Year-End: That's a Wrap

Money market participants have wrapped up their 2012 liquidity needs and are now focusing on several issues on the horizon for early 2013:

- The road ahead for money market reform
- Another bond purchase program courtesy of the Federal Reserve (Fed)
- The likely expiration of unlimited deposit insurance.

The road ahead for money market reforms

In December, the Securities and Exchange Commission (SEC) released a study addressing questions posed by SEC Commissioners Luis Aguilar, Troy Paredes and Daniel Gallagher about the effectiveness of the 2010 reforms, including how money markets would have performed in September 2008 had these reforms been in place. The study found that “funds are more resilient now to both portfolio losses and investor redemptions than they were in 2008. That being said, no fund would have been able to withstand the losses that the Reserve Primary Fund incurred in 2008 without breaking the buck, and nothing in the 2010 reforms would have prevented the Reserve Primary Fund’s holding of Lehman Brothers debt.”\(^1\) The study also addressed some of the implication of additional reforms on money market participants, recognizing that while some dislocation and cost would be involved, significant impact on investors and issuers is likely to be limited.

The release of the study seemed to revive the floating net asset value (NAV) option with Commissioner Aguilar, who suggested he could support such an option if properly structured with consideration to the accounting and taxation issues. Aguilar had previously stated that he believed more research was needed to study the impact and effectiveness of the 2010 reforms. In lieu of such research, he was reluctant to support former SEC Commissioner Mary Schapiro’s proposals on money market funds because “the lack of a foundation for and the rush to act on the proposal.”\(^2\) Commissioner Aguilar stated that the SEC staff would be putting out some money market reform proposals in early January 2013, which we would expect to look very similar to the Financial Stability Oversight Council (FSOC) proposals. If another set of reforms from the SEC are proposed, then the start of a 60-day public comment period would begin.

The Federal Reserve: The gift that keeps on giving (liquidity)

The Fed got into the holiday spirit in December and gave markets the gift of even more liquidity, announcing that once Operation Twist expires at the end of December, it will begin purchasing $45 billion in Treasuries per month (initially) in addition to the $40 billion in mortgage-backed securities (MBS) it currently purchases as part of the third round of quantitative easing (QE3).
December’s Fed statement also introduced a significant shift in the Fed’s communication strategy. The Fed has replaced the year-specific target language in its statement (“...exceptionally low levels for the federal funds rate are likely to be warranted at least through mid-2015”) with language linking its monetary policy with specific economic outcomes in terms of unemployment and inflation. Specifically, the Fed committed to keeping “the target range for the federal funds rate at 0% to 0.25% and currently anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6.5%, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee’s 2% longer-run goal, and longer-term inflation expectations continue to be well anchored.” In a press conference following the release of the statement, Fed Chairman Ben Bernanke clarified that the inflation and unemployment targets do not indicate a change in the Fed’s prior target-year guidance (i.e., mid-2015). The shift in language, he explained, would help financial markets and the public adjust expectations for policy tightening without the Fed changing its date in a non-transparent way.

Time is running out for unlimited deposit insurance

Meanwhile, the window for extending unlimited deposit insurance has closed. In December, the Senate failed to vote on a bill proposed by Senate Majority Leader Harry Reid (D-Nev.) that would have extended unlimited Federal Deposit Insurance Corporation (FDIC) deposit insurance through the end of 2014.

Despite the concerns of smaller banks about the impact this could have on their deposit base, third-quarter data on deposits released by the FDIC continues to support the observation that large deposits (above $250,000) are concentrated in large banks. We continue to believe that there may be some movement of deposits out of commercial banks when the unlimited deposit insurance expires, but we do not know the scope or the speed of such withdrawals. Potential deposit outflows have been estimated anywhere between $100 billion and $300 billion. If these funds were invested directly in short-term securities or government/Treasury money market funds, it could put additional downward pressure on interest rates.

A year in review

Invesco Global Liquidity began 2012 focused on Europe and the hope that policymakers would be able to contain the unfolding banking and sovereign debt crisis that threatened to undermine the region’s common currency. While extraordinary liquidity measures by the European Central Bank (ECB) and expanded European Union bail-out funds helped shore up European markets and restore some investor confidence, we will continue to monitor developments in the coming year.

At the same time, the threat of a significant round of downgrades by Moody’s Investors Service of global banks and financial institutions, and the possibility of additional money market fund reforms, cast a heavy cloud of uncertainty over short-term markets. While the former was carried out mid-year with very limited market impact, the prospect of additional money market reforms continues to play itself out. And yet, it’s worthwhile noting that despite these events as well as a persistent ultra-low (zero) interest rate environment, money market funds have held their own, with a stable core asset base of more than $2.6 trillion as of Dec. 31, 2012, illustrating the vital and important role money market funds continue to serve for investors seeking a convenient and liquid short-term investment vehicle.

Headed into year-end, we prepared portfolios for year-end liquidity conditions. We participated in more term repurchase agreements (term repo) into early January 2013 in order to reduce our reliance on the overnight repo market, as we expect supply to continue shrinking now that most issuers have wrapped up their financing needs for 2012. The year-end uncertainty regarding the fiscal cliff did not translate into significant changes in repo levels. However, we will continue to monitor liquidity conditions in the new year.

Invesco Global Liquidity

This continues to be an evolving environment for money market funds. We believe Invesco Global Liquidity is positioned to help our clients navigate these dynamic events with our judicious investment philosophy, rigorous investment process and ability to respond quickly to ongoing developments.

Our credit team has developed and strictly adheres to a comprehensive set of criteria for evaluating credit risk and identifying high-quality securities, while our portfolio management team constructs and manages the money market portfolios with a commitment to liquidity and to the preservation of principal.