Invesco

Investment Insights | Invesco Global Liquidity

Global Liquidity Snapshot

An at-a-glance look at what's happening in short-term liquidity markets around the world

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4Q highlights

US

On December 18, the Federal Reserve (Fed) lowered short-term interest rates by 25 basis points, resulting in the current federal funds rate range of 4.25%-4.50%. There was only one dissenter among the Fed voters, signifying the collective desire to move out of restrictive policy and normalize rates to achieve the Fed's 2% average inflation target. The outcome of the U.S. presidential election, along with the Republican sweep of the House and Senate, led markets to speculate that new policies could perpetuate more inflation in the future. The median dot plot currently implies two 25 basis point cuts in 2025, versus four 25 basis point cuts priced in during the third quarter of 2024. (1)

US money market fund industry assets ended 2024 at a record high of USD6.85 trillion. Although the US Treasury yield curve has largely dis-inverted, elevated short-term yields have remained attractive to cash investors and have been a driving factor in the continued growth in money market fund assets. (2)

UK

The Bank of England (BoE) cut rates by 25 basis points in November to 4.75%, as widely expected by the market and with the vote split eight to one. The much anticipated UK Budget followed with a big increase in spending, over half of which is planned to be covered by higher taxes and the rest by increased borrowing. The package was more expansionary than anticipated and caused the market to price out extra rate cuts. In December, the BoE Monetary Policy Committee (MPC) kept rates on hold as anticipated at 4.75%. The six-to-three vote split in favour of the hold was a surprise, with the three dissents to cutting rates coming on the back of sluggish demand and a weakening labour market. Prior to the meeting, labour market data surprised to the upside, for both jobs and wages. The minutes confirmed that a gradual easing next year is the baseline for the majority, while the vote split and tone of the minutes were somewhat dovish. (3)

Europe

The European Central Bank (ECB) cut rates in two consecutive 25 basis point cuts, taking the overnight rate to 3.00%, in line with market expectations. The Governing Council maintained its data dependant stance for subsequent rate cuts, but tellingly, it made no mention of the need to keep policy restricted. This suggests that, while it retains its asymmetric aversion to risk, it appears to feel more comfortable with its inflation expectations. (4)

Political instability continued in the eurozone with the collapse of German Chancellor Olaf Schloz's three-way coalition, leading to the lower house of parliament being dissolved and paving the way for a snap election on February 23. France's turmoil continued as Prime Minister Michel Barnier resigned after a no-confidence vote. President Macron named centrist François Bayrou as the successor but the National Assembly remains crippled by the same three-bloc impasse it has experienced since July, with no change likely before July 2025.

continued…

1. Sources: Bloomberg LP; Federal Reserve; as of 9/18/24 and 12/18/24.
2. Source: Bloomberg LP, Investment Company Institute (ICI), as of 1/01/25
3. Source: Bloomberg LP as of 12/31/24, Bank of England 11/06/24, 12/18/24.
4. Source: Bloomberg LP, European Central Bank (ECB) as of 12/12/24.

In the US, the January 2 expiration of the debt ceiling suspension and the March 14 expiration of the continuing resolution are near-term fiscal issues we are watching.

4Q highlights

Europe

Eurozone inflation edged up from it's low of 1.7% in the summer to 2.2% in November and is expected to remain slightly above the ECB's 2% target through the end of the first quarter. PMI data dropped over the quarter through the end of November, with the composite dropping to 48.5 before rebounding to 49.5. This was largely driven by manufacturing, which has ranged between 45 and 46, which is recessionary territory, while services dipped to 49.5 before rising to 51.4 at the latest print. The weak results have been driven by weak data in Europe's two largest economies, France and Germany. (5)

1 to 3-year corporate spreads generally tightened during the fourth quarter, narrowing by 15 basis points to 79 basis points from 94 basis points at the beginning of October, and reaching a low of 75 basis points during the quarter. (6)

Key areas to watch

US

- **Economy:** We are closely watching new presidential cabinet appointments, as well as the new administration's immediate policy focuses and implementation efforts. The January 2 expiration of the debt ceiling suspension and the March 14 expiration of the continuing resolution are near-term fiscal issues we are watching.
- **Credit conditions:** We are watching the evolution of US financial conditions and the impact of the recent shift in monetary policy. Credit valuations remain rich, in our view, and potential challenges facing commercial real estate remain a concern.

UK

- **Lingering inflationary pressures:** The repricing toward fewer BoE cuts started after employment data showed that wages increased more than expected, fanning concerns of lingering inflationary pressures.
- **Labour data:** UK private sector regular pay growth (a key focus of several MPC members) rose in October. However, single-month moves should be treated with caution, and we may see some retracement and/or downward revisions in the coming months.
- **BoE narrative:** UK government bond yields were slightly lower following a dovish hold by the BoE. Current data reinforce the MPC's message of patience and gradualism. The MPC is some way away from declaring victory on inflation.

