Commentary
Cash

December 31, 2021

Monthly Cash Review

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Things are finally getting exciting!

Two big events this month:

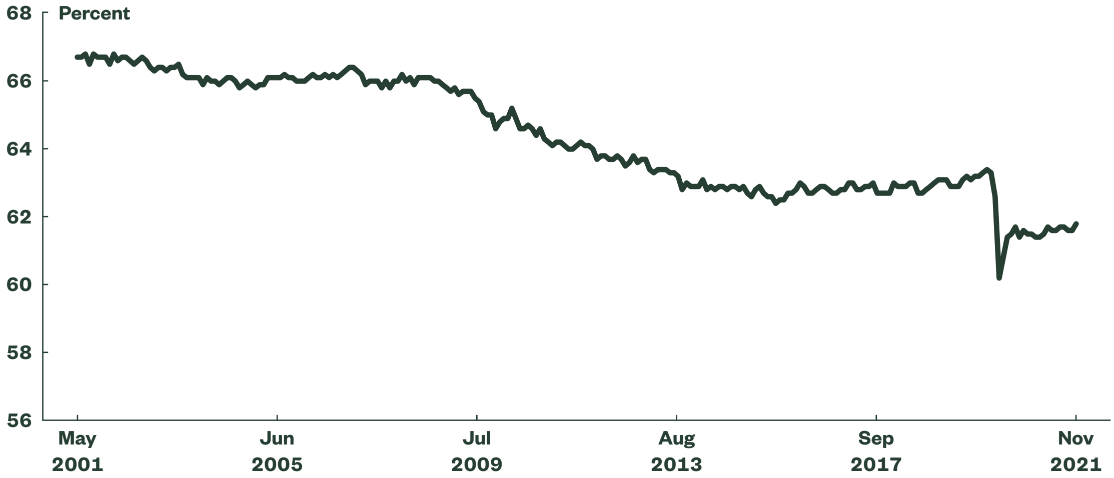
1. The US Federal Reserve, in one of their more dramatic and exciting meetings (as far as Fed meetings go), announces an early taper and the potential for a rate hike in the first half of 2022.

2. The SEC publishes an easy read: 325 pages on **Money Market Fund Reform** and **fact sheet summary**.

2022 will certainly be an eventful year. The likelihood of an early Federal Open Market Committee (FOMC) policy rate hike has all those holding cash feeling a little better at the potential to actually earn some interest. The prospect of higher inflation for a more sustained period of time has some members of the FOMC concerned, although it has not seemed to impact consumer behaviour as of yet. Consumer confidence has been pushing to get back to pre-pandemic highs and holiday shopping has been robust. Many folks got an early start, some as early at June, in anticipation of supply chain issues. So far we have not heard of too many challenges, or perhaps people are shifting their demand to what is available.

In the **Fed's Summary of Economic Projections**, the Fed raised their inflation expectations from their September projections. As Fed Chair Jerome Powell indicated, the committee recognises that 'transitory' is no longer applicable to current price pressures in the economy. From my perspective, the employment picture requires the most attention in 2022. If the US participation rate (Figure 1) does not increase, then upward wage pressure should persist. This harkens back to the good old supply-demand intersection from our Econ 101 classes. If wage pressure remains elevated, then workers can afford higher prices for the goods and services they consume, thus limiting any potential pull-back in economic activity. And such is the Fed's biggest concern: the wage price spiral. It puts the Fed in the position of having to 'tame' inflation, perhaps before we reach full employment, by choking off demand with higher interest rates.

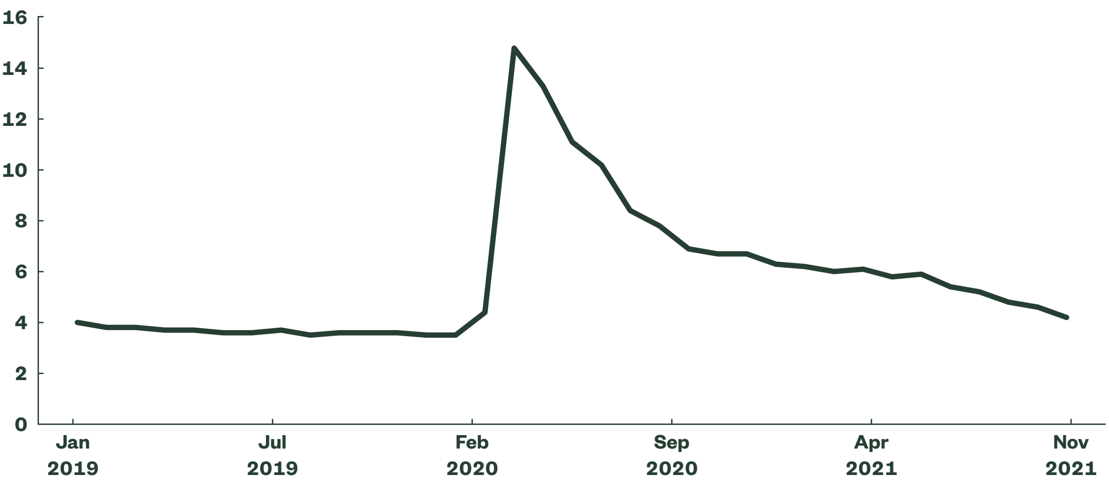
Figure 1
Quit Rate & Participation Rate



Source: Bloomberg, BLS, as of December 31, 2021.

