TAKING TIME TO REFLECT

Significant forces shaped the fixed income and repo markets in new ways in 2016. Have you had time to slow down and reflect on what has changed?

At a recent webinar, BNY Mellon Markets’ experts discussed how money market fund reform, expanding central bank balance sheets and increased regulatory requirements are shaping the fixed income and repo markets and securities financing strategies. Read highlights from this discussion below and leverage these insights as you review your firm’s investment and trading strategies.

MONETARY POLICY BEHIND THE WHEEL
Monetary policy has been a major influence over fixed income market expectations over the past few years. At the center of monetary policy are the major central banks’ quantitative easing (QE) programs which are trying to stimulate economic growth. As a result of these aggressive QE programs, central bank balance sheets have increased at an exponential rate, but the hoped for economic growth has not materialized, as shown in the graphs below.

Slow GDP Growth

Source: IMF World Economic Outlook, as of November 2016
Market speculation about this slow growth and the central banks’ responses (Will they continue their QE programs? Will they expand? Will they contract?) had a significant influence on the fixed income market in 2016, and yields on US Treasuries, UK Gilts, Japanese Government Bonds and German Bunds were on a roller coaster ride throughout the year. Some of the twists and turns of 2016 market expectations included the following:

- During the summer, slow economic growth paired with Brexit tilted market expectations toward the European Central Bank (ECB) expanding its QE program and/or loosening up the program’s capital key. The capital key keeps the ECB's purchases pro-rated according to the size of each country’s economy, making German Bunds the largest group in the ECB’s purchases. As the weeks progressed, the ECB did not expand its program or announce any changes, so market expectations changed and began taking QE tapering into consideration.

- In 2016, the market expected helicopter money from The Bank of Japan (BOJ). (Helicopter money refers to an aggressive form of stimulus that involves coordination between fiscal and monetary stimuli.) Contrary to market expectations, the BOJ did not pursue helicopter money but instead took a step back and had its staff review the impact that QE and negative yields were having on the economy and the market. As a result of this study, the BOJ marginally increased some equity buying and, rather than increasing their QE program, began yield-targeting to keep the 10-year bond somewhere around a 0% yield.

In addition to these examples, expectations around Fed rate hikes and the US presidential election also contributed to fixed income market volatility.
So what does the future hold? It’s difficult to speculate. Will the ECB bond buying program continue or will it expire in March 2017 as presently structured? Do the recent US election results herald future tax cuts and increased fiscal spending? Is low inflation part of the new normal? Market strategists and investors may not have the answers to these questions, but they should consider coming up with a view as to what is most likely to happen because these factors are going to drive the fixed income market for the foreseeable future.

**FIXED INCOME IN THE FAST LANE - SECURITIES LENDING AND CASH COLLATERAL REINVESTMENT**

How is fixed income securities lending faring in 2016? Regulation continues to play a major role, and market participants are using the securities lending markets to source much needed High Quality Liquid Assets (HQLA) which include sovereign bonds. In EMEA, shorter maturity German Bunds have been the most valuable to lend due to limited issuance along with heavy purchases by the ECB due to the capital weighting in its QE program. In the US, there has been increased demand for on-the-run Treasuries. As collateral flexibility has been a key parameter throughout the year, there remains continued heightened interest in borrowing US Treasuries and pledging Japanese Government Bonds as collateral.

For cash collateral reinvestment activity, money market fund reform had a major impact on the market this year. In the months leading up to the money market reform’s October 14 implementation date, prime money market funds essentially stopped investing in term markets because of fund redemptions and the uncertainty around investor behavior. The decrease in available term cash had the effect of putting upward pressure on LIBOR levels, and banks that had historically relied on the mutual fund industry for cash essentially lost this key source of funding. Three-month LIBOR, which had averaged 63 basis points for the first half of the year, increased to 88 basis points on implementation date in mid-October. In addition to the upward pressure on LIBOR, banks were forced to pay wider spreads when issuing securities. During this period, BNY Mellon’s securities lending cash collateral reinvestment program was an active buyer in the floating rate bank paper market, so the increase in LIBOR levels and the widening of spreads helped increase the program’s portfolio yields. Now that the money market fund reform October 14 deadline has passed, some prime funds are investing a bit more in term markets, and the trend of widening spreads is beginning to reverse somewhat. We still view bank paper in the six-month to one-year maturity area as attractive, and we will continue to selectively add these securities to our cash reinvestment portfolio.

**Increase in 3-Month LIBOR**

Source: Bloomberg, as of November 2016
Money market fund reform also increased demand for US Treasuries which resulted in higher usage of the Fed’s reserve repo facility. As cash moved out of prime funds and into government funds ahead of the October 14 deadline, funds increasingly used the reverse repo facility to gain access to Treasury collateral. Balances at the facility remained high even after the end of Q3 whereas previously there was typically a sharp decrease immediately after quarter-end. Balances still remain high compared to historical levels.

Source: Federal Reserve Bank of New York, as of November 2016

**SHORT-TERM INVESTING – AT A CROSSROADS**

2016 introduced new dynamics into the short-term investing/liquidity space, disrupting traditional vehicles such as bank deposits and money market funds and potentially making room for new types of short-term fixed income products. Certain regulations, including the liquidity coverage ratio (LCR) and the supplementary leverage ratio (SLR), are affecting the banks’ appetites for deposits. The LCR discourages banks from accepting certain types of cash deposits, such as those from hedge funds. The SLR limits the amount of leverage that a big bank can take, and this has led many banks to shrink their repo books and deposit base. Onshore US institutional prime money market funds, another short-term investment option, are now subject to floating NAVs and potential fees and gates which potentially compromise the liquidity and safety that investors desire for short-term cash investments.

**The Changing Liquidity Landscape**

1. Market and regulatory changes are effecting liquidity investing
   - Higher short-term rates
   - US money market reform
   - Liquidity Coverage Ratio and Leverage Ratio

2. Money has moved away from some short-term products and towards others.

3. Liquidity investors continue to monitor the changing dynamics and how they effect short-term investment products.
With these new dynamics, what options do investors have for short-term cash investing? Investors who are still able to deposit excess cash at banks can leave it there. Government money market funds, which are generally not subject to potential fees and gates and floating NAVs, are another option. But for how long are investors going to be content to de-emphasize yield and potentially leave money on the table? What will it take to make them consider possibly higher yielding alternative investment vehicles? This has been a topic of discussion in the industry, and alternative short-term fixed income investment options, with potentially higher yields, are emerging. These alternatives include ultra-short bond funds and short-term bond exchange traded funds (ETFs). There are also new 3(c)(7) money market fund-like products that have been introduced into the marketplace. When investors will again turn their focus to yield and consider investing in these new fixed income products is not yet clear, but the industry is watching closely.

To continue this discussion on the fixed income and repo markets and securities finance, reach out to one of our representatives below.

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