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Global Macro Strategist | Global

More Money, More Problems

As central banks continue flooding the system with more real liquidity, more perceived problems are clouding the outlook. The more money that needs to be invested, the fewer problems it takes to catalyze safe-haven investment – which can lead to levered positioning stop-outs and confusion.

Interest Rate Strategy

We add outright short 10y USTs. We maintain EDZZZ4 steepeners. In EGBs space, we maintain 30y OAT-Bund tighteners and 10y Italy vs. Spain. We receive the November RBNZ meeting and close our NZ bond shorts versus Australia and Canada.

Currency & Foreign Exchange

We remain bullish USD versus EUR, JPY, AUD, and CAD and CHF via options. We examine how to position for commodity price divergence. RBNZ hawkishness is now overpriced though AUD/NZD still has a bit of downside momentum. We don't see good risk/reward in buying the NOK/SEK dip at the moment. We look at the growth of currency CTA investors whose momentum models would have turned long USD after the recent Fed meeting.

Inflation-Linked Bonds

We maintain short beta-weighted 10y TIPS breakevens. We continue to see a move from transitory to sustainable CPI inflation, albeit at lower levels. We look into whether JGBi market's inflation expectations are lagging behind reality. We think investors are having a more cautious view about inflation ahead (BEI) compared to other economic entities.

Short-Duration Strategy

We consider different design features of a standing repo facility after the Fed's extensive discussion of it in its minutes. We revisit expectations for RRP growth, particularly going into the debt ceiling.

Interest Rate Derivatives

We evaluate gamma-selling strategies YTD. On a risk-adjusted basis, in the US, strategies selling 30y tails have outperformed those of 10y tails, whereas in Europe, the converse is true.

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Global Macro Strategy

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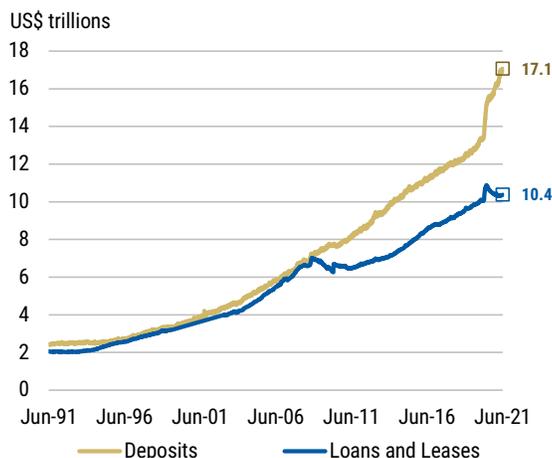
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Money Money Money Money... Money: Part 2

We began a discussion about the money supply in [For the Love of Money](#). We debunked the money multiplier concept, explained how loans create deposits, and analyzed what has driven the money supply higher – banking deposits. We continue the discussion by analyzing how banks are using this deposit base and its implications for inflation.

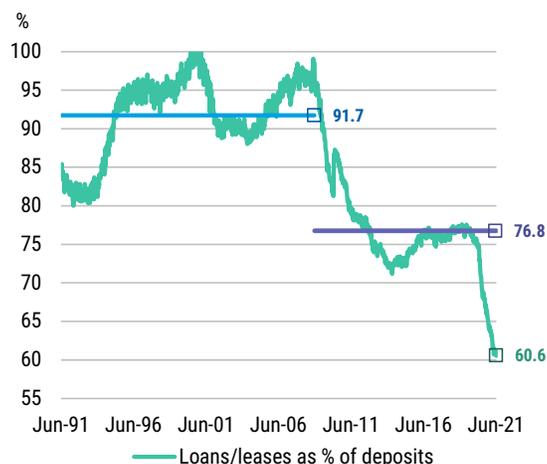
Deposits contributed the most to money supply growth since the pandemic began. So what created those deposits? In the past, loans created most deposits in the banking system (see [Exhibit 1](#)). From the early 1990s to November 2008 – before the Fed began quantitative easing (QE) – loans and leases offset 92% of deposits on average.

Exhibit 1: US commercial bank deposits (liabilities) and loans/leases (assets)



Source: Morgan Stanley Research, Federal Reserve

Exhibit 2: US commercial bank loans/leases (assets) as a % of deposits (liabilities)



Source: Morgan Stanley Research, Federal Reserve

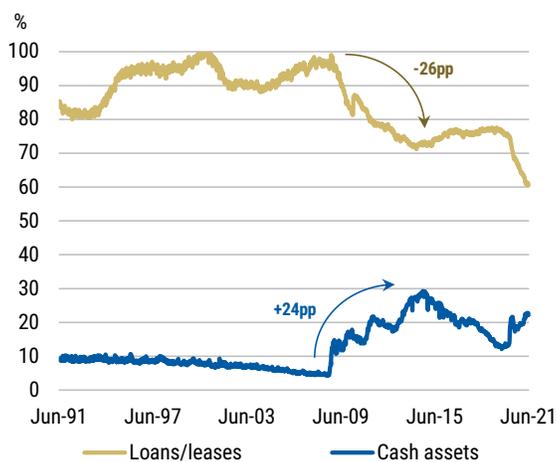
Since the advent of QE, loans and leases have offset 77% of deposits on average. And today, loans and leases offset only 61% of deposits. That leaves \$6.7 billion of other assets to offset the balance of deposit liabilities (see [Exhibit 2](#)). What assets have made up this difference since November 2008, and more recently since February 2020?

In the 6 years post-GFC, cash assets offset nearly the entire decline in loans/leases as a percentage of banking deposits (see [Exhibit 3](#)). Where did this cash come from? The Fed's QE program. The Fed purchased securities with reserves, or electronic cash, from banks, which mostly bought them from the public.

The public sellers took the cash and deposited it with the bank. And that's how it showed up as cash assets of the bank with an offsetting deposit liability. What did banks do with most of the cash back then? Deposited the cash in their reserve account at the Fed each night, as we [showed before](#). For the Fed, these reserve liabilities offset its security assets – completing the T accounting circle of QE (see [T accounting example](#)).

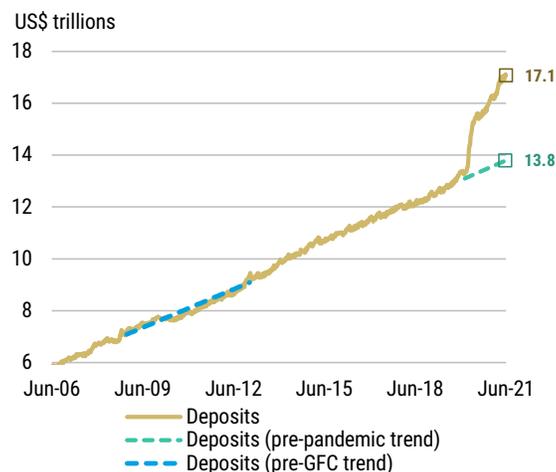
In summary, the rise in deposits after the GFC, which also boosted money supply, came on the back of QE. But this increase in deposits and money supply did not capture investor attention. In fact, deposit growth barely broke its pre-GFC trend in 2009-2012 – in stark contrast to how deposits have overshoot the pre-pandemic trend today (see [Exhibit 4](#)).

Exhibit 3: US commercial bank loans/leases and cash assets as a % of deposits



Source: Morgan Stanley Research, Federal Reserve
Note: Not-seasonally adjusted data used

Exhibit 4: US commercial bank deposits vs. pre-GFC/pre-pandemic trends



Source: Morgan Stanley Research, Federal Reserve
Note: Not-seasonally adjusted data used; Pre-pandemic trend calculated using data from Jan-15 to Jan-20; Pre-GFC trend calculated using data from Nov-03 to Nov-08.

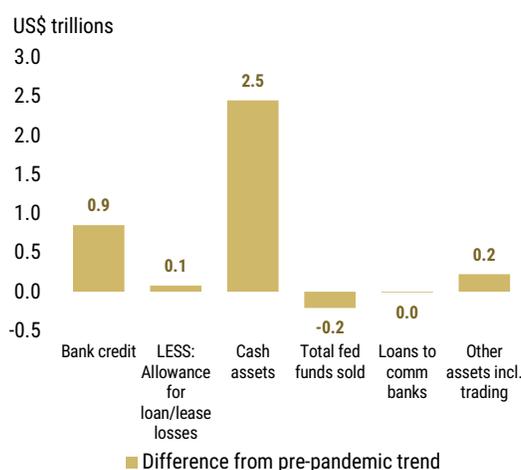
What assets sit opposite this dramatic increase in deposit liabilities, and how do these assets compare to their pre-pandemic trends?

First, we calculate the pre-pandemic trend in the 5 major asset categories for banks: (1) bank credit, (2) cash assets, (3) total fed funds sold and RRP, (4) loans to commercial banks, and (5) other assets, including trading (all found in the [Fed's H.8 report](#)). Second, we calculate the difference between the current asset level (not seasonally adjusted) and where it would be if the pre-pandemic trend continued.

Exhibit 5 shows that bank credit and cash assets constituted the large majority of the deposit increase, relative to the pre-pandemic trend. The \$2.5 trillion relative increase in cash assets is not surprising, given the Fed has purchased \$4.75 trillion in Treasuries and agency MBS since March 2020. This QE-driven increase in cash assets is unlikely to prove inflationary, in our view – similar to post-GFC.

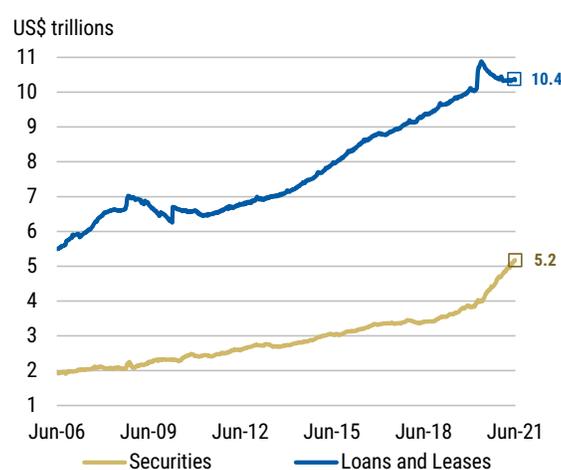
What about the increase in bank credit? In general, we view an expansion of bank credit as more likely to generate higher consumer prices than an expansion in cash assets. As commercial banks lend money – either via securities purchases or traditional loans – the borrowers spend it, either on capital goods or labor services.

Exhibit 5: US commercial bank asset change relative to pre-pandemic trend



Source: Morgan Stanley Research, Federal Reserve
 Note: Not-seasonally adjusted data used; Pre-pandemic trend calculated using data from Jan-15 to Jan-20

Exhibit 6: US commercial bank credit: securities vs. loans and leases



Source: Morgan Stanley Research, Federal Reserve
 Note: Not-seasonally adjusted data used

As Exhibit 6 shows, generally, US banks lend more through traditional channels than securities markets, but not recently. Activity in bank credit relative to its pre-pandemic trend shows that banks have purchased \$1.3 trillion more securities, and made \$0.4 trillion fewer loans (see Exhibit 7 and Exhibit 8).

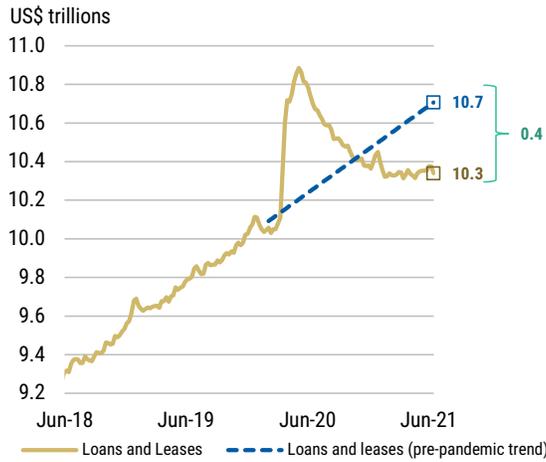
Loans and leases have taken a roller-coaster ride since the pandemic began, which requires an explanation. In addition, we think the composition of securities that banks purchase matters for inflation. So we tackle those dynamics next.

Loans and leases

The Small Business Administration (SBA) Paycheck Protection Program (PPP) has been the major factor driving loans and leases at US commercial banks since March 2020. We discussed the impact this program had on the Treasury's cash balance in [Q&A on the \\$1.6 Trillion TGA](#) (Treasury General Account).

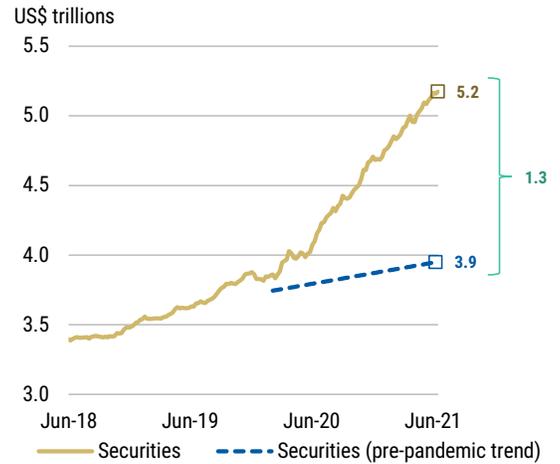
Under the PPP, banks made loans to businesses with the promise that, once the borrower met the criteria for loan forgiveness, the US Treasury would disburse money to the bank, which would forgive the loan. Banks can also receive payment from the Treasury for any defaulted loans, as all PPP loans are 100% guaranteed by the SBA.

Exhibit 7: US commercial bank loans/leases vs. pre-pandemic trend



Source: Morgan Stanley Research, Federal Reserve
 Note: Not-seasonally adjusted data used; Pre-pandemic trend calculated using data from Jan-15 to Jan-20

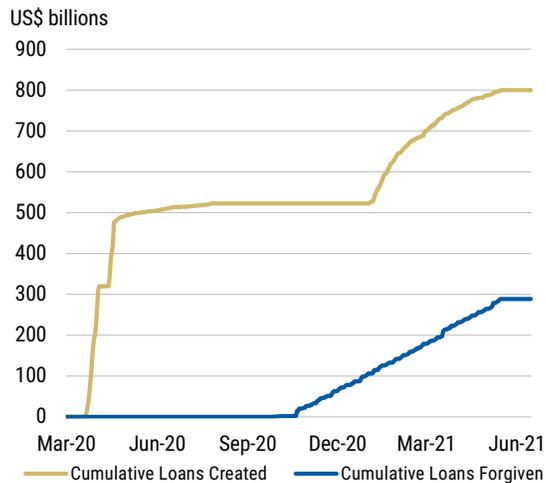
Exhibit 8: US commercial bank securities vs. pre-pandemic trends



Source: Morgan Stanley Research, Federal Reserve
 Note: Not-seasonally adjusted data used; Pre-pandemic trend calculated using data from Jan-15 to Jan-20

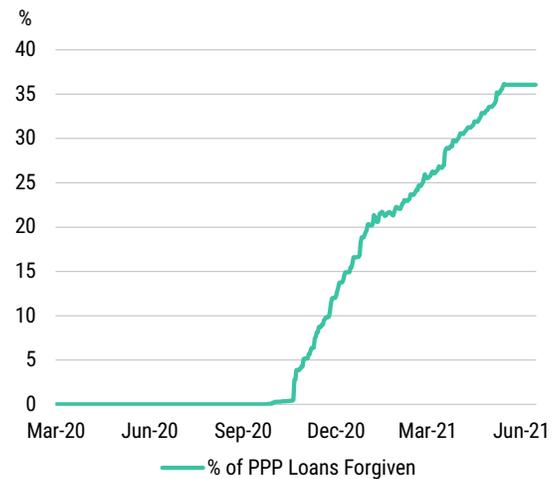
Exhibit 9 shows the history of the PPP loan amounts made by US commercial banks and forgiven by the US government. As banks made the first round of loans, loans on bank balance sheets skyrocketed, as shown in Exhibit 7. And as loans were forgiven, loans on bank balance sheets fell, and cash assets rose. Today, the government has forgiven 40% of the PPP loan amounts, as shown in Exhibit 10.

Exhibit 9: US government PPP loans created by banks and forgiven by US Treasury



Source: Morgan Stanley Research, US Treasury

Exhibit 10: US government PPP loans forgiven as % of loans created



Source: Morgan Stanley Research, US Treasury

Plenty of scope remains for loans on bank balance sheets to decrease, and cash assets to increase. As this program winds down, cash assets could increase by \$500 billion from current levels – taking cash assets to \$3 trillion above the pre-pandemic trend.

At the same time, loans and leases would decline by the same \$500bn that cash assets rose. This would take loans to \$900bn below the pre-pandemic trend. And that would leave overall bank credit only \$0.4 trillion higher relative to its pre-pandemic trend (shown earlier in Exhibit 5).

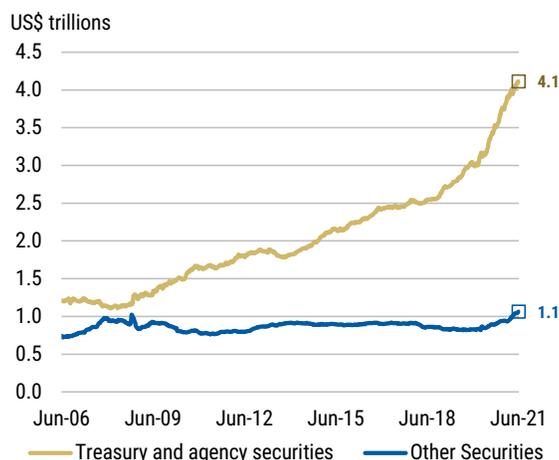
In general, we believe **increases in cash assets on bank balance sheets are less inflationary than increases in loans**, especially if a large majority of those cash assets come from QE. Increased loan activity suggests increased spending/investment activity, which can have multiplier effects throughout the economy – generating higher prices.

Securities

Banks haven't been leaving all of their cash assets parked at the Fed. Based on assessments of deposit durations, banks have been investing more into securities than pre-pandemic trends would suggest (see [Exhibit 8](#) again). The large majority of those securities have been Treasury and agency securities (see [Exhibit 11](#)).

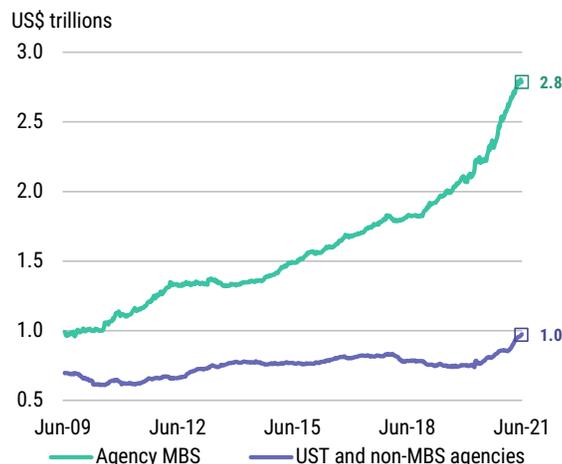
In addition, banks have invested substantially more into agency MBS than into US Treasury and non-MBS agencies (see [Exhibit 12](#)). Does that matter for the inflation outlook? We don't think bank purchases of US government debt add to the inflationary impulse of government spending beyond what the government spending itself did.

Exhibit 11: US Treasury/agency securities and other securities on US commercial bank balance sheets



Source: Morgan Stanley Research, Federal Reserve

Exhibit 12: Agency MBS vs. UST/non-MBS agency securities on US commercial bank balance sheets



Source: Morgan Stanley Research, Federal Reserve

More government spending (or less taxation) that leads to larger deficits puts more money in the banking system (adding narrow liquidity) which eventually finds its way into government bonds (removing narrow liquidity).

If the banks didn't purchase the government bonds, another actor in the system would. Put differently, Treasury securities on bank balance sheets don't represent credit or narrow liquidity (money) creation.

However, bank purchases of agency MBS, which are similar in nature to banks making mortgage loans and retaining them on the balance sheet from a credit-impulse perspective, do represent credit or narrow liquidity (money) creation.

As such, we see bank purchases of agency MBS – extending credit – as potentially inflationary for house prices (and related components of the CPI basket). Our housing strategists, however, are less certain that credit provision has played as important a role as it did before the Great Financial Crisis. They discuss what is driving home prices higher in [Home Prices: Why Is This Time Different?](#) They chalk it up to:

- More demand for single-family shelter in less densely populated areas, due to risk aversion arising from the pandemic.
- Augmented demand coming from a record-low mortgage-rate environment which increased the purchasing power of that demand.
- A historically low-supply environment.

In addition, our housing strategists suggest affordability pressures are growing and see housing prices increasing at a slower pace going forward (see [Home Sales Limbo: How Low Can They Go?](#)).

Our analysis of the money supply has, thus far, led us to believe that it has been and is likely to be much less inflationary than feared. In Part 3 (and final part) of our analysis (forthcoming), we will look at how consumers are spending the money that has contributed to the larger supply.

The Case for a Falling Dollar Falls Apart

We continue to recommend a long USD view, both against G10 and EM currencies: The key arguments of those that push a bearish view on USD are that: i) The Fed will remain dovish, behind the inflation curve, and thus push USD down; and ii) we live in a world of synchronised global growth.

As we have written about since turning bullish on USD (see [Global Macro Strategist: A FAIT Accompli?](#) June 18, 2021, and [US Economics & Global Macro Strategy: FOMC Reaction: Operating With One Eye on the Exit](#), June 17, 2021), we do not believe that the Fed can be counted on to be as dovish as many in the market assume, given the willingness of FOMC participants to raise the dots representing the federal funds rate in line with their higher projections for inflation.

At the same time, the latest survey data suggest a growing divergence in the economic performance of EM economies versus advanced economies, no doubt in part driven by the growing risks posed by the Delta variant to EM economies amid still low levels of vaccination and willingness by authorities to impose restrictions on movement and activity.

Global growth, at least based on the recent PMI numbers, appears less synchronised. The latest manufacturing PMI readings for EM point to a slowdown in the pace of recovery, while in advanced economies, momentum remains exceptionally strong.

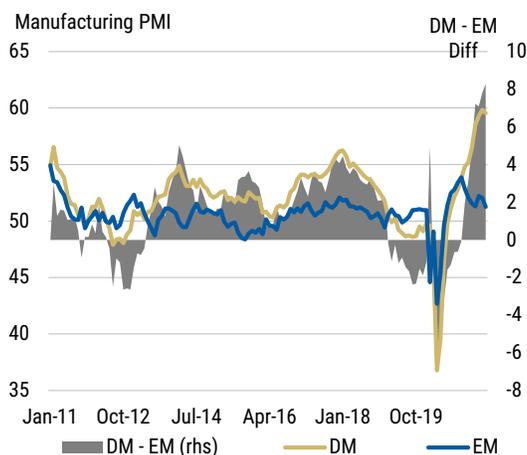
The difference between the level of the manufacturing PMI in DM economies versus EM economies continues to widen in favour of DM and, as of the latest print in June, has never been higher.

Asia economies in particular are starting to see data soften, we believe in part due to rising concerns about the Delta variant amid limited vaccination capacity. While the EM PMI remains above 50, the data raise some questions about the relative momentum of EM versus DM growth and whether growth remains globally synchronised.

The latest reading from our PMI model continues to point to a long USD strategy against EM currencies, given that the peak in EM manufacturing PMIs is behind us vs. stability in the US. The positioning of the PMI portfolio remains long USD, but there is a clear distinction between EM and G10, with the portfolio being significantly more bearish on the former and neutral on the latter.

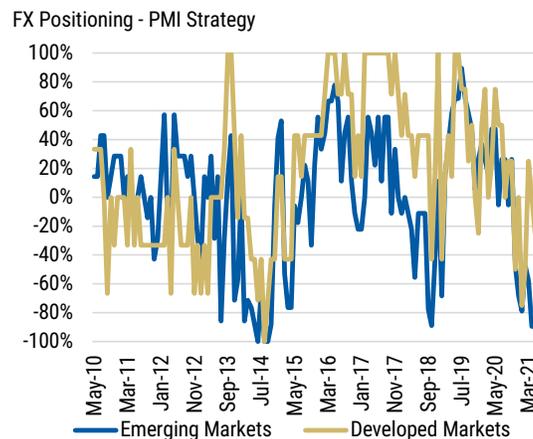
Exhibit 4 shows the model's overall next FX positioning against USD, across both G10 and EM currencies. As is clear, the model is suggesting a high level of long USD exposure versus EM, but is more neutral toward developed markets. Nonetheless, given the diverging monetary policy stance of the Fed versus the ECB, combined with the growing risk of the Delta variant in Europe (see [Euro Area: Delta Blues](#), July 1, 2021), we continue to recommend a short EUR/USD position.

Exhibit 13: How synchronised is the global recovery?



Source: Haver Analytics, Morgan Stanley Research

Exhibit 14: FX PMI strategy shows growing conviction in long USD/EM positions

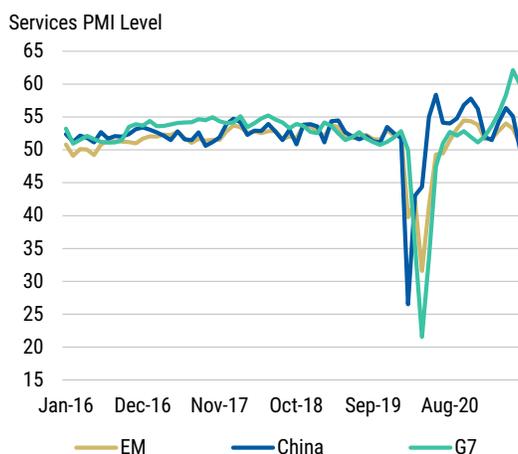


Source: Haver Analytics, Morgan Stanley Research

The divergence is not just relevant for manufacturing PMIs. If anything, the weakness is even more pronounced in service sector PMIs for EM, which perhaps is not very surprising as any increasing social distancing amid rising COVID concerns would naturally hit services more than manufacturing.

China's service sector PMI is at its lowest point since April 2020, at just 50.2, and compared to the 2019 average of 52. The picture is not much different for the broader EM services PMI. The G7 services PMI dropped marginally in June but remains a very strong 60, leaving a 10pt gap vs. EM.

Meanwhile, growth in China's retail sales continues to slow. If we strip out the base effect by looking at the 2y CAGR of retail sales in China, it is at just 3%, at a level consistent with the long-run declining trend. This doesn't seem consistent with an economy rebalancing toward consumption. Next week, on July 15, China will publish its June data for retail sales.

Exhibit 15: Not so synchronised

Source: Haver Analytics, Morgan Stanley Research

Exhibit 16: China retail sales losing momentum

Source: Haver Analytics, Morgan Stanley Research

PBOC shifts to a more dovish policy stance: The weakness in China has reached the point that the PBOC has delivered a 50bp broad-based cut in its reserve requirement ratio, released around CNY1trn into the banking system. Our economists expect this 'fine-tuning' of policy to help stabilise the economy in 2H (see [China Economics: Beijing Affirms Pivot to Easing](#)). That would help to close the divergence, but with monetary policy between China and the rest of the world now diverging (with most other central banks shifting toward tapering/hiking), it seems likely to us that CNH would continue to weaken. **We remain long SGD vs. CNH.**

Could the moves from China be a precursor for a broader shift in EM monetary policy, which has been surprisingly hawkish in recent months? If so, more pressure on EM FX could be on its way. While it may be a bit early to make that call, given high inflation in many EMs, it is not entirely out of the question based on the following plausible sequence of events: Delta remains a risk, causing further social distancing and restrictions amid limited vaccinations in EM, causing further USD strength and both having a knock-on impact to commodity prices, which then take the heat out of inflation in EMs.

Staying short Latam FX

Elsewhere in EM, we keep our bearish view on Latam currencies and recommend increasing USD exposure via an equally weighted basket of long USD versus COP, CLP and MXN, targeting 106 with a stop at 97.

We note that our standalone long USD/COP trade has reached our target of 3785 (spot reference), but we like to keep short COP exposure via the basket as we continue to view Colombia's high twin deficits as making the currency extremely vulnerable to a stronger USD.

We also see attractive risk/reward in short CLP positions, given ongoing political uncertainty, a weaker outlook for metal prices (as we discuss in [G10 | Positioning for commodity price divergence](#)) and low carry. However, we prefer to express this view via the basket, and we close our recommendation to sell USD/CLP 6m ATM straddle versus buy USD/COP 6m ATM straddle.

Lastly, we think that asymmetric USD risks and fairly ambitious market pricing for Banxico's hiking cycle point to increasing risks for MXN, so we switch shift our short MXN exposure from long USD/MXN 6m calls into outright MXN shorts via the basket.

Our Current Stance On Markets

In [global rates markets](#), we recommend going outright short UST 10y nominal rates. We also continue to recommend EDZ2Z4 steepeners, short beta-weighted 10y breakevens (DV01 0.7:1), short July CPI fixing, long 6m T-bills vs. OIS, and Z1/Z2 FRA/OIS flatteners. In US rates vol, we continue to recommend buying 3m5y payer condors, selling 2m10y straddles while buying 5m10y straddles (initially priced 4-Jun-21), and maintaining any existing 1x2 6m5y payer spreads and 1x1 1y30y payer spreads.

In the euro area, we continue to suggest long 30y OATs vs. 30y Bunds, long Ireland 10y vs. short 10y OATs, and long 10y Italy vs. short 10y Spain. In Japan, we recommend closing JGB 7s30s flatteners. We continue to recommend paying 5y ZTIBOR-LIBOR basis, 10y JGB ASW against 3m DTIBOR, ZTIBOR-OIS 5s20s flatteners, 2s10s JPY basis steepeners, and paid positions in 10y10y JPY xccy basis.

In the dollar bloc, we recommend receiving the November RBNZ meeting. We continue to recommend long BAZ2 futures positions, ACGB 5s30s steepeners. We also maintain our long Nov24 ACGB vs. short 50/50 basket of June24 CAGB and May24 NZGB, as well as long Dec 2030 ACGB vs. short May 2031 NZGB.

In [foreign exchange markets](#), we continue to expect USD gains in Regime 3 – one in which real rates rise, breakevens tighten, and the USD turns broadly higher. We like owning USD versus both G10 and EM currencies.

We continue to recommend short AUD/USD (target 0.70, stop 0.78), long USD/JPY (target 112.50, stop 108.40), short EUR/USD (target 1.17, stop 1.2150), short AUD/NZD (target 1.04, stop 1.0730), and long USD/CAD (target 1.27, stop 1.21). We also recommend owning USD versus COP, CLP, and MXN. In FX options space, we continue to suggest short 3m USD/JPY 112.5 call (priced 18-Jun-21) against the long delta position, and we recommend owning USD/CHF 1y risk reversal by buying a 0.9450 call and selling a 0.8850 put (priced 18-June-21).

Interest Rate Strategy

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United States

We see the decline in yields in July as parallel to the rise in yields in March, but in reverse. In March, overnight selling of Treasuries from Japan and Asia catalyzed a misleading narrative of a super-strong economic recovery. In July, the short covering rally and steeper unwinds are catalyzing another misleading narrative centered on the Delta variant, and peaking economic growth. In March, we suggested fading the excessive optimism narrative; we now suggest fading the pessimism narrative by going short 10y UST outright.

Our analysis of futures open interest vs. price action suggests a significant role of short covering in the recent rally in Treasuries. Additionally, futures positioning data suggest a significant flattening exposure from the "other reportables" category, which seems to explain the curve flattening. We think these positioning-driven moves remain unsustainable.

We resist the temptation to fit a narrative to the recent decline in yields. Our analysis shows that the Delta variant concerns are overblown, and our economists maintain their Global growth projections. Similarly, we see demonstrable evidence that the June FOMC meeting was a hawkish surprise, and do not subscribe to the emerging narrative that the June FOMC meeting was instead an obvious mark to market. Fed's hawkishness (or lack of dovishness) remains supportive of higher yields.

Finally, we highlight four reasons we believe short Treasuries could work in the near term: (1) the positioning-driven decline in yields is not likely to be sustainable, (2) economic surprise indices have rolled over, increasing chances of upside surprises, (3) we see positive signs for sustainable inflation, and improvement in labor supply, and (4) Treasury yields tend to rise by 15-20bp in the week of 3s,10s,30s auctions, conditional on having rallied 20-25bp before it. Next week's auctions could be another catalyst.

Euro area

The outcome of the ECB's strategy review came broadly in line with our expectations, with the most notable changes related to a switch to (1) a symmetric inflation target around 2%, (2) a recommendation on the inclusion of owner-occupied housing to the assessment of inflation, and (3) the incorporation of climate factors in monetary policy, backed by a roadmap suggesting implementation of accounting for climate risk in collateral and CSPP from mid-2022. We see limited implications of the review conclusion for the near-term direction of EGB yields and the pricing of ECB policy. However, with the release of the conclusions of the review, we think the path is clear for the ECB to set out its post-pandemic policy response as early as the September Governing Council meeting.

We also review EGB funding progress year to date, noting the negative net supply dynamic expected for a majority of countries for the remainder of the 2021 calendar year, likely supporting spreads into the summer.

According to data released by Japan's Ministry of Finance, the aggregate Japanese investors' were net sellers of EGBs in May for the nine countries we track, following modest net buying in April. Individual countries' net flow numbers were relatively subdued, with the exception of France, which saw a €3bn outflow in May.

Japan

We close our JGB 7s30s flattener trade, since demand for JGB futures from overseas investors has been stronger than we expected, with CTAs seemingly initiating new long positions in decent size, while banks' demand is unlikely to be enough to offset the impact of heavy supply with the lack of lifer demand to chase the yield lower.

Though not our base case, given that the government appears to have over-budgeted quite considerably for both FY2020 and FY2021, another reason for closing the trade is that talks of a summer supplementary budget could serve to rekindle speculation about the possibility of an increase in super-long JGB issuance.

We also discuss whether demand from lifers to purchase long-end JGBs will dissipate. The result of the field test 2020 (FT20) published by the FSA suggested that lifers are no longer in a particular hurry to reduce their asset-liability duration mismatches, given that they are expected to maintain > 100% ESR level under the extreme risk-off scenario. We believe that lifers can perhaps now afford to wait until yields climb to more attractive levels (possibly in 2H FY2021) rather than rushing to buy into a rising market

United States | Short 10y Treasuries

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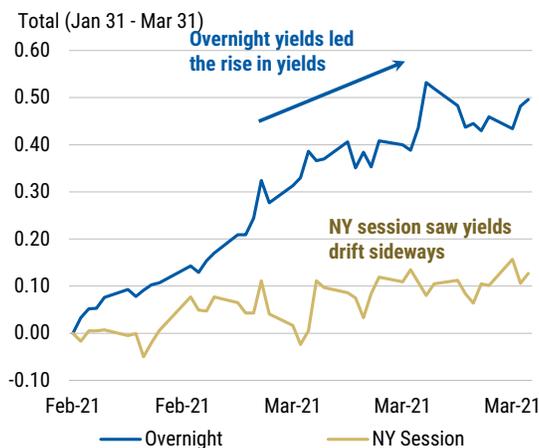
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Don't let the lessons of March 2021 go to waste

We have seen this movie before. It's hard to believe it was only four months ago – in March 2021. The script goes like this. Treasury yields move sharply based off a flow that is sizeable and persistent. The lack of an obvious catalyst leads many investors to create narratives that fit the price action, narratives which are convenient, but not necessarily logically robust. And then begins the head scratching. Why isn't the narrative playing out, investors wonder? Eventually Treasury yields revert to levels that align with the reality of the economy and the Fed, and the old convenient narrative is forgotten.

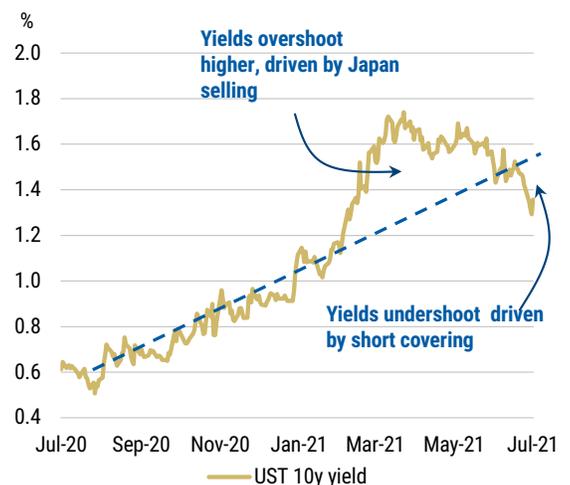
A trip down memory lane, to March 2021, is worth it, for the lessons it offers about the current state of the Treasury market. It all began with the selling flow from Japan, and the ensuing rise in yields that didn't have a connection with the available economic news at that time, but had more to do with the end of the Japanese fiscal year. As evidence, [we flagged](#) that nearly 90% of the rise in yields had happened overnight, and yields had moved largely sideways in the NY session (see [Exhibit 17](#)). In other words, the move didn't seem connected to economic fundamentals or the Fed's dovish stance at that time.

