

Market Insights

Yields Decline As Investors Prepare For Lower Rates

LIQUIDITY | GLOBAL LIQUIDITY TEAM | MACRO INSIGHT | AUGUST 2019

Federal Reserve Board¹

After the Federal Open Market Committee (FOMC) decided to lower the range for the federal funds rate by 0.25% to 2.00%-2.25% on July 31, investors sought additional clarity as to whether the policy adjustment would be a mid-cycle rate cut or the start of a longer cycle of easing by the Federal Reserve. Unfortunately, weakening economic data in Europe and a number of negative news headlines about the U.S.-China trade war in August raised concerns that the Federal Reserve might need to take additional policy measures to “sustain the economic expansion.”

On August 21, the Federal Reserve released the minutes from the July FOMC meeting, which noted the U.S.-China trade war and global growth concerns continued “to weigh on business confidence and firms’ capital expenditure plans.” A reduction in U.S.-China trade tensions could promote a more supportive global economic backdrop and an increase in business confidence.

However, trade tensions continued to escalate in August with China announcing on August 23 that the country would impose tariffs ranging from 5%-10% on \$75 billion of U.S. goods in two stages, effective on September 1 and December 15. In addition, China announced it would resume tariffs

DISPLAY 1 Monthly Interest Rate Summary

As of 8/31/19

US TREASURY RATES	YIELD (%)	MOM CHANGE (%)
1M UST	2.08	0.10
3M UST	1.98	(0.09)
6M UST	1.87	(0.20)
12M UST	1.76	(0.22)
2Y UST	1.50	(0.37)
5Y UST	1.39	(0.44)
10Y UST	1.50	(0.52)
30Y UST	1.96	(0.56)
USD LIBOR CURVE		
O/N LIBOR	2.09	(0.26)
1M LIBOR	2.09	(0.14)
3M LIBOR	2.14	(0.13)

Source: Bloomberg

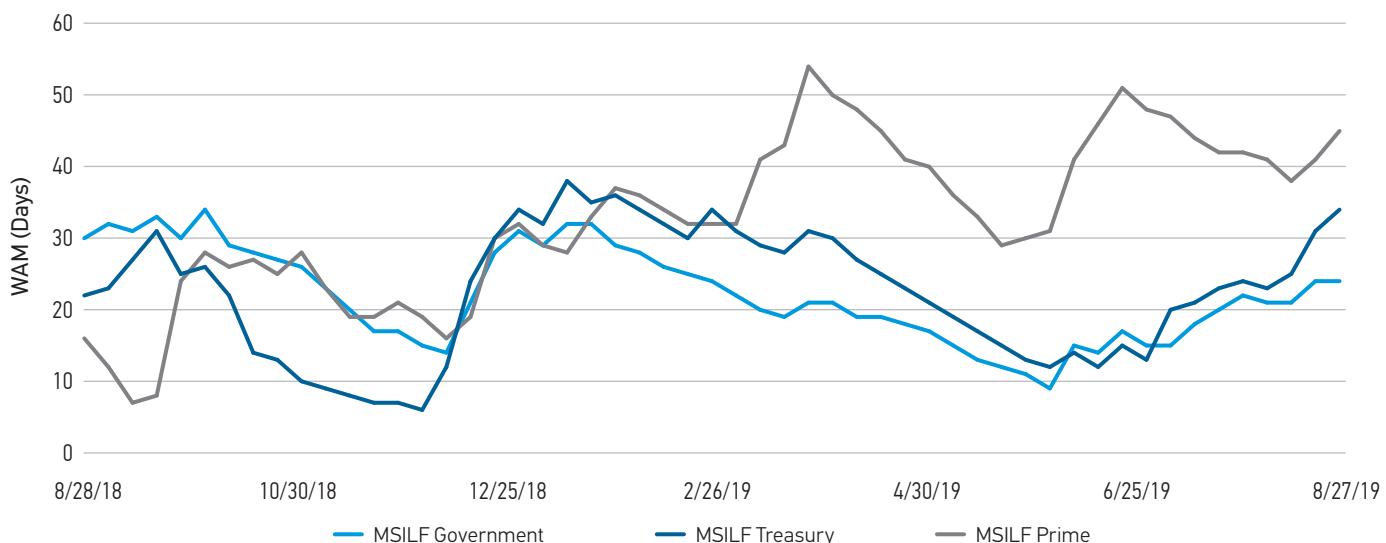
¹ Source: Bloomberg.

The views and opinions expressed are those of the Portfolio Management team as of August 2019 and are subject to change based on market, economic and other conditions. **Past performance is not indicative of future results.**

DISPLAY 2

Morgan Stanley Institutional Liquidity Funds (MSILF) Weighted Average Maturities (WAM)²

8/28/18-8/27/19



Source: iMoneyNet

on U.S. autos, imposing a 25% tariff on U.S. cars and 5% on automobile parts and components, starting December 15.

In response to these additional Chinese tariffs, President Trump announced the U.S. would increase tariffs on \$250 billion of Chinese goods to 30% from 25% on October 1 and would tax an additional \$300 billion of Chinese goods on December 15 at the rate of 15%, rather than the original 10% rate as planned. In addition, President Trump called for U.S. companies to stop doing business with China.

Against this backdrop of escalating U.S.-China trade tensions, investors continued their flight to U.S. Treasuries in August, with the 2-, 5- and 10-year yields falling 37 basis points (bps), 44 bps and 52 bps, respectively, throughout the month. As

of August 31, the 10-year Treasury bond was yielding 48 bps less than the 3-month Treasury bill. The 5-year Treasury bond was yielding 59 bps less than the 3-month Treasury bill as of the same date.

