LIQUIDITY INSIGHTS

# Focus on short-term fixed income

## Q2 in Review: Fed acknowledges strong growth and inflation data, but not ready to act

**June 30, 2021**

### IN BRIEF

- Strong US GDP growth and rising inflation contributed to a more hawkish stance from the Federal Open Market Committee (FOMC) at its June meeting; the median federal funds rate projection now reflects two rate hikes in 2023.
- The FOMC made technical adjustments to its administered rates, increasing the interest rate paid on excess reserves (IOER) and the rate on its overnight reverse repurchases agreement program (RRP) in order to support smooth functioning in short-term funding markets. Short-term yields moved modestly higher on the news, benefitting positioning in our Liquidity Strategies.
- Front-end U.S. Treasury yields rose sharply; two-year and five-year Treasury yields ended the month at 0.25% and 0.89%, respectively. The ICE BofA 1-3 year U.S. Corporate Index average spread tightened 2 bps and we remain constructive on corporate credit, which contributed strongly to performance in some strategies.

**Ted Ufferfilge**
*Head of Investment Specialists, Global Liquidity J.P. Morgan Global Liquidity*

### MARKET REVIEW

U.S. Q1 2021 real GDP grew at a 6.4% quarter over quarter (q/q) seasonally adjusted annual rate, largely driven by personal consumption, which surged an annualized 11.4% after upward revisions. The U.S economy added 850,000 jobs in June, well above consensus expectations of 720,000. Notably, wages rose 0.3% month over month (m/m) and 4.6% on an annualized year-over-two-year basis as businesses raised wages in response to labor market shortages.

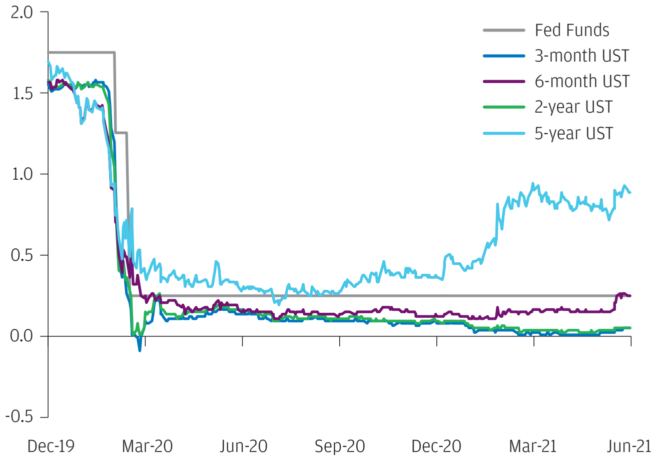
Given the powerful economic rebound coupled with rising wages, inflation remained top of mind for investors as it has now surpassed the 2% target set by the Federal Reserve (Fed). The May U.S. CPI report showed consumer prices rising at their fastest pace in more than a decade and headline CPI for May exceeded expectations, rising +0.6% m/m and +5.0% year over year (y/y).

The Federal Open Market Committee (FOMC) signaled a more hawkish stance at its June meeting, driven by a materially stronger growth and inflation outlook in the medium term. Notably, the median federal funds rate projection now reflects two rate hikes in 2023.

The committee made technical adjustments to its administered rates, increasing the interest rate paid on excess reserves (IOER) and the rate on its overnight reverse repurchases agreement program (RRP) by 5 bps to 0.15% and 0.05%, respectively, in order to support smooth functioning in short-term funding markets. Following the announcement, short-term yields moved modestly higher. These technical adjustments are likely a temporary fix to money market yield levels, which have tested the lower bound of the fed funds target range, as overall supply/demand dynamics remain unchanged. Reserve growth from quantitative easing (QE) and the paydown of the U.S. Treasury's General Account will continue to exert downward pressure on short term rates, particularly as flows into money market funds remain strong and Treasury bill supply declines.

With this backdrop, front-end U.S. Treasury yields rose sharply. Two-year and five-year Treasury yields ended the month at 0.25% and 0.89%, respectively. The ICE BofA 1-3 year U.S. Corporate Index average spread tightened 2 bps to end the month at 39 bps.

**TREASURY BILL YIELDS (%)**




Source: Bloomberg; data as of June 30, 2021.

# PORTFOLIO COMMENTARY

## Liquidity Strategies

The weighted average maturity (WAM) of our **Liquidity Strategy** was in a range of 45 to 55 days and weighted average life (WAL) was in a range of 65 to 75 days during the second quarter. Three-month Libor closed the month at 0.15%, down 4.85 bps on the quarter, and reached a new low of 0.12% in mid-June. One-month Libor ended the month at 0.10% down 1.06 bps from the previous quarter end. Term investments were primarily focused on fixed-rate securities in the three- to 12-month area at the start of the quarter. We also purchased floating-rate securities in the six- to one-year area versus three-month USD Libor plus a spread. During the month of May, as yields compressed further, we reinvested maturities in overnight to one-month securities in anticipation of a technical adjustment to IOER and Fed RRP at the Fed's June meeting, which would lift money market yields higher. Since the FOMC announcement we deployed cash further out the curve to take advantage of uptick in Libor and the slight spread widening. We generally carried 25% to 35% in overnight liquidity and 40% to 50% in monthly liquidity.

