

Market Insights

Trade Tensions Lead to Market Volatility

LIQUIDITY | GLOBAL LIQUIDITY TEAM | MACRO INSIGHT | MAY 2019

Federal Reserve Board¹

As expected, the Federal Open Market Committee (FOMC) kept the range for the federal funds rate unchanged at 2.25% to 2.50% at the conclusion of its May 1 meeting. The Federal Reserve (Fed) noted that in light of global economic and financial developments and muted inflation pressures, the Committee will continue to be “patient” as it decides what future adjustments to the fed funds rate are appropriate. FOMC participants believed the most likely outcome for the U.S. economy would be sustained expansion of economic activity, with strong labor market conditions and inflation nearing its 2% target.

However, the Trump administration’s decision on May 10 to raise tariffs to 25% on \$200 billion of Chinese goods and its threat to levy tariffs on another \$300 billion of Chinese goods following the next G20 meeting in June stoked concerns that the U.S.-China trade war could be longer and more pronounced than expected. The Trump administration’s decision on May 29 to threaten Mexico with a 5% tariff only exacerbated these concerns and raised the specter of additional U.S. trade wars with other countries.

DISPLAY 1

Monthly Interest Rate Summary

As of 5/31/19

US TREASURY RATES	YIELD (%)	MOM CHANGE (%)
1M UST	2.32	(0.10)
3M UST	2.34	(0.07)
6M UST	2.34	(0.10)
12M UST	2.20	(0.17)
2Y UST	1.92	(0.34)
5Y UST	1.91	(0.37)
10Y UST	2.12	(0.38)
30Y UST	2.57	(0.36)

USD LIBOR CURVE		
O/N LIBOR	2.35	(0.02)
1M LIBOR	2.43	(0.05)
3M LIBOR	2.50	(0.08)

Source: Bloomberg

¹ Source: Bloomberg.

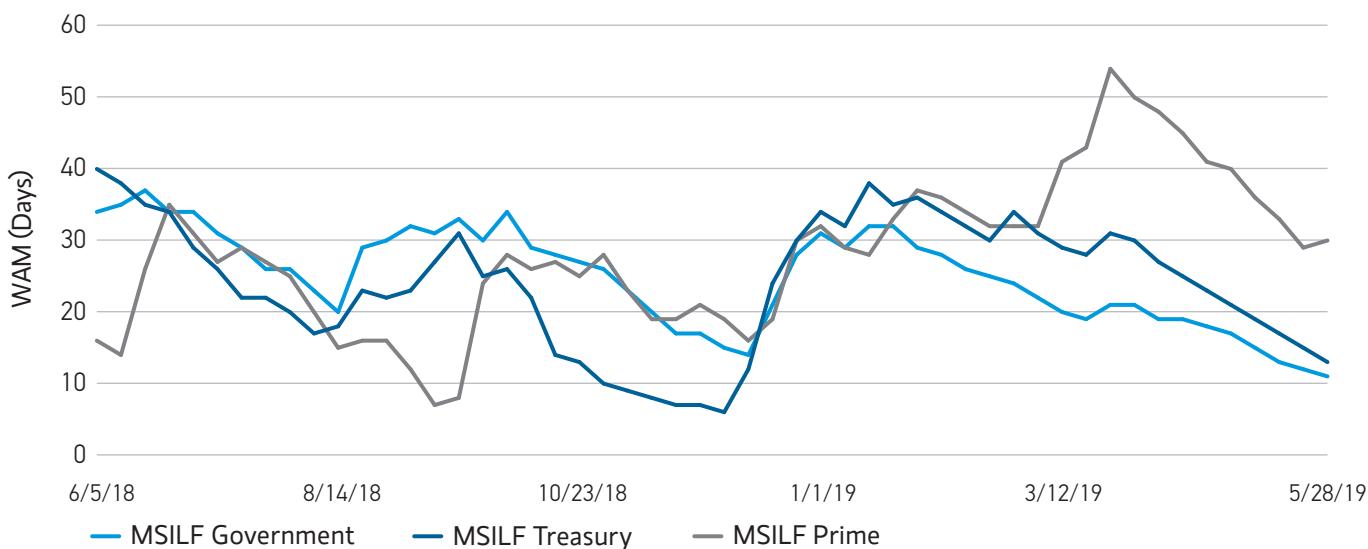
The views and opinions expressed are those of the Portfolio Management team as of May 2019 and are subject to change based on market, economic and other conditions. **Past performance is not indicative of future results.**



