Commentary
Cash

August 2020

Monthly Cash Review

State Street GBP Liquidity LVNAV Fund

The Bank of England held policy rates unchanged in August, and signalled no plans for now to introduce negative interest rates. Economic data in August showed further signs of recovery as the benefits from the easing in lockdown measures continued to be felt. Money markets remained buoyant, but yields continued to fall. Libor fixings across the 12-month curve hit new lows during the month.

Policy

The Governing Council of the European Central Bank (ECB) last met on 16 July, keeping policy and rates unchanged as expected: the deposit rate at -0.50%, the main refinancing rate at 0%, and the marginal lending rate at 0.25%. The Pandemic Emergency Purchase Program (PEPP) is unchanged from €1.35 trillion until at least June 2021, with the bank pledged to reinvest principal payments until at least the end of 2022, and longer if needed. The ECB acknowledged that they will continue doing what it thinks is needed, for as long and as strongly as needed, and that they would continue to provide ample liquidity through its refinancing operations. The minutes from the July meeting, highlight that the September meeting will be important as the council "would be in a better position to reassess the monetary policy stance and its policy tools".

Outlook

The minutes of the ECB meeting clearly highlighted that risks were skewed to the downside, even though signs of improvement have been seen. Headline inflation remains weak, wage growth has slowed significantly, and the currency has risen more than 7% over the last six months. The market doesn't expect the ECB to cut rates further at this stage, considering it more likely the bank will increase the PEPP purchases and perhaps innovate the TLTRO-IIIs before the end of the year. There have been some discussions that the ECB may review the tiering multiplier linked to excess bank reserves held with the bank. The ECB meets on 10 September with expectations for policy to remain unchanged; changes are more likely to be announced in December. We are seeing a 37% probability for overnight rates being around three basis points (bps) lower by July 2021.

Data

Eurozone GDP for the second quarter was aligned to consensus, following up a -3.6% fall in Q1 with a -12.1% contraction, quarter-over-quarter (q/q). On a national level, the biggest contraction was in Spain (-18.5% q/q), followed by France (-13.8%), Italy (-12.4%) and Germany (-10.1%). Market expectations for Eurozone GDP data in Q3 suggest that we should see q/q growth of close to 10%. The ECB's latest projections envisage the economy contracting by -8.7% in 2020, followed by a strong recovery of 5.2% in 2021 and 3.3% in 2022.

Eurozone headline annual inflation turned negative for the first time in four years, falling by -0.2%. The core rate (which excludes energy, food and tobacco) also hit a record low in falling to 0.4% in August; this was down from 1.2% in July, dragged lower by the discounting during the summer sales. German inflation came in at 0% year-on-year, reflecting the low energy prices and the recent VAT rate cut, with the deflationary threat more pressing than any inflationary one. The ECB expects the inflation outlook to be disinflationary, with the headline forecast at 0.3% for 2020 (down from 1.2% in 2019), 0.8% for 2021 and 1.3% for 2022. These are well below the bank's stated target of "close to 2%".

Unemployment in the euro area increased to 7.9% in July, up from 7.8% in June. The ECB's latest projections for unemployment are 9.1% for 2020 (up from 7.6% in its March forecast), 10.1% for 2021 and 9.1% for 2021. Short-time work schemes have kept unemployment artificially low throughout the lockdown period and we expect jobless numbers to continue to rise for some time. Germany has extended their wage compensation to the end of 2021 (which will cost the government approx. an extra €10 billion). About 5.6 million people were receiving benefits in July (down from 7 million in May) in Germany and the unemployment rate stands at 4.2%. France has extended its assistance programme until early 2022 and Italy has requested €28 billion from the EU's SURE (Support to mitigate Unemployment Risks in Emergency) programme.

The eurozone Composite purchasing managers' index (PMI) was revised upwards but disappointed expectations in falling to 51.9 in August from 54.8 in July. The softer reading pointed to a loss of growth momentum in the private sector, with services driving this month's decline as rising virus cases triggered a pull-back in activity. The recovery in eurozone retail sales faltered as sales fell 1.3% in July, compared to the 5.7% rise in June and the revised 20.6% jump in May. This left retail sales 1.2% below their February level. On a positive note, German business sentiment rose more than expected in August as German companies turned more optimistic. The main IFO business climate index rose to 92.6 points in August, from 90.4 in July, improving for the fourth consecutive month. Companies' assessments of their current situations notably improved and expectations moved higher, keeping hopes of a V-shaped rebound alive. The further increase in the Eurozone Economic Sentiment indicator, from 82.4 in July to 87.7 in August, echoes the message from other surveys that the recovery continues.

Markets

Excess liquidity deposited with the ECB increased in August, averaging €2.882 trillion, reaching an historic high on 7 August at €2.908 trillion. Overnight Index Average (Eonia) averaged a yield of -0.468%, remaining stable over the month. Eonia, since October 2019, tracks €ESTR (the ECB's new short-term rate) plus a spread of 8.5 bps.

Euribor continued to trend lower, driven by the large amount of excess liquidity and central bank activity. Three-month Euribor set a new record low at -0.491% on 20 August, less than four months after rising to a four-year high of -0.161% in late April: one-month Euribor averaged -0.52%, 1bp lower than July; three-month Euribor averaged -0.48%, 3bps points lower than July; six-month Euribor averaged -0.43% and one-year Euribor averaged -0.36%, both 8bps lower than July. Overnight government repo and cash deposit rates ranged between -0.55% and -0.60%.

Global bond yields moved higher, pushing prices lower: 10-year US Treasury yields started August at 0.56%, with an all-time low of 0.507% on 4 August, before moving higher to close August at 0.70%. Ten-year German Bund yields started August at -0.52%, closing higher at -0.40%. In the UK, 10-year UK Gilt yields moved higher, starting August at 0.10% and closing higher at 0.31% (with one-to-six-year gilts trading at negative yields). Italian government debt yields continued to rise through the month, but experienced a correction leading into month-end; they 10-year yield began August at 1%, fell to a low of 0.91% on 19 August before closing the month higher at 1.09%.

Fund

At the fund level, the weighted average maturity (WAM) averaged 43 days in August compared to 42 days in July. With the excess liquidity and overall lack of supply in the money markets, issuers continue to achieve more favourable pricing than prior to the pandemic disruption, with spreads compressed across the money market curves, resulting in strong execution across sectors and rating profiles. Investments were mainly in the one-to-three months duration range, with selective investments out to six months. Asset-backed paper continues to be in good supply, offering flexible duration and attractive returns compared to vanilla paper. Short-term liquidity ratios remained above average in both overnight and one-week maturities. 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.

Sources: Bloomberg, J.P. Morgan, Barclays, Credit Agricole, Rabobank, ING, Capital Economics as at 31 August 2020.

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