## Managed Reserves Strategies

The **Managed Reserves Strategies** maintained its long duration position in the second quarter as we believe the Fed is on hold through 2023. Supported by strong technicals from the economic recovery and continued inflows into the front end, front-end spreads remained near all-time tights for the quarter as measured by the Bloomberg Barclays 1-3 Year Index. With economic activity continuing to heat up and lower new issuance expected throughout the remainder of the year, we are constructive on investment grade (IG) credit and have selectively added shorter fixed-rate credit with maturities between 1.5 and 2.5 years and one- to three-year floating rate notes. Although we recognize that valuations are expensive and idiosyncratic risks are increasing, over the near term we see no real catalyst for significant spread widening. Consumer asset-backed securities (ABS) pool performance has remained solid with delinquencies contained, which we will continue to use a portfolio diversifier and for accounts with restrictive credit constraints, but we continue to prefer corporate credit to ABS at current valuations.

## Short Duration Strategies

Within the **Short Duration Strategies**, we saw improving fundamentals and robust technicals drive spreads through all time tights during the second quarter. Our overweight to credit was the largest contributor to outperformance in Q2 as spreads compressed and valuations increased. With credit spreads at historical tights, we pared back those positions we felt had limited additional upside. Our securitized allocation also contributed to outperformance, led by ABS and commercial mortgage backed securities (CMBS), where we favor attractive collateral with significant embedded protection. We continue to own agency mortgage-backed securities (MBS), which provide high quality carry, however, we are allowing this allocation to drift lower as valuations continue to tighten and higher volatility has negatively impacted fundamentals. We remain shorter in duration compared to the benchmark, especially in the three and five year portions of the curve. Although a slight detractor over the quarter, we believe the curve has an asymmetric risk profile with more room to rise than fall and prefer to remain short of the benchmark.

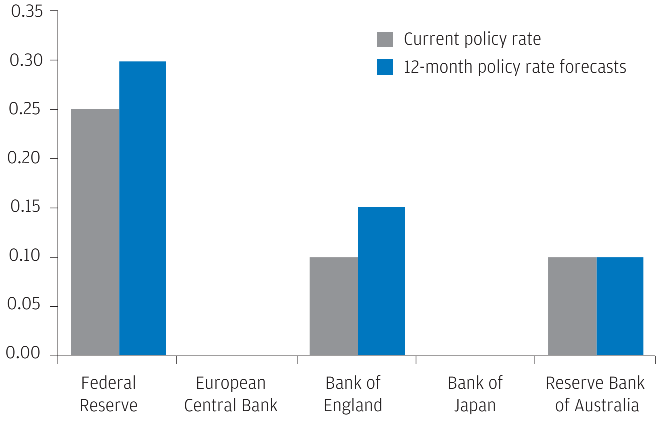
## OUTLOOK

As we enter the third quarter, the U.S. economy remains on track for record growth in 2021 as rising vaccinations and a reopening economy overlap with still supportive fiscal and monetary policy. The growth recovery is likely to continue to run ahead of the recovery in employment with real GDP expected to surpass pre-Covid levels in Q2 and likely to exceed the pre-Covid trend by Q3.

The Fed is now actively discussing a timetable for tapering its massive bond purchases even as the committee voted to maintain the current federal funds target rate range of 0.00%–0.25% and reaffirmed its commitment to $120 billion in asset purchases per month, until it believes "substantial further progress" has been made towards its inflation end employment goals. The committee reiterated its view that higher inflation over the next few months will be transitory.

We expect the Fed to keep policy rates at the zero lower bound for the foreseeable future and to continue its asset purchase program so long as inflation continues to be perceived as transitory. We believe the Fed will begin to taper asset purchases in early 2022 and start hiking rates in the second half of 2023. The evidence of inflation has reduced the hurdle rate for the Fed to see substantial progress in the labor markets.

**MARKET EXPECTATIONS FOR RATE MOVES (%)**




Source: Bloomberg; data as of June 30, 2021.

**KEY U.S. ECONOMIC DATA**

| USA | Current Month (June 2021) | Prior Month (May 2021) |
|---|---|---|
| DJIA | 34,502.51 | 34,529.45 |
| S&P | 4,297.50 | 4,204.11 |
| 2-Yr US Treasury | 0.25 | 0.14 |
| 10-Yr US Treasury | 1.47 | 1.60 |
| Unemployment Rate | 5.9 | 5.8 |
| Chg in Nonfarm Payrolls (3 mo. Avg) | 558 | 580 |
| Housing Starts (000s, saar)* | 1572 | 1569 |
| ISM Manufacturing Survey | 60.6 | 61.2 |
| U. of Mich. Consumer Confidence Sentiment | 86.4 | 82.9 |
| Consumer Price Index (YoY %)* | 5.0 | 4.2 |

*Currently showing the most recent published number as of May (and April in Prior Month). June data has not been released.

Source: Bloomberg; data as at June 30, 2021.

If you have further questions about this or other topics of interest, please reach out to your J.P. Morgan Asset Management Representative.



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