Exhibit 17: 10y yield moves driven by overnight vs. NY session moves in February and March 2021



Source: Bloomberg, Morgan Stanley Research

Exhibit 18: 10y yields in the last year



Source: Bloomberg, Morgan Stanley Research

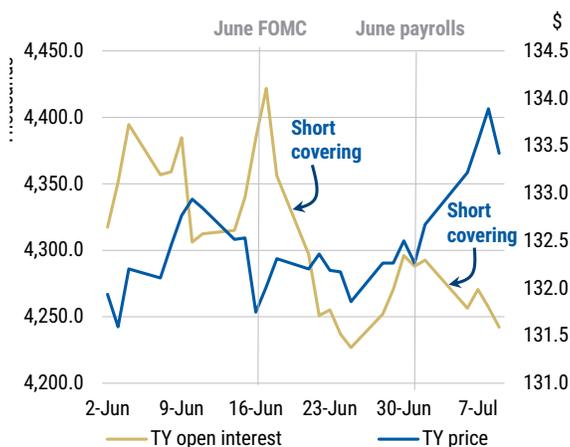
Yet the rise in yields converted many investors into believers of a strong economy, with many investors expecting job growth coming in at a pace of a million new jobs per month for coming months. But as March ended, and the selling from Japan abated, the Fed continued to sound dovish, and payrolls were unable to meet the lofty expectations. 10y yields peaked at 1.75% in late March, eventually moved lower, aligning with the economic recovery and the Fed's stance.

July 2021 looks like March 2021, in reverse. This movie began after the June FOMC meeting. In what was a clear hawkish surprise, the extreme market positioning got exposed, particularly for curve steepeners, which involved going short the 10y or the 30y point. **Positioning data in futures and open interest data offer clues that there has been a wave of short covering in the back end which has driven the rally, and that the tide is starting to turn.**

Exhibit 20 shows that **for the TY contract, we have seen a couple of rounds of short covering waves**, identified as periods where the contract price increases alongside declining open interest (which means positions were covered). We saw some initial short covering right after the June FOMC meeting, and some since the June payroll report was released on July 2.

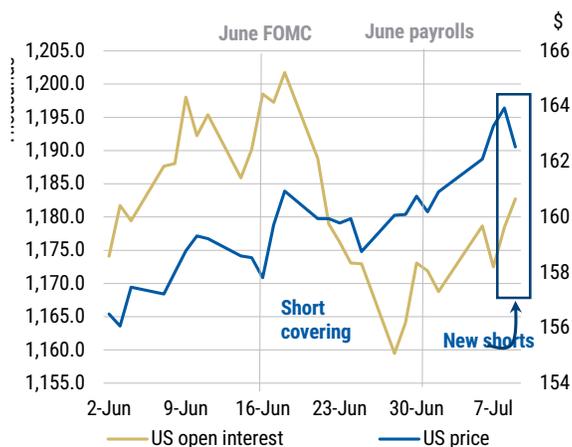
In the same vein, when we examine the US contract (and the WN contract), shown in Exhibit 20, we see a round of short covering around the June FOMC, and one before the June payroll report. However, it is notable that the rise in yields on Friday, July 9, has been accompanied by rising open interest, suggesting **investors are starting to feel confident about adding new short positions, at least in the back end of the curve.**

Exhibit 19: Open interest vs. price action in the TY contract in the last month



Source: Bloomberg, Morgan Stanley Research

Exhibit 20: Open interest vs. price action in the US contract in the last month



Source: Bloomberg, Morgan Stanley Research

Additionally, when we look at the CFTC data for positioning among various categories of investors, we find that the "other reportables" category of investors has been shedding steepeners/adding flatteners very rapidly over recent weeks (for the data as of July 2, see Exhibit 21), which seems to have coincided with the flattening of the curve. This category has added ~\$20bn of 10y equivalents of curve flatteners over the last three weeks. The other reportables category includes corporate treasuries, central banks, smaller banks, mortgage originators, credit unions and any other reportable traders not assigned to the other three categories.

Exhibit 21: Steepener position for "other reportables" over the last five years vs. 5s30s curve

Source: Bloomberg, Morgan Stanley Research

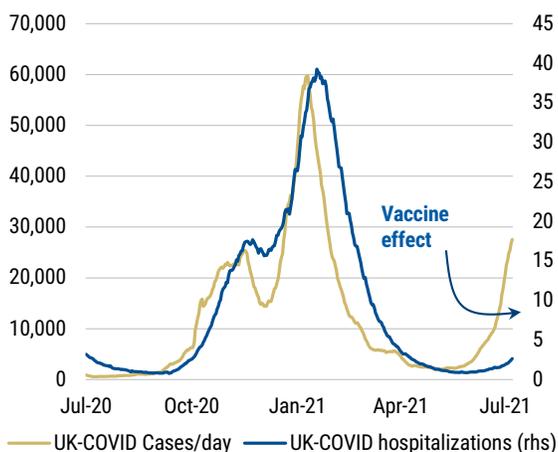
In spite of some evidence showing that short covering and the unwind of steepeners have contributed to the recent decline in yield, investors seem to be questioning the rally in Treasuries, as a reflection of rising concerns about the Delta variant of the virus, and even suggesting that the Fed wasn't really hawkish to begin with. **We resist the temptation to fit a narrative and maintain, based on evidence, that the decline in Treasury yields is largely explained by positioning unwinds, and thereby likely to reverse.** We examine the two most commonly cited narratives, and why they do not seem supported by evidence.

Fitted narrative 1: Markets are reacting to the Delta variant. Let's examine the possibility that the Treasury market is concerned about the rise of the Delta variant. We find this narrative questionable on multiple levels. First, various studies on vaccine efficacy show a high degree of efficacy against hospitalization and death, from the existing AstraZeneca and Pfizer/BioNTech vaccines (see [Exhibit 23](#)). And this efficacy is important because it means that rising case numbers do not necessarily translate to higher hospitalizations (see [Exhibit 22](#)), as we have seen in data from the UK.

In essence, if hospitalizations do not rise because vaccines remain effective, policymakers are likely to promote vaccination efforts rather than shutting down economies, which limits the economic impact of the Delta variant. This is exactly the case in the UK, where the planned reopening on July 19 has not been changed despite a rise in COVID cases fueled by the delta variant.

As an aside, the fact that risk markets have continued strong in the last three weeks amid rising headlines about the Delta variant further highlights that the decline in yields is limited to Treasuries and not to broader macro markets. Overall, we do not think the rise of the Delta variant explains the sharp decline in Treasury yields.

Exhibit 22: COVID cases in the UK vs. hospitalizations



Source: JHU CCSE Covid 19 data

Exhibit 23: Efficacy of COVID vaccines against the Delta variant

Study location	Event	Vaccine	Doses	Efficacy
England	Hospital Admission	Pfizer/BioNTech	1	94%
England	Hospital Admission	Pfizer/BioNTech	2	96%
England	Hospital Admission	AstraZeneca	1	71%
England	Hospital Admission	AstraZeneca	2	92%
Israel	Hospital Admission	AstraZeneca	2	93%

Source: Public Health England, Israeli Health Ministry

Fitted narrative 2: The Fed wasn't really hawkish in June. Some investors have sought to explain the move in Treasuries by saying the Fed wasn't hawkish at the June FOMC meeting, so a rise in yields shouldn't be expected. It's also been suggested that because the June FOMC minutes released earlier this week reaffirmed the Fed's FAIT framework, they were meant to be dovish. We do not think this narrative is supported by evidence either.

Surveys conducted just before the June FOMC meeting asked primary dealers and market participants about their expectations for the dot plot, and both surveys showed an expectation of the 2023 median dot being unchanged or slightly changed, at about 0 hikes in 2023. Yet the 2023 dot showed 2 hikes in 2023 (see Exhibit 24), which is a clearly demonstrable hawkish surprise vs. the expectations recorded in these surveys.

Exhibit 24: Expectations for the June FOMC dot plot vs. actual dot plot

	2021	2022	2023
Primary dealer expectation	0.125	0.125	0.250
Market participants' expectation	0.125	0.125	0.125
Actual June FOMC median	0.125	0.125	0.625

Source: Bloomberg, Morgan Stanley Research

Exhibit 25: Bloomberg economic surprise index over the last year



Source: Bloomberg, Morgan Stanley Research

4 reasons we position for higher yields

Reason 1: Positioning-driven move. As we noted above, we do not think the recent move is driven by a fundamental re-evaluation of the economy or a change in the Fed, but instead largely driven by position squaring, as well as abundant liquidity. Positioning-based moves shouldn't last, and as we noted above, there are already nascent signs that investors are ready to position for higher yields again.

Reason 2: Economic surprise indices at local lows. The economic surprise indices have rolled over (see [Exhibit 25](#)), and are at their local lows. Historically, these surprise indices tend to be cyclical and bounce between highs and lows, which means that as economists' expectations are revised lower for data, chances of upside surprises increase.

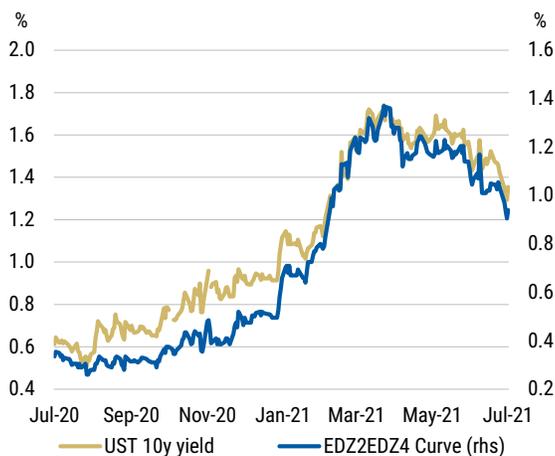
Reason 3: Positive signs for labor market and inflation. Our [economists point out](#) that labor supply is likely to see a bump in late summer as Federal unemployment programs end, which could have positive implications for payrolls over coming months. Additionally, as we note in [United States | Finding the real yield floor](#), shelter inflation could continue to rebound in the coming months, providing a strong backbone and sustainability to inflation at healthy levels, even as transitory components fade.

Reason 4: Could auctions next week kick-start a move higher in yields? In our analysis below, we show that yields tend to rise a very high percentage of times after having rallied by 15-25bp into Treasury supply weeks when the Treasury auctions 3s, 10s and 30s. A 15-20bp rise starting on the Friday before the auction week happens with a high frequency, when yields have rallied sharply in the weeks before.

We suggest going short 10y Treasuries to position for higher nominal yields in the belly of the curve (see [Exhibit 26](#)). We also maintain EDZ2Z4 steepeners as a trade with a similar exposure. As we suggested in our last weekly publication - in the section entitled [All about that Pace](#), EDZ2Z4 steepeners are a way to position for a faster pace of hikes implied by the market. Notably, the pace of hikes has become disconnected from the timing of hikes since the FOMC meeting, and we think this dynamic is also a reflection of positioning-driven bull flattening in the rates market recently. A higher pace of hikes would be consistent with steeper Z2Z4 curve as well as higher 10y yields.

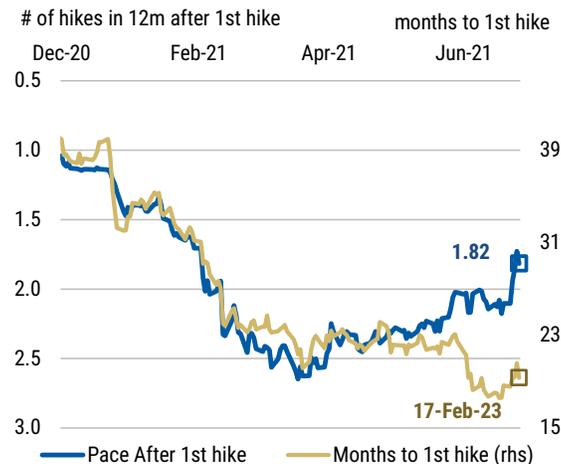
Additionally, we think that real yields will drive the bulk of the move higher in nominal yields, while breakevens will be stable at the current healthy levels. And therefore, we also express our view for higher yields via an underweight in 10y real yields in the form of a **beta weighted 10y breakeven tightener** (DV01 weight 0.7 :1).

Exhibit 26: EDZ2Z4 steepeners vs. 10y yields over the last year



Source: Bloomberg, Morgan Stanley Research

Exhibit 27: Market implied pace of hikes vs. timing of the first hike over the last six months



Source: Bloomberg, Morgan Stanley Research

Can the upcoming auctions support a yield reversal?

We studied how the 10y yield has moved historically into the 3s, 10s and 30s supply cycle following a decline in yields similar to recent moves. The 10y touched its lowest levels since February in the NY morning session Thursday (near 125bp), down ~25bp from the ~150bp level maintained two weeks ago. With supply now on the horizon, the Thursday NY session and Friday have seen a strong reversal higher in yields with the curve bear steepening.

Over the past decade, as markets have turned attention to upcoming supply in the wake of a considerable rally, we identified multiple scenarios in which the 10y yield rose considerably through the supply cycle after rallying 15-25bp ahead of the auctions (Exhibit 28). One strong set of returns came from looking at a 9-business-day window through the supply after a 20bp move lower in rates in the 13 business days ahead of the auctions. Though the max +27.9bp move in 10y yields came in March 2020, these instances also included four other cases of rates reversing +15-20bp after the rally. Weighing on the average for this set is one move 23.7bp lower in August 2011.

Exhibit 28: Rising rate scenarios through 3s, 10s and 30s supply (after a rally)

Rally threshold (ahead of supply)	Threshold day (ahead of supply)	Window after threshold	#Instances with rates higher	% Rates higher	Max move (10y)	Average move (10y)
-20bp/T-13	Thursday	T+9	6 out of 8	75%	+27.9bp	+9.1bp
-20bp/T-6	Thursday	T+6	5 out of 6	83%	+19.5bp	+7.2bp
-25bp/T-10	Thursday	T+6	4 out of 5	80%	+16.6bp	+6.7bp
-25bp/T-10	Thursday	T+5	3 out of 5	60%	+18.9bp	+5.8bp
-20bp/T-7	Friday	T+5	5 out of 7	71%	+20.0bp	+4.1bp
-15bp/T-10	Thursday	T+6	11 out of 17	65%	+19.5bp	+3.7bp

Source: Morgan Stanley Research

Overall, our analysis shows that yields rise a high percentage of times, after having rallied by 15-25bp into Treasury supply weeks when the Treasury auctions 3s 10s and 30s.

Trade idea: Enter short 10y UST at 135bp

Trade idea: Maintain EDZ224 steepeners at 94bp

Euro area | Green light for policy continuity

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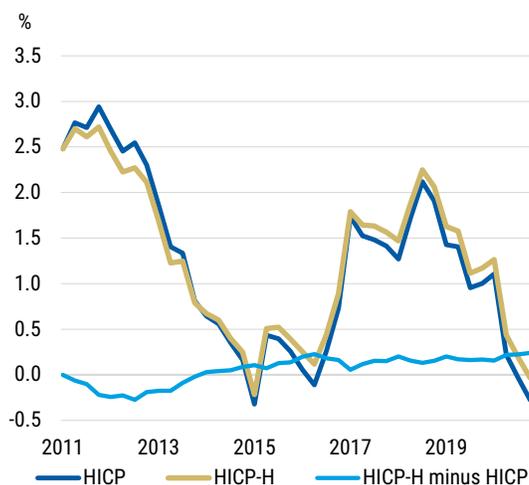
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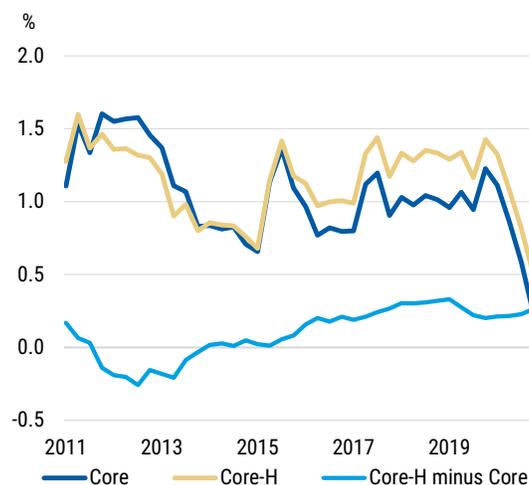
ECB Strategy Review – Limited Near-Term Implications

On July 8th, the ECB published the [outcome](#) of its much-anticipated strategy review, which was broadly in line with our economists' expectations. The most notable change was in the formulation of the central bank's inflation target from "close to but below 2%" to a symmetric inflation target around 2%. The switch did not come as a surprise for market participants and has been consistent with the recent Governing Council rhetoric. While stressing that negative and positive deviations of inflation from the target are equally undesirable, the statement highlighted that when the economy is operating close to the lower bound on nominal interest rates, it requires especially forceful or persistent monetary policy action. Our economists see this as modestly dovish shift but also caution against interpreting this a Temporary Average Inflation Targeting (T-AIT) framework (see [TAIT-lite to Keep it Easy](#)).

The review also recommended including owner-occupied housing (OOH) costs in inflation (see [Putting OOH into HICP](#)). This will be gradually introduced over time – in any case not before 2026. Our economists expect the inclusion to have only a modest impact on inflation – around 7bp over the cycle – but should lead to the ECB paying greater attention to the housing market in its assessment of the economic outlook.

Exhibit 29: Euro area headline inflation

Source: Eurostat, Morgan Stanley Research

Exhibit 30: Euro area core inflation

Source: Eurostat, Morgan Stanley Research

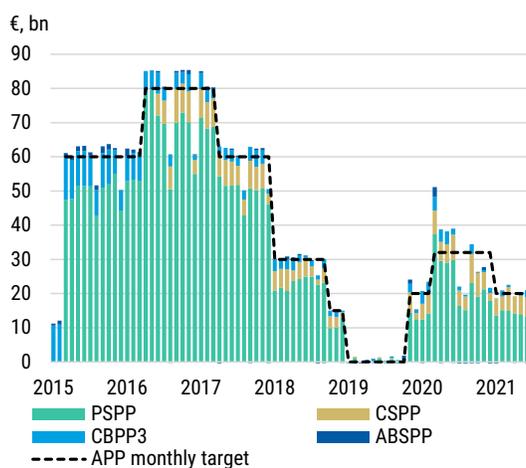
Other changes included a replacement of the existing “monetary pillar” by the broader “financial and monetary pillar”, adapting the communication of monetary policy decisions and a [green shift](#) in monetary policy, backed by a [roadmap](#) that suggests the implementation of accounting for climate risk in collateral and CSPP from mid-2022. The first regular monetary policy meeting of the Governing Council that will apply the new strategy will be held on 22 July 2021.

We see limited implications of the review conclusion for the near-term direction of EGB yields and the pricing of ECB policy. However, with the release of the conclusions of the review, we see a clear path for the ECB to set out its post-pandemic policy response as early as the September Governing Council meeting.

ECB Purchases Programmes Update – German downside capital key deviation continued to decline in June

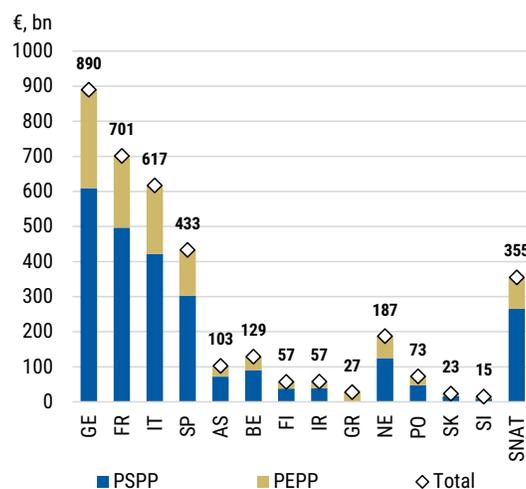
Net APP purchases in June were equal to €20.6bn, broadly in line with the target pace of €20bn/month. Net PEPP purchases were €80.2bn, in line with Apr-May levels. Public sector purchases accounted for 65% of APP buying in June, the lowest monthly level in 2021. We estimate that there is €845.4bn of purchasing power remaining between the programmes before the end of March 2022.

Exhibit 31: APP/PEPP – split by programme



Source: ECB, Morgan Stanley Research

Exhibit 32: Eurosystem holdings by jurisdiction

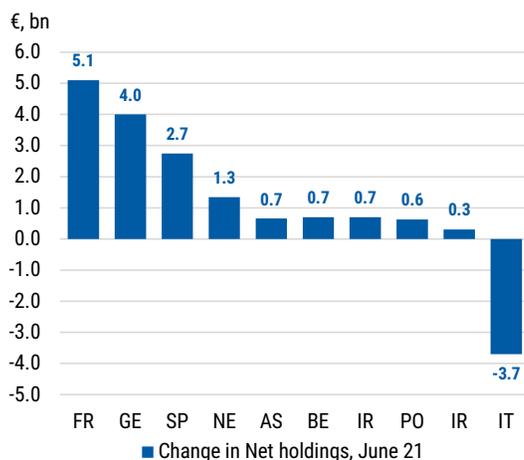


Source: ECB, Morgan Stanley Research. Note: the split of June purchases assumes allocations according to the capital key

On an individual country level, France accounted for the largest share of PSPP purchases ex-supras (€5.1bn), followed by Germany and Spain. The net purchases of Italian debt were negative, likely due to redemptions volumes not being compensated by additional purchases. As a result, June saw a further correction of the downside capital key deviation in Germany within APP, while the upside deviation in Italy was also reduced.

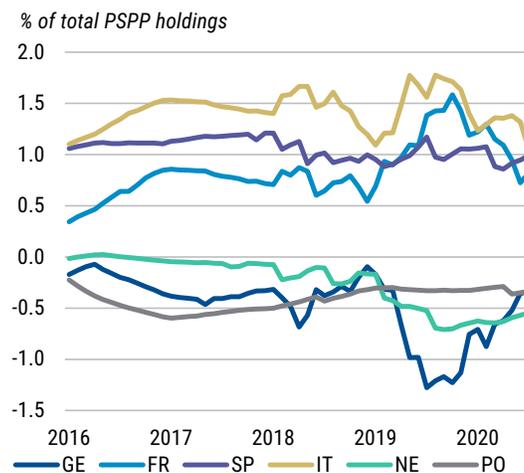
The next bi-monthly release of the split of PEPP holdings by jurisdiction is expected on August 2nd. The ECB will conduct PEPP purchases at an elevated pace at least until the end of Q3 2021. Given the seasonal slowdown of purchases and supply expected in August, the ECB could front-load some of the buying over the month of July.

Exhibit 33: Monthly change in net PSPP holdings in June



Source: ECB, Haver Analytics, Morgan Stanley Research

Exhibit 34: Estimated deviation from the capital key - PSPP

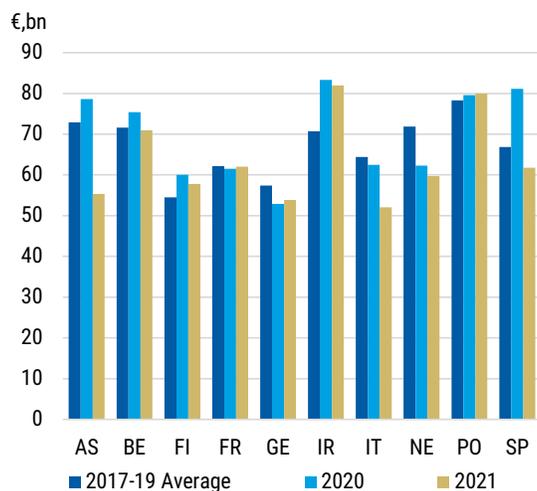


Source: Haver Analytics, Morgan Stanley Research estimates

Funding Progress Update – Past the Peak?

We believe we are now past the peak in this year’s European sovereign supply and look for lower primary market issuance needs at the country level in H2 2021. If history is a guide, following next week’s relatively busy issuance schedule, with auctions from France, Spain, Italy, Germany, and the Netherlands, the pace of supply should meaningfully slow down for several weeks, before picking back up in September.

Exhibit 35: Funding progress in the first 28 weeks of the year relative to final remit/estimates



Source: Morgan Stanley Research estimates

Exhibit 36: Estimated 2021 funding progress

	2021 issuance projection	Issued through Jul 9, €bn	Issuance Remaining, € bn	Issued through Jul 9, % of Expected
Austria	45	25	20	56%
Belgium	36	26	11	71%
Finland	18	10	8	58%
France	290	180	110	62%
Germany	246	132	113	54%
Ireland	18	15	3	82%
Italy	375	195	180	52%
Netherlands	55	33	22	60%
Portugal	15	12	3	80%
Spain	174	107	67	62%

Source: Morgan Stanley Research estimates

In recent years, syndications in the second half of July and August have been rare over the past few years, with several Greek offerings and Finnish placements during the last week of August every year.

Our updated YTD funding progress shows that a majority of countries are now close to 60% through their estimated issuance for the year. Compared to 2020, the issuers appear either in line with the funding progress vs the actual issuance outturn achieved around the same time last year, or slightly behind.

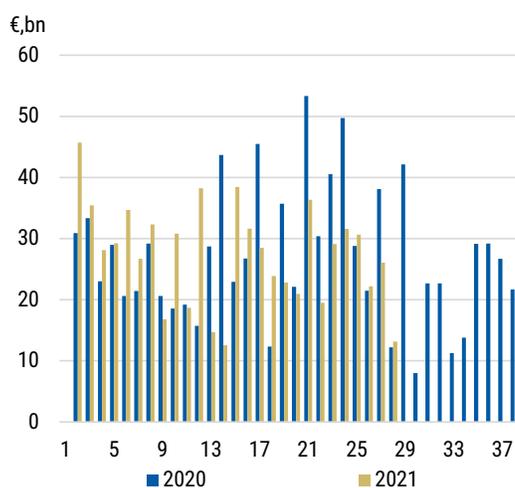
There are likely to be two factors behind it:

1) The large issuance volumes in Q2-Q3 2020 led to an eventual overfunding and the subsequent reduction of full-year remit in Q4. By contrast, the pace of issuance has been more gradual in 2021, leading to slightly lower funding progress.

2) The issuance outturn may end up being below the treasuries projections due to better-than-anticipated fiscal performance, and we may therefore see downside revisions to the funding requirements later in the year. This particularly applies to the countries where the funding progress is close to 50%, as this implies the issuer would have to maintain at least the same pace of supply as in previous months in 2021. However, this may not be feasible given the seasonal factors during the months of August and December.

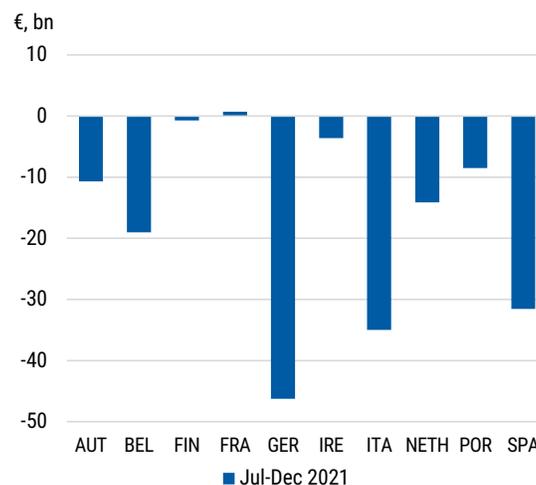
Taking the expected slowdown in issuance, the chances of downside revisions to funding remits and the ongoing elevated pace of ECB buying, spreads should remain supported into the summer months. With the conclusion of the ECB strategy review clearing the way for the potential announcement on the future of ECB QE beyond PEPP at the September Governing Council meeting, a pickup in tapering expectations remains the main risk for duration outperformance.

Exhibit 37: Gross EA11 issuance by week in 2020 and 2021



Source: Morgan Stanley Research estimates

Exhibit 38: Estimated issuance net of QE and redemptions



Source: Morgan Stanley Research estimates

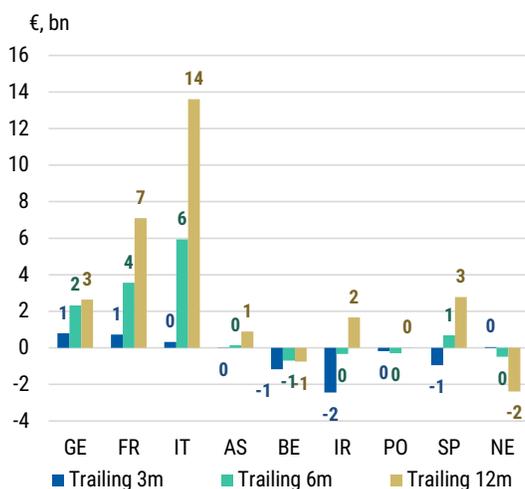
Japanese Investors large sellers of OATs in May

According to data released by Japan's Ministry of Finance, the aggregate Japanese investors' were net sellers of EGBs in May for the nine countries we track, following modest net buying observed in April. Individual countries' net flows numbers were relatively subdued, with the exception of France. Highlights from the monthly data were the following:

- France saw the largest net outflows of €3bn in May, followed by Spain (-€0.8bn) and Netherlands (-€0.6bn). This was the first positive net selling number for OATs since February as 2021 YTD still sees Japanese Investors being net buyers of OATs (€0.5bn) . The largest inflows were from Germany (+€0.8bn) and Italy (+€0.2bn).
- On a rolling 3m basis, Japanese investors remain net sellers of EGBs, with core and semi core countries seeing the most substantial net buying activity with Bund buying activity topping €0.8bn and with France's at €0.7bn. Ireland and Belgium conversely saw the biggest negative flows at -€2.5bn and -€1.2bn, respectively .
- On a rolling 12m basis, flows into BTPs remain notably positive (+€13.6bn), while the semi core complex, with the exception of France (+€7.1bn), is mostly flat with Netherlands registering the biggest outflows (-€2.4bn).
- On an FX-hedged basis, the most attractive yield pick-ups for Japanese investors vs a 10y JGB remain in Italy, Portugal, and Spain, with Ireland being the most attractive in the semi-core space.

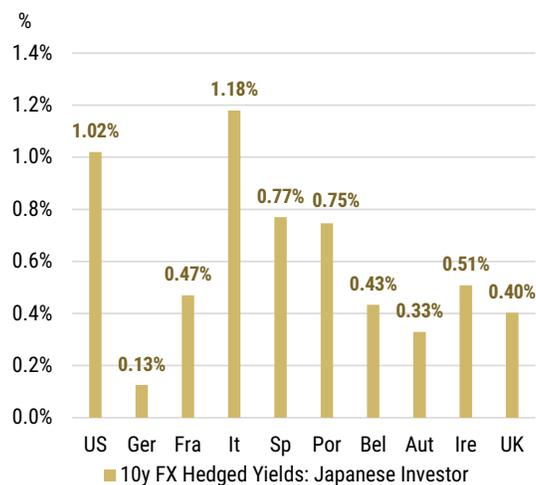
In our view, the most interesting story from this data continues to be the buying of BTPs in 2021, as we first highlighted [here](#).

Exhibit 39: Japanese Investor purchases trailing 3m, 6m and 12m



Source: Japan MoF, Haver Analytics, Bloomberg, Morgan Stanley Research

Exhibit 40: Current FX-hedged yield pick-up for Japanese investor vs 10y JGB



Source: Japan MoF, Haver Analytics, Bloomberg, Morgan Stanley Research

Trade idea: Maintain 10y Italy vs Spain and 30y France vs Germany

Japan | Has demand for super-long JGBs weakened among life insurers?

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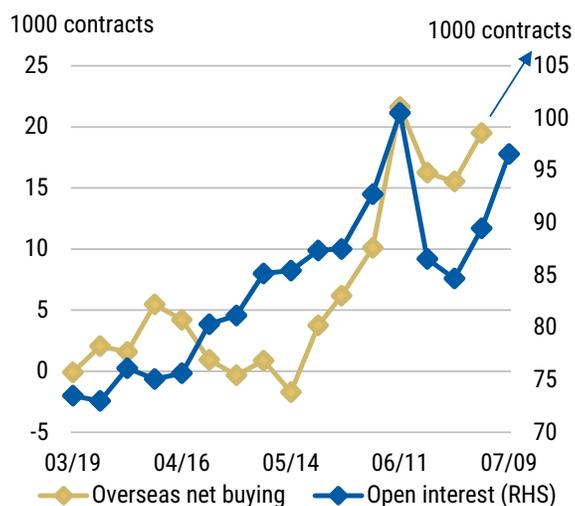
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Futures leading the way

US Treasuries have been rallying of late in a fashion seemingly at odds with the recent strength of economic indicators, with the key drivers appearing to be short-covering by speculators and liquidity-driven demand for carry. JGB futures have also rallied relatively strongly against this backdrop. Given that open interest has continued to increase over the past few weeks and foreign investors have now switched from net sellers to net buyers (see [Exhibit 41](#)), our impression is that the recent decline in US interest rates has caused duration-hungry CTAs to start focusing on the JGB futures sector.

Exhibit 41: Cumulative net purchase of JGB futures by overseas investors and open interest (since March roll)



Source: Japan Exchange Group, Morgan Stanley Research

Exhibit 42: Beta to 1bp change in 10y UST yield



Source: Morgan Stanley Research, Bloomberg

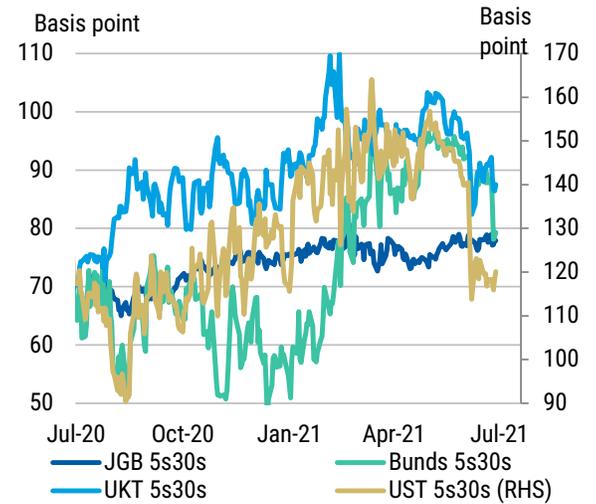
Cash JGBs have meanwhile shown almost no reaction to the UST rally, with longer-dated JGBs looking particularly insensitive to movements in UST yields of late (see [Exhibit 42](#)). For example, the 30y JGB yield has basically just drifted sideways even as the 30y UST yield has fallen more than 40bp from its recent high (see [Exhibit 43](#)). Moreover, the JGB 5s30s curve has steepened despite the massive bull-flattening of other regions' curves (see [Exhibit 44](#)). We attribute this to a combination of (1) increasing supply of super-long JGBs and (2) a general reluctance on the part of Japanese investors to chase yields lower by buying into strength.

