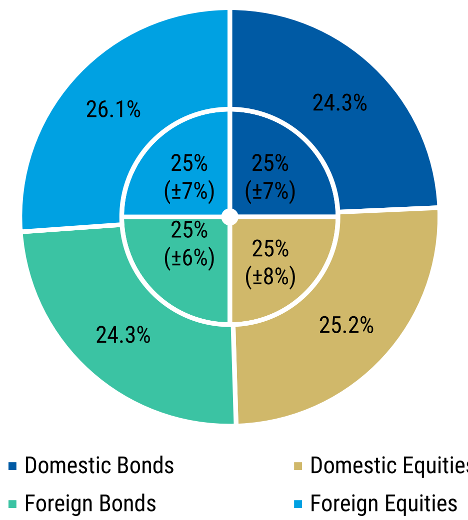
That said, September is often a relatively poor month for bonds, as overseas supply picks up for seasonal reasons. The Fed continues to prioritize its fight against inflation and might very well end up persisting with aggressive rate hikes depending on how various economic indicators pan out.

Interest rates could quite conceivably start to rise again into September if positioning for a more dovish Fed is dialed back, in which case the resultant tightening of financial conditions could bring a temporary halt to the aforementioned rebalancing out of equities into bonds. In any case, we expect such flows to prove comparatively short-lived unless stock prices remain well and truly in rally mode.

We also believe that (predominantly overseas) investors might start crowding back into the "BoJ trade" from September if inflation remains elevated (see Exhibit 58) (our economist now expects Japan CPI ex freshfood to approach 3.0% y/y temporarily) and USD/JPY continues to climb due to a renewed focus on US-Japan monetary policy divergence (presuming that overseas interest rates do indeed move higher).

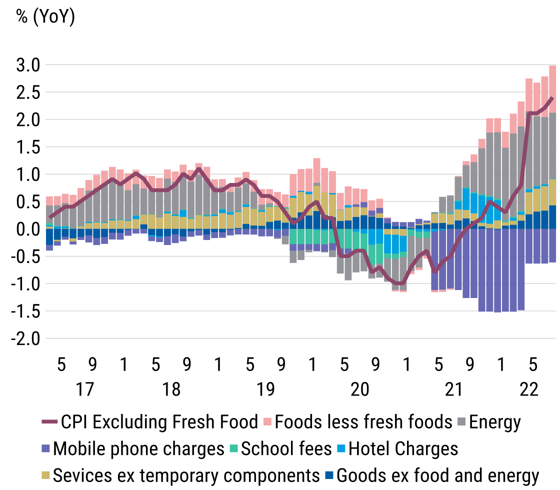
We would also expect JGB shorting to be heaviest in the super-long sector given that the BoJ seemingly remains determined to enforce its +0.25% ceiling over the 10y JGB yield. We therefore continue to envisage a steepening bias, with life insurers—admittedly a potential game changer—looking likely to maintain a wait-and-see approach for at least the time being.

Exhibit 57: GPIF basic portfolio estimation as of 18th-August



Source: GPIF webpage, Morgan Stanley Research Estimatio

Exhibit 58: Japan CPI ex fresh food breakdown



Source: Macrobond, Morgan Stanley Research

Consider buying 10y ASW

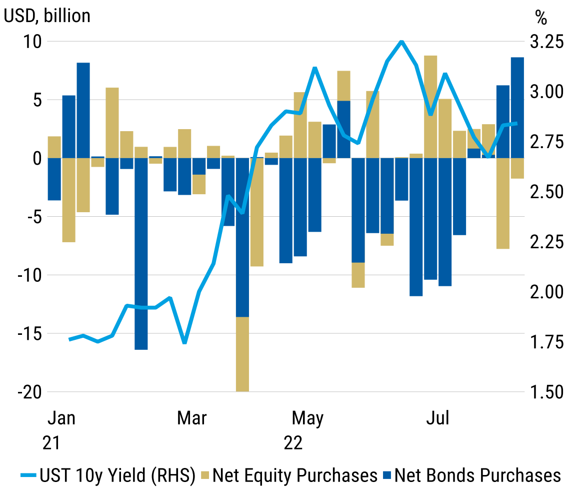
The 5y–10y sector underperformed noticeably into this week. This part of the curve had previously rebounded as (predominantly overseas) investors unwound positioning for near-term BoJ policy adjustments, but short-covering pressure appears to have subsided more recently, with foreigners having gradually reduced their net purchases of Japanese bonds through the end of last month (see Exhibit 59).

Results have also been on the weak side for a number of the BoJ's bond-buying operations in the 5y–10y sector, with this apparent deterioration in supply/demand perhaps owing at least something to profit taking by domestic banks (among others) following quite significant declines in yields (i.e. rises in JGB prices).

We do however expect dip-buyers to step in once again if overseas interest rates keep pulling the 10y JGB yield back towards its +0.25% "ceiling" level. As discussed in "How Might The JGB Market Be Impacted As Special COVID-19 Operations Are Wound Down?", regional financial institutions will perhaps find it somewhat harder than city banks to "avoid" negative interest rates as the BoJ's wind-down of its Special Program to Support Financing in Response to COVID-19—which basically looks set to be terminated at the end of September and is already being scaled right back—translates into a significant loss of (zero-interest) Macro Add-on Balance allowances.

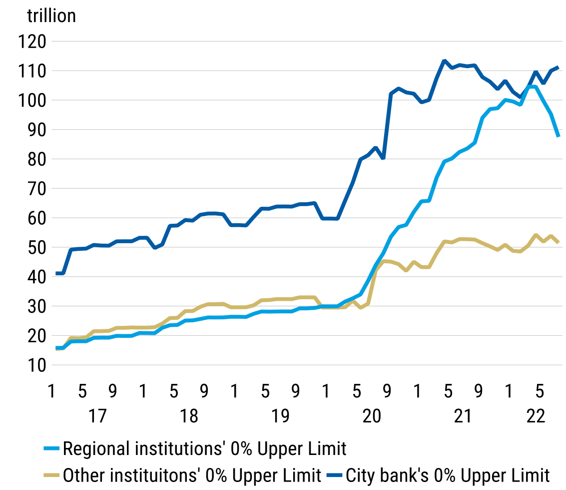
Headroom actually increased for city banks as a result of the July hike in the "Benchmark Ratio Used to Calculate the Macro Add-on Balance" (reflecting their sizable Basic Balances) (see Exhibit 60), but meanwhile declined so sharply for regional financial institutions as to leave them needing to invest almost ¥20 trillion in "surplus" funds.

Exhibit 59: Overseas investors' weekly Japan bonds investment



Source: Japan Mof, Morgan Stanley Research

Exhibit 60: Upper limit of 0% balance under BoJ current account by each investor category



Source: BoJ, Morgan Stanley Research

We expect at least some of this problematic cash to be channeled into 10y JGBs, which are already yielding close to 20bp and should have only limited downside as the BoJ continues to enforce its "yield curve control" framework. We therefore continue to see value in 10s20s JGB steepeners.

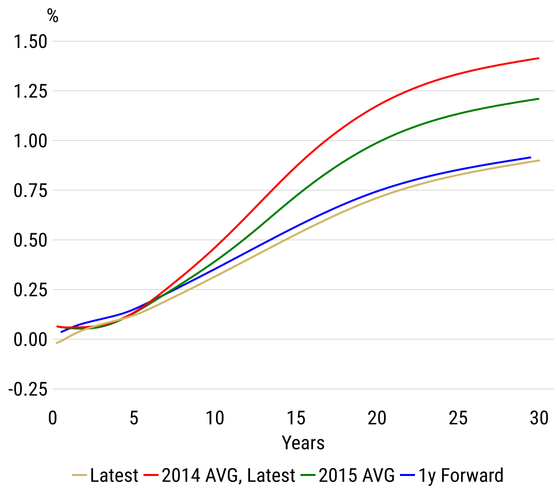
Short- to medium-term TONA OIS rates are already at levels last seen prior to the BoJ's adoption of a negative interest rate policy despite the central bank having continued to rule out any near-term adjustment of policy settings (see Exhibit 61).

We see only limited scope for cheapening from current levels and therefore suggest sticking with previously recommended 5s20s (JPY swaps) steepeners in anticipation of the super-long sector facing relatively strong paying flows if rates do indeed move higher.

10y ASW longs may also warrant consideration by way of a bearish trade. The yield on the newest 10y JGB (JB367) is already threatening to climb past 20bp and looks set to encounter greater resistance as it approaches the BoJ's +0.25% defense line, while the 10y OIS rate should be freer to follow overseas interest rates higher due to a lack of direct BoJ intervention.

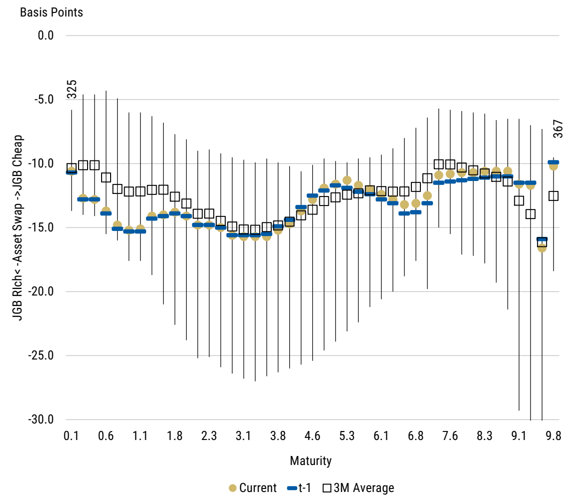
Entry looks appealing with JB367 asset swaps currently the cheapest they have been for some time (see Exhibit 62), although we note the risk to this trade is a scenario where interest rates fall unexpectedly sharply thereby (via the 10y TONA OIS rate) generating yet further cheapening pressure.

Exhibit 61: TONA OIS curve comparison: 2014/2015 average vs latest



Source: Morgan Stanley Research

Exhibit 62: JGB ASW curve around 10y sector



Source: Morgan Stanley Research

Trade idea: Maintain JGB 10s20s steepener

Trade idea: Maintain TONA OIS 5s20s steepener

Trade idea: Enter long JB367 ASW at -11.2 bp

Currency & Foreign Exchange

G10

G10 | Bid-ask spreads

Currency bid-ask spreads have been wide recently. Spreads are significantly wider than seasonal factors or measures of cross-market volatility would suggest. Much of the recent G10 spread widening is attributable to EUR bid-ask spreads. The Euro Area faces a range of uncertainties, including energy price volatility and policy rate uncertainty. These factors may keep EUR (and other currency) bid-ask spreads at historically wide levels.

United States

USD | How much looser are financial conditions?

After tightening by nearly 400bp in fed funds equivalent terms into June 2022, financial conditions have eased meaningfully, by as much as 120bp (now 100bp), despite the Fed hiking 150bp since the June meeting. The key driver of this loosening was the noticeable rally in equities and the decline in Treasury yields.

We think the market is already underestimating the persistence and stickiness in inflation, the Fed's resolve in tackling it, and the enormity of the task the Fed faces in containing inflation. The fact that financial conditions (the transmission mechanism of Fed policy to the real economy) have loosened so much suggests that more Fed hawkishness is likely to be coming, particularly if labor market and activity data remain robust.

This suggests the USD is likely to rise further, particularly versus the EUR, as investors begin to realize that US rates are likely to be higher for longer. We continue to recommend selling EUR/USD targeting 0.97 with a 1.05 stop.

Europe

GBP | What's weighing on the pound

Another upside surprise in UK inflation this week drove a sharp move higher in front-end rates but this did not translate to GBP strength. Hiking in a stagflationary environment is hardly something to cheer for (especially for the currency). We see the current reaction function of GBP as one of "higher rates, weaker FX" as more rate hikes accelerate the growth slowdown, a scenario that does not bode well for the currency, in our view.

As such, we continue to expect more downside risks for GBP, and the poor UK growth outlook should drive GBP underperformance relative to its risk-sensitive peers. However, already low growth expectations, still short GBP positioning and very bearish sentiment should limit a material leg lower for GBP from here.

Dollar Bloc

G10 | Close short EUR/NZD

Given the difficulty of gauging the risks to AxJ growth (and the concomitant risks to global investor optimism), we turn neutral on NZD. While the US growth outlook may be better than expected (and investors continue to believe that US inflation moderates over the coming year), global risk demand may suffer if the rest of the world looks increasingly challenged. Rising core y/y inflation prints in Canada and the UK and a surprisingly high German PPI print this week also challenged the narrative that global inflation has passed its peak as supply dynamics improve. In addition, our China economists have flagged rising downside risks to their forecasts.

G10 FX Trades

Exhibit 63: G10 FX trade ideas

Spot trades	Spot	Target		Stop	
Maintain					
Short EUR/USD	1.004	0.970	3.4%	1.050	-4.6%
Long NOK/SEK	1.080	1.090	0.9%	1.040	-3.7%
Exit					
Short EUR/NZD	1.624				
Options trades		Entry/cost/premium received			
Maintain					
Long 3m USD/JPY seagulls (long ATMF/140 call spread, sell 128 put) at a cost of 0.7% (priced 28-Jun-22)					

Source: Bloomberg, Morgan Stanley Research

USD | How much looser are financial conditions?

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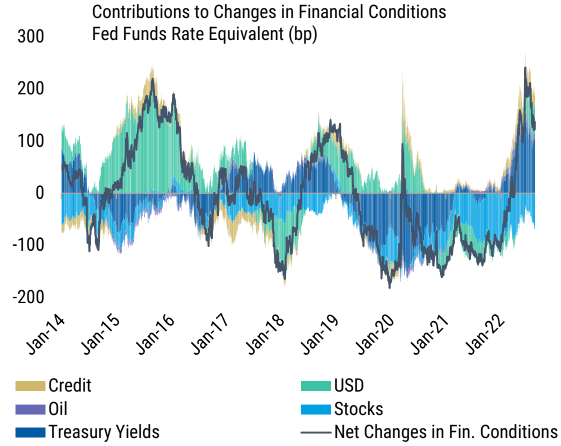
A few months ago we analyzed how financial conditions in the US had evolved. In this note, we update our analysis to see how financial conditions have evolved since May.

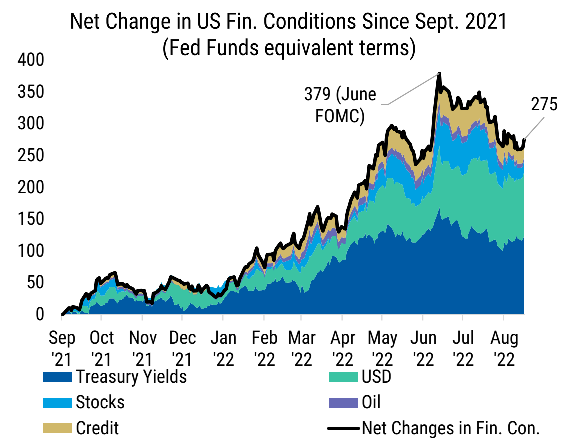
Importantly, financial conditions have *loosened* by the equivalent of 100bp worth of rate cuts since the June FOMC. This is despite the Fed having hiked 150bp since then. This suggests that, in order to curb inflation, financial conditions (FCI) in general may need to re-tighten given robust US consumption, elevated labor-market-sensitive inflation, and a tight labor market. The USD's contribution to financial conditions tightening remains lower than in previous cycles, suggesting more USD strength may be warranted.

Exhibit 64: How have financial conditions evolved in fed funds equivalent terms?



Source: Bloomberg, Morgan Stanley Research

Exhibit 65: Financial conditions tightened by the equivalent of nearly 400bp of rate hikes from Sept 2021-June 2022...

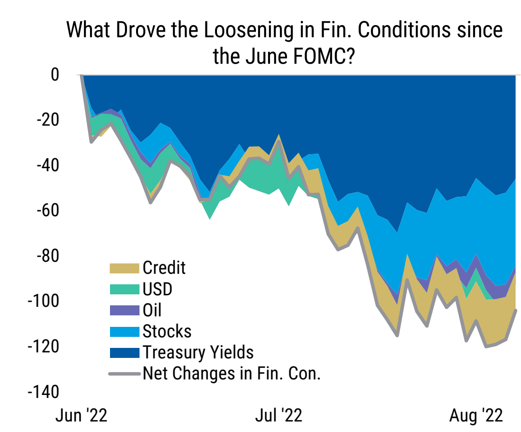


Source: Bloomberg, Morgan Stanley Research

How have financial conditions evolved in recent months? Financial conditions tightened meaningfully from September 2021 through June 2022, reflecting the pullback in Fed asset purchases and subsequent rate hikes (Exhibit 64 & Exhibit 65). Importantly, though, financial conditions have eased meaningfully since the June FOMC, by a maximum of 120bp in fed funds equivalent terms (Exhibit 66) as Treasury yields have fallen more than 50bp and the S&P 500 has risen almost 15%. This is despite the Fed having raised rates 75bp at both the June and July FOMC meetings.

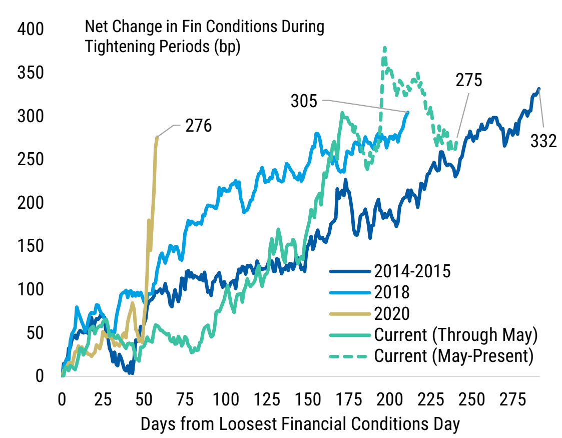
The ramp up in tightening into June 2022 resulted in the pace of tightening transpiring far faster than what we observed in 2014-2015 and 2018 (Exhibit 67), a pace of 2.1bp of tightening per day. The loosening in FCI since June to present has brought the net pace back to more historically-consistent levels, tracking roughly the average pace implied in 2014-2015.

Exhibit 66: ...but have loosened roughly 100bp (max 120bp) since June 2022



Source: Bloomberg, Morgan Stanley Research

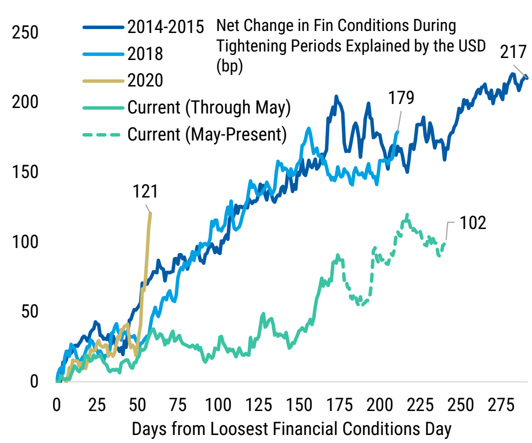
Exhibit 67: The net tightening in financial conditions most resembles the 2014-2015 tightening



Source: Bloomberg, Morgan Stanley Research

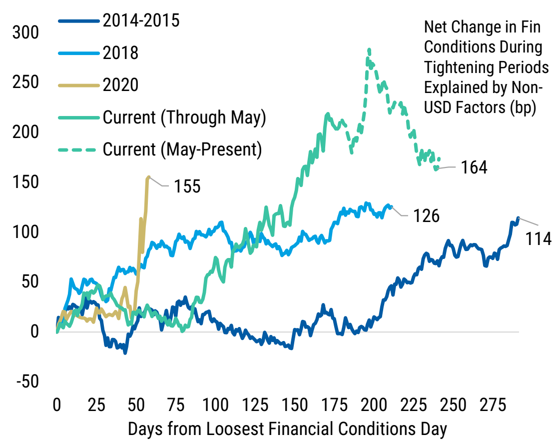
Much as seen in earlier months, the change in financial conditions has been chiefly driven by non-USD factors (equities and rates, mostly, see Exhibit 68). The tightening in FCI attributed to the stronger USD has only been about 100bp since September 2021, and the bulk of this has taken place throughout 2022 alongside the steady rise in the DXY. This contrasts with the USD having done more of the 'heavy lifting' in prior FCI tightening cycles. As well, the loosening in financial conditions since June has also almost entirely been explained by non-USD factors (Exhibit 69), though the contribution of rates and equities to broader FCI tightening is still above that seen in prior tightening cycles.

Exhibit 68: This cycle's financial conditions tightening due to the USD has been limited compared to prior cycles...



Source: Bloomberg, Morgan Stanley Research

Exhibit 69: ...while tightening driven by other factors (equities, Treasuries) is higher than other cycles



Source: Bloomberg, Morgan Stanley Research

Why does this matter for FX investors? We've previously been arguing that the market is underestimating the persistence and stickiness of US inflation, the Fed's resolve in tackling it, and the amount of tightening required to achieve this goal. Higher US rates, tighter global financial conditions, and weaker global growth are all catalysts for a stronger USD.

