Three Cash Investment Trends (and Twists) in 2011

Meet the New Year, same as the old - with a twist.

In preparing our treasury investment strategy outlook for 2011, it seems there isn't much we have not already seen or experienced in 2010 – an exceptionally low interest rate environment, the Eurozone sovereign debt crisis, and a wave of financial regulations. Indeed, we have written about these themes on several occasions. However, complacency can sometimes have a nasty hangover, especially in this profession. In the interest of keeping a healthy dose of skepticism to the consensus view, we feel obliged to offer our take on trends, as well as "twists," in cash investments in the New Year.

Exceptionally low interest rate environment creates yield opportunities further out on the yield curve.

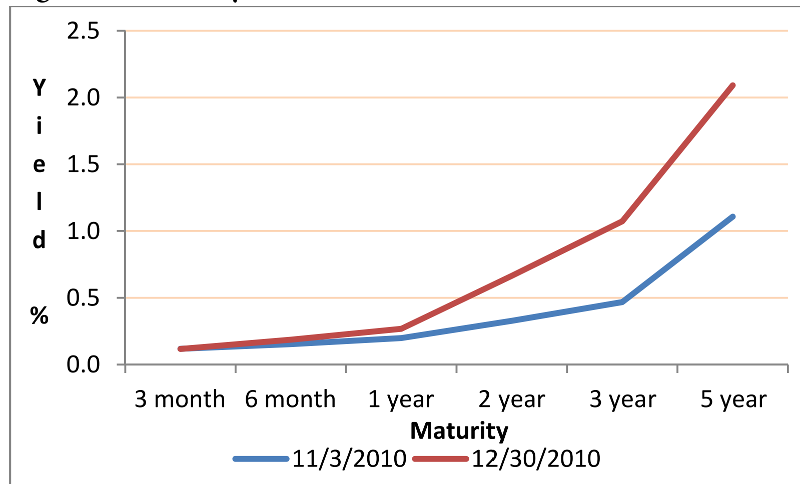
It has been more than two years since the Federal Reserve took the benchmark Fed funds rate down to a range between 0% and 0.25% in December 2008. It is one thing to marvel at the survival of the short-term debt market at these exceedingly challenging levels. It's another trying to gauge when the rates will start to rise, or at least are poised to rise. For much of 2009, and the early part of 2010, the Fed and the markets were getting ready for the eventual arrival of sustained economic expansion and a rising interest rate environment. Alas, the dynamic duo of the Eurozone sovereign debt crisis in the spring and the expiration of housing tax credit in the summer crashed the party. Currently, the Fed is set to complete round two of its $600 billion Large-Scale Asset Purchases (LSAP, also known as Quantitative Easing 2) in long-term Treasury securities by June 2011.[1] By then, the Fed's balance sheet will stand at approximately $3 trillion.

The trend: Since the central bank has made it known that it will deflate its balance sheet before embarking on interest rate increases, it is sensible to expect the Fed funds rate will remain immobile for much of 2011 and perhaps even through the early part of 2012. Hence, the low interest rate environment will likely be with us for another year. Investors of money market funds, short-maturity Treasuries, and bank deposits may have another lackluster year ahead for them.

The twist: Since the Fed's announcement of Treasury purchases at its November 3rd policy meeting, the yield curve has actually steepened, meaning yields on short maturity Treasury bills remain low but longer-term rates are rising (See Figure 1).

During this period, the 3-month Treasury bill rate was unchanged but the 2-year note yield doubled to 0.66%. There are several explanations for this trend: a) economic activities have turned more positive since early November; b) markets are concerned that the Treasury purchases may stoke future inflation; and c) the $858 billion cost of the recently enacted extension of Bush-era tax cuts will be financed entirely with new Treasury debt.

Figure 1: Treasury Yield Curve since Fed's LSAP Announcement



Source: Bloomberg.

The takeaway: Yields on short duration cash portfolios such as money market funds will likely remain low in 2011. Investors who can travel further up on the maturity spectrum may reap greater rewards than in 2010 thanks to a steeper yield curve. The Fed's likely decision to remain on hold could help reduce this strategy's interest rate risk.

