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IDEA

October 30, 2026 11:33 PM GMT

US Rates Strategy | North America

"It's The Rates Market..."

Despite stronger US growth, a rising cost of capital has weighed on risk assets, and the political backdrop may explain some of the risk-off. We think the midterms matter for rates only if they move equities, and we would wait for the vote, payrolls, and CPI before adding duration or curve risk.

Key Takeaways

- By the proxy funds rate, monetary conditions are nearly as tight as at the peak of the last hiking cycle, though the policy rate sits well below that level.
- The proxy funds rate sits >100bp above the effective fed funds rate, outside its usual band, driven by a broad-based increase in bond market yields.
- AI-related IG yields rose 100bp more than Treasury yields over the past year, adding an AI-specific layer to the broader increase in the cost of capital.
- Maintain the SFRZ6Z7 flattener at +35bp with a +10bp target and +53bp trailing stop, as a widening gap between the trough rate and longer-run dot favors it.
- Payrolls and CPI both land within a week of the November 3 vote, and if risk-off continues, curve shape could trade sporadically into both of those releases.

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Interest Rate Strategy

United States | There was a yield level that mattered after all

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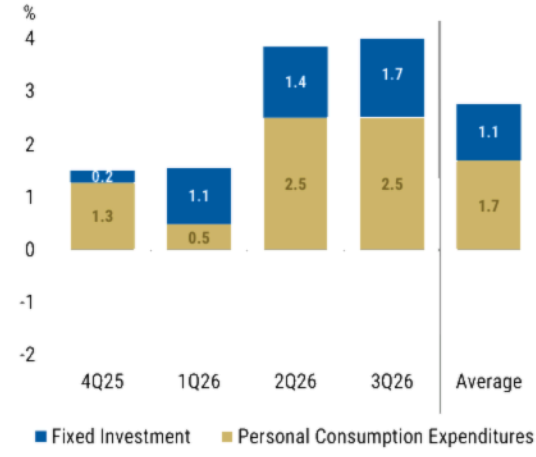
It's the rates market, stupid

In 1992, James Carville – a political strategist and chief campaign adviser for Bill Clinton's successful US presidential campaign against incumbent George H.W. Bush – coined the phrase "It's the economy, stupid." The phrase meant campaign workers should focus messaging on the recession and the public's financial concerns rather than get distracted.

This time, though, with the US economy strengthening into the midterm election, another catchphrase may resonate more: it's the rates market. As Exhibit 1 shows, private domestic final demand contributed 2.8pp to annualized real GDP growth, on average, over the past four quarters – mostly driven by 2Q26 and 3Q26.

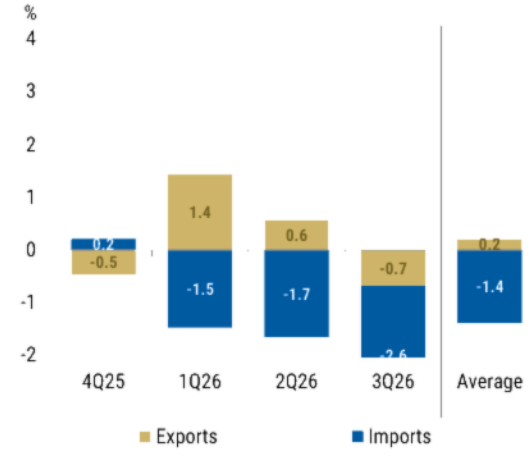
At the same time, as our economists point out often, we need to adjust lower the fixed investment contribution related to the AI theme with imports related to the AI theme. As shown in Exhibit 2, net exports shaved 1.2pp off real GDP – bringing the contribution of private final domestic demand adjusted for net exports to 1.6pp – much lower than 2.8pp.

