Market outlook

- Information contained in the Federal Open Market Committee’s (FOMC or the Committee) Summary of Economic Projections released at the June meeting suggests some additional policy firming by the Federal Reserve (the Fed) is possible, subject to incoming data.

- While the Fed, in our view, will likely maintain a “higher-for-longer” policy stance given still elevated inflation, a tightening of credit conditions from developments in the banking sector could affect their interest rate path.

- Treasury bill (T-bill) issuance has ramped up following the resolution of the US debt limit in early June and should remain robust through the fourth quarter of 2023, with potential implications for New York Federal Reserve overnight repurchase agreement program (RRP) utilization, which declined during the second quarter of 2023.

Q2 highlights

- Following an increase of 0.25% in the federal funds target range to 5.00% to 5.25% at its May meeting, the FOMC left its target range unchanged at its meeting on June 14. The latter action represented the first meeting since “liftoff” commenced in March 2022 that no action was taken by the Committee on the federal funds target rate.

- In a statement released in conjunction with the June meeting, the Committee noted it “remains highly attentive to inflation risks” and acknowledged that “tighter credit conditions for households and businesses are likely to weigh on economic activity, hiring and inflation.”

- The FOMC added that keeping the target range unchanged would enable it “to assess additional information and its implications for monetary policy.”

- The Committee also noted that “in determining the extent of additional policy firming that may be appropriate” to reduce inflation to its 2% objective, they will consider various factors including the amount of tightening so far and the lagged effects of monetary policy.

- The median federal funds rate forecast for 2023 contained in the Summary of Economic Projections (SEP) released in conjunction with the FOMC meeting rose to 5.60% from the projection of 5.10% at the March 22, 2023 meeting, implying, in our estimation, two additional 0.25% increases in the range for the target rate during the balance of this year.

- President Biden signed the Fiscal Responsibility Act into law on June 3, suspending the debt limit through January 1, 2025. T-bill issuance contracted through May 2023, before moving higher following the suspension of the debt limit and ended the quarter up $470 billion. Yields on T-bills maturing in May and June experienced volatility, as investors assessed the potential risks of delayed payments on such instruments.

- RRP utilization contracted from $2.375 trillion as of the end of the first quarter to $1.989 trillion as of late June—the lowest level since early June 2022—before rebounding to $2.034 trillion at the end of the second quarter.

- Assets across the US money market fund (MMF) industry increased $233 billion during the second quarter. Assets of government MMFs and prime MMFs rose by $164 billion and $65 billion, respectively, while municipal MMFs rose by $4 billion.

The Fed’s “dot plot” interest rate forecast implied that additional hikes in the federal funds target range are possible, and we believe rates will likely remain elevated for the foreseeable future.

Active positioning of our MMFs should afford an opportunity to quickly benefit from actual and anticipated policy firming, while our assessment of a potential alteration in the Fed’s policy stance would likely affect our investment strategy.

T-bill supply is expected to remain elevated through the fourth quarter, representing a welcome increase in supply in our view.

Sources:

The BlackRock opinions expressed are as of 30 June 2023 and are subject to change at any time due to changes in market or
Consistent with the increase in government MMF assets across the industry, BlackRock government funds experienced net inflows during the second quarter. Rates on short-term Treasuries moved higher throughout the second quarter, with the most significant yield increase occurring in the 2-year note, which ended the quarter at a high of 4.87%. Yield levels on all tenors increased, as the market began digesting Fed rhetoric and pushing back the probability of a rate cut until 2024.

The 6-month and 1-year T-bills hit highs during the second quarter of 5.52% and 5.41%, respectively, and ended the quarter slightly down at 5.47% and 5.40%, respectively. Throughout the quarter, our focus was to ensure ample liquidity for any potential cash flow volatility. Since the beginning of this rate-hike cycle, we have preferred a below-neutral duration across our government funds; however, in our view, the shift in interest rate policy resulted in more favorable opportunities to extend duration. Purchases throughout the quarter were mostly comprised of 1-month T-bills at an average yield of 4.80% and 2-month T-bills at an average yield of 5.07%.

In 2022, T-bill supply declined by $41 billion, with no material relief anticipated going into 2023, as the US began nearing the debt ceiling limit. We believe this insufficient supply, coupled with a cohort of investors with elevated levels of cash who lacked access to the Fed’s RRP program, contributed to a generally strong demand for T-bills and dealer repurchase agreements. With resolution of the US debt ceiling impasse, markets are expecting $1.4 trillion of new T-bill supply through year-end, with most issuance skewed towards the front-end of the curve. Eligible funds continued to utilize the Fed RRP throughout the period, as the overnight rate increased from 4.80% at the beginning of the quarter to 5.05% following the May FOMC rate hike. Compared to investments in treasury and agency obligations, the Fed RRP remained a compelling investment choice, in our opinion.