Exhibit 43: 30y UST yield vs 30y JGB yield



Source: Japan Exchange Group, Morgan Stanley Research

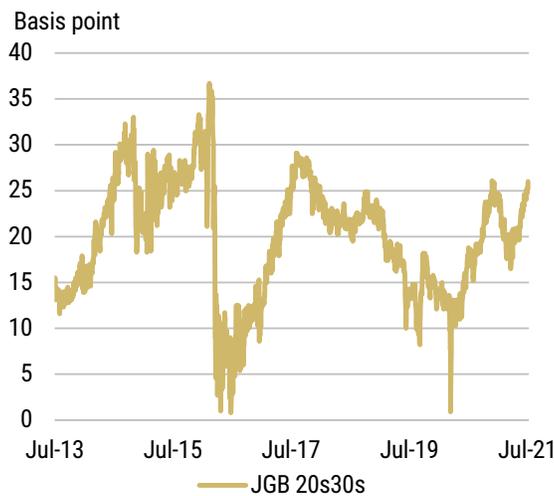
Exhibit 44: G4 government bonds 5s30s curve



Source: Morgan Stanley Research, Bloomberg

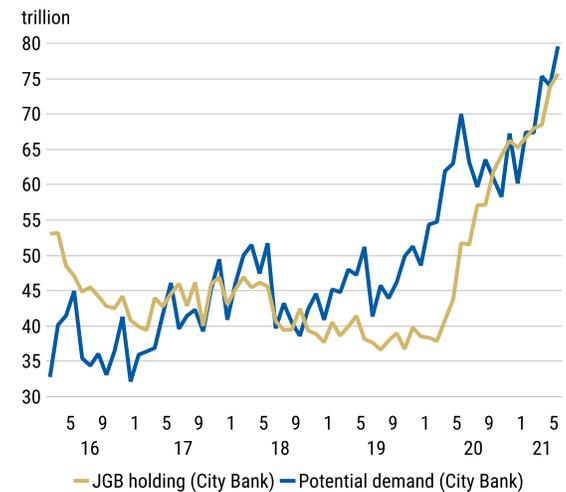
Recent underperformance of the >30y portion of the yield curve means that the 20s30s spread is now near its widest since the launch of the BoJ's "NIRP" back in 2016 (see Exhibit 45). Differences in investor approaches to the JGB market appear to be playing a significant role. As discussed in "Spotlight gradually focusing on carry?", city banks are likely to be channeling at least some of their surplus funds into (predominantly 20y) JGBs as they see a wider deposit-loan gap and also find it harder to "avoid" negative interest rates via the BoJ's Loan Support Program and COVID-19 special operations (see Exhibit 46), while the 30y sector derives much of its support from dip-buying life insurers and is thus liable to be left behind when prices are rising (yields are falling).

Exhibit 45: JGB 20s30s curve



Source: Morgan Stanley Research, Bloomberg

Exhibit 46: Potential investment demand to avoid negative rates on BoJ current account balance (Case of city bank)



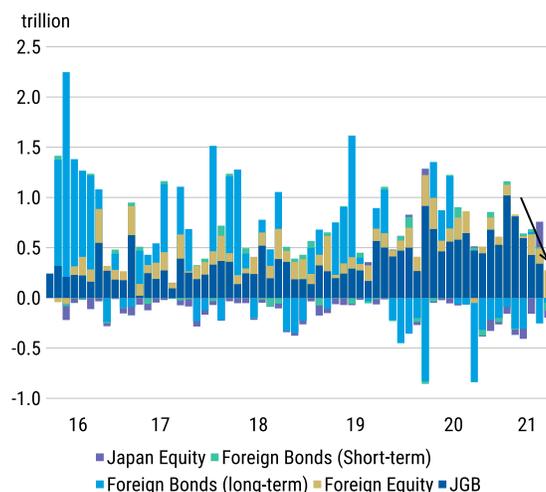
Source: Morgan Stanley Research, BoJ.

Has demand for super-long JGBs weakened among life insurers?

JSDA trading flow statistics point to quite a sharp decline in life insurers' net purchases of super-long JGBs over the past few months (see [Exhibit 47](#)). Given that carry appeal has not diminished all that noticeably (with the 30y yield basically maintaining a 0.65%–0.70% range since April), possible explanations might include diminished inflows of new cash (from policy premiums and the like) (see [Exhibit 48](#)) as well as a sense that lifers are already reasonably well on track in their preparations for Japan's 2025 adoption of an economic-value-based solvency regime (as discussed below).

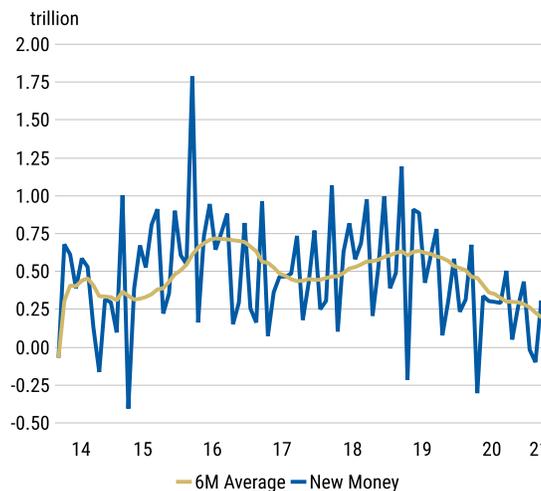
Premium revenues via face-to-face sales and the bancassurance channel have obviously been dealt a major blow by the ongoing pandemic, and lifers have also been facing cash flow pressures in the other direction as many cash-strapped policyholders opt for cancellation.

Exhibit 47: Net purchase of each asset class by Japanese lifers



Source: JSDA, BoJ, Japan Exchange Group, Morgan Stanley Research

Exhibit 48: Lifers' potential new money for investment (Premium income - Surrender value and Other repayment - Claims, Annuities and Benefit)



Source: The Life Insurance Association of Japan, Morgan Stanley Research

Lifers will have been focusing mostly on rebalancing their existing portfolios in the absence of significant new cash inflows, with some sort of balance obviously needing to be struck between overall portfolio performance and preparations for the new solvency regime. 2020 appears to have been characterized by a reduction in exposure to foreign bonds and domestic equities along with increases in exposure to domestic bonds and foreign equities, as would indeed have been consistent with [lifers' stated investment intentions](#) (see [Exhibit 47](#)).

Simply put, it would seem that lifers added to their domestic bond positions and sold off domestic equities with an eye to the new solvency regime—i.e., for reasons of regulatory compliance—while buying up foreign bonds in a bid to improve their overall margins. As mentioned above, however, recent data are indicative of a quite significant decline in net purchases of domestic bonds over the past few months.

Materials published by Japan's Financial Services Agency (FSA) on June 30 include the detailed results of 2020 field tests. The FSA has indicated that the outline of the new economic-value-based solvency framework will be "provisionally determined around 2022" (with a particular focus on specifications for the standardized model) based on both field test results and international developments pertaining to the Insurance Capital Standard (ICS).

The Economic Solvency Ratio (ESR = economic qualifying capital resources / economic capital requirements) basically embodies a requirement to ensure that the market value of net assets (qualifying capital) remains sufficient to cover each insurer's envisaged capital needs under a stress scenario. The working assumption is thus that sub-100% ESR levels might be viewed as the trigger for "early corrective action".

The 2020 field tests actually showed an improvement in average ESR from 180% as of end-March 2019 to 187% at end-March 2020 despite the impact of the then rapidly escalating COVID-19 crisis. This improvement from the 2019 field tests reflected only a comparatively modest contribution from changes to calculation methods and specifications, with fluctuations in asset prices ultimately having quite a significant impact on both the numerator and the denominator.

What about sensitivity to economic assumptions? The biggest threats from a regulatory perspective would still be declines in domestic interest rates and stock prices (see [Exhibit 49](#)), but sensitivity has actually declined by comparison with the 2019 field tests.

Exhibit 49: Sensitivity to each economic assumption (Field Test 2019 vs Field test 2020)

	Field Test 2019			Field Test 2020		
	ESR	Economic qualifying capital resources	Economic capital requirements	ESR	Economic qualifying capital resources	Economic capital requirements
As of Base Date	178%			187%		
50bp rise in JPY rates	+28pt	+10%	-5%	+22pt	+6%	-5%
50bp decline in JPY rates	-40pt	-13%	+12%	-35pt (assuming UFR also is lowered by 50bp)	-10%	+10%
50bp rise in US rates	-1pt	-2%	-1%	-2pt	-2%	-1%
50bp decline in US rates	+1pt	+1%	+1%	+2pt	+1%	0%
Equity, Real estate 10% decline	-7pt	-6%	-2%	-7pt	-5%	-2%
10% appreciation in JPY	-4pt	-5%	-3%	-4pt	-4%	-2%

Source: Japan FSA, Morgan Stanley Research

This should not come as a particular surprise given that lifers have spent much of the past few years looking to reduce the impact of interest rate fluctuations on both the numerator and the denominator by increasing their (longer-dated) domestic bond exposure and thereby reducing asset-liability duration mismatches. Sensitivity to declines in domestic interest rates should have been even lower as of end-March 2021 given that FY2020 saw a further increase in domestic bond holdings (see [Exhibit 47](#)).

Sensitivities are not necessarily additive (given that a simultaneous decline in domestic interest rates and stock prices might result in a different outcome than separate declines), but rough calculations suggest that the average ESR would only fall by 77pt—and as such remain above the 100% "early corrective action" trigger level (or PCR=Prescribed Capital Requirement)—even under a scenario where domestic interest rates fall by 50bp, equity and property prices fall by 50%, and the yen strengthens by 30% from end-March 2020 levels.

Current sensitivity to domestic interest rate movements should be even lower given that domestic bond holdings were increased so significantly in FY2020 as discussed above, which might mean that **life insurers are no longer in a particular hurry to reduce their asset-liability duration mismatches (noting also that they do not necessarily need to be eliminated entirely)**. The net upshot is that lifers can perhaps now afford to wait until yields climb to more attractive levels (possibly in 2H FY2021) rather than rushing to buy into a rising market.

Close JGB 7s30s flattener

Tuesday's 30y JGB auction saw some ¥180 billion in uptake by unidentified buyers, suggesting that banks may have made direct bids. Despite such strong demand from banks, however, the 30y JGB yield has lagged on the curve post the auction amid another rally in USTs. With the lack of lifer's demand to chase the yield lower, we now recognize that banks' demand is unlikely to be enough to offset the impact of heavy supply.

On the other hand, the demand for JGB futures from overseas investors may continue as far as UST yields continue to rally. Hence, we no longer suggest JGB 7s30s flatteners. Though not our base case, given that the government appears to have over-budgeted quite considerably for both FY2020 and FY2021, another reason for closing the trade is that talks of a summer supplementary budget could serve to rekindle speculation about the possibility of an increase in super-long JGB issuance ("[Might JGB issuance need to be hiked due to a FY2021 supplementary budget?](#)").

Trade idea: Close JGB 7s30s flattener

Trade idea: Maintain long 10y JGB ASW against 3m DTIBOR

Currency & Foreign Exchange

The 2021 Institutional Investor (II) Global Fixed-Income Research poll is open. If you enjoy our work, [please rate us](#) five stars in the following categories: USA: Economics & Strategy > Currency & Foreign Exchange; Developed Europe: Economics & Strategy > Currency & Foreign Exchange; Japan > Currency & Foreign Exchange; Asia (ex-Japan) > Local Markets FX Strategy. Thanks for your readership and support!

G10

[G10 | Has USD momentum changed?](#)

Systematic model-based trading strategies, often traded via commodity trading advisors (CTAs), are frequently in focus when markets have large moves that cannot be easily explained by macro stories or what is going on in other asset classes. In the past week, the large decline in US yields was attributed to the CTAs having to close their short US Treasury futures positions as yields fell below key levels. Currency volatility has picked up; have CTAs that use currency momentum to generate a trading signal been playing a role too?

CTA fund assets reached almost USD320bn earlier this year. Currency-specific CTA trader assets have grown almost every quarter since mid 2019, doubling the proportion of total CTA assets from currency-only funds to 8.5%. An estimate of macro CTA performance indicates they would have been short the US dollar going into the June 16 Fed meeting, then only turned long about a week later. CTAs had been short USD (DXY) since March.

A simulated G10 FX momentum signal is still very long the USD, especially against NOK and AUD, though it isn't far from the extreme peak reached in March 2020. The 14D DXY RSI is also close to overbought territory. We continue to suggest being long the US dollar, with upside momentum to accelerate on a move above the prior high of 93.95.

[G10 | Positioning for commodity price divergence](#)

Our commodity correlation analysis shows that FX correlations to commodities have shifted significantly since the onset of COVID-19, and not only due to changes in how the USD trades. CAD has become less correlated to oil prices, while NOK's relationship to oil has strengthened. USD/JPY is no longer closely linked to copper prices, while gold and silver have regained their strong negative correlation to USD, which had started to wane prior to COVID.

We also highlight the best expressions of expected commodity price *divergence*. USD/CLP and USD/JPY should receive a boost if crude oil gains while zinc and copper prices fall (as our Commodities Research colleagues [expect](#)), and USD/CHF should rise if their expectation for crude oil strength relative to gold and silver materializes. Finally, RUB should outperform CLP if (as we expect) gasoil prices rise while long TIPS ETF positioning reverses.

[Introducing our FX Month-End Signal Framework](#)

We recently published a foundation report on relating month-end FX moves to asset performance during the month. We find cyclicalities in G10 FX trading volumes and returns over a calendar month. Currencies with strong local equity markets tend to outperform versus the USD. Based on this information, we discuss a signal with inconsistent but positive historical returns.

Every month, we are asked what we expect to be the USD flows at month end. Predicting the market direction is difficult due to: a) varying definitions of month end (last week, last day, last hour); b) a variety of flows and events that influence exchange rates, and c) dynamic currency hedging.

Positive local equity returns are linked to appreciating G10 currencies versus USD, possibly due to asset manager flows. Intraday, we see strong links between monthly equity market performance and FX around closing on the last day of a month. FX moves at month end relative to equity market performance can provide pockets of value for investors, but the moves need to be considered as one input into a broader trading strategy.

Europe

[NOK/SEK | Moving into a new lower range?](#)

NOK has underperformed lately despite the Norges Bank turning even more hawkish and the US equity market and oil prices holding up well. NOK/SEK has broken below its recent sideways trading range around 0.9890-1.0040 as investors reduced their risk exposure. Global participants, particularly banks, have been the main sellers of NOK. NOK/SEK is now trading at a large discount relative to oil prices, and our rates strategists expect the US 2s10s curve to steepen, which should be supportive for NOK/SEK.

Long NOK/SEK was a favoured trade among real money investors, so their position adjustment has contributed to some of the recent weakness in the pair. We assume that the market is overall still long NOK/SEK. With uncertainty over the spread of the coronavirus delta variant, NOK being the most sensitive G10 currency to risk appetite, and thinner summer liquidity exacerbating the risk of volatile moves in the illiquid NOK, we don't see good risk-reward in buying the NOK/SEK dip at the moment.

Rate differentials matter for NOK/SEK, but with limited new monetary policy signals expected from Norges Bank and Riksbank until at least September, global risk sentiment should be the main driver of the pair in the coming weeks. We are watching the 0.9900 level on the topside and ~0.9670 on the downside.

Dollar Bloc

[NZD | Receiving the November RBNZ](#)

Market pricing of the RBNZ's "Great Hawkish Shift" has finally gone too far. We use this as an opportunity to close our short NZ rates recommendations (versus Australia and Canada) and instead seek to receive the November RBNZ meeting.

We maintain our AUD/NZD short, though this is largely for technical and momentum reasons. We tighten our stop to 1.0730.

We fully acknowledge that data have improved since the May MPS and this should keep the RBNZ on track to begin hiking rates in 1H22. We think hikes in 2021 are a bridge too far, though, given: 1) the RBNZ is still purchasing assets and a hike before fully tapering seems aggressive to us; 2) international borders are largely still closed, limiting employment gains in certain sectors; and 3) COVID-19 risks remain asymmetrically negative, particularly given the rising Delta variant.

We expect relatively little excitement from the upcoming July meeting, though we are watching guidance on the balance sheet closely. A formal end to asset purchases at the July meeting (not our base case) would be a signal to us that rate hikes in 2021 may, in fact, be on the table.

AUD | Staying short AUD/USD

The RBA was a bit more hawkish than anticipated, electing not to roll the YCC target bond as expected but signalling a pullback in asset purchases. Nonetheless, we still see compelling reasons to remain short AUD/USD (targeting 0.70 with a 0.78 stop).

First, markets are pricing in excessive RBA hawkishness, with liftoff now fully priced for July 2022, compared to RBA guidance for 2024. Second, higher US real yields and tighter breakevens suggest a weaker AUD. Third, COVID-19 risks remain asymmetrically negative in Australia, particularly with the more transmissible Delta variant. Fourth, rising concerns about global growth (as evident in the distribution of equity returns) should be AUD/USD-negative. And finally, positioning (while cleaner) is still long AUD in options, and leveraged funds are long in futures.

With the July RBA out of the way, major AUD/USD catalysts are more likely to come from outside Australia than within. COVID-19 cases remain our number one domestic watchpoint, alongside US real yields and breakevens, US data and Fed rhetoric, risk appetite, and global growth expectations.

Japan

JPY | USD/JPY, buying on dips!

We see the current outperformance of JPY a good opportunity for initiating a new JPY short position. The recent deterioration in performance of cross-yen rates is consistent with the worsening performance of US cyclical stock and appears to reflect growing concerns about the outlook for the US and global economies.

Our discussions with equity investors suggest that stock market participants have viewed the recent bull-flattening of UST yield as a signal that the US and global economies might indeed be set to slow. However, we believe that the recent declines in US interest rates are due more to positioning than to fundamental changes.

Hence, we would advise against worrying too much about stock market performance with liquidity still in such abundant supply. We also expect the yen's funding-currency status to start being conducive to underperformance once again if risk asset markets do indeed shift back into recovery mode.

G10 FX Trades

Exhibit 50: G10 FX trade ideas

Spot trades	Spot	Target		Stop	
Maintain					
Short EUR/USD	1.1860	1.1700	1.3%	1.2150	-2.4%
Short AUD/NZD	1.0700	1.0400	2.8%	1.0730	-0.3%
Long USD/CAD	1.2500	1.2700	1.6%	1.2100	-3.2%
Short AUD/USD	0.7470	0.7000	6.3%	0.7800	-4.4%
Long USD/JPY	109.98	112.50	2.3%	108.40	-1.4%
Options trades	Entry/cost/premium received				
Maintain					
Short 3m USD/JPY 112.50 call to receive 0.40% (priced on 18-Jun-21)					
Long USD/CHF 1y risk reversal, buy 0.9450 call, sell 0.8850 put to receive 0.21% (priced on 18-Jun-21)					

Source: Bloomberg, Morgan Stanley Research

G10 | Has USD momentum changed?

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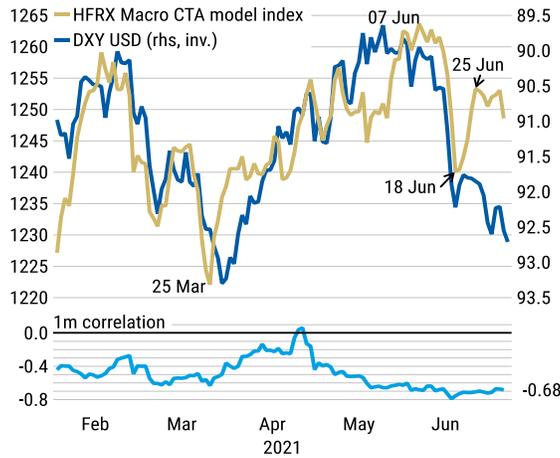
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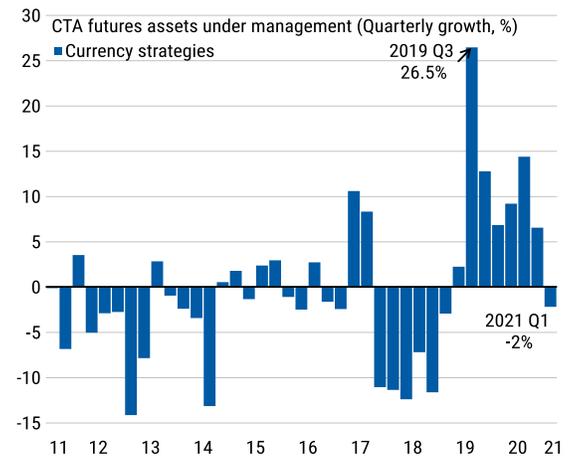
A simulated G10 FX momentum signal is still very long the USD, especially against NOK and AUD, though isn't far from the extreme peak reached in March 2020. The 14D DXY RSI is also close to overbought territory. We continue to suggest being long the US dollar, with upside momentum to accelerate on a move above the prior high of 93.95.

Exhibit 51: Macro CTAs likely flipped to long USD since the June Fed meeting



Source: Bloomberg, Macrobond, Morgan Stanley Research

Exhibit 52: Currency trader CTA strategy assets have been growing since 2019



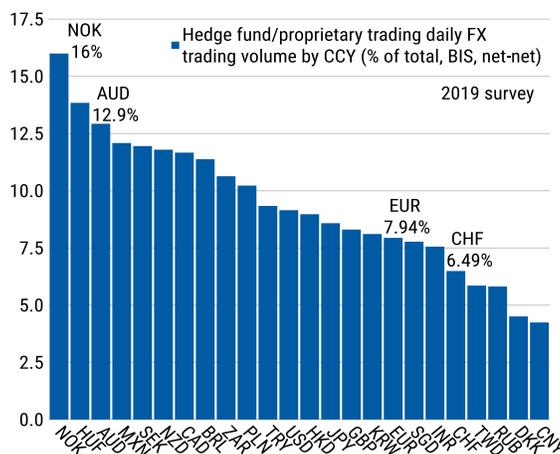
Source: Barclay Hedge, Morgan Stanley Research

High proportion of commodity currencies traded by hedge funds

As mentioned above, CTA is an acronym for Commodity Trading Advisor, a type of hedge fund that uses futures contracts for trading. They will commonly use the recent price momentum in assets or currencies to trigger a signal - e.g. buying when the currency has been rallying consistently and against many pairs.

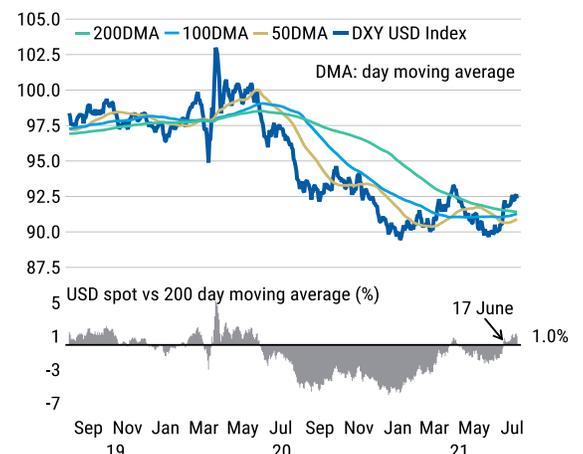
It is not easy to know what proportion of daily FX trading comes from CTAs. The BIS FX trading volume survey combines broader hedge funds with CTA funds, which in total made up 9% of FX trading volume in 2019. We assume that proportion can vary with market volatility but the relative size versus say banks or corporates is unlikely to change dramatically.

Exhibit 53: Commodity and risky currencies tend to have a higher proportion traded by speculators



Source: Macrobond, Morgan Stanley Research

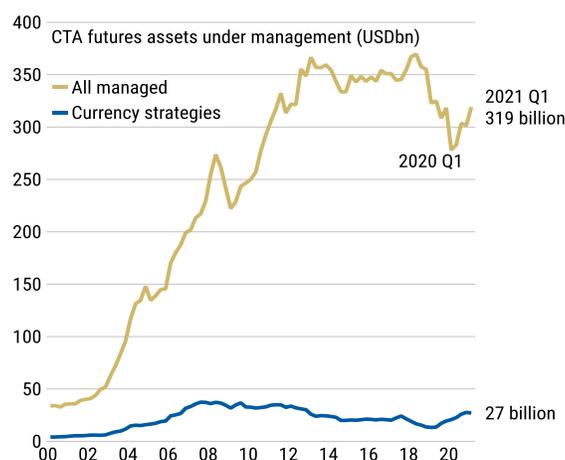
Exhibit 54: USD momentum models turned bullish as DXY traded above the 200 day moving average in June



Source: Macrobond, Morgan Stanley Research

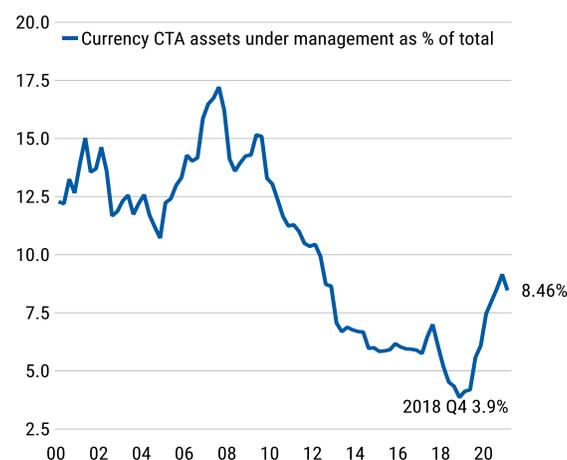
Exhibit 53 shows the proportion of daily FX trading volumes by currency that were attributed to hedge funds or proprietary traders, including CTAs. It is no surprise that the commodity linked currencies and risk sensitive currencies have a higher proportion of trading coming from speculators as these currencies will be less used for global borrowing or trading as are the US dollar or euro. NOK has the highest proportion traded by hedge funds at 16% of total, with AUD not far behind at around 13%. The higher the proportion of trading executed by leveraged speculators, the more likely the currency is to move more on days dominated by market momentum changes, often times when the market is either very risk-on or very risk-off.

Exhibit 55: CTA fund assets under management at almost USD 320bn this year



Source: Barclay Hedge, Morgan Stanley Research

Exhibit 56: Currency-only CTA trader assets have grown in importance



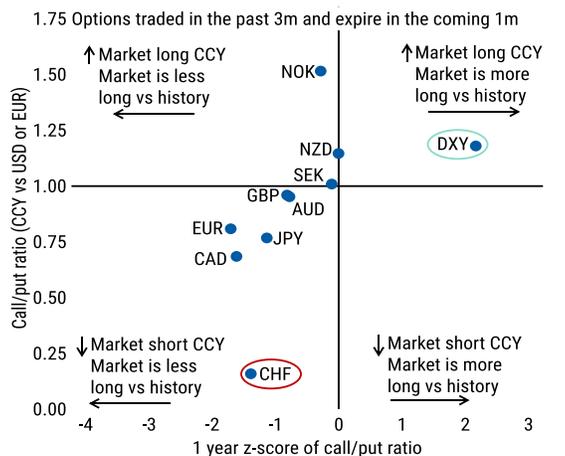
Source: Barclay Hedge, Morgan Stanley Research

Momentum, market positioning and sentiment

One of the reasons that US dollar model signals likely flipped to long is that the DXY index stopped weakening early in the year, then traded sideways and has now spent several weeks trading higher and trying to move into a new higher range. Of note, Exhibit 54 shows that the DXY USD index traded above the 200-day moving average in mid-June, when there was a clearest signal that the US dollar was no longer on a weakening path. At that point, CTA models likely added to long USD versus the riskiest currencies like AUD and NOK, as they had both started to weaken.

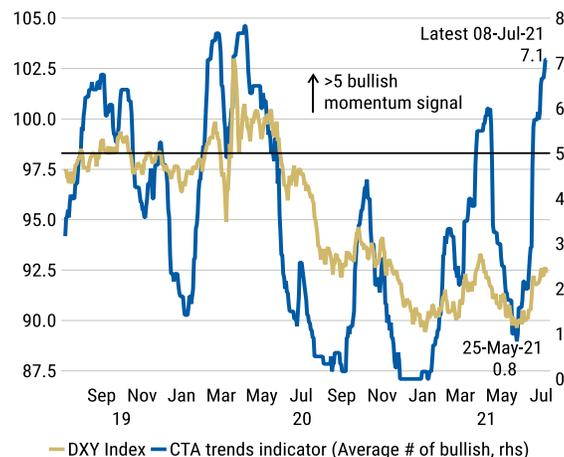
Our analysis of month-end FX flows and rebalancing made an assumption that asset managers were the largest participants in adjusting and hedging their asset portfolios, with hedge funds likely following to speculate on the flow/FX moves. In this sense, estimating hedge funds positioning has become an important part of our FX analysis to identify sensitivities to market turns. The best proxy is using traded options data, with the latest estimate showing the market being long the USD index and extremely short CHF (Exhibit 57). JPY short positioning has remained consistently high for several weeks now.

Exhibit 57: The options market remains very short CHF and short EUR



Source: Bloomberg, Morgan Stanley Research

Exhibit 58: Momentum CTA model estimate has turned from extreme bearish USD in late May to very bullish USD today

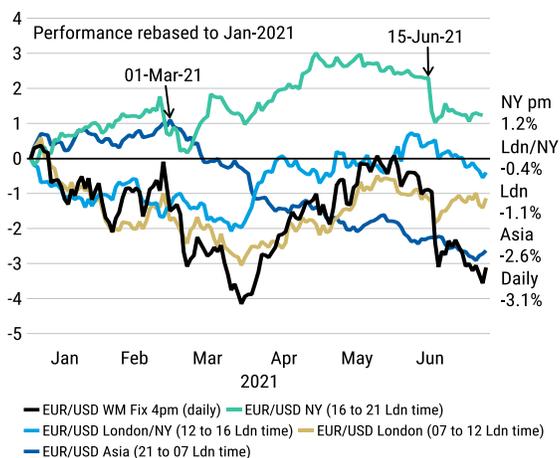


Source: Bloomberg, Morgan Stanley Research

Did timezone matter?

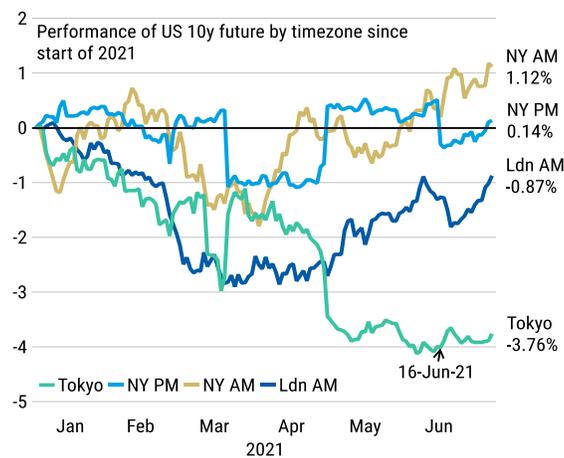
Breaking down currency performance by the timezone can provide some guidance on who may be the dominant participant in a particular market and so if momentum could be building. Taking EUR/USD as an example for USD sentiment, we find that EUR/USD has consistently weakened during the Asia timezone since March (Exhibit 59). Since the hawkish June Fed meeting, EUR/USD has continued to weaken in Asia timezone but also in the London afternoon/New York morning.

Exhibit 59: EUR/USD consistently weakened in Asia timezone, now London and NY selling too



Source: Bloomberg, Macrobond, Morgan Stanley Research

Exhibit 60: US treasury bond futures have rallied recently even when the US dollar strengthened too



Source: Bloomberg, Macrobond, Morgan Stanley Research

What has been surprising is the US dollar strength has come as US nominal long end yields have been falling. Exhibit 60 shows that US treasury futures have rallied the most during the London morning and New York morning. The latter coincides with the period when the USD strengthened versus EUR. Assuming that CTA funds are mostly located in Europe and the US, the Tokyo/Asia session didn't see much trading in US treasuries recently, unlike the April bond sell-off (green line in Exhibit 60)

Trade idea: Maintain short EUR/USD at 1.1860 with a target of 1.1700 and a stop of 1.2150
Trade idea: Maintain long USD/CHF 1y risk reversal, buy 0.9450 call, sell 0.8850 put, to receive 0.21% (priced on 18-Jun-21)
Trade idea: Maintain long USD/CAD at 1.2500 with a target of 1.2700 and a stop of 1.2100

Exhibit 61: USD index 14D RSI is now overbought, for upside momentum to continue, needs to break above the prior high at 93.95



Source: Bloomberg, Morgan Stanley Research

G10 | Positioning for commodity price divergence

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Our commodity correlation analysis shows that FX correlations to commodities have shifted significantly since the onset of COVID-19, and not only due to changes in how the USD trades. CAD has become less correlated to oil prices, while NOK's relationship to oil has strengthened. USD/JPY is no longer closely linked to copper prices, while gold and silver have regained their strong negative correlation to USD which had started to wane prior to COVID.

We also highlight the best expressions of expected commodity price *divergence*. USD/CLP and USD/JPY should receive a boost if crude oil gains while zinc and copper prices fall (as our commodity research colleagues [expect](#)), and USD/CHF should rise if their expectation for crude oil strength relative to gold and silver materializes. Finally, RUB should outperform CLP if (as we expect) gasoil prices rise while long TIPS ETF positioning reverses.

G10 currencies' correlation to commodity prices has changed significantly since prior to COVID. [Exhibit 62](#) shows CCY/USD correlations to commodity price changes prior to the onset of COVID-19. The correlations reflect weekly % changes over the preceding 12 months; USD refers to the Fed's broad trade-weighted USD index.

Prior to COVID, country-specific correlations to broadly traded commodities were relatively restrained. Risk sensitive currencies like AUD, NZD, NOK, and CAD traded inversely to crude oil prices and copper. Low yielding currencies like CHF and JPY traded closely in line with gold prices. Outside these patterns, few reliable commodity relationships emerged in G10 currencies.

Since COVID, the USD has traded strongly inversely to commodities. Negative correlations to the USD have risen broadly - particularly precious metals' inverse trading relationship to USD. In line with this change, G10 currencies have become strongly positively correlated to gold, copper, and silver prices ([Exhibit 63](#)).

Exhibit 62: Pre-COVID correlations

Jan 2020	Copper	Gold	Iron Ore	Crude Oil	Silver	Bitcoin	CRB RIND
USD	-0.47	-0.26	-0.21	-0.19	-0.14	-0.14	-0.11
CAD	0.41	0.37	0.08	0.40	0.29	0.01	0.00
AUD	0.49	0.11	0.07	0.17	0.12	-0.06	0.15
NZD	0.32	0.25	0.04	0.19	0.19	-0.22	0.12
NOK	0.43	0.22	0.15	0.28	0.10	0.01	0.13
SEK	0.25	0.21	-0.02	0.10	0.08	0.00	0.09
GBP	0.17	0.07	0.08	0.07	0.00	-0.08	0.02
EUR	0.16	0.42	-0.03	0.04	0.17	0.06	-0.10
CHF	0.06	0.54	-0.17	-0.03	0.20	0.09	-0.03
JPY	-0.48	0.60	-0.22	-0.18	0.29	0.10	-0.37

Source: Bloomberg, Macrobond, Morgan Stanley Research

Exhibit 63: Post-COVID correlations

July 2021	Gold	Copper	Silver	CRB RIND	Crude Oil	Bitcoin	Iron Ore
USD	-0.67	-0.62	-0.60	-0.42	-0.25	-0.24	-0.15
CAD	0.51	0.60	0.48	0.41	0.28	0.27	0.20
AUD	0.57	0.61	0.56	0.49	0.31	0.35	0.17
NZD	0.48	0.67	0.48	0.37	0.37	0.21	0.07
NOK	0.47	0.58	0.51	0.39	0.43	0.31	0.11
SEK	0.66	0.58	0.64	0.38	0.23	0.24	0.15
GBP	0.54	0.45	0.54	0.22	0.29	0.24	-0.04
EUR	0.67	0.55	0.67	0.34	0.21	0.12	0.23
CHF	0.72	0.49	0.65	0.35	0.05	0.15	0.25
JPY	0.53	0.22	0.43	0.18	-0.09	0.06	0.08

Source: Bloomberg, Macrobond, Morgan Stanley Research

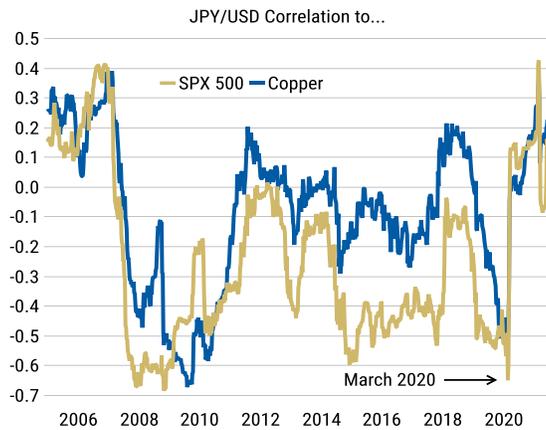
One of the largest shifts since prior to COVID is JPY's relationship to copper prices. JPY has shifted from being strongly *negatively* correlated to copper prices to instead becoming weakly positively correlated to copper.

The JPY-copper correlation has mirrored JPY's changing relationship to broader risk appetite ([Exhibit 127](#)). One feature of the post- 2008 Global Financial Crisis was JPY's inverse correlation to risk demand. JPY traded very inversely to the S&P 500 index for much of the 2008-2011 period.