Exhibit 1: Private domestic final demand contributions to real GDP Q/Q SAAR



Source: Morgan Stanley Research, BLA, Bloomberg

Exhibit 2: Exports and imports contributions to real GDP Q/Q SAAR

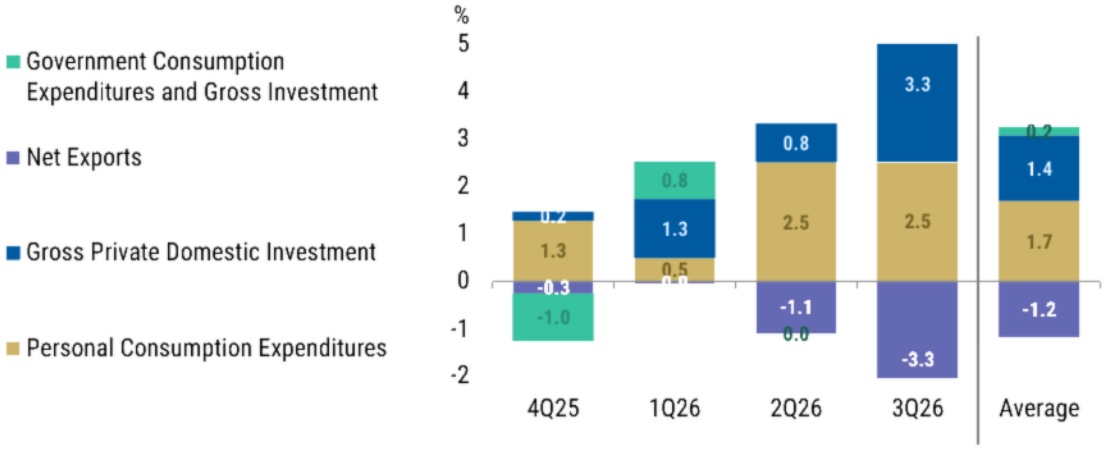


Source: Morgan Stanley Research, BLA, Bloomberg

- Indeed, adjusting the overall fixed investment contribution by the overall import contribution suggests the two in combination actually subtracted from real GDP over the past four quarters.
- Of course, neither all fixed investment nor all imports relate to the AI theme alone. Still, we think this broader viewpoint places the AI theme and its impact on the overall economy into perspective.

Nevertheless, real GDP growth over the past year remained solid (and more recently "strong", per the October FOMC statement). Real GDP grew at 2.1% Y/Y and, over the past two quarters, at 2.8% SAAR (see Exhibit 3).

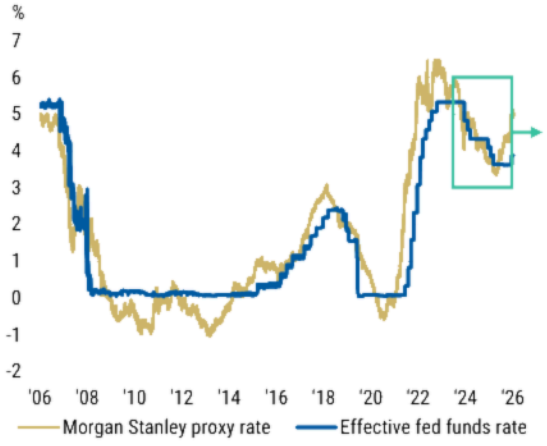
Exhibit 3: Contributions to US real GDP growth Q/Q SAAR



Source: Morgan Stanley Research, BLA

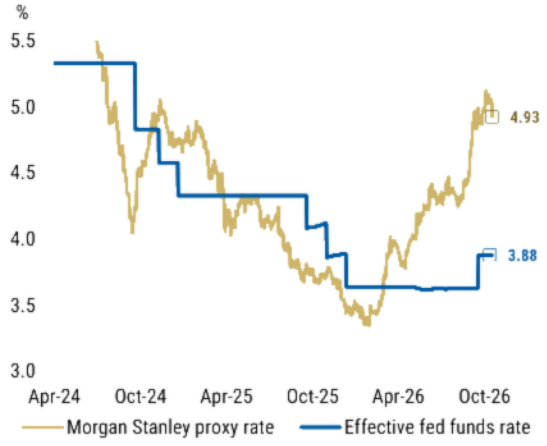
If the real economy accelerated recently, then why did risky assets languish more recently? Our US equity strategists point to a rate-of-change deceleration in (earnings) growth (see Weekly Warm-up: Clearing Events Still Ahead). This growth inflection preceded a very aggressive tightening in monetary conditions, embodied by the proxy effective fed funds rate (or the "proxy funds rate", see Exhibit 4 and Exhibit 5).

