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Short-Term Fixed Income

- **The ECB announced a full-blown quantitative easing program on Thursday, the size and open-endedness of which came as a positive surprise to market participants**
- **From March until September of next year, the ECB is scheduled to purchase €60bn in assets per month, with an extension of purchases possible**
- **The ECB's commitment to QE and recent rate cutting by other central banks put the Fed in a peculiar situation as it prepares for raising rates and normalization**
- **Despite this divergence and other challenges faced by the Fed, we maintain our view for a June rate hike**
- **As expected, FBOs heavily reduced the size of their balance sheets over the end of the year. However, 2014's contraction came earlier, was more severe, and has not rebounded as quickly as previous year-ends. We attribute these trends to regulatory compliance pressures and the appreciating USD's impact on foreign bank funding**

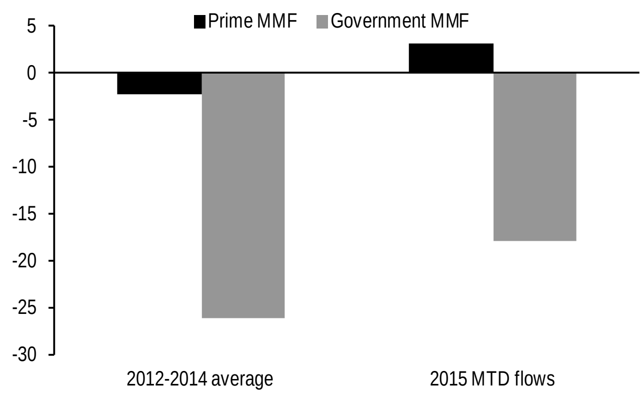
Market commentary

Despite several significant central bank developments and movement in the long-end of the curve, action in the money market space was business as usual this week. While trading volumes picked up as investors increasingly came off of the year-end sidelines, short-term rates remained mostly pinned, with a slight richening across certain rates: ON GC tightened by 5bp week-over-week to 0.13% while CP rates showed signs of modest softening. From a flows perspective, assets invested in prime and government MMFs are mostly unchanged since year-end, with modest inflows of +0.22% and outflows of -1.83% respectively through January – mostly in line with seasonal flows experienced (Exhibit 1).

The week's biggest news across the fixed income markets came on Thursday, when Mario Draghi and the ECB formally announced its long-awaited plan to engage in quantitative easing, an additional step to bolster growth in the Eurozone. Beginning in March, the ECB is scheduled to purchase €60bn (~$68bn) of assets per month until September of 2016, amounting to total purchases of €1.2tn. Furthermore, purchases may extend past

Exhibit 1: January MMF flows are mostly in line with historical averages

January flows of prime and government MMF ($bn)



Source: iMoneyNet

September 2016, contingent upon the pace of inflation and its proximity to the ECB's target, leaving the program open-ended for the time being. On balance, our European rates strategists believe that the size and open-endedness of the program positively exceeded market expectations (See "ECB delivers more than expected", Greg Fuzesi, 1/22/15). Away from QE, the ECB also removed the 10bp spread on the TLTRO over the main refinancing rate in an effort to increase uptake in the facility, which has experienced weaker than expected demand over its previous two operations.

The ECB's commitment to QE, coupled with other recent surprising moves taken by central banks (Exhibit 2), has clearly signaled real and mounting concerns over growth in economies around the world. As a divergent Fed continues to plot its exit strategy and prepares for its first tightening cycle in over a decade, this global growth anxiety is weighing on the US central bank. Add ongoing inflation concerns and a recent soft spell of US economic data (December core CPI, average hourly earnings and retail sales) to the equation, the timing of Fed rate hikes and normalization becomes less certain, skewing the expectations of some market observers to late 2015 or even 2016. However, all things considered, with continuing solid gains in job growth and GDP we still maintain that that the Fed will hike sooner than later, and our house view still remains for the Fed to liftoff during its June meeting. Looking forward, next week's FOMC meeting may provide more color on the Fed's sentiment towards the issues outlined above as well as its ongoing normalization efforts.