Unlike the 2008 crisis, since the onset of COVID-19 JPY/USD has risen (i.e. USD/JPY has fallen) in weeks when the S&P 500 has also gained. JPY's relationship with copper has moved broadly in line with its relationship to broader risk demand, and both correlations are at post-2008 highs.

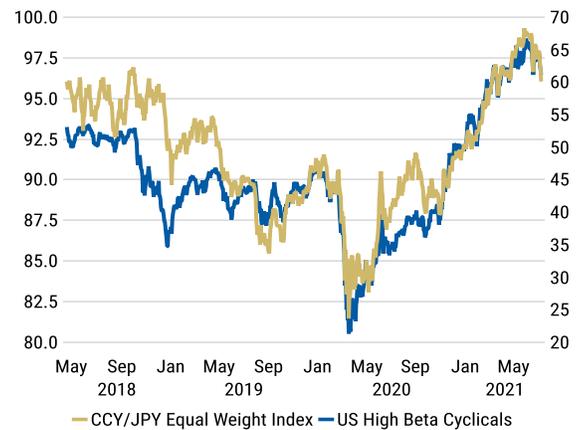
We expect JPY's relationship to risk demand and copper prices to return to a negative correlation. While these correlations have temporarily turned positive in the wake of COVID-19, we expect them to revert to pre-2020 trend as the market increasingly views the USD as an asset currency. JPY has consistently traded inversely with cyclical stock performance throughout the pre- and post-COVID period (Exhibit 65).

Exhibit 64: JPY's correlation to both equities and copper reached decade lows just before COVID



Source: Macrobond, Morgan Stanley Research

Exhibit 65: JPY has tracked cyclical equity performance since prior to the onset of COVID

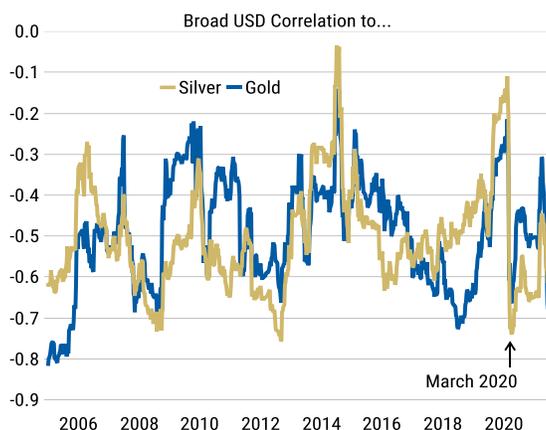


Source: Macrobond, Morgan Stanley Research

One of the other major shifts in G10 correlations has been the drop in USD's correlation with precious metal prices. That correlation reached decade-long highs (i.e., less negative) prior to the onset of COVID-19 (Exhibit 66).

For much of the last decade, gold has traded broadly inversely to US real yields (Exhibit 67). Gold prices rallied in 2019 as US real yields fell towards zero. USD remained firm throughout the year, however, as falling European yields offset the impact of lower US yields on the USD. The negative gold-USD correlation fell (in absolute terms) as the USD failed to decline despite the rise in gold prices and the decline in real Treasury yields.

Exhibit 66: USD's correlation to precious metals is near the past decade's lows



Source: Macrobond, Morgan Stanley Research

Exhibit 67: Gold continues to trade inversely to US real yields



Source: Macrobond, Morgan Stanley Research

We expect the USD to gain and US real yields to rise in the coming months as the Fed approaches confirmation that it will taper its asset purchases in the coming months. Given that our Commodity Research colleagues [expect](#) gold prices to decline in the coming months, the pronounced negative correlation between USD and gold may continue.

Given the broad USD's high negative correlation to commodity prices after COVID, all G10 currencies have become highly correlated to commodity prices since COVID. For example, all G10 currencies' correlation to silver prices is greater than 0.4 over the past year.

However, certain currencies have been more correlated to silver (for example) than other currencies. For example, EUR's correlation to silver has risen dramatically since the COVID onset. The magnitude of the change in this correlation (from ~0.2 to ~0.7) suggests either a technical or fundamental dynamics linking EUR movements with silver prices.

We can identify which correlations are driven by country-specific factors (rather than either spurious correlations or those driven by broad USD moves) by identifying where correlations both are high in absolute terms and relative to other G10 currencies. [Exhibit 68](#) shows correlations that are high in absolute terms (coefficient > 0.4) and relative to other CCY/USD correlations (z-score > 1). The top 3 z-scores are shown in descending order; no commodities are listed if none meet both criteria.

Some country-specific takeaways:

CAD and NOK: CAD's reliable relationship with crude oil has declined post-COVID. Whereas CAD was singularly reactive to crude oil prices prior to COVID-19 (correlation coefficient 0.4, z-score 2.10), NOK is now the most reactive currency to crude oil prices in G10 (correlation coefficient 0.44, z-score 1.7). CAD remains sensitive to oil derivatives like heating oil prices (z-score 1.04) but less so than NOK (z-score 2.00). Instead, CAD is highly sensitive to palladium (z-score 1.52) and copper (z-score 1.34) prices.

Exhibit 68: Idiosyncratic G10 FX Correlations

		CAD	AUD	NZD	NOK	SEK	GBP	EUR	CHF	JPY
Post-COVID	1st	Palladium	CRB RIND	Copper	Heating Oil	Zinc		Silver	TIPS ETF	
	2nd	Copper	Tin	Nickel	Gasoil	Silver		TIPS ETF	Gold	
	3rd	Tin	CRB All	Aluminum	Crude Oil	Gold		Gold	Nickel	
Pre-COVID	1st	Crude Oil				TIPS ETF		Gold	Gold	Gold
	2nd									
	3rd									

Source: Macrobond, Bloomberg, Morgan Stanley Research

AUD and NZD: Investors often think of AUD as closely linked to iron ore prices and NZD as related to agriculture commodities like dairy. We observe little evidence of either relationship either before or after the onset of COVID-19. Neither AUD nor NZD showed a reliable relationship with iron ore or dairy during either period. Instead, AUD and NZD have traded particularly closely with the prices of raw industrial materials.

EUR and CHF: Of all idiosyncratic G10 FX correlations, the only consistent pre- and post-COVID relationship has been between gold prices and EUR/USD and CHF/USD. Since the COVID onset, EUR and CHF have also shown notable relationships with silver (z-score 1.80 for EUR) and with flows to US TIPS ETFs (CHF z-score 2.44). Given our view that **positioning is highly stretched** in TIPS ETFs, CHF may weaken as US real yields rise if retail TIPS positioning reverses.

Commodity divergence trades: The chart above suggests some clear outright expressions of commodity views. For example, investors who expect gold prices to rise can express that view through long EUR or CHF positions. Short NOK positions are an effective way to position for falling oil prices.

However, these outright correlations do not capture how best to position for commodity *divergence*. For example, investors may expect gold prices to rise but expect iron ore prices to fall.

Exhibit 69: How to express commodity price divergences

BEARISH	Gold	x	-	-	-	-	-	-	USD/JPY	USD/CHF	USD/HUF	USD/ZAR	USD/HUF
	Copper	-	x	-	-	-	-	-	-	USD/CLP	USD/NZD	USD/NZD	USD/CLP
	Silver	-	-	x	-	-	-	-	-	USD/CHF	USD/EUR	USD/GBP	USD/CZK
	Zinc	-	-	-	x	-	-	-	-	USD/JPY	USD/EUR	USD/ZAR	USD/CZK
	TIPS ETF	-	-	-	-	x	-	-	RUB/CLP	-	-	USD/ZAR	USD/CHF
	CRB RIND	-	-	-	-	-	x	-	-	-	-	-	USD/RUB
	Aluminum	-	-	-	-	-	-	x	-	-	-	-	USD/CNH
	Gasoil	JPY/USD	-	-	-	CLP/RUB	-	-	x	-	CLP/RUB	-	-
	Crude Oil	CHF/USD	CLP/USD	CHF/USD	JPY/USD	-	-	-	-	x	-	-	-
	Bitcoin	HUF/USD	NZD/USD	EUR/USD	EUR/USD	-	-	-	-	-	-	x	-
	Iron Ore	ZAR/USD	NZD/USD	GBP/USD	ZAR/USD	ZAR/USD	-	-	-	RUB/CLP	-	-	-
	Natural Gas	HUF/USD	CLP/USD	CZK/USD	CZK/USD	CHF/USD	RUB/USD	CNH/USD	-	-	-	-	RUB/INR
		Gold	Copper	Silver	Zinc	TIPS ETF	CRB RIND	Aluminum	Gasoil	Crude Oil	Bitcoin	Iron Ore	Natural Gas
	BULLISH												

Source: Macrobond, Bloomberg, Morgan Stanley Research

Exhibit 69 shows currency pairs that best express these commodity divergence views. For example, investors who expect silver prices to rise (i.e., bullish silver) but expect iron ore prices to fall (i.e. bearish iron ore) may benefit from long GBP/USD positions.

GBP has neither the highest positive correlation to silver nor the lowest correlation to iron ore prices. Silver is most positively correlated to EUR (coefficient 0.67), and iron ore is most negatively correlated with ZAR (coefficient -0.16). However, EUR/ZAR gains would be limited if silver prices rise by ZAR's not insignificant correlation with silver (coefficient 0.33) and EUR's decently large correlation with iron ore (coefficient 0.23).

Instead, the trade that best expresses the expectation for commodity price divergence would be long the currency with the largest *positive difference* between its correlation to silver and iron ore price movements and short the currency with the largest *negative difference* between its correlation to silver and iron ore price movements.

While GBP's correlation coefficient to silver prices (0.54) is somewhat below the equivalent for SEK or EUR, it is weakly negatively correlated to iron ore prices - the difference in correlation coefficients is 0.59. USD, by contrast, is highly negatively correlated to silver prices (-0.60) and only moderately negatively correlated to iron ore prices (-0.15) - a difference of -0.45. Long GBP/USD is therefore the cleanest expression of the expectation for commodity price divergence.

To minimize spurious relationships, [Exhibit 69](#) shows only currency pairs for which both correlation coefficient differences are at least 0.3 in absolute terms. For example, RUB is significantly more correlated to gasoil than bitcoin (the difference in coefficients is 0.32), while CLP is much less correlated to gasoil than to bitcoin (a difference of -0.39).

FX implications of Commodity Divergence: As noted above, our rates strategy colleagues see stretched TIPS positioning raising risks of significant retail outflows. Given that these flows have been closely linked to movements in USD/CHF, such outflows could **boost USD/CHF**.

However, **long RUB/CLP** is another attractive expression of our expectation that flows to TIPS ETFs may reverse. Our energy strategy colleagues **expect** gasoil prices to rise over the next twelve months, and long RUB/CLP is the best expression of falling flows to TIPS ETFs when gasoil prices rise. As we discuss in [The Case for a Falling Dollar Falls Apart](#), we expect CLP to weaken while bullish RUB positions fit with our broader [position on the Russian financial market outlook](#).

In addition, our metal and energy strategist colleagues **expect** oil to materially outperform metals including gold, silver, copper and zinc. [Exhibit 69](#) shows these divergences should support USD against CHF, CLP, and JPY.

As with all correlation analyses, the risk to this approach is that previously observed correlations no longer hold in the future. However, investors can avoid relying on specious or transient correlations by relying only on pairs with relatively large correlation divergences (>0.3 for each leg).

NOK/SEK | Moving into a new lower range?

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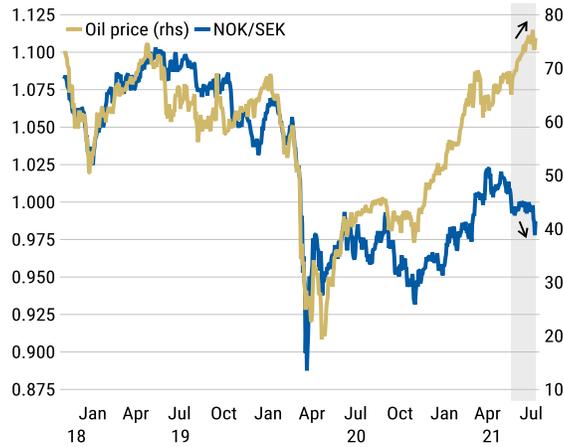
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NOK has underperformed lately despite Norges Bank turning even more hawkish and the US equity market and oil prices holding up well. NOK/SEK has broken below its recent sideways trading range around 0.9890-1.0040 as investors reduced their risk exposure. Global participants, particularly banks, have been the main sellers of NOK. NOK/SEK is now trading at a large discount relative to oil prices, and our rates strategists expect the US 2s10s curve to steepen, which should be supportive for NOK/SEK.

Long NOK/SEK was a favoured trade among real money investors, so their position adjustment has contributed to some of the recent weakness in the pair. We assume that the market is overall still long NOK/SEK. With uncertainty over the spread of the coronavirus Delta variant, NOK being the most sensitive G10 currency to risk appetite, and thinner summer liquidity exacerbating the risk of volatile moves in the illiquid NOK, we don't see good risk reward in buying the NOK/SEK dip at the moment.

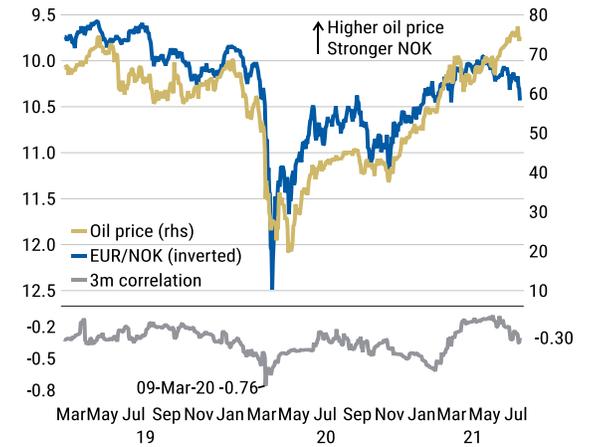
Rate differentials matter for NOK/SEK, but with limited new monetary policy signals expected from Norges Bank and Riksbank until at least September, global risk sentiment should be the main driver of the pair in the coming weeks. We are watching the 0.9900 level on the topside and ~0.9670 on the downside.

Exhibit 70: NOK/SEK has weakened while oil prices have rallied



Source: Bloomberg, Macrobond, Morgan Stanley Research

Exhibit 71: NOK/EUR is also trading weaker than oil prices suggest

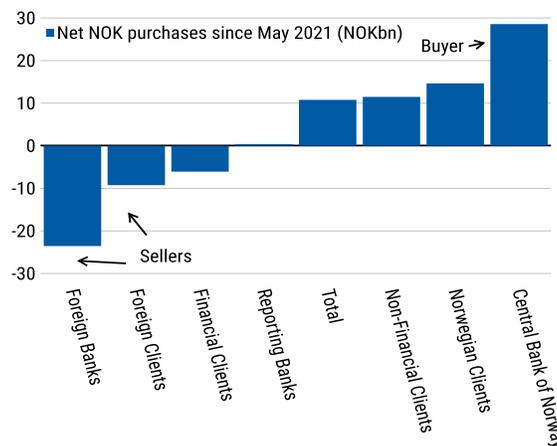


Source: Bloomberg, Macrobond, Morgan Stanley Research

NOK/SEK trading weaker than oil prices suggest... NOK/SEK has historically tracked oil prices but diverged since mid-May. As oil prices rallied to new recent highs, NOK/SEK moved in the opposite direction, falling below 1.00 or parity (Exhibit 70). Using the prior relationship, NOK/SEK should be trading closer to 1.10 instead of the current 0.98.

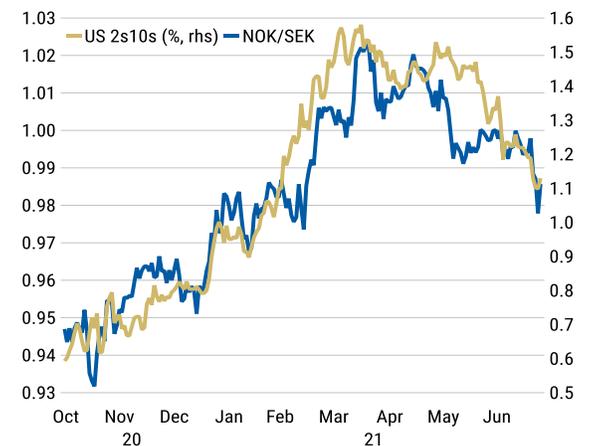
...as investors reduce commodity FX risk exposure: In our view, the oil-FX divergence can be explained by markets reducing some of their risk exposure – particularly in the more illiquid assets like NOK – as volatility started picking up in some pockets of the market such as in cryptocurrencies back in May. The US 10-year inflation breakeven rate also peaked on 17th May, and the US yield curve started flattening during that period too, which are further signs of reduced optimism on risk. Global investors outside of Norway, particularly banks, have been the main sellers of NOK since the currency started weakening in May (Exhibit 72).

Exhibit 72: Foreign investors have been the main sellers of NOK since the currency peaked



Source: Macrobond, Morgan Stanley Research

Exhibit 73: NOK/SEK has weakened as the US 2s10s curve flattened

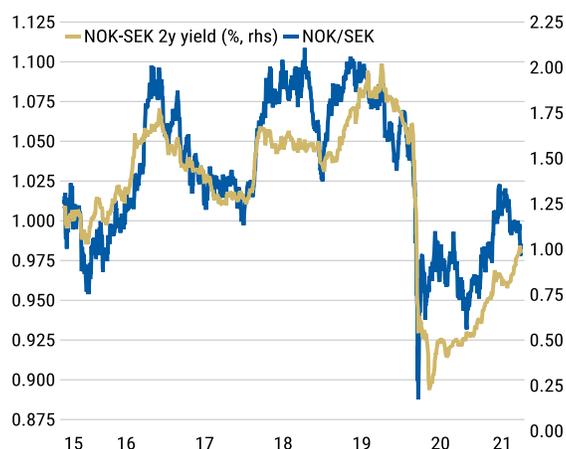


Source: Bloomberg, Macrobond, Morgan Stanley Research

Flatter US 2s10s curve = weaker NOK/SEK: Interestingly, NOK/SEK has followed the shape of the US 2s10s curve in recent months, weakening as the US yield curve flattened ([Exhibit 73](#)). This is a reflection of NOK's higher sensitivity than SEK to global risk and hence growth expectations, which the US yield curve gives information about. [Our rates strategists think](#) the fall in US long-end yields is now overdone and see the US 2s10s curve steepening, which would provide support for NOK/SEK.

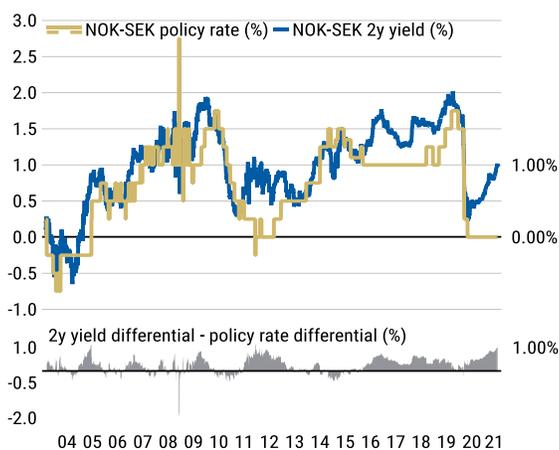
The new NOK/SEK range? A steeper US 2s10s curve should allow NOK/SEK to narrow the gap with oil prices. However, with uncertainty over the spread of the Delta variant and NOK being the most sensitive G10 currency to risk appetite, we think the risk/reward of being long NOK/SEK is unfavourable for the time being. This is especially as we are entering the summer months when market liquidity is thinner than usual, increasing the risks of volatile moves in NOK, which is already the most illiquid currency in the G10.

Exhibit 74: NOK/SEK follows the 2-year yield differential



Source: Bloomberg, Macrobond, Morgan Stanley Research

Exhibit 75: Markets are already pricing in the Norges Bank-Riksbank policy divergence



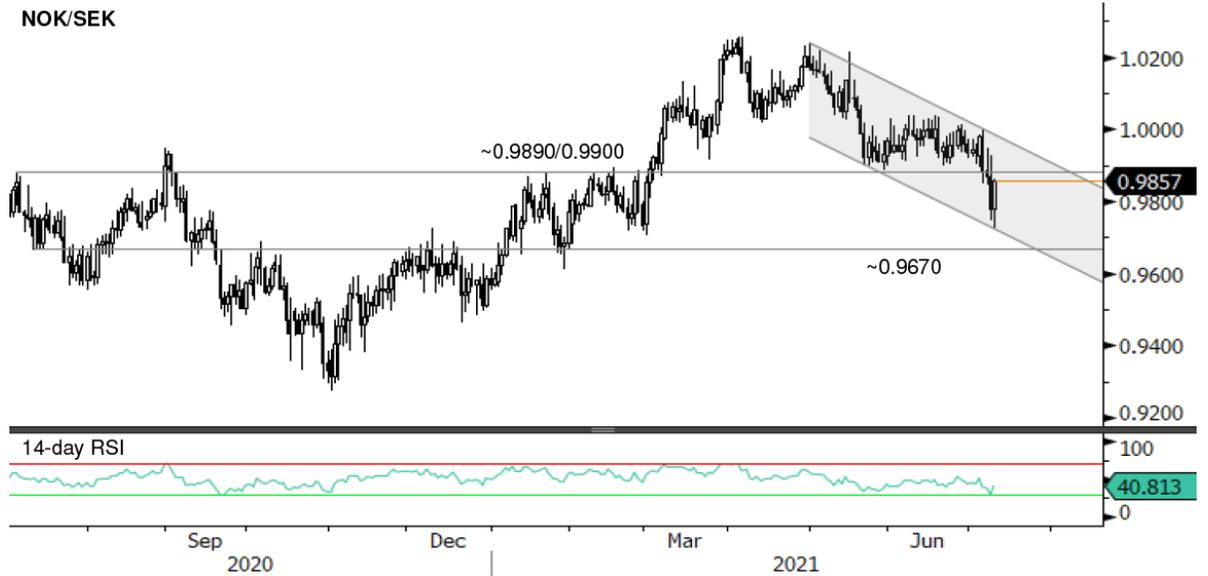
Source: Bloomberg, Macrobond, Morgan Stanley Research

What about the monetary policy divergence? One key factor often cited for bullish NOK/SEK positions is monetary policy divergence – for good reason. NOK/SEK does track the Norway-Sweden 2-year yield differential, which is currently suggesting that the pair is trading at a fair level ([Exhibit 74](#)). As markets are already pricing in four 25bp rate hikes for Norges Bank by the end of next year and the first hike for the Riksbank only in 4Q23, we may need Norges Bank to be further along in its hiking cycle in order to push the 2-year yield differential much higher to support NOK/SEK ([Exhibit 75](#)).

NOK the main driver of NOK/SEK: With no new monetary policy signals expected at least until the Norges Bank and Riksbank meetings in September, and the growth outlook for Norway and Sweden looking similarly strong, global risk appetite should be the main driver of NOK/SEK in the coming weeks. As NOK is more sensitive to global risk sentiment, this means that NOK should be the main driver of the NOK/SEK pair.

Key levels to watch: NOK has reached oversold levels against both EUR and SEK on the 14-day RSI measure, suggesting some stabilisation in the near term. The first key level to watch on the upside in NOK/SEK is ~0.9900 - at the bottom end of its prior sideways trading range ([Exhibit 76](#)). On the downside, the level we are watching is ~0.9670. For the pair to break out of its recent downtrend, it needs to break above ~0.9960.

Exhibit 76: Is ~0.9670-0.9900 the new range for NOK/SEK?



Source: Bloomberg, Morgan Stanley Research

NZD | Receiving the November RBNZ

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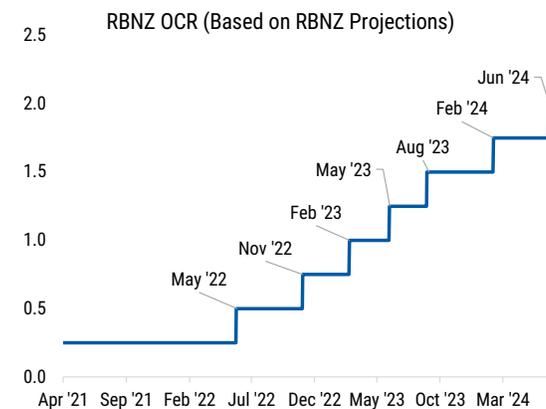
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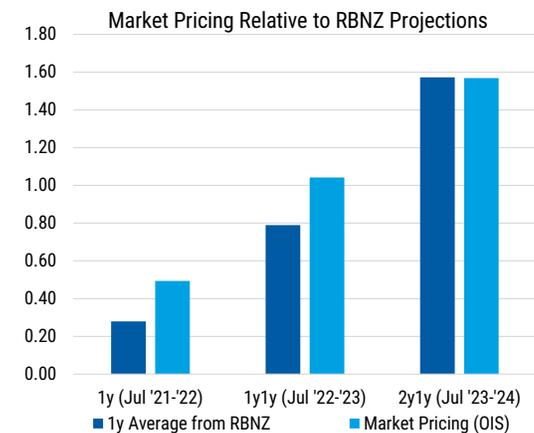
We [previously argued](#) that much – if not most – of the RBNZ's "Great Hawkish Shift" was in the price: tapering and liftoff were fair, while much of the hiking cycle and even the terminal rate were also priced in.

Exhibit 77: Morgan Stanley's RBNZ rate path assumptions



Source: RBNZ, Morgan Stanley Research

Exhibit 78: Markets are pricing in positive term premium relative to the RBNZ's May projections



Source: RBNZ, Bloomberg, Morgan Stanley Research

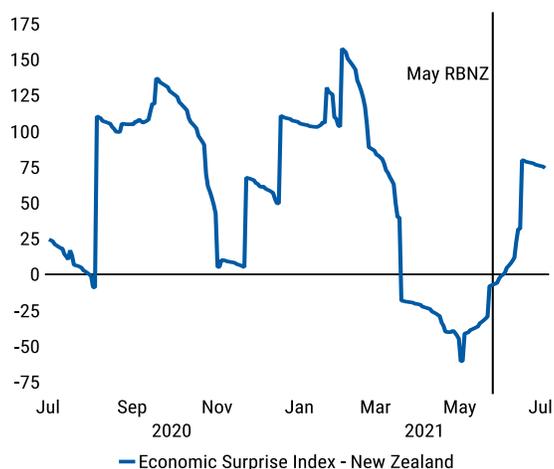
At this point, pricing for hikes appears excessive, in our view. The RBNZ's projections from the May meeting were far from dovish – it was penciling in a full hiking cycle beginning in May 2022 (by our estimates) with 2-3 hikes per year following ([Exhibit 77](#)).

However, market pricing right now is even more aggressive, with almost a full 25bp rate hike priced in for the November 2021 meeting and several more hikes implied in 2022 (Exhibit 78).

To be clear, we fully agree that the data have been robust. Since the May [Monetary Policy Statement](#), economic data have generally surprised to the upside (Exhibit 79). 1Q21 GDP rebounded faster than market consensus and shows a meaningful divergence with the RBNZ's May GDP projections (Exhibit 80). House price appreciation is largely tracking with the RBNZ's forecasts (Exhibit 81) while the unemployment rate is only 60bp above the 4Q19 level (Exhibit 82).

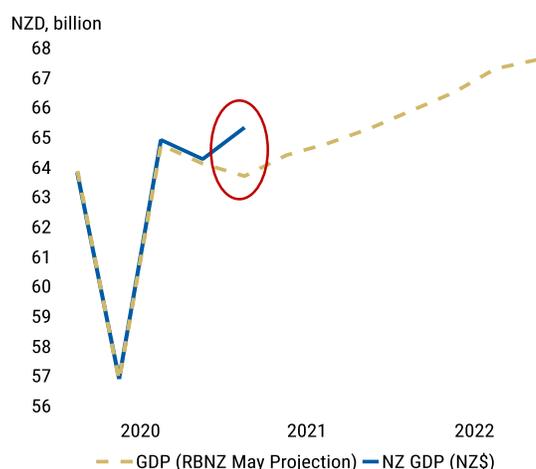
Indeed the RBNZ's forecasts for continued labor market tightening are fairly gradual and thus easily surprised if hiring gains pace. This seems increasingly possible, particularly given the most recent [Quarterly Survey of Business Opinion](#), which showed not just expectations for a pickup in orders and output but also hiring (Exhibit 83). While hiring intentions were at a 5y high, shortages of skilled labor reached an all-time high.

Exhibit 79: NZ economic data have surprised to the upside since the May RBNZ meeting



Source: Bloomberg, Morgan Stanley Research

Exhibit 80: 1Q GDP rebounded versus RBNZ expectations for a modest decline



Source: RBNZ, Macrobond, Morgan Stanley Research

However, we think there are also good reasons to think that a hike *this year* may be a bridge too far, and that risk/reward now favors receiving front-end rates.

First, the RBNZ is still purchasing assets. Granted, the pace of purchases has slowed markedly, and it's entirely plausible that the RBNZ will fully end its purchases this year (Exhibit 84). However, we think the RBNZ would seek to avoid hiking rates while it is also expanding its balance sheet. Thus, as long as purchases continue, we think markets should be judicious regarding how much they are pricing for near-term rate changes.

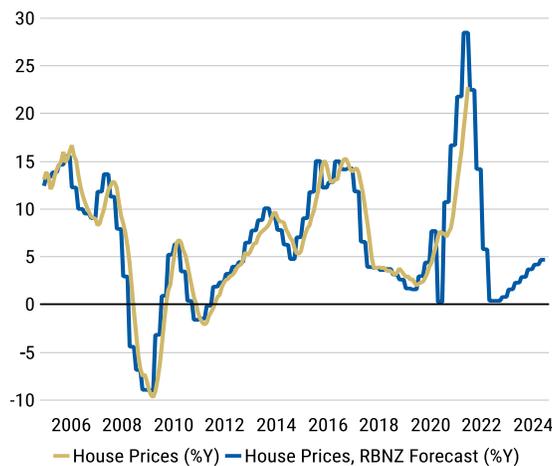
To this end, we think **a formal announcement of the end of asset purchases would be a key hawkish signal and would concretize market expectation that hikes are coming – and coming soon. Until that happens, we should be more cautious.**

Second, international border restrictions remain and are likely to remain for some time, and we are skeptical that the RBNZ would want to begin tightening policy actively when border restrictions remain.

Exhibit 85 shows the net change in employment by sector since 4Q19. While total employment is above pre-pandemic levels, a positive sign, job gains are not as broad-based as would be implied by the headline figure. Policy tightening is likely to be a headwind to employment gains in these sectors, many of which are likely to remain under pressure so long as borders remain closed.

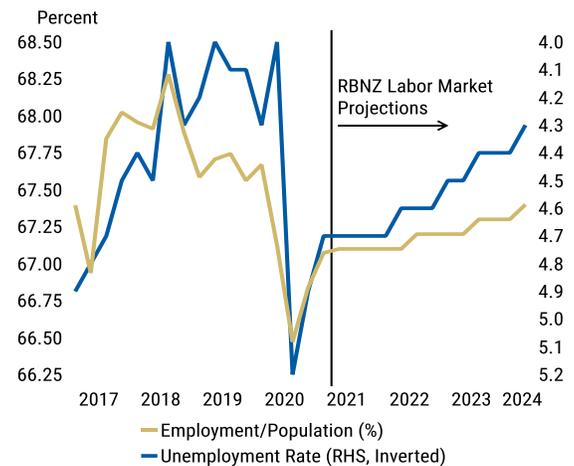
Third, we think the balance of risks on COVID-19 are asymmetrically negative vis-à-vis the Delta variant. Daily COVID-19 cases have remained consistently in the single digits since the NZ government closed the border, only recently having reopened flights to Australia. This has enabled economic and social activity to largely return to normal.

Exhibit 81: House price appreciation is largely tracking the RBNZ's forecasts



Source: Macrobond, RBNZ, Morgan Stanley Research

Exhibit 82: The RBNZ is forecasting modest labor market tightening from here



Source: Macrobond, RBNZ, Morgan Stanley Research

We think the Delta variant poses a key risk here, though. We think the government has a conservative reaction function and an uptick in cases would likely generate meaningful restrictions in activity in the hopes of eliminating viral transmission.

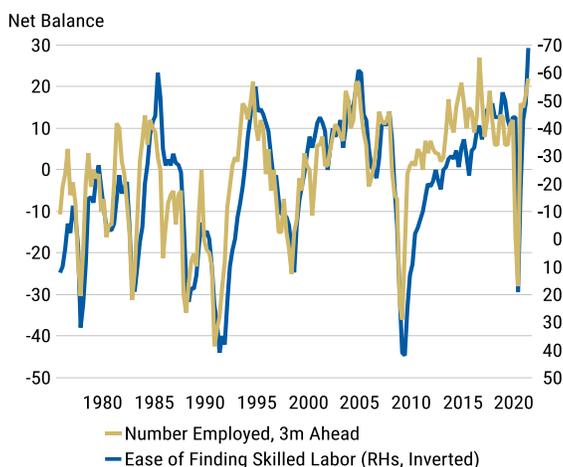
Exhibit 86 shows our estimate of the percentage of New Zealanders who will be fully vaccinated (which assumes two doses of vaccine required per person). We use the actual number of vaccinations to date coupled with the RBNZ's projections of vaccine distributions, and assume all vaccines requires a two-dose distribution to fully vaccinate an individual. The RBNZ expects the pace of vaccination to quicken later this year, though in the short term the population's resistance to COVID-19 is low (due to lack of immunity from past infection and low vaccination rates).

As a result, we think markets may finally be overpricing the RBNZ's hawkishness. We thus look to close our relative value rates trades, which benefited from RBNZ hawkishness. Moreover, we look to enter a receiver position to the November RBNZ meeting, which we think is overpriced to the hawkish side.

Trade idea: Enter receive November RBNZ meeting at 44bp
Trade idea: Exit long December 2030 ACGB vs short May 2031 NZGB
Trade idea: Exit long November 2024 ACGB vs short 50/50 basket of June 2024 CAGB and May 2024 NZGB
Trade idea: Maintain short AUD/NZD at 1.0700 with a target of 1.04 and an adjusted stop of 1.0730

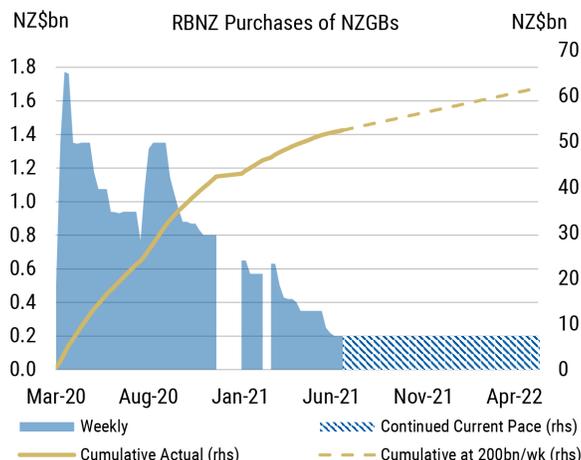
First, we recommend receiving the November RBNZ meeting. We think a fair level for this meeting is something like 30-33bp, which would imply a 20-30% chance of a 25bp hike by November. However, at ~45bp, this implies an 80% chance, which we think is excessive. The risk to this trade is that the RBNZ begins to signal that a November hike is on the table, though we think that signalling would more likely come at the August MPS (via the OCR projection) than at the July meeting.

Exhibit 83: Forward-looking indicators of labor suggest continued tightening



Source: Macrobond, Morgan Stanley Research

Exhibit 84: The speed of RBNZ LSAPs has declined steadily



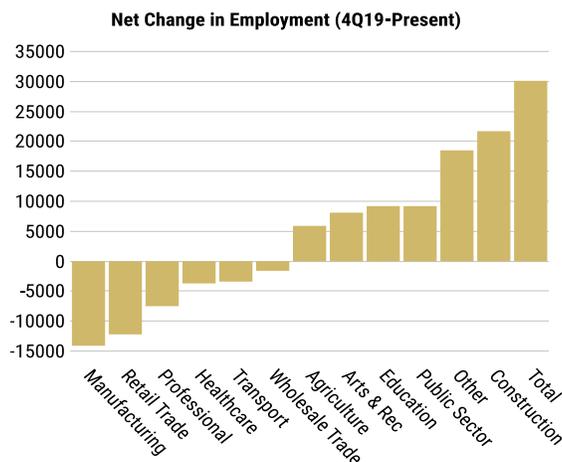
Source: RBNZ, Morgan Stanley Research

We have had several trade recommendations which benefit from RBA-RBNZ policy divergence. We think the time has come to take profit here. We recommend closing long the Dec 2030 ACGB vs short the May 2031 NZGB and long the November 2024 ACGB versus a 50/50 basket of short the June 2024 CAGB and May 2024 NZGB.

