

## Three Challenges in 2014

### Abstract

*We elaborate on three key challenges for corporate cash investors in 2014: the emergence of new financial regulations, anticipation of a steeper yield curve, and proliferation of innovative products.*

*As a number of financial regulations reach the stage of implementation, short-duration investors will start to feel the impact of regulatory initiatives. Even though higher interest rates may not be on the immediate radar screen, we caution our readers regarding the possibility of a volatile front-end yield curve adjustment and we advise our readers to assess long-duration strategies in their cash portfolios. As scarcity continues among traditional cash instruments, we may see more innovative products such as collateralized commercial paper and putable corporate notes emerge to satisfy investors' thirst for yield and issuers' regulatory obligations.*

### Introduction

In our first newsletter of the year, we typically condense our trend outlook for the New Year for corporate cash investors into three major challenges. We find this exercise to be helpful in planning for what lies ahead, but this year's task proved to be unusually difficult because a long list of challenges from prior years remain unresolved and because the investment climate may shift direction in the upcoming year.

Recognizing our readers' probable fatigue with year-end outlook literature, we try to avoid ubiquitous subjects such as supply constraints, low yields, and "taper" speculation on the Federal Reserve's asset purchase program. Instead, we group related subjects into three main themes: the emergence of new financial regulations; the anticipation of a steeper yield curve; and the resurgence of innovative instruments. And while some challenges from 2013 will likely linger, we think the New Year may offer the beginning of a new, and more interesting, investment environment for our fellow investors.

January 1, 2014

### Managing the Aftermath of Financial Regulations

2014 marks the sixth year since the 2008 financial crisis and the majority of new regulations aimed at reducing the vulnerability of financial systems will finally start arriving on the scene. In the U.S., multi-agency efforts have led to laws that promote liquidity in bank balance sheets, higher capitalization standards, limited derivatives activities, and enhanced oversight and disclosure of securitization products. Globally, stricter requirements on systemically important institutions, including stricter capital requirements and mandatory living wills in the event of a failure, also are taking shape.

Also in 2014, both the U.S. and Europe are expected to finalize their proposed rules regarding money market funds which may have a profound impact on the short-term securities markets. Among the items to be resolved are how the FDIC's authority to

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dissolve a large financial holding company may affect bond holders, whether the financial transaction tax will be passed by the European Union, and how such a tariff may impact repurchase agreements (repos) and other short-term instruments.

As investors in short-duration instruments, we are likely to experience profound impacts from these regulatory changes. For example, enhanced bank liquidity rules will mean reduced commercial paper (CP) backup facilities, fewer sponsors for asset-backed CP programs and fewer short-term municipal debt issuers. Higher capitalization and leverage ratios may mean that there is less incentive for banks to stay engaged in low risk but low profitability businesses such as repos. As firms rush to ensure compliance with the new framework, the shortage of eligible investments we felt last year likely will get more severe.

We think that the probable final rule on money market funds deserves special mention in this “aftermath” challenge. Of particular interest is how shareholders will react to regulatory changes notwithstanding their likely long implementation period. While some investors point to government money market funds as potential safe havens, we do not think those funds have much capacity to accommodate any meaningful asset inflows, especially in light of the shrinking pools of eligible investments.

#### **Anticipation of a Steeper Yield Curve**

A subject that may impact our readers more than changes to money market fund rules is the potential for volatility in the shape of the yield curve in 2014. Although the Federal Reserve has announced modest tapering of asset purchases beginning in January, it has also vowed to keep the fed funds rate low for the foreseeable future. Despite the current mixed messages coming from the central bank, this past summer reminded us just how quickly market interest rates may adjust in anticipation of a shift in the Fed’s stance on monetary policy. The anticipation, rather than the actual policy changes, may be more relevant for investors beyond the typical 60-day weighted average maturity (WAM) of the money market fund world.

