Commentary
Currency & Cash

July, 2021

Monthly Cash Review

State Street EUR Liquidity LVNAV Fund

Economic releases in July continued to reflect the improving landscape as activity ramped up against the backdrop of a quickening vaccination rollout. Notwithstanding this improvement and the parallel pickup in inflationary pressures, the European Central Bank maintained a dovish outlook, adopting a new inflation target and indicating a willingness to keep interest rates at current levels for an extended period, Market rates declined through the month.

Policy

The Governing Council of the European Central Bank (ECB) met on 22 July, keeping rates unchanged as expected but it made significant changes to its forward guidance on interest rates to reflect its latest strategy review. The deposit rate thus remains at -0.50%, the main refinancing rate at 0%, and the marginal lending rate at 0.25%. The Pandemic Emergency Purchase Program (PEPP) remains at €1.850 trillion until at least March 2022, with the Asset Purchase Program unchanged at €20 billion per month. In support of the target, the ECB expects its key interest rates to remain at their current or lower levels until it sees inflation reaching 2% well ahead of the end of its so-called projection horizon and durably for the rest of the period. The ECB said this "may also imply a transitory period in which inflation is moderately above target." ECB President Christine Lagarde referred to "this element of patience" and said the new guidance is "intended to avoid premature tightening that would be detrimental to the economy". President Lagarde's remarks "by past experience and by most recent history" call to mind when the ECB raised borrowing costs in 2011 to curb inflation, an action which was then quickly reversed in the same year as the euro-debt crisis developed.

From the minutes of the Council meeting, there was broad agreement to continue PEPP purchases at a higher pace in Q3, although some members wanted to slow the pace. President Lagarde advised that the Council were unanimous that the forward guidance had to be changed to be aligned with strategy and that an overwhelming majority supported this. Earlier in the month, the ECB completed its monetary policy strategic review, adopting a symmetric 2% inflation target, amending its previous aim of keeping inflation "near but just below 2%".

Outlook

The ECB's new monetary policy measures reinforce the ECB's efforts to keep ultra-loose policy, including record low negative interest rates, in place for as long as needed. This certainly sets it apart from some of the world's central banks. The next council meeting is on 9 September and market expectations are that the ECB will potentially face a heated debate on whether to provide more monetary stimulus in the form of more asset purchases. The ECB's tone about the economy was more upbeat, hinting at new upward revisions to GDP growth and inflation projections for September. At the end of July, the futures markets were pricing in a 23% probability that the overnight rate will be around two basis points (bps) lower by July next year, with market expectations of higher rates being pushed out by a further year to summer 2024, perhaps even into 2025.

Data

The eurozone economy grew faster than expected, with the initial estimate of second quarter GDP growth of 2% quarter-on-quarter (q/q), 13.7% year-on-year (y/y). Amongst the major economies, the southern countries rebounded with force; Spain grew by 2.8%, stronger than median forecasts of 2.1%; Italy grew 2%, beating analysts' median forecast of 1.3%; Germany grew 1.5% q/q, lower than median forecasts of 2%; France grew by 0.9% q/q, close to forecasts of 0.8%. The ECB's latest economic growth projections are for 4.7% in 2021, 4.7% in 2022 and 2.1% in 2023.

The eurozone's headline inflation rate rose to 2.2% in July from 1.9% in June. Although above the ECB's target, this will not cause the ECB alarm as they have already warned of a temporary spike — energy prices were the driving factor in the latest inflation number, rising 14.1% y/y. Additionally, base effects from the end of Germany's temporary VAT rate cut and rising food costs contributed to the increase, with Germany's harmonised inflation increasing from 2.1% in June to 3.1% in July. Core inflation (which excludes energy) eased from 0.9% in June to 0.7% in July. Looking ahead, eurozone inflation is still likely to increase and possibly reach as high as 3% in the second half of 2021 — this is well above the ECB's target, but expectations are that the surge will be transitory. The latest ECB projections for HICP inflation are 1.9% for 2021, 1.5% in 2022 and 1.4% for 2023.

