Commentary
Cash

July 2021

Monthly Cash Review

With July's headlines focused on the Delta variant and the potential impact on the economy, the Federal Reserve's (the Fed) views on the economic reopening and subsequent further impacts on their QE program and inflation concerns did not shift materially during their FOMC meeting.

Thus far the surge in confirmed cases of the Delta variant does not seem to be impacting economic output or market sentiment. Equity markets continue to surge with the S&P 500 Index and the NASDAQ maintaining their year-to-date high valuations, while investment grade and high yield corporate indices have come off their beginning of month tights. US Treasury yields also portray a slightly more cautious outlook as the 10-year yield touched a three-month low of 1.19% on July 19th before closing at 1.22% on month-end. Why are yields so low? Chair Powell had this comment: "In terms of what's been happening in bond markets, I don't think there's a real consensus on what explains the moves between the last meeting and this meeting. We've seen long-term yields go down significantly. Some of it is a fall in real yields, which may have been connected to sentiment around the delta variant and concern about growth. There was also some decline in inflation compensation, which has significantly reversed. And there's also so-called technical factors, which is where you put things that you can't explain." Perhaps 10-year yields are pricing in unforeseen risk in the economic reopening or perhaps just recognizing that inflation concerns should not be as high as some previously believed. Although the reopening has run into challenges, we can see how certain inflationary pressures are subsiding (e.g., lumber prices) and unsustainable (e.g., used cars).

The month's FOMC meeting and press conference added heightened attention to the Fed's plans to taper their asset purchase program. The minutes of the June meeting noted some committee members thought the taper could happen sooner and, perhaps, at a more accelerated pace. However, in Powell's press conference he noted that the standard of "substantial further progress" is still "a ways off". He also noted there is "little support" for tapering mortgage-backed securities (MBS) purchases before Treasuries, adding that he thinks the Fed will taper them "at the same time". Based on these comments and a Bloomberg survey of economists (Figure 1) we should expect a real hint at tapering in September, with a proper announcement and a commencement of the tapering program in December and January, respectively. We'd expect a level of $10 billion per month, split between Treasury ($7 billion) and MBS ($3 billion), over a 12 month time period.

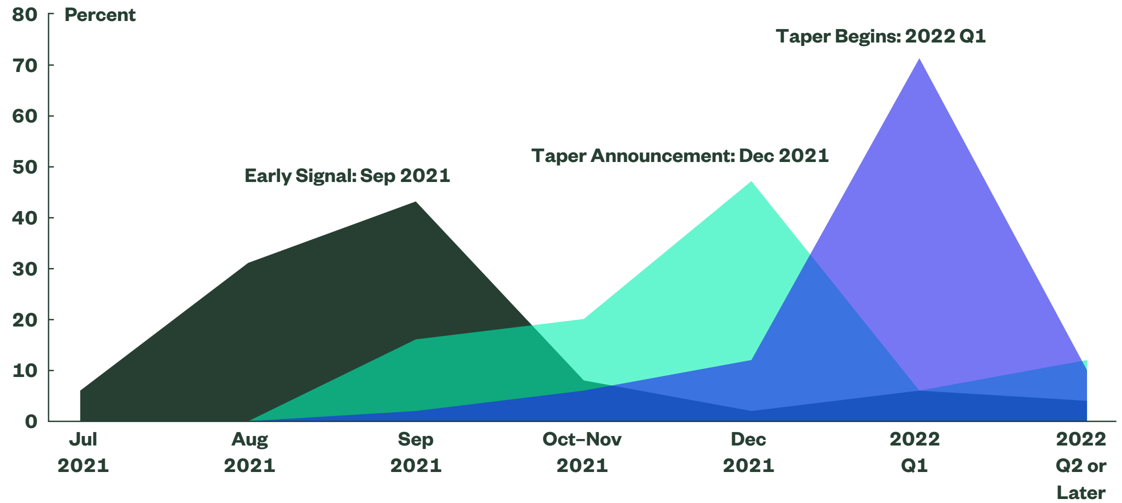
The Fed also formally announced two standing repo facilities at their July meeting. Most market participants assumed this was coming and, in fact, a facility was in place but not formalized. The announcement confirmed the Fed is ready to be the lender of last resort in the event of another funding crisis like we saw in September of 2019. One facility will have a maximum operational size of $500 billion and will fund initially at 25bp, somewhat above the general level of overnight interest rates for primary dealers. This rate is dynamic and will be adjusted as conditions warrant, similar to the rate set on the Fed's RRP and what they pay on required and excess reserves. It's expected that over time the program will be expanded to include more banks. The second, FIMA, allows foreign central banks and sovereign authorities to loan Treasury collateral to the Fed at a rate of 25bps. Both of these programs are intended to relieve the stress we saw on the demand for dollars during the month of March 2020.

Politics and Policy

There continues to be forward progress on the new bipartisan infrastructure bill. Although still a long way off, the progress is incremental and could further the economic stimulus and drive growth. GDP came in weaker than expected in July — 6.5% due to inventory draw down — although personal consumption rose more than expected at +11.8% quarter-over-quarter. Overall signs point to clear economic growth that will come in substantially above historical averages in the long-term.

Money markets were broadly unchanged over the course of the month. The technical adjustment that was implemented at the Fed's June meeting has been absorbed by the market and yields on rates and credit did not move materially. Durations of the funds were also largely unchanged over the course of the month.

Figure 1
Percentage of Bloomberg Survey Results for Timing of Taper Events



Source: Bloomberg Survey as of July 23, 2021. Number of surveyed economists = 51.

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