Issues and Trends in Money Markets

Reflections from the Baltimore Money Market Fund Conference

Abstract

As we recap market developments in the first six months of 2013 and look to the future, we reflect on the following five observations from a recent liquidity conference:

- *Low yield environment turning the corner;*
- *Corporate cash balances up, investors less worried;*
- *Supply still constrained, but more issuers entering the market;*
- *New money market fund proposal is here, but reform may be years away; and*
- *Portfolio strategies still defensive, but more diversified*

Introduction

The first half of 2013 saw developments that may alter the cash investment landscape for years to come. As we hit the midpoint of the year, we reflect on some of the key trends that are either already in place or developing. Reflections from a conference organized by money market fund data publisher Crane Data held in Baltimore from June 19th through 21st help us identify and confirm such trends. We think that 2013 is an inflection point for short-term interest rates, supply and demand dynamics, and the regulatory environment, all of which will impact investor behaviors and portfolio strategies.

Looking back at the first six months of the year, we witnessed the expiration of the FDIC guarantee on large deposits, the "fiscal cliff" and the ensuing sequesters, deposit defaults in Cyprus, chatter about the Federal Reserve's "tapering" of asset purchases and the culmination of the SEC's money market fund reform proposal, just to name a few.

How will these events affect our market? Where do we go from here? What are the likely responses to regulatory changes? These were the questions on the minds of some 450 conference attendees, representing money market portfolio managers and salespeople, commercial paper issuers, securitization specialists, dealers, ratings analysts, attorneys and government representatives, as well as corporate and institutional investors.

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Lance Pan, CFA
Director of Investment Research
Main: 617.630.8100
Research: 617.244.9466
lpan@capitaladvisors.com

In this credit commentary's limited space, we attempt to summarize trends we've observed in the following five areas: short-term rates, corporate cash balances and investor behaviors, supply dynamics, regulatory development and portfolio strategies.

Low Yield Environment Turning the Corner

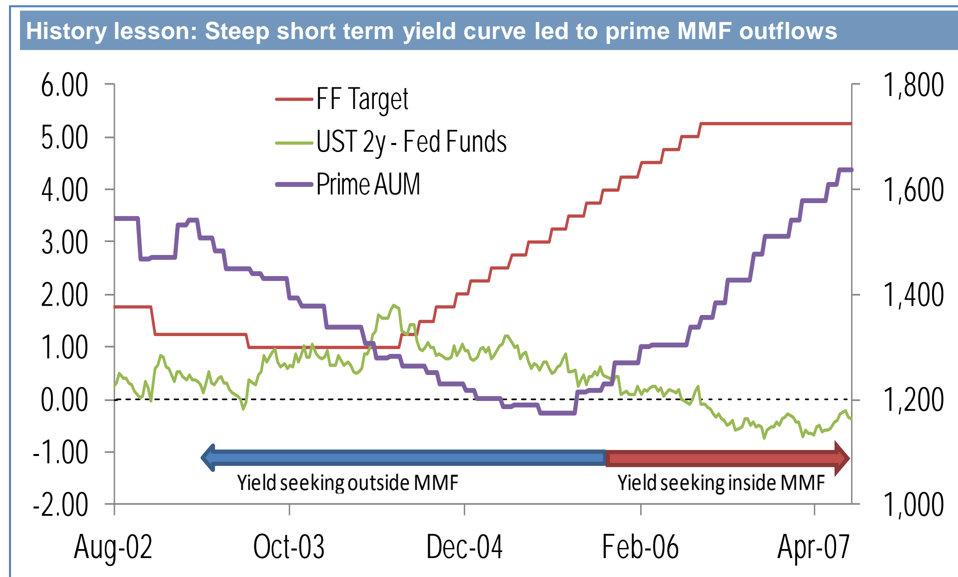
The Federal Open Market Committee (FOMC) met on June 18-19, which, coincidentally, was during the time of the Baltimore conference. Chairman Ben Bernanke's post-meeting remarks on phasing out the Fed's bond purchases this year sparked sell-offs in many markets. Several conference strategists agreed that gradually reducing the $85 billion per month purchase pace simply means less expansion of the monetary supply, but not the end of the easing cycle, much less the beginning of a tightening cycle.

Conference participants agreed that the Fed effectively has made the size of its monthly asset purchases the new "fed funds rate," the FOMC's principal tool used in monetary policy. The consensus was that the Fed will start reducing purchases at its September 2013 meeting and will conclude the program in mid-2014. Actual increases in the fed funds rate, if any, will not commence until mid-2015. Encouraging but lackluster economic data combined with benign inflation suggests that the Fed's "tapering" of the current program likely will be measured.