DISPLAY 2

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

6/5/18-5/28/19



Source: iMoneyNet

Fearing continued trade tensions could weaken economic growth, investors fled to U.S. Treasuries in May. The Treasury yield curve flattened significantly, with the 2-, 5- and 10-year yields falling 34 basis points (bps), 37 bps and 38 bps, respectively, throughout the month and the belly of the curve becoming inverted. As of May 31, the 10-year Treasury bond was yielding 22 bps less than the 3-month Treasury bill. The 5-year Treasury bond was yielding 43 bps less than the 3-month Treasury bill as of the same date. Given this shift in sentiment, the market was pricing in at least two rate cuts by the Fed by the end of 2019.

European Central Bank¹

While the European Central Bank (ECB) did not hold a policy meeting in May, the ECB released the results of its

semi-annual Financial Stability Review on May 29, highlighting the potential economic risks to the euro zone. The report noted that asset prices could move substantially lower if the U.S.-China trade war continues to escalate and weaker gross domestic product (GDP) growth persists. The report also warned that global leveraged loans could be significantly impacted by weaker corporate earnings and European banks would continue to struggle to meet their return on equity targets.

On the economic data front, consumer prices in May were only 1.2% higher than a year earlier (down from 1.7% in April 2019 and the lowest level since April 2018), putting increased pressure on the ECB to take additional action in order to meet its 2% inflation target.

Bank of England¹

In the U.K., the pound continued to weaken versus the euro following the announcements of a delayed Brexit and Theresa May's resignation as prime minister. Given continued uncertainty around Brexit, the Monetary Policy Committee (MPC) voted unanimously to maintain its bank rate at 0.75% during its meeting ending on May 1. While the MPC kept rates on hold, it revised up its 2019 growth forecasts to 1.5% from 1.2%, noting better-than-expected GDP growth to start the year.

Portfolio Strategy**PRIME STRATEGY³**

As widely expected, the Fed voted unanimously to maintain the target range for the federal funds rate at 2.25% to 2.50% at the conclusion of its April 30/

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.

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.

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May 1 FOMC meeting. The Committee repeated language from its previous meeting, saying it “will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate.” With mixed economic data and increased geopolitical headlines throughout the month, Treasuries rallied, with the 10-year yield ending the reporting period at 2.12%, a 17-month low. Three-month LIBOR also ended the reporting period at a recent low, setting at 2.5% on May 31, down 8 bps month-over-month. With the Fed indicating that it would be on hold in the near term, and LIBOR continuing to grind tighter, we opportunistically added duration to the portfolio, purchasing fixed-rate securities in the 6- and 9-month tenors.

GOVERNMENT/TREASURY STRATEGY⁴

With the Fed indicating during its April 30/May 1 meeting that it would be on hold in the near term, we added duration to the portfolio, investing into longer-term, floating-rate agencies and Treasuries up to 2 years in maturity. We also invested into shorter fixed-rate Treasuries and agencies up to 6 months in maturity. We continue to manage the portfolios to be responsive to changing market conditions and to invest a significant portion of most portfolios in overnight repurchase agreements.

TAX-EXEMPT STRATEGY⁵

At the short end of the curve, yields for variable rate demand obligations (VRDOs) dropped throughout the month of May. The SIFMA Index,⁵ which measures yields for weekly VRDOs, fell 0.70% over the course of the month to 1.42%. At the long end of the money market range, there was very little new financing and the Municipal Market Data (MMD) One-Year Note Index⁶ closed the month down 0.02% to 1.68%. June typically has some of the largest coupon inflows of the year, which may place additional downward pressure on variable rate yields. We maintain our emphasis on high levels of liquidity and relatively short duration as we watch how monetary policy unfolds.

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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