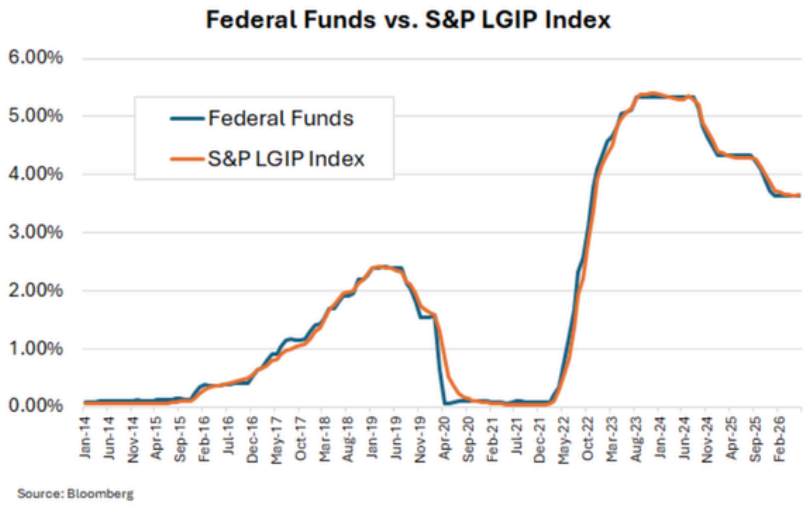
Federal Reserve Policy and LGIP Yields

Perspectives for LGIP Participants

Introduction

Local Government Investment Pools (LGIPs) sit at the intersection of public-sector liquidity management, short-term fixed income markets, and the Federal Reserve's monetary policy. The Federal Open Market Committee (FOMC) is the monetary policy committee of the Federal Reserve that sets interest rates. Because LGIPs generally have a short maturity structure, the FOMC's policy directives materially impact pool yields.

The FOMC directly controls the federal funds rate and influences other short-term rates, which anchor overnight and very short-term money-market yields. As short-term instruments such as Treasury bills, repurchase agreements, commercial paper, certificates of deposit, and variable-rate instruments reprice, LGIP portfolio yields tend to follow. The movement is directional but not instantaneous: existing portfolio holdings must mature or reset before new market rates are fully reflected in pool earnings. The chart below depicts this relationship as reflected by Federal Funds rate and the S&P LGIP Index (an index comprised of 73 LGIPs).



For LGIP participants, the practical implication is straightforward: rising-rate environments generally support increasing LGIP distribution yields, while easing cycles tend to reduce yields and therefore LGIP income. However, the size and speed of that effect depend on portfolio structure, weighted average maturity, liquidity targets, security selection, credit constraints, and the pool's accounting and regulatory framework.

The Rate Transmission Mechanism

The FOMC typically meets eight times per year. At its board meetings the FOMC reviews economic and financial conditions and determines the appropriate stance of monetary policy in pursuit of stable prices and maximum employment. Its decisions affect the supply and cost of reserve balances and thereby influence the federal funds rate, which serves as a core anchor for short-term interest rates across the financial system.

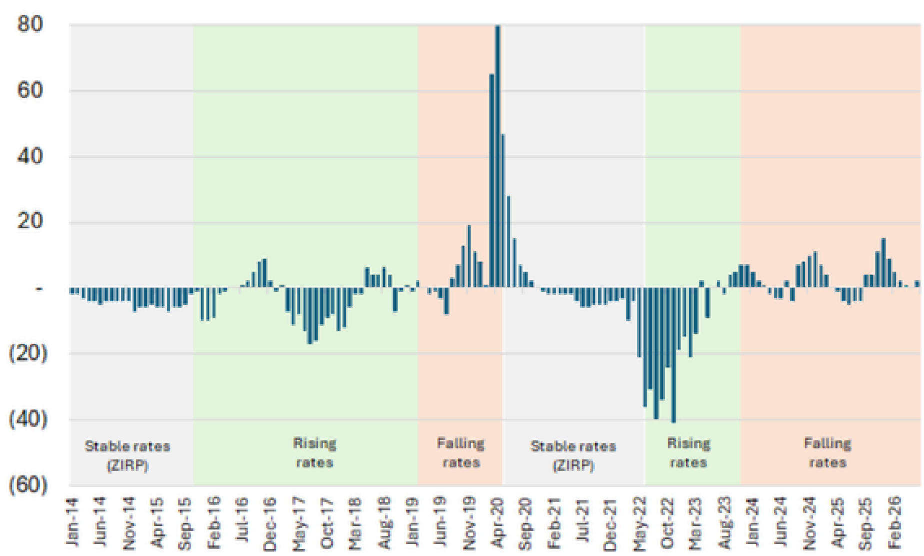
The federal funds rate is the overnight benchmark around which a broad constellation of short-term rates adjusts. The transmission chain begins with the FOMC target range and the Federal Reserve's administered rates, including interest on reserve balances and the overnight reverse repo facility. These rates influence overnight funding markets and provide a floor or reference point for many short-term instruments. Dealers, banks, issuers, and investors then reprice Treasury bills, commercial paper, repurchase agreements, and other instruments to reflect the new policy environment.