The sell-off in the Treasury bond market since the June 19th Fed announcement has been stunning. The 10-year Treasury note yield rose 0.38% to 2.57%. The two-year note yield rose 0.14% to 0.40%. Both yield levels have not been seen since July 2011, according to Bloomberg data. High grade and high-yield credit spreads to benchmark Treasury yields widened by 0.13% and 0.38%, respectively, since June 18th, according to Merrill Lynch corporate indices.

We believe that a change in investor expectations on the timing and magnitude of the next Fed moves drove rates higher, especially for bonds of longer maturities. While the sell-offs may be overdone for now, we think that we are at or near the turning point of the low yield environment. Yields on very short maturities are influenced by the near-zero fed funds rate, but attractive opportunities may lie further out on the yield curve. The steepening of the yield curve should offer relief to investors capable of owning bonds with slightly longer duration than money market securities. ***As Figure 1 shows, the period just prior to the last tightening cycle coincided with outflows from money market funds.***

Figure 1: Steep Short-Term Yield Curve Led to Prime MMF Outflows



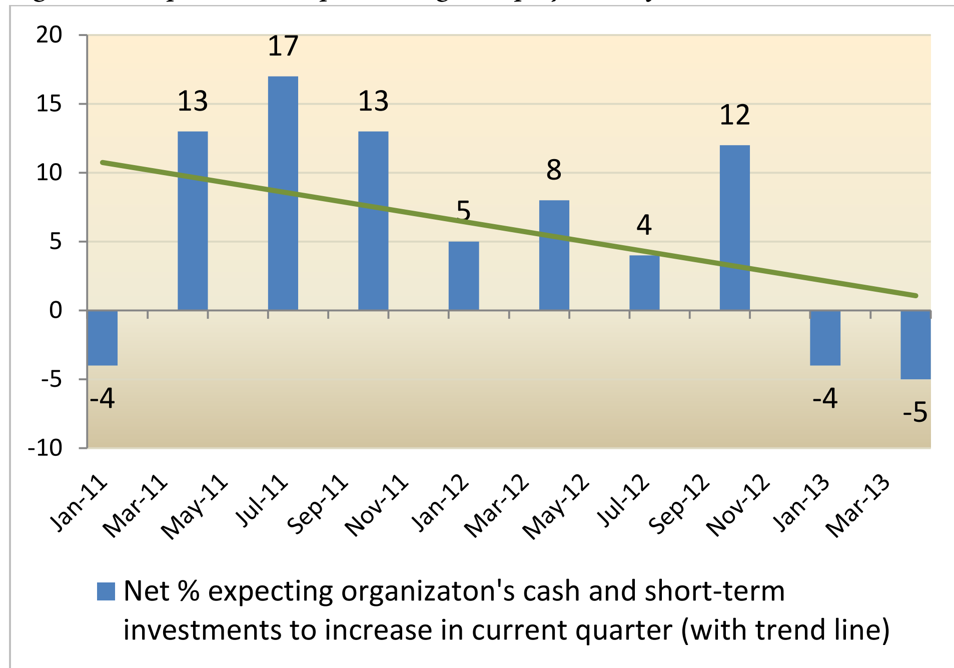
Source: 2013 Baltimore conference's "Strategists Speak (Alex Roever & Garret Sloan)" session.

Corporate Cash Balances Up, Investors Less Worried

On the first day of the conference, a representative from the Association for Financial Professionals (AFP) presented the trade association's annual liquidity survey results. The results from 885 respondents showed a generally higher demand for liquidity, a more upbeat perspective on growth prospects, growing confidence in banking relationships and more discipline in cash investment policies, according to the survey's press release.[1]

While corporations continue to build cash in 2013, a new trend has developed, resulting in a slower rate of increase in cash balances. On balance, fewer firms now expect cash to grow in the current quarter, suggesting the firms' deployment of cash towards capital expenditures, inventory and share/debt buybacks will pick up. (See Figure 2.) ***This trend may bring some relief to the current dilemma of institutional cash chasing few eligible investments.***