Sovereign debt crisis may spread beyond the Southern European "Ring of Fire" to stateside and challenge U.S. investors.

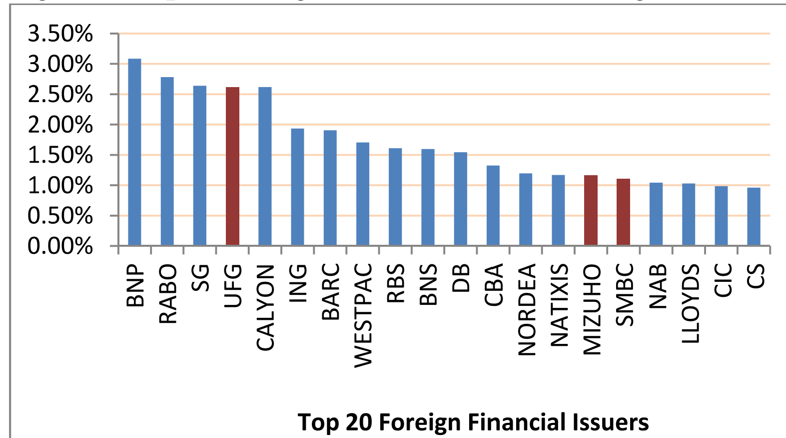
The on-again-off-again European sovereign debt crisis does not seem to have an end in sight. After Greece and Ireland fell under the weight of skyrocketing borrowing costs in the bond market, both governments sought help from the European Union (EU) and the International Monetary Fund (IMF). Pressure on Portugal is building, with Fitch Ratings downgrading its debt to A+ from AA- on December 29 and Moody's threatening to take its A1 rating down by up to two notches just a week earlier. Spain, the big elephant in the room, representing the fifth largest economy in the EU, is weighed down by debt-laden savings ("caja") banks and overspending by local governments. The country-by-county piecemeal solutions from the EU seem to only light a fire elsewhere in the Eurozone, which prompts sporadic rumblings of the breakup of the common euro currency. The difficulties in instituting an EU-wide debt

solution and a fiscal union, the spreading of social unrest due to tough austerity measures, and the interconnected nature of various financial institutions all point to the continuation of this subject being front and center on debt investors' minds.

The trend: We think market jitters will continue as more sovereign names receive credit downgrades and face funding challenges. Behind Portugal and Spain, the potential lineup already includes Belgium, the United Kingdom, and France. Borrowing by the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM), a permanent replacement for the former, will commence in early 2011 to pay for the Irish rescue deal, and potentially other sovereign bailouts. We expect initial market responses to these bonds to be positive given the collective pledges behind them and the entities' AAA credit ratings. Meanwhile, we expect cash investors to remain on guard towards financial issuers with large southern European exposures.

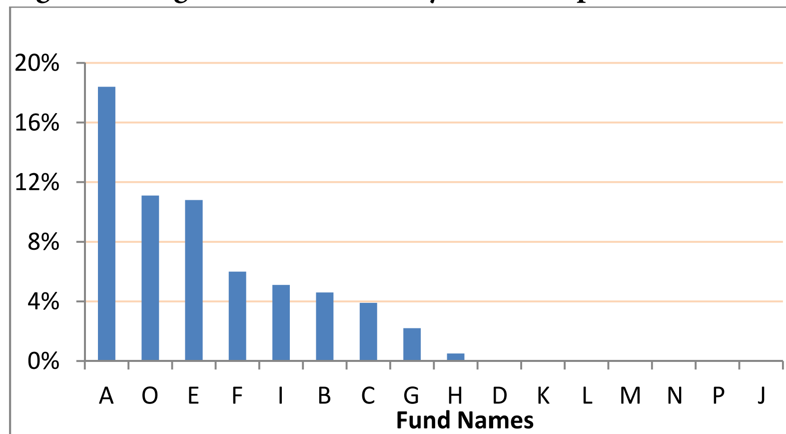
The twist: With the market's attention on southern Europe, we would like to redirect the focus to other parts of the world, specifically Japan and the United States, both of which rely heavily on government debt issuance. Japan's public debt level of $10 trillion, roughly twice its GDP, prompted a warning by its Prime Minister Naoko Kan in June 2010 in which he compared Japan's financial crisis to Greece's.[2] In the U.S., many local governments and some states are facing grave budget challenges which have led to a number of high profile defaults or near defaults, a trend that will likely continue into 2011. Even the Federal government is under a cloud of negative rating agency actions.[3] We mention these observations because of the recent increase in exposure to Japanese banks and municipal issuers in the peer group of 15 of the largest prime institutional money market funds we track (see Figures 2 and 3). As of November 30, overall Japanese bank exposure made up 5.4% of the 34.0% in total exposure to foreign issuers in the peer group. Among these taxable money market funds, some have substantial exposure to tax-exempt securities as funds were attracted by the recent spike in yields related to municipal challenges.

