A need for speed

U.S. Cash Management investment commentary

BlackRock

Q1 2022

Market outlook

- Amid elevated inflation and ongoing geopolitical uncertainty, futures contracts for federal funds are priced for a series of interest rate hikes by the Federal Open Market Committee (FOMC or the Committee) over the balance of 2022, including the possibility of one or more 0.50% increases.
- We expect the FOMC to announce additional details at the May 4 FOMC meeting about its plans to reduce its securities holdings. In our view, the initiation of the balance sheet "runoff" program as soon as May is also possible.
- A further, near-term contraction in the supply of Treasury bills (T-bills) and overall lopsided demand for short-term supply has the potential, in our estimation, to contribute to ongoing downward pressure on yields of T-bills with very short maturities and on overnight repurchases agreements (repo).

Q1 Highlights

- As was generally expected, at its meeting on March 16, 2022, the FOMC raised the target range for the federal funds rate by 0.25% to 0.25% - 0.50%, the first such increase since December 2018. Federal Reserve Bank of St. Louis President James Bullard dissented in favor of a 0.50% increase in the target range.
- In a statement released in conjunction with the meeting,[1] the Committee acknowledged the "tremendous human and economic hardship" from the invasion of Ukraine by Russia and the "highly uncertain" implications of the crisis for the U.S. economy.
- According to the updated "dot plot", median federal funds rate forecast accompanying the meeting,[1] the FOMC penciled in a total of seven rate hikes over the balance of 2022, with an additional three to four hikes in 2023, and no additional hikes in 2024. Such actions if realized would bring the median federal funds rate above the Committee's "longer run" estimate of the neutral level of the federal funds rate (or the theoretical rate that neither stimulates nor restrains economic growth).
- In a separate implementation note,[1] the Federal Reserve (Fed) raised both the interest rate on overnight excess reserves (IOER) and the offering rate on overnight reverse repurchase agreements (RRP) by 0.25% to 0.40% and 0.30%,respectively, thereby maintaining the current yield differential between these rates of 0.10%.
- Defensive positioning by investors amid geopolitical uncertainty and expectations for rate hikes by the FOMC—combined with an acute disparity between supply and demand in the money markets—have contributed, in our view, to downward pressure on yields of T-bills with very short maturities and overnight repo.
- The 3-month LIBOR-Overnight Indexed Swap spread (L-OIS)—a gauge of stress in the financial system—rose from 0.09% at the beginning of the quarter to a high of 0.43% as of March 16, before reverting to a level close to its 5-year average of 0.23% at the end of the quarter.

A series of interest rate hikes is expected over the balance of 2022.

Active positioning of our money market funds (MMF) should afford an opportunity to quickly benefit from actual and anticipated rate hikes.

Defensive positioning and a persistent disparity between money market supply and demand is likely to exert downward pressure on short-dated instruments.

Source 1: U.S. Federal Reserve as of March 16, 2022.
The BlackRock opinions expressed are as of March 31, 2022 and are subject to change at any time due to changes in market or economic conditions. Forecasts are based on estimates and assumptions. There is no guarantee that they will be achieved.

Money market fund strategy

Government & treasury funds

Consistent with the decrease in assets of government MMFs across the industry, BlackRock government funds experienced net outflows throughout the quarter. This is likely due to investors looking to deploy their year-end liquidity balances and pay corporate taxes.

Rates on short-term Treasuries repriced throughout the quarter, leading to yield curve steepening in the front end, as investors began pricing in rate moves by the Federal Reserve. However, rates across the Treasury bill curve changed little following the Fed's 0.25% rate increase at their March meeting, indicating that the action taken by the Fed was already sufficiently priced into the market.

The 1-year T-bill and 2-year T-note peaked during the quarter at 1.66% and 2.35% and ended the quarter slightly down at 1.60% and 2.28%, respectively. We believe this is due to typical quarter-end funding dynamics.

Throughout the quarter, our focus was to ensure ample liquidity for any potential flow volatility. Since year-end, we have preferred a below-neutral duration profile across our government funds; however, the shift in dynamics have resulted in more favorable entry points to extend duration.

Purchases throughout the quarter were mostly comprised of 2-month T-bills at an average yield of 0.11% and 4- and 6-months T-bills at an average yield of 0.41%. Eligible funds continued to utilize the Fed's RRP throughout the month, as the overnight rate of 0.05% increased to 0.30% following the rate hike, allowing it to remain a compelling investment choice in our opinion.

Looking forward, T-bill issuance is expected to decline, as the Treasury takes in income tax receipts, and the Fed is expected to initiate the reduction of its balance sheet, which could affect the amount of available T-bill supply in the intermediate term. With this in mind, the duration of our flagship, repo eligible funds remains underweight, as we expect additional rate increases by the Fed. We will continue to regularly participate in the primary market and look to opportunistically extend duration with any meaningful increase in rates.

Prime funds

Consistent with the prime funds industry, assets of BlackRock prime funds decreased throughout the quarter, given the uncertainty around the impact of the Russia invasion of Ukraine. The shift in monetary policy from the Fed's 0.25% rate increase at their March meeting gave some relief to prime funds and provided investors with additional income headed into quarter-end. At the end of March, the 30-day spread between prime institutional and government institutional funds was 0.06%.[2] The widest spread since August 2020.