We still recommend short AUD/NZD, though risk/reward is less favorable from a fundamental RBA-RBNZ divergence perspective. We think there is more scope for declines but that is more based on technicals and momentum. AUD/NZD has just broken below the daily ichimoku cloud, and downside momentum doesn't quite appear stretched using an RSI.

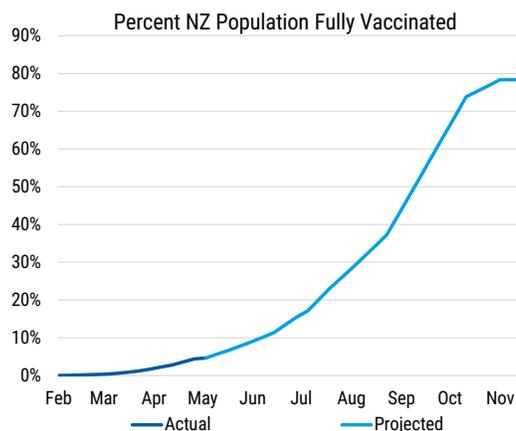
Thus we adjust our stop loss. We continue to target 1.04, but would look to close the trade at 1.0730, just above the 200d moving average. We don't view 1.0730 as a re-assessment level; if we go back above the 200d moving average, upside momentum would likely continue. So we think investors should treat this as a "hard" stop loss level.

Exhibit 85: Employment in some sectors remains below pre-COVID levels



Source: Macrobond, Morgan Stanley Research

Exhibit 86: Projections of fully vaccinated New Zealanders



Source: RBNZ, Morgan Stanley Research assumptions

What to expect from the July meeting? Ultimately, we don't think this meeting is one in which the RBNZ will seek to make significant changes. Its May meeting offered enough hawkish implications and much has been priced in. While data have improved relative to expectations, we think the RBNZ will continue to affirm what we already know (i.e., that tapering is happening and hikes later on are the base case), but that continued accommodation is needed and risks remain a key watchpoint.

With markets appearing to get excited about even the possibility of an August 2021 hike (not to mention November 2021), we think the risk is that "no news" could be seen as dovish. Put another way, if the RBNZ really did want to start laying the groundwork for hiking this year, it would likely start sooner than later to avoid an unwarranted tightening in financial conditions.

Should the MPC formally end the asset purchase program at this meeting, we think this would be taken as a signal that hikes are coming soon. Barring that, though, we think there would be sufficient vaguery in the language and sufficient focus on upside and downside risks to offer few clues as to very short-term policy action.

AUD | Staying short AUD/USD

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The RBA **may have been** a bit more hawkish than expected, but ultimately we think the direction of travel for AUD/USD remains negative for now.

Trade idea: Maintain short AUD/USD at 0.7470 with a target of 0.70 and a stop of 0.78

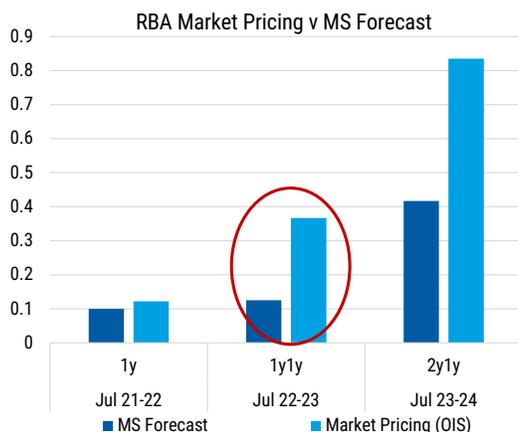
The RBA announced it would taper its asset purchases to a weekly pace of A\$4bn, with a pre-commitment to review this at its November meeting, while maintaining its soft guidance that it expects to reach conditions for liftoff in 2024 (which is now the central scenario, not a floor).

Nonetheless, we think there are good reasons to remain short AUD/USD.

First, the market is still overpricing the RBA hiking path to a considerable degree.

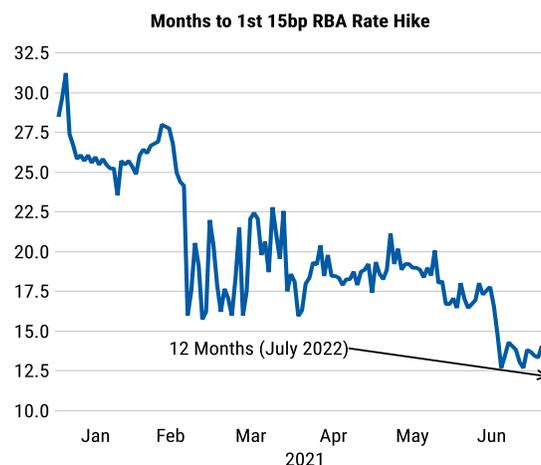
[Exhibit 87](#) shows current market pricing for the RBA relative to our economists' base case. We assume that the RBA pulls forward its current 2024-at-the-earliest guidance to 2023, which would already be a hawkish surprise, and hikes twice in 2023 (May and November).

Exhibit 87: Markets are pricing in significant RBA hikes in 2022-2023



Source: Bloomberg, Morgan Stanley Research

Exhibit 88: Markets have fully priced RBA liftoff for July 2022



Source: Bloomberg, Morgan Stanley Research

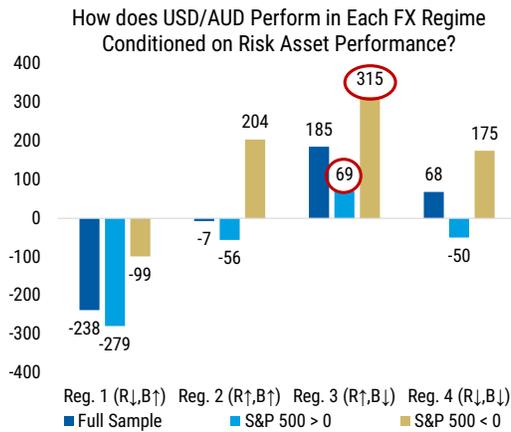
Even despite assuming the RBA turns more hawkish, though, the market is still way ahead of this. The 1y1y forward rate implies not just liftoff in July 2022 ([Exhibit 88](#)), but also likely two more 25bp rate hikes between mid-2022 and mid-2023. This is significantly more hawkish than the RBA, and we think this is aggressive considering the RBA continues to emphasize that **realized data, not forecasts**, will govern when liftoff occurs, and its targets for realized data (3%+ wage growth, ~4% unemployment rate) are quite lofty.

Second, higher US real yields and tighter breakevens over the summer continues to be plausible - which is USD positive. This is known as "Regime 3" of our [four-regime USD framework](#) and it tends to see AUD/USD weakness. Importantly, AUD/USD weakness in Regime 3 takes place on average even *despite* higher equity prices ([Exhibit 89](#)).

Third, like in New Zealand, COVID-19 risks in Australia are asymmetrically-negative.

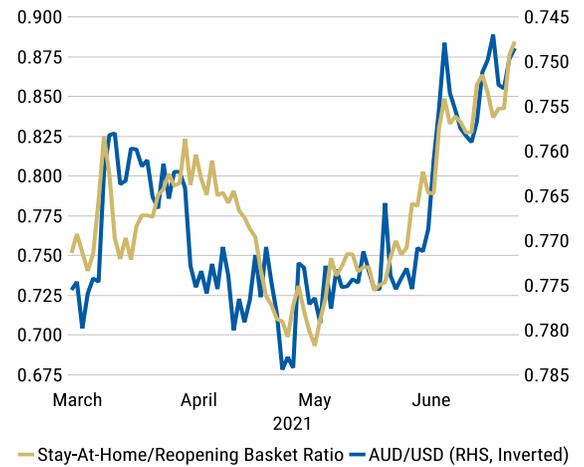
Low vaccination rates and low levels of previous cases suggest limited immunity to COVID-19 already, and the Delta variant's pace of transmission is concerning. [Our economists](#) and [the RBA](#) appear to agree that lockdowns, once they're over, are unlikely to generate lasting economic damage.

Exhibit 89: AUD/USD tends to weaken in 'Regime 3' even if equities are rising=



Source: Bloomberg, Morgan Stanley Research

Exhibit 90: AUD/USD has weakened alongside equity rotation out of 'reopening' stocks...



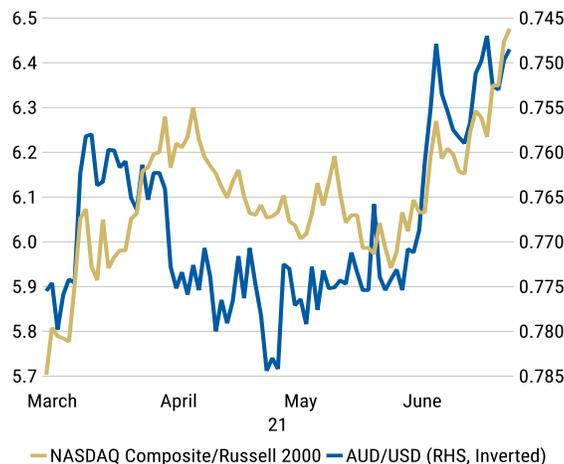
Source: Macrobond, Morgan Stanley Research

However, we emphasize that this is an asymmetric risk. Should COVID-19 be difficult to contain, the RBA's labor market goals would be far more difficult to achieve, particularly as it would keep border closures present for much longer.

Fourth, the rotation in the equity market suggests that markets are getting increasingly defensive about the global growth outlook. The USD tends to be negatively correlated with global risk appetite and when global growth is strong and synchronized, we tend to see a weaker USD (and stronger AUD).

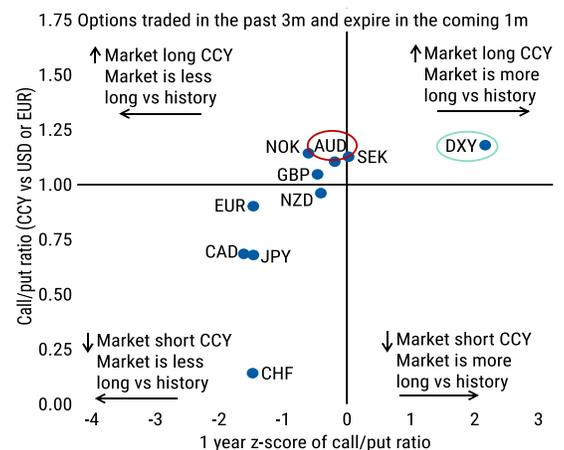
Exhibit 90 shows AUD/USD relative to a ratio of two equity baskets - stocks that benefit from 'stay-at-home' and stocks that benefit from reopening. We repeat the exercise in using the ratio of the NASDAQ Composite to the Russell 2000 in Exhibit 91, which tells a similar story (large cap tech names benefit more from 'stay at home' versus small caps which are more services-oriented).

Exhibit 91: ...and into defensive stocks



Source: Macrobond, Morgan Stanley Research

Exhibit 92: AUD positioning is still marginally long compared to rising short positions in other currencies



Source: Macrobond, Morgan Stanley Research

The shift in equity performance suggests to us that the rising impact of the Delta variant may be softening market expectations for the global outlook, particularly in areas where vaccination rates remain low and/or areas where policymakers' reaction functions are relatively conservative, suggesting a higher propensity for lockdowns.

Fifth, there remains some AUD-long positioning relative to other G10 pairs. Take the options market for example. While positioning has shifted toward long USD, positioning is still modestly long AUD ([Exhibit 92](#)). There remains a noticeable long AUD position [among leveraged funds](#) in the futures space as well. This suggests further scope for an unwind.

Key risks and catalysts: For now, the main driver of AUD/USD is more likely to come from the USD. With the July RBA out of the way, the most likely major catalyst from the Australia side of things is COVID-19. We are watching US data, Fed rhetoric, the composition of US real yield and breakeven changes, and the equity market "under the hood" closely. Positioning is not nearly as stretched as it once was, but remains long AUD based on some measures. And the technical picture is mixed, with the 14d RSI approaching 30 (suggesting a short term pullback higher), but AUD/USD well below the ichimoku cloud.

JPY | USD/JPY, Buying on Dips!

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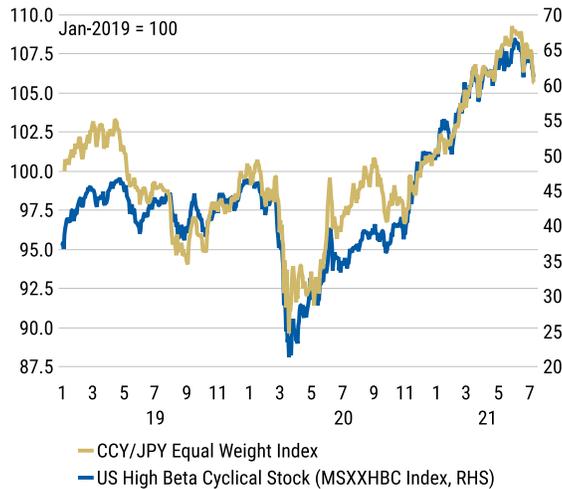
USD/JPY, Buying on Dips!

The yen has outperformed other currencies over the past few days as US interest rates have fallen sharply. Given that the Swiss franc and recently underperforming euro have also seen strong buying interest, our impression is that "safe haven" funding currencies are being favored at this juncture. Both US real yields and TIPS breakevens have also declined of late, meaning that recent price action corresponds to Regime 4 of our [USD framework](#) (falling real yields and falling breakevens). Recent outperformance of "safe currencies" such as JPY and CHF, should thus come as little surprise.

The recent deterioration in performance of cross-yen rates is consistent with the worsening performance of US cyclical stocks (see [Exhibit 93](#)) and appears to reflect growing concerns about the outlook for the US and global economies. US equities have held up relatively well at the index level, but the cyclical and value sectors have been big underperformers while the growth sector has started to outperform (see [Exhibit 94](#)).

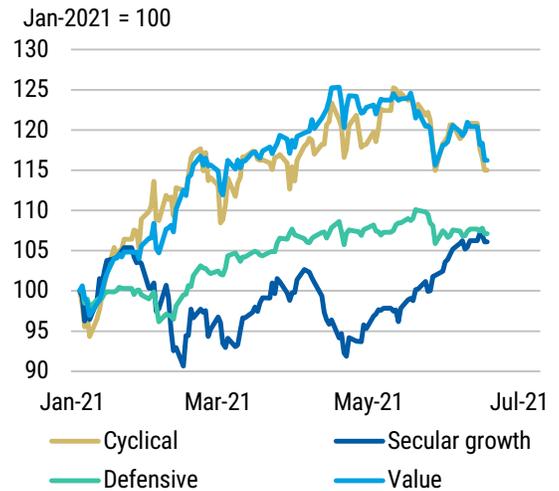
There are also signs of "stay home" stocks outperforming "reopening" stocks (see [Exhibit 95](#)), suggesting that some market participants might expect the resumption of economic activity to be delayed in regions that are seeing increased spread of the Delta variant. Given that the UST yield curve has been bull-flattening of late, **our impression is that stock market participants have viewed the recent bull-flattening of the UST curve as a signal that the US and global economies might indeed be set to slow.**

Exhibit 93: CCY/JPY performance has aligned with US cyclical stocks



Source: Morgan Stanley Research, Bloomberg

Exhibit 94: Cyclical and value stocks have underperformed amid the recent risk-off move.



Source: Morgan Stanley Research, Bloomberg

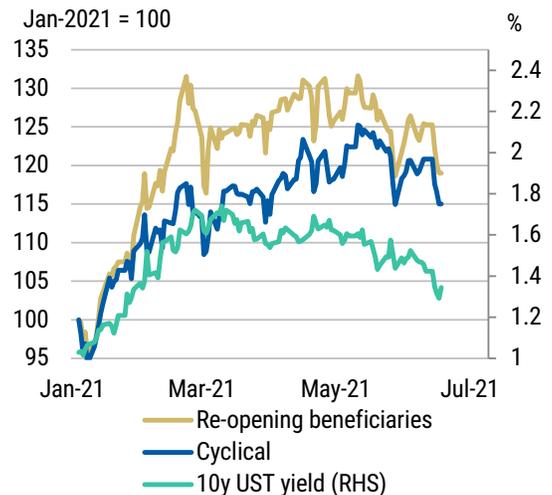
The recent corrections in cyclical and "reopening" stocks did in fact occur only after US interest rates had fallen (see [Exhibit 96](#)). This week we have been fielding a number of questions from equity investors about the reasons why US rates have been falling, suggesting that many expect sectoral performance to be quite significantly influenced by what happens to US rates from this point forward.

Exhibit 95: "Reopening" beneficiaries recently have underperformed "Staying at home" winners



Source: Morgan Stanley Research, Bloomberg

Exhibit 96: UST yield lowered first, then followed by cyclical and reopening beneficiaries



Source: Morgan Stanley Research, Bloomberg

But we are not yet convinced that recent UST bull-flattening is truly a reflection of fundamentals. At the very least we find it difficult to identify any particularly dramatic shift in fundamentals within the past few weeks. US jobs data continue to improve, and while strong inflation prints do seemingly owe much to supply-side bottlenecks, they also offer some indication that demand-side pressures are intensifying as economies are reopened.

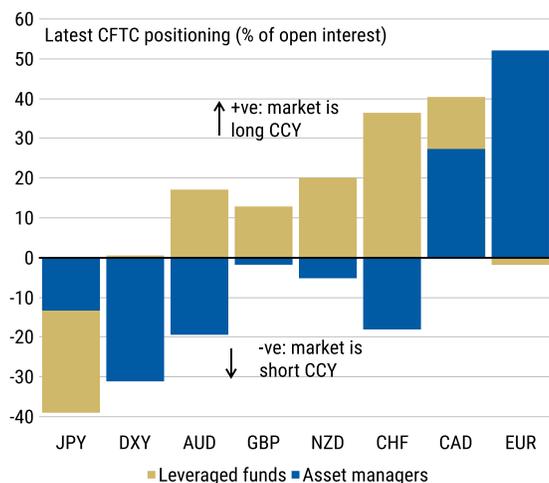
Our economists expect supply-side bottlenecks to act as a temporary brake on economic activity via the cost-push inflation channel, but our basic expectation is still that strong appetites for capital investment will continue to shore up growth rates over the medium to long term.

We believe that the recent decline in US interest rates is due more to positioning than to fundamental changes. Given that the fundamental outlook remains essentially unchanged, we would advise against worrying too much about stock market performance, given that liquidity is still in such abundant supply. We also expect the yen's funding-currency status to start being conducive to underperformance once again if risk asset markets do indeed shift back into recovery mode.

The recent selloff in yen cross also looks like somewhat of an overshoot relative to the performance of cyclical stocks. Positioning is once again likely to be the main reason. CFTC data show JPY to be the most shorted currency among the G10 (see Exhibit 97), with fleet-footed leveraged funds appearing to have built up particularly large yen-short positions. Unwinding of such positions has almost certainly contributed to the yen's recent outperformance.

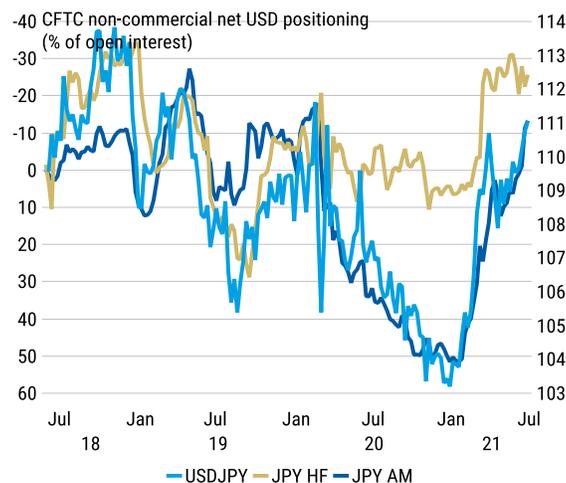
Asset managers—historically among the biggest drivers of JPY performance (see Exhibit 98)—meanwhile appear only modestly short the yen (having been long until recently). Asset managers are also known for investing with an eye to the longer term, suggesting that they are unlikely to start reversing their positioning in the absence of some strong hint at a change in fundamentals (such as a significantly more dovish tone from the Fed).

Exhibit 97: CFTC data suggested that investors were most short JPY



Source: CFTC, Macrobond, Morgan Stanley Research

Exhibit 98: Asset managers appear to lead JPY direction



Source: CFTC, Macrobond, Morgan Stanley Research

Our main scenario is still for the yen to underperform—by virtue of its "funding currency" status—as the global economy continues to recover. We are thus sticking with our USD/JPY-long recommendation. The June FOMC minutes confirm that the Fed continues to prioritize actual data, with the recent stronger-than-expected inflation prints seemingly having translated into broader support for a commencement of tightening sooner rather than later.

The labor market is obviously still quite some distance away from full employment, but the Fed has expressed some optimism about the continuing pace of improvement. Our economists still expect the Fed to announce details of its tapering plan at the September FOMC meeting, at which point markets should once again start to price in the envisaged tightening trajectory. USD/JPY might even end up facing an ideal scenario of rising US real yields and liquidity-driven maintenance of global risk appetites.

Trade idea: Maintain short 3m USD/JPY call at 112.50 to receive 0.40% (priced 18-Jun-21)

Trade idea: Maintain long USD/JPY at 109.98 with a target of 112.50 and a stop of 108.40

G10 | Currency Summary

USD

0.8%

**Our view: Bullish****Risk skew: Bullish***Watch: CPI, PPI, Beige Book, Jobless Claims, Retail Sales**DXY* **Support:** 91.25, 90.50/75, 89.75, 89.00/25, 88.50, **Resistance:** 92.80, 93.50, 94.25, 94.75, 95.75

We remain bullish on the USD and recommend long positions versus EUR, JPY, AUD, CAD, and CHF via options. Arguably the two most compelling arguments for USD shorts in 2021 have been strong and synchronized global growth and a dovish Fed. With the Fed continuing to indicate that it will discuss tapering options at its July meeting (and likely signal tapering in September, in our view), and now risks rising around the global growth outlook due to the Delta variant, USD gains are likely to continue. Technicals continue to suggest a higher USD (e.g., Ichimoku cloud), though rising RSIs suggest the pace of gains may slow. A rebound in US real yields with tighter breakevens should keep the USD rally intact.

EUR

-1.0%

**Our view: Bearish****Risk skew: Bearish***Watch: Eurogroup, Ecofin Meetings, Industrial Production, Trade Balance, Final Inflation**EUR/USD* **Support:** 1.1780, 1.1700, 1.1625, 1.1500, 1.1425, **Resistance:** 1.2000, 1.2100, 1.2200, 1.2250/75, 1.2300

We remain bearish on EUR and short EUR/USD. The ECB's dovish approach stands out versus many other central banks in G10, which have been turning more hawkish after the recent stronger growth and inflation data. The ECB's new policy strategy does not represent a radical shift of the central bank's thinking, but solidifies its dovish stance. We continue to pay attention to the spread of the Delta variant of the coronavirus throughout the Eurozone and the impact it may have on the economic recovery. Tactically, the EUR/USD sell-off appears somewhat overdone, with short-term options positioning also reaching an extreme short. We continue to see risks eventually tilted towards USD strength, including against the EUR, with risks of exceeding our 1.17 target towards the bear case of 1.14.

JPY

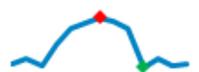
1.1%

**Our view: Neutral****Risk skew: Bearish***Watch: Weekly Mof data, BoJ MPM**USD/JPY* **Support:** 109.50, 109.25, 108.75, 107.75, 107.00, **Resistance:** 111.60/70, 112.25/50, 113.00, 113.75

We remain bearish skew for JPY. The JPY outperformed other G10 currencies this week as demand for safe haven assets increased amid the risk-off move. Leveraged funds' heavy short JPY positioning also exaggerated the outperformance of JPY. Equity markets seemingly interpreted this week's massive bull-flattening of the UST curve as a sign of global growth concerns. However, we believe that such a movement would more likely be driven by technicals rather than a change of fundamental market views. With the global recovery narrative remaining intact, we see the current dip of CCY/JPY a good opportunity for dip-buying. We continue to prefer long USD/JPY, with JPY expected to be used as a robust funding currency while USD is gradually being regarded as an asset currency as the Fed moves into tapering.

GBP

0.0%

**Our view: Neutral****Risk skew: Neutral***Watch: Economic Reopening Decision, CPI, Unemployment**GBP/USD* **Support:** 1.3730, 1.3675/1.3700, 1.3575, 1.3450, 1.3200, **Resistance:** 1.3900, 1.4000, 1.4100, 1.4250, 1.4350/75, 1.4550

We continue to expect GBP/USD to trade sideways, with EUR/GBP remaining in a range. GBP/USD is very sensitive to the UK-US real yield differential, and with the Bank of England meeting still a month away, US real yields may be the more important driver of the differential for now. We continue to see upside potential for US real yields, which should put some downward pressure on GBP/USD. However, the BoE remains one of the hawkish central banks in the G10, meaning GBP could outperform on crosses versus AUD for example. Short term speculators have reduced long GBP positions via the options market. We will be watching to see if GBP/USD can hold in the recent trading range, with 1.3670 watched to the downside.

CHF

-0.5%

**Our view: Bearish****Risk skew: Bearish***Watch: Sight Deposits, President Jordan's speech, House Prices**EUR/CHF* **Support:** 1.0840, 1.0800, 1.0750, 1.0675, 1.0625, **Resistance:** 1.1000/25, 1.1100, 1.1150/75, 1.1200

We maintain our bearish stance on CHF despite the recent strength and remain long USD/CHF via 1y risk reversals. The market is now very short the CHF, especially via options, which contributed to the CHF strengthening sharply this week as global growth concerns intensified. Our expectation for higher US real yields and a weaker EUR/USD means USD/CHF risks remain skewed to the upside. Focus will be on whether the Swiss National Bank (SNB) intervened in FX markets following this week's volatility and by how much; we will get more information on that in Monday's sight deposits data. In EUR/CHF, the pair has now given up all of its gains since yields started moving higher in late February. 1.08 is the next big support level we are watching.

CAD



AUD



NZD



SEK



NOK

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

Watch: BoC Decision

USD/CAD **Support:** 1.2275, 1.2200, 1.2125, 1.2050, 1.1925 **Resistance:** 1.2590, 1.2625/50, 1.2725/50, 1.2850

We continue to recommend long USD/CAD positions targeting 1.27. CFTC data indicate that both leveraged funds and asset managers have reduced CAD longs positions, but longs continue to have significant room for unwinds. Markets are priced for BoC liftoff early in the spring of 2022 - very shortly after January, when we expect the BoC to wrap up its QE purchases. Given the compressed (and overly optimistic) market-implied timeline for BoC policy, we think front-end Canadian rates should decline in the coming weeks. A potential catalyst for that move would be the BoC signaling that it expects to continue to taper purchases at a "gradual" pace, which would imply a reluctance to taper faster than once per quarter.

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

Watch: Consumer and Business Confidence, Employment

AUD/USD **Support:** 0.7400, 0.7350/75, 0.7225, 0.7150, **Resistance:** 0.7600, 0.7650, 0.7775, 0.7900, 0.7950

While the RBA was a bit more hawkish than expected, we continue to see compelling reasons to be short AUD/USD (targeting 0.70 with a 0.78 stop). Markets are pricing in excessive RBA hawkishness, with liftoff now fully priced for July 2022, compared to RBA guidance for 2024. Higher US real yields and tighter breakevens suggest a weaker AUD. COVID-19 risks remain asymmetrically negative in Australia, particularly with the more-transmissible Delta variant. Rising concerns about global growth (as evident in the distribution of equity returns) should be AUD/USD-negative. And finally, positioning is still long AUD in options, and leveraged funds are long in futures.

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

Watch: REINZ House Sales, RBNZ Decision, CPI

AUD/NZD **Support:** 1.0660, 1.0550, 1.0500, 1.0425, **Resistance:** 1.0720/30, 1.0800, 1.0875, 1.0925, 1.1000, 1.1050

After months of underpricing the RBNZ's "Great Hawkish Shift", we think markets have finally begun to overprice the RBNZ's hawkishness. For this reason, we think the risk skew for NZD/USD has turned bearish, particularly amid continued signs of broader USD strength. We continue to see downside risks for AUD/NZD - not so much driven by fundamentals (RBA-RBNZ divergence) given overpricing of the RBNZ, but rather technicals and momentum. As a result, we tighten our stop and caution investors to be nimble, and at a break above 1.0730, positions should be removed. Assuming the RBNZ does not formally end its asset purchase program at the upcoming meeting, we think market pricing for a November 2021 rate hike is overdone, and we look to enter receiver positions for the November 2021 meeting.

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

Watch: Riksbank Minutes, Inflation, Inflation Expectations, House Prices

EUR/SEK **Support:** 10.10, 10.05, 10.03, 9.75/78, 9.45, **Resistance:** 10.25, 10.29/30, 10.35, 10.40, 10.43

We continue to see SEK weakening moderately, with risk sentiment key to watch. EUR/SEK proved particularly resilient to this week's risk-off move, failing to break above the 10.20 resistance level. Further long positioning unwinds in NOK/SEK supported SEK, but we think this creates the risk of a EUR/SEK catch-up rally if equities continue to weaken amid the current global growth scare. We don't expect EUR/SEK to break out of the 10-10.40 range though. Swedish growth data for May disappointed expectations but our economists continue to expect a 3Q rebound, keeping market hopes for a hawkish turn from the Riksbank later in the year alive and preventing a significant weakening of SEK.

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

Watch: Global Risk Appetite

NOK/SEK **Support:** 0.9750, 0.9700, 0.9650, 0.9500 **Resistance:** 1.0000/50, 1.0250, 1.0400, 1.0575, 1.0700

We remain neutral on NOK. NOK has weakened considerably due to the risk sell-off. While the fundamental story in Norway remains strong, with growth looking robust, a hawkish Norges Bank that should start its rate hiking cycle in September, and NOK trading at a discount to oil, we don't see good risk/reward in buying the NOK dip at the moment. With uncertainty over the coronavirus delta variant, the risk-sensitive NOK is susceptible to weakness if global growth concerns increase. Thinner summer liquidity could exacerbate volatile moves in the illiquid NOK. That said, NOK has reached oversold levels against EUR and SEK based on the 14-day RSI so it could stabilise in the near term. 10.18 is the key level to watch on the downside in EUR/NOK.

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

The 2021 Institutional Investor (II) Global Fixed-Income Research poll is open. If you enjoy our work, [please rate us](#) five stars in the following categories: USA: Economics & Strategy > Treasury Inflation-Protected Securities and U.S. Rates Strategy; Developed Europe: Economics & Strategy > Inflation-Linked Bonds; Japan > Interest Rate Strategy; Asia (ex-Japan) > Local Markets Rates Strategy. Thanks for your readership and support!

United States

With long positioning and a vigilant Fed likely to limit a widening in breakevens and positive carry and healthy CPI prints providing support for breakevens, we see guardrails on both sides likely to keep breakevens in a range over coming weeks. We expect real yields to lead the move higher in nominals, and contribute to our call for higher 10y nominal yields. We maintain beta weighted 10y breakeven shorts as a way of being underweight real yields vs. nominals.

Japan

Data as of June offer clear signs of an improvement in inflation expectations among both households and businesses, albeit to somewhat differing extents. The biggest factor has been a rise in gasoline, electricity, and other energy prices, but we note with some interest that consumers and firms do not appear to view such pressures as temporary.

JGBi market participants seemingly believe otherwise, however, with the breakeven inflation rate (BEI) priced into JGB linkers basically just continuing to range between 20bp and 30bp. There have indeed been some modest movements in the BEI driven by recent action in the nominal JGB market, but bond market participants as a whole appear comparatively unconvinced that inflation is set to accelerate. We examine whether the JGBi market's inflation expectations are lagging behind reality or not.

United States | Finding the real yield floor

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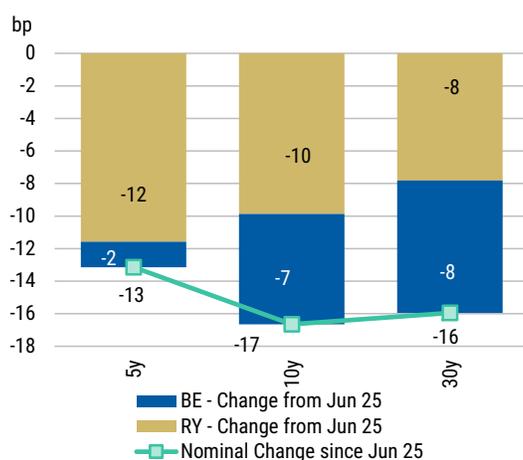
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As markets confronted technical pressure on nominal yields and lukewarm economic data (ISM services and jobless claims), a short-lived leg lower in real yields after the holiday weekend eventually gave way to broad breakeven tightening on Wednesday and Thursday ([Exhibit 99](#)). Markets shifted somewhat Friday, with higher real yields and wider breakevens, albeit not enough to reverse tightening from earlier in the week. Notably, towards the end of the week, there was palpable resistance to further lower real yields, even when nominal yields plunged, suggesting investors are starting to see real yields at stretched levels. The 30y real yield ricocheted sharply after breaking through the -30bp level last seen in January.

The decline in nominal yields highlights one of the advantages of being short real yields in a relative value trade relative to nominals. On an outright basis, real yields are lower over the last two weeks, but on a relative basis, adjusted for beta, real yields have actually underperformed and the beta-weighted breakeven short has worked (see [Exhibit 100](#)).

Exhibit 99: Moves in TIPS real yields and breakevens over the past two weeks



Source: Morgan Stanley Research

Exhibit 100: Beta-weighted 10y breakeven over the last one year



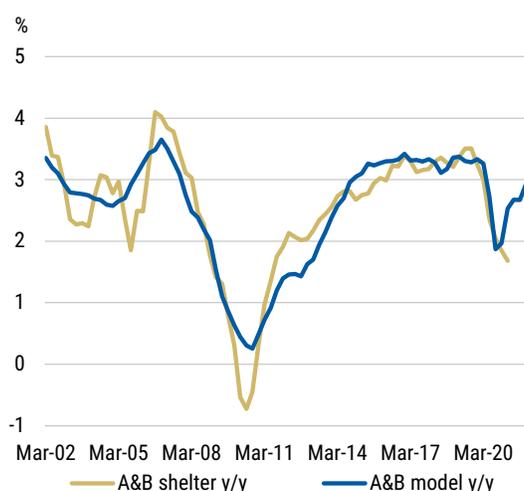
Source: Morgan Stanley Research

On the breakeven side, we think breakevens are currently in a rangebound environment, with a skew that breakevens can tighten rather than breakevens can widen. We think this is because, while the June FOMC has reduced the upside tail for breakevens, given the Fed's palpable concern around inflation, there is potentially downside risks that remain given the concentrated positioning, particularly in the TIPS ETF space.

However, breakevens do have support in the near term as well, given that the June CPI could be another strong month buoyed by used car prices, as well as shelter inflation. Our shelter inflation model has been suggesting a V-shaped recovery in rents over recent months, and CPI data in the last 3 months has only bolstered the case for continued optimism.

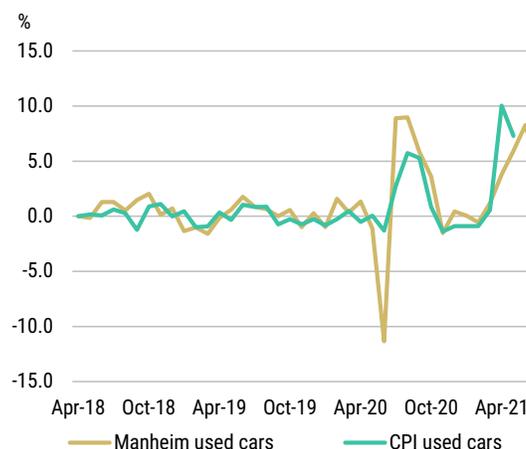
If CPI prints come in at another strong print, not only would that help the perception of strong inflation, it would also further help with the positive carry in long breakeven trades. While there are signs that used car price inflation will slow down eventually (see [Exhibit 102](#)), we see shelter inflation continuing to do well, providing a strong backbone to the CPI trajectory. Thus, we see guardrails on both sides for breakevens, likely to keep them in range for now. We maintain beta weighted 10y breakeven tighteners as a way to be underweight TIPS vs. nominals.