Meanwhile, financial conditions are a key transmission mechanism by which Fed policy tightening transmits to the real economy, thus having an impact on the labor market, growth, and inflation. **The more that financial conditions are loosening, the more tightening the Fed will have to pursue to ensure that inflation is ultimately tackled. This suggests markets may be unprepared for a re-tightening in FCI in response to the Fed. Moreover, the USD's contribution to tighter financial conditions has been limited, suggesting that a higher USD could contribute far more to tighter FCI.**

We continue to recommend EUR/USD shorts targeting 0.97 with a 1.05 stop. While any tightening in US financial conditions owing to more Fed hawkishness is likely to be supportive for the USD, the outlook for eurozone growth continues to soften amid elevated energy and food prices. This week's upcoming Jackson Hole conference could be an important USD-positive catalyst as it offers the Chair an opportunity to emphasize the Fed's commitment to tackling inflation.

Trade idea: Maintain short EUR/USD at 1.004 with a target of 0.970 and a stop of 1.050
Trade idea: Maintain long NOK/SEK at 1.080 with a target of 1.090 and stop of 1.040

G10 | Bid-ask spreads

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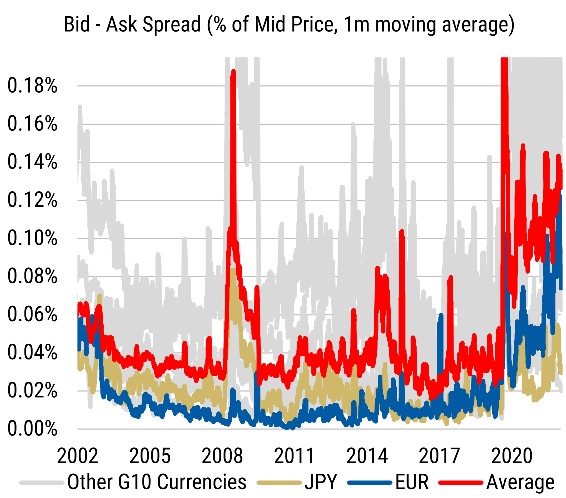
Currency bid-ask spreads have been very wide recently. Exhibit 70 shows that the average bid-ask spread across G10 currencies (each normalized by their own mid price) is well above pre-COVID averages.

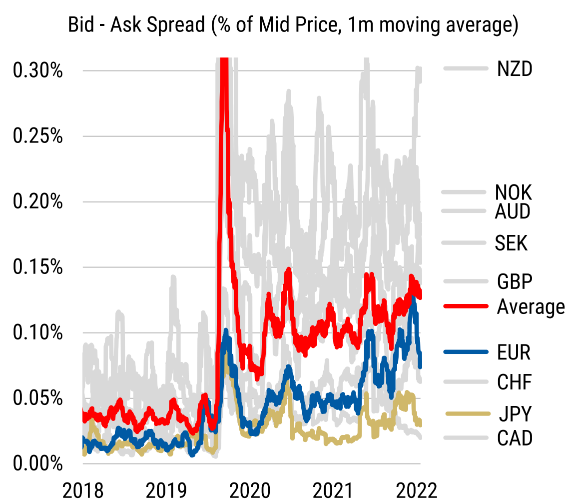
These spreads are significantly wider than seasonal factors or measures of cross-market volatility would suggest. Much of the recent G10 spread widening is attributable to EUR bid-ask spreads. The Euro Area faces a range of uncertainties, including energy price volatility and policy rate uncertainty. These factors may keep EUR (and other currency) bid-ask spreads at historically wide levels.

Exhibit 70: Bid-ask spreads have been very elevated...



Source: Bloomberg, Morgan Stanley Research

Exhibit 71: ...including among core G10 currencies



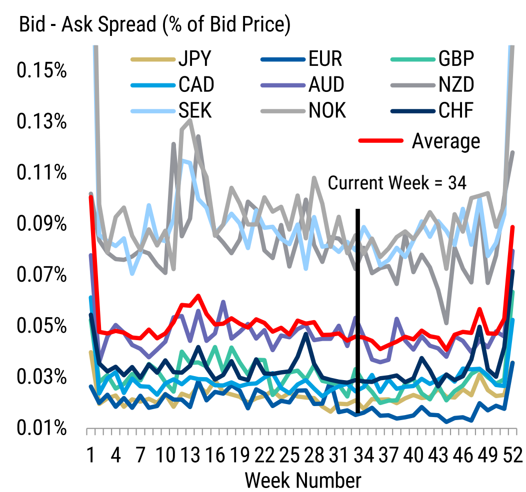
Source: Bloomberg, Morgan Stanley Research

The widening in bid-ask spreads has not been driven by a few outlier currencies. Exhibit 71 shows that in recent months EUR bid-ask spreads have widened well beyond both pre- and post-COVID averages, just like bid-ask spreads for more volatile currencies like NZD and NOK.

The bid-ask spread widening over the past two months is especially notable when considering liquidity seasonality.

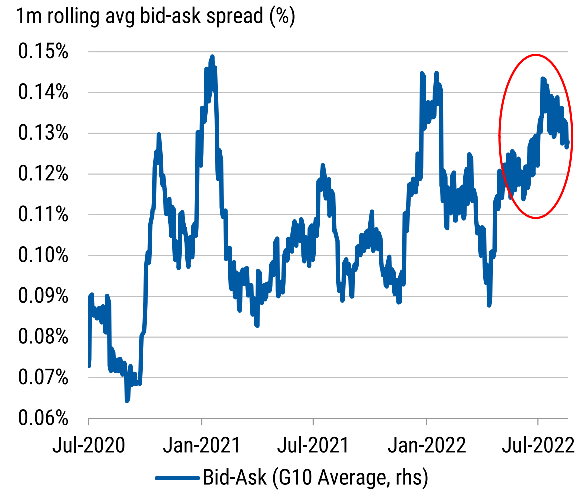
There is a clear seasonal pattern to G10 bid-ask spreads (Exhibit 72). Spreads widen around the end of the year and tighten again in January, and then widen again modestly around the end of the first quarter.

Exhibit 72: Seasonal factors do not explain the recent widening in bid-ask spreads...



Source: Bloomberg, Morgan Stanley Research

Exhibit 73: ...which are hovering around seasonal wides

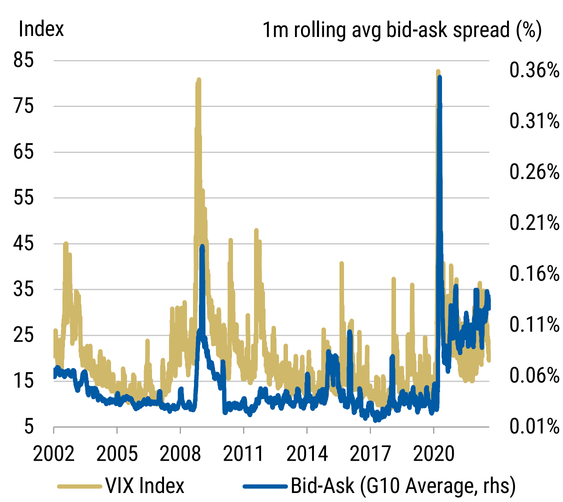


Source: Bloomberg, Morgan Stanley Research

However, bid-ask spreads do not typically widen during the middle of the year. In fact, bid-ask spreads typically *tighten* into the third quarter.

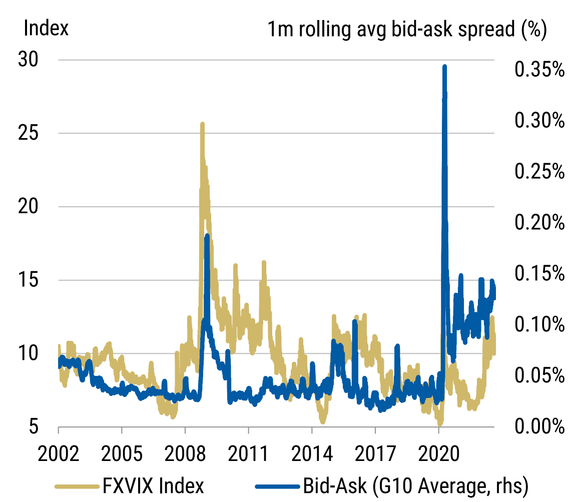
The previous episodes of bid-ask spread widening seen since COVID were in line with that historical pattern. Bid-ask spreads widened (from already elevated levels) around the end of 2021 and 2022. However, the recent widening has occurred outside of the usual seasonal pattern (Exhibit 73).

Exhibit 74: Both equity market volatility...



Source: Bloomberg, Morgan Stanley Research

Exhibit 75: ...and currency volatility show a loose relationship with bid-ask spreads

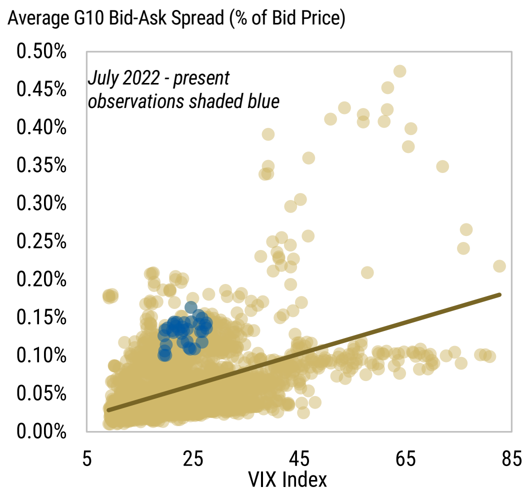


Source: Bloomberg, Morgan Stanley Research

Moreover, bid-ask spreads have widened more than metrics of market volatility might suggest.

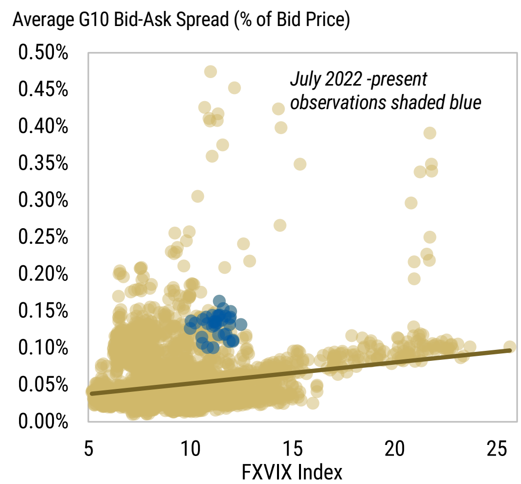
Historically, bid-ask spreads have shown a broadly consistent relationship with both the VIX (Exhibit 74) and the FXVIX (Exhibit 75), metrics of implied volatility in equity and currency markets.

Exhibit 76: Recent bid-ask spreads would be historically consistent with both elevated equity market volatility...



Source: Bloomberg, Morgan Stanley Research

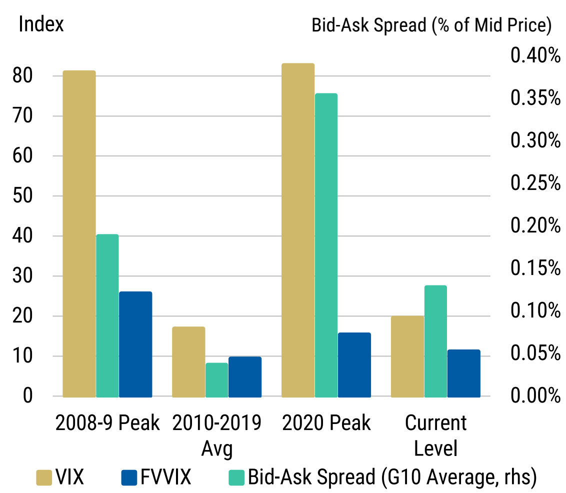
Exhibit 77: ...and exchange rate volatility



Source: Bloomberg, Morgan Stanley Research

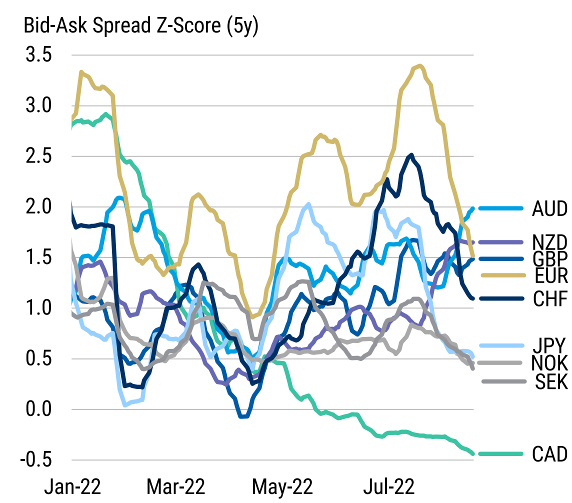
However, recent (July-present) bid-ask spreads have been well above levels historically associated with the current level of exchange rate or equity market volatility.

Exhibit 78: Unlike volatility, bid-ask spreads are well above pre-COVID levels



Source: Bloomberg, Morgan Stanley Research

Exhibit 79: EUR illiquidity has been notable this year



Source: Bloomberg, Morgan Stanley Research

Recent bid-ask spreads would be historically consistent with crisis-level equity (Exhibit 76) and exchange rate volatility (Exhibit 77).

Another way to show the relative wideness of G10 FX bid-ask spreads is to compare them with 2010-2019 average levels. Bid-ask spreads widened during the GFC and in 2020 during the onset of COVID.

However, unlike the VIX and FXVIX, spreads have not settled back to around pre-COVID levels. Spreads are almost three times wider than their 2010-2019 average.

Exhibit 71 above shows that NZD and NOK bid-ask spreads are currently widest among G10 currencies.

However, these currencies have historically been among the least liquid currencies due to the relatively small size of their economies. Exhibit 72 shows that NZD, SEK, and NOK bid-ask spreads are historically wider than other G10 currencies.

Therefore, to investigate the drivers of recent illiquidity, Exhibit 79 normalizes bid-ask spreads relative to their history by showing a five year z-score of the current bid-ask spread.

Exhibit 79 shows that the recent widening has been notable for *all* G10 currencies except CAD. NOK and SEK bid-ask spreads have been only modestly wider this year.

EUR bid-ask spreads have recently moderated somewhat relative to history, however, EUR illiquidity this summer has been pronounced.

While EUR illiquidity might be attributed to policy uncertainty from the ECB, other central banks (RBA, Bank of England, Bank of Canada) have similarly revised their forward guidance and/or delivered rate hikes sized differently than implied by swap pricing.

Instead, relative **EUR illiquidity this year may be attributable to the *range* of uncertainties regarding the Euro Area outlook**. Aside from policy rate uncertainty, energy prices (particularly forward electricity delivery contracts) in the Euro Area have been highly volatile. Political developments have clouded the outlook for fiscal, institutional, and security policy and internal policy coordination.

EUR bid-ask spreads may remain wide. Our colleagues in European economics expect the European economy to tip into recession this year. The duration and course of the invasion of Ukraine are both uncertain, potentially putting further upward pressure on energy prices. The ECB may find it challenging to communicate its future path of policy in a stagflationary environment.

In addition to reasons to maintain a bearish stance on the EUR, we see these factors as potentially keeping EUR (and other) bid-ask spreads at historical wides. Our view remains that it will be difficult for FX volatility to fall meaningfully from current levels. For these reasons (and the possibility that forward curves may steepen), we recommend investors front-load hedges.

GBP | What's weighing on the pound

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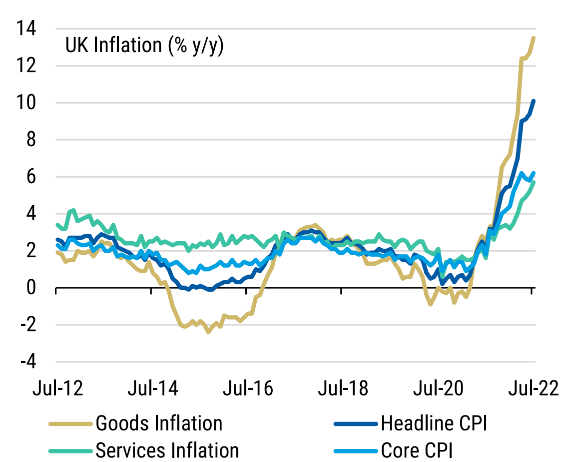
Another upside surprise in UK inflation this week drove a sharp move higher in front-end rates but this did not translate to GBP strength. Hiking in a stagflationary environment is hardly something to cheer for (especially for the currency). We see the current reaction function of GBP as one of "higher rates, weaker FX" as more rate hikes accelerate the growth slowdown, a scenario that does not bode well for the currency, in our view.

As such, we continue to expect more downside risks for GBP and the poor UK growth outlook should drive GBP underperformance relative to its risk-sensitive peers. However, already low growth expectations, still short GBP positioning and very bearish sentiment should limit a material leg lower for GBP from here.

An upside surprise in inflation drove front-end rates higher: UK CPI beat expectations and the BoE's forecasts this week, rising to a 40-year high of 10.1%. While food prices were the main contributor to the upside surprise in inflation, core inflation was very solid too, supported not just by strong services inflation but also an increase in core goods inflation (Exhibit 80).

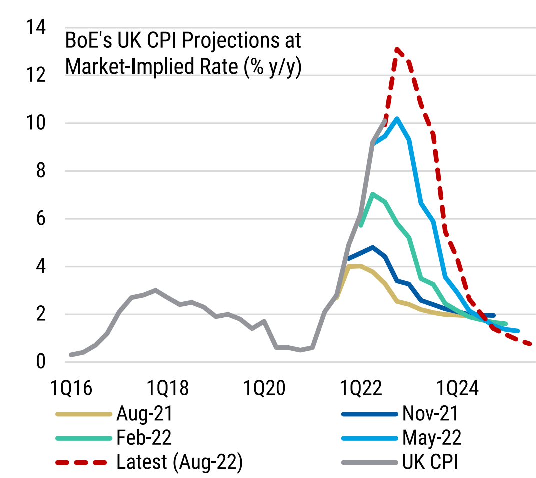
The inflation print came in yet again higher than the BoE's forecasts (Exhibit 81), leading to a sharp repricing in front-end rates as markets price in more policy tightening from the BoE. The market-implied UK terminal rate jumped almost 40bp on the day, rising to a new high of 3.8%, which is now higher than that in the US at 3.7%. While our economists now expect a 50bp hike from the BoE in September, they think the terminal rate pricing is overdone and see the terminal rate at 2.75% at year-end (Exhibit 83).

Exhibit 80: The rise in UK inflation was broad-based...



Source: ONS, Morgan Stanley Research

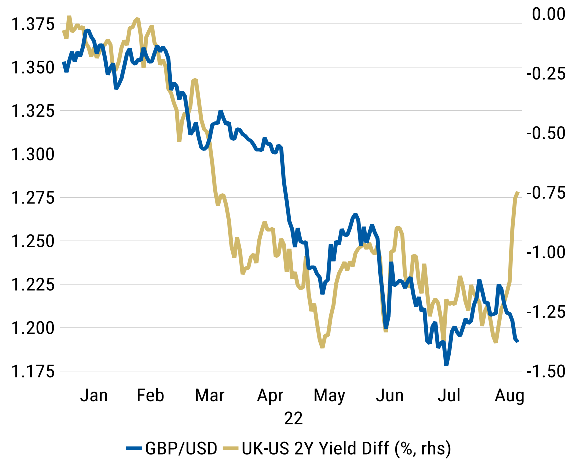
Exhibit 81: ... and continued to surprise to the upside relative to BoE's forecasts



Source: Bank of England, Haver Analytics, Morgan Stanley Research

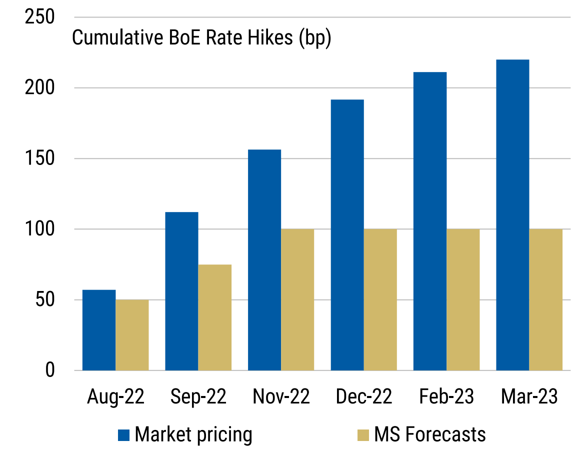
Higher rates no longer translate to higher FX: The GBP price action on the back of the inflation surprise was telling. The usual playbook of "higher rates, stronger FX" is no longer in play here. Despite a 35bp increase in 2-year differentials between the UK and the US, GBP/USD was largely flat to down on the day (Exhibit 82). In fact, the higher the inflation, the more the central bank has to hike in spite of decelerating growth and it is the need to hike into a recessionary environment that drives GBP weakness, in our view.