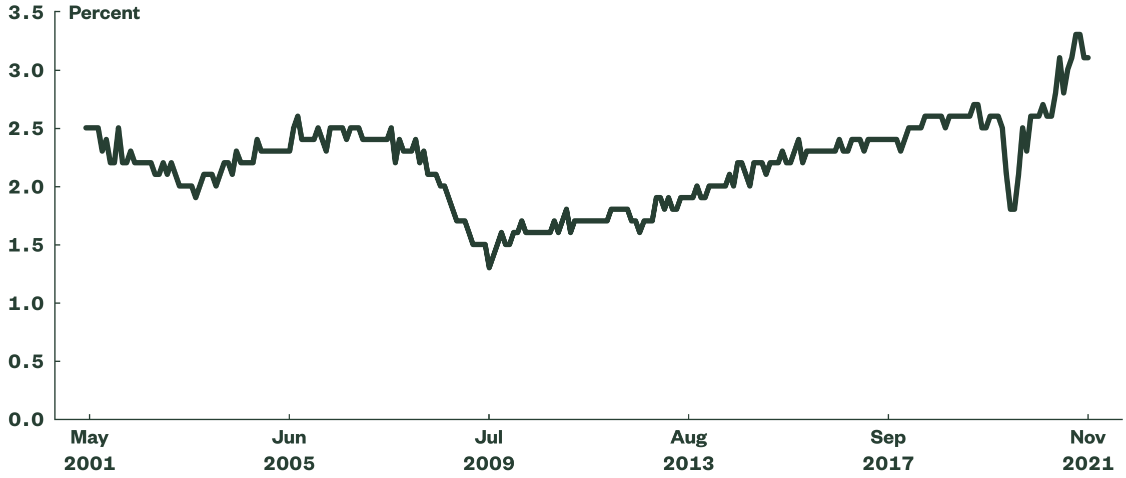
On the topic of employment, the Fed also lowered their unemployment rate forecast to a pre-COVID record low of 3.5% (Figure 2). At 4.2%, we aren't far off from those pre-pandemic levels, making it entirely possible that the Fed could raise rates as soon as March. Other employment data to watch for is the quit rate, which measures voluntary resignations and is currently at record levels (Figure 3). Figure 4 reflects the total job openings minus the total unemployed — if all those currently registered as unemployed (6.8 million people) obtained employment, there would still be 4.1 million job openings. I can't find anything comparable to this imbalance in the historical data I've looked at. It is highlighting the need for more workers! As an anecdote, my nephew (18 years old, high school senior) walked into a Jiffy Lube asking about a job. Without hesitation, the manager said: "Fill this out. Can you start today?"

Figure 2
U-3 Unemployment Rate



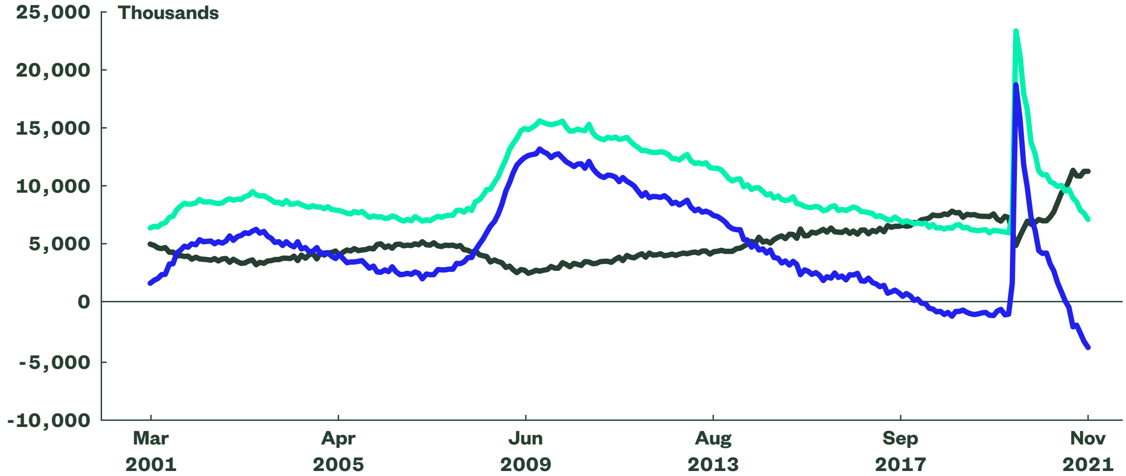
Source: Bloomberg, BLS, as of December 31, 2021.

