New World of Cash Webinar

Yeng Butler: Good morning, everyone. On behalf of State Street Global Advisors' Global Cash Team, thank you for joining us today for "What to Expect in the Upcoming Rate Hike Cycle: A Strategy Session for Cash Investors." I'm Yeng Butler, Head of the US Cash Business, and it's my pleasure to serve as moderator today.

Just a quick note before we get started -- there are slides accompanying this call on the Global Cash website found at www.ssga.com/cash. Hopefully you have those in front of you.

In addition, feel free to follow up with our speakers after the call with any questions.

Now, let's get started. So, last month we released our New World of Cash research piece outlining how to prepare for the sweeping regulatory changes that have surfaced since the global financial crisis. These changes include the SEC's decision last July to amend its 2a-7 rules to require a floating NAV for institutional prime money market funds. The floating NAV requirement could potentially prompt investors, institutional investors, in particular, to gravitate to government funds.

It is one of many regulations that could lead to greater demand for short-term government securities, and in an environment such as todays, where there is less supply for substitutes such as high-quality bank debt. We also highlighted how revisiting your cash flows and business needs and dividing or bucketing cash by specific purpose can help you to take advantage of these changes and invest more efficiently in this new landscape of cash that we face.

Today we do a deeper dive into one of the most salient trends facing cash investors. This is also discussed in our New World of Cash and is increasingly impacting cash management decisions. When will the US Federal Reserve raise interest rates, and how should cash investors position themselves for the next rate hike cycle?

I am joined today by two colleagues, Will Goldthwait, Portfolio Strategist, and Matt Steinaway, Head of Global Cash Management.

I'll start by discussing the possible mechanics behind the Fed's pending rate increases. Then Will and Matt will lay out differing scenarios for the timing of the rate hikes and the thinking behind each. We hope that this will spark conversation about the two views and help you craft actionable insights as to where the Fed is headed this year. Finally, Matt will provide some key considerations for cash clients concerning recent regulations as well as market development, such as the massive QE recently embarked upon in Europe.

As all of you are aware, the Fed has held its Fed Funds target rate at a range of 0 to 25 basis points since 2008. We believe the Fed will continue to target a range and not necessarily revert back to a firm number once rate hikes begin.

Now, there are two mechanisms by which the FOMC will raise their target range. First, the Interest on Excess Reserves, or IOER, will mark the top of the range at 25 basis points. This is the rate the Fed pays to banks to keep excess reserves on overnight deposit at the Fed. Second, the bottom of the range could be established by the Fed's Reverse Repo Program. Recently the RRP has been paying 5 basis points on an overnight basis to approved counterparties to lend cash and receive US Treasury securities as collateral.

When the Fed raises rates, we expect it to raise both the IOER rate and the RRP rate. So if the Fed changes their Fed Funds rate target to a range of 25 to 50 basis points, they will set the IOER at 50 and the RRP at 25.

The Fed's reinvestment program will also impact short-term markets. This program involves the reinvestment of principal as well as coupon payments received by the Fed's roughly $4 trillion portfolio. We believe that at some point the Fed will stop that reinvestment and let the portfolio wind down. Prior to the Fed's first QE program, it typically held about $1 trillion of T bills in its account in order to transact in the Fed Funds market.

Next I'd like to turn it over to Will to give his thoughts on timing. But before that I'd like to start by asking the audience a polling question of when you think the Fed will begin its rate hikes: second quarter of this year; third quarter; fourth quarter; or in 2016? Please submit your response on the screen. And now I'll turn it over to Will.

Will Goldthwait: Yes, thank you, Yeng. Good morning, everybody.

I'm taking a more hawkish view on Fed policy in the coming year. I believe that the Fed is going to raise interest rates or raise their target range, as Yeng described, at their June meeting. One thing that I'll be on the lookout for is when they drop the "patient" phrase in their FOMC minutes. I would expect at the March meeting we're going to see that "patient" word dropped, and that will lead to the June meeting for a Fed rate hike.

It's taken a very long time for the US economy to get back on its feet after the financial crisis of 2008, but at last it has. I'm focused on two of the Fed mandates: jobs and inflation.

First on jobs, the unemployment rate has fallen approximately 1 point every year since the high in 2009 of 10 percent. It currently stands at 5.7 percent. Job gains have averaged over 200,000 for the past 11 months, with just over 1 million jobs added in the last three months. And these past three months have been the strongest three-month period of job gains since 1997.

Yeng Butler: So, Will, you talked a little bit about unemployment numbers being at 5.7 percent. We understand job growth currently has been growing fairly healthily. What do you think about wage inflation specifically?

Will Goldthwait: Yes, that's a good question. The Fed measures and economists measure wage inflation using NAIRU. NAIRU stands for the non-accelerating inflation rate of unemployment. This is a backward-looking number, but it's anticipated that the Fed is thinking that number is around 5 percent. So if the job gains continue and we continue to see the unemployment rate drop, then we should see unemployment punch through that 5 percent bogey and spur wage inflation.