Exhibit 4: Morgan Stanley proxy effective fed funds rate* and actual effective fed funds rate: since 2006



Source: Morgan Stanley Research, FRB San Francisco, Bloomberg
* https://www.frbsf.org/research-and-insights/data-and-indicators/proxy-funds-rate/

Exhibit 5: Morgan Stanley proxy effective fed funds rate* and actual effective fed funds rate: since 2024



Source: Morgan Stanley Research, FRB San Francisco, Bloomberg
* https://www.frbsf.org/research-and-insights/data-and-indicators/proxy-funds-rate/

- Indeed, the proxy funds rate nearly returned to the peak effective fed funds rate in the 2022-2023 hiking cycle.

The proxy funds rate rarely strays far from its effective fed funds rate sibling. Outside crises like the Great Financial Crisis (GFC) and Great Covid Recession (GCR), the spread between the proxy funds rate and the effective fed funds rate stays within a +/- 100bp band (see Exhibit 6 and Exhibit 7).

- Of course, the spread between the two rates can fall if either (2) the FOMC continues to hike rates, as our economists expect, or (2) bond yields in the US - including US Treasuries and corporate bonds - fall.

Exhibit 6: Morgan Stanley proxy effective fed funds rate* less actual effective fed funds rate: since 2006



Source: Morgan Stanley Research, FRB San Francisco, Bloomberg
* https://www.frbsf.org/research-and-insights/data-and-indicators/proxy-funds-rate/

Exhibit 7: Morgan Stanley proxy fed funds rate* less actual effective fed funds rate: since 2024



Source: Morgan Stanley Research, FRB San Francisco, Bloomberg
* https://www.frbsf.org/research-and-insights/data-and-indicators/proxy-funds-rate/

Our US equity strategists conceded that, historically, equity markets continue to show strength even as the rate of change on growth slows – as long as it's still above 0% – while leadership shifts to high quality.

However, they note that, in a "mid-cycle adjustment" phase, a rapid increase in the cost of capital (rates) tends to also hurt economically sensitive equity sectors more, thereby broadening out the correction already underway – what we saw more recently.

The cost of capital rose both through the increase in US Treasury yields, but also through a dramatic rise in AI-related investment grade corporate bond spreads to US Treasuries (see Exhibit 8 and Exhibit 9).

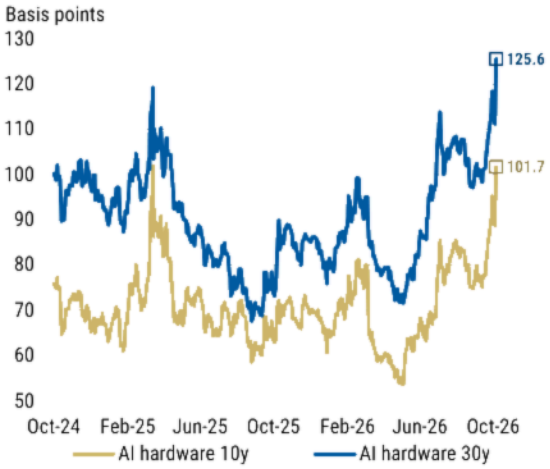
- AI data center-related investment grade bond yields rose 100bp more than US Treasury yields – which also rose 100bp at one point – over the past year.
- AI hardware-related investment grade bond yields rose 50bp more than US Treasury yields just over the past five months.

Exhibit 8: Investment Grade AI data center bond spreads to US Treasuries



Source: Morgan Stanley Research, Bloomberg

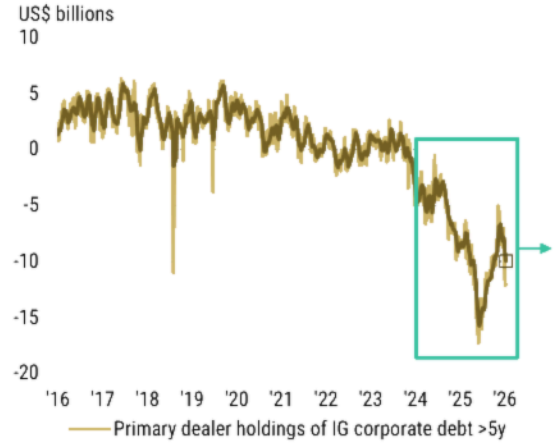
Exhibit 9: Investment Grade AI hardware bond spreads to US Treasuries



