Commentary
Global Cash Management

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Market Forecast

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The second half of 2021 could prove both dull and exciting, depending on a variety of factors: debt ceiling resolution, a taper tantrum, money fund regulation, and crypto or stable coins. In the first half of the year, we saw continued growth in cash holdings. With those cash increases, came challenges of excessive balances presenting to both banks and money market funds. The Federal Reserve's (Fed) Quantitative Easing purchase program continues to add approximately $120 billion of new reserves (cash) each month and the money markets have reached a point of saturation that could pose a problem. How is too much cash a problem? Banks can no longer store funds for their clients due to swelling balance sheets and the impact of required regulatory capital and liquidity ratios. Some of this cash has flowed into money market funds and other short-term debt investments causing certain rates to reach zero and negative yields. As investors continue to seek returns above zero, they reach out on the duration curve and down the credit curve. This additional risk could pose a challenge should rates become more volatile.

The Fed: There were no big surprises at the Federal Open Market Committee (FOMC) meeting last month. As is typical, the committee tried to downplay any subtle changes to their standard language. In fact, when speaking to a change in policy language, Chair Powell noted, "you can expect us to drag our feet a little on that, because that is what you do with statement language". We could not help but laugh and remember the famous Alan Greenspan (Fed Chair from 1987 to 2006) quote: "I know you think you understand what you thought I said, but I'm not sure you realize that what you heard is not what I meant." Thus marks the plight of those trying to read between the lines and forecast what the FOMC will do at future meetings. There were some hawkishness to some of the data and Chair Powell cautioned on applying too much weight to the "dots". This can't be over emphasized: the dots are estimates and estimates can change depending on the economic data.

Key takeaways and what to expect:

- The median forecast for the end of 2023 climbed 50 basis points (bps) — from 0.125% to 0.625% — versus an expectation of only one hike in 2023. There is hope of a future rate hike.

- The Fed talked about talking about tapering. I expect a September announcement that their asset purchase program will begin to wind down in January 2022.

- We saw a big jump in near-term inflation forecast, but 2022 and 2023 remained virtually the same, implying their view of inflation as transitory but perhaps now over a longer period of time. Chair Powell sounded more open to upside inflation risks but continues to lean on 'transient'. We don't see inflation as a near-term or long-term risk.

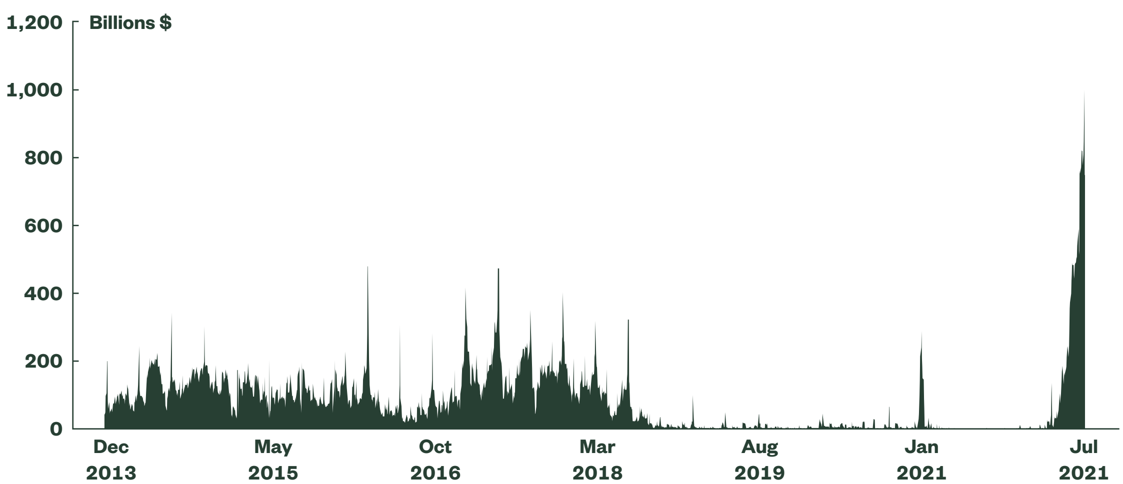
- The Fed's statement showed few changes, albeit a slightly more positive spin on economic growth. Emerging from the COVID-19 lock down will be long and challenging for certain sectors.