European Central Bank¹

While the European Central Bank (ECB) kept its policy rates unchanged during its July 25 meeting, the Governing Council acknowledged muted inflation pressures and slowing economic growth in the eurozone could lead the ECB to take additional accommodative policy measures, including the potential of lowering rates, during future meetings.

Even though the ECB's next monetary policy meeting would not be until September, there were a number of economic data releases in August which led many investors to believe

additional rate cuts would be necessary. In particular, the eurozone's August inflation was only 1.0% and its August composite PMI was 51.8, one of the lowest readings during the last six years.

Bank of England¹

As expected, the Bank of England's (BOE) Monetary Policy Committee (MPC) kept rates unchanged at 0.75% during its meeting on August 1. While the MPC did not adjust rates, the BOE lowered U.K. growth forecasts to 1.3% in 2019 and 2020, down from 1.5% and 1.6%, respectively, in its previous forecast. However, the BOE noted that these revised growth forecasts assumed the U.K. would leave the European Union smoothly and that growth could be much lower in the event of a no deal Brexit.

² **Weighted Average Maturity (WAM):** Measures the weighted average of the maturities of the portfolio's individual holdings, taking into account reset dates for floating rate securities.

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Portfolio Strategy

PRIME STRATEGY³

Minutes from the Federal Reserve's July FOMC meeting indicated that officials viewed their 25 bps interest rate cut on July 31 as "insurance against too-low inflation and the risk of a deeper slump in business investment stemming from uncertainty" due to global trade concerns. With the market pricing in approximately 60 bps worth of rate cuts for the remainder of 2019, Treasuries continued to rally in August, with both the 10- and 30-year note ending the month at recent lows of 1.50% and 1.96%, respectively. As yields continued to move lower in August ahead of the September FOMC meeting, we remained comfortable adding duration to the portfolios, predominantly purchasing fixed rate securities in the 6- and 9-month tenors. We continue to manage our portfolios from a conservative positioning standpoint, maintaining our emphasis on high levels of weekly

liquidity and structuring our portfolios to respond to changes in monetary policy.

GOVERNMENT/TREASURY STRATEGY⁴

During the month of August, more Treasury bill supply hit the market, helping to invert the bill curve further. Treasury bills in general continued to rally on solid investor demand, with the 1-year bill yield falling by about 15 bps during August. We continued to invest in fixed-rate agencies and Treasuries, favoring 3-month to 7-month tenors and added longer Treasury floating-rate notes, to a lesser extent. We continued to maintain a large portion of certain portfolios in short-term repurchase agreements and manage the portfolios to be responsive to changes in market conditions and interest rate levels.

TAX-EXEMPT STRATEGY⁵

At the short end of the curve, yields for variable rate demand obligations (VRDOs) dropped during the month

of August. The SIFMA Index,⁵ which measures yields for weekly VRDOs, fell 0.05% over the course of the month to 1.35%. Yields at the longer end of the municipal money market maturity range were little changed during the month. The Municipal Market Data One-Year Note Index⁶ finished the month at 1.16%, up 0.01% from the prior month. In a recently published report, Moody's Investors Service noted strong revenue collections have allowed states to limit the amount of debt issued to fund capital investments, opting to utilize pay-as-you-go financing for capital investments rather than issuing bonds. Moody's cited steady revenue growth since the last recession as the principal reason for this shift in funding priorities. It also pointed to the growing trend of taxpayer aversion to increased debt or taxes as contributing factors as well. In the period ahead, we will watch to see how monetary policy unfolds and determine what impact it may have on municipal yields.

³ The Portfolio will be required to price and transact in their shares at a floating net asset value ("NAV") and will be permitted to impose a liquidity fee on redemptions or temporarily restrict redemptions in the event that the Portfolio's weekly liquid assets fall below certain thresholds.

⁴ Government and Treasury Funds are Stable NAV funds.

⁵ The **SIFMA Index** is issued weekly and is compiled from the weekly interest rate resets of tax-exempt variable rate issues included in a database maintained by Municipal Market Data which meet specific criteria established from time to time by The Bond Market Association. The index is unmanaged and should not be considered an investment. It is not possible to invest directly in an index.

⁶ Thomson Reuters Municipal Market Data (MMD) AAA Curve is a proprietary yield curve that provides the offer-side of "AAA" rated state general obligation bonds, as determined by the MMD analyst team. The "AAA" scale (MMD Scale), is published by Municipal Market Data every day at 3:00 p.m. eastern standard time with earlier indications of market movement provided throughout the trading day. The MMD AAA curve represents the MMD analyst team's opinion of AAA valuation, based on institutional block size (\$2 million+) market activity in both the primary and secondary municipal bond market. In the interest of transparency, MMD publishes extensive yield curve assumptions relating to various structural criteria which are used in filtering market information for the purpose of benchmark yield curve creation. MMD yield curves are available on a subscription basis from Thomson Reuters TM3.

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You could lose money by investing in the Fund. Although the Fund seeks to preserve the value of your investment at \$1.00 per share, it cannot guarantee it will do so. An investment in the Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. The Funds' sponsor has no legal obligation to provide financial support to the Fund, and you should not expect that the sponsor will provide financial support to the Fund at any time.

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The Tax-Exempt Portfolio may invest a portion of its total assets in bonds that may subject certain investors to the federal Alternative Minimum Tax (AMT). Investors should consult their tax adviser for further information on tax implications.

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