Commentary
Global Cash Management

Q2 2020

Market Forecast

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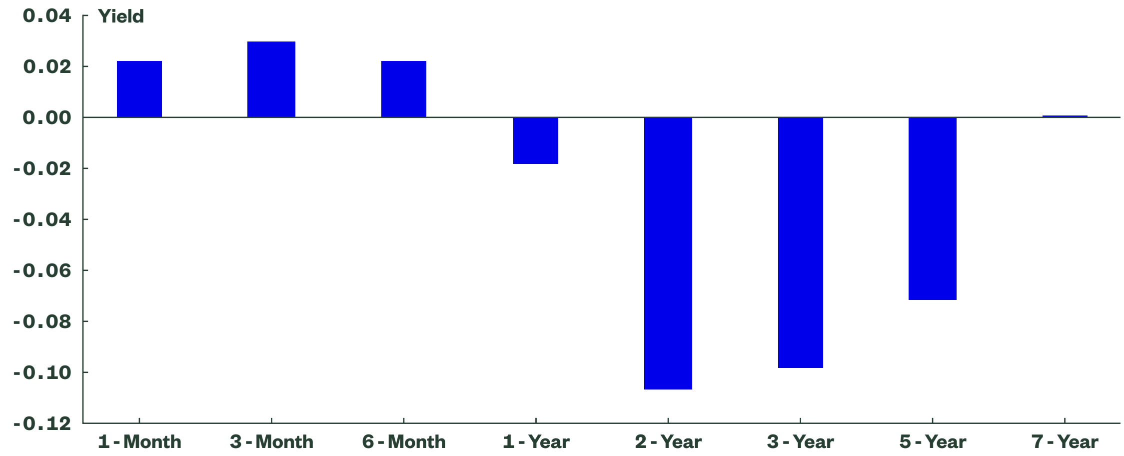
As COVID-19 caused a global economic shut down in the first quarter of the year and a partial reopening in the second quarter, we recognize that the resurgence of infections is forcing many to reshape their outlook on economic activity. Uncertainty will be the theme for the next six months.

The first half of the year's challenges have highlighted how difficult it will be to create a clear path forward. In the last 100 years, 2020 will certainly be one of the most challenging. The economic recovery we have seen in some of the data has the potential to be the start of better things, but it could also just be a partial snap back of the severe downturn we saw in March and April. The good news is with each passing day we learn more about the virus and through this knowledge we can better understand how to get back to business. Fortunately, central banks and governments around the world have pulled out all the stops and continue to impress upon us that they are not done supporting businesses and individuals. More monetary and fiscal stimulus is in the works and is expected to follow the news cycle. However, there are other questions on cash investors' minds that cannot be ignored, most importantly questions of market liquidity and the possibility of negative rates.

NEGATIVE RATES in Europe, the US and UK We have spent a lot of time listening to central bank governors in the US and UK talk about negative rates. To date it appears both banks will not be implementing a negative rate policy. The members of Federal Reserve's (Fed) FOMC seem aligned and consistent in their view that negative rates are not something they plan to implement in the near- or intermediate-term. We have also heard from each of the Fed Regional Bank Presidents, none having shown support for implementing a negative rates policy. We wrote a short piece explaining why **here**.

The Bank of England (BOE) has not been as consistent in their views on negative interest rates. The message from the BOE's leadership has been mixed, resulting in conflicting messages from members that have, at times, caused volatility in market yields. More recently, the BOE played down negative interest rate policy from the most recent Monetary Policy Committee meeting in June, with the message, "the use of negative interest rates did not come up in policy discussions," although the governor was careful not to rule anything out. Voting on policy at the June meeting was unanimous, deciding 9–0 to hold rates after slashing rates in March.