Unemployment in the euro area fell in June to 7.7%, down from an upwardly revised 8% in May; this was driven by the lifting of coronavirus restrictions and the reopening of businesses in the services sector. Amongst the largest euro area economies, the highest jobless rates were recorded in Spain (15.1%), Italy (9.7%) and France (7.3%), while the lowest rates were recorded in the Netherlands (3.2%) and Germany (3.7%). The ECB's latest unemployment projections are for 8.2% for 2021, 7.9% for 2022 and 7.4% for 2023.

Eurozone data continued to indicate a strong expansion for Q2 and into Q3. Economic sentiment in the region maintained its improvement, rising to 119 in July (an historical high), from 117.9 in June. The eurozone composite purchasing managers' index (PMI) rose from 59.5 in June to 60.6 in July. The increase was entirely driven by the services sector with the steepest pace of expansion in the sector for 15 years, with the services PMI rising to 60.4 in July from 58.3 in June. The manufacturing PMI stood at 62.8, down slightly from 63.4 in June, as manufacturers continued to face supply side challenges. However, July's survey continued to highlight increasing inflationary pressures stemming from input costs reaching a new decade high due to supply shortages and higher energy costs. Eurozone industrial production declined by 1% in May, with the semiconductor shortage hitting car production. Production fell in the big four economies of the eurozone. Compared to pre-pandemic levels, production is down 1% in Italy, 1.5% in Spain, nearly 6% in France stalled and approx. 6% in Germany, with the auto industry impacted heavily. The German Ifo Business Climate Index reported a small decline to 100.8 in July, from a downwardly revised 101.7 in June, a surprising outcome given the strong PMI survey readings. The sectoral breakdown showed that the manufacturing, services and retail components all dipped in July, while the construction index edged up.

Markets

Rebounding economic growth and higher inflation continue to be the main themes influencing bond markets with investors looking for signs that global central banks may start to scale back stimulus measures, while recognising that the factors influencing inflation over the next few months may be temporary. In contrast, the ECB continues to step up their monthly asset purchases (averaging €80.328 billion in the second quarter compared to €62.160 billion in the first quarter) — July's purchases increased by an additional €7.6 billion to €87.557 billion. This suggest that the ECB has done some "front loading" with anticipation of an August lull, given the summer holidays and traditionally less market activity. Following the ECB's announcement that they will not be withdrawing emergency support too early, German two-year government yields continued to move lower, declining 10 bps to in the month to close July at -0.77%. At the longer end of the euro government bond market, German 10-year Bund yields started July at -0.20% before moving 26 bps lower through the month to close at -0.46%. Italian 10-year government yields followed suit, starting the month at 0.80% and then closing at 0.62%. The spread between 10-year Italy and Germany bond yields ended the month at around 108 bps.

Excess liquidity deposited with the ECB continued to increase, averaging €4.275 trillion in the month, with a high at €4.313 trillion on 14 July. The euro short-term rate (€STR) was stable through July, averaging a yield of -0.57%. Euribors recorded some small adjustments lower over the month: one-month Euribor averaged -0.56%; three-month Euribor averaged -0.55%; six-month Euribor averaged -0.52%; and one-year Euribor averaged -0.49%.

Euro cash overnight deposit rates ranged between -0.56% and -0.65% in the period. Government repo ranged from -0.60% to -0.62%. Euro-denominated core government bill yields ranged from -0.64% to -0.70%. Three-month French Treasury bills ranged from -0.64% to -0.70%.

Fund

At the fund level, the weighted average maturity (WAM) averaged 42 days in July. We selectively targeted high-quality credit issuers in the one-to-three-month duration range, with selective investments out to six months. Asset-backed paper continued to be in good supply, offering flexible duration and attractive returns compared to vanilla paper. Fund liquidity was covered with a combination of government and agency holdings, government/supranational repo and bank deposits. As always, liquidity and capital preservation remained the key drivers for the portfolio, with yield a distant third.

Source: State Street Global Advisors/ Bloomberg, 31 July 2021. The above targets are estimates based on certain assumptions and analysis made by Bloomberg. There is no guarantee that the estimates will be achieved.
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* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of June 30, 2021 and includes approximately $63.59 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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Switzerland: State Street Global Advisors AG, Beethovenstr. 19, CH-8027 Zurich. Registered with the Register of Commerce Zurich CHE-105.078.458. T: +41 (0)44 245 70 00. F: +41 (0)44 245 70 16.

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