Commentary
Cash

November, 2021

Monthly Cash Review

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The month of November was a time of Thanksgiving. A time when many of us gathered with our loved ones for the first time (indoors) in a long time. And a time when COVID reminded us that it is not over. At their November meeting, the Federal Reserve (Fed) announced the beginning of the end of the asset purchase program, with Fed Chair Jerome Powell indicating it would be wound down by the middle of 2022. With the taper now officially forthcoming, markets began to get very excited about a potential rate hike — 1-year Libor had risen 13 basis points (bps) during October and rose another 11bps to its 0.47% high on Nov 25th before dropping back to 0.38% by month-end. Impressively, the Fed Fund Futures market was pricing in three 25bps rate hikes before news of the new coronavirus variant, Omicron, hit the tape on Friday, November 26th.

Chair Powell's testimony to the Senate Banking Committee noted the expectation that upward price pressures should abate over time, while also acknowledging that supply chain problems have made it difficult for some producers to meet demand. He indicated that inflation pressures have been more sustained and longer lasting than initially expected and that it is finally time to retire the term "transitory" as it relates to inflation. The Chair also suggested that an acceleration of the asset purchase program taper could be in order, perhaps ending a few months earlier than expected. In terms of the US Treasury curve, we have seen a bear flattening move where two-year yields moved higher while 10-year yields moved lower through November, resulting in an overall flattening by 17bps. This indicates the market does not see any long-term threat from inflation and anticipates the Fed taking action on the near-term inflation threat — one or two rate hikes in 2022. However, it should be noted that both two-year and 10-year yields dipped on the latest Omicron headlines.

The payroll data for November will be an important event, but this will not reflect the effect of the most recent Omicron headlines. Consensus market expectations are for over a half million jobs to have been added to the non-farm payroll, which builds on the 531k added in October and would be a welcome sign for the Fed and the market. However, we should also keep a close eye on hourly earnings and the participation rate. Upward wage pressure should continue to be the main story for 2022 and a determining factor on whether inflation pressures will linger longer than anyone likes.

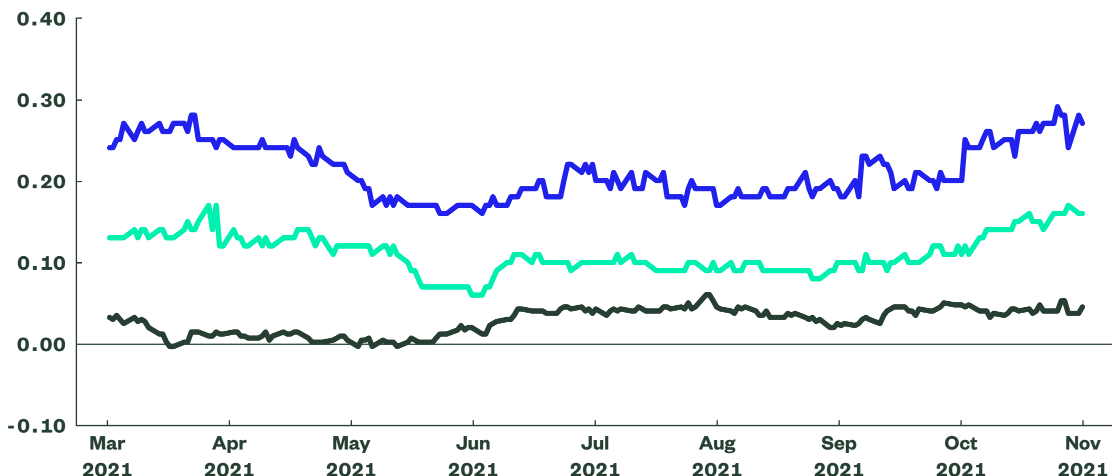
The money markets are moving quickly into a precarious time of the year: December and year end. The end of the year is always challenging amid seasonal fund inflows and increased volatility. The Broker/Dealers are very reluctant to provide liquidity as they try to protect the size of their balance sheets in order to avoid any additional regulatory scrutiny or additional capital costs. Thus, the bid side of the market is weak and should be avoided (i.e. we don't want to have to sell anything!). We expect the Fed's RRP to increase in size from its November average of ~$1.5 trillion to potentially $2 trillion by year end. This increase is simply a reflection of the excess cash and liquidity that is in the system and should not be a cause for concern; however, it is another reason the Fed would be smart to end QE sooner!

Though the news cycle has faded on the topic, the debt ceiling continues to be an issue. The decrease in headlines is to be expected as both the Democrats and Republicans recognize there is no political ground to be gained by making a spectacle out of it. Expect a resolution in the first half of the month.

As we move into the new year, we could start to see a widening spread between a prime MMF and a government MMF. Over the course of the past two months, we have seen more upward pressure on CP and CD yields than T-Bill yields (Figure 1). This upward pressure is also reflected in the Libor OIS spread (Figure 2). This is a good sign for prime money market fund investors. At the moment, there is not a lot of interest in prime funds as the spread does not provide the yield that makes a variable NAV and the risk of gates and fees worthwhile. Most prime funds are yielding the same as a government fund with only a select few providing some pickup. We have seen investors continue to leave prime funds throughout the year (Figure 3). It is possible that we see the spread widen as it did in 2015 when the Fed raised rates for the first time in seven years (Figure 4). Time will tell.