And that leads to the second Fed mandate, inflation. I believe the Fed will view this recent downtick in inflation as transitory and largely influenced by energy cost. Overall, I think they're comfortable with inflation returning to their 2 percent long-range target. They will view the drop in energy prices as a positive shot to the consumer. I think we can all say we've been pleasantly surprised when filling our cars at the gas station.

And consumer confidence in the US is the strongest it's been since the pre-crisis level of 2006 and 2007. Given our consumer-focused society, I think this bodes well for demand and prices.

And, finally, even after the Fed begins their tightening cycle, which I think will start in June, overall monetary policy will remain very accommodative. The Fed has stated that their long-run neutral rate is 3.75, so we'll have a lot of hikes in Fed policy before we can get close to that number.

And with that I'll turn it over to the dove in the room, Matt.

Matt Steinaway: Thank you, Will, and I am the dove in the room.

So in my analysis in thinking about the Fed's activities in 2015, I do believe that in fact they will take a rate hike later in the year, most likely in the month of September. My analysis really reflects on the three key components.

One is the dual mandate that Will referenced, although I will take a view of this from a slightly different lens than Will did. The second group of factors I consider is really reflecting on the exogenous events that are going on in the global rate markets and their impact on the US markets and the Fed view on those US markets. And the third point really is a reflection on the Fed's view of its own downside risk and the activities that it may undertake and the risks it would place to a larger economy.

So, really reflecting on my first point around the dual mandate, while I agree generally with Will that the recent economic data has been favorable, I do believe there is an underlying trend that we should not miss, that, while there has been improvement, that improvement is from significant historical lows. I'm going to talk about four factors today where we have seen recent improvement but that recent improvement when compared to historical normal averages really puts it in position where we might think that the Fed may in fact take a later rate hike.

So the first one of those data points is what we call U6 unemployment measurement. And that really is a broader measurement of unemployment in the economy. That currently stands at 11.5 percent today, down from approximately 13 percent a year ago and from a peak in the crisis of 16.5 percent. So while we have had improvement in the U6 unemployment rate, it's worth noting that at 11.5 percent it's still relatively high to the pre-crisis averages for that index. So in my view, while there has been improvement in the unemployment rate, it has not been substantial enough relative to the pre-crisis lows.

The second factor we can consider is the Employment Cost Index. On Page 5 of the slide deck we do outline the Employment Cost Index as a percentage year-over-year index change. The most recent print for this index is 2.2 percent. That reflects the potential for inflation resulting from the cost of employment, or wages and healthcare benefits. And, while that is up from 1.72 percent as of 3/31 from last year and a substantial improvement, it's still -- and up significantly from 1.39 at the peak of the crisis in 12/31/09, it's still relatively low compared to the pre-crisis high. The lowest point we had pre-crisis was 2.63 percent at 12/31/08. So, again, another example of recent improvement, but when compared to historical averages still below the historical norm.

The third point that we'll talk about when reflecting on the dual mandate is the labor force participation rate. Currently that number stands at approximately 63 percent. That is a historical low and certainly below the rate at 65.8 percent as of 12/31/08. While we did experience low rates in the early '80s and in the '70s, that was largely due to structural changes in the marketplace, and we believe that the participation rate still has some room to increase before we see the employment rate improves.

The final data point is really around core PCE, or core personal consumption expenditures, which is also outlined on Slide 5. This is an index that the Federal Reserve watches closely to reflect on inflation felt by the consumer. That currently stands at 1.3 percent today, and importantly is expected to decline to 1.2 or 1.1 percent over the coming months as a result of the reduction in oil prices.

While the Fed has acknowledged that that reduction may be transitory in nature, we do believe that the Fed will be cautious in reflecting on inflation in the future and not necessarily consider those factors to be transitory, but rather take a position that they want to wait to ensure that they are transitory. We do think that view is reinforced by the view of the broader market when reflecting on the TIPS marketplace and the fact that the market is expecting below 2 percent inflation in the near and intermediate term.

Yeng Butler: Matt, can I pause you there for one second? I am curious to what extent the other extrinsic factors, in particular the global market, that could potentially derail rate hikes at all in 2015.

Matt Steinaway: Sure. So we think, and my second point here in reflecting on the exogenous factors impacting the global rates market, speaks specific to that. So there are two things that we're thinking about there.

Really the first is the global rates market and the central bank activities in other countries. We've talked a little bit about QE in Europe, but there are certainly other non-euro countries that are in a rate reduction cycle. Some of them have been recent surprises, including Australia. So there are central bank activities that are running a course that is contrary to the Federal Reserve, and we think that that does create some challenges for the Fed as it pertains to the foreign exchange rate as well as capital flows. So we think there are some real challenges presented to the Fed and their position by central bank activities away from the Federal Reserve.