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Exhibit 2: Central banks around the world are responding to economic growth concerns

Recent actions taken by central banks

Central Bank	Date	Key Policy Action
Bank of Japan	October 31st, 2014	Surprise expansion of asset purchases
People's Bank of China	November 21st, 2014	25bp cut to benchmark 1-year deposit rate
Reserve Bank of India	January 15th, 2015	25bp cut to repo rate
Swiss National Bank	January 15th, 2015	- Removal of EUR/CHF floor - 50bp cut to sight deposit rate
Central Reserve Bank of Peru	January 15th, 2015	25bp cut to benchmark rate
Danish National Bank	January 19th - 22nd, 2015	Two 15bp cuts to main deposit rate
Central Bank of Turkey	January 20th, 2015	50bp cut to one-week repo rate
Bank of Canada	January 21st, 2015	25bp cut to target O/N rate
European Central Bank	January 22nd, 2015	Aggressive quantitative easing plan introduced

Source: J.P. Morgan, Bloomberg

Regarding the Fed's normalization efforts, on January 16th the FRBNY announced the addition of 25 new counterparties eligible to participate in its reverse repo program (RRP)[1]. The additions included 7 banks, 6 GSEs (Farmer Mac along with 5 regional FHLBs), and 12 money market mutual funds – 6 government funds, 4 prime funds, and 2 muni funds with a combined AuM of $131bn. All new counterparties are eligible to participate once operationally enabled, and are subject to the existing facility terms.

In aggregate, we believe that these additions will increase demand for the RRP going forward. However, the magnitude of such increased demand remains unclear. As discussed in our previous note[2], banks historically have not been significant users of RRP, averaging less than 2% of daily usage since the facility's inception. Although GSEs have been larger users, representing ~14% of daily usage on average, it is hard to gauge how much Farmer Mac and the 5 extra FHLBs will tap the facility, and the possible effects on the Fed Funds effective rate should they choose to use the RRP as a substitute to using the Fed Funds market. Finally, while the 12 new MMFs will certainly see the RRP as a source of supply, their usage capacity is relatively small compared to the existing MMF counterparties ($131bn vs $2.1tn in AUM), and it is possible that they only have a marginal impact on demand.

Furthermore, regardless of the effect on demand that the new counterparty additions may have, the Fed still has plenty of time to tweak other parameters of the RRP, with an additional year of testing pre-authorized. At some point throughout the course of the year, the Fed is likely to test higher rates, although it is unclear as to how much higher and when.

Rising USD + Regulations = Shrinking Foreign Bank Balance Sheets

With year-end behind us and some data points in hand for the first two weeks of the year, we think it's worth examining how US branches and agencies of foreign banks have evolved during this time period. It's typical that they demonstrate large swings in their balance sheets over year-ends, and this past year-end was no different based on data supplied in the Fed's H.8. weekly report. However, upon a closer look, we also noticed a few key observations. Specifically, the magnitude of this year's change was influenced by regulations that are coming online in 2015 and the effects of USD appreciation that began in the second half of 2014.

The contraction was more severe. Compared to prior year-ends, the pullback in foreign bank balance sheets in the US was more acute this past year-end. As Exhibit 3 shows, peak to trough in the weeks leading up to 2015, total assets on foreign bank balance sheets declined by $568bn. This fall was entirely driven by the shrinkage in cash assets which totaled $598bn during this period. On the liability side, there was also a drop in their net due to related foreign offices of $476bn. Comparatively, during the prior year-end, foreign banks saw their total assets, cash assets, and net due to related foreign offices fall by only $325bn, $313bn, and $222bn respectively. All told,

1 http://www.newyorkfed.org/markets/ec-150116.html
2 A. Roever, "Short-Term Market Outlook & Strategy", 01/12/2015

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the contraction this past year-end was nearly twice as large as the prior year's.

