Commentary
Cash

August, 2021

Monthly Cash Review

State Street EUR Liquidity LVNAV Fund

Financial markets in August continued to weigh the benefits of reopening economies in Europe against the spread of the Delta variant across the continent and beyond. In broad terms, investors adopted an upbeat stance and remained in risk-on mode for much of the month. Economic data continued to paint an optimistic backdrop even if there were some signs that momentum was waning after the post-lockdown boost. Eurozone government bonds were a little weaker in the month, while interbank rates were largely stable throughout with few signs the European Central Bank was planning to tighten policy.

Policy

The Governing Council of the European Central Bank (ECB) last met on 22 July, when it kept rates unchanged as expected but 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.”

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 additional monetary stimulus in the form of more asset purchases. Eurozone data continues to indicate a strong expansion for Q2 and into Q3, with inflation continuing to surprise on the upside. The ECB has hinted at new upward revisions to GDP growth and inflation projections for September. Between September and December, the ECB will need to decide what to do with the PEPP programme — end/extend or expand?

At the end of August, the futures markets were pricing in a 1% probability that the overnight rate will be around one basis points (bps) lower by July next year, with market expectations of higher rates being pushed out by a further year to summer 2024, or perhaps even into 2025.

Data

The eurozone economy grew faster than expected, with the latest estimate of second quarter GDP showing an expansion of 2% quarter-on-quarter (q/q), 13.6% year-on-year (y/y). Amongst the major economies, the southern countries rebounded with force; Spain grew by 2.8% q/q; Italy grew 2.7% q/q; Germany grew 1.6% q/q and France was revised higher to 1.1% q/q. 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 a ten-year high of 3% in August, up from 2.2% in July. This was stronger than anticipated, although expectations have been that inflation would reach 3% by the second half of 2021. Both energy and food inflation moved higher, along with core inflation (which excludes energy, food, alcohol and tobacco) which more than doubled to 1.6% in August, from 0.7% in July. The large jump in core inflation was likely due to last year's VAT cut in Germany, influencing the year-on-year comparisons. Although this remains well above the ECB's target, with near-term risks to the upside, expectations are that the surge will be transitory with the headline rate falling back to 2% by the end of the year. ECB President Lagarde repeatedly said at the July meeting, that they would not act on temporary inflation data. The latest ECB projections for HICP inflation are 1.9% for 2021, 1.5% in 2022 and 1.4% for 2023. Market expectations are for these to be revised at the September ECB meeting.

Unemployment in the euro area fell in July to 7.6%, down from an upwardly revised 7.8% figure in June; this appeared to be due to a decline in the overall labour force rather than increasing employment. Amongst the largest euro area economies, the highest jobless rates were recorded in Spain (14.3%%), Italy (9.3%) and France (8%, Q2), while the lowest rates were recorded in the Netherlands (3.1%) and Germany (3.6%). The ECB's latest unemployment projections are for 8.2% in 2021, 7.9% in 2022 and 7.4% in 2023.

Economic sentiment in the region declined in August, but still signalled strong growth for Q3, as the index declined from 119 in July (an historical high) to 117.5. The eurozone composite purchasing managers' index (PMI) fell from 60.2 in July, to 59.5 in August, suggesting that growth slowed only slightly despite supply problems. The manufacturing PMI stood at 61.4 in August, down slightly from 62.4 in July, as manufacturers continued to face supply side challenges. Eurozone industrial production declined 0.3% in June, following a revised 1.1% decline in May. The ongoing supply chain difficulties particularly impacted Germany (with semiconductor shortages hitting car production), which reported a 1% decline in industrial production. The other three large economies of the eurozone saw production increase: France by 0.4%, Spain by 0.1% and Italy reported a strong ending to Q2 with 1% output growth. The German Ifo Business Climate Index recorded a second successive monthly decline to 99.4 in August, from a revised 100.7 in July, providing further evidence that Germany's recovery is losing some momentum. Both manufacturing and services dipped in August, while the only sector that saw an improvement was construction.

Markets

Global markets continued to look for signs whether global central banks would scale back stimulus measures, with focus on economic growth and the higher inflation outlook. The ECB has stepped up their monthly asset purchases averaging €80 billion a month since April. In July, ECB purchases increased by an additional €7.6 billion to €87.557 billion, suggesting some "front loading" with anticipation of an August lull, given the summer holidays and traditionally less market activity. For the first three weeks of August, PEPP purchases amounted to €72 billion (final data due 6 September). At the longer end of the euro government bond market, German 10-year Bund yields rose by 10 basis points to end August at -0.39% (from -0.49% a month earlier). Italian 10-year government yields followed suit, starting the month at 0.57% and closing at 0.71%. The spread between 10-year Italy and Germany bond yields ranged 100-110 bps over the month.

Excess liquidity deposited with the ECB continued to increase, averaging €4.325 trillion in the month, with a high at €4.348 trillion on 9 August. The euro short-term rate (€STR) was stable through August, averaging a yield of -0.57%. Euribors were stable: one-month Euribor averaged -0.56%; three-month Euribor averaged -0.55%; six-month Euribor averaged -0.53%; and one-year Euribor averaged -0.50%.

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 -0.66%.

Fund

At the fund level, the weighted average maturity (WAM) averaged 44 days in August. 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 August 2021.
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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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