- The Board of Governors voted unanimously to raise IOER and ON RRP by 5bps. Thank goodness!

The FOMC's next meeting is July 28th. We don't expect much news from that meeting but would anticipate additional discussion around tapering of the asset purchase program. Also keep an eye on the Jackson Hole Symposium; this would be a good venue to hint at the taper of purchases. The September FOMC meeting is a good time to announce the wind down of the program in January of 2022. We would expect a reduction of $10 billion per month over 12 months in equal proportions ($7 billion US Treasury and $3 billion MBS). We would not anticipate any accelerated reduction in MBS over Treasuries or on any particular part of the US Treasury curve.

Outlook: The rates outlook in the cash markets will be more of what we saw in the first half of the year. Although the Fed Funds Futures curve has steepened in 2023, providing some hope of a rate hike, the near-term prospects of any lift-off are dim. Treasury bill (T-Bill) supply might provide a glimmer of hope for some upward rates pressure. Some estimate there could be an additional $300 billion in new supply in the second half of the year, but not before a debt ceiling resolution! Even with that supply, it seems unlikely that short-term bill rates could move materially higher without another tweak in the RRP. After the RRP adjustment, 1-month T-Bill yields were higher by 2bps but as of this writing they are almost 5bps higher from their lows in May. One-year T-Bills are only 3bps higher from their lows in May at the time of this writing; there is simply too much demand. The take-up at the Fed's RRP (the Fed receives cash and pledges US Treasuries) will remain very large. Currently we are seeing daily volume significantly higher than the previous zero interest rate cycle with volumes reaching a record of $991 billion on the June 30 quarter-end (Figure 1).

Figure 1
Fed's Reverse Repo Allotment (Since Inception)

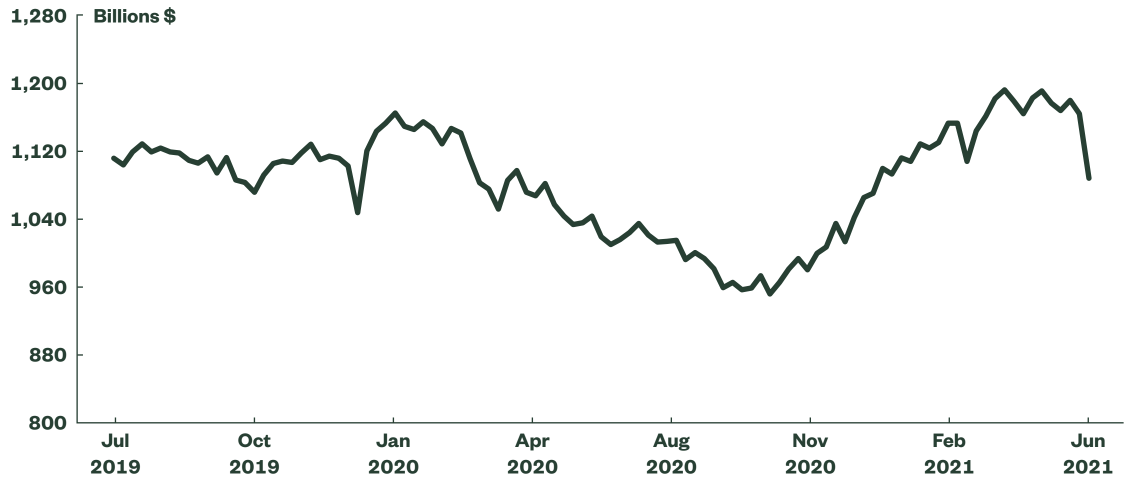


Source: Federal Reserve and Bloomberg as of July 2, 2021.

It seems odd that the Fed's purchase program puts cash into the market ($120 billion per month) and then the Fed's RRP takes cash back out of the market (over $600 billion on average per day in the month of June), in such staggering quantities. At what point does this exchange start to decline? Perhaps not until the Fed begins to shrink their balance sheet or the private and public sector start to spend their accumulation of cash.

