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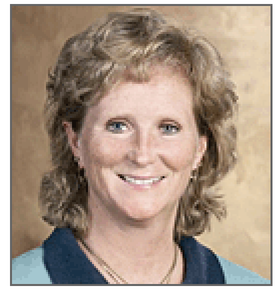
# Month in Cash: How long can this keep going on?

July 30, 2010



Deborah A. Cunningham

Credit spreads tightened in July amid an easing of concern over liquidity and solvency issues in the euro zone. Though viewed with some skepticism, generally favorable results from stress tests performed on the balance sheets of European banks appeared to satisfy investors that another financial crisis was not imminent. Of 91 banks examined in 20 countries, only seven failed their test. Those results, in combination with soft U.S. economic data and dovish comments from Fed Chairman Ben Bernanke, pushed interest rates lower across all sectors and maturities, thus reversing modest increases from the previous month. Lower rates were particularly evident on non-government paper, with yields on one-month London interbank offered rate (Libor) falling 3.2 basis points to 0.315%, three-month Libor dropping 5.8 basis points to 0.475%, six-month Libor declining 6.4 basis points to 0.687%, and one-year Libor plunging 10.8 basis points to 1.064%.

Notably, the yield on two-year Treasury notes — the security considered most sensitive to potential changes in official interest rates — dropped to an all-time low. The catalyst for the latest decline in the two-year Treasury yield was Chairman Bernanke's semi-annual testimony to Congress, in which he acknowledged that the U.S. economic outlook was "unusually uncertain" and that risks to growth were skewed to the downside. He also stressed that the central bank had ammunition remaining in its monetary arsenal to combat another downturn — assuming one occurred — despite the rock-bottom level of official interest rates. The Fed has maintained a target range of zero to 0.25% on benchmark rates since December 2008. Not only is the nominal level of rates at historically low levels, but the length of time that the Fed has kept rates steady is also highly unusual.

### No relief for savers

With core inflation in the United States running at the lowest level since the early 1960s and large amounts of excess capacity remaining in labor and resource markets, investors have concluded that a rate hike this year is off the table. We concur with that view, and are pleased with our purchases of some longer-dated securities when yields briefly ticked higher in June. The unprecedented magnitude and duration of the Fed's easy money policies has exerted a heavy price on savers. We believe that over time, the government's efforts to revive growth will succeed and that cash yields will trend higher. Given the strong immediate headwinds to full employment as households and governments embrace some degree of austerity, however, it is virtually certain that the journey towards more generous yields on cash equivalents will not begin until next year.

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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 Co.
42832


Federated®

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

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