Exhibit 101: Class A and Class B shelter inflation alongside model



Source: Morgan Stanley Research

Exhibit 102: Used car CPI inflation vs. the Manheim index



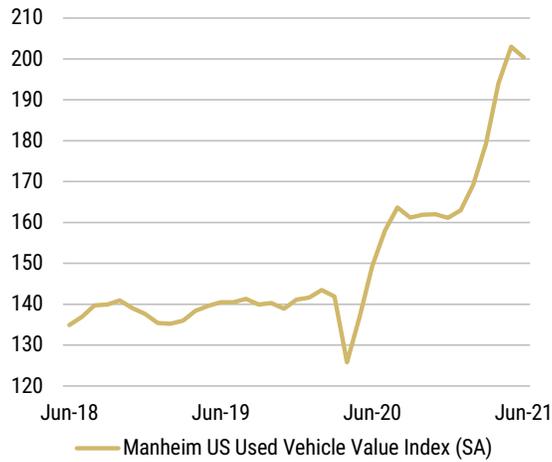
Source: Morgan Stanley Research

A yellow light for used car prices?

Our auto equity analysts [noted](#) the Manheim used vehicle value index reached what they called an "inflection point" in June, with prices slipping -1.3% m/m on a seasonally adjusted basis. This marked the first m/m retreat for the index since December 2020 after an impressive set of price gains ([Exhibit 103](#)). The team [expects](#) continued declines in the index as supply normalizes in what they dubbed "Manheim fatigue."

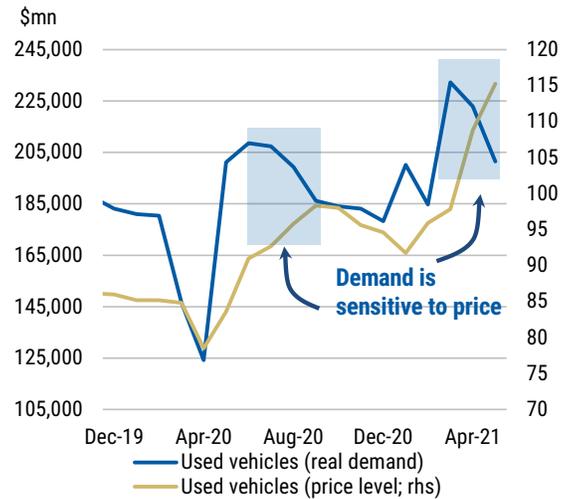
These expectations also resonate with the [demand story](#) we've highlighted in used vehicles among other categories (i.e., furniture) through PCE real demand and price levels. Specifically, as exhibited in [past cases](#) of sharp price increases, such as tariffs in 2018, we continue to see the potential for high prices to derail rising demand for products/sectors that benefitted in the pandemic economy ([Exhibit 104](#)). Categories such as used cars and furniture should offer some of the "payback" across future CPI prints that our economists [anticipate](#), as they look for m/m prints to slow as transitory pressures fade. Meanwhile, we continue to look for categories like [shelter](#) to provide a firm base for a sustained inflation recovery.

Exhibit 103: Manheim US used vehicle value index (seasonally adjusted)



Source: Bloomberg, Morgan Stanley Research

Exhibit 104: Used vehicles: PCE real demand alongside price index



Source: Morgan Stanley Research

Trade idea: Maintain 10y beta-weighted breakeven shorts at 200bp

Japan | Are the JGBi market's inflation expectations lagging behind reality?

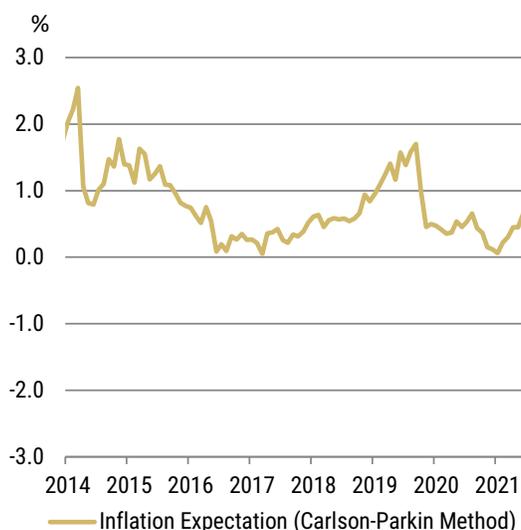
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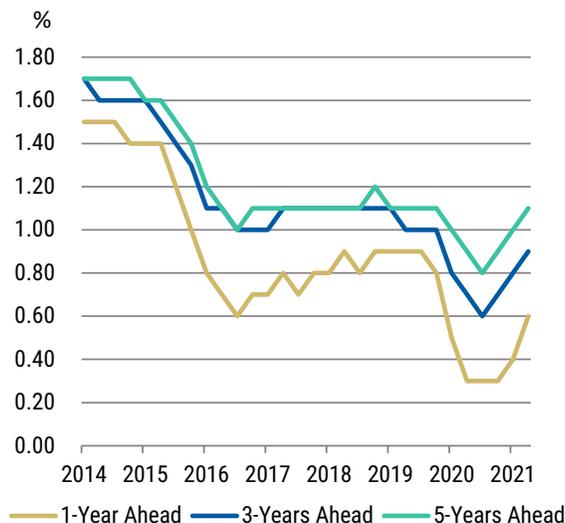
Data as of June offer clear signs of an improvement in inflation expectations among both households and businesses, albeit to somewhat differing extents. The biggest factor has been a rise in gasoline, electricity, and other energy prices, but we note with some interest that consumers and firms do not appear to view such pressures as temporary.

Exhibit 105: Consumer Confidence Survey based household inflation expectations (1-year ahead)



Source: Morgan Stanley Research

Exhibit 106: BoJ Tankan based enterprises inflation expectations



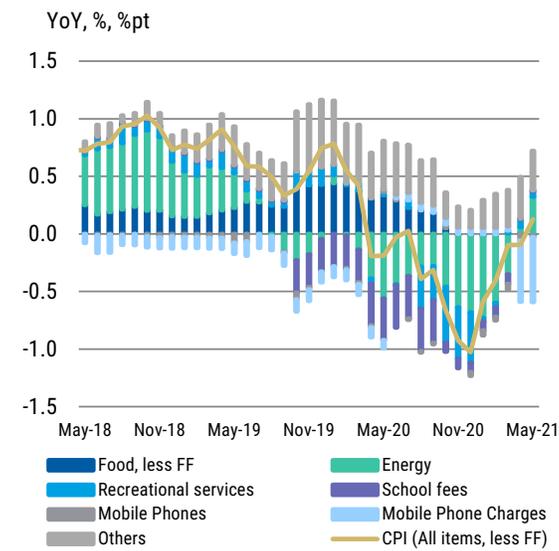
Source: Bank of Japan, Morgan Stanley Research

A fourth state of emergency declaration is set to be imposed on Tokyo while a number of other prefectures remain subject to so-called "quasi-emergency measures", but our impression is that households and businesses are looking for prices to climb as economic activity is restarted.

JGBi market participants seemingly believe otherwise, however, with the breakeven inflation rate (BEI) priced into JGB linkers basically just continuing to range between 20bp and 30bp (...though it broke the 20bp level for the first time since May due to the risk-off mood in markets). There have indeed been some modest movements in the BEI driven by recent action in the nominal JGB market, but bond market participants as a whole appear comparatively unconvinced that inflation is set to accelerate.

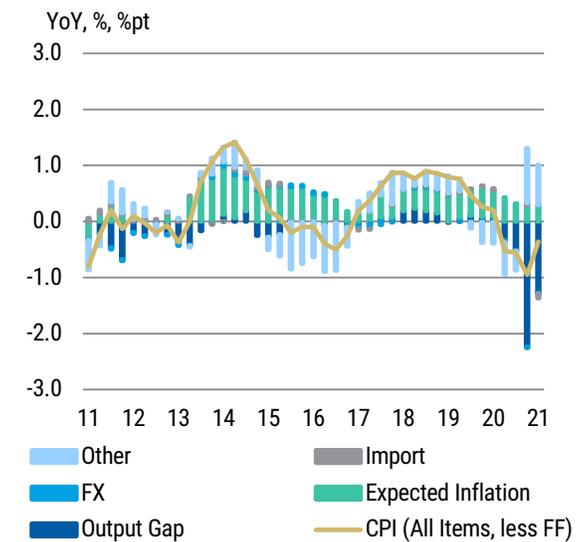
This is perhaps understandable given that—as discussed in our previous report—the core (all items less fresh foods) and core-core (all items less fresh foods and energy) CPI inflation measures continue to be buffeted by competing temporary factors such as (inflation-positive) rises in energy prices and (fire and earthquake) insurance premiums and (inflation-negative) cuts to mobile phone charges.

Exhibit 107: Japan-style core CPI inflation and its contributing items



Note: Morgan Stanley Research calculations
Source: Ministry of Internal Affairs and Communications, Morgan Stanley Research

Exhibit 108: Japan-style core CPI inflation and its contributing factors



Note: Note: Morgan Stanley Research calculations
Source: Morgan Stanley Research

We have yet to see clear evidence of significant price rises for other CPI components, which may help to explain why bond market participants remain relatively bearish (or perhaps even pessimistic?) vis-à-vis the inflation outlook (although allowance does of course also need to be made for the impact of supply/demand factors specific to the JGBi market).

Tokyo and Okinawa will remain under a state of emergency through August 22 and a number of other prefectures continue to impose "quasi-emergency measures", and it seems quite possible that these protracted restrictions on economic activity will end up dampening the consumption appetites of market participants and other individuals.

Pent-up demand may of course provide some temporary "relief", but we are surely not alone in wondering whether propensities to save (rather than spend) might be set to strengthen yet further as a consequence of the pandemic.

A number of investors have told us that they do not necessarily expect the Japanese public to start spending even once emergency and quasi-emergency measures are finally lifted and it becomes possible to travel overseas (noting that overseas consumption by Japanese travelers should technically be classified as an import of services).

Considered in this context it is perhaps somewhat ironic that the JGBi BEI—so often viewed as a reflection of supply/demand factors outside the consumer price domain—currently appears consistent with a wait-and-see stance on the part of Japanese consumers.

Our main scenario is still for the BEI to remain rangebound. We do envisage some occasional skittishness driven by price action in the nominal JGB market, but a sustained range-break looks unlikely in the absence of big movements in UST yields.

The BEI does look likely to rise slightly in the near term as the indexation coefficient drives the real yield lower, but we are now less confident than before in BEI upside given that (1) so much remains dependent on nominal yield levels and (2) questions are now starting to be asked about the outlook for US interest rates.

Short-Duration Strategy

The 2021 Institutional Investor (II) Global Fixed-Income Research poll is open. If you enjoy our work, [please rate us](#) five stars in the following categories: USA: Economics & Strategy > Short-Duration Strategy and U.S. Rates Strategy; Developed Europe: Economics & Strategy > Interest Rate Strategy; Japan > Interest Rate Strategy; Asia (ex-Japan) > Local Markets Rates Strategy. Thanks for your readership and support!

United States

In the US, we first revisit the Standing Repo Facility after it had a prominent role in the Fed's minutes, released this past Wednesday. While there still seems to be discussions left to be had as to the exact design details of the facility, it seems like it will share features with the existing repo operations as well as the discount window. Importantly, the introduction of an SRF marks a shift back towards a more corridor-like system.

The Fed also made note that it would consider raising counterparty limits once again on the RRP facility. It is very possible that several of the large holders of Fed RRP are nearing the \$80bn limit, particularly on statement dates when RRP usage tends to spike. We expect that RRP usage will continue to grow, reaching levels greater than \$1.5tn by the end of September when the TGA is at its lowest due to the debt ceiling before declining modestly once the debt ceiling is resolved.

United States | The Corridors of (the Fed's) Power

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With a discussion more seriously considering a standing repo facility (SRF) and the potential for a further fortification of the RRP facility, the Fed appears to be moving back towards a corridor monetary policy framework.

A standing ovation for the Standing Repo Facility (SRF)

After coming in and out of the spotlight over the last several years (see [2020 Year-Ahead Outlook](#) for a prior discussion on the facility), it seems that the SRF is back and here to stay. In the Fed's [minutes](#) from their June meeting, released this past Wednesday, there was a very lengthy discussion on the Standing Repo Facility and design elements of the facility.

While many aspects and characteristics of the facility have yet to be discussed, such as timing of operations during the day, term limits on operations (i.e. only overnight or longer?), and size limitations, there were clear steps made in deciding who the eligible counterparties would be, what eligible collateral would be, and where the rate should be set. A comparison of the SRF, as detailed in the minutes, versus the discount window and existing repo operation offerings can be seen in [Exhibit 109](#).

Exhibit 109: Comparison of SRF to current repo offerings and the discount window

	SRF*	Discount Window	Repo Operations
Rate	Upper Bound of Target Range	Upper Bound of Target Range	IOER + 5bp
Eligible Counterparties	Primary Dealers (and maybe other banks over time)	Depository Institutions	Primary Dealers
Eligible Collateral	UST securities (and maybe Agency debt and Agency MBS)	Wide variety of assets, detailed on the Fed website	UST securities, Agency Debt, Agency MBS
Term of Operation	Unclear	Up to 90 days**	Overnight***
Timing During Day	Unclear	Anytime during business day; posted at close of Fedwire (7:00pm ET)	1:30pm - 1:45pm ET each business day
Size Limit	Unclear	None	\$500bn in aggregate

Source: Federal Reserve, Morgan Stanley Research

*All details on the SRF are as proposed in the minutes

**The Fed extended credit for up to 90 days on March 15, 2020, effective March 16, 2020

***The Fed was also offering term repo operations until February 2021

On the whole, the design of the facility appears to be a bit of a hybrid between existing repo operations and the discount window. All three facilities offer collateralized lending to eligible counterparties. Much like the existing repo operations (which have gone unused since July 2020), the Staff recommends that the facility would be available to primary dealers and that the eligible collateral is limited to UST securities (and potentially also Agency securities and Agency MBS). This differs from the discount window as the discount window is available to all depository institutions and takes in a much broader set of collateral.

However, much like the discount window, the Staff recommends that the rate on the facility be set at the upper bound of the target range, above the current placement of the repo offerings, which are set at IOER + 5bp. In the discussion of where the rate should be set, there seemed to be some disagreement as to the appropriate placement (our **emphasis**):

*"Several participants noted the importance of setting the minimum bid rate high enough so that the facility was **positioned as a backstop**, while some pointed out the **importance of not setting the rate so high that usage of the facility could be stigmatized** or that the facility would **not sufficiently contain pressures** that could spill over into the federal funds market."*

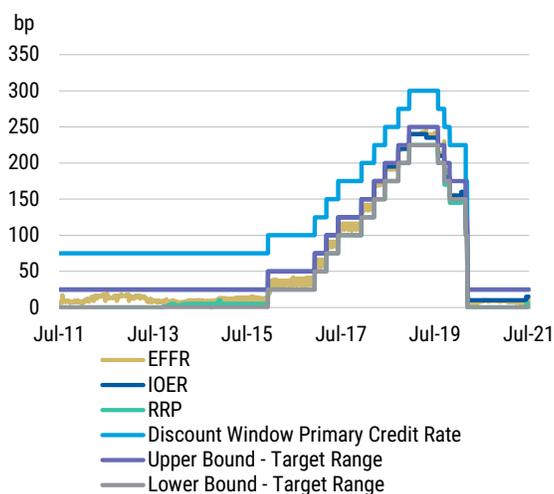
The key seems to be finding a rate that is high enough so as to avoid frequent usage and perhaps introduce moral hazard, but low enough such that it avoids the stigma that the discount window has.

But, wouldn't a Standing Repo Facility at the upper bound just be redundant with the discount window? After all, the discount window's rate is presently set at 25bp (the upper bound of the target range) after being lowered from 50bp above the upper bound of the target range on March 15, 2020.

Perhaps the creation of a Standing Repo Facility would justify a move of the discount window primary credit rate back to 50bp above the upper bound of the target range. As seen in [Exhibit 110](#) and in [Exhibit 111](#), the discount window primary credit rate has historically always been above the upper bound of the target range until March 2020. Even in the GFC, when the discount window rate was lowered, it still remained above the upper bound of the target range. While this move was made in an attempt to remove stigma from the facility, the introduction of the SRF may allow the Fed to raise the primary credit rate once again.

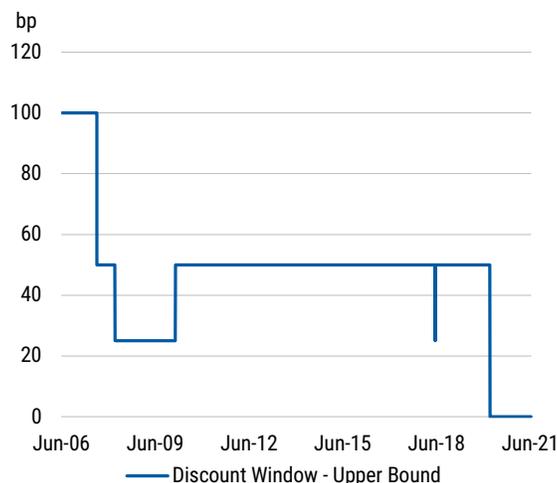
If that were to happen, you would end up with two leaky ceilings, in effect. The SRF would be a leaky ceiling in that not all borrowers of cash would have access to the facility if only made available to primary dealers (i.e. levered investors, other small banks). Further, the limitations on eligible collateral create a leaky characteristic as well. Meanwhile, the broader eligibility of counterparties and collateral at the discount window should make it stronger, but the stigma associated with it introduces some leakiness.

Exhibit 110: Various Fed policy rates/tools



Source: Bloomberg, Morgan Stanley Research

Exhibit 111: Discount window has traded at a premium to the upper bound until March 2020



Source: Bloomberg, Morgan Stanley Research

Something that could fortify the ceiling that an SRF would provide is central clearing. While the Fed has not provided central clearing on repo or reverse repo operations in the past, "Several participants suggested that, in order to ensure an SRF continues to be effective, it may be appropriate to study the costs and benefits of additional adjustments over time, such as moving to a cleared settlement structure." Allowing dealers to centrally clear, and therefore net, repo operations from the Fed would provide a more effective backstop for funding markets, as the clearing aspect would make this provision of liquidity not as balance sheet intensive as it is presently.

On the whole, though, the introduction of a SRF would be a more direct move back towards a corridor or corridor-like system. This is something that the Fed has deemed unnecessary in an ample reserves regime (see [Outlook for 2019 Year-End](#)), so the timing of this discussion is certainly an interesting one, as reserves near \$4tn.

On the margin, the introduction of an SRF would be supportive of collateral. However, given the already rich levels of repo/collateral, we don't think an announcement at this time should have a huge immediate impact on markets.

Fed prepares for another RRP counterparty limit increase

In the minutes, the SOMA Manager (Lorie Logan), also made note that the Fed would consider raising the counterparty limits once again on the RRP facility. Usage at the RRP facility has been growing substantially (a phenomena discussed in greater detail in [Betsy's Banking Buzz | Episode 61](#) and in [Strong Views on Global Macro | Ep. 28](#)).

Exhibit 112: MMF holdings of Fed RRP by MMF type, as of the end of May 2021

Type of MMF	Amount of RRP as of End of May	% of Total RRP Usage
GovtInst	224.25	46.8%
GovtRet	83.449	17.4%
TreasInst	63.27	13.2%
TreasRet	7.727	1.6%
PrmInst	58.209	12.1%
PrmRetail	19.068	4.0%

Source: Crane Data, Morgan Stanley Research

As of the end of May, MMFs accounted for 95% of all RRP usage, with the remaining 5% likely some GSEs. Institutional government MMFs are the largest users of RRP, accounting for nearly 50% of all RRP usage (see [Exhibit 112](#)). If Treasury only institutional MMFs are included, this swells to 60%. Prime MMFs, as well as all retail MMFs, make up a much smaller percentage of RRP usage.

Exhibit 113: Largest holders of Fed RRP as of the end of May 2021, extrapolated to present day

Top 10 Largest Holders	Fund Family	Fed RRP Holdings as of End of May	Extrapolated to present day based on RRP growth
FGTXX	Goldman Sachs	48.0	78.7
SPAXX	Fidelity	43.8	71.8
OGVXX	JPMorgan	40.5	66.4
FDRXX	Fidelity	35.9	58.8
MVRXX	Morgan Stanley	35.8	58.7
FID01	Fidelity	35.3	57.8
FIGXX	Fidelity	27.6	45.2
TFDXX	BlackRock	25.6	41.9
FID05	Fidelity	22.6	37.1
TSTXX	BlackRock	16.7	27.4
Total		331.8	543.7
% of Overall RRP Usage		69.2%	

Source: Crane Data

Further, the largest 10 holders of Fed RRP accounted for nearly 70% of all RRP usage (see [Exhibit 113](#)). At the time, overall RRP usage was roughly \$480bn, and no single counterparty was close to the \$80bn counterparty limit.

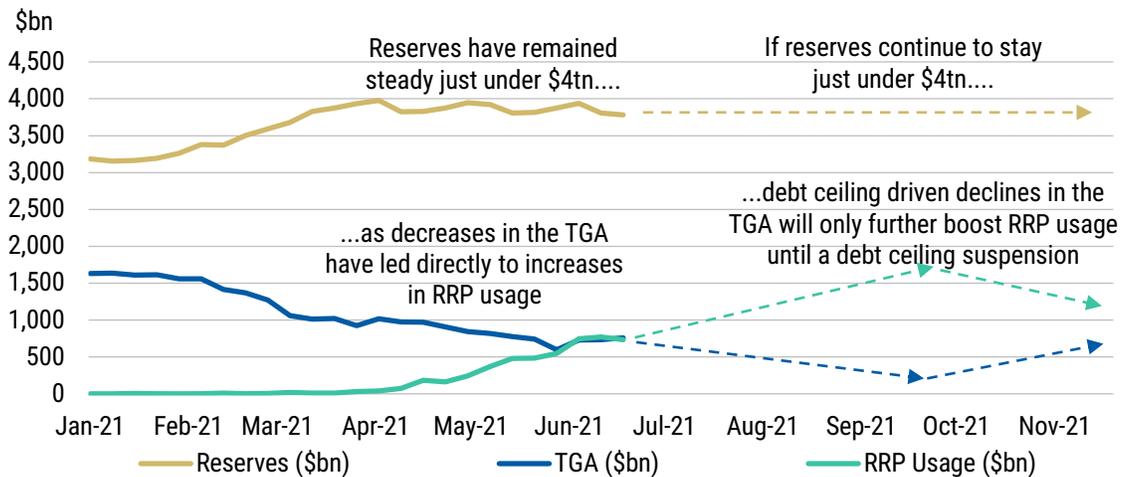
If we extrapolate since then to account for growth in overall RRP usage, it is very possible that some counterparties are nearing the \$80bn limit and maybe even reached it on month-end when RRP usage swelled towards \$1tn. While we will get new data on MMF holdings of RRP as of the end of June shortly, for the purpose of this piece, we make some rough estimates. First, we assume that MMFs held their share of overall RRP usage since the end of May - this is likely not a realistic assumption as we have seen the number of counterparties using RRP increase as overall usage of RRP has increased. However, we make this assumption for simplicity.

If we make this assumption, we see that a couple of MMFs could be within \$10bn of those \$80bn counterparty limits. Again, it's likely that these are overestimates given there are now more counterparties engaging in the facility. But, for demonstration purposes, it suggests that the \$80bn limits could be reached soon should the RRP continue to grow.

But will the RRP continue to grow? We think so. As seen in [Exhibit 98](#), reserves seemed to have stalled out just under \$4tn, suggesting the banking system is saturated with reserves at these levels. So, instead, deposits are going into MMFs who then deposit the funds into the RRP facility, thereby sterilizing the Fed's purchases.

If we assume 100% of TGA drawdowns and continued QE, which would otherwise increase reserves, are sterilized into the RRP, we could see the RRP swell by ~\$500bn this month (\$120bn from monthly QE purchases and \$400bn from TGA drawdowns as we expect TGA to end the month at \$450bn). By late September/early October, at the peak of the debt ceiling, we estimate the TGA could reach an estimated nadir of ~\$100bn. This decline in the TGA could drive RRP usage to well over \$1.5tn.

Exhibit 114: Changes to the TGA are instantly sterilized, as reserves appear saturated at \$4tn



Source: Bloomberg, Federal Reserve, Morgan Stanley Research

Further, T-bills are getting paid down during this same time, which could actually drive RRP usage even higher as T-bills are seen as a substitute to the RRP facility (and vice versa). While it is very difficult to predict the exact amounts by which the RRP could grow, the path of the facility does seem to be higher, at least until the debt ceiling is resolved.

Once the debt ceiling is resolved, we expect the Treasury to increase T-bill issuance over a short 2-3m period to grow the TGA back towards the \$750-800bn levels. In doing so, this will drain liquidity from the system, likely most of which will come out of the RRP facility. So, there will likely be an ebb and flow of the facility into 4Q21, with the facility ending the year at meaningfully higher levels than today. Also, it is worth noting that on statement dates, these levels are likely to spike, as seen on June month-end.

Trade idea: Maintain long 6m T-bills vs OIS

Trade idea: Maintain Z1/Z2 FRA/OIS flatteners

Interest Rate Derivatives

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United States

In the US, we evaluate systematic gamma-selling performance midway through the year. We find that selling EUR swaption straddles has outperformed selling USD vol this year, driven by lower realized volatility and range-bound swap rates. Strategies that sell 30y tails have outperformed those that sell 10y tails in the US.

Digging further into performance of each strategy, we find that delta-hedging has led to losses over the past few months given no consistent trend in rates, though we would expect profits from these positions over the past few days given the significant one-sided rally in rates. We then evaluate the vol surface for opportunities to sell other points. We backtest selling 6m10y straddles, which has fairly consistent performance to 3m10y straddles but slightly higher returns and volatility. We continue to favor selling shorter expiries to maximize short-gamma exposure.

United States | USD vol-selling slows while EUR soars

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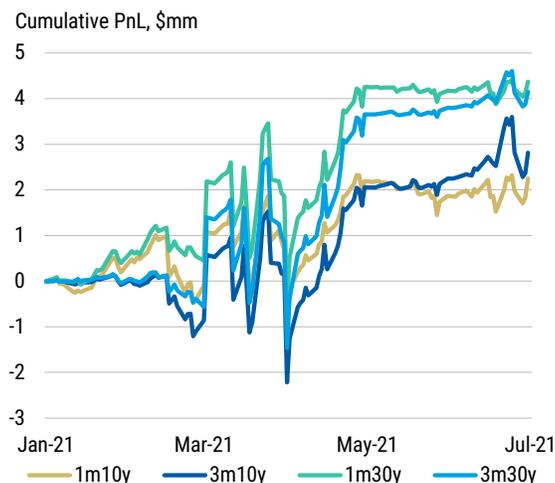
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Recapping strategy performance

When we last discussed systematic vol-selling in our [mid-year outlook](#), we found that these strategies had performed fairly well, shaking off a challenging first quarter to deliver strong performance over the month of April and beginning of May. We also recently [flagged](#) June and July as seasonally weaker months for volatility compared to market expectations, while we expect vol to pick up later in the year.

As we include more recent performance through end of June, we find that USD vol-selling backtests have slowed somewhat, with performance roughly flat through the end of May then some choppy performance in June, particularly around the FOMC meeting. On the year performance is still fairly strong, with 30y tails and 1m expiries outperforming in our backtests on a risk-adjusted basis ([Exhibit 116](#)).

Exhibit 115: Systematic USD gamma-selling performance YTD



Source: Morgan Stanley Research, Bloomberg

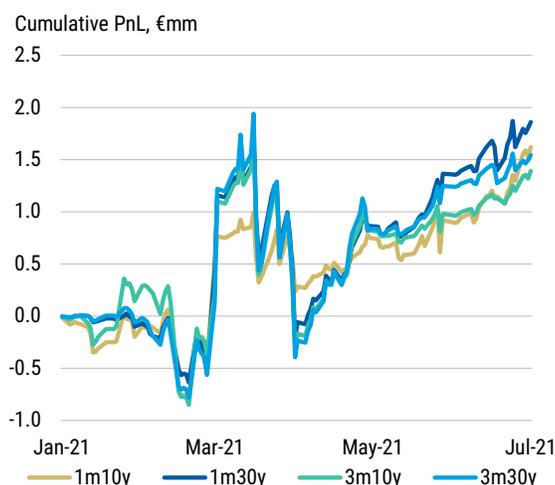
Exhibit 116: Systematic USD gamma-selling performance statistics

	1m10	3m10	1m30	3m30
	Y	Y	Y	Y
Sharpe Ratio	0.88	0.84	1.27	1.14
Profitable Weeks (%)	61%	59%	59%	59%
Max Weekly Loss / Average Annual Return	-1.6	-2.1	-1.3	-1.4
Average Annualized Weekly Return	5%	6%	9%	8%

Source: Morgan Stanley Research, Bloomberg

Meanwhile, selling EUR swaption straddles appears to have been a strong-performing strategy of late. Range-bound interest rates have allowed for strong risk-adjusted performance since April, though returns are still below USD strategies using equal notional exposure over the full year. On an outright basis, performance has been more consistent across expiries and tails that we've studied than in the US, with 1m10y straddle-selling programs leading the pack, trailed closely by 3m10y strategies (Exhibit 118). However, on a risk-adjusted basis, 1m10y strategies are clearly the front-runner.

Exhibit 117: Systematic EUR gamma-selling performance YTD



Source: Morgan Stanley Research, Bloomberg

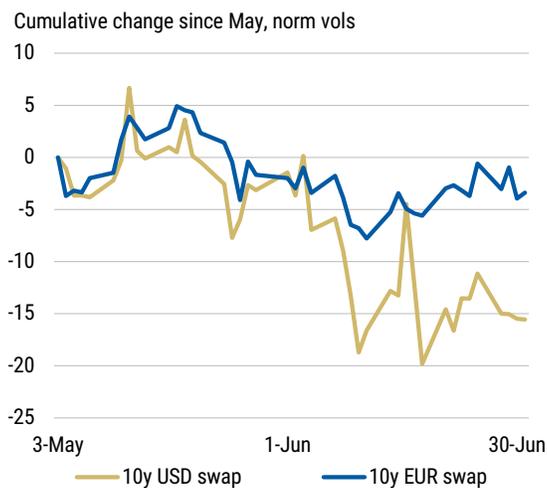
Exhibit 118: Systematic EUR gamma-selling performance statistics

	1m10	3m10	1m30	3m30
	Y	Y	Y	Y
Sharpe Ratio	1.36	0.91	0.52	0.56
Profitable Weeks (%)	60%	57%	58%	57%
Max Weekly Loss / Average Annual Return	-0.9	-1.3	-2.3	-2.3
Average Annualized Weekly Return	4%	3%	2%	2%

Source: Morgan Stanley Research, Bloomberg

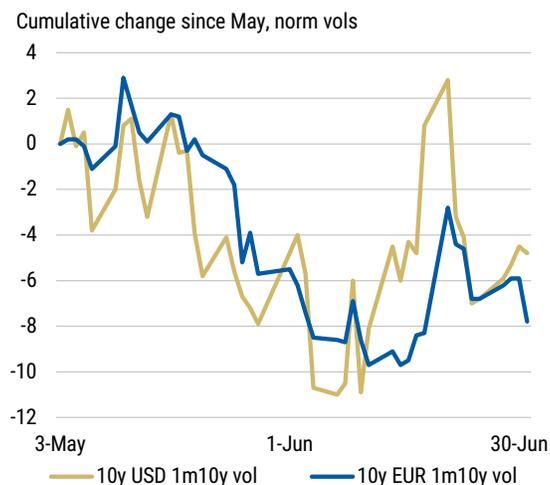
Comparing swap rates and implied vols, we see how range-bound rates (Exhibit 119) have allowed for EUR vol-selling to outperform. Despite rates moving about 15bp lower in the US in May and June, we find that EUR implied vols have underperformed USD vols (Exhibit 120).

Exhibit 119: EUR swaps were fairly range-bound relative to USD in June



Source: Morgan Stanley Research, Bloomberg

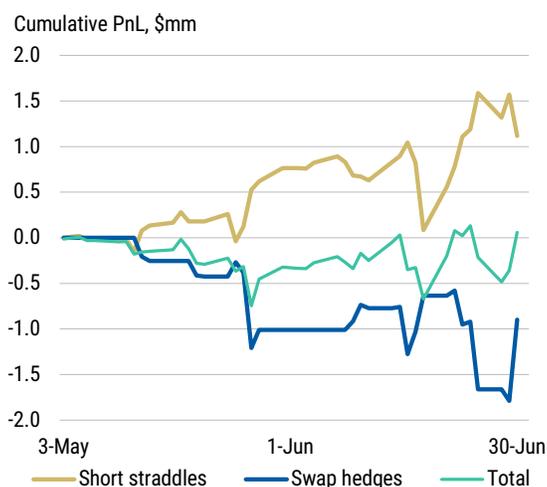
Exhibit 120: EUR vol has dropped further than USD vol



Source: Morgan Stanley Research, Bloomberg

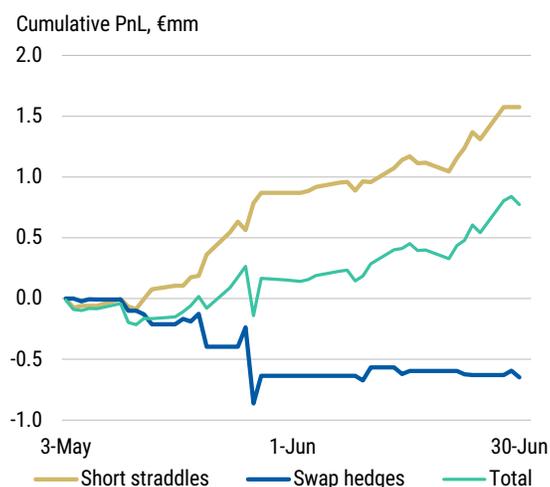
Digging deeper into the performance of 1m10y programs for each currency since May, we find similar return patterns in that both strategies' profits were driven by short straddle positions rather than delta-hedging. We think this is fairly intuitive as implied vols have decreased over the term we are considering, while rates have not moved with a consistent trend. Over the past few days, we would expect delta-hedging USD positions to perform well given a consistent rally in rates.

Exhibit 121: 1m10y USD vol-selling performance breakdown



Source: Morgan Stanley Research, Bloomberg

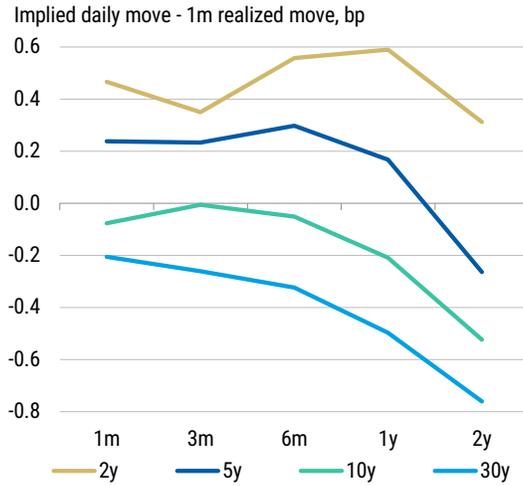
Exhibit 122: 1m10y EUR vol-selling performance breakdown



Source: Morgan Stanley Research, Bloomberg

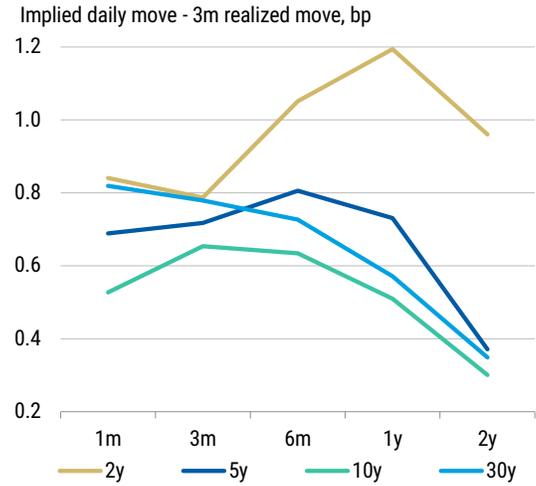
Looking to the US vanilla vol surface, we compare implied daily breakeven moves to realized vol to look for areas with relatively more vol priced in. As we discussed last week, the 1y2y point leads the surface by this metric as we have seen a large uptick in implied volatility of late. By comparison, the 10y and 30y points seem to have less of a vol premium priced in (Exhibit 123). We see that 30y tails appear rich relative to 10y tails on a longer lookback window (Exhibit 124). By this metric, it is intuitive that, as we have discussed, US 30y tails appear to have been more profitable so far this year.