Consistent with the increase in assets of prime MMFs across the industry, BlackRock prime funds experienced net inflows during the second quarter. Amid broader market volatility, we believe, investors exhibited demand for prime funds to take advantage of the incremental yield and diversification. As of June 30, the spread between institutional government and prime MMF yields was 0.19%. Tier 1 commercial paper (CP) outstandings increased by $19.6 billion over the quarter, to $426.3 billion. As expected, CP rates continued to reprice due to the FOMC rate hike seen during the quarter. Financial CP within our prime funds maturing in three months or less ended the quarter with an average yield of 5.39%.

Rates on money market deposit instruments continued to increase throughout the quarter, as overnight rates averaged at 4.98% and 1-week at 4.97%. Our prime funds favored these investments, which provided additional yield compared to Treasuries. Throughout the quarter, our focus was to ensure ample liquidity for any potential flow volatility. Purchases during the period were primarily of certificate of deposits and time deposits at an average yield of 4.97%, CP and overnight repo for eligible portfolios.

Although we favored a shorter-duration stance over the last several months to protect against interest rate risk, we have been opportunistically adding short-term credit to add duration where appropriate. At quarter-end, the portfolios remained defensively positioned, as we anticipate additional action from the Fed. As of June 30, the prime funds had an average daily liquidity of approximately 50%.

Sources:
- MoneyNet as of 30 June 2023.
- Federal Reserve as of 30 June 2023.
- BlackRock as of 30 June 2023.

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Money market fund strategy

Municipal funds

Tax-exempt money funds reported slight net inflows over the second quarter, ending the period with just over $114 billion in industry assets.

Highlighted by seasonal weakness as a result of tax-related redemptions, variable rate demand note (VRDN) inventory on dealer balance sheets remained elevated for a good portion of the quarter but ended at $2.4 billion, well below the rolling 12-month average of $4.6 billion.

While the Securities Industry and Financial Markets Association (SIFMA) Index (which represents the average yield on 7-day municipal floating-rate debt) fluctuated in a large range from 2.17% to 4.18% over the quarter, SIFMA averaged 3.32% and closed the quarter at 4.01%. We believe that large seasonal coupon flow, along with maturing securities, will result in VRDN yields drifting lower until the excess cash in the asset class is deployed.

In the fixed-rate space, the US Treasury market finished the second quarter wider across most of the curve, while 1-year municipal bond yields and 1-year municipal note yields widened substantially from 2.49% and 2.96% to 3.05% and 3.44%, respectively.

Ultra-short bond fund

Consistent with the theme across the ultra-short bond industry throughout 2022 and into 2023, the BlackRock Short Obligations Fund experienced net outflows in the second quarter.

Following the banking events in the first quarter, Tier 1 CP outstandings increased by $19.6 billion to $426.3 billion during the quarter. Tier 2 CP hit an all-time high of $142.6 billion in February but fell $91.5 billion by the end of June. Reinvestment rates for short-term credit instruments climbed each week, at 5.22% in late June.

Yields in the Investment Grade (IG) space were volatile throughout the quarter, with the yields on the JULI Financials 1- to 3-year Index ranging between 5.23% and 5.84%. Money market and IG spreads also experienced volatility throughout the second quarter resulting from stubborn wage growth and elevated inflation levels driving changes in investors’ expectations for the path of monetary policy and the outlook for economic growth.

Financials dominated the weaker tone in credit markets, although spreads closed the month tighter by 19 basis points underpinned by investors chasing the limited high-quality supply in the front-end of the USD curve and quarter-end funding dynamics.

Throughout the quarter, our focus was keeping the fund well positioned to capture higher reinvestment rates by focusing purchases on CP maturing between 1-week and 2-months at yields ranging from 5.14% to 5.39%. This short duration strategy enabled the fund to capitalize on each rate hike.

Other investments consisted of 6- to 12-month CDs at a 5.60% yield and fixed- and floating-IG debt maturing in 1 to 3 years at yields ranging from 4.77% to 6.01%.

While we anticipate that the Fed will likely maintain a “higher-for-longer” policy stance, the outlook for the third quarter remains uncertain, with the aftermath of the banking sector events in the first quarter and inflation remaining elevated.

In our view, opportunity remains for additional rate and spread volatility, leading us to remain neutral in our mandates as it seems too early to extend duration.

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Please consider the investment objectives, risks, charges and expenses of the BlackRock Short Obligations Fund carefully before investing. The Fund’s prospectus and summary prospectus contains this and other information about the Fund and are available, along with information on other BlackRock Funds, by calling 800-441-7762 or by accessing the website at www.blackrock.com/cash. The prospectus should be read carefully before investing.

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