Europe

- The European growth outlook remains challenging. Divergence among the growth expectations of member states continues and we will be monitoring harmonized inflation data and PMI and growth data for further signs of cooling across the eurozone.
- There is potential for geopolitical surprises, due to domestic disruptions in Germany and France and from further developments with the ongoing conflict between Ukraine and Russia.
- Markets will likely monitor future comments by ECB members, after a moderate December meeting, along with any changes in forward guidance on inflation.

Investment implications

US

- We are closely monitoring flows in the money market fund industry and the impact of the Fed's forward guidance on monetary policy
- Inflation should continue to moderate as we enter 2025, although we expect it to remain higher than the Fed's 2% target.
- The market digested the Fed's 100 basis points of rate cuts in 2024 without extreme price volatility, but we expect some marginal interest rate volatility as the market prices the terminal federal funds rate, given the resilience of the US economy.

5. Sources: Bloomberg LP, Eurostat, S&P Global, ICE Bond Indices, as of 12/31/24

6. Sources: Bloomberg LP, ICE Bond Indices, as of 12/31/24

We expect the Fed to cut policy rates by 25 basis points at each of the March and June 2025 meetings.

Market expectations of ECB rate cuts over the next three meetings is in line with our expectations and would take the overnight deposit rate to 2%.

Investment implications

UK

- Markets are no longer fully pricing one cut per quarter from the BoE next year amid signs of sticky price pressures that support the case for cautious monetary easing.
- Markets are now pricing a 65% chance of a 25-basis point cut in February, but there seems to be little certainty beyond that. [7]
- Our strategy remains to be nimble, keep well laddered maturities and invest in floating rate opportunities as they arise, given the ongoing uncertainty about how fast rate cuts will take place. We continue to extend purchases in commercial paper (CP) or floating rate notes where pricing makes sense.

Europe

- Market expectations of ECB rate cuts have declined slightly to three cuts over the next three meetings, which is in line with our expectations and would take the overnight deposit rate to 2%.
- Money market fund yields dropped as two ECB rate cuts took effect in 4Q and the rolling off of maturities reflected this. We have seen outflows, which have necessitated selling some positions and also contributed to a drop in yield. Given the risk and uncertainty around potential flows, our strategy has been to target high quality assets, while terming out within three to six-month tenors, and, where appropriate, being mindful of the current political and economic risks.

Outlook

US

Base case

- We expect the Fed to cut short-term interest rates by 25 basis points at each of the March and June 2025 meetings.

Risks:

- The potential disruption of the Fed's orderly monetary easing process due to unexpected volatility in economic data and market price action that could cause interest rate and price volatility.
- Dis-inversion of the yield curve may slow flows into the money market industry, although higher short-term rates should still provide an attractive lower-risk option for investors.

UK

Base case:

- We expect the BoE to be on track for a 25 basis point cut in February, but the rates outlook beyond February is less clear as the MPC battles with stagflation.
- In our view there is still a high probability of quarterly cuts in 2025.

Risks:

- **Monetary policy:** The BoE, like central banks across the globe, is attempting to manage current economic challenges and combat future headwinds. Worries over the stagnating UK economy and accelerating inflation are pushing up domestic borrowing costs.
- **Geopolitical risks:** We could see increased economic and market uncertainty and risks, as wars continue, budget battles rage and democracies come under pressure. This can quickly affect market pricing and move the needle on investments and issuers typically utilized in money market and short-term strategies.

7: Sources: Bloomberg LP, as of 12/31/24

Outlook

Europe

Base Case

- According to the ECB's December inflation forecast, headline HICP inflation is expected to edge up at the end of the fourth quarter and remain just above the 2% target in the first quarter of 2025, mainly due to base effects in energy prices, before returning to a downward path by the end of the second quarter. The ECB expects 2.1% inflation in 2025 and 1.9% in 2026. [8]
- On the back of recent economic data and ECB member comments, we believe the ECB will cut the overnight deposit rate by 25 basis points in each of the next three meetings, taking the rate to 2.25%.