Figure 2: Top 20 Foreign Financial Issuers in Large U.S. Prime Money Funds



Source: Aggregate exposures of financial issuers in 15 of the largest AAA-rated U.S. institutional prime money market funds as of 11/30/2010 collected by FundIQ, a research service of Capital Advisors. For a detailed description on the group of funds, refer to the June 1, 2010 CAG newsletter titled "European Financial Debt and U.S. Prime Money Market Funds" by Lance Pan.

Figure 3: Large U.S. Prime Money Funds' Exposure to Municipal Issuers



Source: see footnote of Figure 2.

The takeaway: We remain cautious on credits with Southern European exposures and also are keeping an eye on names exposed to other regions of concern including Japan, as well as certain U.S. municipal entities.

New financial regulations usher in a new era of risk mitigation and redefine cash investment choices.

Much has been discussed about 2010 being the year of the regulators. 2011 probably will be no different since many subjects of interest to cash investors, including money market fund reforms, bank capital and liquidity requirements, and resolutions on systemically important financial institutions (SIFIs), will need more time to be ironed

out. In fact, the New Year may turn out to be a bigger year than the last for the regulators, since discussions of potentially floating the net asset values (NAVs) on money funds and unlimited FDIC insurance on non-interest bearing bank deposits may collectively represent a game changer for the corporate cash investment community for decades to come.

The trend: The "funding gap" resulting from issuers being told to issue longer-term debt while investors being advised to buy shorter-dated ones likely will continue, resulting in more liquidity premiums (longer maturities = higher yield) in cash instruments. Assets under management in institutional money market funds may see further declines, courtesy of the sovereign debt crisis, the FDIC insurance rule change, and the threat of a floating NAV.

The twists: We see a couple of twists on the regulatory front. For one, the strategy of extending maturity in cash portfolios to pick up yield forfeited by money funds due to new SEC 2a-7 rules seems to be gathering steam. In addition to bolstering separately managed account capabilities, a number of fund companies have introduced ultra-short bond funds with WAMs resembling older versions of the 2a-7 rule. The irony of the SEC's attempt to make funds safer by limiting WAMs is not lost here. Another twist we see is the watering-down tendency in interpreting and implementing new mandates. Already, we have seen relaxed interpretations of bank capital treatments by the Basel III Accord and the scaled-backed derivatives measures from the Dodd-Frank Act. As we move further away from the 2008 financial crisis, the new rules could look as much like "pause" buttons as they are "resets" for financial firms ready to engage in risk taking.

The takeaway: We expect more uncertainties and reform delays with the addition of some relaxed interpretations of newer financial regulations. We also expect the arrival of creatively packaged "cash" investments meant to circumvent the new rules. Investors should not let their guard down in pursuing due diligence in risk monitoring and risk mitigation tactics.

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[1] Refer to the press release of the December 14, 2010 FOMC meeting. http://www.federalreserve.gov/newsevents/press/monetary/20101214a.htm

[2] Hiroko Tabuchi, Japan's Prime Minister warns that debt could bring a crisis like that of Greece, The New York Times, June 11, 2010.

[3] Cordell Eddings, Moody's says Obama tax proposal deal is negative for U.S. credit ratings, Bloomberg, December 13, 2010. Umesh Desai, S&P says U.S. should move to protect AAA-ratings, Dow Jones News Service, August 26, 2010.

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