Federated

Month in Cash: Much ado about nothing

As of 07-01-2011

With apologies to Shakespeare, it was mostly much ado about nothing—at least from the standpoint of the cash market. Despite an exceptionally portentous month for major news stories, short-term interest rates were little changed over the period, although normal technical factors exerted some downward pressure on overnight yields as the end of the quarter approached. Haven-buying of Treasury debt also temporarily pushed repo rates into negative territory due to a shortage of collateral. Still, no portion of the cash curve between one and 12 months closed more than half a basis point from where it began, with London interbank offered rate (Libor) yields ranging 0.19% on one-month paper to 0.73% on 12-month securities.

Certainly, there was no shortage of dramatic economic and geopolitical events to keep investors on edge. For the second consecutive summer, Greece flirted with default on its sovereign debt, thus casting a shadow upon some major financial institutions in the euro zone. The looming showdown between the Obama administration and congressional Republicans over raising the $14.3 trillion U.S. debt ceiling also contained key implications for financial markets, as did the conclusion of the Federal Reserve's $600 billion second round of quantitative easing, or QE2. Meanwhile, investors parsed the text of Fed Chairman Ben Bernanke press conference in which he seemed to dismiss the possibility of a "QE3" despite clear evidence that the U.S. economy was in yet another "soft patch." Bernanke did acknowledge that the recovery from the 2007-'09 recession was "frustratingly slow" and revised downward the Fed's projection for real U.S. economic growth this year to roughly 3%.

No further easing doesn't mean tightening is nigh

We concur with the Fed's view that the deceleration in the rate of economic expansion will prove temporary and that another recession is not on the horizon. Not surprisingly, supply chain disruptions caused by Japan's tragic earthquake and tsunami took a bite out of global economic growth, as did the sharp rise in food and energy prices. Bernanke's recent assertion that "monetary policy cannot be a panacea" for all that ails the U.S. economy implies that the Fed believes it has done what it can to promote growth and is anxious to normalize monetary policy as conditions warrant. Notably, policymakers have expressed mild concern over the rise in core inflation this year, though inflationary expectations remain below what the central bank considers acceptable limits. However, given the Fed's overarching desire to avoid a repeat of Japan's disastrous experience with deflation, benchmark interest rates probably will not begin moving higher for another two or three FOMC meetings.

Given what we perceive to be a dearth of value across the cash curve, we are focusing new purchases on short-term securities, which carry less interest rate risk and also provide the liquidity necessary to lock in higher yields as they appear. Of course, we are carefully monitoring the events in Greece given modest positions in some of the European banks that hold at least some Greek government bonds on their balance sheets. Our analysis indicates that Federated's exposure of those large financial institutions is limited, manageable and represents no meaningful threat to the banks themselves or to our holdings. As always, we will remain vigilant to these and other issues which potentially might impact the pools, whose creditworthiness remains our highest priority.

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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.

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