Exhibit 82: Higher front-end rate differentials did not translate to strong GBP/USD



Source: Bloomberg, Morgan Stanley Research

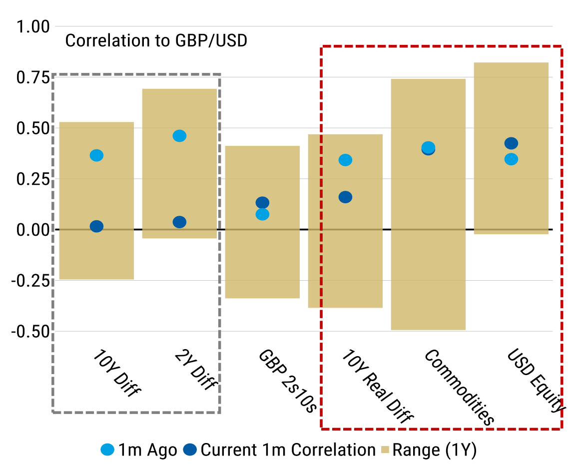
Exhibit 83: Markets are still pricing in too much tightening in our view



Source: Bloomberg, Morgan Stanley Research forecasts

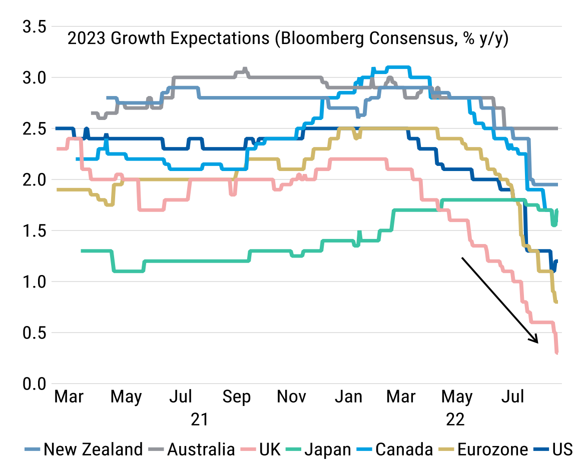
Growth expectations and the broader risk backdrop continue to be the main drivers of GBP: We have been of the view that GBP is driven by global factors (risk backdrop and the USD) and UK growth expectations, more so than nominal rate differentials. This has increasingly been the case, with 1-month correlations of GBP/USD to 2-year and 10-year rate differentials falling to 0 in the past month (Exhibit 84). We see this dynamic continuing, and low growth expectations in the UK, both in absolute terms and relative to the rest of the G10, should continue to weigh on GBP (Exhibit 85).

Exhibit 84: GBP is increasingly driven by global factors and growth expectations rather than rate differentials



Source: Bloomberg, Morgan Stanley Research

Exhibit 85: UK growth expectations have fallen sharply and are now the lowest in G10

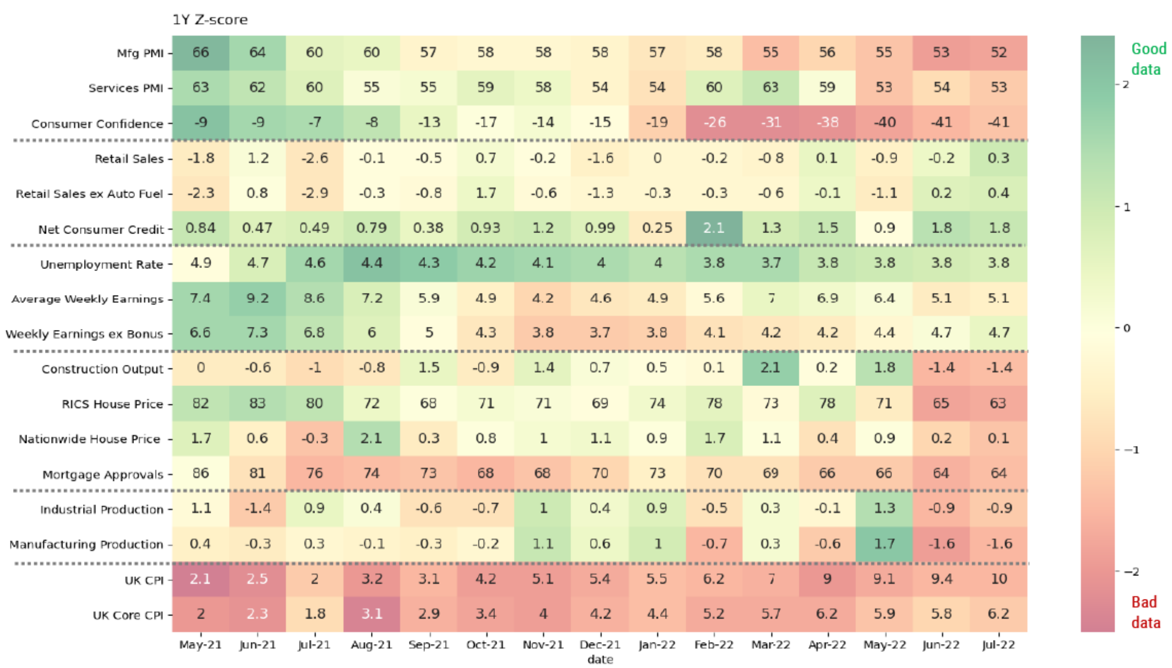


Source: Bloomberg, Morgan Stanley Research

What do macro indicators look like now? Below we flag some key economic indicators we are watching and how they have evolved over the past year (Exhibit 86). Most indicators have deteriorated over in the past few months (the redder it is, the worse a picture the indicator paints), with inflation rising to 40-year highs, manufacturing sector weakening, house prices falling and PMIs and consumer confidence continuing to point to a deteriorating economic outlook.

In contrast, the labour market remains extremely tight, with pay growth continuing to be solid. Retail sales have also held up decently well, supported by online sales in July. We will be watching these indicators closely as potential next shoes to drop.

Exhibit 86: How have UK economic indicators evolved?

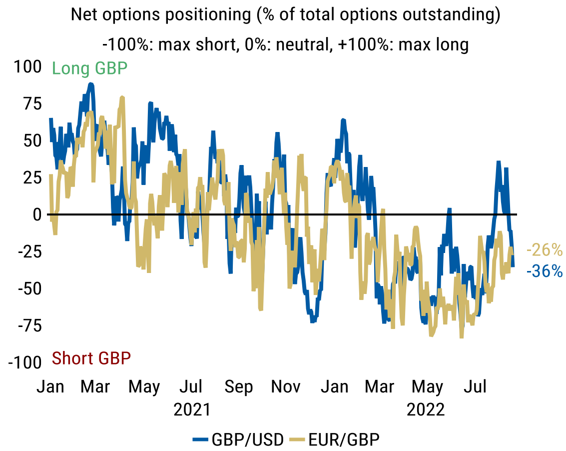


Source: Bloomberg, Morgan Stanley Research

What does this mean for GBP? Given its positive correlation to risk, we expect GBP/USD to be largely driven by the broader risk outlook and the USD. But hiking into a stagflationary scenario (increasingly the case for the UK) does not bode well for the currency, in our view. A continued deterioration in the UK's growth outlook should keep GBP weak. The pricing of more rate hikes will also be negative for the currency, as it only accelerates the growth slowdown.

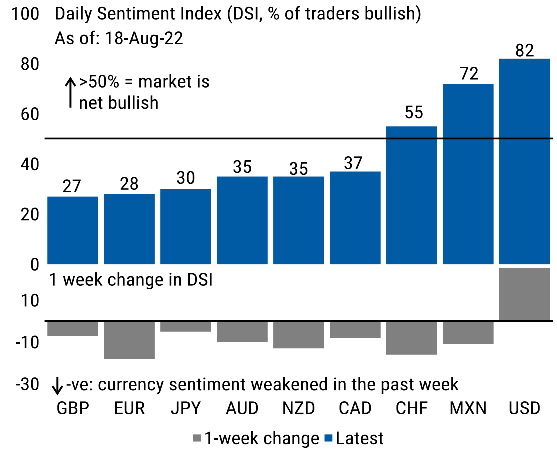
As such, **we stay neutral on GBP but think downside risks remain.** Given the UK's poor growth outlook and persistently high inflation weighing on households, we continue to see GBP underperforming its risk-sensitive peers in a USD rally. That said, we do not see a sharp leg lower in GBP from here, given already low growth expectations , still short GBP positioning (Exhibit 87) and very bearish sentiment (Exhibit 88).

Exhibit 87: Short-term positioning remains short GBP, both against the USD and EUR



Source: DTCC, Bloomberg, Morgan Stanley Research. Options positioning data as of August 18, 2022

Exhibit 88: Futures traders are most bearish on GBP



Source: www.trade-futures.com, Morgan Stanley Research

G10 | Close short EUR/NZD

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We recommend closing short EUR/NZD positions.

Our recommendation was based on a view that a relatively hawkish RBNZ would raise medium-term NZ rates expectations, reducing the inversion of the 1s5s OIS curve.

In addition, we expected investor risk demand to improve as risks of a global recession abated. In our view, relatively resilient US data and a declining US inflation path would reassure investors about risks that the Fed would drive the US economy (and the global economy) into recession in the coming year.

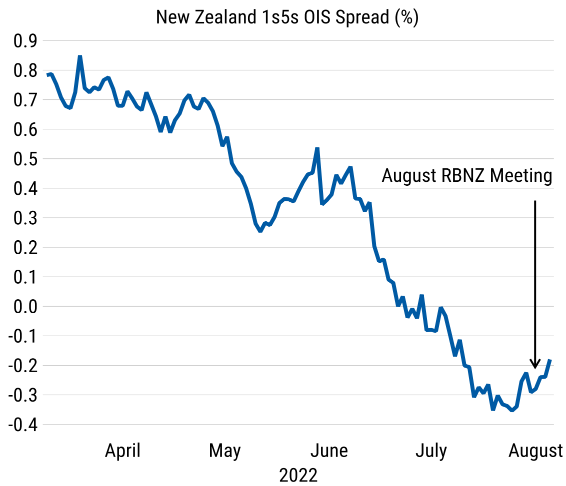
We expected these factors to boost NZD given NZD's sensitivity to global investor risk demand.

While investors continue to believe that US inflation moderates over the coming year (Exhibit 90), rising core y/y inflation prints in Canada and the UK and a surprisingly high German PPI print this week also challenged the narrative that global inflation has passed its peak as supply dynamics improve.

In addition, European energy developments this week (see Paying Top USD to Reduce EUR Risk) and myriad risks to the Chinese economy have soured investor sentiment on global growth this week.

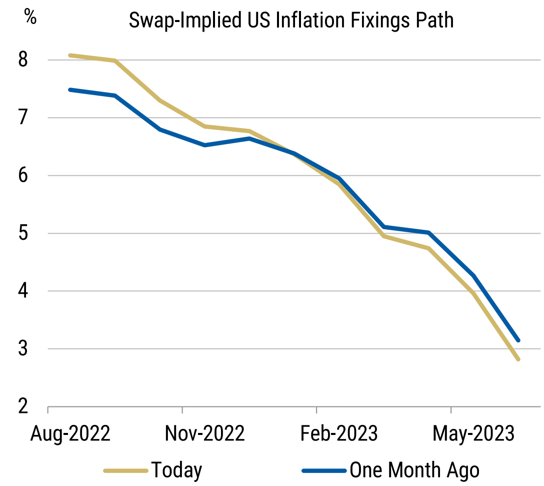
Developments this week have weighed especially on risk-sensitive currencies, including ZAR and COP. NZD has underperformed as well. While the US growth outlook may be better than expected, global risk demand may suffer anyway if the rest of the world looks increasingly challenged.

Exhibit 89: 1s5s OIS has risen



Source: Bloomberg, Morgan Stanley Research

Exhibit 90: US inflation is expected to moderate



Source: Bloomberg, Morgan Stanley Research

Have risks to global growth been fully priced in?

Our China economists have flagged rising downside risks to their forecasts, which are already below the sell-side median. We have little clarity regarding the duration of the PBoC easing cycle. Risks from the housing sector are "non-linear," according to our China equity analysts. And policymakers appear committed to maintaining their "dynamic COVID zero policy."

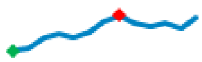
Given the difficulty of gauging the risks to AxJ growth (and the concomitant risks to global investor optimism), we turn neutral on NZD.

Trade idea: Close short EUR/NZD

G10 | Currency Summary

USD

5.9%



Our view: Bullish **Risk skew: Bullish**

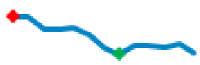
Watch: New Home Sales, Durable Goods, Jobless Claims, GDP Revision, PCE, UMich, Jackson Hole

DXY **Support:** 107.00, 106.25, 105.50, 104.75, 103.75, **Resistance:** 108.75/109.00/109.25, 111.25, 113.50

We stay bullish on the USD particularly versus the EUR. Financial conditions have loosened to the equivalent of 100bp in rate cuts, largely eroding the tightening effect of the Fed's 150bp in hikes since the June meeting. Markets are underpricing the stickiness of inflation, the Fed's resolve in tackling it, and the tightening required to achieve it. The loosening in financial conditions suggests a re-tightening may be required as growth remains robust and the labor market remains tight. Chair Powell's Jackson Hole speech may be an important catalyst to refocus market attention on "higher for longer" US rates.

EUR

-6.1%



Our view: Bearish **Risk skew: Bearish**

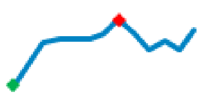
Watch: German IFO, Eurozone M3, PMIs

EUR/USD **Support:** 1.0000, 98.75/99.00, 97.00/25, **Resistance:** 1.0200, 1.0350/75, 105.00, 1.0600, 1.0650

We remain bearish on EUR both versus the USD and on crosses like NZD. High energy prices and drought conditions continue to dampen the growth outlook, which was already appearing uncompelling, and the probability of a deeper-than-expected recession into the winter months seems to be increasing. The ECB may limit its normalization in response to such weak growth prospects despite high inflation, while political uncertainties remain elevated.

JPY

7.5%



Our view: Neutral **Risk skew: Bearish**

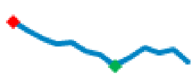
Watch: Weekly Mof ata, Tokyo ku CPI, BoJ board member speech

USD/JPY **Support:** 135.50, 134.50, 133.00, 132.00, **Resistance:** 137.50, 139.00, 139.50, 141.50, 145.50

We maintain bearish risk skew for JPY. While July FOMC minutes have a balanced tone, the Fed continues to adopt a data-dependent approach and sees the intention to hike rates into restrictive territory. Given the relatively firm US economic data recently, we see the room for US-implied terminal rates to reprice higher, suggesting higher USD/JPY via policy divergence. If the US market priced in the implied terminal rate of 4.0%, we see the chance for USD/JPY to touch 140.00. Worsening of Japan's terms of trade via elevated energy prices also help weaker JPY, particularly against the currencies that are less dependent on imported energy, since Japan is highly depended on import for energy products and higher energy prices typically weigh on the Japanese economy.

GBP

-5.7%



Our view: Neutral **Risk skew: Bearish**

Watch: Retail Sales, PMI, DMP Survey, House Prices

GBP/USD **Support:** 1.1800, 1.1700, 1.1650, 1.1450, **Resistance:** 1.2025, 1.2300, 1.2400, 1.2475, 1.2600

We remain neutral on GBP but continue to see downside risks. The recent upside surprise in inflation, with UK CPI rising to a 40-year high of 10.1% in July, led to a sharp repricing in the front-end of the UK rates curve but did not translate into GBP strength. We think such price action is telling of the change in the reaction function of GBP to rate differentials and market expectations of policy tightening, as more policy tightening accelerates the growth slowdown, leading to GBP weakness. We continue to see the weak growth outlook weighing on GBP. However, we do not see a material leg lower in GBP from here given how low growth expectations already are and how bearish sentiment is already on GBP. Short-term positioning remains short GBP, particularly against the EUR.

CHF

0.2%

Our view: Neutral **Risk skew: Bullish**

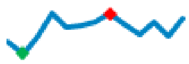
Watch: Sight Deposits, KOF Leading Indicator, Inflation, Retail Sales, Manufacturing PMI, GDP, Unemployment Rate

EUR/CHF **Support:** 0.9600, 0.9350, 0.9000, 0.8500/25, **Resistance:** 0.9700, 0.9800/25, 1.0050, 1.0150

We remain constructive on CHF and see further upside from here. The bleak euro area outlook heading into winter should keep EUR/CHF under pressure following any near-term consolidation, and we see a low of 0.95 being reached by September. At the same time, the market is increasingly pricing more persistent inflation in Europe, with year-ahead electricity prices continuing to push higher. This has negative implications for the SNB, which has been using the currency to lean against inflationary pressures from abroad. More persistent inflation in the euro area suggests the SNB will thus persist with its preference for a stronger currency. One factor we are watching closely is positioning, with the market being very bearish on EUR/CHF, in our estimates. Still, we think positioning is unlikely to prevent another move lower in EUR/CHF, particularly if our expectation of EUR/USD breaking below parity again is realised.

CAD

2.0%



Our view: Neutral **Risk skew: Neutral**

Watch: Business Barometer

USD/CAD **Support:** 1.2825, 1.2775, 1.2625, 1.2525, 1.2475, **Resistance:** 1.3125/75, 1.3225, 1.3350, 1.3425

We expect CAD to outperform against other risk-sensitive currencies like AUD and SEK. Relatively robust North American growth, rising energy prices, and rising y/y core inflation data this week should also maintain relative CAD strength. However, we continue to expect USD/CAD to rise. Our commodity strategists see evidence of demand destruction limiting upside potential for energy prices. In addition, core inflation metrics have been declining on a month-on-month basis, potentially allowing the BoC to slow its pace of tightening.

AUD

-3.5%

Our view: Neutral **Risk skew: Bearish**

Watch: PMIs

AUD/USD **Support:** 0.6775, 0.6700, 0.6550/75, 0.6500, **Resistance:** 0.7125/50, 0.7275, 0.7350, 0.7450

AUD may suffer in line with global risk demand as the global growth outlook looks increasingly challenged. Rising core y/y inflation prints in Canada and the UK and a shockingly high German PPI print this week also challenged the narrative that global inflation has passed its peak as supply dynamics improve - necessitating further central bank tightening. In addition, our China economists have flagged rising downside risks to their forecasts. In addition, soft wage and labor market prints this week may raise concerns about the durability of the RBA hiking cycle.

NZD

-4.7%

Our view: Neutral **Risk skew: Neutral**

Watch: Retail Sales

AUD/NZD **Support:** 1.1000, 1.0925/75, 1.0850/75, 1.0750, **Resistance:** 1.1150/75, 1.1200, 1.1300, 1.1350

The RBNZ was relatively hawkish this week, and 1s5s OIS curve has become less inverted as 5y rate expectations have gained. However, Governor Orr said that the Reserve Bank is moving towards the point where the next rate move is not obvious. While this statement may have been implicit from the Bank's OCR forecast, it may soften front-end NZGB yields and weigh on NZD. In addition, given the difficulty of gauging the risks to AxJ growth (and the concomitant risks to global investor optimism), we turn neutral on NZD and no longer recommend short EUR/NZD positions.

SEK

7.3%

Our view: Bearish **Risk skew: Bearish**

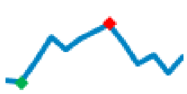
Watch: Retail Sales, Economic Tendency Survey, Consumer Confidence, PMIs, GDP

EUR/SEK **Support:** 10.50, 10.34, 10.22/24, 10.12, 10.08, **Resistance:** 10.64, 10.72/73, 10.74

We stay bearish on SEK and see it underperforming its risk-sensitive peers (NOK in particular) in a risk rally. A combination of weakening growth backdrop, import, Sweden's high sensitivity to euro area growth, and falling inflation leading to the pricing out of some policy tightening drive our SEK bearish view. While risk sentiment remains the main driver of SEK, we think the weak economic fundamentals mean SEK is likely to underperform NOK in the risk rebound. We continue to like recommending long NOK/SEK, which should benefit from the current risk rally.

NOK

3.1%



Our view: Bullish **Risk skew: Bullish**

Watch: Norges Bank Daily FX Purchases, Industrial Production, Unemployment Rate, GDP, Inflation

NOK/SEK **Support:** 1.0575, 1.0400, 1.0250, 1.0125/50, **Resistance:** 1.0875, 1.0975, 1.1150

We stay bullish on NOK and long NOK/SEK with a target of 1.09. Norges Bank voted unanimously for a 50bps hike at its August meeting. Although the central bank provided open-ended forward guidance for September, our economists expect another 50bp hike in September and a terminal rate of 3.0%. Global factors (like risk sentiment and commodity prices) continue to be more important drivers of NOK than domestic developments, but a sufficiently hawkish Norges Bank has also been supportive for the currency through 2y yield differentials. We continue to have a relative preference for Norway over Sweden, given Norway's better economic fundamentals, lower dependency on the euro area, and support from higher oil and gas prices.

