Key takeaways from the Fed's Jackson Hole Summit and an analysis of the record level of US money market funds

August 26, 2024

David Chao
Global Market Strategist,
Asia Pacific (ex-Japan)

It was no surprise that Fed Chair Powell pivoted the Fed's focus at the annual Jackson Hole summit from inflation to employment concerns after a significant downward revision in the payroll employment data and the rise in the unemployment level in July.

Powell summed it up best by saying, "The upside risks to inflation have diminished and the downside risks to employment have increased".[1]

The labour market in the US has unmistakably started to cool though "the Fed does not seek nor welcome any further cooling."

Markets rallied shortly after Powell detailed that "the time has come for policy adjustment" though he did not guide to a specific size cut in September. [2]

So the question now is no longer whether the Fed is going to cut in September but by how much.

That said, Powell did leave the door open for larger cuts in case labour conditions deteriorate further. Thus the market read through is that the Fed appears to be open to cutting interest rates faster than previously expected.

Still, our base case remains for 2 cuts of 25bps by the end of 2024. While the labour data is softening, other indicators of the US economy remain resilient, such as retail sales, wage growth and financial conditions.

I will be closely watching the upcoming PCE (Personal Consumption Expenditures) inflation inflation data especially in light of the strong retail sales number last month.

These inflation data points can certainly feed into whether the Fed has any urgency to cut rates. I'd still like to point out that monetary policy has a lag on economic activity and the current policy rate remains very restrictive.

There is growing concern that the Fed may soon fall behind the curve if cuts are not swiftly implemented.

Implications on the record amount of cash parked in US money market funds

The record amount of cash parked in US money market funds may not automatically pivot to risk assets such as stocks once the Fed starts cutting interest rates.

While it's plausible to think that the record amount of cash sitting on the sidelines is just waiting to be deployed elsewhere, these expectations may be overblown.

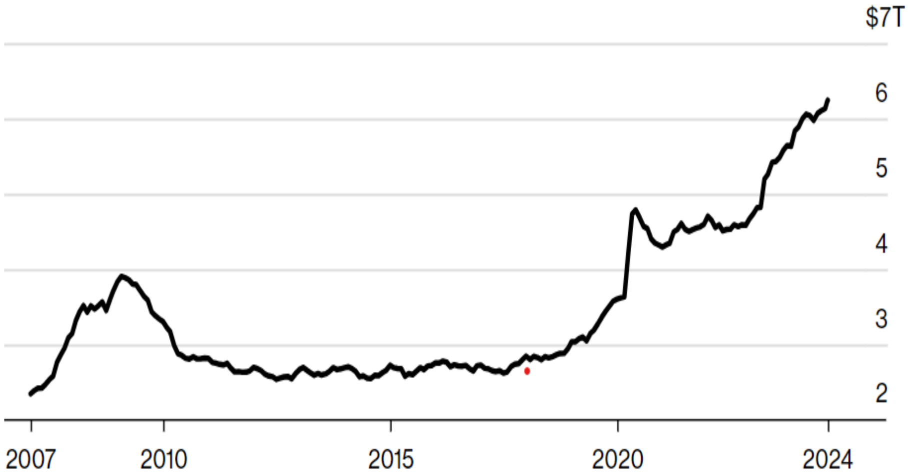
Invesco

Key takeaways from the Fed's Jackson Hole Summit and an analysis of the record level of US money market funds

August 26, 2024

The current high interest rate environment is only one of the reasons why market participants have parked a record USD 6.22trn into US money market funds[3] and just because the Fed starts to cut rates, doesn't necessarily portend to a re-deployment of funds elsewhere.

US money market funds total assets (Trillion USD)



Source: Investment Company Institute
Note: Data as of Aug. 21, 2024

Let's take a closer look at how we got here. Since 2019, US money market funds have seen a net inflow of around USD 2.6trn that have occurred broadly in three time periods.[4]

The first period was right after COVID-19, when the global economy faced a significant number of uncertainties.

The second period came from retail inflows when the Fed started raising rates in 2022 and the final phase came during the regional bank crisis during in March 2023 with both retail and institutional flows fled regional banks into money market funds.

Money market funds unlikely to return to pre-COVID levels even if the Fed starts cutting rate in Sep

I believe that money market funds are unlikely to return to their pre-COVID levels of around USD 4trn even if the Fed starts its rate cutting cycle in September.

We still expect 2 rate cuts of 25bps for 2024 and a series of more rate cuts in 2025 as the disinflationary process continues and economic activity slows.[5]

In our base case - which expects a bumpy landing scenario over the next 12 months - we estimate that twelve months from now, it's likely that the policy rate remains around 3.5%.

This would mean that money market yields would likely stabilize around this range, although with a lag. These yields would most likely still be attractive when compared to other cash alternatives.

In the worst case, hard landing scenario, the Fed would cut the policy rate aggressively over a shorter period of time which would in theory make current yields less attractive though investors are apt to still allocate a portion of their assets to money market funds for liquidity concerns and defensive purposes.

It's possible that investors would lock in more funds in the money market in the event of a deep recession.

And in the run-up to the rate cutting cycle next month, I foresee some investors locking in some of high yields, which may be more attractive than short-term certificate of deposits (CDs) or longer term US treasuries, whose yields would fluctuate downwards with the rate cuts.

Retail vs institutional flows in and out of money market funds

Let me also distinguish the different rationale for retail versus institutional flows in and out of money market funds. Institutional funds account for around 61% of money market funds while retail is around 37%.[6]

When institutional funds exit money market funds, they are apt to allocate to high quality, shorter duration assets rather than stocks as institutional investors are motivated more so by safety rather than yields. Retail funds, which makes up the minority of money market funds, are more apt to re-allocate to stocks.

In conclusion, while money market funds under management have hit an all-time high over the past couple of years, it is likely to stay high even when the Fed starts to cut rates.

Allocation to stocks is likely to be lagged and limited. Thus, this money on the sidelines may not be stock market boon that some may hope for.

Key takeaways from the Fed's Jackson Hole Summit and an analysis of the record level of US money market funds

August 26, 2024

Reference:

1. Source: Speech by Chair Powell on the economic outlook - Federal Reserve Board
2. Source: Speech by Chair Powell on the economic outlook - Federal Reserve Board
3. Source: Bloomberg, 23rd August 2024.
4. Source: Money-Market Funds Have Lured $106 Billion So Far in August - Bloomberg
5. Source: Invesco Mid-Year Investment Outlook, June 2024.
6. Source: Barclays Fixed Income Research, 21st August 2024.