Figure 3
Quit Rate



Source: Bloomberg, BLS, as of December 31, 2021.

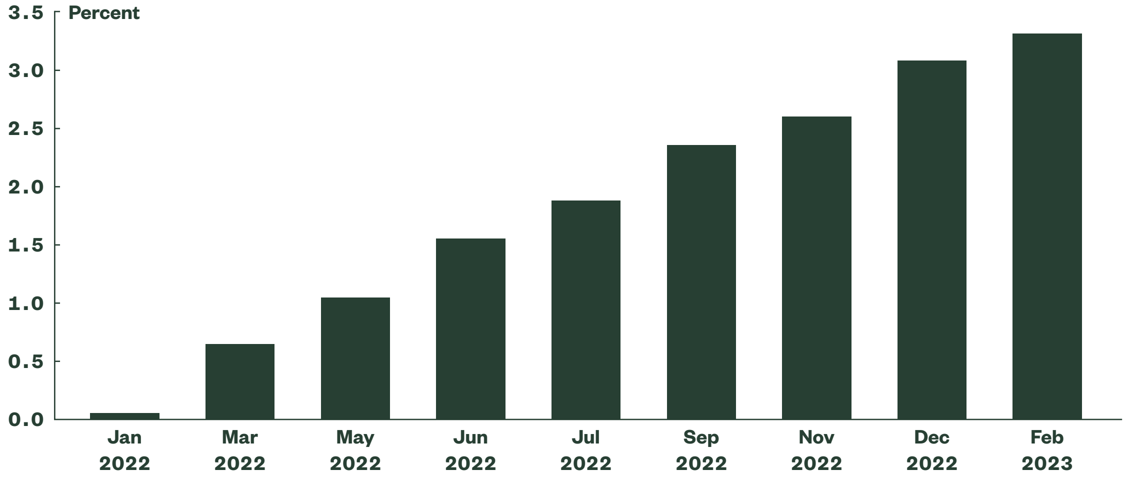
Figure 4
Labour Shortage



Source: Bloomberg, BLS, as of December 31, 2021.

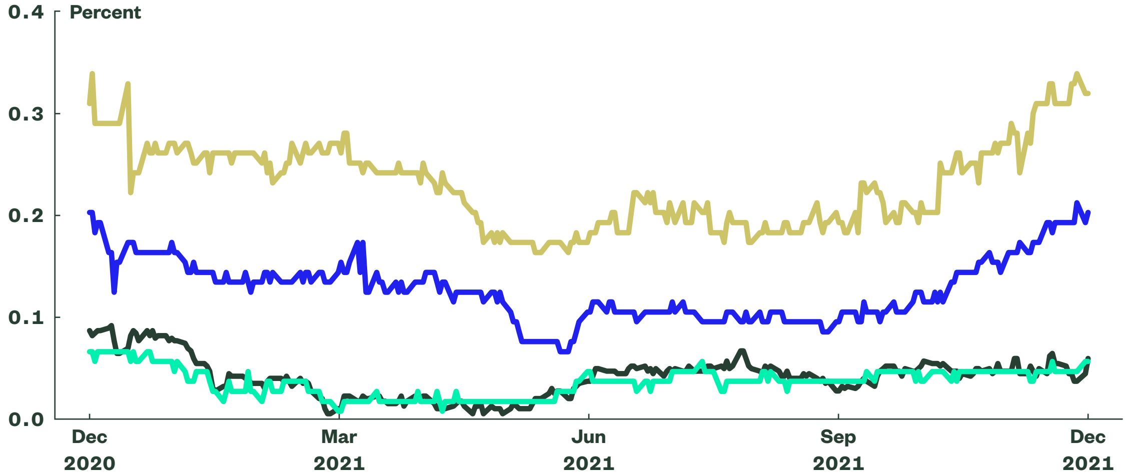
Figure 5 looks at the Fed Funds Futures market's probability of a policy hike. It is measured in increments of 25bps policy rate hikes. Each date is a FOMC meeting. The market is pricing 2.8 25bps hikes by this time next year and a 50% probability for a hike at the March meeting. The CP market is reflecting this shift as the curve has steepened in expectation of the rate hike, with both Tier 1 and Tier 2 CP yields having risen (Figure 6). Unfortunately, T-Bill and Agency discount notes have not seen a similar rise in yield. This is typical as these markets are slow to price in rate hikes until it is very clear they will actually happen. Prime money market funds should see their yields push slightly higher before that of government or treasury money market funds. We witnessed this back in 2015 (Figure 7).

