

US Dollar Liquidity Fund

Morgan Stanley Funds plc

Launch date:
June 2003

Portfolio manager:
Jonas Kolk

Location:
New York

Base currency:
US dollars

Benchmark:
1 Week USD LIBID

MARKET REVIEW

Market headwinds were front and centre in October, putting tremendous strain on the credit markets and essentially causing them to cease and freeze. The 3-month Libor emphasised this unprecedented situation by shooting up to nearly 4.82% on 10 October, 200 basis points higher than on 15 September. However, the 3-month Libor finished the month at 3.03%, which was still elevated, given the Fed's attempts to unfreeze the markets. Notably, the Libor drop occurred after the FOMC's 8 October inter-meeting rate cut, in which the Federal funds target rate was cut by 50 basis points, from 2% to 1.5%. Even as the Libor rate began to decline, a spread of this magnitude between Libor and the Fed funds rate is historic.

October was an active month for the Fed, against a backdrop of weak credit markets and a gloomy economy. As mentioned, at an inter-meeting move, the Fed cut its target rate from 2% to 1.5% and then at the regularly scheduled 29 October FOMC meeting, the target rate was cut again by 50 basis points to 1%. The 29 October decision by the Fed presented its view of the balance of risks as skewed to downside growth. The daily Fed funds effective rate – overnights trading in relation to the target level – were trading significantly below target. In fact, 8 October was the last date the daily Fed funds effective traded above target.

Economic data reported in October took a significant turn for the worse. The situation infused concerns into central banks around the world, prompting the coordinated easing of rates on 8 October. ISM manufacturing posted a steep decline on 1 October to a 43.5% level. The silver lining in this report, however, is that due to the swift decline of the economy, the prices-paid component of the report dropped by 20 points. A positive note about the quick downward spiral of the economy is that it is removing pricing pressures from the markets.

Unemployment remains weak with non-farm payrolls posting a loss of 159,000 jobs, marking the ninth consecutive negative month. Meanwhile, retail sales were dismal, finishing the month down 1.2%. A number of regional Fed and industrial production indexes also declined, with industrial production falling 2.8%. The regional Philadelphia Fed manufacturing index dropped a substantial 37.5%, its lowest level since October 1990. At the same time, consumer confidence fell dramatically.

Third quarter GDP, released on 30 October, showed a 0.3% contraction, with early fourth quarter GDP numbers looking very bleak.

Moving forward, the market largely anticipates additional easing at the upcoming 16 December FOMC meeting.

STRATEGY AND OUTLOOK

During October, we continued to maintain a relatively high cash balance in overnight maturities. In light of the events in the economy, our primary focus was to build liquidity and preserve capital. We remained constant with our holdings, with an eye toward maintaining a shorter duration stance.

We will continue to structure the portfolio to reflect the tenuous situation in the credit market. We remain attentive to maintaining liquidity and capital preservation due to the relatively constant illiquid market of recent months.

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Commentary

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