Figure 1
UK GILT Yields



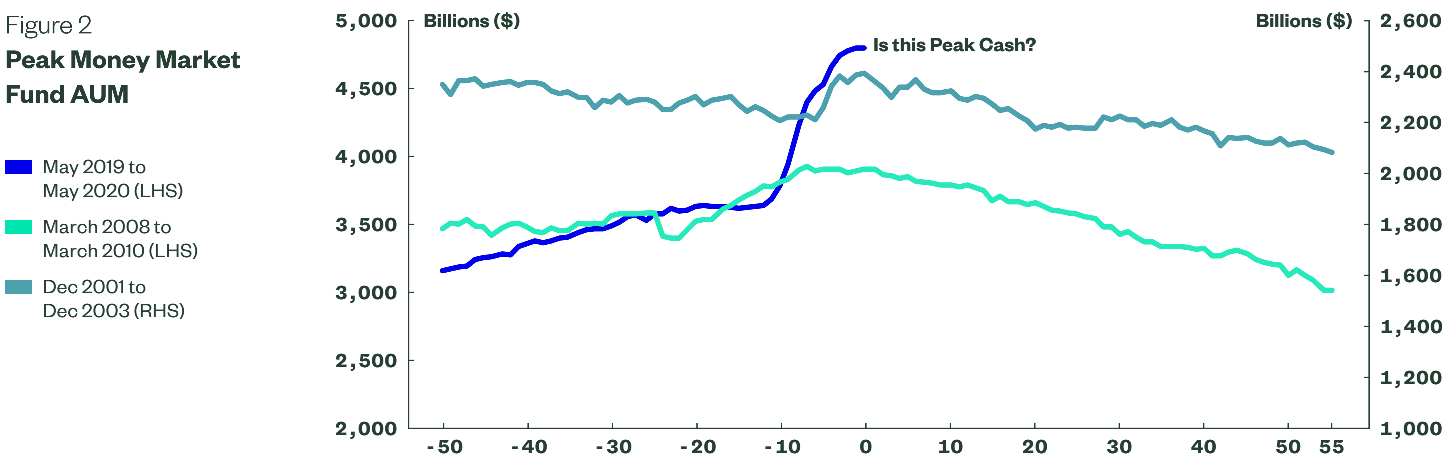
Source: Bloomberg as of July 12, 2020.

As of this writing, UK GILT yields are negative out to seven years and the money market curve first shows a negative element in May 2021. Clearly the market believes negative policy rates are a real possibility in the UK.

The European Central Bank (ECB) continues to live with negative policy rates. Many experts will argue it has been counterproductive and has put a larger strain on the banking and capital markets systems while other experts will stand by the importance of negative rates to stimulate economic growth and boost inflation. Market rates don't indicate the ECB has plans to move their policy higher or lower in the near term. However, as we have seen in the past, markets can change as quickly as the words leave the lips of banking officials.

FLOWS AND SUPPLY There has been an extraordinary amount of cash amassed on corporate balance sheets over the first six months of the year. Liquidity was critical in the first quarter of the year after March's crisis, and the second quarter was spent building up that liquidity and ensuring there was plenty of it.

Figure 2
Peak Money Market Fund AUM



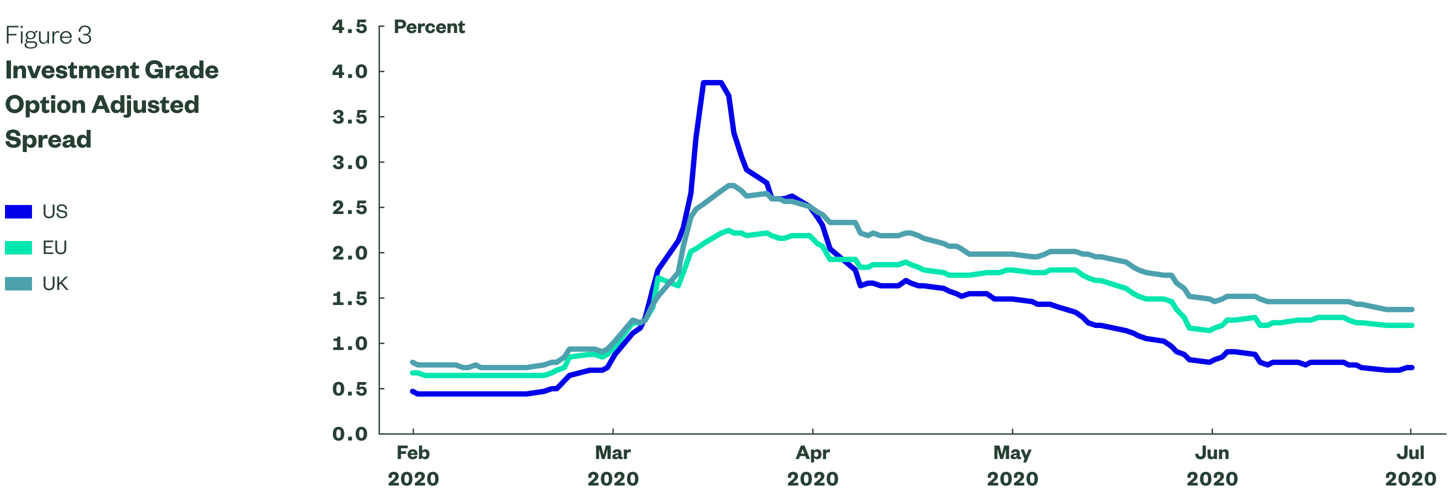
Source: ICI as of June 30, 2020.

