Morgan Stanley

INVESTMENT MANAGEMENT

Exploring the Peak

MARKET INSIGHTS | GLOBAL LIQUIDITY TEAM | December 2023

Federal Reserve Board[1]

The Federal Open Market Committee (FOMC) held the federal funds target rate at its current range of 5.25% to 5.50% in December. The press release was relatively unchanged aside from a minor adjustment suggesting economic activity has "slowed," versus "expanded at a strong pace" previously. Chairman Powell's press conference was perceived as much more dovish than anticipated, leading to a strong rally in longer-term bonds and pulling market forecasts forward for the initial rate cut in 2024.

The December meeting included an update of the Federal Reserve's (Fed) summary of economic projections. The Fed's dot plot showed officials' median projection for the benchmark rate at the end of 2023 decreased to 5.4% from 5.6% in September. The 2023 median gross domestic product (GDP) growth projection was increased substantially, by 50 basis points to 2.6%. The 2024 GDP growth forecast decreased marginally to 1.4%. The 2023 unemployment rate estimate was left unchanged at 3.8%. The Fed lowered its median 2023 personal consumption expenditure (PCE) inflation forecast to 2.8% in December from 3.3% in September. The 2024 PCE projection was reduced by 10 basis points to 2.4%.

DISPLAY 1

Monthly Interest Rate Summary

As of 12/31/2023

US TREASURY RATES	YIELD (%)	MOM CHANGE (%)
1M UST	5.40	0.03
3M UST	5.33	(0.06)
6M UST	5.25	(0.15)
12M UST	4.76	(0.36)
2Y UST	4.25	(0.43)
5Y UST	3.85	(0.42)
10Y UST	3.88	(0.45)
30Y UST	4.03	(0.47)

Source: Bloomberg

European Central Bank[1]

The European Central Bank's (ECB) Governing Council left the deposit rate unchanged at 4.00% at the conclusion of its policy meeting on December 14. The ECB reiterated messaging from its prior meeting, suggesting that policy rates need to remain "sufficiently restrictive" for a "sufficiently long duration" to combat inflation. Economic projections were revised lower since September, as the policy committee now projects inflation to average 5.4% for 2023 and 2.7% in 2024. The Governing Council remains "data-dependent" and is keen to bring inflation below its 2% target.

Bank of England[1]

The Bank of England (BoE) Monetary Policy Committee (MPC) voted 6-3 to hold the Bank Rate steady at 5.25% at the conclusion of its December meeting. Three dissenting members preferred to increase the rate 0.25% to 5.50%. U.K. GDP was flat in the third quarter in line with expectations. At 4.6%, October headline 12-month inflation data came in well below September's reading. The MPC has noticed

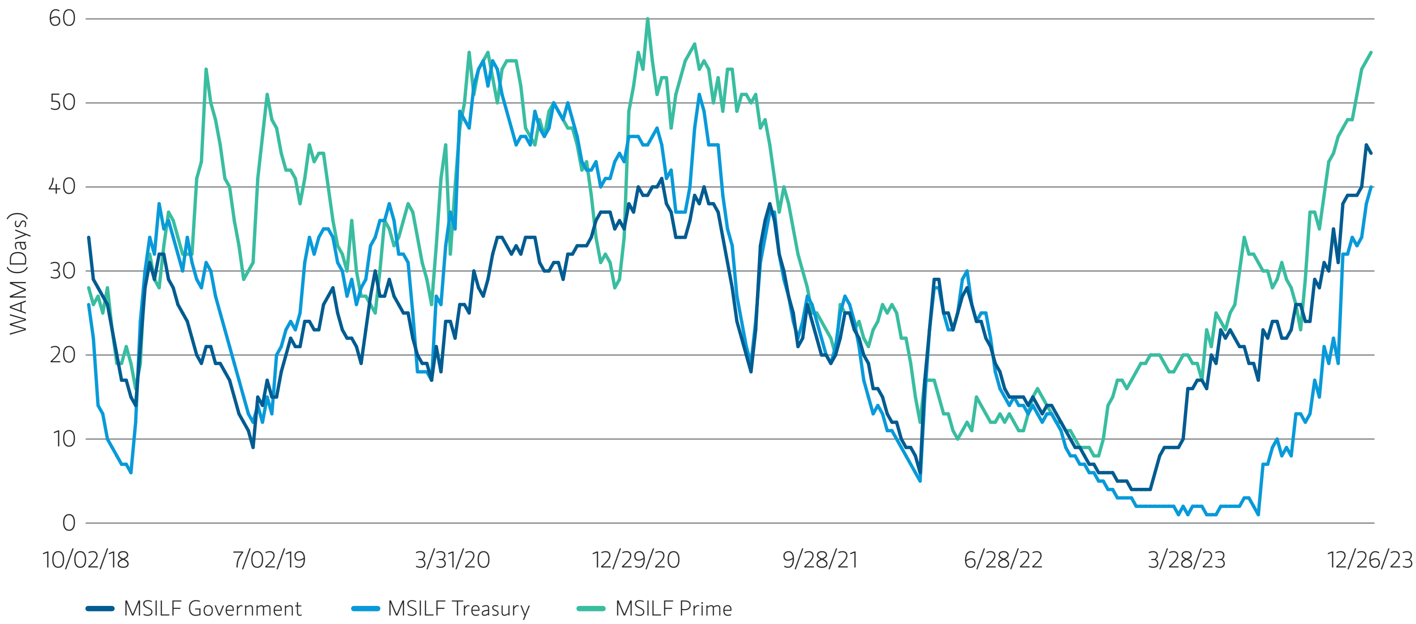
[1] Source: Bloomberg.