Figure 5
#Hikes/Cuts



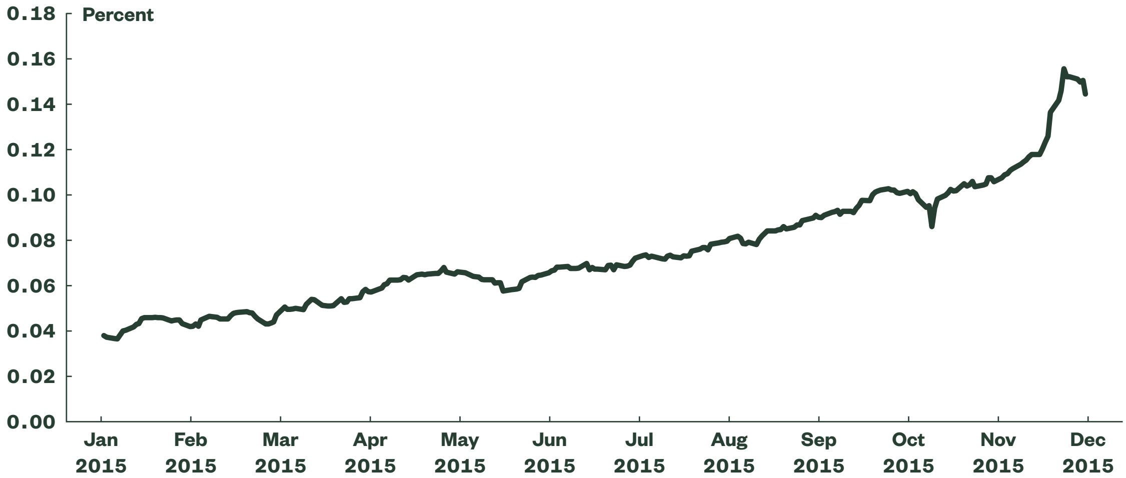
Source: Bloomberg, as of January 3, 2022.

Figure 6
3 Month Money Market Rates



Source: Bloomberg, as of December 21, 2021.

Figure 7
Yield Difference Between Prime and Govt MMF



Source: Bloomberg, as of December 31, 2021.

The SEC kicked off what will be an interesting period of debate and adjustment of rules that govern money market funds. This will be the third set of reforms that the SEC has put forth since the great financial crisis. These reforms should be a bit more straightforward, but still not without some debate. There are four major rule changes up for debate. From the SEC's fact sheet (link **here**):

1 Increasing minimum liquidity requirements to provide a more substantial buffer in the event of rapid redemptions — daily liquidity raised to 25% from 10% and weekly liquidity raised to 50% from 30%.

2 Removing the ability of money market funds to impose liquidity fees and redemption gates when they fall below certain liquidity thresholds, which would eliminate an incentive for preemptive redemptions.

3 Requiring certain money market funds to implement swing pricing so that redeeming investors bear the liquidity costs of their redemptions (*this is the hot topic*).

4 Enhancing certain reporting requirements to improve the Commission's ability to monitor and analyse money market fund data.

Topics 1, 2 and 4 all seem fairly straightforward. Raising liquidity requirements further challenges prime and municipal funds to deliver the relative value that one would hope to see. The increased liquidity could cost as little as 4bps and as much as 14bps depending on the curve, rate environment, credit conditions and individual fund liquidity demands. The removing of gates and fees was largely expected and generally agreed upon. It was felt gates and fees were the cause of the problem for prime funds back in March 2020, and so part of the solution would be to eliminate them. Enhancing reporting is good. Increased transparency should be a good thing.

Swing pricing is the hot topic. As background, swing pricing is the process by which a fund adjusts the NAV price of the fund based on market conditions and a predetermined formula given liquidity demands on that fund — we will have a short paper forthcoming that goes into much more detail. For a money market fund, the challenges lie in the timeliness of the process. T+0 pricing multiple times per day poses operational challenges to the fund administrator. As a solution, it's possible the fund companies adjust some of their offerings in light of this, i.e. pricing a fund once a day or changing the pricing time of the fund. The challenge for investors is how they view the "potential" of a swing price. If they view it as remote and appropriate then it's possible this is the best outcome and it should not lead to "runs" on the fund. If they view it as a liquidity fee in disguise, then we are right back to where we started. Investors will consider first mover advantage and set liquidity alarms — points at which they will exit the fund if breached.

The SEC has set a 60-day review and comment period. We will be doing both and will keep you informed of updates as we have them.

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* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of September 30, 2021 and includes approximately $59.84 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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