Commentary
Cash

Novmber 2021

Monthly Cash Review
State Street EUR Liquidity LVNAV Fund

The emergence of the Omicron variant in late November rattled financial markets, driving a shift away from risk assets. ECB President Christine Lagarde reiterated surging inflation should moderate and that rate hikes in 2022 were very unlikely, and along with many European countries tightening COVID restrictions, government bonds benefited from investor caution. Money markets were less volatile but interbank rates were similarly, albeit more modestly, lower across the curve.

Policy

The Governing Council of the European Central Bank (ECB) last met on 28 October, when it kept its policy settings and forward guidance unchanged; 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, with the ECB confirming that this will end in March 2022. The Bank confirmed that it will make monthly asset purchases under the PEPP at a “moderately lower” pace compared to March-September and that it will continue net purchases under the APP until shortly before it starts to raise key ECB interest rates.

Outlook

ECB President Christine Lagarde continued with her assessment that euro area inflation will ease as the economies rebound, falling back below the 2% target in the medium term. Eurozone inflation has risen at the fastest pace since 2008, energy prices have increased, staff shortages and supply chain bottlenecks remain issues, all of which are fuelling inflation fears. President Lagarde did note that wage growth could accelerate but repeated that she did not see price growth lingering. She reiterated that any interest rate increases in 2022, implied by recent financial market trading, was “very unlikely”, although she said she wouldn’t venture into 2023.

We saw forward markets push back their expectations of a 10 basis points (bps) rate hike out to February 2023, from December 2022 (where as much as 20 bps of tightening had been priced in). At the end of November, the futures markets were pricing in a 25% probability that the overnight rate will be around four bps higher by September next year (compared to last month, where 55% probability was priced in that the rate would be sixteen bps higher). The next council meeting is on 16 December. The ECB has communicated that the December meeting will be the timeframe for further policy updates.

Data

The eurozone economy demonstrated greater strength in the third quarter, with GDP expanding 2.2% quarter-on-quarter (q/q), following a revised 2.1% growth rate in the second quarter. Growth expectations for Q4 are likely to be weaker as the supply disruptions take their toll and the additional downside risk due to rising covid cases. Amongst the bloc's biggest economies, France posted the fastest pace of expansion, advancing by 3% in the third quarter, followed by Italy (2.6%), Spain (2%), and Germany (1.8%). On a yearly basis, the euro area economy grew by 3.7%, slightly above forecasts of 3.5%. The ECB's latest GDP growth projection for 2021 is 5%. For 2022 and 2023, the ECB expects eurozone GDP growth to come in at 4.6% and 2.1%, respectively.

The eurozone's flash headline inflation rate continued to trend higher from 4.1% in October to 4.9% in November. This was stronger than median forecasts of 4.5%. Food inflation rose to 2.2% and energy inflation continued to rise to a new record high of 27.4%. Core inflation (which excludes energy, food, alcohol and tobacco) also rose to a record high of 2.6%, up from 2% in October. The ECB's current projections for HICP inflation stand at 2.2% in 2021, 1.7% in 2022, and 1.5% in 2023.

Unemployment in the euro area edged down again to 7.3% in October from 7.4% in September, below its February pandemic level of 7.4%. Amongst the largest euro area economies, the highest jobless rates were recorded in Spain (14.5%), Italy (9.4%) and France (7.6%), while the lowest rates were in the Netherlands (2.9% September) and Germany (3.3% September). The ECB's latest unemployment projections are for 8.2% in 2021, 7.9% in 2022, and 7.4% in 2023.

The eurozone composite purchasing managers' index (PMI) showed an unexpected rise from 54.2 in October, to 55.8 in November — the first increase in four months. Price pressures continue to work their way to consumers as shortages in the economy and higher energy costs are keeping input prices high, which is consistent with the view that headline inflation will remain high for some time. Eurozone industrial production declined 0.2% in September for the second successive month, as supply chain difficulties persist, particularly impacting the auto sector. The decline in September followed a revised -1.7% decline in August.

Germany's recovery continues to lose momentum and with coronavirus restrictions being tightened further, the outlook for Q4 remains weak. German industrial production declined 1.1% m/m in September, following a massive 3.5% m/m fall in August, leaving industrial output 9.5% below its pre-pandemic February 2020 level. Manufacturing output fell 1.4%, with car production at less than half of the pre-pandemic level, with prospects for Q4 have been deteriorating. The Ifo Business Climate Index recorded its fifth successive monthly decline to 96.5 in November from 97.7 in October. The largest fall was in the services sector while manufacturing continues to struggle with supply chain problems.

Markets

Global fixed income markets experienced significant risk-off moves on the back of concerns about the economic impact of the Omicron variant and the announcement of escalating lockdown situations in various European countries. German 10-year Bund yields moved lower in November by 24 basis points (bps), closing at -0.35% (from -0.11% in October); Italian 10-year government yields followed suit, lower by 20 bps to close at 0.97% (from 1.17% in October). The spread between 10-year Italy and Germany bond yields widened, ranging between 114-131 bps over the month.

Excess liquidity deposited with the ECB continued to increase, averaging €4.445 trillion in the month, with a high at €4.498 trillion on 9 November. The euro short-term rate (€STR) was stable through November, averaging a yield of -0.57%. Euribor rates moved 1 bp lower across all fixings; both one-month Euribor and three-month Euribor averaged -0.57%, with the three-month index hitting an all-time low -0.583% on 24 November; six-month Euribor averaged -0.54% and one-year Euribor averaged -0.49%.

Euro cash overnight deposit rates ranged between -0.57% and -0.65%, trending lower. Government repo ranged from -0.60% to -0.62%. We continue to see increased activity in euro short-term government bills, driven by a shortage of collateral in the repo markets and the abundance of cash looking to be invested over year end. Prices rising in response and yields moving lower. Three-month German Treasury bills moved below -1% for the first time on 23 November, three-month French Treasury bills averaged -0.87% in November, compared to -0.74% in October.

Fund

At the fund level, the weighted average maturity (WAM) averaged 41 days in November. We selectively targeted high-quality credit issuers in the one-to-three-month duration range, with selective investments past six months. Issuance into January was scarce and levels expensive. Some issuers are well funded and are choosing not to roll maturing trades. Asset-backed paper continued to be in good supply, offering flexible duration and attractive returns compared to vanilla paper. As always, liquidity and capital preservation remained the key drivers for the portfolio, with yield a distant third.

Source: State Street Global Advisors/Bloomberg, 30 November 2021.
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ID833355-3950558.1.1.EMEA.INST 1221
Exp. Date: 31/12/2022