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

DISPLAY 2

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

As of 12/31/2023



Source: iMoneyNet

"loosening" in the labor market as employment growth has "softened." Committee members noted that its current policy is "restrictive," and will need to remain that way for an "extended period of time" to reduce inflation substantially.

Portfolio Strategy

GOVERNMENT/TREASURY STRATEGY

The measured extension continued for money funds heading into year-end, as slowing labor and inflation data, along with some dovish Fed speak, catalyzed a market rally that began on the heels of the November FOMC meeting and was sustained by the December meeting. During this time, we maintained our attractive positions in 6-month paper while also adding 1-year exposure in a fixed-rate format. As a tactical trade, we capitalized on the increased funding needs of the Federal Home Loan Bank system with purchases of shorter floating-rate securities.

The tone in the market has shifted toward expecting the next FOMC move to be a rate cut; the question now is just how long the committee might be willing to hold rates at current levels before doing so. Fed speakers have become increasingly divided on this topic lately, and the market will look to Chair Powell for firm guidance. In the near term, carry is crucial given the likely "on-hold" stance for some time, while it also makes sense to hold some longer duration exposure as ballast, as mentioned above.

Supply remains elevated, and the market was again tasked with taking down larger Treasury bill auctions. However, with such large reverse repo (RRP) balances in the system, this supply continues to be taken down incredibly well—with investors eager to add T-bills even with minimal pickups to RRP. Toward the end of the month, we started to see calibration cuts to short-dated T-bill auctions, which likely could continue through the end of the year.

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

We have no concerns with respect to T-bill liquidity in the current environment.

PRIME STRATEGY[3]

Softening in the labor market and slowing inflation, along with mixed Fed speak, further solidified our comfort with the recent duration extension in the portfolio. With the Fed likely on hold in the near term, we continue to find value in locking in fixed yields through the first half of 2024 and longer, avoiding reinvestment risk if the Fed eases sooner than the market anticipates. With the bulk of the duration extension occurring prior to the recent rally in September and October, we remain patient and opportunistic when adding fixed-rate exposure given our current maturity profile.

We typically anticipate a seasonal pattern of spread widening in the wholesale funding market in the fourth quarter for technical reasons; however, spreads tightened marginally. We still find credit attractive and think we're appropriately compensated to add both duration and spread duration risk, but we remain patient as there is still potential for spread widening in the last month of the year that we believe we're well positioned to take advantage of.

Overall, we have no current concerns about market liquidity, which remains strong and dealer balance sheets remain unconstrained.

TAX-EXEMPT STRATEGY

Municipal bond yields continued to rally following the Fed's December meeting. With the FOMC pausing their tightening cycle for a third straight meeting, leaving the benchmark rate in a range of 5.25% to 5.50%, but reiterating "that the central bank isn't fully confident that it has tightened enough to return inflation to 2%," we marginally extended WAM/WAL ahead of historically strong January municipal market technicals.

The SIFMA Index,[4] which measures yields for weekly variable rate demand obligations (VRDOs), averaged 3.69% in December as a result of tax-exempt money market fund inflows.

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

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

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One basis point = 0.01%

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

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