LGIP yields respond through reinvestment. When a pool receives maturities, coupon payments, new participant contributions, or proceeds from called securities, the portfolio manager purchases securities at current market yields. In a tightening cycle, reinvestment typically occurs at higher yields; in an easing cycle, reinvestment generally occurs at lower yields.

Why LGIP Yields Lag FOMC Decisions

An LGIP's reported or distributed yield is a weighted result of its portfolio holdings. If the pool purchases a 90-day Treasury bill two weeks before a rate hike, the yield on that holding does not automatically change the next day. The pool realizes the benefit of the higher rate environment as holdings mature and cash is reinvested. The shorter the weighted average maturity (WAM) of the LGIP portfolio, the faster this adjustment occurs. A pool with a large overnight repo allocation or very short WAM will reprice quickly. A pool with a longer maturity ladder may lag more in the early phase of a hiking cycle but may also retain higher-yielding assets for longer after the FOMC begins cutting rates.

Fed Funds/S&P LGIP Index Basis Point Differential



The chart below shows the basis point differential between the federal funds rate and the S&P LGIP Index during different rate cycles. For example, from May 2022 to July 2023 the FOMC increased the federal funds rate 10 times for a total of 5.25%. Because of the security repricing process, LGIP yields lagged changes in the federal funds rate. There were also periods in which the FOMC instituted a zero-interest rate policy (ZIRP).

During periods in which ZIRP was implemented, the federal funds rate was stable but set in a range of 0% to 0.25%. In these time periods most LGIP yields lagged the federal funds rate because of the wide implementation of fee waivers.

Investment Strategies to Add Value during Changing Rate Environments

In a rising-rate environment, LGIPs typically experience improving portfolio yields as older, lower-yielding instruments roll off. Investors may see distribution yields rise over days, weeks, or months depending on the pool's maturity profile. Portfolio managers often balance the desire to capture higher rates with the need to preserve liquidity and avoid overextending credit or maturity risk.

The trade-off is especially important in fast tightening cycles. Keeping the portfolio shorter can improve reinvestment flexibility, but it may reduce yield pickup available from modestly longer instruments. Extending maturities can lock in yields, but it reduces the speed at which the portfolio can benefit if rates continue to rise.

In an easing cycle, LGIP yields generally decline as high-yielding instruments mature and are replaced with lower-yielding securities. A somewhat longer maturity structure may cushion the decline for a period, but public-sector liquidity needs and statutory investment limits usually constrain how much duration a pool can add.

The table below provides a general perspective on interest rate scenarios and strategic decisions a portfolio manager can execute to add value strategically.

Rate Scenario Decision Making Framework

Scenario	Likely market effect	LGIP yield behavior	Portfolio Manager focus
FOMC hikes	T-bills, repo, CP, CDs reprice higher	Yield rises with reinvestment lag	Reduce WAM, maintain liquidity while capturing higher reinvestment rates
FOMC holds	Short rates stabilize around target range	Yield stabilizes near portfolio run-rate	Optimize maturity ladder and credit spread pickup
FOMC cuts	Money-market yields decline	Yield falls as holdings mature/reset	Extend WAM, preserve income where prudent; avoid liquidity sacrifice
Market stress	Liquidity premiums widen; credit spreads may move	Yield may rise, but risk and liquidity become more important	Prioritize safety, diversification, participant liquidity and portfolio stress tests

Practical Implications for Public Entities

Public entities should view LGIP yields as a function of both FOMC policy and portfolio design. A finance officer evaluating pool yields should ask not only whether the FOMC is expected to raise or cut rates, but also how quickly the pool's portfolio is likely to reprice. Key metrics to review include WAM, weighted average life (WAL), daily liquidity, weekly liquidity, credit exposure, maximum final maturity, and allocation to overnight instruments.

For budgeting, entities should stress test investment income under multiple rate paths. For liquidity planning, they should coordinate operating cash needs with pool redemption policies, known seasonal tax inflows, payroll cycles, debt service dates, and capital project disbursements.

Key Takeaways

Question	Answer
What does the FOMC control?	The FOMC sets the target range for the federal funds rate and uses policy tools to influence short-term rates.
Why do LGIP yields react?	LGIPs invest in short-term instruments whose yields are tied to overnight funding rates and Treasury bill levels.
Why is there a lag?	Securities already owned by the pool continue earning their existing coupons or discount yields until maturity or reset.
What matters most operationally?	Weighted average maturity, daily and weekly liquidity, maturity laddering, credit quality, and participant cash-flow behavior.
What should investors monitor?	LGIP portfolio structure, WAM/WAL, pool liquidity levels, and monthly yield trends.

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Disclosures