FLORIDA PRIME

Weekly Commentary

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The FDIC's decision to effectively raise the insurance assessment fee on banks by broadening the base of eligible deposits to include all sources of wholesale funding—and not just domestic deposits—continued to wreak havoc in the repo markets last week. The change, which went into effect April 1 at a time the cash markets already were confronting supply issues because of the Treasury's paring of supplemental financing as the federal debt ceiling neared, caused overnight repo rates to effectively mirror their movements of the prior week, falling back to near zero early last week before recovering to 7 to 10 basis points on Thursday after cash traders essentially rebelled and shifted their purchases away from overnight repos to short-term Treasury and agency securities. Repo rates got another bump Friday, a settlement day in the cash markets, reaching the mid-teens to 20 basis points.

We expect repo rates will slip back from those seemingly lofty levels early this week, but also would be surprised to see them settle back into the low single digits again. The reality is the second quarter is likely to remain soft until the end of June, when the Fed is set to wrap up QE2 and the showdown over extending the debt ceiling is resolved, freeing the Treasury to step up supplemental financing purchases. We could envision repo rates settling into the mid-teens in the third quarter and even reaching the mid-20s by the fourth quarter, which given current levels, would be a welcome turn for the money markets. The futures markets currently are pricing in an initial tightening in the federal funds rate in early 2012, but we believe it's possible a move could come sooner if the fixed-income market reflects nervousness over budding inflationary pressures.

On the inflation front, the headline numbers for March CPI and PPI picked up considerably in March, rising 2.7% and 5.7% respectively year-over-year as the spike in oil and agricultural commodity prices began to take root. The core numbers were more reserved and within the Fed's implicit target range, but have begun to tick up as well, running at year-over-year levels of 1.2% and 1.9%, respectively. In other economic news last week, despite higher gas prices and a late Easter this year, March retail sales were stronger than expected, and both February and January were revised up, too. March industrial production also surprised to the upside, with broad-based improvement.

Outside of the movement in the repo market, credit rates in the money markets dipped across the curve, with one-month and three-month London interbank offered rates (Libor) falling 2 basis points to 0.21% and 0.27%, respectively, and six-month and one-year Libor falling a basis point each to 0.44% and 0.77%. Four-week and 26-week Treasury bills also slipped 2 basis points to 0.03% and 0.11%, respectively.

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Views are as of April 18, 2011, and are subject to change based on market conditions and other factors.