Figure 2: Corporations Expect to Begin Deployment of Cash



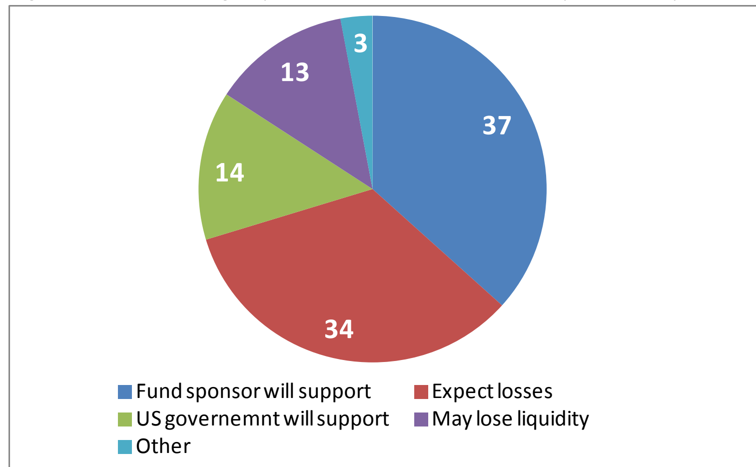
Source: Reproduced from the Baltimore presentation by Jeff Glenzer, Chief Content Office, AFP

Corporations did not seem to be deterred by the December 31, 2012, expiration of the FDIC's transaction account guarantees (TAG) that provided protection on unlimited balances in non-interest-bearing transaction accounts (NIBTAs). After the program expired, the fear of a sudden and massive exodus from the $1.6 trillion NIBTAs never materialized. The mean allocation of short-term investments to deposits only dropped slightly to 50%, compared to 51% in 2012, and well above 25% in 2008, the year the program was put into place. The AFP presenter and a few other panelists attributed the lack of change in deposits to the general mindset that corporations do not consider banks as credit counterparties. ***Said differently, corporate treasurers continue to be unconcerned about their uninsured deposits at the presumed "too-big-to-fail" banks, a notion contrary to recent regulatory developments.***

A question in the AFP survey asked what happens when the net asset value (NAV) of a money market fund drops below $1.00. It is worth noting that a significant portion of the respondents continue to expect external capital support. Figure 3 shows that 34% of the respondents expect principal losses and 13% expect losing all or part of their liquidity. The largest group, 37%, however, expects some form of sponsor support. Another 14% expect the U.S. government to bail out the fund. This finding directly contradicts the fund industry's claim that shareholders understand that money market funds are not guaranteed by the fund sponsor or the government. ***It also reinforces the***

government's assertion that more regulation is needed to solve the systemic issues in the money market fund industry.

Figure 3: Percentage of Anticipated Outcomes if NAVs of MMFs Drop Below $1.00



Source: Reproduced from the Baltimore presentation by Jeff Glenzer, Chief Content Office, AFP

Supply Still Constrained, but More Issuers Entering the Market

Panelists expressed frustration with diminishing supply in the short-duration debt market. This is hardly surprising. New rules requiring high quality security collateral in financial transactions left fewer government securities for cash investors. Government mandates for Fannie Mae and Freddie Mac to shrink their mortgage portfolios led to a reduction in their capital markets borrowing needs. Financial authorities also encourage banks to reduce their reliance on the short-term debt market. ***The general consensus was that short-term supply, especially collateral for traditional repurchase agreements (repos), will remain constrained for some time.***

But not all is lacking on the supply side. In fact, this year's record conference attendance was in no small part due to the return of issuers and intermediaries who lost favor with cash investors during the market turmoil that started in 2007. Examples of returning and new suppliers include callable commercial paper (CP) issuers, asset-backed and collateralized commercial paper (ABCP and CCP) conduits, real estate investment trusts (REITs) as repo counterparties, peripheral European banks and developing markets banks. Another favorite subject de jour: non-financial CP issues with tier 2 credit ratings. ***While these names may be off-limits to traditional conservative cash investors, many such issues have made their way into money market funds and separately managed accounts.***

An important issuer is the U.S. Treasury. As the Treasury continues to extend the WAM of its liability portfolio, short-maturity Treasury issuance is expected to dwindle.

Potential relief may come in the form of Treasury floating rate notes (FRNs), which may be issued between October 2013 and March 2014, according to a recent Treasury press release.[2] The Treasury representative reiterated the government's plan to offer $10 billion to $15 billion of two-year notes per month with 13-week rate resets, eventually reaching hundreds of billions of dollars. In the near term, the new debt simply may replace some Treasury bills without increasing overall supply. ***In the long run, FRNs may replace some longer maturity notes and increase net Treasury supply.***

New Money Market Fund Proposal Is Here, but Reform May be Years Away

Perhaps the biggest topic at the conference was the SEC's money market fund reform proposal, an undertaking three years in the making. The analysis on the proposal, 698 pages in length, is beyond the scope of this commentary, but it is helpful to summarize responses from money market veterans and how corporate cash investors may be impacted.