Tier 1 commercial paper (CP) oustandings started off the year strong at approximately $388 billion and has since grown to $395 billion as of quarter-end. CP and overnight time deposits (TDs) were favored by most prime fund investors during the period, as they provide more income compared to U.S. Treasuries and U.S. Agencies. After the rate hike, 1-day CP yields rose significantly from 0.07% to 0.19%, and overnight time deposits went from 0.14% to 38%. We believe the spread widening will continue throughout the year as the market reprices in the possibility of more rate hikes.

We maintained a conservative strategy during the quarter, with weekly liquid assets ranging from 54% to 58%, given the geopolitical risks and the FOMC March meeting.

The trade activity in the BlackRock prime funds consisted of overnight certificates of deposits, time deposits, repurchase agreements and high-quality fixed rate CP maturing within 3-months at an average yield of 0.09%.

Following the FOMC's rate hike in March, the prime funds began to purchase 1-week CP at an average yield of 0.35%. Overnight time deposits, certificates of deposits and repurchase agreements also saw a rise in yields at an average of 28% to 32%.

As we continue with our strategy, we prefer to keep the duration of the prime funds short with a weighted average maturity (WAM) around 24 to 31 days and weighted average life (WAL) around 47 to 54 days, as we anticipate a more hawkish policy in the FOMC May meeting.

Source 2: iMoneyNet as of March 31, 2022.

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Money market fund strategy

Municipal funds

Despite the municipal market as a whole seeing outflows, tax-exempt municipal money funds saw slight inflows for the final three consecutive weeks of the quarter. This brought total industry assets to $87.4 billion at the end of March. Yields on weekly variable rate demand notes (VRDNs) are above taxable equivalents, having attracted crossover interest, which has led to a decline in dealer VRDN inventories to a very manageable level of $1.8 billion below the rolling 12-month average of $3.2 billion.

A combination of a Fed rate hike, quarter-end and tax season pressures pushed the Securities Industry and Financial Markets Association (SIFMA) Index—the average yield on 7-day municipal floating rate debt—wider to 0.51% by the end of Q1, exceeding 50 basis points for the first time since April 2020.

As we head towards tax season, in addition to municipal bond funds continuing to experience outflows, we expect SIFMA Index to remain attractive to crossover investors. With the market factoring in future rate hikes by the Fed, the 1-year municipal bond yields moved higher over the course of the quarter to 1.57%, while 1-year municipal note yields ended the quarter at 1.44%.

As our municipal money market funds position with high levels of daily and weekly liquidity, we continue to pursue a more defensive investment strategy in our national fund as well as our state-specific funds.

Target WAMs are positioned in the 20-day range for our national fund and the 10-day range for state-specific funds, as we remain selective given current valuations for municipal notes and bonds.

We continue to ladder CP trades with maturities in the 30- to 90-day range, as pressure on short duration notes and bonds grows in anticipation of Fed rate hikes.

Ultra-short bond funds

Gross investment grade (IG) corporate bond issuance was over $460 billion during the first quarter of 2022, which exceeds total issuance compared to this time last year. Roughly 20% of this new issuance has been concentrated in the 0- to 3.5-year space. Total CP outstandings increased by roughly $50 billion throughout the quarter to a total of $494 billion on March 31st. The majority of new CP issuance was concentrated in the Tier 2 space for most of the quarter, but a wave of net maturities caused outstandings to fall sharply at quarter-end.

All-in yields on IG corporate bonds were significantly higher quarter-over-quarter according to the JULI 1-3-year ex-EM index, which saw its yield climb from 1.39% to 3.25% as of March 31st. The sharp rise in Treasury rates during the first quarter was the primary driver of higher all-in IG yields as opposed to material spread widening. The index's spread to the Treasury hit a quarter-high of 0.98% before tightening to 0.76% at quarter-end, up 0.21% quarter-over-quarter. CP rates also materially rose during the period, as seen by yields on 90-day AA financial CP and A2/P2 nonfinancial CP increasing by 0.56% and 0.73%, respectfully. The steeper money market curve at quarter-end highlights the increased term premium investors have started to receive during the quarter.

Positioning at quarter-end reflected a bias that short-term rates will continue to experience upward pressure for some time. The duration of the fund was shortened from 0.47 years to 0.41 years, as reinvestments were kept short with expectations of additional FOMC rate hikes in the first half of 2022.

Most trades in the BlackRock Short Obligations Fund (BISOX) throughout the quarter consisted of short-dated CP maturing inside of 180 days, with yields ranging from 0.20% to 1.50%. Following the FOMC's first rate hike, the fund purchased 1-week CP at an average yield of 0.59%. As of March 31st, roughly 47% of the fund was made up of floating rate securities, with an additional 20% of securities maturing by the end of May.

As the market anticipates a more hawkish policy shift from the Fed amid growing geopolitical uncertainty, we are mindful of any additional rate repricing and volatility in the front-end. We will aim to maintain a short duration profile to allow us to capitalize on additional Fed rate moves and subsequent repricing along the money market curve.

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