The credit market has also seen dramatic demand that has caused yields to reach all-time lows. The 3-month Libor index reached a historic low of 0.118 on June 14th. Since the Fed raised RRP and IOR by 5bps, yields have risen but only modestly; 3-month Libor was 0.145 on June 30. All the while, outstanding commercial paper (CP) debt has risen. Over the past nine months the CP market has grown by almost $300 billion at its peak before contracting to $1.16 billion at month-end (Figure 2).

Figure 2
Total CP Outstanding



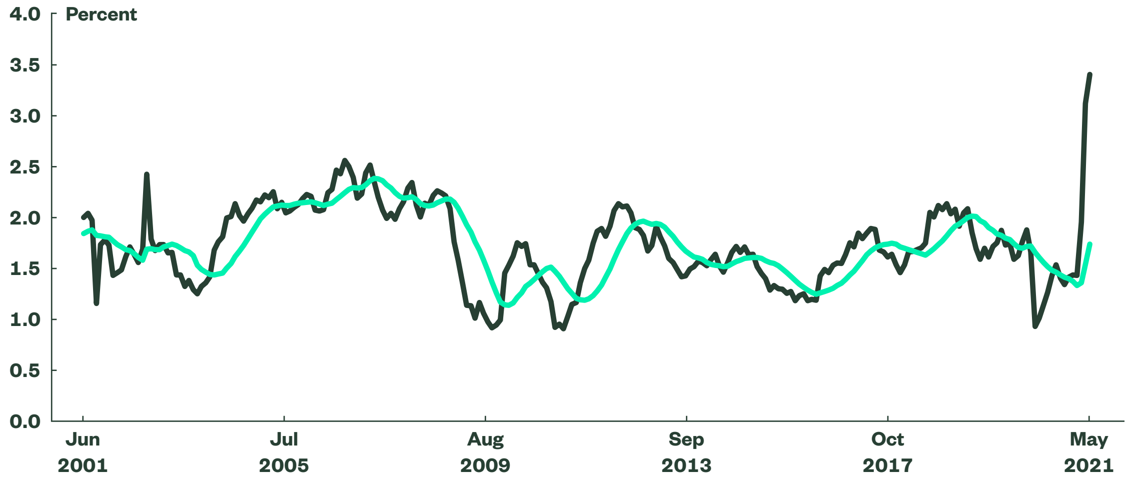
Source: Federal Reserve and Bloomberg as of June 30, 2021.

So with additional supply, why are rates falling? There is speculation that there is a new buyer in the market: stable coins, also known as token currencies. Token currencies are new to the capital markets. They have a hard currency backing them (like USD or EUR) but allow users to trade that token currency on distributed ledger exchanges. They are different from crypto currencies but often trade in 'pairs' (one token with one crypto). Crypto currencies do not have any assets backing them and their value is based on demand (like baseball cards or Beanie Babies, for those old enough to remember). One token currency that has been in the spotlight and received some attention from regulators is Tether. A **recent presentation by Boston Fed President Eric Rosengren,** noted that Tether owns approximately $20 billion of CP (the asset that backs their token), making Tether the second largest CP investor. We will be watching this space closely over the coming months and years, both for the risks that it poses but also the opportunities that might come. Could a money market fund back a token, allowing a more dynamic exchange of value? We will see.

Economic Data: There remains significant noise in economic data. The sudden stop and, seemingly, sudden start in certain sectors of the economy have wreaked havoc on the data. It will take a long time for this to smooth out to pre-COVID norms. We will continue to focus on the employment gains (payroll) and decline in the **unemployment rate.** As we have said many times, the Fed's new policy framework puts more emphasis on employment and less on inflation, given the number of years inflation has remained below the 2% target (Figure 3).