Charts show 3M performance against USD, as normally quoted and DXY for USD. Click on any currency for a reference webpage on Matrix.

Inflation-Linked Bonds

United States

We are excited to introduce our new Inflation-Linked Market Strategy Publication. This weekly collaborative piece will provide commentary on inflation market pricing, model updates, and fixings data. Please note that we will still be contributing to the Global Macro Strategist.

Breakevens rose across the curve, led by the back end. The move was driven by a bear-flattening in the nominal curve. The 30y TIPS yield dropped on the week, after a strong reopening auction on Thursday. Commodities fell, though their affect was muted by increased concerns around persistent inflation.

The theme of the week has been continued pricing of sticky inflation. On the month, sub-1y fixings have priced downward pre-December CPI releases, while '23 fixings out to July have moved upward. A similar story holds for forward pricing, with the 2y1y through 5y1y points all moving upward vs. prior months.

To disentangle the economic vs. technical aspects of inflation pricing, we updated our 5s30s two-stage regression model. This model controls for short-term inflation pricing and technical factors to explain the structure of the 5s30s BE curve. We find signs that pricing dynamics are diverging from the past several years, as the market "pushes" inflation into the future.

We continue to recommend buying forward inflation. Our preferred play has been buying the 1y1y forward, using zero-coupon inflation swaps. For investors who prefer using breakevens, our TIPS-equivalent recommendation is to combine the Jul23 and Jul24 breakevens

United States | Here to stay

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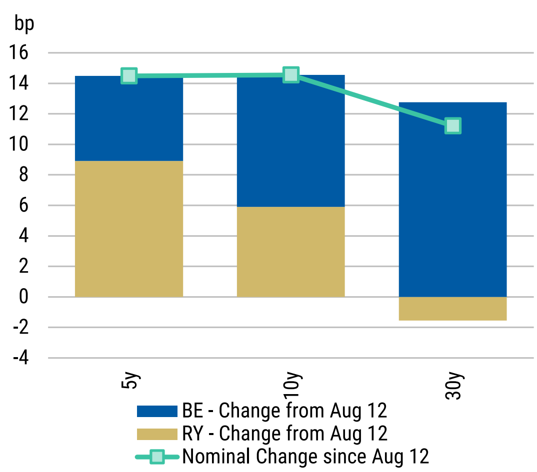
We are excited to introduce our new Inflation-Linked Market Strategy Publication. This weekly collaborative piece will provide commentary on inflation market pricing, model updates, and fixings data. Please note that we will still be contributing to the Global Macro Strategist.

Breakevens rose across the curve, led by the back end. The move was driven by a sell-off in treasuries, as the nominal curve bear-flattened. The real yield curve twist flattened, with the 30y TIPS closing out the week down ~2bp. Sub-1y fixings were lower on the week, with '22 releases underperforming vs. '23 releases.

The drop in the 30y TIPS yield came after a strong reopening auction on Thursday. The auction statistics were stronger than the previous three auctions, with the 2.69 bid-to-cover well above the previous 2.17 value (see Exhibit 92). Coming one week after a weak 30y nominal auction, these results suggest a large investor base demanding back end US inflation-linked paper.

Exhibit 91: Weekly Moves in UST, RY, and BE



Source: Bloomberg, Morgan Stanley Research

Exhibit 92: 30y Auction Stats vs. Previous 3 Average

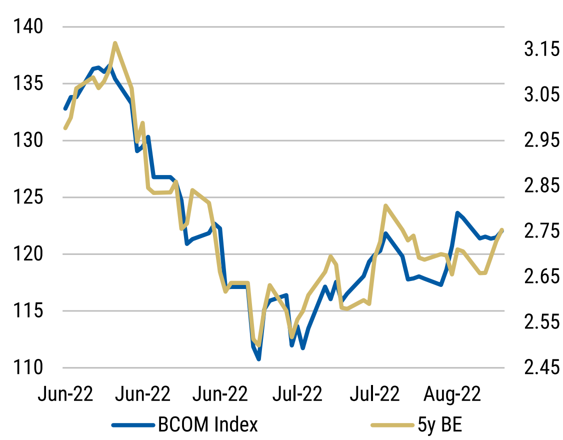
Statistic	8/18/22 Auc	Avg Past 3 Auc
Bid-to-cover	2.69	2.27
Dealer award	11.1%	16.7%
Direct award	12.0%	12.3%
Indirect award	76.9%	71.0%

Source: Bloomberg, Morgan Stanley Research

Commodities (ex natgas) continued showing weakness on the week. Brent was down $2/bbl as of this morning, having reached intraweek lows of ~$91/bbl on Wednesday. Our estimates suggest this drop should have translated into a ~4bp drop in front-end breakevens. The divergence between breakevens and commodities is all the more notable since the two have been co-moving heavily over the past three months (see Exhibit 93).

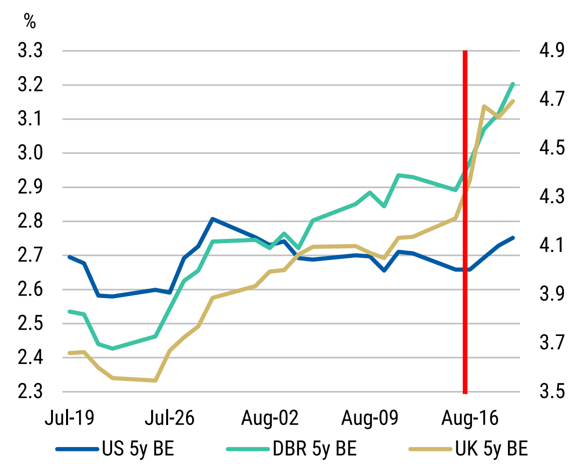
A partial explanation for the support in breakevens can be seen in Wednesday's UK CPI release. The 10.1% reading came in well above consensus expectations, and led to a large upward repricing in UK breakevens and RPI fixings, in addition to a ~5bp widening in the US 5y BE (see Exhibit 94). As we discuss below, recent inflation releases across the globe point toward sticky inflation – and price action this week indicates the US is no exception.

Exhibit 93: BCOM vs. 5y BE over past 3m



Source: Bloomberg, Morgan Stanley

Exhibit 94: US, UK, and EU 5y BE post-UK CPI Release

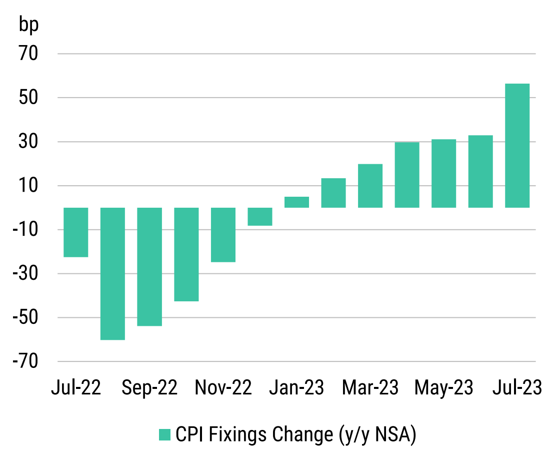


Source: Bloomberg, Morgan Stanley Research

Residual Stickiness

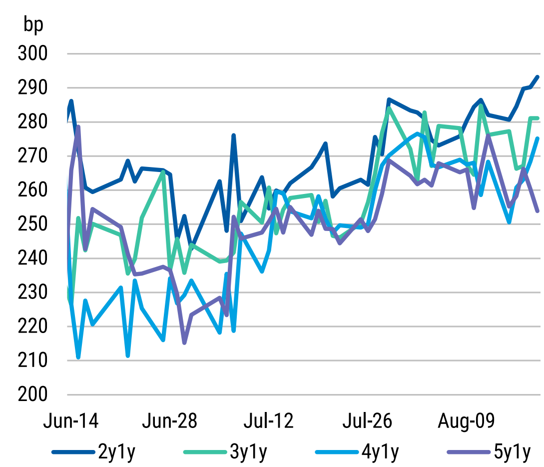
The theme of the week has been continued pricing of sticky inflation. On the month, sub-1y fixings have priced downward pre-December CPI releases, while '23 fixings out to July have moved upward (see Exhibit 95). A similar story holds for forward pricing, with the 2y1y through 5y1y points all moving upward vs. prior months (see Exhibit 96).

Exhibit 95: August 19 fixings vs. 1 month ago



Source: Morgan Stanley Research

Exhibit 96: Forward Swaps pricing since June '22

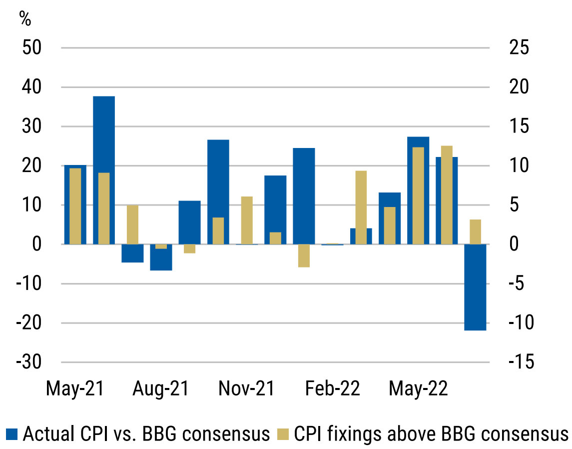


Source: Bloomberg, Morgan Stanley Research

Sticky inflation has been central to our long 1y1y US inflation recommendation. Our view is economically founded in the fact that Philips-curve sensitive CPI components will make dropping from 5% to 2% CPI slower than 9% to 5% (see The Sticky Inflation Problem). The last CPI print, combined with improvements in our economists' MSSCI index, supports this view – "froth" will come off, but a sticky CPI base has been set.

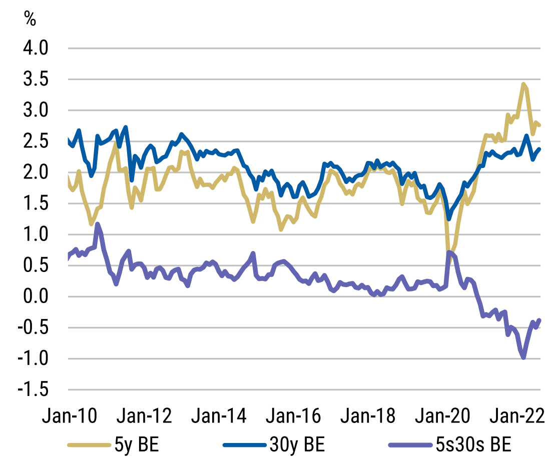
Of course, fixings, and inflation swaps more generally, are market prices. This means they do not represent pure inflation expectations, but rather also include a "term premium." Consider, for example, that fixings generally trade in line with Bloomberg medians, but not perfectly so (see Exhibit 97).

Exhibit 97: Fixings term premium vs. BBG Consensus



Source: Bloomberg, Morgan Stanley Research

Exhibit 98: 5y BE, 30y BE, and 5s30s BE curve



Source: Bloomberg, Morgan Stanley Research

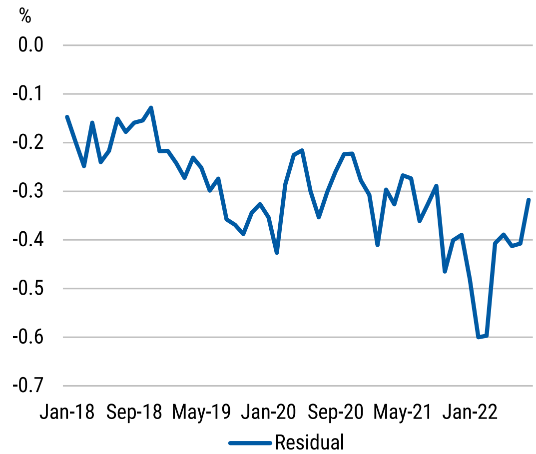
It is thus important to disentangle the economic vs. technical aspects of inflation pricing. To do so, we updated our 5s30s two-stage regression model. The first stage regresses the 5s30s BE curve on the 5y BE (58% R^2), a proxy for the effect of short-term developments on inflation pricing (e.g., commodities prices, central bank policy).

The model residual measures how the present 5s30s structure compares against short-term inflation pricing. Negative values indicate the observed 5y BE level is usually associated with a steeper 5s30s curve, i.e., the 30y is not priced as high as short-term inflation justifies it should be. Positive values indicate the opposite.

Taking a look at the results in Exhibit 99, we see that the model residual has been trending downward for several years. In other words, the 5s30s curve has been flatter than the economic factors embedded in the 5y BE can be explain. Starting in 2022, however, the 5s30s curve has steepened toward model-implied levels.

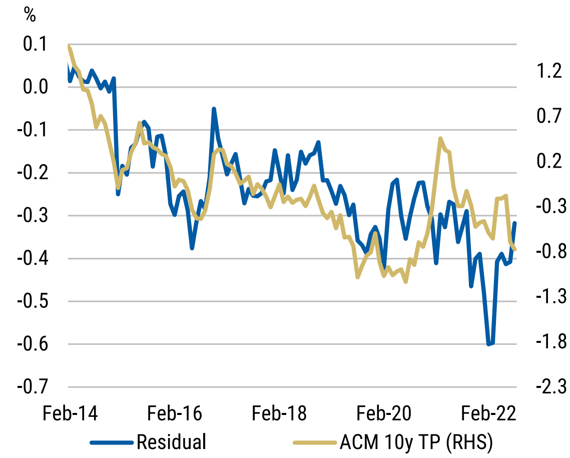
To understand what might be driving the flattening, we next regress the residual against the 10y Adrian-Moench-Crump (ACM) term premium (70% R^2). The correlated relationship between the two variables suggests that part of the excessive flatness in the 5s30s curve is attributable to compression in term premia (see Exhibit 100). Since the term premia have been compressed as a result of technical factors, namely QE and pension fund flows, this shows that technical factors remain important in explaining BE flatness.

Exhibit 99: First Stage Regression Residuals



Source: Bloomberg, Morgan Stanley Research

Exhibit 100: First Stage Regression Residuals vs. 10y ACM TP



Source: Bloomberg, NY Fed, Morgan Stanley Research

We do note, however, that term premiums have been trending downward, while the residual has continued moving upward (see Exhibit 100). The divergence between the two variables signals that the steepening of the 5s30s curve is not a result of short-term inflation or technical term premium factors. Rather, it points toward a willingness to price inflation into the future, a further sign of sticky inflation.

In this light, we continue to recommend buying forward inflation. Our preferred play has been buying the 1y1y forward, using zero-coupon inflation swaps. For investors who prefer using breakevens, our TIPS-equivalent recommendation is to combine the Jul23 and Jul24 breakevens.

Trade idea: Maintain long 1y1y US CPI swaps
Trade idea: Maintain long July '24 TIPS BE vs. short July '23 TIPS BE

Short-Duration Strategy

United States

Elevated demand for current 2yr notes this week as measured by the cash-OIS spread has been reflected in increased special repo activity in bilateral funding markets. Over the past 10 days, 2yr notes have outperformed OIS by ~11bp. We attribute this move to short-covering and potential increased demand for the sector.

We also examine how dealer net positioning and thin liquidity as measured by bid/ask spreads could lead to further "specialness." We also evaluate the effect that this dynamic has on SOFR and curve shape.

Finally, we conclude that these episodes of sudden richening in the front-end on the back of short-driven demand could reoccur in the future as we navigate the current hiking cycle.

Euro area

We update our model on the FRA/€STR basis. The discount on the 2023 basis is lower than on the 2022 one, but the compression move on credit indices seems behind us and equity volatility is back to very low levels. We think the recent setback is an opportunity to add long basis trades. We keep our long June 23 FRA/€STR basis widener.

United States | Feeling special

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Popular 2s

Following this year's theme of ample liquidity in the front-end, funding markets continued to be well-behaved this week, with SOFR printing below the ON RRP award rate (228bp vs. 230bp as of 8/18). Moreover, tri-party GC (general collateral) repo came in 4bp below the ON RRP this week (226bp vs. 230bp).

This is despite $74bn in US Treasury net supply this week. As we mentioned last week (see here), GC is likely to stay well supported as MMFs are currently allocating over $2.6tr to repo as they keep a low WAM.

Nonetheless, a notable development this week in repo has been the current (on the run) 2yr note trading "special." As a recap, repo (an agreement to borrow cash in exchange for Treasury collateral) can either trade as GC (general collateral) or bilateral (specific security). Hence, a security is said to be trading "special" when the repo rate is lower than that offered by GC.

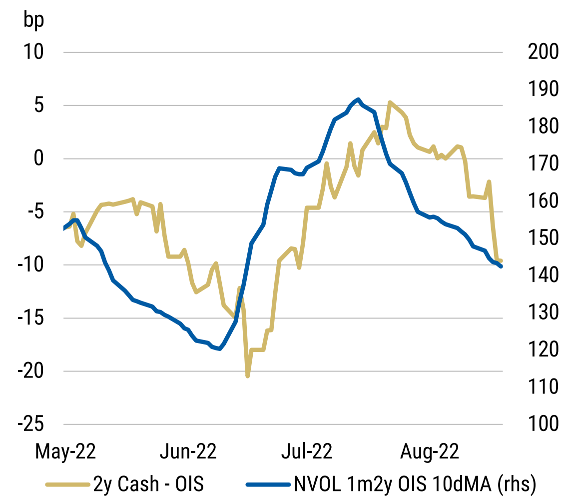
Elevated demand for a particular security makes lenders in bilateral repo willing to earn a lower return for their cash in exchange for securing a "special" security (in this case, the current 2yr note). This week, we saw this dynamic play out as 2yr notes traded intraday as low as ~110bp in repo yesterday (8/18), over 120bp below GC.

This increased demand is evidenced by looking at the 2y cash-OIS spread (nominal 2y rate vs. 2y OIS), which has declined by ~11bp month-to-date as of yesterday's close (Exhibit 101). This outperformance of 2y nominal rates vs. OIS generally reflects that the 2y note is trading richer and in high demand from investors.

Exhibit 101: 2y Cash-OIS has declined, reflecting increased demand

Source: Bloomberg, Morgan Stanley Research

Exhibit 102: Over the past few months, demand has picked up when volatility declines



Source: Bloomberg, Morgan Stanley Research

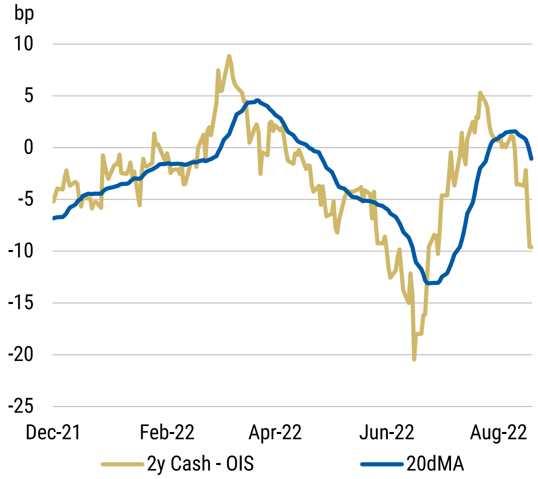
Who wants it?

In a hiking cycle, investors might want to take advantage of expected higher rates by shorting the front part of the curve. To establish this short position, the investor would likely borrow a liquid on-the-run security (through repo) and sell it to the market. The cash that is generated from the sale is then used to pay the security lender in the bilateral repo transaction.

This allows the investor to benefit if rates increase as they will purchase the security again in the market at a lower price and deliver this cheaper collateral to close out the position. Given that 2y rates have sold off by ~250bp this year, being short has paid off. However, a short base naturally creates pent-up demand that is "unleashed" when fast money investors decide to realize profits or are stopped out of their short positions.

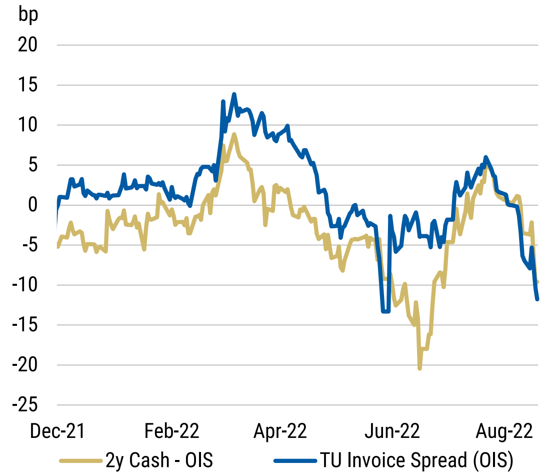
As we have seen over the past few months (Exhibit 102 above), demand for 2y notes as measured by cash-OIS increases after volatility declines. If the market believes it has greater visibility on the future path of hikes, money sitting in the sidelines or in the very front end could get redeployed back into the 2y sector. This same shift in market sentiment could then lead shorts to cover their positions, leading 2y notes to richen further.