The results were staggering: US money market funds saw more than $1 trillion in growth in a two month period while European money market funds saw similar growth. Based on the past six weeks of data, it appears that growth has finally come to a stopping point and we have reached peak cash. This is not dissimilar to what was seen in 2008-2009 during the Global Financial Crisis. Based on past data, we would expect to see cash be redistributed and reinvested into the economy over the next few months to a year. But is this time different? The unknown path of the virus' infection rate has created heightened uncertainty and could lead to prolonged elevated cash holdings.

Supply remains shocking with debt levels beyond eye popping, to the point where one would seriously question if there would ever be a plan to pay it back. US Treasury bills outstanding debt has increased by $2 trillion over the past three months. The growth in bill issuances is mostly accountable for the more than $19 trillion in total US Treasury debt. As a point of reference, in July 2008 there was $4.8 trillion of US Treasury debt outstanding. The UK is not far off on a growth basis. In July 2008, total central government debt stood at £655 billion and is now over £2 trillion. Central banks have stepped up to absorb the glut of supply and created what looks like the start of, or perhaps the move towards, modern monetary theory. Are we witnessing helicopter money? The Fed's balance sheet has increased by 80% from a year ago, while the BOE's has increased by 42% and the ECB by 34% across the same time period. We expect all those numbers will continue to grow in the second half of the year.

CREDIT SPREADS The rally in credit spreads since the depths of the liquidity crisis (March 23) has been nothing short of remarkable. The liquidity programs introduced by the Fed were instrumental in turning sentiment. The market continues to rely on these programs to support current market levels, even if only as an emergency backstop. Three-month commercial paper rates have improved by 175 basis points (bps) versus Treasuries from the end of March to today. Three-month USD Libor has improved by 118bps over the same period.

Figure 3
Investment Grade Option Adjusted Spread



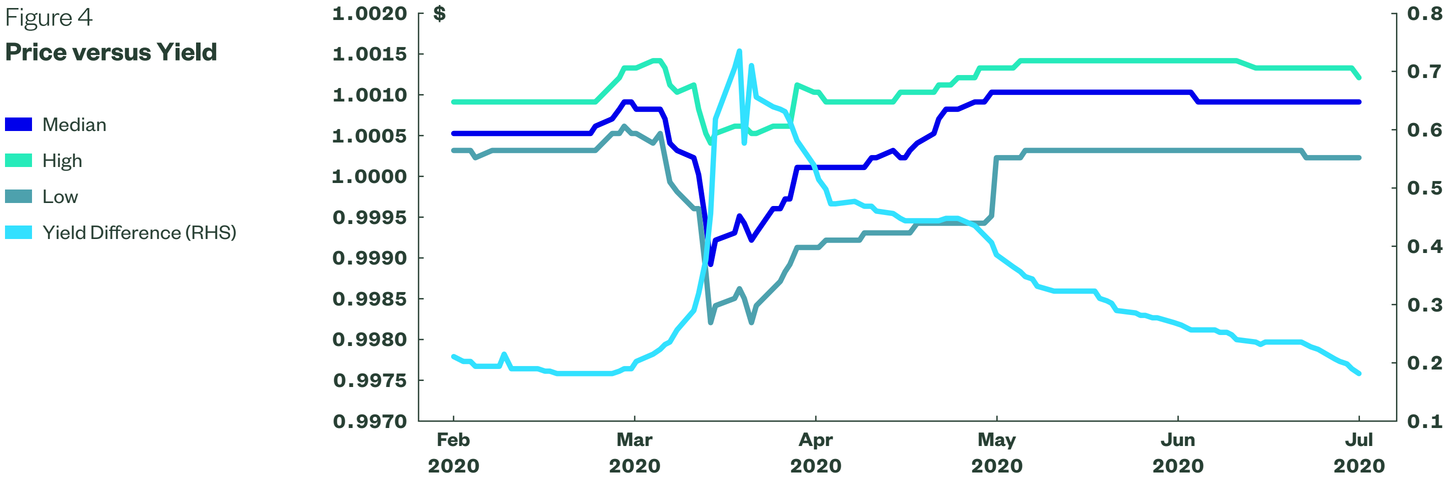
Source: Bloomberg Barclays Index as of July 12, 2020.