Figure 3
Personal Consumption Expenditures, 20 years

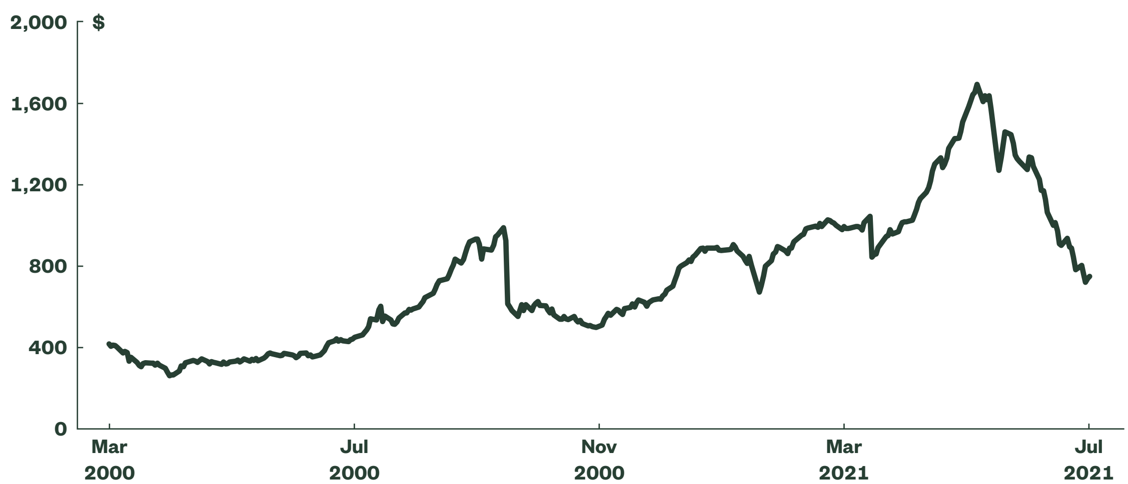
PCE Core YOY%
1y Average



Source: BLS and Bloomberg as of July 1, 2021.

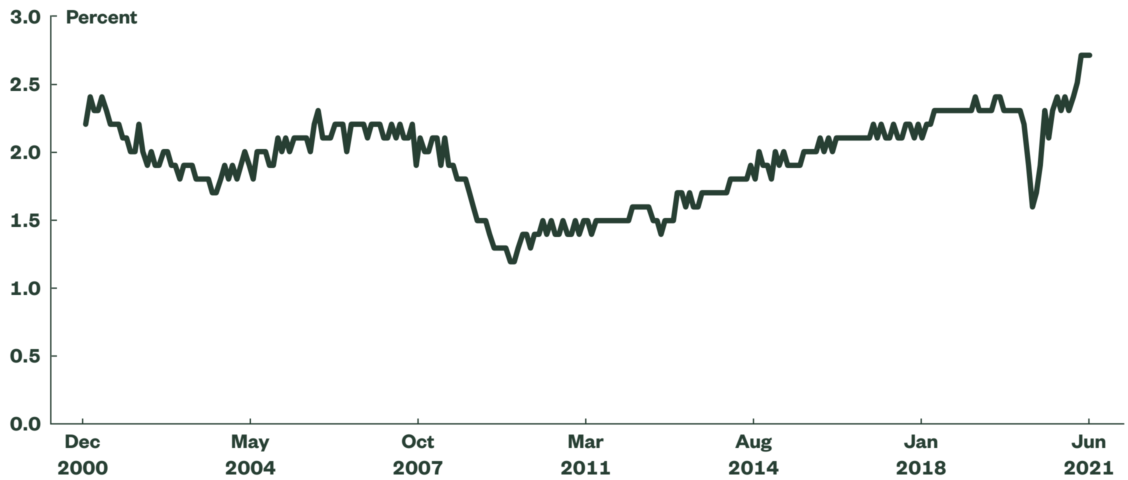
And although the rise in inflation data has our attention we can already see signs of price pressure subsiding, notably in lumber (Figure 4) and some of the froth coming out of the housing sector. A person only has to rebuild their deck or renovate a kitchen, once every so often or during COVID lockdown and thus the increase in activity around home improvement. This means the supply chain bottlenecks should decline as people resume their pre-COVID routines. But the question on people's mind is one of wage inflation. Is there evidence of persistent and sustainable wage inflation? Anecdotes of these increases are everywhere but it's unclear if they will materialize in the data. Since the Global Financial Crisis the employee has been timid to ask for a raise, with job safety fears outweighing more income. Perhaps there has been a shift, or the beginning of a shift, for the employee to ask for a higher wage? The Quit (resignation) Rate might be a good indicator as it reaches a two decade high (Figure 5). First, we must see what happens as certain unemployment benefits expire. We have seen some employment growth follow and with most of the additional unemployment benefits expiring this fall, we should see continued growth in the labor force.