Exhibit 103: 2y cash-OIS has been more variable since the start of the hiking cycle



Source: Bloomberg, Morgan Stanley Research

Exhibit 104: 2y notes (cash) and TU (futures) vs. OIS



Source: Bloomberg, Morgan Stanley Research

Exhibit 103 shows 2y cash-OIS relative to its 20-day moving average. Since the start of the hiking cycle, episodes of cheapening (higher cash-OIS) have been followed by periods of richening (lower cash-OIS).

This makes intuitive sense as an above-average cash-OIS spread signals selling pressure and the establishment of new shorts, while a below-average spread shows renewed demand and short-covering. This dynamic saw 2y cash-OIS trade as low as -20bp in mid-June and 2y repo ~200bp lower than GC.

Also, we could compare the 2y cash-OIS spread with the TU (2y futures) invoice OIS swap spread to quantify how rich 2y notes are trading on the back of increased short-covering demand relative to futures. As shown in Exhibit 104, 2y cash – OIS in June bottomed at -20bp, while TU was 16bp cheaper at -4bp relative to OIS.

So far, TU and 2yr notes have moved richer in tandem, suggesting that short covering is likely occurring both in cash and futures. Future divergence could serve as a potential signal on the likelihood of mean reversion.

Who has it?

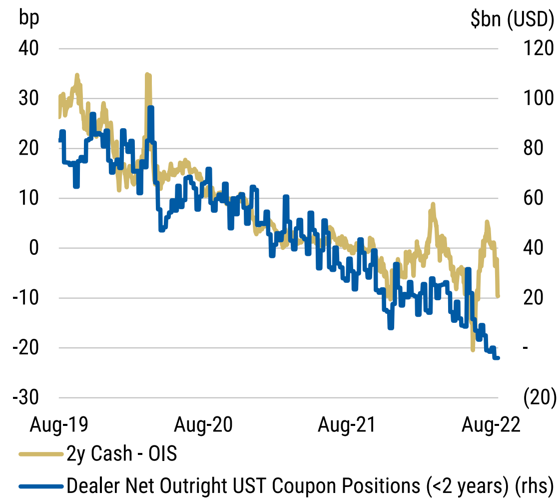
Supply factors could also lead to repo trading special for a specific security. As we saw above, when a specific CUSIP trades special in repo, it also trades rich in the "cash" market. This is because dealers will go to the repo market and source securities that are in high demand and not readily available in their inventory. This dynamic gets magnified depending on the availability and cost of this collateral.

Starting with availability, we can look at weekly data on net dealer positioning in the sector. As expected, an increase in selling activity results in cheaper 2y notes vs. OIS and higher dealer net positioning. Similarly, increased demand leads 2y notes to richen vs. OIS and results in lower dealer net positioning.

Exhibit 105 shows that dealers have significantly reduced the lendable supply of <2y US Treasury notes in their balance sheets and were net short as of last week. This leads to a reduced inventory of collateral available for repo and suggests that dealers will continue to tap into the repo market to source 2y notes while strong demand persists.

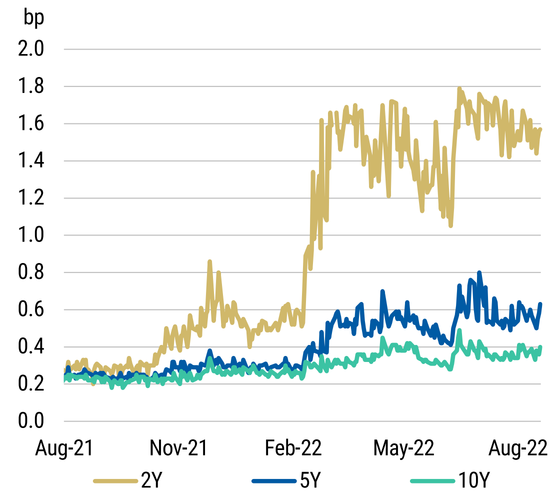
Also, the recent divergence in 2y cash-OIS vs. dealer net positioning could explain the pace of richening in 2y notes on the back of increased demand.

Exhibit 105: Dealer net positioning has declined significantly



Source: Federal Reserve, Bloomberg, Morgan Stanley Research

Exhibit 106: Average bid/ask spreads to on$25k/01 continue to be wide



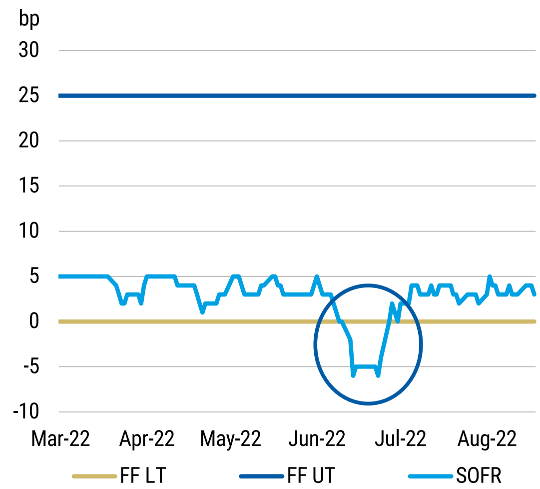
Source: Morgan Stanley Sales Desk, Morgan Stanley Research

In terms of cost, bid/ask spreads continue to be wide in the 2y sector, as shown in Exhibit 106. This translates to 2y notes being more expensive to source in cash markets and, combined with thin dealer positioning, could also increase current 2y "specialness" in repo.

Collateral damage

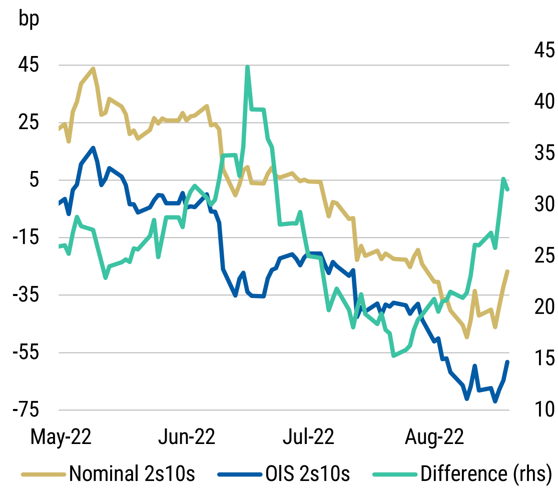
As we have seen in the past, a significantly large increase in special repo activity could temporarily lower SOFR as bilateral repo is included in the calculation. SOFR removes the bottom 25% of bilateral repo transactions but has no other mechanism to isolate special repo activity. As shown in Exhibit 107, during the last episode of short covering and increased special repo activity in June, SOFR printed up to 6bp below the fed funds lower target.

Exhibit 107: SOFR is pulled lower when special repo activity increases



Source: Federal Reserve, Morgan Stanley Research

Exhibit 108: Nominal 2s10s versus OIS 2s10s diverge with increased special repo



Source: Bloomberg, Morgan Stanley Research

Temporary demand for 2y notes due to short covering also magnifies any steepening in nominal rates. As shown in Exhibit 108, cash 2s10s (nominal 10y notes – nominal 2y notes) diverges as expected from OIS 2s10s (10y OIS – 2y OIS) when the 2y swap spread widens. This could make the curve appear "steeper" relative to the market's interest rate expectations as measured by OIS swaps.

As swap spreads mean revert, cash and OIS 2s10s converge and have continued to follow the general flattening trend that we have observed since the start of the hiking cycle. Given our view that the curve will flatten further (see United States | Were the FOMC minutes really dovish?), this dynamic could play out again in future months as a short base lingers in the market.

Looking Ahead

The brew of increased demand combined with poor liquidity could keep 2y swap spreads wider in the coming days as market participants continue to chase collateral. However, settlement of next week's 2y auction at the end of the month and further liquidation of short positions should help with mean reversion in cash-OIS spreads.

Moving forward, front-end swap spreads could remain vulnerable to upticks in demand, leaving the door open for this occurrence to repeat itself in the coming months as the market navigates the current hiking cycle. As discussed, this is an important consideration for investors as wider swap spreads could cause downward pressure on SOFR and magnify any steepening in nominal rates.

Euro area | Revisiting FRA/€STR basis valuation

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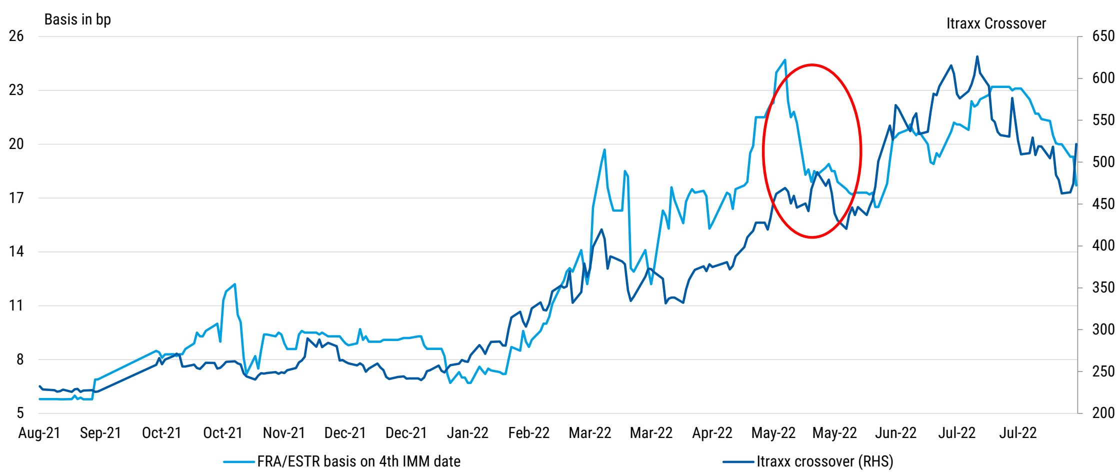
FRA/€STR edging lower since late July

As Exhibit 25 below shows, 2023 FRA/€STR basis have retraced by 5bp since their recent peak on late July. The compression from the peak in July has been consistent with the better price action on credit indices and the protracted decline in equity volatility.

Exhibit 109: FRA/€STR basis has tightened since late July, lagging credit indices



Source: Bloomberg, Morgan Stanley Research

However, as Exhibit 26 illustrates, although two of the three factors behind the dynamics of the FRA/ESTR basis fell, the basis tightening move has been too pronounced, with the current basis remaining too low versus our model. This is especially true for the September and December 22 basis, both of which are 8bp too low. Regarding the 2023 ones, the mispricing is around 3 to 4bp.

Exhibit 110: Observed vs fitted change in FRA/€STER

FRA/ESTR basis 3m changes	Obs 3m change	Theoretical 3m change	Gap (+ive= tighter, -ive= wider)	Current Z score
1st Basis	-7.0	1.8	-8.8	-2.61
2nd Basis	-7.5	1.2	-8.7	-2.53
3rd Basis	-2.0	2.5	-4.5	-1.71
4th Basis	-0.9	2.4	-3.3	-1.11
5th Basis	-0.3	2.3	-2.6	-0.83
7th Basis	-0.3	1.6	-1.9	-0.55

Source: Bloomberg, Morgan Stanley Research

What about the path for FRA/€STR basis over the coming months?

Our equity analysts consider that the equity market has front-run a durable Fed pause – the odds for that scenario being low – and accordingly remain bearish on equities (see Weekly Warm-up: The Challenge with Front-Running a Fed Put), forecasting a resumption of the bear market as soon as September on a repricing of forward earnings.

We think that bearish outlook does not bode well for both equity volatility and credit markets. Hence, we would assume a central scenario over the next three months of a VIX back above 30% and an Itraxx crossover series above 600bp. Regarding the excess liquidity, the most optimistic scenario would be a decline to 4200bn after the September TLTRO repayment, in our view.

For the alternative scenario, we would assume firmer US activity data and stable US risky assets, which could warrant a stable VIX around 20% and further credit outperformance with the Itraxx crossover down to 425bp.

Exhibit 27 below shows the new gap between the current FRA/€STR basis and the new fair value over the coming months. Under our base scenario, the mispricing on the basis would increase by another 3bp all over the maturities, with around a 7bp gap on the 2023 maturities.

Under the alternative scenario, which is a risk on the base scenario, front basis would be still too low by 5bp, while 2023 ones would be close to fair value or still 2bp away.

In conclusion, we do not think that the recent compression in EUR basis is sustainable as the gap to fair value starts to be quite significant. Moreover, there has been a clear change of price action on the EUR credit indices over the past several days. We believe that EUR basis should stabilise soon before widening back. We think investors who agree with our normalisation analysis should take advantage of the recent compression to add or enter 2023 FRA/€STR basis.

Exhibit 111: Observed level vs forward fair value under base and alternative scenarios

3m changes (in bp)	Obs 3m change	Theoretical change in 3m : Base	Gap Base (+ive= tighter, -ive= wider)	Gap Alternative (+ive= tighter, -ive= wider)
1st Basis	-7.0	4.9	-11.9	-4.9
2nd Basis	-7.5	5.4	-12.9	-5.2
3rd Basis	-2.0	8.0	-10.0	-2.8
4th Basis	-0.9	6.1	-7.0	0.1
5th Basis	-0.3	6.8	-7.1	-1.6
7th Basis	-0.3	6.0	-6.3	-2.4

Source: Bloomberg, Morgan Stanley Research

Trade idea: Maintain the long June 23 FRA/€STR basis targeting a return to mid/high 20s

Technical Analysis

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Pivot Points

Pivot points are charting levels used by day traders to determine market direction, support, and resistance levels. We calculate weekly pivot points using the previous week's open, high, low, and closing levels.

Exhibit 112: Government bond yield weekly pivots, support and resistance levels

	UST 10y	CAN 10y	DBR 10y	UKT 10y	JGB 20y	ACGB 10y
Weekly resistance 3	3.330	3.495	1.504	2.426	1.004	3.807
Weekly resistance 2	3.267	3.445	1.465	2.378	0.986	3.725
Weekly resistance 1	3.194	3.387	1.416	2.320	0.968	3.692
Weekly pivot high	3.006	3.237	1.292	2.174	0.918	3.547
Weekly pivot low	2.974	3.212	1.272	2.150	0.908	3.506
Weekly Support 1	2.912	3.162	1.233	2.102	0.890	3.424
Weekly Support 2	2.839	3.104	1.184	2.044	0.872	3.391
Weekly Support 3	2.755	3.037	1.129	1.979	0.849	3.320

Source: Morgan Stanley Research

Exhibit 113: Foreign exchange rates weekly pivots, support, and resistance levels

	DXY	EURUSD	USDJPY	GBPUSD	AUDUSD	USDCAD
Weekly resistance 3	109.47	1.0631	137.60	1.2314	0.6972	1.3202
Weekly resistance 2	108.83	1.0482	137.23	1.2203	0.6945	1.3139
Weekly resistance 1	108.33	1.0389	136.92	1.2135	0.6922	1.3108
Weekly pivot high	106.82	1.0240	136.01	1.2025	0.6853	1.2988
Weekly pivot low	106.50	1.0198	135.82	1.1988	0.6839	1.2956
Weekly Support 1	105.86	1.0091	135.45	1.1914	0.6812	1.2893
Weekly Support 2	105.36	0.9998	135.14	1.1846	0.6789	1.2862
Weekly Support 3	104.66	0.9933	134.72	1.1810	0.6757	1.2804

Source: Morgan Stanley Research

Exhibit 114: Foreign exchange rates weekly pivots, support, and resistance levels

	EURJPY	EURCHF	EURNOK	EURSEK	NOKSEK	AUDNZD
Weekly resistance 3	144.80	1.0133	10.4515	10.8760	1.0645	1.1179
Weekly resistance 2	142.70	1.0064	10.3906	10.8186	1.0590	1.1154
Weekly resistance 1	141.40	1.0022	10.3530	10.7831	1.0562	1.1128
Weekly pivot high	139.30	0.9953	10.2921	10.7257	1.0456	1.1058
Weekly pivot low	138.69	0.9931	10.2767	10.7092	1.0428	1.1046
Weekly Support 1	137.20	0.9884	10.2312	10.6683	1.0373	1.1021
Weekly Support 2	135.90	0.9842	10.1936	10.6328	1.0345	1.0995
Weekly Support 3	135.01	0.9816	10.1635	10.6086	1.0294	1.0963

Source: Morgan Stanley Research

Cyclical and Secular Trends

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Government Bonds

In The Tactical Bull Market Is Back, we discussed a simple methodology based on the Ichimoku Kinko charting technique for classifying market movements as bullish, bearish, or range bound. Then, we define whether the market movement is cyclical or secular in nature. A cyclical move is shorter term in nature, and a secular move is longer term in nature. For cyclical moves, we further divide them into tactical and strategic. We use daily data to inform tactical moves, and weekly data to inform strategic moves. We use monthly data to inform secular movements.

Exhibit 115: Summary of cyclical (tactical & strategic) and secular bull, bear, and range-bound rates markets

	Daily Last	Daily Cloud Lower	Daily Cloud Upper	200d MA	Cyclical Tactical Daily	Cyclical Strategic Weekly	Secular Monthly
UST 2y	3.234	2.944	3.050	2.011	Bear Market	Bear Market	Bear Market
UST 5y	3.093	3.060	3.142	2.289	Range bound	Bear Market	Bear Market
UST 10y	2.972	3.021	3.099	2.349	Bull Market	Bear Market	Bear Market
UST 30y	3.212	3.187	3.205	2.590	Bear Market	Bear Market	Bear Market
DBR 2y	0.824	0.634	0.677	-0.037	Bear Market	Bear Market	Bear Market
DBR 5y	1.042	1.058	1.125	0.286	Bull Market	Bear Market	Bear Market
DBR 10y	1.230	1.366	1.384	0.549	Bull Market	Bear Market	Bear Market
DBR 30y	1.404	1.502	1.588	0.784	Bull Market	Bear Market	Bear Market
UKT 2y	2.525	1.764	1.887	1.335	Bear Market	Bear Market	Bear Market
UKT 5y	2.276	1.834	1.891	1.382	Bear Market	Bear Market	Bear Market
UKT 10y	2.411	2.202	2.232	1.612	Bear Market	Bear Market	Bear Market
UKT 30y	2.714	2.410	2.584	1.818	Bear Market	Bear Market	Bear Market
JGB 10y	0.202	0.243	0.257	0.185	Bull Market	Bear Market	Bear Market
JGB 20y	0.778	0.834	0.889	0.693	Bull Market	Bear Market	Bear Market
JGB 30y	1.089	1.132	1.232	0.945	Bull Market	Bear Market	Bear Market
JGB 40y	1.204	1.280	1.368	1.026	Bull Market	Bear Market	Bear Market
ACGB 2y	2.878	2.698	2.857	1.768	Bear Market	Bear Market	Bear Market
ACGB 5y	3.184	3.312	3.420	2.402	Bull Market	Bear Market	Bear Market
ACGB 10y	3.405	3.665	3.729	2.695	Bull Market	Bear Market	Bear Market
ACGB 20y	3.767	3.905	3.988	3.094	Bull Market	Bear Market	Bear Market
NZGB 2y	3.515	3.448	3.506	2.788	Bear Market	Bear Market	Bull Market
NZGB 5y	3.495	3.594	3.716	3.004	Bull Market	Bear Market	Bull Market
NZGB 10y	3.562	3.839	3.940	3.165	Bull Market	Bear Market	Bear Market
CAN 2y	3.423	2.987	3.207	2.116	Bear Market	Bear Market	Bear Market
CAN 5y	3.075	3.093	3.164	2.263	Bull Market	Bear Market	Bear Market
CAN 10y	2.941	3.204	3.257	2.374	Bull Market	Bear Market	Bear Market
CAN 30y	2.941	3.110	3.170	2.488	Bull Market	Bear Market	Bear Market

Source: Morgan Stanley Research, Bloomberg

Exhibit 116: Summary of cyclical (tactical and strategic) and secular bull, bear, and range-bound FX markets