And we also touched on oil briefly when talking about PCE. The global commodity down-cycle, where we had significant reductions in some commodity prices, has had a, depending on how you look at it, a positive impact on inflation. In other words, inflation for the consumer is less than what it would have been had the commodity prices not declined. I think the challenge for the Fed is really reflecting on the, as I've talked about, is that transitory, is that permanent, and what are the ultimate impacts of those reductions across the US economy?

So that, again, answers, I think, the second point I wanted to cover. And the third and final point in terms of my dovish position is really reflecting on the Fed and where we've come from since the crisis starting in 2008 and how they view their positioning.

My view is that the Fed, looking at other central banks' activities and the errors that have occurred in the past when it comes to raising rates, will likely take a more dovish position to be conservative, to ensure that the economy continues to grow out of a very significant down-cycle in 2008. So my view is that they would rather err on the side of caution, run the risk of having higher inflation in the short term, knowing that they can raise rates to mediate that, and not run the risk of taking the US economy off the tracks earlier than they need to do.

Yeng Butler: So, if we could turn to Slide 6, and I'd be also curious for both of our speakers today, what should clients be watching out for within the next three to six months? Matt, Will?

Matt Steinaway: So, I think -- there are three things listed here, and as we think about a rising rate environment and managing cash portfolios in that rising rate environment, that would normally be a challenge no matter what as we were trying to anticipate Fed moves and trying to position Fed portfolios around those Fed moves. What will make this cycle, I think, somewhat different or substantially different are the three key issues that we list here, so the first being the consequences of regulatory reform.

There have been significant shifts resulting from regulatory activities, both around Dodd-Frank, Basel III and 2a-7 money fund reform, but there have been substantial shifts in supply mechanisms and demand mechanisms in the liquidity markets. So we have seen within the supply mechanism in the market, we have seen a decreased issuance from banks, financial institutions, three months and in, and that does make it more challenging to manage a portfolio in a rising rate environment where you're trying to keep your weighted average maturities relatively short.

The second issue, the shifting asset mix in the money fund universe, speaks directly to the 2a-7 money fund reform. We have seen the potential for, and in fact in some cases an announcement around the movement from prime money funds that do buy short-term paper, bank paper and repo and Treasury bills, into funds that only purchase Treasury bills. So, again, that is additional pressure on the front end, particularly in a high-quality Treasury space, where a lot of investors in a rising rate environment would normally seek short-duration, high-quality assets. It is our view that that shift will make those assets much more expensive, much more scarce.

And, finally, the third piece, which we've talked a little bit about today, is the quantitative easing in Europe. So as we reflect upon portfolio positioning and, again, how it reacts to supply, it's also very challenging to think about the rate environment and the impact of QE in the European markets and what this does to investors that typically invest in those European markets. For example, a very large percentage of sovereign debt in Europe, approximately 25 percent, currently trades at a negative rate. For investors who choose not to or cannot invest in those levels, would they be incented to seek out that yield in the US market, therefore pushing down our yield and our capacity?

So we do think this cycle, this rising rate cycle, will be more challenging for cash managers as they enter the cycle because of the regulatory challenges in front of us. But with challenges are opportunities and we do think there are opportunities for clients who will consider these challenges and reflect on their own investment policy statement.

Yeng Butler: Great. Thanks, Matt. Thanks, Will.

Before we turn to Slide 7 for some final thoughts, given everything that you've heard this morning, I'd like to ask another polling question about investment policy statements in particular. Specifically, we'd like to get a sense for what your current investment policy statements allow your organizations to invest in: unrated money funds; unregistered funds; a 60-day maturity limit fund; and/or Tier 2 securities? Great. Thanks for responding.

And on Slide 7, just in conclusion, I think we can conclude that the global market environment for cash has never been more challenging. The investment offerings that will be available to cash investors will be changing more in the next few years than they have in the past 20. Therefore, it will be critical for you as cash investors to review your current investment and investment policy statement to ensure you're best positioned for both hurdles and opportunities, as Matt had alluded to earlier.

Thank you very much for listening to our call. We invite you to read our whitepaper, 2015 Global Cash Outlook: The New World of Cash, which can be found on our website for more detail.

If you have any further questions after this call, please reach out to us using the contact information on the final slide.

Have a great day. Thank you.

Sources: The Federal Reserve Bank of New York, as of February 6, 2015; Board of Governors of the Federal Reserve, as of February 6, 2015; Board of Governors of the Federal Reserve, Bureau of Labor Statistics as of January 9, 2015; Bloomberg, as of February 11, 2015; Bureau of Labor Statistics as of February 6, 2015; Board of Governors of the Federal Reserve as of February 9, 2015; State Street Global Advisors, the Board of Governors of the Federal Reserve as of January 28, 2015; Bloomberg as of February 12, 2015; Morgan Stanley as of January 22, 2015.

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