Figure 4
First Lumber Contract



Source: Chicago Mercantile Exchange and Bloomberg as of July 2, 2021.

Figure 5
Quit Rate



Source: BLS and Bloomberg as of July 1, 2021.

Politics and Policy: The central focus for the money market investor will be the debt ceiling resolution. The current thinking is a resolution will not be reached before the August recess but will be reached in September. That leaves the Treasury with about $850 billion of spending room going into August. It is expected that the $850 billion could last until mid-October before the Treasury would have a technical default. Let's hope for a painless resolution in September.

Another key focus will be prime and municipal money market fund reform. There is expectation that the SEC will make an announcement prior to their regulatory agenda date of April 2022, and perhaps as early as Q4 this year. There is broad consensus among industry participants that a decoupling of liquidity gates and redemption fees from the weekly liquid asset metric is necessary. We agree, but are feeling less confident in the belief that prime funds survive this round of reform given recent headlines by Eric Rosengren. "The money-market fund reform that occurred after the last crisis actually made things worse and so far there has not been a solution," Rosengren said, adding that prime money-market funds "need to be cleaned up." Randy Quarles also noted: "The March [2020] market turmoil is the second time in roughly a decade that we have witnessed destabilizing runs on MMFs. More concerning this time, however, is that we had taken steps between these events precisely to reduce the likelihood of such runs." The Financial Stability Board published **their report** with Quarles further stating, "that will set out consequential policy proposals to improve MMF resilience". Could capital and liquidity buffers or swing pricing be in our future?

Lastly the fiscal spending continues. It appears the latest stimulus bill may be passed before the August recess but it is not a lock. Republicans have seen most of their core demands met. The deal at $579 billion is much smaller than what the Democrats wanted and primarily focused on physical infrastructure. The issue of who will pay for this is still being negotiated. This deal should be good for the Fed, if passed. It will give them the confidence to begin their tapering in the new year as spending will continue support the economic recovery. How the spending continues is unclear and we will not wade into those speculative waters.

Money Markets: Money market funds have been the beneficiary of the technical adjustment in short-term rates (RRP and IOR) but thus far it has failed to affect fund yields. A few funds have adjusted their waivers so their yields are higher, but the vast majority of fund yields have remained unchanged at their previous floors. All money market funds still have some fee waiver in place. We would not expect another adjustment in RRP or IOR until the FOMC begins raising their Monetary Policy rate. In the meantime, there is some relief for fund companies to operate off of zero and the negative rates are gone, at least for the near term.

Government money market fund weighted average maturities (WAM) grew shorter in the first half of the year. As the curve continued to flatten it did not make as much sense to chase yields further out on the curve. Weighted average lives (WAL, maturity duration) also shrank but only by a few days. We would expect these durations to lengthen over the course of the second half of the year. If the Fed has made their technical rate adjustment there could be selective buying opportunities. Prime money market funds saw very little change to their WAM and WAL over the course of the first six months of the year. With credit spreads at historic tight levels it does not make sense to chase yield. As specific opportunities present themselves we will invest, otherwise hold ground and wait.

Conclusion

The next six months will have three significant events that could disrupt the money markets. We see the probability of disruption as remote in all three. First, debt ceiling resolution: we have been here before, have not seen a technical default, and this time should be no different. Expect a resolution sometime in September. Second, the taper announcement could come as early as September but as late as December's FOMC meeting. We do not expect the timing to change and the wind down of asset purchases should start in January 2022. Depending on this timing, we could see some volatility in Treasury yields although we don't expect much impact in T-Bill yields. And lastly, prime fund regulation, which could impact commercial paper markets negatively and push yields higher. As the end of the year approaches, it will be less likely to hear an announcement as the SEC will not want to impact CP funding costs over year-end.

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* This figure is presented as of March 31, 2021 and includes approximately $60.33 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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