	Daily Last	Daily Cloud Lower	Daily Cloud Upper	200d MA	Cyclical Tactical Daily	Cyclical Strategic Weekly	Secular Monthly
DXY	108.10	105.30	106.39	100.37	Bull Market	Bull Market	Bull Market
USDJPY	136.97	132.88	136.27	123.80	Bull Market	Bull Market	Bull Market
USDCAD	1.2994	1.2871	1.2959	1.2756	Bull Market	Bull Market	Bear Market
USDCHF	0.9592	0.9749	0.9780	0.9441	Bear Market	Bull Market	Bear Market
USDNOK	9.8138	9.7814	9.9931	9.2391	Range bound	Bull Market	Bear Market
USDSEK	10.5939	10.2036	10.3736	9.6362	Bull Market	Bull Market	Bull Market
EURUSD	1.0037	1.0285	1.0370	1.0861	Bear Market	Bear Market	Bear Market
GBPUSD	1.1829	1.2061	1.2214	1.2876	Bear Market	Bear Market	Bear Market
AUDUSD	0.6875	0.6865	0.6983	0.7141	Range bound	Bear Market	Bull Market
NZDUSD	0.6194	0.6209	0.6319	0.6600	Bear Market	Bear Market	Range bound
EURJPY	137.56	138.47	140.10	134.10	Bear Market	Bull Market	Bull Market
NOKSEK	1.0794	1.0341	1.0372	1.0433	Bull Market	Bull Market	Bull Market
AUDNZD	1.1126	1.1048	1.1048	1.0828	Bull Market	Bull Market	Bull Market
USDBRL	5.1703	5.0905	5.2697	5.2193	Range bound	Bear Market	Bull Market
USDMXN	20.17	20.23	20.46	20.41	Bear Market	Bear Market	Bear Market
USDARS	136.16	121.31	125.50	112.91	Bull Market	Bull Market	Bull Market
USDCLP	944.76	919.93	952.12	847.11	Range bound	Bull Market	Bull Market
USDCOP	4,377.35	4,203.04	4,299.89	3,997.22	Bull Market	Bull Market	Bull Market
USDPEN	3.8645	3.8130	3.8606	3.8468	Bull Market	Range bound	Bull Market
USDZAR	17.00	16.24	16.50	15.72	Bull Market	Bull Market	Bull Market
USDTRY	18.1012	16.1122	16.9629	15.0060	Bull Market	Bull Market	Bull Market
USDILS	3.2673	3.4296	3.4643	3.2688	Bear Market	Bull Market	Bear Market
USDRUB	118.69	76.43	77.44	75.11	Bull Market	Bull Market	Bull Market
USDPLN	4.7326	4.5442	4.6130	4.2940	Bull Market	Bull Market	Bull Market
USDCZK	24.5492	23.7465	23.9395	22.8168	Bull Market	Bull Market	Bull Market
USDHUF	402.51	383.85	394.74	349.57	Bull Market	Bull Market	Bull Market
USDCNY	6.8176	6.6865	6.7217	6.5071	Bull Market	Bull Market	Range bound
USDIDR	14,838.00	14,682.00	14,854.00	14,491.98	Range bound	Bull Market	Range bound
USDINR	79.78	77.72	78.83	76.49	Bull Market	Bull Market	Bull Market
USDKRW	1,325.85	1,276.05	1,292.98	1,235.81	Bull Market	Bull Market	Bull Market
USDMYR	4.4777	4.3896	4.4213	4.2851	Bull Market	Bull Market	Bull Market
USDPHP	55.95	54.29	55.19	52.44	Bull Market	Bull Market	Bull Market
USDSGD	1.3920	1.3879	1.3968	1.3690	Range bound	Bull Market	Bear Market
USDTWD	30.0280	29.4665	29.7678	28.7534	Bull Market	Bull Market	Bear Market
USDTHB	35.6730	35.0875	35.4850	33.9920	Bull Market	Bull Market	Bull Market
GOLD	1,747	1,772	1,804	1,841	Bear Market	Bear Market	Bull Market
SILVER	19.05	19.66	20.71	22.60	Bear Market	Bear Market	Bull Market
CRUDE OIL	90.77	100.71	103.16	89.63	Bear Market	Bull Market	Bull Market

Source: Morgan Stanley Research, Bloomberg

G4 Smarter (beta) Trading Strategy

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Enhancements to a G4 10y government bond futures momentum strategy have produced higher Sharpe ratios and stronger returns, relative to total return government bond indices for the G4, US, Germany, Japan, and the UK since 2000. See A "Smarter" (Beta) Way to Trade G4 10y Futures Duration? for more information on these strategies.

Trading Strategy 1 – "Trade Longs/Fade Shorts"

When the 5-day moving average crosses above the 20-day moving average, buy the futures contract (long duration) and hold for a 25-business-day period. When the 5-day moving average crosses below the 20-day moving average, buy the futures contract and hold for a 25-business-day period. In short, this strategy buys futures when the Simple Moving Average Crossover (SMAX) generates both a long and a short signal, given the historical outperformance of long signals traded long and underperformance of short signals traded short. Given that the SMAX could generate both a long and a short signal within the predefined holding period, an investor may have a 200% long position since each of the two signals would be traded in separate portfolio sleeves.

Trading Strategy 2 – Trade "Longs Only"

When the 5-day moving average crosses above the 20-day moving average, buy the futures contract (long duration) and hold for a 25-business-day period. When the 5-day moving average crosses below the 20-day moving average, do nothing. In short, an investor ONLY trades long signals initiated by the SMAX given their historical precedent to outperform

Exhibit 117: Trading signals for G4 smarter (beta) trading strategy

Current Risk, G4 10y Futures	G4 Strategy Weight	Trade Longs Portfolio	Fade Shorts Portfolio	Total Risk Trade Longs Only	Total Risk Trade Longs/Fade Shorts (max 200%)	Trade Longs Portfolio Entry Date	Trade Longs Portfolio Exit Date	Fade Shorts Portfolio Entry Date	Fade Shorts Portfolio Exit Date
JB 10y Future	32.50%	0%	0%	0%	0%	-	-	8/22/2022	9/28/2022
GE 10y Future	29.25%	0%	100%	0%	100%	-	-	8/17/2022	9/21/2022
US 10y Future	30.50%	0%	100%	0%	100%	-	-	8/12/2022	9/19/2022
UK 10y Future	7.75%	0%	100%	0%	100%	-	-	8/15/2022	9/20/2022

Source: Morgan Stanley Research

Bond Market Indicators

Our BMI(10) models are neutral to mildly bearish on all markets. The vol-adjusted carry signal is positive for Japan. Momentum signals remained broadly bullish. Equity market signals are bullish for all markets, except for the US.

Our BMI(2) models are neutral to bullish for most markets. The vol-adjusted carry signal is positive across all markets, except for the US, New Zealand, and Canada. Momentum signals are bullish for Germany, Japan, and New Zealand. Business cycle indicators are negative for the UK and Japan.

Our iBMI models are neutral for TIPS, UKTi and bearish for HICPxT & JGBi. Equity signal grew less bearish across TIPS, UKTi, HICPxT and JGBi. Momentum signal turned bullish for TIPS, grew more bullish for UKTi ,grew less bearish for HICPxT and JGBi. Oil signal grew less bearish for all the regions.

Latest readings

Exhibit 118: Morgan Stanley Bond Market Indicators - BMI(10)

	Vol-Adjusted Carry	Momentum	Equity Markets	Business Cycle	FX	Average	Overall
US	-9.6 (-9.7)	4.7 (8.6)	-0.7 (-0.3)	0.9 (0.9)	-7.3 (-3.5)	-2.4 (-0.8)	**-2.4 (0.0)**
DE	-9.3 (-9.2)	3.1 (4.5)	2.0 (2.8)	3.4 (3.4)	-5.7 (-8.0)	-1.3 (-1.3)	**0.0 (0.0)**
UK	-7.1 (-5.9)	1.2 (3.0)	2.9 (5.0)	-7.0 (-4.1)	7.9 (3.0)	-0.4 (0.2)	**0.0 (0.0)**
JP	3.1 (4.2)	5.3 (-2.7)	3.0 (5.9)	-8.9 (-8.8)	3.1 (5.5)	1.1 (0.8)	**0.0 (0.0)**
AU	-5.4 (-5.7)	3.1 (4.6)	0.7 (1.6)	5.1 (5.0)	3.7 (2.2)	1.4 (1.5)	**0.0 (1.5)**
NZ	-7.5 (-7.5)	5.2 (6.5)	0.9 (0.4)	7.3 (7.3)	-5.7 (-7.5)	0.0 (-0.2)	**0.0 (0.0)**
CA	-9.9 (-9.9)	5.4 (6.5)	2.2 (4.0)	6.2 (6.1)	2.5 (6.3)	1.3 (2.6)	**0.0 (2.6)**

Source: Morgan Stanley Research
Note: Positive # = long duration; Negative # = short duration, (#) = previous week Thursday close which may differ from the post-nonfarm payroll update, Indicators bounded between -10 and +10, Overall signal set to zero if abs(Signal)<=1.5

Exhibit 119: Morgan Stanley Bond Market Indicators - BMI(2)

	Vol-Adjusted Carry	Momentum	Equity Markets	Business Cycle	FX	Average	Overall
US	-1.4 (0.9)	-7.0 (-7.1)	-0.7 (-0.3)	0.9 (0.9)	-9.3 (-0.4)	-3.5 (-1.2)	**-3.5 (0.0)**
DE	3.7 (2.9)	1.8 (2.3)	2.0 (2.8)	3.4 (3.4)	-4.5 (-5.7)	1.3 (1.1)	**0.0 (0.0)**
UK	5.9 (2.5)	-3.5 (-4.9)	2.9 (5.0)	-7.0 (-4.1)	10.0 (5.0)	1.7 (0.7)	**1.7 (0.0)**
JP	1.3 (-3.9)	9.7 (9.5)	3.0 (5.9)	-8.9 (-8.8)	-7.5 (-0.4)	-0.5 (0.5)	**0.0 (0.0)**
AU	3.9 (3.6)	-0.7 (-1.0)	0.7 (1.6)	5.1 (5.0)	7.9 (5.4)	3.4 (2.9)	**3.4 (2.9)**
NZ	-0.7 (-0.3)	2.7 (4.1)	0.9 (0.4)	7.3 (7.3)	-9.9 (-9.8)	0.1 (0.3)	**0.0 (0.0)**
CA	-4.2 (-5.2)	-7.4 (-6.5)	2.2 (4.0)	6.2 (6.1)	10.0 (10.0)	1.4 (1.7)	**0.0 (1.7)**

Source: Morgan Stanley Research
Note: Positive # = long duration; Negative # = short duration, (#) = previous week Thursday close which may differ from the post-nonfarm payroll update, Indicators bounded between -10 and +10, Overall signal set to zero if abs(Signal)<=1.5

Exhibit 120: Morgan Stanley Bond Market Indicators - xBMIs

	Long US	Long DE	Long UK	Long JP	Long AU	Long NZ	Long CA
vs. US	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	1.8 (0.0)	1.9 (0.0)	0.0 (0.0)	1.8 (1.7)
vs. DE	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (2.0)
vs. UK	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)
vs. JP	-1.8 (0.0)	0.0 (0.0)	0.0 (-1.9)	0.0 (0.0)	0.0 (0.0)	0.0 (-2.1)	0.0 (0.0)
vs. AU	-1.9 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)
vs. NZ	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)
vs. CA	-1.8 (-1.7)	0.0 (-2.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)

Source: Morgan Stanley Research
Note: Positive # = long cross market spreads; Negative # = short cross market spread, (#) = previous week Thursday close which may differ from the post-nonfarm payroll update, Indicators bounded between -15 and +15, Signal is set to zero if abs(Signal)<=2

Exhibit 121: Morgan Stanley Euro Sovereign Bond Market Indicators - eBMI

	Business Cycle Surprises	Momentum	Vol. Adj. Carry	Supply	Risky Assets	Overall
Periphery vs. Core	0.5 (0.6)	0.3 (-6.9)	0.0 (-0.9)	5.2 (5.2)	-0.3 (1.3)	**1.2 (-0.1)**
Semi-Core vs. Core	7.1 (4.9)	-2.3 (-1.3)	5.0 (4.6)	-1.1 (-1.1)	8.5 (9.0)	**3.5 (3.2)**
Periphery vs. Semi-Core	-3.3 (-2.2)	1.3 (-2.8)	-2.5 (-2.7)	3.2 (3.2)	-4.4 (-3.8)	**-2.3 (-3.3)**

Source: Morgan Stanley Research
Note: Positive # = long spreads; Negative # = short spreads, (#) = previous week Thursday close which may differ from the post-nonfarm payroll update, Indicators bounded between -10 and +10.

Exhibit 122: Morgan Stanley Inflation Bond Market Indicators - iBMI

Market	Oil	Momentum	Equities	Value	Average	Overall
TIPS	-1.6 (-3.8)	0.3 (-0.3)	-0.4 (-0.6)	0.9 (1.2)	-0.2 (-0.9)	**0.0 (0.0)**
UKTi	-1.4 (-3.9)	3.6 (1.5)	-1.3 (-1.8)	3.0 (5.5)	1.0 (0.3)	**0.0 (0.0)**
HICPxT	-1.5 (-3.7)	-0.2 (-1.5)	-0.9 (-1.2)	-3.6 (-2.7)	-1.6 (-2.3)	**-1.6 (-2.3)**
JGBi	-1.8 (-4.2)	-1.1 (-1.5)	-1.1 (-1.8)	-5.6 (-6.1)	-2.4 (-3.4)	**-2.4 (-3.4)**

Source: Morgan Stanley Research
Note: Positive # = long inflation breakeven; Negative # = short inflation breakeven, (#) = previous week Thursday close which may differ from the post-nonfarm payroll update, Indicators bounded between -10 and +10, Overall signal set to zero if abs(Signal)<=1.0

How to read the xBMIs

The "FX/Rates" row displays the FX/rates relationship signal. The "Combined BMI differential" row displays the difference between the relevant BMI(10) signals after having applied the signal strength check, i.e., abs(signal) >= 1.5. The "Average xBMI" row displays the average of the "FX/Rates" and "Combined BMI differential" rows. And the "Overall" score requires that the sign of the "Average xBMI" signal match the sign of the "Combined BMI differential" signal and be ≥ the absolute value of 2.

Swap Spread Indicators

Our SSI(2) models imply that 2y spreads are roughly 7.9bp wide to fair value on a 6m rolling lookback. The 1sd trading threshold is met. Our model-implied fair value can be found on Bloomberg using the ticker MSSIUS2 Index.

Our SSI(10) models imply that 10y spreads are roughly 4.5bp tight to fair value on a 6m rolling lookback. The 1sd trading threshold is met. Our model-implied fair value can be found on Bloomberg using the ticker MSSIUS10 Index.

Our SSI(30) models suggest that 30y spreads are 16.9bp tight to fair value on our 2y lookback window. The 1sd trading threshold is met. Our model-implied fair value can be found on Bloomberg using the ticker MSSIUS30 Index.

Based on each of the SSI models, the 2s10s spread curve is ~12.3bp flat to fair value using a 6m lookback. The 10s30s spread curve is about ~4.1bp flat to fair value using our 2y lookback window.

Detail on the variable selection and model construction of these Swap Spread Indicators can be found in Modeling Swap Spreads. Within the piece, we discuss the various fundamental and flow-related drivers of 2y, 10y, and 30y spreads, and use these variables to construct multivariate regression models. We then develop and test trading strategies that employ these models. Updates to model-implied fair values, as well as backtesting of trading signals, can be found below.

Latest readings

Exhibit 123: Morgan Stanley Swap Spread Indicators - Model Implied Fair Values

	6m Rolling Lookback Window	2y Rolling Lookback Window	5y Rolling Lookback Window	Matched-Maturity Swap Spread Level
2y Swap Spreads	22.4	21.7	9.6	30.3
10y Swap Spreads	7.0	10.2	3.8	2.5
30y Swap Spreads	-23.4	-22.2	-17.1	-34
2s10s Swap Spread Curve	-15.4	-11.5	-5.8	-27.7
2s30s Swap Spread Curve	-45.8	-43.8	-26.7	-64.3
10s30s Swap Spread Curve	-30.3	-32.4	-20.9	-36.5

Source: Morgan Stanley Research
Note: The levels shown in the table are the model-implied fair values for each of the spread sectors using various lookback windows. For curves, we calculate model-implied fair value based on the difference between the model-implied fair value of the two individual spreads that make up the spread curve.

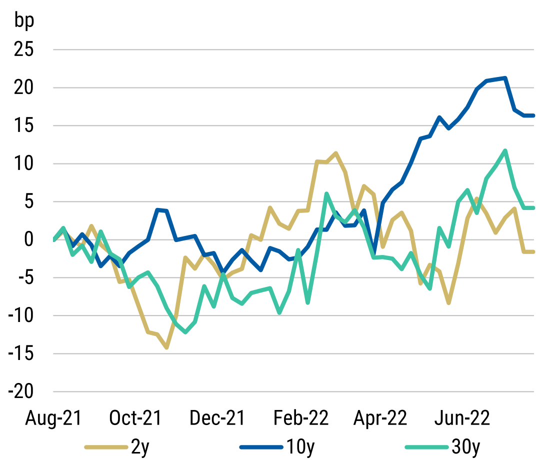
Exhibit 124: Morgan Stanley Swap Spread Indicators - Trading Signals

	Trading Signal*	Trade with 0.5sd threshold?	Trade with 1sd threshold?	Trade with 2sd threshold?
2y Swap Spreads	Tighten	Y	Y	N
10y Swap Spreads	Widen	Y	Y	N
30y Swap Spreads	Widen	Y	Y	N

Source: Morgan Stanley Research
Note: The thresholds are derived from the standard deviation of the difference between model-implied fair value and market values for the preferred rolling window for each spread sector.
*We use our preferred lookback windows for the trading signals. Our preferred lookback windows, based on regression fit an explanatory power, are 6m for 2y and 10y spreads and 2y for 30y spreads.
**For curves, we use 2y rolling regression lookback windows for consistency when constructing the trading signals.

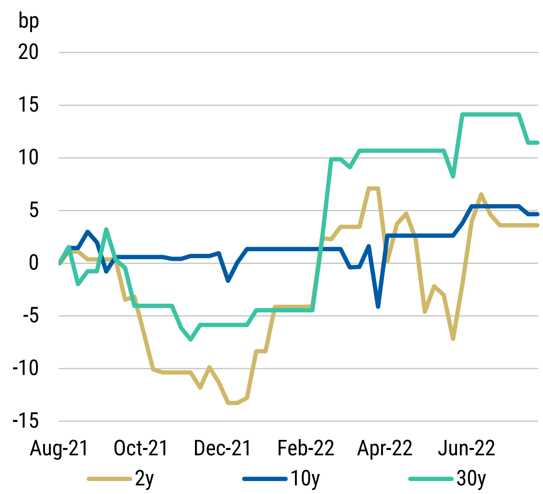
Backtesting results

Exhibit 125: Backtesting results for each spread sector using preferred lookback window and no trading threshold (last 12 months)



Source: Morgan Stanley Research
*Our preferred lookback windows, based on regression fit an explanatory power, are 6m for 2y and 10y spreads and 2y for 30y spreads

Exhibit 126: Backtesting results for each spread sector using preferred lookback window and a trading threshold of 1.0sd (last 12 months)



Source: Morgan Stanley Research
*Our preferred lookback windows, based on regression fit an explanatory power, are 6m for 2y and 10y spreads and 2y for 30y spread

Note about backtesting: The performance data provided is a hypothetical illustration of mathematical principles, it does not predict or project the performance of an investment or investment strategy. Past performance is no guarantee of future results.

Government Bond Supply

In the US, total coupon issuance (new 20y, 30y TIPS re-opening, new 2y, 5y, 7y) settling at the end of August is $149bn vs. $8.8bn coupons and $118.4bn redemptions, resulting in net issuance of $21.76bn. **In the euro area,** we estimate €11bn of issuance (from BEL, GER, ITA and possibly FIN) against no coupons or redemptions, resulting in net issuance of €11bn. **In the UK,** UKTi 0.125% Gilt 2039 will be tapped for £0.75bn against no coupons or redemptions. **In Japan,** there will be two auctions for enhanced liquidity for ¥500bn each, against no coupons or redemptions. **In Canada,** 10y CAN will be issued for an estimated $5bn, against no coupons or redemptions. **In Australia,** ACGB 1.75% June 2051, ACGB 3% Nov 2033 and ACGB 3.25% April 2029 will be issued for $300m, $800m and $700m, respectively, against no cash flow coming to the market. Additionally, ACGBi 0.25% Nov 2032 will be issued for $150mn. **In New Zealand,** NZGB 4.50% 15 Apr 2027; NZGB 2.00% 15 May 2032 and NZGB 2.75% 15 Apr 2037 will be issued for $200m, $150m and $50m, respectively, against no cash flow coming to the market.

