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Month in Cash: Meager short rates won't likely move much with QE2

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With the eyes of the investment world trained on the widely presumed next round of quantitative easing by the Federal Reserve, short-term interest rates meandered within a tight range in October, anchored to the super-low federal funds target range of zero to 0.25%. At month's end, the one-month London interbank offered rate (Libor) sat at 0.25%, three-month Libor was at 0.29%, six-month was at 0.45% and 12-month Libor was at 0.76%—all virtually unchanged from a month ago despite notable remarks from Kansas City Fed President Thomas Hoenig that benchmark interest rates should be raised to at least 1%. Clearly, investors do not expect Hoenig's hawkish views to prevail in light of Fed Chairman Ben Bernanke's well-known fears that Japanese-style inflation could infect the U.S economy.

As of this writing, the size and timing of QE2, as it has come to be called, remains a matter of market speculation. Fed officials, including Bernanke, have given only vague hints about the details of its implementation, though that veil could be lifted somewhat at Wednesday's conclusion of this week's two-day Federal Open Market Committee meeting. But while another program of money creation might have the potential be a "game changer" over the long haul, it is not likely to materially impact the short end of the yield curve—and thus interest rates on cash investments—for at least several months. That's because QE2 is expected to involve Fed buying of intermediate-term Treasury securities, and with short-term interest rates already at rock bottom, there is little scope for cash yields to fall further. In addition, even if QE2 succeeds in cutting the jobless rate and raising inflationary expectations as intended, there is scant reason to believe that benchmark interest rates will rise until at least the middle of next year, Hoenig's protestations notwithstanding.

Still, we remain on high alert for rising inflation and the onset of a new monetary tightening cycle. If it is still true that the Fed eventually gets what the Fed wants, then it is only a matter of time before the central bank's relentless and creative attempts at reflation succeed. In fact, the introduction of reverse repurchase agreements strongly implies that policymakers already are preparing to shrink the Fed's balance sheet when the threat of deflation is extinguished and a self-sustaining recovery powered by private demand is underway. And while growth and employment remain unacceptable depressed, there are indications that the economy has stabilized. In that regard, we were pleased to note that third quarter earnings painted a reasonably healthy picture of corporate credit metrics.

Proposed money market reforms stay out of harm's way

Finally, a report from the President's Working Group on Financial Markets reassured market participants that proposed financial reforms of the money market fund industry are not likely to be disruptive. The report outlined considerations that will be studied by the Financial Stability Oversight Committee, with the goal of strengthening the industry and bolstering investor confidence in its ability to withstand stresses like those encountered in the wake of the 2008 financial crisis. In our view, the document appears to meet those important objectives.

Views are as of November 1, 2010, and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security.

Bond prices are sensitive to changes in interest rates and a rise in interest rates can cause a decline in their prices.

London interbank offered rate (Libor): The rate at which banks can borrow funds from other banks in the London interbank market. The Libor is fixed on a daily basis by the British Bankers' Association and acts as a benchmark for other short-term interest rates.

The yield curve is a graph showing the comparative yields of securities in a particular class according to maturity. Securities on the long end of the yield curve have longer maturities.

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