Source: Morgan Stanley Research, Bloomberg

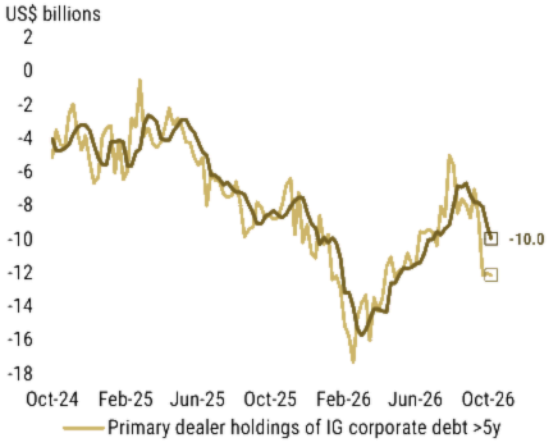
The more recent widening of corporate bond spreads appear less related to supply than risk-off sentiment. Indeed, it appears as if primary dealers in the US hold fewer longer-maturity investment grade corporate bonds today than in August when inventory peaked (see Exhibit 10 and Exhibit 11).

Exhibit 10: US primary dealer holdings of IG corporate debt >5-years in maturity: past decade



Source: Morgan Stanley Research, FRB New York, Bloomberg

Exhibit 11: US primary dealer holdings of IG corporate debt >5-years in maturity: past 2 years



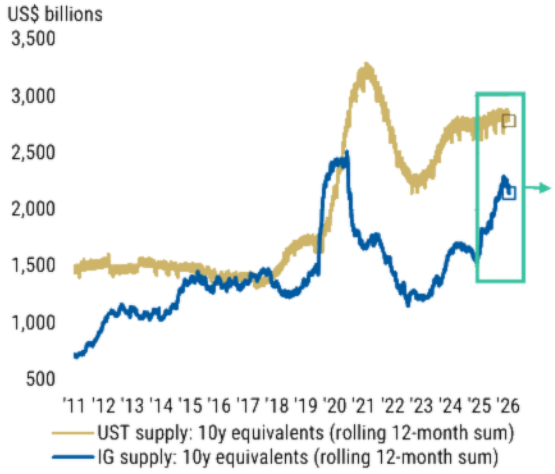
Source: Morgan Stanley Research, FRB New York, Bloomberg

This suggests that either (1) some investors took advantage of the higher yields and wider spreads, and/or (2) that supply dwindled. Our tracking of US Treasury and investment grade corporate bond supply suggests the latter played a role, at least (see Exhibit 12 and Exhibit 13).

- Over the 21 business days ending October 21, investment grade corporate supply (gross) totaled $82bn 10y US Treasury equivalents – matching the lowest amount of gross supply over any 21-day window all year.

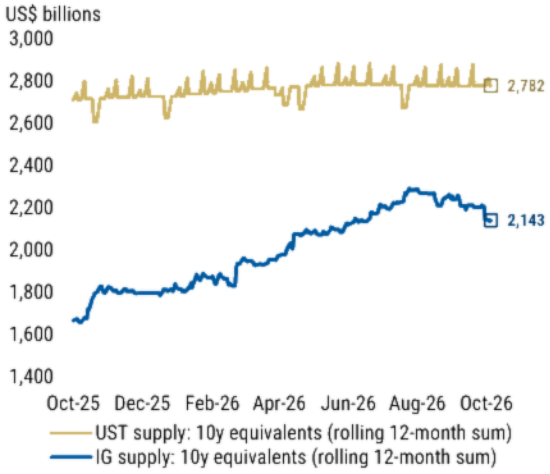
- Through October 21, investment grade corporate bond supply (gross) looks on track to come in below the average gross supply in October for the past three years – the first time this would happen in any month all year.