Exhibit 123: Most vanilla vols imply lower vol than what we have seen over past 1m



Source: Morgan Stanley Research, Bloomberg

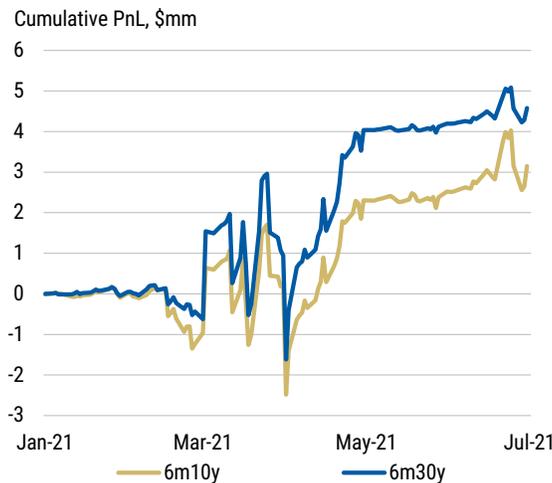
Exhibit 124: Over a longer lookback, 1y2y appears rich while 30y tails lead 10y tails



Source: Morgan Stanley Research, Bloomberg

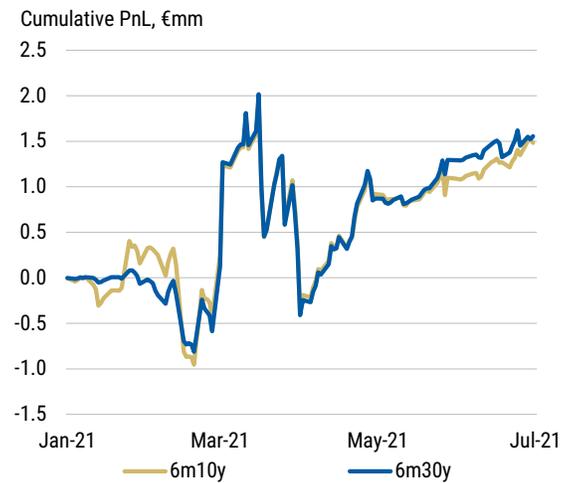
Focusing on the 10y and 30y points we have studied in detail so far for systematic vol-selling, we find that short-expiry 10y and 30y tails do not appear as rich or attractive to sell as other points on the surface over a 1m lookback, potentially given the large realized moves we have seen over the past month. Further down the expiry curve, we find that 6m expiries appear somewhat attractive, and as a result we wanted to backtest strategies which sold straddles on that point to see how they would perform relative to shorter expiries ([Exhibit 125](#) and [Exhibit 126](#)).

Exhibit 125: Performance of selling 6m expiries USD



Source: Morgan Stanley Research, Bloomberg

Exhibit 126: Performance of selling 6m expiries EUR



Source: Morgan Stanley Research, Bloomberg

Of course, selling 6m straddles requires having more open positions at any given point. If you sell 6m straddles on a weekly basis, you could have 24-25 open positions at any given time compared to 12-13 and 4-5 for 3m and 1m selling strategies, respectively. As a result, we adjust the notional on these strategies such that the overall DVO1 risk outstanding at any given point is equivalent for a cleaner comparison. Details on this risk adjustment can be found in [Systematic Vol Selling: Theory and Practice](#).

Overall, we find that 6m expiries perform roughly in line with 3m expiry performance, though returns more recently have been slightly higher. In general we tend to prefer selling shorter expiries in this sort of strategy to maximize short gamma exposure without creating unnecessarily large short vega positions. Given the current state of the expiry curve, we may continue to evaluate 6m expiries if implied vol continues to richen for those expiries.

Trade idea: Maintain 3m5y payer ladder with downside protection for zero cost

Trade idea: Maintain sell 2m10y ATMF straddle and buy 0.6x 5m10y ATMF straddle

Trade idea: Maintain buy US 1y30y 1x1 payer spread

Trade idea: Maintain buy US 6m5y 1x2 payer spread, struck for zero cost

Technical Analysis

The 2021 Institutional Investor (II) Global Fixed-Income Research poll is open. If you enjoy our work, [please rate us](#) five stars in the following categories: USA: Economics & Strategy > Technical Analysis (Charting); Developed Europe: Economics & Strategy > Technical Analysis (Charting); Asia (ex-Japan) > Technical Analysis (Charting). Thanks for your readership and support!

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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 127: Government bond yield weekly pivots, support and resistance levels

	UST 10y	CAN 10y	DBR 10y	UKT 10y	JGB 20y	ACGB 10y
Weekly resistance 3	1.549	1.496	-0.134	0.828	0.448	1.569
Weekly resistance 2	1.473	1.429	-0.189	0.758	0.441	1.501
Weekly resistance 1	1.427	1.388	-0.223	0.715	0.436	1.460
Weekly pivot high	1.351	1.320	-0.278	0.644	0.421	1.393
Weekly pivot low	1.325	1.298	-0.295	0.620	0.418	1.375
Weekly Support 1	1.275	1.253	-0.333	0.574	0.411	1.325
Weekly Support 2	1.229	1.212	-0.367	0.531	0.406	1.284
Weekly Support 3	1.205	1.190	-0.390	0.509	0.399	1.253

Source: Morgan Stanley Research

Exhibit 128: Foreign exchange rates weekly pivots, support, and resistance levels

	DXY	EURUSD	USDJPY	GBPUSD	AUDUSD	USDCAD
Weekly resistance 3	93.16	1.1964	111.95	1.4015	0.7688	1.2734
Weekly resistance 2	92.84	1.1942	111.31	1.3987	0.7616	1.2662
Weekly resistance 1	92.64	1.1921	110.92	1.3952	0.7571	1.2624
Weekly pivot high	92.32	1.1862	110.29	1.3864	0.7499	1.2483
Weekly pivot low	92.24	1.1851	110.10	1.3850	0.7477	1.2447
Weekly Support 1	92.00	1.1829	109.65	1.3822	0.7427	1.2375
Weekly Support 2	91.80	1.1808	109.26	1.3787	0.7382	1.2337
Weekly Support 3	91.63	1.1781	109.01	1.3748	0.7355	1.2269

Source: Morgan Stanley Research

Exhibit 129: Foreign exchange rates weekly pivots, support, and resistance levels

	EURJPY	EURCHF	EURNOK	EURSEK	NOKSEK	AUDNZD
Weekly resistance 3	133.01	1.0999	10.5863	10.2449	1.0140	1.0771
Weekly resistance 2	132.15	1.0952	10.5136	10.2288	1.0035	1.0758
Weekly resistance 1	131.62	1.0923	10.4730	10.2150	0.9969	1.0745
Weekly pivot high	130.77	1.0876	10.3261	10.1746	0.9864	1.0709
Weekly pivot low	130.48	1.0863	10.2897	10.1665	0.9829	1.0702
Weekly Support 1	129.91	1.0829	10.2170	10.1504	0.9759	1.0689
Weekly Support 2	129.38	1.0800	10.1764	10.1366	0.9693	1.0676
Weekly Support 3	129.10	1.0779	10.1064	10.1180	0.9658	1.0660

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 130: Summary of cyclical (tactical and strategic) and secular bull, bear, and range bound rates markets

	Daily	Daily	Daily	200d MA	Cyclical	Cyclical	Secular
	Last	Cloud Lower	Cloud Upper		Tactical	Strategic	Monthly
					Daily	Weekly	
UST 2y	0.213	0.150	0.159	0.151	Bear Market	Range bound	Bull Market
UST 5y	0.785	0.807	0.850	0.611	Bull Market	Range bound	Bull Market
UST 10y	1.360	1.589	1.619	1.257	Bull Market	Bear Market	Bull Market
UST 30y	1.989	2.285	2.308	1.983	Bull Market	Bear Market	Bull Market
DBR 2y	-0.676	-0.679	-0.664	-0.706	Range bound	Bear Market	Bull Market
DBR 5y	-0.596	-0.591	-0.549	-0.670	Bull Market	Bear Market	Bull Market
DBR 10y	-0.293	-0.231	-0.166	-0.394	Bull Market	Bear Market	Bull Market
DBR 30y	0.206	0.330	0.393	0.086	Bull Market	Bear Market	Bull Market
UKT 2y	0.087	0.072	0.097	0.000	Range bound	Range bound	Bull Market
UKT 5y	0.295	0.345	0.354	0.164	Bull Market	Range bound	Bull Market
UKT 10y	0.655	0.812	0.816	0.541	Bull Market	Bear Market	Bull Market
UKT 30y	1.173	1.339	1.346	1.091	Bull Market	Bear Market	Bull Market
JGB 10y	0.033	0.083	0.095	0.061	Bull Market	Bear Market	Range bound
JGB 20y	0.421	0.451	0.466	0.440	Bull Market	Bear Market	Bull Market
JGB 30y	0.676	0.658	0.672	0.661	Bear Market	Bear Market	Bull Market
JGB 40y	0.744	0.710	0.718	0.707	Bear Market	Bear Market	Bull Market
ACGB 2y	0.095	0.061	0.069	0.092	Bear Market	Bull Market	Bull Market
ACGB 5y	0.742	0.805	0.829	0.597	Bull Market	Bear Market	Bull Market
ACGB 10y	1.360	1.702	1.755	1.334	Bull Market	Range bound	Bull Market
ACGB 20y	1.986	2.397	2.439	2.058	Bull Market	Range bound	Bull Market
NZGB 2y	0.773	0.259	0.295	0.247	Bear Market	Range bound	Bull Market
NZGB 5y	1.068	0.970	1.032	0.675	Bear Market	Range bound	Bull Market
NZGB 10y	1.660	1.711	1.781	1.317	Bull Market	Bear Market	Bull Market
CAN 2y	0.488	0.286	0.314	0.271	Bear Market	Range bound	Bull Market
CAN 5y	0.941	0.905	0.936	0.681	Bear Market	Range bound	Bull Market
CAN 10y	1.327	1.511	1.524	1.116	Bull Market	Bear Market	Bull Market
CAN 30y	1.817	2.043	2.103	1.652	Bull Market	Bear Market	Bull Market

Source: Morgan Stanley Research

Foreign Exchange

Exhibit 131: Summary of cyclical (tactical and strategic) and secular bull, bear, and range bound FX markets

					Cyclical	Cyclical	Secular
	Daily	Daily	Daily	200d MA	Tactical	Strategic	Monthly
	Last	Cloud Lower	Cloud Upper		Daily	Weekly	
DXY	92.10	90.26	91.49	91.42	Bull Market	Range bound	Bear Market
USDJPY	110.14	109.23	109.39	106.79	Bull Market	Bull Market	Range bound
USDCAD	1.2447	1.2127	1.2330	1.2645	Bull Market	Bear Market	Bear Market
USDCHF	0.9147	0.9020	0.9202	0.9072	Range bound	Range bound	Range bound
USDNOK	8.6695	8.3040	8.4150	8.6321	Bull Market	Bear Market	Bull Market
USDSEK	8.5712	8.3357	8.5052	8.4727	Bull Market	Range bound	Bear Market
EURUSD	1.1876	1.1985	1.2159	1.2007	Bear Market	Range bound	Bull Market
GBPUSD	1.3901	1.3959	1.4096	1.3674	Bear Market	Bull Market	Range bound
AUDUSD	0.7488	0.7712	0.7745	0.7580	Bear Market	Bull Market	Range bound
NZDUSD	0.6986	0.7130	0.7219	0.7070	Bear Market	Bull Market	Range bound
EURJPY	130.80	131.21	132.94	128.22	Bear Market	Bull Market	Bull Market
NOKSEK	0.9868	1.0011	1.0072	0.9823	Bear Market	Bull Market	Bear Market
AUDNZD	1.0716	1.0704	1.0774	1.0721	Range bound	Bull Market	Range bound
USDBRL	5.2604	5.2850	5.4738	5.3890	Bear Market	Range bound	Bull Market
USDMXN	19.87	20.01	20.34	20.27	Bear Market	Bear Market	Bull Market
USDARS	95.98	92.92	94.14	87.08	Bull Market	Bull Market	Bull Market
USDCLP	748.50	715.27	719.05	735.78	Bull Market	Range bound	Bull Market
USDCOP	3,834.01	3,695.60	3,727.82	3,652.40	Bull Market	Bull Market	Bull Market
USDPEN	3.9689	3.7301	3.7883	3.6921	Bull Market	Bull Market	Bull Market
USDZAR	14.22	13.89	14.30	14.87	Range bound	Bear Market	Range bound
USDTRY	8.6615	8.3240	8.5291	7.9214	Bull Market	Bull Market	Bull Market
USDILS	3.2766	3.2666	3.2945	3.2867	Range bound	Bear Market	Bear Market
USDRUB	74.35	73.82	75.53	74.99	Range bound	Range bound	Bull Market
USDPLN	3.8286	3.6997	3.8118	3.7711	Bull Market	Range bound	Bull Market
USDCZK	21.6871	21.0114	21.5346	21.7439	Bull Market	Bear Market	Bear Market
USDHUF	299.36	288.46	296.73	298.76	Bull Market	Bear Market	Bull Market
USDCNY	6.4790	6.4136	6.4682	6.5362	Bull Market	Bear Market	Bear Market
USDIDR	14,528.00	14,337.00	14,390.00	14,342.57	Bull Market	Range bound	Bull Market
USDINR	74.64	73.17	73.80	73.52	Bull Market	Bull Market	Bull Market
USDKRW	1,148.90	1,119.24	1,121.33	1,120.42	Bull Market	Range bound	Range bound
USDMYR	4.1917	4.1234	4.1260	4.1053	Bull Market	Range bound	Bull Market
USDPHP	50.08	47.97	48.17	48.31	Bull Market	Bull Market	Bear Market
USDSGD	1.3511	1.3274	1.3342	1.3374	Bull Market	Range bound	Bear Market
USDTWD	28.0490	27.8013	28.0820	28.3219	Range bound	Bear Market	Bear Market
USDTHB	32.6050	31.0440	31.2840	30.8456	Bull Market	Bull Market	Bear Market
GOLD	1,808	1,797	1,864	1,828	Range bound	Range bound	Bull Market
SILVER	26.10	26.27	27.52	25.81	Bear Market	Bull Market	Bull Market
CRUDE OIL	74.62	62.85	65.07	55.77	Bull 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 132: 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%	-	-	-	-
GE 10y Future	29.25%	100%	100%	100%	200%	7/5/2021	8/9/2021	6/28/2021	8/2/2021
US 10y Future	30.50%	100%	100%	100%	200%	4/12/2021	8/10/2021	5/4/2021	8/3/2021
UK 10y Future	7.75%	0%	0%	0%	0%	-	-	-	-

Source: Morgan Stanley Research

Bond Market Indicators

The 2021 Institutional Investor (II) Global Fixed-Income Research poll is open. If you enjoy our work, [please rate us](#) five stars in the following categories: USA: Economics & Strategy > Quantitative Analysis; Developed Europe: Economics & Strategy > Quantitative Analysis. Thanks for your readership and support!

Our BMI(10) models are mildly bullish on Japan, Australia and Canada overall. The vol-adjusted carry signal is positive across most markets, aside from negative prints for Germany and Japan. The carry signal remained quite positive for Australia at 9.8. Momentum signals were quite bullish, aside from more neutral readings for Germany and New Zealand. Equity market signals are bullish across the board.

Our BMI(2) models are mildly bullish on Australia overall but neutral across the other markets. The vol-adjusted carry signal is notably positive in Australia and New Zealand, while notably negative for Japan and Germany. Momentum signals are fairly bearish overall, aside from a bullish signal for Australia. Business cycle indicators are more neutral, with a particularly bearish print in the UK.

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

Latest readings

Exhibit 133: Morgan Stanley Bond Market Indicators - BMI(10)

	Vol-Adjusted Carry	Momentum	Equity Markets	Business Cycle	FX	Average	Overall
US	4.6 (6.6)	7.1 (5.1)	2.9 (-3.9)	-2.3 (-2.5)	-9.3 (-9.6)	0.6 (-0.9)	0.0 (0.0)
DE	-7.1 (-5.8)	-0.2 (0.3)	4.9 (-4.1)	0.4 (-7.0)	7.8 (9.5)	1.2 (-1.4)	0.0 (0.0)
UK	0.7 (3.0)	4.1 (-0.5)	4.5 (-3.1)	-8.8 (-9.8)	-3.8 (-5.0)	-0.7 (-3.1)	0.0 (-3.1)
JP	-2.8 (-1.6)	7.7 (2.4)	4.1 (-5.0)	5.3 (-2.8)	4.0 (1.0)	3.7 (-1.2)	3.7 (0.0)
AU	9.8 (10.0)	6.0 (3.9)	1.7 (-4.9)	-0.3 (-1.2)	-1.9 (-4.9)	3.1 (0.6)	3.1 (0.0)
NZ	1.4 (5.0)	0.5 (-1.2)	0.8 (2.0)	-0.4 (-2.2)	0.8 (2.7)	0.6 (0.5)	0.0 (0.0)
CA	0.8 (4.8)	5.3 (4.4)	3.8 (-5.4)	1.2 (-0.1)	-0.4 (0.8)	2.1 (0.9)	2.1 (0.0)

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 134: Morgan Stanley Bond Market Indicators - BMI(2)

	Vol-Adjusted Carry	Momentum	Equity Markets	Business Cycle	FX	Average	Overall
US	3.7 (8.8)	-9.0 (-6.3)	2.9 (-3.9)	-2.3 (-2.5)	-0.1 (3.3)	-1.0 (-0.1)	0.0 (0.0)
DE	-7.2 (-5.8)	-2.5 (-0.1)	4.9 (-4.1)	0.4 (-7.0)	0.5 (1.0)	-0.8 (-3.2)	0.0 (-3.2)
UK	5.0 (4.2)	-1.0 (-7.3)	4.5 (-3.1)	-8.8 (-9.8)	0.6 (-0.8)	0.1 (-3.4)	0.0 (-3.4)
JP	-8.2 (-8.3)	-7.5 (-3.4)	4.1 (-5.0)	5.3 (-2.8)	0.0 (-1.6)	-1.3 (-4.2)	0.0 (-4.2)
AU	10.0 (10.0)	5.8 (9.2)	1.7 (-4.9)	-0.3 (-1.2)	-3.1 (-1.8)	2.8 (2.3)	2.8 (2.3)
NZ	8.5 (7.4)	-7.8 (-2.6)	0.8 (2.0)	-0.4 (-2.2)	2.4 (0.9)	0.7 (0.3)	0.0 (0.0)
CA	4.4 (0.3)	-8.8 (-5.5)	3.8 (-5.4)	1.2 (-0.1)	3.0 (0.0)	0.7 (-2.7)	0.0 (0.0)

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 135: 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)	1.5 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)
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 (0.0)
vs. UK	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	2.2 (0.0)	1.9 (1.8)	0.0 (1.8)	0.0 (2.0)
vs. JP	-1.5 (0.0)	0.0 (0.0)	-2.2 (0.0)	0.0 (0.0)	0.0 (0.0)	-1.5 (0.0)	0.0 (0.0)
vs. AU	0.0 (0.0)	0.0 (0.0)	-1.9 (-1.8)	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 (-1.8)	1.5 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)
vs. CA	0.0 (0.0)	0.0 (0.0)	0.0 (-2.0)	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 136: Morgan Stanley Euro Sovereign Bond Market Indicators - eBMI

	Business Cycle Surprises	Momentum	Vol. Adj. Carry	Supply	Risky Assets	Overall
Periphery vs. Core	8.8 (8.6)	4.8 (4.5)	9.1 (9.0)	4.7 (2.2)	0.3 (3.5)	5.6 (5.6)
Semi-Core vs. Core	8.5 (9.4)	1.2 (-2.5)	4.3 (4.0)	-7.9 (-4.7)	7.5 (9.1)	2.7 (3.0)
Periphery vs. Semi-Core	0.1 (-0.4)	1.8 (3.5)	2.4 (2.5)	6.3 (3.5)	-3.6 (-2.8)	2.8 (2.5)

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 137: Morgan Stanley Inflation Bond Market Indicators - iBMI

Market	Oil	Momentum	Equities	Value	Average	Overall
TIPS	1.2 (3.4)	2.4 (1.5)	-1.8 (0.9)	-4.1 (-5.0)	-0.5 (0.2)	0.0 (0.0)
UKTi	2.2 (4.5)	1.2 (1.5)	-2.0 (0.7)	-2.2 (-3.0)	-0.2 (0.9)	0.0 (0.0)
HICPxT	2.1 (4.4)	4.4 (5.9)	-2.4 (0.7)	-1.8 (-2.2)	0.6 (2.2)	0.0 (0.0)
JGBi	1.2 (3.9)	4.6 (7.1)	-2.1 (0.8)	-7.5 (-8.5)	-1.0 (0.8)	0.0 (0.0)

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

The 2021 Institutional Investor (II) Global Fixed-Income Research poll is open. If you enjoy our work, [please rate us](#) five stars in the following categories: USA: Economics & Strategy > Quantitative Analysis; Developed Europe: Economics & Strategy > Quantitative Analysis. Thanks for your readership and support!

Our SSI(2) models imply that 2y spreads are about 4bp wider than fair value. The 0.5sd trading threshold is exceeded. Our model implied fair value can be found on Bloomberg using the ticker MSSIOUS2 Index.

Our SSI(10) models imply that 10y spreads are about fair value on the 6m rolling lookback. None of the trading thresholds are exceeded. Our model implied fair value on Bloomberg: MSSIOUS10 Index.

Our SSI(30) models suggest that 30y spreads are about fair value on our 2y lookback window. None of the trading thresholds are exceeded. Our model implied fair value can be found on Bloomberg using the ticker MSSIOUS30 Index.

Based on each of the SSI models, the 2s10s and 2s30s curves are slightly flatter than fair value, while the 10s30s curve is slightly wider than fair value.

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.

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.

Latest readings

Exhibit 138: Morgan Stanley Swap Spread Indicators - Model Implied Fair Values

Spread	6m Rolling Lookback Window	2y Rolling Lookback Window	5y Rolling Lookback Window	Matched-Maturity Swap Spread Level
2y Swap Spreads	4.2	1.0	1.4	7.9
10y Swap Spreads	-4.0	-2.0	-5.2	-4.4
30y Swap Spreads	-24.2	-33.7	-27.4	-34.1
2s10s Swap Spread Curve	-8.2	-3.0	-6.6	-12.3
2s30s Swap Spread Curve	-28.4	-34.7	-28.8	-42.0
10s30s Swap Spread Curve	-20.1	-31.7	-22.2	-29.7

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 139: Morgan Stanley Swap Spread Indicators - Trading Signals

Spread	Trading signal*	Trade with 0.5sd threshold?	Trade with 1.0sd threshold?	Trade with 2.0sd threshold?
2y Swap Spreads	Tighten	Y	N	N
10y Swap Spreads	Widen	N	N	N
30y Swap Spreads	Widen	N	N	N

Source: Morgan Stanley Research

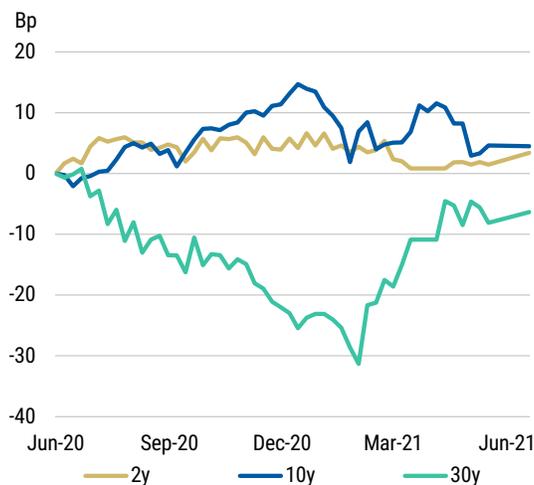
Note: The thresholds are derived from the standard deviation of the difference between model-implied fair value and market values for the preferred rolling window for each spread sector.

*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 140: 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 141: 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

Government Bond Supply

In the US, total coupon issuance (new 3y, reopening of 10y, 30y) settling in mid July is \$120bn versus \$1.6bn coupons and \$69bn redemptions, resulting in net issuance of \$49.4bn. **In the euro area**, we estimate ~€34.75bn of issuance (from GER, ITA, FRA, SPA) versus €2.5bn coupons and €16.5bn redemptions, resulting in net issuance of €15.8bn. **In the UK**, new UKT Jan 2039 will be issued for an estimated £6-8bn against £0.09bn coupons and no redemptions. **In Japan**, 20y JGB will be issued for ¥1.2trn and there will be an auction for enhanced liquidity for ¥0.4trn against no coupons or redemptions. **In Canada**, CAN 0.25% Aug 2023 will be issued for C\$5bn, against no cash flow coming into the market. **In Australia**, ACGB 1.25% May 2032 and ACGB 0.25% Nov 2025 will be issued for A\$0.8bn and A\$0.7bn, respectively, against, A\$0.7bn coupons and no redemptions. In addition, ACGBi 0.75% Nov 2027 will be issued for A\$0.1bn. **In New Zealand**, NZGB 0.5% May-24, NZGB 3% Apr-29, NZGB 2.75% Apr-37, will be issued for N\$200mn, N\$200mn and N\$100mn, respectively, against no cash flow.

Exhibit 142: Sovereign supply calendar

Monday	Tuesday	Wednesday	Thursday	Friday
12-JUL	13-JUL	14-JUL	15-JUL	16-JUL
UK: New UKT Jan 2039, £6-8bn*	GER: BKO 0% June 2023, €5bn ITA: BTP Auction, €7.5-8.75bn New	GER: DBR 0% 15 Aug 2031, €4bn	FRA: OAT Auction, €9.5-10.5bn OAT 0% Feb 2024, OAT 0% 25 Feb 2026, OAT 2.75% Oct 2027, OAT 0.75% Nov 2028	AUS: ACGB 0.25% Nov 2025, A\$700mn
US: New 3y UST, \$58bn US: 10y UST Re-opening, \$38bn	BTP Aug 2024, €4-5bn; BTP 0.5% Jul 2028, €2.25-2.75bn; BTP 0.95% Mar 2037, €1.25-1.75bn NETH: DSL 15 Jan 2042 Tap, €2-1.5-2.5bn US: 30y UST Re-opening, \$24bn JPN: 20y JGB, ¥1200bn AUS: ACGBi 0.75% Nov 2027, A\$100mn	AUS: ACGB 1.25% May 2032, A\$800mn	FRA: Linker Auction, €1.25-1.75bn OATei 0.1% 25 July 2031, OATei 0.1% 25 July 2036 SPA: SPGB Auction, €5-6bn* SPGB 0.25% July 2024, SPGB 0% Jan 2028, SPGB 0.5% Oct 2031, SPGB 4.2% Jan 2037 JPN: Auction for Enhanced Liquidity, ¥400bn NZ: NZGB 0.5% May-24 Tap, N\$200mn; NZGB 3% Apr-29 Tap, N\$200mn; NZGB 2.75% Apr-37 Tap, N\$100mn CAN: CAN 0.25% Aug 2023, C\$5bn	
19-JUL	20-JUL	21-JUL	22-JUL	23-JUL
	GER: DBR 0% 15 Nov 2028 Tap, €3bn UK: UKT 1.625% Gilt 2071, £1.5bn* JPN: Auction for Enhanced Liquidity, ¥500bn*	GER: DBR 1.25% 15 Aug 2048 Tap, €1bn US: 20y UST Re-opening, \$24bn*	US: New 10y TIPS, \$16bn* NZ: NZGB 0.5% May-26 Tap, \$200mn; NZGB 0.25% May-28 Tap, \$200mn; NZGB 3.5% Apr-33 Tap, \$100mn; NZGBi 2.5% Sept 2040, \$50mn	

Source: Morgan Stanley Research, Treasuries
* Morgan Stanley estimate. ** Possible Auction

QIS Macro Strategy Signals

The 2021 Institutional Investor (II) Global Fixed-Income Research poll is open. If you enjoy our work, please rate us five stars in the following categories: USA: Economics & Strategy > Quantitative Analysis; Developed Europe: Economics & Strategy > Quantitative Analysis. Thanks for your readership and support!

Rates Value - Quantitative Investment Strategies Research: Rule-Based Value Investing

Rates Value is a strategy for investing in global 10y government bond futures. The strategy considers a series of market and macroeconomic variables to drive investment decisions, using a LASSO regression to avoid over-fitting.

Exhibit 143: Rates Value positioning, last 12 months

Country	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul
Australia	22%	22%	22%	22%	22%	22%	22%	22%	22%	22%	22%	22%
Canada	-17%	-17%	-17%	14%	14%	-16%	16%	16%	16%	-18%	19%	19%
France	19%	-19%	-19%	20%	22%	22%	22%	22%	22%	22%	22%	22%
Germany	20%	21%	20%	22%	22%	22%	-22%	-22%	-22%	21%	21%	21%
Italy	11%	12%	12%	-13%	-13%	13%	14%	10%	11%	12%	11%	11%
Japan	22%	22%	22%	22%	-22%	22%	22%	22%	22%	22%	22%	22%
Korea	-22%	-20%	20%	20%	20%	20%	20%	22%	22%	-22%	-22%	-22%
UK	16%	15%	14%	14%	15%	15%	15%	17%	-17%	19%	17%	17%
US	19%	19%	20%	21%	-21%	-21%	22%	19%	-19%	-20%	-19%	19%
Net												
Duration Exposure	90%	55%	94%	142%	59%	99%	131%	139%	57%	58%	93%	131%

Source: Morgan Stanley Research, Bloomberg

Rates Trend - Quantitative Investment Strategies Research: Investing in Central Bank Momentum

The Rates Trend strategy invests in the front four contracts of global Short-Term Interest Rate (STIR) futures by trend-following, using different look-back windows to generate long and short signals. The strategy incorporates GARCH, a parsimonious statistical model, to capture the time-varying and clustering aspects of market volatility.

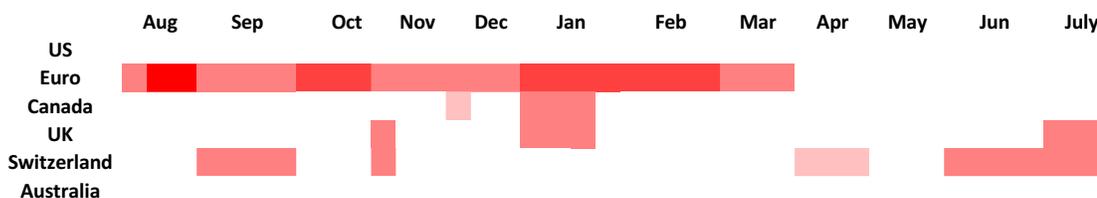
Exhibit 144: Rates Trend net contract exposure, last 12 months

	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul
US	4	2	2	2	2	2	4	4	4	4	4	4
Euro	2	4	4	4	4	4	4	4	4	-4	-4	-4
UK	2	4	4	4	0	-2	-2	0	0	-4	-4	-4
Canada	2	2	4	4	2	2	2	2	2	2	2	2
Switzerland	0	2	4	4	-2	-2	-2	0	0	0	0	0
Australia	2	4	4	4	4	4	-2	-2	4	2	0	0
Strategy	2	3	3	3	2	1	1	1	2	1	0	1

Source: Morgan Stanley Research, Bloomberg

Note: Numbers represent the net exposure of the strategy among the front 4 contracts for the given country

Exhibit 145: GARCH forecasted volatility regimes, last 12 months



Source: Morgan Stanley Research, Bloomberg. Red indicates a high volatility regime.

FX Equity-Driven Momentum - Quantitative Investment Strategies: FX Equity-Driven Momentum

FX Equity-Driven Momentum is long/short strategy whose positions in currencies are driven by the relative performance of the corresponding equity markets. The strategy goes long currencies where the local equity market has outperformed the US by Sharpe ratio over the past 3 months, and short currencies which have underperformed the US.

Exhibit 146: FX Equity Momentum Positioning, emerging markets, year to date

Month	BRL	CLP	CNH	COP	CZK	HUF	IDR	ILS	INR	KRW	MXN	PEN	PHP	PLN	RON	RUB	SGD	THB	TRY	TWD	ZAR	USD
Aug	2%	-3%	-1%	-3%	-1%	-3%	-3%	-1%	8%	5%	-2%	-5%	-9%	3%	-4%	-2%	-9%	-6%	-3%	11%	-2%	28%
Sep	-2%	-3%	9%	-3%	-3%	-3%	-3%	-5%	6%	2%	-2%	-5%	-9%	-3%	-2%	-3%	-9%	-6%	-3%	12%	-2%	36%
Oct	-2%	-3%	-6%	-3%	-3%	-3%	-4%	-4%	7%	0%	-1%	-6%	-12%	-3%	-2%	-2%	-9%	-7%	-3%	5%	-2%	62%
Nov	-2%	-3%	-1%	-3%	-3%	-3%	-4%	-5%	4%	-3%	0%	-4%	-1%	-3%	-4%	-2%	-8%	-7%	-3%	0%	-1%	57%
Dec	2%	3%	6%	-2%	3%	3%	4%	-5%	8%	7%	3%	3%	12%	-3%	-5%	-2%	9%	6%	1%	8%	2%	-61%
Jan	2%	3%	-7%	3%	3%	3%	-2%	5%	8%	5%	3%	-3%	13%	-3%	-5%	-2%	8%	-4%	-2%	8%	-1%	-35%
Feb	-1%	2%	-6%	-2%	3%	3%	-4%	3%	9%	5%	-2%	-7%	-16%	-3%	5%	1%	7%	-7%	2%	9%	-2%	2%
Mar	-2%	3%	7%	-3%	4%	3%	-4%	3%	8%	4%	-2%	-2%	-8%	-3%	-5%	-3%	1%	-8%	2%	11%	2%	-9%
Apr	0%	2%	-2%	-1%	3%	3%	-3%	4%	8%	5%	-1%	-4%	-3%	-3%	-2%	-1%	5%	-6%	1%	9%	0%	-14%
May	-2%	-3%	-8%	-2%	-1%	-4%	-6%	-5%	-6%	4%	-1%	-3%	-11%	-4%	-1%	-3%	8%	-7%	-1%	-7%	-1%	64%
Jun	0%	-3%	-8%	-2%	4%	3%	-6%	-5%	-7%	-1%	3%	-2%	-11%	3%	6%	-3%	6%	-7%	-1%	-6%	-3%	40%
Jul	3%	-3%	-9%	-3%	4%	1%	-7%	-6%	-8%	2%	-3%	-2%	-7%	3%	-3%	4%	-8%	-7%	-2%	-7%	-3%	60%

Source: Morgan Stanley Research, Bloomberg. Percentages represent the average exposure of the strategy in each currency forward for the given month.

Exhibit 147: FX Equity Momentum Positioning, developed markets, year to date

Month	AUD	CAD	CHF	EUR	GBP	JPY	NOK	NZD	SEK	USD
Aug	-2%	3%	-14%	5%	-10%	-14%	-6%	-2%	10%	31%
Sep	-9%	-5%	-7%	-13%	-10%	-14%	-7%	-4%	-3%	71%
Oct	-9%	-13%	-13%	-13%	-9%	-5%	-6%	-9%	-2%	79%
Nov	-9%	-14%	-15%	-14%	-9%	10%	-6%	-9%	-9%	74%
Dec	9%	8%	-15%	15%	10%	13%	4%	5%	10%	-59%
Jan	9%	-8%	-15%	-15%	-8%	9%	-6%	-9%	-9%	52%
Feb	9%	-11%	-15%	9%	-9%	15%	4%	-9%	10%	-2%
Mar	1%	13%	-14%	-14%	3%	-17%	1%	-8%	9%	26%
Apr	-8%	-17%	-9%	-17%	-8%	-9%	-6%	-9%	-12%	95%
May	-8%	13%	-13%	14%	9%	-16%	8%	-8%	9%	-9%
Jun	-9%	14%	10%	14%	11%	-16%	1%	-8%	2%	-20%
Jul	-9%	12%	11%	-13%	-12%	-19%	-7%	-8%	-9%	54%

Source: Morgan Stanley Research, Bloomberg. Percentages represent the average exposure of the strategy in each currency forward for the given month.

