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## Month in Cash

August 3, 2009

When Federal Reserve Chairman Ben Bernanke traveled to Capitol Hill in late July to present his semiannual Humphrey Hawkins testimony, lawmakers were determined to extract guidance on two key issues: How and when does the Fed plan to remove the monetary stimulus that it provided the financial system over the last nine months?

Answers to those questions are important from both a macroeconomic and financial market perspective. If the Fed tightened before the upcoming expansion put down solid roots — as the Bank of Japan is believed to have done in the 1990s — the economy could slip back into recession. But if policymakers kept rates too low for too long, inflation could revive, as happened in the United States during the 1970s.



**Deborah A. Cunningham**

Bernanke assured Congress that the central bank was working on a so-called exit strategy for the monetary stimulus, but that the economy was still much too weak to begin executing that plan. Investors seemed to like what they heard. If Bernanke had implied that the Fed was eager to begin removing the stimulus, credit spreads would have widened. Instead, London interbank offered rates (Libor) inched lower. Meanwhile, the yield on two-year Treasury notes — the security most sensitive to looming changes in monetary policy — remained steady at slightly under 1% during Bernanke's two days of testimony.

### Tightening next year should nudge rates up

Of course, a continuation of highly accommodative monetary policy is not good news for investors holding cash, at least over the near term. Rock-bottom interest rates on government securities and narrowing credit spreads already had reduced cash yields to the lowest levels in several decades. Yields on one-month Libor declined by another three basis points during the month to 0.28%, while three-month Libor fell by 12 basis points to 0.48%.

The Fed is likely to maintain the status quo on monetary policy until at least the middle of next year. However, we anticipate that cash yields will begin inching up as the onset of a new tightening cycle appears on the horizon. The higher yields that should follow the unwinding of the monetary stimulus will doubtless come as a welcome relief to savers who have borne the brunt of the U.S. government's efforts to support and revive the economy by dropping the price of money to virtually zero.

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Views are as of August 3, 2009, 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.

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 rates.

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