Recall that the 10-year Treasury note yield rose from 1.63% on May 2nd to 3.00% on September 5th based on Fed officials’ comments regarding the possibility of a tapering of asset purchases in “coming meetings”. The yield on the 2-year note rose from 0.20% to 0.52% during the same period. While the threat of a government shutdown in October and the Fed officials’ delayed action on the taper led rates back down, the 10-year yield is almost back to 3.00% again (2.98% as of December 30th). Meanwhile, the 2-year yield, at 0.38%, has risen only 18 basis points since May. (All data points are generic government bond yields obtained from Bloomberg.)

The government bond yield data from last summer leads us to believe that some investors may not anticipate an adjustment in the front-end of the yield curve when the economy improves further and the Fed starts to reduce its asset purchases. Although the two- to ten-year part of the yield curve has become quite steep, this is not the case inside two years. Although the Fed has stated that it intends to hold short-term rates at near zero until the unemployment rate is well below 6.5% (perhaps for another two

years), the extent of remaining monetary stimulus and the speed of the economic recovery may ultimately determine the Fed's policy rate decisions.

We think that the valuation impact on most short-duration portfolios from unanticipated yield curve shifts will be mild. For investors who added portfolio duration through three-, five-, or even seven-year investments during the low-yield environment, 2014 should be a year to reevaluate their duration appetite and bring portfolio strategies back to the norm. It may even be worthwhile for investors whose portfolio WAM is comfortably inside of two years to conduct stress tests as a defensive move. Portfolios of lower credit quality may be more impacted by the yield curve shifts, as credit spreads may also widen as the curve sells off.

### **Proliferation of Innovative Products**

A third major theme we see developing in 2014 is the potential proliferation of innovative products which are tailor-made for short-duration investors. Recent financial regulations, the low yield environment, the long drought of eligible investments and increased investor risk appetite likely will contribute to this trend.

As market participants are keenly aware, the more traditional instruments of commercial paper, bank certificates of deposits, Treasury bills, Agency discount notes and repos backed by government collateral likely will continue to see lower issuance levels. Two sources of supply may bring some relief to this shortage in 2014: Treasury floating rate notes (scheduled to launch in late January), and the Federal Reserve's reverse repo facility, which remains a test program through the end of January 2014. However, on balance, we expect the shortage of high quality investments to continue in this year.

Supply of some non-traditional products, however, may flourish in the upcoming year. One such product is collateralized commercial paper (CCP), an asset class that we discussed in [May 2011](#) when it made its debut. These programs, typically backed by term repos with broker-dealers, often provide higher yields without subjecting money market funds to the liquidity constraints of term repos. After some initial resistance, the money market fund community now embraces CCP, and we saw both the number and volume of issuance grow significantly in 2013.

Another innovative product is a puttable long-term corporate note designed to fit money market fund regulations. When the investor decides to stop rolling the paper from month-to-month, its maturity is then extended by 12 months. A third type is callable commercial paper that allows the issuer to pay the investors back prior to maturity.

We should stress that these innovative products remain modest in size today and not all investors use them regularly. As the pool of high quality investments shrink, we expect these products to further fill the void. Our concern, as always, lies in the potential excesses of these new products, especially when fund managers are pressured in the low yield environment. A reversal of the market's risk appetite could raise questions regarding the liquidity, and perhaps solvency, of these innovative products.

### Conclusions

Like a complicated jigsaw puzzle, the landscape of a “normal” post-2008 financial crisis investment environment may finally be starting to take shape. We can see three main themes during this early stage of the new normal.

As a number of financial regulations reach the stage of implementation, short-duration investors will start to feel the impact of regulatory initiatives. Even though higher interest rates may not be on the immediate radar screen, we caution our readers regarding the possibility of a volatile front-end yield curve adjustment and we advise our readers to assess long-duration strategies in their cash portfolios. As scarcity continues among traditional cash instruments, we may see more innovative products such as collateralized commercial paper and putable corporate notes emerge to satisfy investors’ thirst for yield and issuers’ regulatory obligations.

Should the economy continue to gain a stronger footing and global headwinds subside, we would look forward to a more normal investment environment where investment risk and reward are more rationally correlated and portfolio performance is more reflective of selective credit and interest rate decisions rather than macro market conditions. Happy New Year!

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