A bit further out the curve, the Bloomberg Barclays 1–3 Month Investment Grade US Credit spread has improved by 322bps while the Bloomberg Barclays European Investment Grade 1–3 Year Credit spread has improved by 100bps (+187 to +87). But are we priced for perfection? There has been much discussion over recent valuations in risk assets and questions if they are considering all of the factors that could be in store over the next six months. A credit spread shock is not expected, but a more gradual repricing of risk assets is not out of the question as the result of the longer timeline COVID-19 will have on economic output and growth. Currently it appears that fiscal and monetary stimulus are working to soften the economic damage, but the reopening of the economy is happening more slowly than some would have anticipated or liked. Defensive positioning will remain a top priority in credit portfolios.

US dollar prime funds, both US-domiciled and European-domiciled, have come under significant scrutiny since March 2020. Two large US asset managers chose to provide liquidity through asset purchases to their funds during the month of March and separately, two large US asset managers chose to close and liquidate their Institutional Prime money market funds. Both events caused quite a buzz in the markets with the obvious question being raised: what is the future of prime funds? As Mark Twain once said, “The reports of my death have been greatly exaggerated,” and we suspect the same is true for prime funds. Although there will be considerable discussion by investors, fund providers and regulators, we would expect that both US and European prime strategies will continue to exist but also anticipate changes coming. In Europe, the Institutional Money Market Fund Association is expected to review the rules that govern European money market funds in 2022. This seems a long way off, but you can be sure some of those discussions have already begun. We expect a draft of revisions to be released in the next six to 12 months. This could mean the future of LVNAV is in question. Originally thought to be a good middle ground between variable NAV and stable NAV, the LVNAV structure highlighted challenges that still exist with stable NAV products. USD investors have also showed their heightened sensitivity to prime strategies — clearly the memories of the Reserve Fund of 2008 remain fresh. US-domiciled prime funds did see significant outflows but the variable NAV of the Institutional funds allowed investors to redeem at market rates, preventing the “stealing of liquidity” that plagued the funds in 2008. But even with the pricing mechanism working, there remained liquidity issues in the market, resulting in the reliance on the Fed’s Money Market Liquidity Facility. We suspect that market participants, central banks and regulators will discuss and debate what can be done to help relieve the challenges of liquidity or eliminate the stigma that Prime money market funds still operate under. It is important to note that we operate other Prime-like money market funds that did not experience the outflows that our Institutional Prime fund experienced.

As investors evaluate the merits of investing in Prime strategies, they have real data to help them make that decision. The weeks in March and April and the resulting stresses placed on Prime strategies have provided excellent data for analyses.

Figure 4
Price versus Yield



Source: Bloomberg as of July 12, 2020.

Figure 4 shows the NAV of Institutional Prime money market funds versus the yield advantage over a Government money market fund. As the spread between a Prime and Government strategy continue to compress, the current yield differential is approximately 18bps as of July 12, some will determine there is not enough value to warrant the investment while others will conclude the value remains.

LIBOR The Libor transition continues to be a lively discussion. Many thought the pandemic would slow the roll out of the new reference rates and the eventual conversion away from Libor but regulators seem steadfast in their timeline and desire to move off the Libor Benchmark. Cash investors have been encouraged to understand what the fall back language is on the bonds they are currently invested in. As the calendar draws closer to December 2021, when Libor submitting banks will no longer be required to submit Libor levels, we will be evaluating the market to determine what is best for our investors. It is important to note that we have a fiduciary obligation to our investors. If there is floating rate debt issuance using Libor as the index we will evaluate investments in the context of the market and other indexes, ready to purchase what is best for our investors and the strategy. We would consider the maturity of this instrument, if that maturity occurs beyond December 2021, and what the alternative terms are if the Libor index ceases to exist. Separately, there continues to be discussion over other credit indexes as potential substitutions for Libor. To date there do not appear to be any viable candidates.

Our Four Focus Themes for the Second Half of 2020:

1. Ensure you have the right kind of liquidity to handle stressed markets. We learned valuable lessons in March; not all liquidity is equal. By using that month's data as a benchmark, you can stress your current portfolio to ensure you have the right type of liquidity.
2. Credit conditions have dramatically improved but we are not yet on the road to recovery. Considerable uncertainty remain around economic growth and the labor market recovery. One company's cut is another company's revenue; remain defensive.
3. Fiscal and monetary support remain unwavering. While we are moving towards a new paradigm of big government, big debt and big balance sheet, it is not as scary as it appears.
4. Regulation and rules will continue to change and evolve. Expect further constraints placed on how cash is invested and how liquidity is managed in the money markets.

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* This figure is presented as of March 31, 2020 and includes approximately $51.62 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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