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Investors shouldn't go looking for trouble

Investors are overreacting to the flattening of the short end of the yield curve.

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As you learn in Economics 101, financial markets tend to act irrationally. Of course, the emphasis is on high-flying equities, not the grounded Treasury market. But lately, you can make a strong case that investors at the short end of the yield curve are not using common sense. In May the yield curve flattened, briefly twisted (3-month and 1-year Treasury yields dipping below 1-month) and then flattened again, but with the 1-year lower. These days, it appears that the 1-year is joining the larger inversion out the curve.

Perhaps irrational is too strong a word, but recent investor behavior is—to use financial jargon instead of academic textbooks—overdone. The flattener is simply not justified by the domestic economic data that, while moderating, is still strong. We are among the many who think the U.S. is not likely headed to a recession anytime soon. While significant, all of the geopolitical issues circling, such as trade conflicts, central bank easing and Brexit, hardly justify this overreaction. Nor does the likelihood of the Federal Reserve being on hold for the remainder of 2019. The issue seems to be a case of investing via group think.

But some investors may be overthinking. One of the reasons for the recent flattening is a misread, in our view, of a very technical maneuver by the Federal Reserve that investors shouldn't be tracking anyway: interest on excessive reserves (IOER). The story goes like this: by cutting the interest the Fed pays banks on the money they keep in their Fed accounts, policymakers have surreptitiously lowered rates.

Hmmm. People seem to have forgotten that the Fed has lowered IOER twice within the last six months without any market consternation. The only difference is that they were raising the fed funds target rate at the time. With rates on hold, the market seems to be perceiving the reduction as a proxy for a rate cut—the easing that so many have already forecast. But the fact is that the Fed tightened IOER to give it more control over monetary policy from a federal funds perspective, and also to incentivize banks to move funds into the marketplace. It isn't easing.

The good news for cash managers is that money market funds remain attractive in this environment. That's especially the case when compared to Treasuries and bank deposits, whose rates are falling and weren't great to begin with.

In contrast, flows continue to be positive into all three money fund categories (government, tax free and prime). Prime money funds have benefited because their reference rate, the London interbank offered rate, has not inverted. Media outlets have written that high-net-worth families have a significantly higher percentage of money in cash. In short, liquidity products are a solid option, even though rates are steady and look to be that way for some time. In response, we kept our weighted average maturities in a range of 30-40 days for our government funds, and 40-50 days for prime and tax free.

TAGS

LIQUIDITY | MONETARY POLICY | MARKETS/ECONOMY

DISCLOSURES

Views are as of the date above and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

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.

Yield Curve: 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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