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Month in Cash: Same old, same old

September 1, 2010

Cash yields tumbled in August as a spate of disheartening economic statistics persuaded investors that higher benchmark interest rates were off the table for the foreseeable future. Although the downbeat reports were generally in line with expectations, they nonetheless portrayed an economy steadily losing momentum. A growing perception that the euro-zone's banking crisis was contained, if not resolved, also helped to push nominal yields and spreads lower.

With the U.S. government facing significant fiscal constraints, market participants were keenly attuned to two events involving monetary policy. Early in the month, the Federal Open Market Committee downgraded its assessment of economic conditions and voted to reinvest proceeds of maturing mortgage debt. Though the move did not represent a loosening of monetary conditions, it did delay the shrinkage of the Fed's hefty balance sheet. In late August, the annual gathering of the world's central bankers at Jackson Hole, Wyo., provided yet another window into the Fed's intentions. In a widely anticipated and parsed speech, Chairman Ben Bernanke indicated that risks to growth were skewed to the downside and that the Fed had monetary ammunition remaining to combat a further worsening of economic conditions despite policy rates that cannot be lowered below the present range of zero to 0.25%.



Deborah A. Cunningham

Libor tumbles across the board

The combination of weak economic data and the Fed's concerns about growth and employment triggered a major flattening of the cash-yield curve. The one-month London interbank offered rate (Libor) declined five basis points to 0.26%, three-month Libor cratered by 16 basis points to 0.30%, six-month Libor fell 15 basis points to 0.52% and 12-month Libor declined 20 basis points to 0.84%. At one point during the month, the yield on two-year Treasury notes—the security considered most sensitive to rate expectations—fell to an all-time low. Clearly, investors believe that the Fed will not raise policy rates this year, and perhaps not until 2012. Though we are not as pessimistic as the consensus, the Fed has telegraphed a willingness to err on the side of caution in providing monetary accommodation.

With investors discounting what amounts to a worst-case scenario, it has become increasingly difficult to find value in the cash marketplace. As such, we are concentrating new purchases in floating rate securities and those maturing within three months. As its name implies, the floating rate sector includes paper whose yields are reset to a short-term benchmark, thus providing potential upside if economic circumstances turn out to be less dire than is widely believed.

Relatively speaking, T-bills and repos hold up

There were two tiny glints of "non bad" news for cash investors during the month. First, it was disclosed that the Fed's new purchases of Treasury securities will not take place within the bill market; had that been the central bank's plan, yields on T-bills would have plunged to zero or below. Also, a sharp pickup in the supply of Treasury and agency paper indirectly helped elevate—albeit modestly—repo rates to near the 25 basis point upper end of the target range for fed funds.

Views are as of September 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 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.

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