Month in Cash: The Fed and the ECB ease liquidity

As of 01-04-2012

The cash-yield curve steepened during December as a sharp drop in the supply of overnight paper pushed rates lower at the short end while mounting jitters over the continuing euro-zone debt crisis nudged yields higher at the longer end. Normal year-end window dressing and other seasonal factors accounted for the dearth in repo supply, which effectively pushed some overnight rates down into the single digits. Meanwhile, the one-month London interbank offered rate (Libor) rose 2 basis points in December to 0.30%, three-month Libor increased 5 basis points to 0.58%, six-month Libor climbed 6 basis points to 0.81%, and one-year Libor moved up 6 basis points to 1.1%. The increase in Libor could have been larger had not the Federal Reserve in early December lowered the rate it charges foreign institutions to “swap” euros for dollars. The Fed intervention, which was designed to provide dollar liquidity to the euro-zone financial system, curtailed interbank lending, thus limiting the scope of upward pressure on Libor.

It was a challenging month from a cash management perspective. Supply was severely constrained as banks and broker-dealers closed their books for the year, even as seasonal inflows necessitated putting new funds to work. It remained our objective to keep maturities relatively short to take advantage of the more generous cash yields that we believe will be available if, as we expect, the U.S. economic recovery gains traction in 2012.

The United States and Europe diverge

News from the domestic economic front was mostly positive in December. Retailers generally reported solid holiday sales, initial unemployment claims continued their gradual decline, some housing metrics showed clear improvement and consumer confidence unexpectedly rose, probably in response to the promising jobs data. Indications that the U.S. economy was pulling out of its summer soft patch further reduced the probability of the Fed initiating a third round of quantitative easing, or the purchasing of Treasury debt with newly printed money. For savers, the absence of a QE3 is positive, since heavy Fed bond buying would exert more downward pressure — albeit indirectly — on short rates and imply that policymakers were moving farther away from the first rate hike.

As the New Year unfolds, investors will be casting a watchful eye on Europe. During the first few months of 2012, Italy will need to rollover massive amounts of government debt, and while recent action by the European Central Bank to extend longer-term loans to the region’s struggling banks will significantly reduce the possibility of a liquidity crisis, major sovereign solvency issues remain unresolved. We are carefully monitoring financial conditions in the euro zone and are maintaining sufficient cash to invest if the yield curve continues to steepen in coming months.

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Also by Deborah A. Cunningham

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Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices.

London interbank offered rate (Libor): The rate at which banks can borrow funds from other banks in the London interbank market. The Libor is fixed on a daily basis by the British Bankers' Association and acts as a benchmark for other short-term interest rates.

The cash-yield curve is a graph showing the comparative yields of securities in a particular class according to maturity. Securities on the long end of the yield curve have longer maturities.

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