In Case You Missed It

[Podcast | Thoughts on the Market: Special Episode: U.S. Infrastructure: What's in the Price?](#)

01 Jul 2021

Is U.S. infrastructure already priced into Treasury yields? The answer may lie with whether investors are accurately gauging the true size of the final package.

[Global Macro Strategy: Introducing Our FX Month-End Signal Framework](#)

29 Jun 2021

We find cyclicality in G10 FX trading volumes and returns over a calendar month. Currencies with strong local equity markets tend to outperform versus the USD. Based on this information, we discuss a signal with inconsistent but positive historical returns.

[Global Macro Strategist: For the Love of Money](#)

25 Jun 2021

Talking about tapering, tapering, and no longer net buying securities each have different implications for macro markets. For now, the Fed and ECB continue buying sizeable amounts of bonds that could add another \$1.5 trillion of liquidity to macro markets before year end - supporting risk-taking.

[Global Volatility Playbook: A Long Runway](#)

23 Jun 2021

The Fed's hawkish turn puts a floor on volatility today but the runway to higher volatility is long. FX vols are better to own as US real rates rise, as are vols in credit, which is priced for perfect liquidity conditions. Equity and rate vols need more nuance.

Forecasts

Government bonds

Exhibit 148: Morgan Stanley sovereign 2y, 5y, 10y, and 30y yield base case forecasts

	2Y				5Y				10Y				30Y			
	3Q21	4Q21	1Q22	2Q22	3Q21	4Q21	1Q22	2Q22	3Q21	4Q21	1Q22	2Q22	3Q21	4Q21	1Q22	2Q22
US	0.25	0.25	0.30	0.35	0.80	0.85	0.95	1.10	1.70	1.80	1.90	2.00	2.40	2.45	2.45	2.55
Germany	-0.65	-0.65	-0.60	-0.60	-0.55	-0.50	-0.45	-0.40	-0.20	-0.15	-0.10	0.00	0.35	0.40	0.45	0.50
Japan	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.05	0.15	0.15	0.15	0.20	0.70	0.70	0.70	0.75
UK	0.15	0.20	0.25	0.25	0.50	0.55	0.60	0.65	0.90	1.00	1.05	1.10	1.45	1.55	1.60	1.65
Canada	0.45	0.55	0.70	0.85	1.10	1.20	1.30	1.40	1.65	1.75	1.80	1.90	2.15	2.25	2.35	2.40
Australia	0.10	0.10	0.10	0.10	0.90	1.00	1.10	1.20	1.85	1.95	2.10	2.30	2.50	2.60	2.60	2.65
New Zealand	0.25	0.50	0.65	0.75	0.95	1.10	1.25	1.35	1.85	1.90	1.95	2.00				
Austria*	5	5	5	5	10	5	5	5	15	10	5	5	25	20	20	20
Netherlands*	0	0	0	0	0	0	0	0	5	5	5	0	5	5	5	5
France*	5	5	5	5	5	5	5	5	30	25	20	15	40	35	30	30
Belgium*	5	5	5	5	5	5	5	5	25	20	20	15	40	35	30	30
Ireland*	10	5	5	5	10	5	5	5	25	20	15	15	40	35	30	30
Spain*	15	10	10	10	35	30	25	25	60	55	50	50	95	85	80	75
Italy*	30	25	20	15	70	65	60	55	100	90	85	80	135	125	115	105
Portugal*	15	10	10	10	30	25	20	20	55	50	45	45	90	85	80	75

Source: , Morgan Stanley Research, *Spread to German Bunds

Exhibit 149: Morgan Stanley sovereign 10-year yield bull, base, and bear case forecasts

	Bull				Base				Bear			
	3Q21	4Q21	1Q22	2Q22	3Q21	4Q21	1Q22	2Q22	3Q21	4Q21	1Q22	2Q22
US	1.35	1.45	1.60	1.70	1.70	1.80	1.90	2.00	1.80	1.95	2.05	2.20
Germany	-0.45	-0.50	-0.45	-0.45	-0.20	-0.15	-0.10	0.00	-0.10	0.00	0.15	0.25
Japan	0.00	0.05	0.10	0.15	0.15	0.15	0.15	0.20	0.15	0.15	0.20	0.25
UK	0.50	0.40	0.30	0.25	0.90	1.00	1.05	1.10	1.10	1.20	1.30	1.35
Canada	1.40	1.45	1.50	1.60	1.65	1.75	1.80	1.90	1.70	1.90	2.05	2.15
Australia	1.60	1.60	1.65	1.80	1.85	1.95	2.10	2.30	1.90	2.00	2.10	2.20
New Zealand	1.45	1.30	1.20	1.10	1.85	1.90	1.95	2.00	1.90	2.00	2.10	2.20
Austria*	5	5	0	0	15	10	5	5	35	40	45	50
Netherlands*	0	0	-5	-5	5	5	5	0	30	35	40	50
France*	15	10	10	5	30	25	20	15	55	65	80	85
Belgium*	10	10	5	5	25	20	20	15	50	60	75	80
Ireland*	20	15	10	10	25	20	15	15	70	85	100	110
Spain*	45	35	30	25	60	55	50	50	90	100	110	120
Italy*	85	75	65	55	100	90	85	80	145	155	170	260
Portugal*	45	30	25	25	55	50	45	45	95	105	115	125

Source: Morgan Stanley Research, *Spread to German Bunds

Foreign exchange

Exhibit 150: Morgan Stanley foreign exchange base case forecasts

	3Q21	4Q21	1Q22	2Q22	3Q22	4Q22
EUR/USD	1.22	1.21	1.19	1.18	1.20	1.23
USD/JPY	109	110	111	112	109	107
GBP/USD	1.43	1.40	1.41	1.41	1.42	1.43
USD/CHF	0.92	0.93	0.95	0.97	0.95	0.93
USD/SEK	8.28	8.35	8.66	8.81	8.53	8.26
USD/NOK	8.03	8.10	8.32	8.47	8.40	8.33
USD/CAD	1.19	1.21	1.23	1.23	1.23	1.23
AUD/USD	0.77	0.77	0.76	0.75	0.78	0.81
NZD/USD	0.73	0.74	0.74	0.75	0.76	0.77
EUR/JPY	133	133	132	132	131	131
EUR/GBP	0.85	0.86	0.85	0.84	0.85	0.86
EUR/CHF	1.12	1.12	1.13	1.14	1.14	1.14
EUR/SEK	10.10	10.10	10.30	10.40	10.27	10.13
EUR/NOK	9.80	9.80	9.90	10.00	10.11	10.21
USD/CNY	6.45	6.48	6.53	6.55	6.47	6.40
USD/HKD	7.75	7.75	7.75	7.75	7.75	7.75
USD/IDR	14150	14300	14500	14700	14482	14264
USD/INR	73.5	74.0	74.8	75.4	74.9	74.4
USD/KRW	1105	1120	1130	1140	1116	1092
USD/MYR	4.09	4.12	4.15	4.18	4.07	3.97
USD/PHP	47.6	48.0	48.3	48.6	48.4	48.3
USD/SGD	1.32	1.33	1.34	1.35	1.33	1.32
USD/TWD	27.7	27.8	28.0	28.2	28.2	28.3
USD/THB	30.9	31.1	31.2	31.5	31.1	30.6
USD/BRL	5.25	5.30	5.30	5.40	5.60	5.40
USD/MXN	20.00	20.40	20.80	21.00	20.41	19.81
USD/ARS	104	123	137	147	155	168
USD/CLP	695	710	705	700	687	673
USD/COP	3800	3900	3950	4000	3762	3525
USD/PEN	3.65	3.60	3.55	3.50	3.49	3.48
USD/ZAR	14.5	14.8	14.8	15.3	14.9	14.5
USD/TRY	8.38	8.54	8.59	9.02	9.25	9.50
USD/ILS	3.22	3.25	3.24	3.26	3.26	3.26
USD/RUB	73.8	74.8	74.8	75.9	72.8	69.8
EUR/PLN	4.46	4.42	4.37	4.39	4.39	4.39
EUR/CZK	25.1	24.8	24.8	25.2	25.6	26.0
EUR/HUF	352	348	344	346	346	345
DXY	90	91	92	93	91	90
Fed's Broad USD Index	111	112	114	115	113	111

Source: Morgan Stanley Research. [Click here](#) for custom cross forecasts

Exhibit 151: Morgan Stanley foreign exchange Base, Bear, Bull scenarios

2Q22	Bear	Base	Bull
EUR/USD	1.14	1.18	1.26
GBP/USD	1.36	1.41	1.53
USD/JPY	104	112	114
AUD/USD	0.68	0.75	0.78
USD/CNY	6.20	6.55	6.75
USD/INR	71.0	75.4	78.0
USD/ZAR	14.8	15.3	16.9
USD/BRL	5.00	5.40	6.00
USD/MXN	19.75	21.00	22.30

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
Short US 10y	135bp	9-Jul-21		We suggest going short 10y Treasuries to position for higher nominal yields in the belly of the curve. We maintain, based on evidence, that the decline in Treasury yields is largely explained by positioning unwinds, and therefore likely to reverse.	The key risks to this trade are a deterioration of the virus situation or growth disappointing.
Receive November RBNZ meeting		9-Jul-21		We think markets are overestimating the risk that the RBNZ hikes rates in 2021. A 2021 hike is unlikely in our view for now given 1) the RBNZ is still purchasing assets, 2) international borders are still closed, and 3) COVID-19 risks remain asymmetrically negative in NZ.	The key risk is that the RBNZ formally ends its asset purchase program at the July or August meetings, which would signal a November rate hike to the market.
Long BAZ2	98.81	25-Jun-21		Market pricing implies BoC liftoff unrealistically early - and much sooner than the BoC's current guidance. We also expect the post-liftoff pace of hikes from the BoC to more closely resemble the Fed than currently implied by market pricing.	The key risk to this trade is that inflation rises quickly in Canada, leading the BoC to tighten policy sooner than markets expect.
5s30s ACGB Steepener	146bp	25-Jun-21		We think the move higher in RBNZ policy expectations is aggressive but less implausible than the corresponding move in RBA pricing. We recommend 5s30s steepeners in Australia, where the RBA has a significantly more dovish reaction function than the RBNZ.	The key risks to the trade are that the Fed sounds incrementally more hawkish at upcoming meetings or the RBA unexpectedly does not extend its QE program.
30y OAT -Bund tightener	69bp	25-Jun-21		We think that 30y France could outperform Germany as political risk from regional elections subsides and with France returning to trade more in line with core.	The main risk is that the French Treasury comes with a 30y syndication in July.

Buy 10y Italy vs Spain	46.4bp	16-May-21	We see scope for Italy's outperformance over Spain as Italy is expected to re-converge faster to its 2019 level of output, with the higher take-up of NGEU loans and grants money so far requested helping the country in outperforming.	Delay in Recovery Fund disbursement or an anticipation of tapering by the ECB could push the spread wider.
Long Ireland 10y vs 10y France	6.5bp	22-Jan-21	In 2021, we look for Irish bonds to reverse 2H 2020 underperformance, which was likely due in part to Brexit uncertainty. In addition, supply schedule favours Irish outperformance vis a vis France.	Currently, Ireland has one of the higher Covid infection rates in the world, potentially meaning a longer period in Level 5 restrictions and additional government spending measures/issuance. Additionally, our view that Ireland has completed the majority of its 10-year issuance could prove wrong in future quarterly remits.
Underweight 10y UST and 10y DBR vs 10y UKT and 10y ACGB	-22.6bp	10-Jun-20	In the US, a fast economic recovery along with an even higher expectation for supply could drive the curve steeper, while in Germany the skew for Bunds appears to be higher in the light of the creation of a substitute AAA rated EU debt for financing SURE and Next Generation EU in 2020 and 2021, respectively. In relative terms, in the UK the curve should flatten more on the expectation of NIRP and easy MPC policy, while in Australia the relative demand driven by RBA and foreign investors should help the curve to steepen less than the US and German ones.	Reemergence of Covid or a less pronounced economic recovery would lead investors to bid for safe haven assets, which in turn would support US Treasuries and Bunds more than UK Gilts and Australian bonds. This would flatten the US and German curves more than those in the UK and Australia.

Currency and Foreign Exchange

TRADE	ENTRY LEVEL	ENTRY DATE	RATIONALE	RISKS
Long USD versus CLP, COP, and MXN	100	9-Jul-21	We keep our bearish view on LatAm currencies and recommend increasing USD exposure via an equally-weighted basket of long USD versus COP, CLP, and MXN. We like to keep short COP exposure as we maintain the view that its high twin deficits make it extremely vulnerable to a stronger USD. We also see attractive risk/reward in short CLP positions, given ongoing political uncertainty, a weaker outlook for metal prices, and low carry. Lastly, we think that asymmetric USD risks and fairly ambitious market pricing for Banxico's hiking cycle point to increasing risks for MXN.	A weaker USD.
Long USD/JPY vs selling 3m 112.50 USD/JPY call	110.28, 0.4%	18-Jun-21	We expect "Regime 3" of our USD framework on the back of the hawkish Fed, but see risk remaining resilient given ample liquidity. We see JPY underperforming as a funding currency, while USD should go higher as markets price in a more hawkish Fed.	Significant risk-off resulting in demand for safe haven currencies. The Fed turning dovish again, leading to broader USD weakness.
Short AUD/USD	0.7500	18-Jun-21	We think AUD/USD will fall as we enter Regime 3 of our USD framework where real yields rise, breakevens tighten, and the USD broadly rallies. AUD/USD is particularly vulnerable to a pullback now that much of hawkishness at the RBA's upcoming July meeting is in the price.	The risk is that the USD rally is short lived, limiting AUD/USD weakness, or that the RBA ends up much more hawkish than expected.
Long USD/CHF 1y risk reversal (buy 0.9450 call, sell 0.8850 put)	0.21%	18-Jun-21	We expect the USD rally to continue and CHF to be one of the biggest underperformers within the G10. Leveraged funds are very long CHF. Front end implied volatility has risen with the bigger spot moves recently, making 1y vol a bit more attractive.	US economic data start to underperform, which causes US real yields to fall again and the market to re-engage in short USD positions

Short EUR/USD	1.2100	4-Jun-21	We suggest selling EUR/USD as a way to play for upcoming USD upside risks. The pair has struggled to break above 1.22 despite several EUR-positive developments, suggesting long positioning is posing headwinds for the currency and putting the focus on the USD leg. Increasing central bank divergence (as the ECB continues to sound dovish), PBoC concerns about CNY appreciation, a US inflation disappointment that pushes US real yields higher and breakevens lower, and the Fed moving closer towards reducing the pace of its asset purchases all raise the prospects of USD strength in coming months.	Global growth significantly outperforms or US growth momentum slows, pushing US real yields lower and generating broad USD weakness.
Long USD/CAD	1.2104	14-May-21	USD/CAD has fallen meaningfully in the last 12 months due to the combination of risk asset price gains, increased expectations for US (and thus also Canadian) economic outperformance, higher oil prices, and a hawkish BoC relative to market expectations. We think that, as the USD begins to turn later this year as the Fed signals normalization, USD/CAD likely turns as well, reflecting higher US real yields and the broader USD trend. Moreover, quite a lot of the "good news" for Canada and the BoC is priced into markets, and market sentiment appears bullish CAD.	The risk is that the USD continues to broadly depreciate amid lower US real yields and wider breakevens, which would likely push USD/CAD below 1.20 to a meaningful degree.
Short AUD/NZD	1.081	19-Mar-21	We look to sell AUD/NZD on rallies to 1.0850. Trans-Tasman policy divergence should continue, with the RBA more forcefully pushing back against AUD strength as the RBNZ continues its "Great Hawkish Shift" (albeit gradually). AUD/USD also looks particularly vulnerable to fall should we shift forward into Regime 3 of our framework.	RBNZ pushing back more aggressively than RBA against currency strength.

Inflation-Linked Bonds

TRADE	ENTRY LEVEL	ENTRY DATE	RATIONALE	RISKS
Short July CPI fixing	271	6-Jun-21	We think markets are extrapolating CPI fixings too much, and there is a reasonable case for mean reversion.	The risk is that outliers keep driving CPI prints higher.
Short beta weighted 10y breakevens (Dv01 0.7 : 1)	208bp	14-May-21	We think breakevens are too high and real yields are too low relative to nominal yields.	The risk is that breakevens continue to widen while real rates stay low.

Short-Duration Strategy

TRADE	ENTRY LEVEL	ENTRY DATE	RATIONALE	RISKS
EDZ2Z4 steepener	104bp	25-Jun-21	We think EDZ2Z4 steepeners offer positive asymmetry. We think the timing of the first hike in December 2022 has limited room to move in earlier than December 2022, which means it will be difficult for the EDZ2 contract to sell off if economic data are strong (as they be, given our analysis above), while EDZ4 has more rome to sell off. We therefore expect a bear steepening of the curve if data beat expectations.	This trade could underperform if the market begins to price in Fed rate hikes sooner than December 2022, or if the market expects fewer rate hikes following the initial hike
Z1/Z2 FRA/OIS flattener	3.88	11-Jun-21	With (1) higher GSIB surcharges leading to uncertain bank balance sheet practices, (2) the potential for SLR constraints to materialize, and (3) expected increases to T-bill issuance in 4Q, we think there is good risk/reward in positioning for this year-end to widen out.	If FRA/OIS compresses even further, the curve could steepen as nearer contracts will likely experience more of the impact.

Buy 6m T-bills vs OIS	-6bp	21-May-21	We expect significant paydowns of T-bills to occur in 2021, especially headed into the debt ceiling. With reserves continuing to increase alongside Fed QE and a drawdown in the TGA, demand for T-bills will likely increase as supply decreases, leading to a richening of bills across the curve. The trade carries positively the life of the trade.	If stimulus is significantly larger than expected, there will likely be increased issuance of T-bills, which could lead to modest cheapening.
EDM2EDM3 Flattener	41.5bp	26-Feb-21	This trade positions for a fade in the market pricing of Fed hikes. We prefer this curve expression over an outright long in EDM3, as the curve is unlikely to react to changes in FRA/OIS.	Additional market pricing of Fed hikes in 2022 and 2023.
USD/JPY basis 2s10s steepener	-13bp	26-Feb-21	We expect USD/JPY basis curve to steepen going forward and enter USD/JPY basis 2s10s steepeners, with spreads at the short end looking to be at heightened risk of widening on the back of concern about hawkish Fed pricing, while longer-dated basis swaps should continue to be paid for yield enhancement and deal-related demand.	Worsening of financial conditions lead to the wider credit spread.
Pay USD/JPY basis 10y10y	-54bp	20-Nov-20	Further tightening of global credit spreads and demand for carry.	Deal-related receiving flow in the longer end. Worsening credit conditions.

Interest Rate Derivatives

TRADE	ENTRY LEVEL	ENTRY DATE	RATIONALE	RISKS
Buy ATMF 3m5y payer (1.02%), Sell ATMF+10bp and ATMF+15bp 3m5y payers (1.12% / 1.17%), buy ATMF+33bp 3m5y payer (1.35%)	0c	18-Jun-21	Rates could move higher if the market continues to price in a more hawkish Fed; this trade positions for 5y rates to sell off 15-20bp vs the forwards.	If 5y rates sell off dramatically in the short term, this trade will lose money, though the ATMF+33bp payer provides some downside protection.
Sell 2m10y ATMF straddle and buy 0.6x 5m10y ATMF straddle	0c	4-Jun-21	Public policy announcements could support vol later in the year, while we expect implied vols to trade flat to lower in the near term.	Sooner-than-expected progress on major policy events, including potential news on a Fed leadership changes, the debt ceiling, expiration of unemployment benefits, and infrastructure headlines, could cause this trade to underperform.
Buy 10yJGB ASW against 3m DTIBOR	0.5bp	4-Jun-21	The level of 3m DTIBOR swap looks stretched, and this position provides the attractive carry.	Further receiving demand for 3m DTIBOR-referencing swap from Japanese banks' ALM department.
Pay 5y ZTibor-Libor basis	-6.375bp	4-Jun-21	The level looks stretched, and we expect loan hedge related paying to dominate the market towards June-end as seasonality suggested.	Further receiving demand for TIBOR-LIBOR basis from Japanese banks' ALM department.
ZTIBOR-OIS 5s20s flattener	11bp	9-Apr-21	ZTIBOR are expected to discontinue on 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.
US 1y30y 1x1 payer spread (2.04%/2.34%)	2.90%	26-Feb-21	This trade takes advantage of elevated payer skew and captures a distribution of rates that we believe will occur under our base case.	If back-end rates rally or vol increases, this trade will not perform.
US 6m5y 1x2 payer spread (0.89%/1.19%)	0c	26-Feb-21	6m5y 1x2 payer spreads position well for a move (even an unexpectedly large move higher) in 5y yields, given the extremely rich levels of payer skew, as well as the fact that the 5y point has the most implied yield curve control.	5y rates sell off by more than 40bp in the next six months or if payer skew and vol richen further.
US 6m5y 1x2 Payer Spread (0.57%/0.77%)	0c	19-Jan-21	6m5y 1x2 payer spreads position well for a move (even an unexpectedly large move higher) in 5y yields, given the extremely rich levels of payer skew, as well as the fact that the 5y point has the most implied yield curve control.	5y rates sell off by more than 40bp in the next six months or if payer skew and vol richen further.

Exhibit 152: History of recommendations

Buy 1y USD/CHF risk reversal, buy 0.9450 call, sell 0.8850 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/IDR	12m	Long EMFX (IDR, INR, BRL, MXN, ZAR) vs. CHF, JPY	15-Nov-20	14721	15-Jan-21	14589				IRN+12M Curncy	
USD/INR	12m	Long EMFX (IDR, INR, BRL, MXN, ZAR) vs. CHF, JPY	15-Nov-20	77.6	15-Jan-21	76.45				IRN+12M Curncy	
USD/BRL	12m	Long EMFX (IDR, INR, BRL, MXN, ZAR) vs. CHF, JPY	15-Nov-20	5.5236	15-Jan-21	5.4078				BCN+12M Curncy	
USD/MXN	12m	Long EMFX (IDR, INR, BRL, MXN, ZAR) vs. CHF, JPY	15-Nov-20	21.3491	15-Jan-21	20.5999				MXN+12M Curncy	
USD/ZAR	12m	Long EMFX (IDR, INR, BRL, MXN, ZAR) vs. CHF, JPY	15-Nov-20	16.1953	15-Jan-21	15.7831				ZAR+12M Curncy	
USD/CHF	-	Long EMFX (IDR, INR, BRL, MXN, ZAR) vs. CHF, JPY	15-Nov-20	0.9155	15-Jan-21	0.8896				USDCHF Curncy	
USD/CHF	12m	Long EMFX (IDR, INR, BRL, MXN, ZAR) vs. CHF, JPY	15-Nov-20	-109.45	15-Jan-21	-96.75				CHF+12M Curncy	
USD/JPY	-	Long EMFX (IDR, INR, BRL, MXN, ZAR) vs. CHF, JPY	15-Nov-20	105.52	15-Jan-21	104				USDJPY Curncy	
USD/JPY	12m	Long EMFX (IDR, INR, BRL, MXN, ZAR) vs. CHF, JPY	15-Nov-20	-54.8	15-Jan-21	-51.82				JPY12M Curncy	

Long USD/JPY outright with selling 3m USD/JPY call at 112.50											
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	Buy USD/JPY 3m ATM Calls	4-Jun-20	1.20%	04-Aug-20	1.60%				USDJPY Curncy	
USD/JPY	3m	Sell 3m 103-107 USD/JPY strangle 1.5%	2-Oct-20	1.50%	04-Jan-21	0.80%				USDJPY Curncy	
USD/JPY	3m	Sell 3m 103-107 USD/JPY strangle	14-Oct-20	1.50%	11-Nov-20	0.80%				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.

Unless otherwise specified, the time frame for recommendations included in the Morgan Stanley Fixed Income Research reports is 1 - 3 months and the price of financial instruments mentioned in the recommendation is as at the date and time of publication of the recommendation.

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.

For important disclosures related to the proportion of all investment recommendations over the past 12 months that fit each of the categories defined above, and the proportion of issuers corresponding to each of those categories to which Morgan Stanley has supplied material services, please see the Morgan Stanley disclosure at <https://ny.matrix.ms.com/eqr/article/webapp/a4e79666-92e7-11eb-be2a-2ded72795adb>

Event Calendar

Exhibit 153: Risk Event Calendar

Date	Time (Ldn)	Ccy	Event	Ref. Period	MS forecast	Market	Previous	
10-Jul	N/A	INT	2nd Day of G20 Finance Ministers and Central Bankers Meeting					
10-20 J	N/A	CHF	Swiss House Prices	2Q			504	
11-Jul	13:10	EUR	ECB's Lagarde spks (Green Financing)					
	23:45	NZD	Card Spending Retail (MoM)	Jun			1.7%	
12-Jul	00:50	JPY	Machine Orders (MoM)	May	2.6%	2.4%	0.6%	
	00:50	JPY	Domestic CGPI (YoY)	Jun	5.0%	4.8%	4.9%	
	05:30	SEK	SEB House Price Indicator	Jul				
	07:00	JPY	Machine Tool Orders (YoY)	Jun P			141.9%	
	08:30	SEK	Riksbank Minutes	Jul-01				
	09:00	CHF	SNB Sight Deposits				712.1B	
	10:00	EUR	ECB's de Guindos spks (Economy and Monetary Policy)					
	11:00	HUF	EU Decision on Hungary's Recovery Plan					
	13:00	EUR	Eurogroup Meeting					
	13:00	INR	CPI (YoY)	Jun	6.7%	6.59%	6.3%	
	14:00	RUB	Trade Balance	May		11.3B	10.6B	
	17:00	USD	Fed's Kashkari (non-voter) spks					
	23:45	NZD	Food Prices (MoM)	Jun			0.4%	
	12-16 J	N/A	PHP	Foreign Reserves	Jun			107.3B
	13-Jul	N/A	CNY	Trade Balance	Jun	\$46.1B	\$44.4B	\$45.54B
		N/A	CNY	Exports (YoY)	Jun	19.5%	23.1%	27.9%
N/A		CNY	Imports (YoY)	Jun	24.0%	29.8%	51.1%	
00:01		GBP	BRC Sales Like-For-Like (YoY)	Jun			18.51%	
00:30		AUD	Consumer Confidence				107.8	
02:30		AUD	NAB Business Confidence	Jun			19.8	
07:00		GBP	BoE Financial Stability Report					
07:00		RON	CPI (YoY)	Jun		3.76%	3.75%	
07:00		EUR	German CPI (YoY)	Jun F	2.3%	2.3%	2.3%	
07:45		EUR	French CPI (YoY)	Jun F	1.4%	1.5%	1.5%	
08:00		CZK	CPI (YoY)	Jun	2.8%	2.8%	2.9%	
09:00		EUR	Ecofin Meeting					
11:00		USD	NFIB Small Business Optimism	Jun		99.5	99.6	
13:30		USD	CPI (YoY)	Jun	4.9%	4.9%	5%	
13:30		USD	CPI Ex Food and Energy (YoY)	Jun	3.9%	4%	3.8%	
14:00		SEK	Riksbank's Ingves spks (Inflation)					
14:00		CHF	SNB's Jordan spks (Inflation)					
17:00		USD	Fed's Bostic (voter), Kashkari, Rosengren (non-voters) spk (Diversity)					
22:00		KRW	Export Price Index (YoY)	Jun			12.3%	
14-Jul		01:00	SGD	GDP (YoY)	2Q A	15.0%	14.3%	1.3%
	01:30	AUD	Westpac Consumer Confidence	Jul			107.21	
	02:10	JPY	BoJ Outright Bond Purchase 1-3y, 3-5y, 5-10y, 25y+					
	03:00	NZD	RBNZ Rates Decision		0.25%	0.25%	0.25%	

	05:30	JPY	Industrial Production (MoM)	May F				-5.9%	
	07:00	GBP	CPI (YoY)	Jun	2.06%	2.2%		2.1%	
	07:00	GBP	CPI Core (YoY)	Jun	1.87%	2%		2%	
	07:30	INR	Wholesale Prices (YoY)	Jun	12.2%	12.18%		12.94%	
	08:00	EUR	Spanish CPI (YoY)	Jun F	2.6%	2.6%		2.6%	
	08:30	SEK	CPI (YoY)	Jun	1.4%	1.3%		1.8%	
	08:30	SEK	CPIF (YoY)	Jun	1.5%	1.5%		2.1%	
	10:00	EUR	Industrial Production (MoM)	May	-0.9%	-0.1%		0.8%	
	12:00	TRY	CBT Rates Decision		19.00%	19%		19%	
	N/A	EUR	European Commission Releases "Fit for 55" Green Legislative Package						
	13:30	CAD	Manufacturing Sales (MoM)	May				-2.09%	
	13:30	USD	PPI (YoY)	Jun	6.7%	6.7%		6.6%	
	13:45	EUR	ECB's Schnabel spks (Challenges of Low Interest Rates)						
	15:00	CAD	BoC Rates Decision		0.25%	0.25%		0.25%	
	15:00	CAD	BoC Monetary Policy Report						
	15:30	USD	EIA Crude Oil Inventories						-6866k
	16:00	CAD	BoC Press Conference						
	17:00	USD	Fed's Powell (voter) spks (Semi-annual Monetary Policy Testimony to House)						
	18:00	GBP	BoE's Ramsden spks						
	18:30	USD	Fed's Kashkari (non-voter) spks (Diversity)						
	19:00	USD	Fed Releases Beige Book						
	23:00	CLP	CBCH Rates Decision		0.50%			0.5%	
15-Jul	00:50	JPY	Japan MoF Weekly Security Flow						-202.1B
	N/A	KRW	BoK Rates Decision		0.50%	0.5%		0.5%	
	02:30	CNY	New Home Prices (MoM)						0.52%
	02:30	AUD	Employment Change	Jun	10k	20k		115.2k	
	02:30	AUD	Unemployment Rate	Jun	5.0%	5%		5.1%	
	03:00	CNY	GDP (YoY)	2Q	7.8%	8%		18.3%	
	03:00	CNY	Retail Sales (YoY)	Jun	10.8%	10.9%		12.4%	
	03:00	CNY	Industrial Production (YoY)	Jun	7.0%	8%		8.8%	
	03:00	CNY	Fixed Assets Ex Rural YTD (YoY)	Jun	11.8%	12%		15.4%	
	03:00	CNY	Unemployment Rate						5%
	05:30	JPY	Tertiary Industry Index (MoM)						-0.7%
	07:00	GBP	Jobless Claims Change						-92.6k
	07:00	GBP	Average Weekly Earnings (Ex. Bonuses, 3M/Y)						5.6%
	07:00	GBP	ILO Unemployment Rate 3Mths						4.7%
	07:00	GBP	Employment Change (3M/3M)						113k
	07:00	SEK	Prospera Swedish Inflation Expectations Survey						
	09:00	PLN	CPI (YoY)	Jun F	4.4%			4.4%	
	09:00	EUR	Italian HICP (YoY)	Jun F	1.3%	1.3%		1.3%	
	09:00	EUR	ECB's Elderson spks						
	09:30	GBP	BoE Credit Conditions Survey						
	11:00	GBP	BoE's Saunders spks (UK Inflation Outlook)						
	12:30	INR	Trade Balance						\$-9.4B
	12:30	INR	Exports (YoY)						69.4%
	N/A	INT	OPEC Monthly Oil Market Report						
	13:30	USD	Empire Manufacturing						17.4
	13:30	USD	Philadelphia Fed Business Outlook						30.7

	13:30	USD	Initial Jobless Claims				350k	373k
	14:00	CAD	Existing Home Sales (MoM)	Jun				-7.4%
	14:15	USD	Industrial Production (MoM)	Jun	1.5%	0.6%		0.9%
	14:15	USD	Capacity Utilization	Jun			75.6%	75.2%
	14:15	USD	Manufacturing Production (MoM)	Jun			0.3%	0.9%
	14:30	USD	Fed's Powell (voter) spks (Semi-annual Monetary Policy Testimony to Senate)					
	16:00	USD	Fed's Evans (voter) spks (Economy)					
	16:30	ILS	CPI (YoY)	Jun			1.65%	1.5%
	20:00	ARS	CPI (MoM)	Jun	2.9%			3.3%
	23:30	NZD	Manufacturing PMI	Jun				58.6
	23:45	NZD	CPI (YoY)	2Q			2.7%	1.5%
	N/A	PEN	GDP (YoY)	May				58.49%
16-Jul	N/A	JPY	BoJ Rates Decision		-0.10%	-0.1%		-0.1%
	N/A	JPY	BoJ 10y Yield Target		0.00%			0%
	N/A	JPY	BoJ Outlook Report					
	01:30	SGD	Non-Oil Domestic Exports (YoY)	Jun			8.6%	8.8%
	07:30	JPY	BoJ Press Conference					
	09:00	EUR	Italian Trade Balance	May				5870.19m
	09:00	EUR	Spanish Trade Balance	May				-1296.9
	10:00	EUR	Trade Balance	May				9.44B
	10:00	EUR	CPI (YoY)	Jun F	1.9%	1.9%		1.9%
	10:00	EUR	CPI Core (YoY)	Jun F	0.9%	0.9%		0.9%
	13:00	PLN	CPI Core (YoY)	Jun	3.8%	3.6%		4%
	13:15	CAD	Housing Starts	Jun				276k
	13:30	CAD	Wholesale Trade Sales (MoM)	May				0.4%
	13:30	USD	Retail Sales Advance (MoM)	Jun	-1.9%	-0.6%		-1.3%
	13:30	USD	Retail Sales Ex Auto (MoM)	Jun	-0.3%	0.4%		-0.7%
	13:30	USD	Retail Sales Control Group (MoM)	Jun	-0.8%	0.5%		-0.7%
	14:00	USD	Fed's Williams (voter) spks (Workplace Culture)					
	15:00	USD	Business Inventories	May			0.4%	-0.2%
	15:00	USD	Univ. of Michigan Confidence	Jul P			86.5	85.5
	21:00	USD	Total Net TIC Flows	May				101.2B
18-Jul	11:00	ILS	GDP (QoQ)	1Q F				-6.2%
	23:30	NZD	Performance Services Index	Jun				56.1

Source: Morgan Stanley Research, Bloomberg

Government Bond Ratings

Exhibit 154: 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			NEG														
	Fitch				STA													
GER	Moody	STA																
	S&P	STA																
	Fitch	STA																
FRA	Moody			STA														
	S&P			STA														
	Fitch			NEG														
AUT	Moody		STA															
	S&P		STA															
	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				NEG													
SPA	Moody								STA									
	S&P							POS										
	Fitch							STA										
ITA	Moody																	
	S&P									NEG				STA				
	Fitch													STA				
IRE	Moody						STA											
	S&P				STA													
	Fitch					STA												
POR	Moody																	
	S&P																	
	Fitch								STA					STA				
GRE	Moody																	
	S&P																	
	Fitch														POS		STA	
Australia	Moody	STA																
	S&P	STA																
	Fitch	STA																
New Zealand	Moody																	
	S&P																	
	Fitch																	
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		INVESTMENT BANKING CLIENTS (IBC)			OTHER MATERIAL INVESTMENT SERVICES CLIENTS (MISC)	
	COUNT	% OF TOTAL	COUNT	% OF TOTAL IBC	% OF RATING CATEGORY	COUNT	% OF TOTAL OTHER MSC
Overweight/Buy	1530	44%	416	48%	27%	675	44%
Equal-weight/Hold	1439	41%	362	42%	25%	657	43%
Not-Rated/Hold	1	0%	0	0%	0%	0	0%
Underweight/Sell	529	15%	91	10%	17%	206	13%
TOTAL	3,499		869			1538	

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