Risks

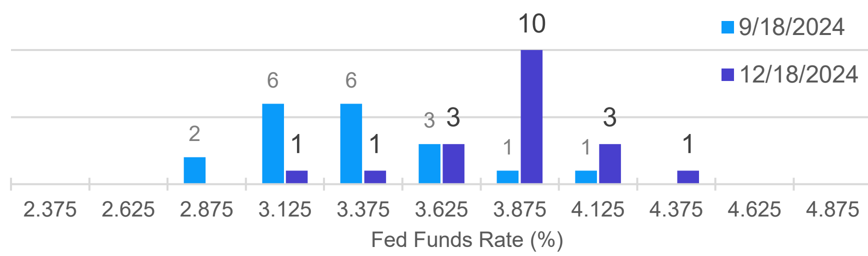
- The potential for aggressive tariffs imposed by the Trump administration, which could hamper exports and erode trade with the US. and with China, revolving around the supply of electric vehicles and potential for retaliatory tariffs placed by China . These developments could pose a risk to European growth and lead to weaker productivity.
- Continued German and French political instability could impact the economies of the two largest markets in the eurozone, further dragging down the European bloc.

Data spotlight

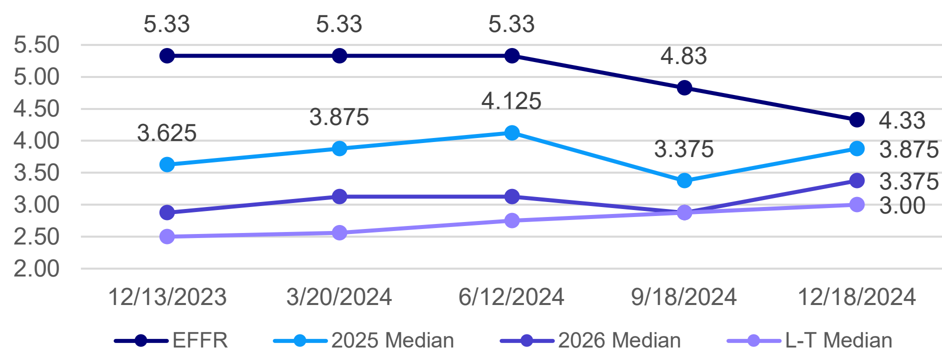
Shifting policy rate expectations

Based on the December 18, 2024 Summary of Economic Projections, the distribution of participants' judgements of the midpoint of the appropriate target range for the federal funds rate has shifted to the right, which indicates a higher level of rates than previously expressed. We believe this is appropriate, given the resilience of the US economy and potential inflationary policies that the incoming administration may enact.

2025 fed funds rate midpoint, # of participants [9]



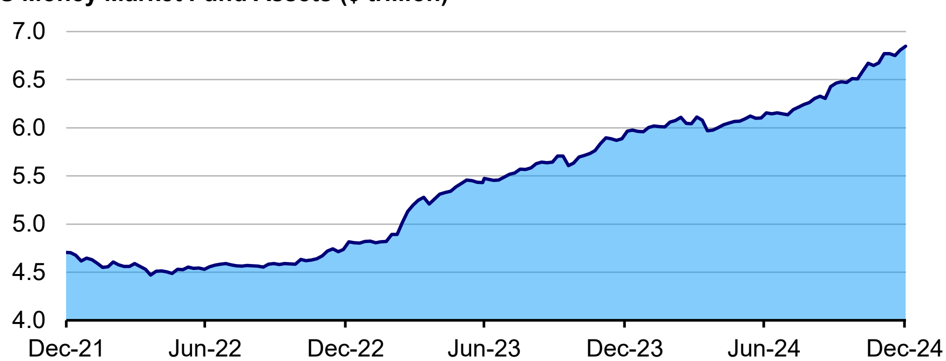
Fed funds rate (%) median projection [9]



The expanding US money market landscape

US money funds continued to hit record highs reaching $6.85 trillion even while the Fed lowers policy rates.

US Money Market Fund Assets ($ trillion) [10]



