

Month in Cash: Tale of two crises

As of 08-02-2011

Troubling economic fundamentals were eclipsed in July by the ever-absorbing “tale of two crises” playing out on both sides of the Atlantic. Over the first half of the month, concerns that European political leaders would fail to avoid a Greek sovereign debt default—with its likely contagion to Italy and Spain—caused credit spreads to widen. No sooner had the eurozone drama been at least temporarily resolved, however, than the spotlight shifted to the high-stakes political brinkmanship playing out at a glacial speed in Washington.

Though few analysts expected the August 2 deadline for raising the \$14.3 trillion U.S. debt ceiling to pass without an agreement, nerves grew increasingly frayed as the day of reckoning approached. With tensions on the rise during the last week of July, yields spiked on securities that matured in early August, creating a negative yield curve in which shorter-dated paper yielded more than their longer-term counterparts. On July 1, for instance, the U.S. Treasury bill maturing on August 4 carried a zero percent yield; by July 28, its yield had climbed to 0.20%, even though the T-bill was then only one week from maturing. Meanwhile, signs of stress reappeared in the interbank funding market as investors appeared to have second thoughts about the staying power of the eurozone debt fix. Overall, the six-month London interbank offered rate (Libor) climbed 3.25 basis points to 0.43% in July while 12-month Libor rose by 2.67 basis points to 0.76%.

After debt limit drama, investors will refocus on economy

Though investors worried that a default by the U.S. Treasury would threaten the sanctity of the \$1 a share net asset value of money market funds, we never considered credit quality to be the underlying issue. In fact, it is ironic that some cash investments actually benefited from the U.S. debt crisis through the higher yields it created across the credit spectrum.

As of this writing, a compromise deal on raising the debt ceiling and cutting the budget deficit had just been reached between the White House and leaders of both parties on Capitol Hill. Assuming the agreement gains congressional approval, the focus of investors will return to the economic fundamentals that typically drive monetary policy. And while asset markets were transfixed by the debt stories, those fundamentals revealed a U.S. economy still struggling to escape the soft patch it entered during the winter. Yet modest improvement was evident in some employment and housing numbers, and the long overdue end to the debt drama should help to improve consumer sentiment. Combined with the waning negative impact of the Japanese tragedy and a moderation of food and energy inflation, we expect economic growth to revive during the second half of the year. In that environment, we do not expect yields to fully recycle to earlier lows, especially as non-traditional institutional players like hedge funds that had been using cash as a port in the global debt storm exit the sector.



Deborah A. Cunningham, CFA

Chief Investment Officer for the Taxable Money Markets, and Senior Portfolio Manager, with additional responsibility for the Tax-Exempt Money Market and Municipal Investment Groups

Recent Cash Management

Month in Cash: Much ado about nothing

Jul 01, 2011 :: Deborah A. Cunningham

Month in Cash: Another soft patch pushes back expectations for Fed tightening

Jun 01, 2011 :: Deborah A. Cunningham

Money Market Outlook

May 23, 2011 :: Deborah A. Cunningham

Views are as of the date above 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 or sector.

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

The cash-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.

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.

Federated Investment Management Company

Copyright © 2011 Federated Investors, Inc.



Federated Investors Tower
1001 Liberty Avenue
Pittsburgh, PA 15222-3779
Telephone: 412-288-1900