In general, reaction to the proposal was cautiously positive. This is no small feat since the majority in attendance was representatives from fund companies, their vendors and distributors who typically resist more regulation since the passing of the 2010 reform. ***Of the two SEC proposals, panelists and attendees overwhelmingly favored the liquidity gates and fees option over the floating NAV.*** Several people went so far as to claim that the floating NAV proposal was all but dead. In our opinion, this assertion, by no means a new one, was wishful thinking, at best.

Most participants credited the SEC staff for its thoughtful and thorough approach to the subject, as evidenced by the *War and Peace* size of the proposal. Most applauded the agency for exempting government funds and retail investors from further regulation. Attendees also liked the fact that minimum balance at risk (MBR) and capital buffers, two of the more widely opposed options, no longer are on the menu. Enhanced disclosure of fund information was uniformly applauded.

Panelists questioned the merits of abolishing the amortized cost method in NAV calculations, although very short-term securities (within 60 days) are still exempt. ***The issue is related to the difficulty in intra-day securities pricing that may affect a fund's ability to allow for intra-day liquidity.*** Accounting and tax implications continue to be the major obstacles to the floating NAV approach. Some expressed concerns with ambiguity on municipal funds and the retail definition of $1 million redemptions.

We believe that, from a corporate investor's perspective, the voluntary liquidity gates option is the least attractive one, yet an option most favored by the industry. In theory, gating may solve liquidity runs, but, in fact, it simply deals with the symptoms of a run,

not its causes. ***Institutional shareholders have virtually no control over their liquid positions in a gating situation, a fatal shortcoming that may greatly reduce the funds' cash management utility.*** We plan to issue formal comments on this subject in the near future.

We should stress that whatever route the SEC decides to take, the effective date of new reforms is at least 18 months away given the long comment period and the one- to two-year effective period specified. Investors will have time to chart new courses of action.

Portfolio Strategies Still Defensive, but More Diversified

This brings us to the topic in which we are most interested. Oddly enough, this year's conference did not have a panel that addressed separately managed accounts or alternative investments to money market funds. Information from other panels, however, allowed us to piece together how portfolio strategies have changed at major asset management firms.

In general, portfolio managers continue to maintain adequate liquidity buffers above the required 30% weekly liquidity. Several managers were comfortable with longer WAMs, in the "mid 50-day range, along with our peers," according to one portfolio manager. Recent market developments may cause them to revise that assessment.

Another portfolio manager commented that the traditional "barbelled" structure of simultaneously maintaining large balances in overnight and long positions has morphed due to a change in the outlook on interest rates and credit conditions. The short positions grew longer and the long positions became shorter, she said.

On separately managed accounts, one panelist commented on the recent popularity of "cash plus" accounts, defined as portfolios with a 6-month WAM and 2-year final maturity. More investors are seriously considering BBB-rated non-financial issuers as diversifiers away from bank exposure. Lastly, panelists agreed that government money market funds will have very little capacity to absorb prime institutional investors who want to avoid the floating NAV reform. ***We think it is prudent to consider alternatives other than government funds as potential prime fund diversifiers.***

Conclusions – An Inflection Point with Threats and Opportunities

At the start of the second half of 2013, we are pleased to have more things to talk about than low yield, deteriorating credit and an uncertain regulatory environment; a trio of recurring themes for much of the last five years. A reflating yield curve may bring about yield opportunities for the right investors. An upbeat economic outlook may alleviate the demand side of market imbalances. Treasury FRNs, structured finance and second

tier credits, along with other non-traditional issues, are filling some gaps in the supply side of the equation. The framework for continued debate on money market fund reform is set, but implementation remains in the distant future. Lastly, portfolio strategies reflect the culmination of the trends thus discussed in a subtly more positive environment for outperformance.

Meanwhile, economic recoveries remain uneven as moderate growth in the U.S. is contrasted by a prolonged recession in the Eurozone and growth deceleration in China. Credit and interest rate risks continue to be the primary risks with which to contend. Recent volatility in the capital markets may highlight negative consequences from asset bubbles brought about by accommodating central banks in recent years.

Stay tuned and be cautiously optimistic. Enjoy the fun in the sun, fellow investors!

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[1]For detailed information on the survey, please refer to the "2013 AFP Liquidity Survey Introduction & Key Findings" PDF file link. http://www.afponline.org/liquidity/ Password required.

[2] See U.S. Department of Treasury press release website: Minutes of the Meeting of the Treasury Borrowing Advisory Committee of the Securities Industry and Financial Markets Association" April 30, 2013. http://www.treasury.gov/press-center/press-releases/Pages/jl1923.aspx

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