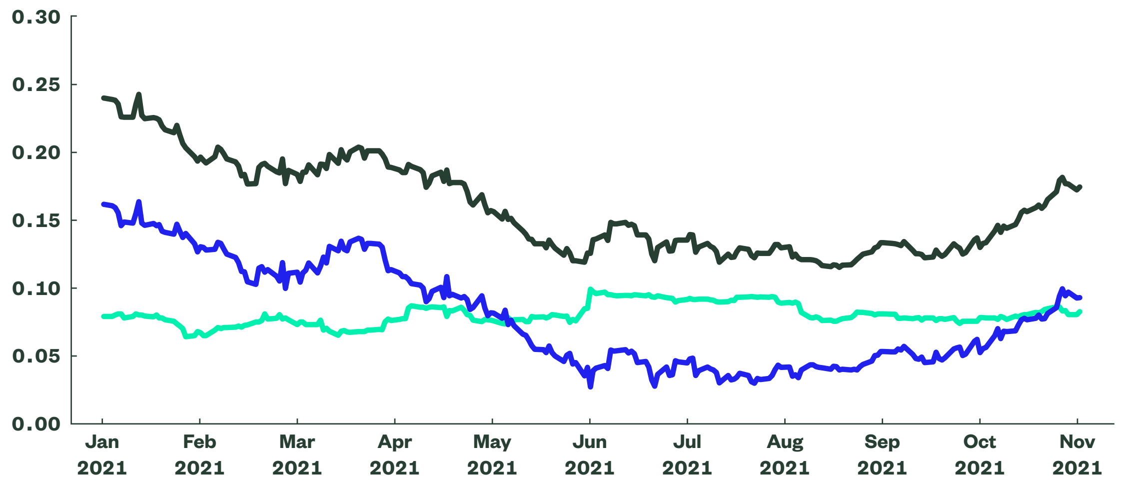
Figure 1
3month T-Bills and Commercial Paper

- 3m T-Bills
- 3m Tier 1 CP
- 3m Tier 2 CP



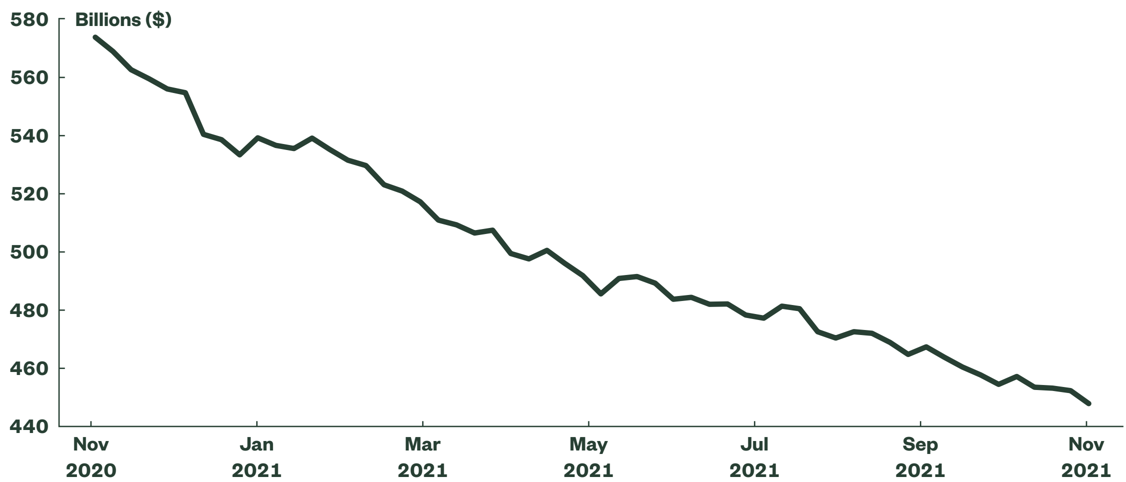
Source: Bloomberg as of November 30 2021.

Figure 2
Libor and OIS Yields



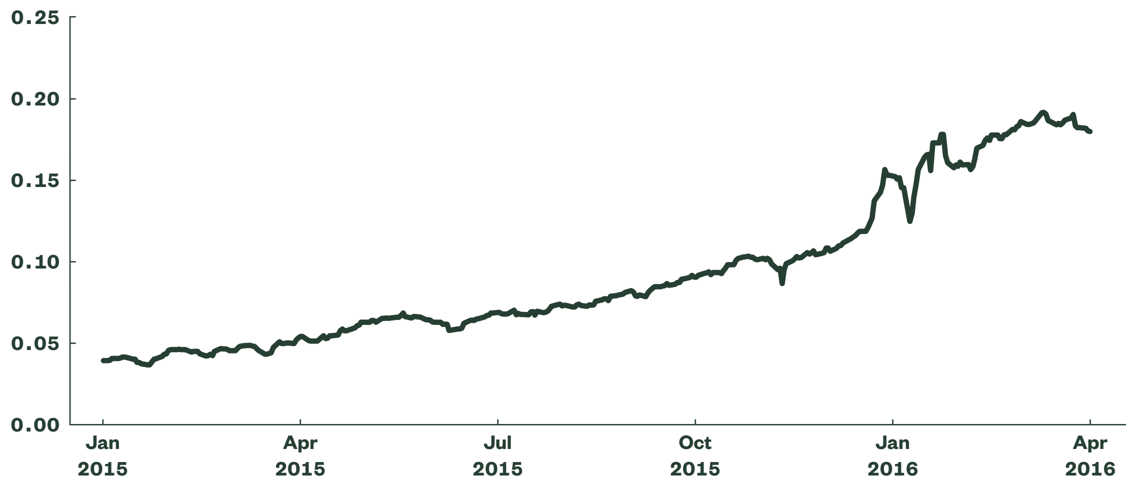
Source: Bloomberg as of November 30 2021.

Figure 3
Prime MM Fund AUM



Source: ICI, Bloomberg as of November 30 2021.

Figure 4
Prime and Government MMF Yield Difference (Jan 2015 to April 2016)



Source: Bloomberg as of November 30 2022.

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