8: Sources: European Central Bank, as of 12/12/24

9. Sources: Bloomberg LP, Federal Reserve; as of 12/18/24

10. Sources: Bloomberg LP, Investment Company Institute (ICI); as of 1/1/25

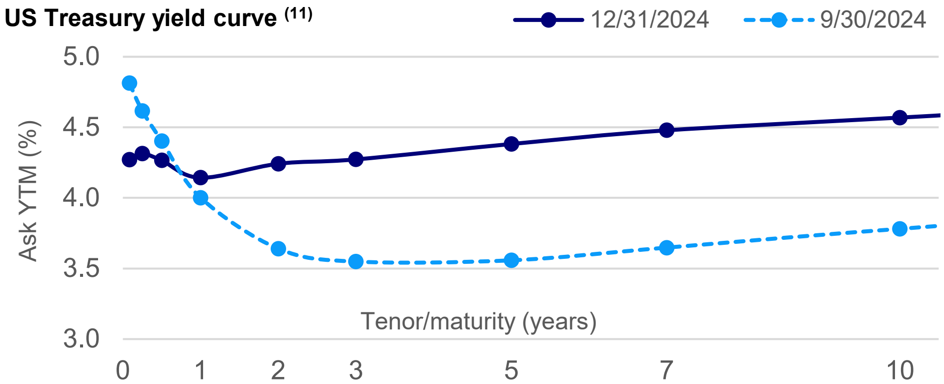
Data spotlight

Money market yields lower, front end slightly inverted

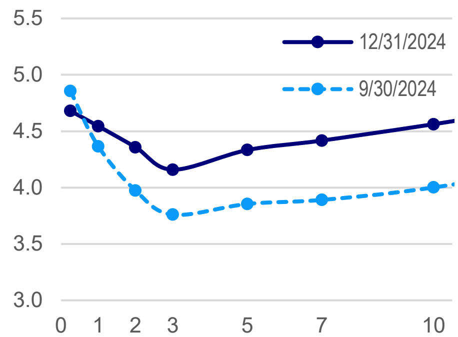
The 2's to 10's part of the US Treasury yield curve steepened in 4Q as yields jumped on resilient economic data and the US election.

However, the very short end of the yield curve, between 3-months and 12-months, remained inverted due to expectations of a few more rate cuts by the Fed.

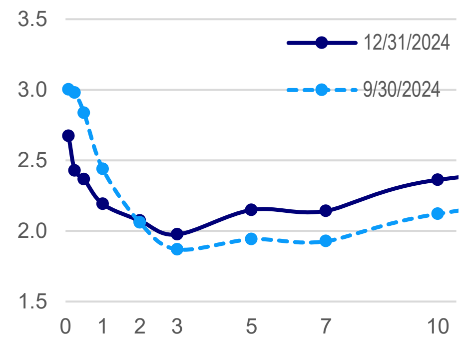
US Treasury yield curve [11]



UK Government curve [11]



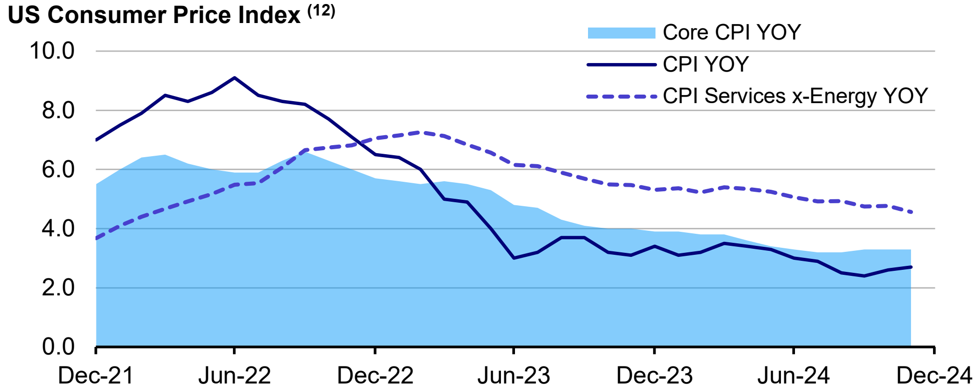
German Government curve [11]



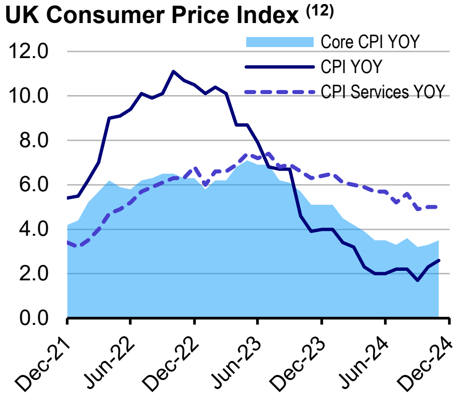
Inflation measures gravitating to 2% targets

Confidence that inflation moving lower has provided solace for central banks to ease policy rates. In the US, the FOMC is refocused on its dual mandate.

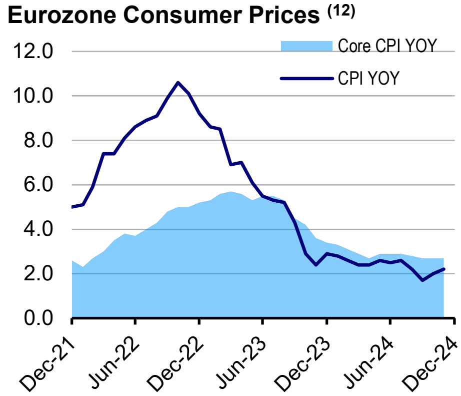
US Consumer Price Index [12]



UK Consumer Price Index [12]



Eurozone Consumer Prices [12]



11. Sources: Bloomberg LP as of 12/31/24

12. Sources: Bloomberg LP, Bureau of Labor Statistics as of November 2024, UK Office for National Statistics as of November 2024, Eurostat as of November 2024.

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Invesco Global Liquidity

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