Exhibit 127: Sovereign supply calendar

Monday	Tuesday	Wednesday	Thursday	Friday
22-AUG	**23-AUG**	**24-AUG**	**25-AUG**	**26-AUG**
BEL: OLO Auction, €1-2bn* OLO Oct 2027, OLO 0.35% June 2032 ***FIN: Possible New 5y RFGB, €3bn* AUS: ACGB 1.75% June 2051, $300mn	UK: UKTi 0.125% Gilt 2039, £0.75bn US: New 2y UST, $44bn JPN: Auction for Enhanced Liquidity, ¥500bn AUS: ACGBi 0.25% Nov 2032, $150mn	GER: DBR 1.7% 15 Aug 2032 Tap, €4bn US: New 5y UST, $45bn AUS: ACGB 3% Nov 2033, $800mn	ITA: BTPst Auction, €2.5bn* ITA: BTPei Auction Cancelled US: New 7y UST, $37bn JPN: Auction for Enhanced Liquidity, ¥500bn CAN: 10y CAN, $5bn* NZ: NZGB 4.50% 15 Apr 2027, $200mn; NZGB 2.00% 15 May 2032, $150mn; NZGB 2.75% 15 Apr 2037, $50mn	AUS: ACGB 3.25% April 2029, $700mn
29-AUG	**30-AUG**	**31-AUG**	**1-SEP**	**2-SEP**
CAN: 2y CAN, $3.5bn*	ITA: BTP Auction, €6-7bn* JPN: 2y JGB, ¥2800bn*		FRA: Long-term Auction, €9-10bn* SPA: SPGB Auction, €5bn* IRE: IRISH Auction, €1-1.5bn* UK: UKT 0.875% Gilt 2046, £1.7bn* JPY: 10y JGB, ¥2700bn* CAN: 30y CAN, $2bn*	BEL: ORI Auction, €0.5bn*
5-SEP	**6-SEP**	**7-SEP**	**8-SEP**	**9-SEP**
	AUT: RAGB Auction, €1.5bn* UK: UKT 0.25% Gilt 2025, £3.4bn* JPN: 30y JGB, ¥900bn*	GER: DBR 1% May 2038 Tap, €1.5bn UK: UKT 1% Gilt 2032, £2.6bn*	JPN: Auction for Enhanced Liquidity, ¥500bn*	

Source: Morgan Stanley Research, Treasuries
* Morgan Stanley estimate. ** Possible Auction ***Possible syndication in the week beginning 22nd August, 2022.

In Case You Missed It

Global Macro Strategy: Inflation-Linked Market Strategy: Pricing in Sticky Inflation

18 Aug 2022

We analyze price action in the US, EU, and UK inflation markets, particularly inflation-linked bonds and inflation swaps.

UK Inflation Watch: Higher Profile, More Hikes

17 Aug 2022

The July print was strong. While food was the clear culprit for the beat, core was strong too. The peak in headline is yet to come. We now expect a 50bp hike from the BoE in September, 25bp in November and 25bp in December, with a cut in 4Q23. We target 5y RPI to 5.75%

Global Futures Rolls Report: US Treasury and Gilt Futures Rolls

17 Aug 2022

We present our views on US Treasury and gilt futures contract rolls for the September to December cycle. We look at the fundamental drivers of the roll, investor positioning, delivery optionality, and relative value. Finally, we suggest optimal rolling strategies.

Podcast: Strong Views on Global Macro: Challenging the 'Stag' in Stagflation | Ep. 102

16 Aug 2022

Stronger US employment and weaker CPI inflation challenge the stagflation narrative in the US, but not in Europe. Matt talks with Guneet Dhingra, Head of US Rates Strategy, about the US CPI report, how to position in US inflation markets and on the Treasury curve, and takeaways for macro markets.

Global Macro Strategy: G10 FX Chart Pack

16 Aug 2022

Top charts we are watching for each G10 currency with economic indicators, flows, positioning, and drivers.

Forecasts

Government bonds

Exhibit 128: Morgan Stanley sovereign 2y, 5y, 10y, and 30y yield base case forecasts

	2Y				5Y				10Y				30Y			
	3Q22	4Q22	1Q23	2Q23	3Q22	4Q22	1Q23	2Q23	3Q22	4Q22	1Q23	2Q23	3Q22	4Q22	1Q23	2Q23
US	3.15	4.00	3.70	3.40	3.05	3.85	3.55	3.25	2.90	3.50	3.28	3.05	3.00	3.55	3.40	3.25
Germany	1.60	1.40	1.20	1.00	2.00	1.70	1.50	1.30	2.25	2.00	1.75	1.60	2.35	2.25	2.10	2.00
Japan	-0.10	-0.10	-0.05	-0.05	0.00	0.05	0.10	0.10	0.20	0.25	0.30	0.30	0.95	1.00	1.00	1.10
UK	1.50	1.50	1.50	1.50	1.60	1.60	1.60	1.60	2.20	2.10	2.25	2.25	2.30	2.20	2.25	2.25
Canada	3.10	3.25	3.30	3.30	3.10	3.20	3.25	3.30	3.10	3.20	3.30	3.35	3.10	3.20	3.30	3.35
Australia	3.10	3.15	3.15	3.15	3.40	3.50	3.55	3.60	3.70	3.75	3.85	3.90	4.05	4.10	4.15	4.20
New Zealand	3.65	3.70	3.70	3.70	3.85	3.90	3.95	4.00	4.00	4.05	4.10	4.10	4.10	4.15	4.20	4.25
Austria*	5	5	5	5	10	15	15	15	45	50	60	50	50	55	65	55
Netherlands*	5	5	5	5	10	10	10	10	25	30	35	30	15	20	25	20
France*	5	5	5	5	20	25	30	25	50	55	65	55	75	85	95	85
Belgium*	5	5	5	5	20	25	30	25	50	60	70	60	90	100	110	100
Ireland*	5	5	5	5	20	30	35	30	55	70	80	70	80	95	105	95
Spain*	50	65	75	70	70	80	90	80	110	130	140	130	150	170	180	170
Italy*	70	100	130	120	140	160	190	180	200	230	250	240	240	280	290	280
Portugal*	45	60	70	65	65	75	85	75	125	155	165	155	175	215	225	215

Source: Morgan Stanley Research, *Spread to German Bunds

Exhibit 129: Morgan Stanley sovereign 10-year yield bull, base, and bear case forecasts

	Bull				Base				Bear			
	3Q22	4Q22	1Q23	2Q23	3Q22	4Q22	1Q23	2Q23	3Q22	4Q22	1Q23	2Q23
US	2.80	2.80	3.28	2.50	2.90	3.50	3.28	3.05	3.00	3.75	3.88	4.00
Germany	1.75	1.30	1.10	0.90	2.25	2.00	1.75	1.60	2.40	2.75	2.50	2.25
Japan	0.15	0.15	0.10	0.05	0.20	0.25	0.30	0.30	0.25	0.35	0.35	0.45
UK	1.70	1.70	1.65	1.65	2.20	2.10	2.25	2.25	2.30	2.30	2.20	2.10
Canada	2.95	3.00	3.05	3.10	3.10	3.20	3.30	3.35	3.25	3.35	3.45	3.55
Australia	3.55	3.55	3.60	3.65	3.70	3.75	3.85	3.90	3.75	3.90	4.00	4.10
New Zealand	3.80	3.85	3.90	3.95	4.00	4.05	4.10	4.10	4.10	4.20	4.25	4.30
Austria*	40	45	55	45	45	50	60	50	55	60	70	60
Netherlands*	20	25	30	25	25	30	35	30	35	40	45	40
France*	45	50	60	50	50	55	65	55	60	65	75	65
Belgium*	45	55	65	55	50	60	70	60	60	70	80	70
Ireland*	50	65	75	65	55	70	80	70	65	80	90	80
Spain*	100	110	120	110	110	130	140	130	120	150	160	150
Italy*	175	190	220	200	200	230	250	240	210	250	270	260
Portugal*	110	115	125	115	125	155	165	155	135	175	185	175

Source: Morgan Stanley Research, *Spread to German Bunds

Exhibit 130: Morgan Stanley foreign exchange base case forecasts

	3Q22	4Q22	1Q23	2Q23	3Q23	4Q23
EUR/USD	0.97	0.99	1.01	1.03	1.05	1.08
USD/JPY	141	140	139	138	132	126
GBP/USD	1.15	1.17	1.18	1.20	1.23	1.25
USD/CHF	0.99	0.96	0.95	0.95	0.96	0.96
USD/SEK	11.24	10.81	10.50	10.19	9.80	9.42
USD/NOK	11.03	10.51	10.10	9.71	9.43	9.16
USD/CAD	1.34	1.30	1.28	1.27	1.27	1.26
AUD/USD	0.66	0.68	0.69	0.69	0.69	0.72
NZD/USD	0.61	0.63	0.64	0.65	0.63	0.65
EUR/JPY	137	139	140	142	139	136
EUR/GBP	0.84	0.85	0.86	0.86	0.86	0.86
EUR/CHF	0.96	0.95	0.96	0.98	1.01	1.03
EUR/SEK	10.90	10.70	10.60	10.50	10.32	10.13
EUR/NOK	10.70	10.40	10.20	10.00	9.93	9.85
USD/CNY	6.85	6.65	6.58	6.50	6.45	6.40
USD/HKD	7.85	7.84	7.82	7.80	7.78	7.77
USD/IDR	15700	15400	15100	14800	14708	14617
USD/INR	82.0	79.5	78.5	77.0	77.3	77.7
USD/KRW	1330	1315	1290	1270	1251	1231
USD/MYR	4.60	4.50	4.40	4.30	4.22	4.15
USD/PHP	59.0	57.0	56.0	55.0	55.0	55.0
USD/SGD	1.425	1.400	1.380	1.360	1.353	1.346
USD/TWD	30.3	29.9	29.6	29.3	29.4	29.5
USD/THB	37.5	36.5	36.0	35.0	34.5	34.1
USD/BRL	5.80	5.60	5.40	5.35	5.26	5.25
USD/MXN	21.50	21.20	21.00	20.70	20.71	20.73
USD/ARS	149	171	195	215	233	254
USD/CLP	1050	1040	1025	1000	941	883
USD/COP	4800	4650	4450	4300	4109	3918
USD/PEN	4.20	4.15	4.05	4.05	3.98	3.91
USD/ZAR	17.5	17.9	17.5	17.3	16.9	16.6
USD/TRY	18.00	20.00	21.00	22.00	23.00	24.00
USD/ILS	3.50	3.45	3.40	3.35	3.35	3.35
EUR/PLN	4.80	4.90	4.70	4.60	4.46	4.32
EUR/CZK	25.0	25.2	25.0	24.8	25.5	26.1
EUR/HUF	420	405	390	380	375	369
DXY	112	110	108	106	104	101
Fed's Broad USD Index	127	124	123	121	120	118

Source: Morgan Stanley Research. Click here for custom cross forecasts

Exhibit 131: Morgan Stanley foreign exchange Base, Bear, Bull scenarios

2Q23	Bear	Base	Bull
EUR/USD	0.97	1.03	1.07
GBP/USD	1.13	1.20	1.25
USD/JPY	132	138	141
AUD/USD	0.62	0.69	0.72
USD/CNY	6.35	6.50	6.80
USD/INR	72.0	77.0	79.0
USD/ZAR	14.5	17.3	15.3
USD/BRL	5.20	5.35	5.70
USD/MXN	19.00	20.70	21.50

Source: Morgan Stanley Research

Trade Ideas

Below you will find a list of our current trade ideas, entry levels, entry dates, rationales, and risks.

Interest Rate Strategy

TRADE	ENTRY LEVEL	ENTRY DATE	RATIONALE	RISKS
October 147/145/144 Bund broken put fly	18 cents	19-Aug-22	Our view is driven by a number of factors, including the 10y bund yield being rich, ECB comments highlighting concerns around inflation, and positioning.	Bund richness persists for longer than expected.
2s5s10s German fly (using Sep 22 CTDs)	-3.5	19-Aug-22	With the resumption of EGB supply in less than two weeks, we expect current mispricing In the belly of the cash curve to be corrected.	The supply takes longer to affect mispricing than suggested by historical relationships.
30s50s OAT steepener (long OAT May 50 vs May 72)	-6.2bp	19-Aug-22	The 30s50s OAT should renormalize on (i) a re-steepening in 10s30s OAT to account for the possible 30y syndication impact, (ii) lower to stable long-end volatility, and (iii) a re-steepening on front-end rates to price in the prospects of a more aggressive ECB.	The cheapening of the 30y OAT due to the expected September syndication would outweigh our core thesis of a re-steepening in front-end rates and stable to lower long-end vol.
Long JB367 ASW	-11.2bp	19-Aug-22	The 10y JGB yield should be capped at 25bp in the event of a large bond market sell-off, while OIS tends to underperform given no direct support from the BoJ. If the market starts to price in possible BoJ tweaking on the combination of a strong CPI print and higher USD/JPY, we expect this position to perform.	Another rally in global yields.
Short SPGB Jan 27 vs. FTFR Feb 27	33bp	12-Aug-22	We think this is an interesting expression, considering that the spread is back to 2022 lows (ex late March, when investors were concerned with the outcome of the French elections).	A further richening of Spanish bonds, supported by domestic flows or a further tightening in peripheral risk more broadly.
Short UKT 1T 57	245bp	12-Aug-22	September is a weak month for gilts, based on our seasonality analysis. We recommend positioning ahead of the seasonal impact in September. From a relative value perspective, we find that the 35y gilts are rich relative to the 30y sector.	Seasonality trend does not persist, and the 35y sector does not cheapen.

Long BAZ2 - BAZ3 Steepeners	-61bp	5-Aug-22	Given strong economic momentum in North America and market pricing implying central bank cuts next year, we see the potential for the spread between end-2022 and end-2023 Canadian rates expectations to compress.	Oil prices decline along with global growth expectations, weighing on Canadian inflation and central bank policy expectations into 2023.
1s10s flatteners	-44bp	5-Aug-22	We expect most of the Fed's hawkishness to be priced in the form of higher terminal rates, whereby terminal rates are likely to be above neutral rates. That would lend itself to the possibility of inverted 1s10s and 2s10s curves, which we think would happen, and should continue in 2022. We see value in this trade on a long-term horizon.	Geopolitical risk puts downward pressure on the front of the curve.
Short FFN3	96.525	5-Aug-22	With the inflation and labor market backdrop, we could see the market focus on pricing 75bp hikes into September and November. We suggest paying the July 23 FOMC meeting via selling the FFN3 contract.	The key risk is that inflation cools off, or that the Fed adopts a dovish reaction function.
Sell OAT ASW	48bp	5-Aug-22	Strong seasonality and expensive valuation should support a tactical short position in ASW.	A continued rally in core/semi core duration drives cash richer.
10s30s EUR Steepeners	-14bp	22-Jul-22	We think that any move flatter in the money market will re-steepen 10s30s.	The main risk for the trade would be a sharp steepening of the money market curve, which would push the fair value toward or below the current market level.
Long UKT 1E 39 vs. UKT 0H 61	-23.2bp	22-Jul-22	We suspect that the strength in the 30y sector may face headwinds, including increased supply and QE.	The continuation of acute market volatility, which could keep the curve distorted.
Conditional Bund ASW widener	Buy 150.50, sell strike 1.95%	10-Jun-22	Bund ASW is 10bp cheap vs. our ASW model and Bund volatility is very low vs. the swaption, making the conditional trade attractive.	A rally with a tighter ASW.
Long June 2023 FRA/€STR basis	19.7	20-May-22	The prospects of a further cheapening on iTraxx crossover and the June 23 TLTRO repayments should lead to a wider basis.	The announcement of another extension of 3y TLTROs and an extension of APP.
TONA OIS 5s20s steepener (DV01 neutral)	68bp	29-Jul-22	Longer tenors should have room to steepen given the dovish global market pricing and the subsequent recovery in global risk sentiment.	A risk-off move, with a subsequent bull-flattening of the curve.
Buy 30y OAT vs BTP	139	10-May-22	Lower excess liquidity, an end of APP in H2, and an attractive valuation of OATs for Asian investors would lead to a protracted spread widening.	The key risk to the trade is an extension of APP.
Receive EUR 5y5y inflation swap	2.3	10-May-22	With the gradual tightening approach, ECB would be seen as behind the curve, increasing the demand for inflation protection.	Risks to the trade include a 50bp hike by the ECB in order to speed up the normalization process.
JGB 10s-20s steepener DV01 neutral	65bp	18-Jun-22	The 10y yield will likely be capped by the BoJ's unlimited purchase operation, while the 20y JGB yield will likely be vulnerable for any global yield sell-off without banks' demand.	The main risk to this trade is that of the curve bull-flattening more dramatically due to banks ramping up their net purchases again.
Receiving Sep-22 MPC OIS	0.0168	18-Mar-22	We think the current pricing is excessive vs. BoE's guidance	The data support a faster tightening.
Pay fixed EUR 10y10y swap	55bp	14-Nov-21	The prospect of stickier eurozone inflation in 2H22 and a higher term premium due to the end of APP should contribute to duration weakness. A repricing of the 10s20s and 10s30s with the short end anchored would lead to both higher yields and steeper curves.	A more dovish ECB, higher pace of APP purchases.

Currency and Foreign Exchange

TRADE	ENTRY LEVEL	ENTRY DATE	RATIONALE	RISKS

TRADE	ENTRY LEVEL	ENTRY DATE	RATIONALE	RISKS
Long NOK/SEK	1.064	12-Aug-22	A strong employment report and weaker-than-expected US CPI could allow the current risk rebound to continue a little longer as stagflation risks get priced out, in turn supporting risk currencies like NOK. Fundamental factors continue to be more supportive for Norway than in Sweden. Norway has had the largest improvement in its terms of trade in G10. Sweden has seen the largest deterioration instead; it is more sensitive to a euro-area growth slowdown, and our economists expect a recession at the turn of the year. A hawkish Norges Bank meeting could also support the currency via yield differentials.	A sudden and sharp move lower in risk assets, caused by a renewed hawkish tilt by the Fed or renewed global recession fears.
Short EUR/USD	1.015	8-Jul-22	EUR/USD should decline as concerns over global growth persist and elevated inflation prompts continued increases in US rates, supporting the USD.	Inflation begins to show signs of slowing, reducing Fed policy expectations and weighing on the USD.
Long 3m USD/JPY seagulls (buy 3m ATMF/140 call spread, sell 128 put)	0.7% P	27-Jun-22	Risks for the JPY remain skewed to the downside, in our view, against USD. We are, however, less convinced that the recent pace of depreciation will be maintained, as JPY short positioning has become crowded in both the options and futures markets. JPY implied volatility has picked up recently to new post-Covid highs, and it is the most expensive across G10 in our idiosyncratic risk premium model. This makes selling OTM puts an effective way to cheapen the cost of USD/JPY upside exposure.	A fall in US yields as global growth concerns intensify; improvement in Japan's trade balance if commodity prices fall.

Inflation-Linked Bonds

TRADE	ENTRY LEVEL	ENTRY DATE	RATIONALE	RISKS
Long July '24 TIPS BE vs. short July '23 TIPS BE	281bp	7/29/2022	We see inflation being stickier and more persistent than current market pricing suggests. We believe that present levels represent an attractive entry point.	Shock to inflation results in CPI dropping faster than anticipated
Long 1y1y ZCIS	277bp	7/15/2022	We see inflation being stickier and more persistent than current market pricing suggests. We believe that present levels represent an attractive entry point.	Shock to inflation results in CPI dropping faster than anticipated
Buy OATei24 vs FRTR2.25 5/24	373bp	7/18/2022	We think flows should support wider front-end Bes; hence, our long position in OATei24 BE. Carry is also supportive for front-end OATeis, resulting in accommodative BE through August.	A drop in commodities that will push overall BEs lower, especially at the front end.
Buy 5y UK RPI swap	4.26%	24-Jun-22	We expect more inflation premium to be priced into the front end of UK inflation forwards due to sticky inflation.	A fall in commodities that would weigh on all short-dated inflation instruments, including the 5y RPI forward.

Short-Duration Strategy

TRADE	ENTRY LEVEL	ENTRY DATE	RATIONALE	RISKS
TONA/SOFR basis 2s10s20s fly	-6.8bp	13-May-22	Global growth concerns and a subsequently wider credit spread would likely lead to further widening pressure in the belly of the curve, while we expect the widening pressure on both the short and long ends to likely be offset by the demand for foreign CCY JGB ASW from overseas real money investors.	Safe haven USD demand leads to strong widening pressure on the front end.

Interest Rate Derivatives

TRADE	ENTRY LEVEL	ENTRY DATE	RATIONALE	RISKS
Sell 3m10y ATMF straddle vs buying 3m10y AMTF-50/ATMF+50 strangle	-2.45% (i.e. premium earned)	13-May-22	We believe that, with the Fed now actively considering 75bp hikes, gamma has probably reached a peak, so we prefer to sell at these levels. However, we don't want unlimited downside exposure, so we use relatively cheaper vol smile to our advantage and buy wingy options to protect the downside.	The main risk are if rates move away from ATMF by more than 30bp in each direction and the trade begins to move into negative territory.
Buy 2y2s30s curve floor spread, struck at ATMF/ATMF-75 (-4bp/-79bp)	26bp	13-May-22	This trade complements our more structural flatteners, while taking advantage of (1) relatively cheaper 2y2s30s curve vol, (2) positive vol roll, and (3) positive delta roll.	The main risk to this trade is that the curve steepens further, in which case the premium would be lost.
Buy 20y JGB ASW vs ESTR compound	78bp	13-May-22	This is a medium-term carry trade. EUR-denominated JGBs on the long end should provide attractive yield pickup vs. Bunds ASW with a matched maturity.	Significant widening of the JPY/EUR basis on the longer end on the back of a credit crunch; low demand for 20y JGB ASW from the banking community.
Buy 6m5s30s conditional bull steepeners, constructed by buying 6m5y receivers in 1x notional struck at ATMF - 20 (1.63%) and selling 6m30y receivers in 0.24x notional struck at ATMF - 22 (1.71%)	0c	28-Jan-22	We find this trade to be an attractive hedge for our 5s30s flatteners. Given how flat forwards are priced, this trade carries positively in the rate space. Also, we find the difference between receiver skew in 5y and 30y tails to be attractive for owning downside in 5y tails and selling downside in 30y tails to fund that position.	The main risk to this trade is if the curve were to bull flatten.
ZTIBOR-OIS 5s20s flattener	11bp	9-Apr-21	ZTIBOR are expected to discontinue in Dec-2024, and we expect the market to start to price in the expected fallback spread.	Another loan swap hedge-related paying in the long end.

