FLORIDA PRIME

Weekly Commentary

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Rates continued last week at low, low levels, thanks to the Federal Reserve's ongoing quantitative easing program, to the tune of $85 billion worth of Treasuries and agency mortgage-backed securities (MBS) purchases each month. Fed Chairman Ben Bernanke's dual testimonies before the House and Senate turned out to be somewhat anticlimactic—Bernanke was about as dovish as he could be while still leaving the door open for the idea of tapering of QE measures later in 2013. The Fed chairman hedged quite a bit, saying that any move toward tapering was not preordained, the Fed's decision would be data-dependent and there could easily be a course change should economic data change. Despite Bernanke's qualifications, markets heard what they wanted to hear—tapering was to begin in September, and that absent any economic changes, QE could be history by mid-2014. If and when the Fed does begin tapering of QE, all signs point to a gradual process, possibly cutting back purchases at the rate of $10-15 billion per month. Over the course of several months, tapering could help to lessen pressure on the repo markets.

In another effort at communication through repetition, Bernanke also pointed out that tapering is not tightening, and just because the Fed might cut back on QE, it doesn't necessarily mean that a change to the federal funds rate is in the offing. As a matter of fact, Bernanke indicated that there could be a period of watching and waiting between the end of QE and the beginning of tightening. Nevertheless, federal funds futures contracts reflect an anticipated tightening in 2014, expectations that might not be warranted.

London interbank offered rates (Libor) were down slightly for the week, with three-month down a basis point to 0.26%, six-month steady at 0.40%, and one-year down a basis point to 0.68%. Short-term Treasuries were down as well, with one-month down a basis point to 0.01%, three-month down a basis point to 0.03%, six-month steady at 0.07% and one-year down a basis point to 0.11%. Repo markets remained under pressure, trading at a single basis point for Treasury repos and two basis points for mortgage-backed repos for most of the last week. Although this softness was expected, it doesn't make it any less painful. In past periods in which repos have traded at near-zero rates for an extended period of time, the low rates have been, at least in part, demand-driven. This time around, the blame can be put on supply factors. The Treasury has been flush with cash as a result of tax receipts, the $60 billion payment from Fannie Mae, and lower financing needs as a whole. Early in the second quarter, Treasury bill auctions were cut back sharply as a side effect of the smaller deficit. In recent weeks, auctions have just kept pace with maturing amounts, a trend that's expected to continue for a while. Issuance of some cash-management bills is expected in mid-August, which could ease the strain a bit.

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Views are as of July 22, 2013, and are subject to change based on market conditions and other factors.