Exhibit 12: US investment grade corporate bond supply and US Treasury supply (gross), in 10y UST equivalents, rolling 12-month summation



Source: Morgan Stanley Research, Dea Logic

Exhibit 13: US investment grade corporate bond supply and US Treasury supply (gross), in 10y UST equivalents, rolling 12-month summation



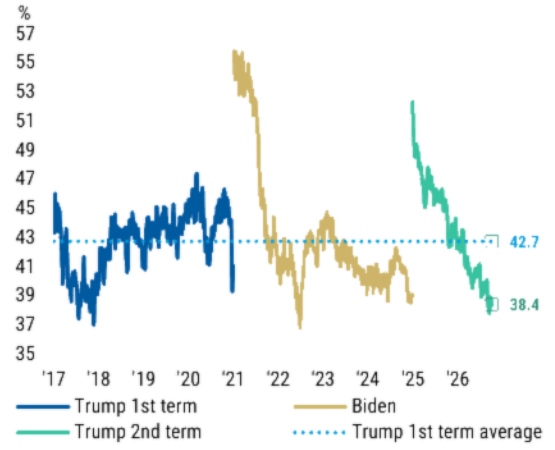
Source: Morgan Stanley Research, Dea Logic

If the risk-off price action continues, we would expect Treasury yields to fall further, with yield curve shape trading sporadically into nonfarm payrolls and CPI – both set to land within a week of the midterm election on Tuesday, November 3.

We don't think the midterms mean much for the rates markets, unless they mean much to equity markets (see Midterms FAQs: Two Weeks Out). In that sense, we wonder whether some of the recent risk-off relates to the political backdrop going into the midterms.

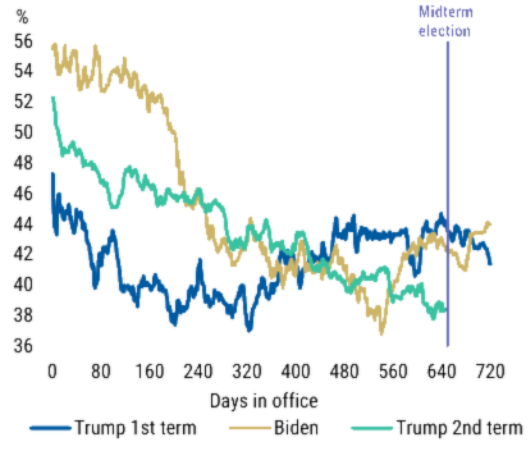
- President Trump's average approval rating sits at his first term lows, and prediction markets price a Democrat sweep at 69% (see Exhibit 14 and Exhibit 15).

Exhibit 14: RealClear Politics job approval polling average: Trump vs. Biden



Source: Morgan Stanley Research, Real Clear Politics, Bloomberg

Exhibit 15: RealClear Politics job approval polling average: Trump vs. Biden by days in office



Source: Morgan Stanley Research, Real Clear Politics, Bloomberg

Until we get the midterm election results and through the next round of economic data, we remain sidelined on duration and yield curve shape, and suggest investors do as well.

- **Trade idea: Maintain SFRZ6Z7 curve flattener at +35bp with a target of +10bp and a trailing stop of +53bp.**
- **Trade idea: Maintain long 2-year (Sep '27) UST SOFR swap spreads at -5bp with a target of 0bp and a trailing stop of -6bp.**

Valuation Methodology and Risks

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**
SFRZ6Z7 flattener	42bp	10/23/2026	We think the combination of an usually steep curve, growing divergence between the trough rate and longer-run dot, and strengthening relationship between SFRZ6Z7 and the trough rate all create a more compelling case for fading the recent steepening.	The main risk to the trade is stronger-than-expected economic activity or an increase in the perceived neutral rate could keep the December 2027 implied rate elevated.
Long 2y (Sep '27) UST SOFR swap spread	-21.6bp	10/3/2025	We expect softer funding conditions and a steepening of the very front end to cause swap spreads in the front end to widen given recent relationships.	Risks to the trade include firmer funding than expected or a stabilizing job market.

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Equal-weight/Hold	1563	42%	394	42%	25%	763	
Not-Rated/Hold	2	0%	1	0%	50%	1	
Underweight/Sell	570	15%	96	10%	17%	227	
Total	3,734		946			1774	

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