Exhibit 132: History of recommendations

EUR 5s30s Swap Flattener

Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re-assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG
EUSA10 Curncy	19-Oct-31	Receive 5s10s30s Eur Swap Fly	15-Oct-21	0.22%	29-Oct-21	0.28%				EUSA10 Curncy
EUSA5 Curncy	19-Oct-26	Receive 5s10s30s Eur Swap Fly	15-Oct-21	-0.13%	29-Oct-21	0.02%				EUSA5 Curncy
EUSA30 Curncy	19-Oct-51	Receive 5s10s30s Eur Swap Fly	15-Oct-21	0.51%	29-Oct-21	0.34%				EUSA30 Curncy
5y PLN IRS	8-Feb-27	Receive 5y PLN IRS vs. Pay 5y EUR IRS	08-Feb-22	3.50	21-Mar-22	3.8				PZSW5 Curncy
5y EUR IRS	8-Feb-27	Receive 5y PLN IRS vs. Pay 5y EUR IRS	08-Feb-22	3.50	21-Mar-22	3.8				EUSA5 Curncy
Interest Rate Swap	5Y	Receive PLN 5yr versus EUR 5yr	21-Feb-22	0.04	25-Mar-22	0.0528				PZSW5 Curncy
Interest Rate Swap	5Y	Receive PLN 5yr versus EUR 5yr	21-Feb-22	0.01	25-Mar-22	0.00807				EUSA5 Curncy
EUR Annual (vs 6M Euribor)	8-Apr-27	EUR 2s5s Steepeners	08-Apr-22	1.15	22-Apr-22	1.399				EUSA5 BGN Curncy
EUR Annual (vs 6M Euribor)	8-Apr-24	EUR 2s5s Steepeners	08-Apr-22	0.68	22-Apr-22	0.89				EUSA2 BGN Curncy
10y swap EUR 6M	7-Jun-32	EUR 10s30s swap flattener	03-Jun-22	1.8	17-Jun-22	2.44				EUSA10 Curncy
30y swap EUR 6M	7-Jun-52	EUR 10s30s swap flattener	03-Jun-22	1.91	17-Jun-22	2.15				EUSA30 curncy
EUSA5 Curncy	8-Jul-27	Pay EUR 2s5s10s	08-Jul-22	1.74	19-Aug-22	1.85				EUSA5 Curncy
EUSA10 Curncy	8-Jul-32	Pay EUR 2s5s10s	08-Jul-22	2.16	19-Aug-22	2.05				EUSA10 Curncy
EUSA2 Curncy	8-Jul-24	Pay EUR 2s5s10s	08-Jul-22	1.30	19-Aug-22	1.69				EUSA2 Curncy

Pay Fixed EUR 10y10y Swap

Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re-assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG
USD Forward Start Semi annual 30/360 vs 3M Libor)	3-Mar-42	Receive US 10y10y vs EUR 10y10y	01-Mar-22	0.02	21-Mar-22	2.50%				USFS1010 Curncy
EUR Forward Start v 6M	3-Mar-42	Receive US 10y10y vs EUR 10y10y	01-Mar-22	0.01	21-Mar-22	1.32%				EUSA1010 Curncy
EUR Forward	10Y	Pay EUR 10y10y	14-Nov-21	0.54%	28-Mar-22	1.25%	1.00%			EUSA1010 Index

Buy OAT 30y versus BTP

Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re-assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG
BTPS 2.15 09/01/2052	1-Sep-52	Short BTP Sep 2052 vs long SPGB Jul 2066	18-Mar-22	0.02	22-Apr-22	3.08				IT0005480980
SPGB 3.45 07/30/2066	30-Jul-66	Short BTP Sep 2052 vs long SPGB Jul 2066	18-Mar-22	0.02	22-Apr-22	2.72				ES00000128E2

Conditional Bund ASW Widener

Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re-assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG
EUR Spread RX1 vs 6M		Buy Bund ASW vs Schatz	15-Oct-21	40.33bp	05-Nov-21	40.22				ASWABUND BGN Curncy
EUR Spread DU1 vs 6M		Buy Bund ASW vs Schatz	15-Oct-21	28.11bp	05-Nov-21	34.52				ASWASHATZ BGN Curncy

EUR 10s30s Steepener

Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re-assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG
EUSA10 Curncy	19-Oct-31	Receive 5s10s30s Eur Swap Fly	15-Oct-21	0.22%	29-Oct-21	0.28%				EUSA10 Curncy
EUSA5 Curncy	19-Oct-26	Receive 5s10s30s Eur Swap Fly	15-Oct-21	-0.13%	29-Oct-21	0.02%				EUSA5 Curncy
EUSA30 Curncy	19-Oct-51	Receive 5s10s30s Eur Swap Fly	15-Oct-21	0.51%	29-Oct-21	0.34%				EUSA30 Curncy
SPGB 0.1 04/30/31	30-Apr-31	Short Bono Apr 31 ASW	22-Oct-21	0.46%	14-Jan-22	0.53%				ES0000012H41
EUR Annual (vs 6m Euribor)	26-Oct-31	Short Bono Apr 31 ASW	22-Oct-21	0.29%	14-Jan-22	0.36%				EUSA10 Curncy
SPGB 1.3 10/31/2026	31-Oct-24	Short Bono Oct 2026 ASW	14-Jan-22	-0.27%	25-Mar-22	0.62%				ES00000128H5
EUR Annual (vs 6m Euribor)	20-Jan-32	Short Bono Oct 2026 ASW	14-Jan-22	0.36%	25-Mar-22	1.18%				EUSA10 Curncy
EUR Annual (vs 6M EURIBOR)	11-Mar-32	pay GBP 10y swap vs EUR 10y swap	11-Mar-22	0.01	29-Apr-22	0.0168				EUSA10 Curncy
GBP Swap OIS	11-Mar-32	pay GBP 10y swap vs EUR 10y swap	11-Mar-22	0.02	29-Apr-22	0.0189				BPSWS10 Curncy
Interest Rate Swap	10Y	Receive EUR 10yr vs. GBP 10yr	25-Mar-22	1%	10-May-22	1.96%				EUSA10 Curncy
Interest Rate Swap	10Y	Receive EUR 10yr vs. GBP 10yr	25-Mar-22	2%	10-May-22	2.04%				BPSWS10 Curncy
10y swap EUR 6M	7-Jun-32	EUR 10s30s swap flattener	03-Jun-22	1.8	17-Jun-22	2.44				EUSA10 Curncy
30y swap EUR 6M	7-Jun-52	EUR 10s30s swap flattener	03-Jun-22	1.91	17-Jun-22	2.15				EUSA30 curncy
EUSA5 Curncy	8-Jul-27	Pay EUR 2s5s10s	08-Jul-22	1.74	19-Aug-22	1.85				EUSA5 Curncy
EUSA10 Curncy	8-Jul-32	Pay EUR 2s5s10s	08-Jul-22	2.16	19-Aug-22	2.05				EUSA10 Curncy
EUSA2 Curncy	8-Jul-24	Pay EUR 2s5s10s	08-Jul-22	1.30	19-Aug-22	1.69				EUSA2 Curncy

Buy UKT 1E 39 versus UKT 0H 61

Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re-assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG
UKT 0 1/2 10/22/61	22-Oct-61	Buy UKT 0H 61 on ASW	13-May-22	1.84	28-Jul-22	2.407				GB00BMBL1D50
40y SONIA swap	5-May-24	Buy UKT 0H 61 on ASW	13-May-22	1.55	28-Jul-22	2.11				BPSWS40 Curncy
UKT 1E 39	31-Jan-39	Buy 1E 39 versus 4Q 32 and 1Q 51	20-Jul-22	0.58%	12-Aug-22	0.45%	0.38%	0.65%		GB00BLPK7334
UKT 1Q 51	31-Jul-51	Buy 1E 39 versus 4Q 32 and 1Q 51	20-Jul-22	0.58%	12-Aug-22	0.45%	0.38%	0.65%		GB00BLH38158
UKT 4Q 32	7-Jun-32	Buy 1E 39 versus 4Q 32 and 1Q 51	20-Jul-22	0.58%	12-Aug-22	0.45%	0.38%	0.65%		GB0004893086

Pay Germany 2s5s10s

Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re-assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG
DBR 0 15/08/2031	15-Aug-31	Long 10y Bund vs UST	23-Jul-21	-0.42	10-Dec-21	-0.35				DE0001102564
T 1 15/05/31	15-May-31	Long 10y Bund vs UST	23-Jul-21	1.29	10-Dec-21	1.42				US91282CCB54
DBR 0 15/08/2031	15-Aug-31	Sell OAT 10y vs DBR 10y	19-Nov-21	-0.25%	08-Mar-22	0.03%				DE0001102564
FRTR 0 25/11/2031	25-Nov-31	Sell OAT 10y vs DBR 10y	19-Nov-21	0.11%	08-Mar-22	0.47%				FR0014002WK3

Buy 3m USD/JPY Seagulls (Buy 3m ATMF/135 Call Spread, Sell 124 Put)

Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re-assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG
USD/JPY	3m	Long USD/JPY outright with selling 3m USD/JPY call at 112.50	19-Jun-21	100.20 (0.4% for call option)	20-Sep-21	0.0%				USDJPY Curncy
USD/JPY	3m	Buy 3m USD/JPY seagulls (buy 3m ATMF/135 call spread, sell 124 put)	25-Apr-22	0.69% P	28-Jun-22	3.75% P				USDJPY CURNCY

Source: Morgan Stanley Research

Definition of terms

Buy/Long: The analyst expects the total or excess return (depending on the nature of the recommendation) of the instrument or issuer that is the subject of the investment recommendation to be positive over the relevant time period.

Sell/Short: The analyst expects the total or excess return (depending on the nature of the recommendation) of the instrument or issuer that is the subject of the investment recommendation to be negative over the relevant time period.

Selling protection or Buying Risk: The analyst expects that the price of protection against the event occurring will decrease over the relevant time period.

Buying protection or Selling Risk: The analyst expects the price of protection against the event occurring will increase over the relevant time period.

Pay: The analyst expects that over the specified time period the variable rate underlying the swap agreement that is the subject of the investment recommendation will increase.

Receive: The analyst expects that over the specified time period the variable rate underlying the swap agreement that is the subject of the investment recommendation will decrease.

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When more than one issuer or instrument is included in a recommendation, analyst expects one part of the trade to outperform the other trade or combination of other trades included in the recommendation on a relative basis.

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Event Calendar

Exhibit 133: Risk Event Calendar

Date	Time (Ldn)	Ccy	Event	Ref. Period	Market	Previous
22-Aug	01:00	KRW	First 20-Days Exports (YoY)	Aug		14.5%
	02:15	CNY	1-Year Loan Prime Rate		3.6%	3.7%
	02:15	CNY	5-Year Loan Prime Rate		4.35%	4.45%
	08:00	CHF	M3 (YoY)	Jul		-0.1%
	08:00	MYR	Foreign Reserves			109.2B
	09:00	TWD	Export Orders (YoY)	Jul	5.45%	9.5%
	09:00	CHF	SNB Sight Deposits			751.3B
	13:30	USD	Chicago Fed Natural Activity Index	Jul		-0.19
	14:00	ILS	BoI Rates Decision		1.75%	1.25%
	N/A	PEN	GDP (YoY)	2Q		3.8%
23-Aug	00:00	AUD	PMI Composite	Aug P		51.1
	00:00	AUD	PMI Services	Aug P		50.9
	00:00	AUD	PMI Manufacturing	Aug P		55.7
	01:30	JPY	PMI Services	Aug P		50.3
	01:30	JPY	PMI Composite	Aug P		50.2
	01:30	JPY	PMI Manufacturing	Aug P		52.1
	05:00	SEK	Valueguard/HOX House Prices			
	06:00	SGD	CPI (YoY)	Jul	6.9%	6.7%
	06:30	JPY	Nationwide Dept Sales (YoY)	Jul		11.7%
	08:15	EUR	French PMI Manufacturing	Aug P	49	49.5
	08:15	EUR	French PMI Services	Aug P	53.1	53.2
	08:20	IDR	BI Rates Decision		3.5%	3.5%
	08:30	EUR	German PMI Manufacturing	Aug P	48.1	49.3
	08:30	EUR	German PMI Services	Aug P	49	49.7
	09:00	EUR	PMI Manufacturing	Aug P	48.9	49.8
	09:00	EUR	PMI Services	Aug P	50.5	51.2
	09:00	EUR	PMI Composite	Aug P	48.9	49.9
	09:30	GBP	PMI Manufacturing	Aug P	51	52.1
	09:30	GBP	PMI Services	Aug P	52	52.6
	09:30	GBP	PMI Composite	Aug P	51	52.1
	12:00	EUR	ECB's Panetta spks (Monetary Policy)			
	14:45	USD	PMI Manufacturing	Aug P	52	52.2
	14:45	USD	PMI Services	Aug P	50.2	47.3
	15:00	USD	Richmond Fed Manufacturing Index	Aug		0
	15:00	EUR	Consumer Confidence	Aug P	-28	-27
	15:00	USD	New Home Sales	Jul	580k	590k
	15:00	USD	New Home Sales (MoM)	Jul	-1.7%	-8.1%
	20:00	ARS	Economic Activity (YoY)	Jun		7.4%
24-Aug	00:00	USD	Fed's Kashkari (non-voter) spks			

	02:10	JPY	BoJ Outright Bond Purchases 1-3y, 3-5y, 5-10y			
	07:00	JPY	Machine Tool Orders (YoY)	Jul F		5.5%
	07:00	NOK	Credit Indicator Growth (YoY)	Jul		5.1%
	09:00	ZAR	CPI (YoY)	Jul	7.8%	7.4%
	11:00	SEK	Riksbank's Floden spks (Monetary Policy)			
	12:00	MXN	Bi-Weekly CPI (2w/2w)		0.34%	0.23%
	13:00	BRL	IPCA Inflation (MoM)	Aug		0.13%
	13:30	USD	Durable Goods Orders	Jul P	0.6%	2%
	13:30	USD	Durables Ex Transportation	Jul P	0.1%	0.4%
	15:00	USD	Pending Home Sales (MoM)	Jul	-2.5%	-8.6%
	15:30	USD	EIA Crude Oil Inventories			-7056k
	23:45	NZD	Retail Sales (QoQ)	2Q	1.7%	-0.5%
24-30 A	N/A	EUR	German Import Prices (YoY)	Jul		29.9%
25-Aug	00:50	JPY	Japan MoF Weekly Security Flow			-234.8B
	N/A	KRW	BoK Rates Decision		2.5%	2.25%
	02:30	JPY	BoJ's Nakamura spks			
	07:00	NOK	Unemployment Rate (AKU)	Jun		3.2%
	07:00	EUR	German GDP (QoQ)	2Q F	0%	0%
	07:00	SEK	Household Lending (YoY)	Jul		6.2%
	07:45	EUR	French Business Confidence	Aug	101	102.9
	07:45	EUR	French Manufacturing Confidence	Aug	104	106.2
	08:00	HUF	NBH 1-week Deposit Rate			10.75%
	09:00	EUR	IFO Business Climate	Aug	86.8	88.6
	09:00	EUR	IFO Current Assessment	Aug	96	97.7
	09:00	EUR	IFO Expectations	Aug	78.7	80.3
	11:00	GBP	CBI Reported Sales	Aug	-8.5	-4
	12:00	MXN	GDP (YoY)	2Q F	2%	2.14%
	12:00	MXN	Economic Activity IGAE (YoY)	Jun		2.09%
	12:30	EUR	ECB Minutes			
	13:30	USD	Initial Jobless Claims			250k
	13:30	USD	GDP (QoQ)	2Q S	-0.9%	-0.9%
	13:30	USD	PCE Core (QoQ)	2Q S		4.4%
	16:00	USD	Kansas City Fed Manufacturing Activity	Aug		13
	23:00	NZD	ANZ Consumer Confidence Index	Aug		81.9
25-27 A	N/A	USD	Annual Jackson Hole Forum			
26-Aug	00:30	JPY	Tokyo CPI (YoY)	Aug	2.7%	2.5%
	05:00	MYR	CPI (YoY)	Jul	4.4%	3.4%
	07:00	EUR	German GfK Consumer Confidence	Sep	-31.8	-30.6
	07:00	SEK	PPI (YoY)	Jul		25.6%
	07:00	NOK	Retail Sales (MoM)	Jul		0%
	07:00	SEK	Unemployment Rate SA	Jul		7.7%
	07:45	EUR	French Consumer Confidence	Aug	79	80
	09:00	EUR	M3 (YoY)	Jul	5.6%	5.7%
	09:00	EUR	Italian Consumer Confidence Index	Aug	91.6	94.8
	09:00	EUR	Italian Business Confidence	Aug	105.2	106.7
	N/A	GBP	Ofgem October Price Cap Announcement			
	13:30	USD	Advance Goods Trade Balance	Jul	-98.95B	-98.6B
	13:30	USD	Wholesale Inventories (MoM)	Jul P		1.8%

	13:30	USD	Personal Income	Jul	0.6%	0.6%
	13:30	USD	Personal Spending	Jul	0.3%	1.1%
	13:30	USD	PCE Core (YoY)	Jul	4.8%	4.8%
	15:00	USD	Fed's Powell (voter) spks (Economic Outlook)			
	15:00	USD	Univ. of Michigan Confidence	Aug F	55.1	55.1
27-Aug	02:30	CNY	Industrial Profits YTD (YoY)	Jul		1%
	17:25	EUR	ECB's Schnabel spks (Outlook for Policy Post-Pandemic)			
28 A-3 S	N/A	GBP	Nationwide House Prices (MoM)	Aug	0.1%	0.1%

Source: Morgan Stanley Research, Bloomberg

Government Bond Ratings

Exhibit 134: Government Bond Ratings

no		Aaa/ AAA	Aa1/ AA+	Aa2/ AA	Aa3/ AA-	A1/ A+	A2/ A	A3/ A-	Baa1/ BBB+	Baa2/ BBB	Baa3/ BBB-	Ba1/ BB+	Ba2/ BB	Ba3/ BB-	B1/ B+	B2/ B	B3/ B-	Below B3/ B-
US	Moody	STA																
	S&P		STA															
	Fitch	STA																
JPN	Moody					STA												
	S&P					STA												
	Fitch						STA											
UK	Moody				STA													
	S&P			STA														
	Fitch				STA													
GER	Moody	STA																
	S&P	STA																
	Fitch	STA																
FRA	Moody			STA														
	S&P			STA														
	Fitch			NEG														
AUT	Moody		STA															
	S&P		POS															
	Fitch		STA															
NETH	Moody	STA																
	S&P	STA																
	Fitch	STA																
FIN	Moody		STA															
	S&P		STA															
	Fitch		STA															
BEL	Moody				STA													
	S&P			STA														
	Fitch				STA													
SPA	Moody								STA									
	S&P						STA											
	Fitch							STA										
ITA	Moody										NEG							
	S&P									STA								
	Fitch									STA								
IRE	Moody					POS												
	S&P				STA													
	Fitch				STA													
POR	Moody									STA								
	S&P									STA								
	Fitch									POS								
GRE	Moody													STA				
	S&P											STA						
	Fitch												POS					
Australia	Moody	STA																
	S&P	STA																
	Fitch	STA																
New Zealand	Moody	STA																
	S&P	STA																
	Fitch		POS															
Canada	Moody	STA																
	S&P	STA																
	Fitch		STA															

Source: Morgan Stanley Research, Moody's, Standard and Poor, Fitch
STA: Outlook Stable, NEG: Outlook Negative, DEV: Outlook Developing, OW-: On Watch Negative, POS: Outlook Positive, SD: Selective Default

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STOCK RATING CATEGORY	COVERAGE UNIVERSE COUNT	COVERAGE UNIVERSE % OF TOTAL	INVESTMENT BANKING CLIENTS (IBC) COUNT	IBC % OF TOTAL IBC	IBC % OF RATING CATEGORY	OTHER MATERIAL INVESTMENT SERVICES CLIENTS (MISC) COUNT	MISC % OF TOTAL OTHER MISC
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Underweight/Sell	**613**	**17%**	**91**	**12%**	**15%**	**226**	**15%**
TOTAL	**3,538**		**766**			**1527**	

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