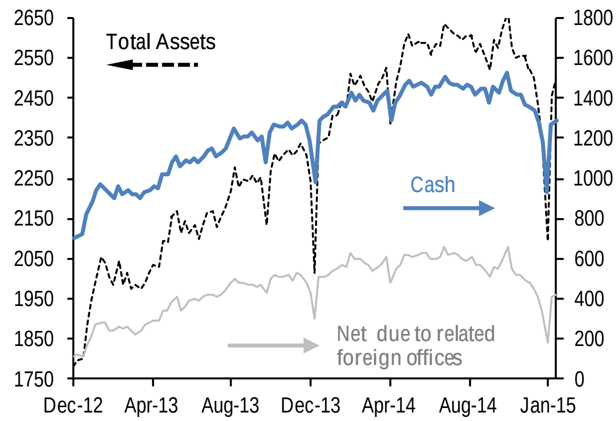
The contraction began earlier. While preparation for year-ends typically takes place in December (as was the case in 2013 when foreign banks began winding down their balance sheets 2 to 3 weeks before), Fed data show that they actually began reducing their balance sheet in late October for this past year-end. While a large part of the asset contraction still took place in December, it's somewhat unusual for banks to make such a sizable reduction ($143bn) in the month of November.

The post-year-end rebound has been less robust. Admittedly, with only two data points in the new year in hand, it's hard to conclude that a trend exists. Even so, we think it's worth noting that the rebound in assets this year has so far been more subdued than prior years. Year-to-date, total assets on foreign bank balance sheets in the US have only increased $400bn or 70% of their contraction. At current levels, they are running about $55bn below its 6m average (Exhibit 4). Comparatively, over the prior year-end, it took foreign banks less than two weeks to fully recover their assets that they shed for the end of December.

We think the above observations highlight two central themes. First is a theme that we have emphasized previously: **that is the impact of banking regulations is beginning to unfold and they are exerting their influences on the markets.** The sharp contraction we saw at year-end was likely driven by the need for foreign banks to comply with their leverage ratio requirements, which for the first time will be publicly revealed in 2015. Also, LCR provisions that officially become binding this year likely prompted some issuers to diminish their carry trades with the Fed, as the spread earned from issuing further out the curve (>30 days) and IOER compresses. This has in turn reduced the amount of cash foreign banks are depositing at the Fed. Furthermore, regulatory pressures to increase bank capital and liquidity have resulted in some financial institutions pulling back from certain funding markets. For example, MMF holding data indicate Deutsche Bank reduced its repo funding with money market funds from $75bn as of August 2014 to $4bn as of December 2014.

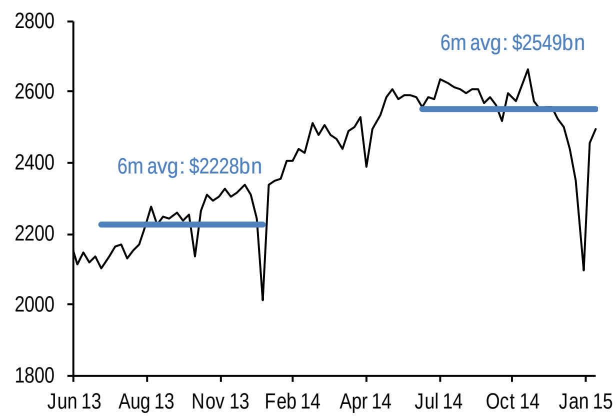
The second -- and perhaps the more immediately impactful theme is that the appreciating USD is making it more expensive for foreign banks to fund in USD. As Exhibit 5 shows, there is a strong correlation between the USD exchange rate and the amount of funding foreign banks leave in their US branches. As the dollar appreciates, it becomes more expensive for foreign banks to fund in USD

Exhibit 3: The contraction in foreign bank balance sheets in the US was much more acute this year-end
Balance sheet items of US branches and agencies of foreign banks ($bn)



Source: J.P. Morgan

Exhibit 4: The post-year-end rebound in foreign bank balance sheets has been less robust
Balance sheet items of US branches and agencies of foreign banks ($bn)



Source: J.P. Morgan

relative to other currencies. As a result, there are fewer dollars being sent to their US branches, which collectively reduce the size of their balance sheets. Ultimately, the movement in the USD currency is magnifying the impact that regulations are having on banks.

Interestingly, in spite of the regulations and the appreciating USD, we have not seen a material impact on cross-currency bases (Exhibit 6) nor on the level of bank exposures prime MMFs are holding in their portfolios. In fact, foreign bank exposures in prime MMFs have been relatively steady over the past year (Exhibit 7). These two measures will be something we have to continue to monitor.

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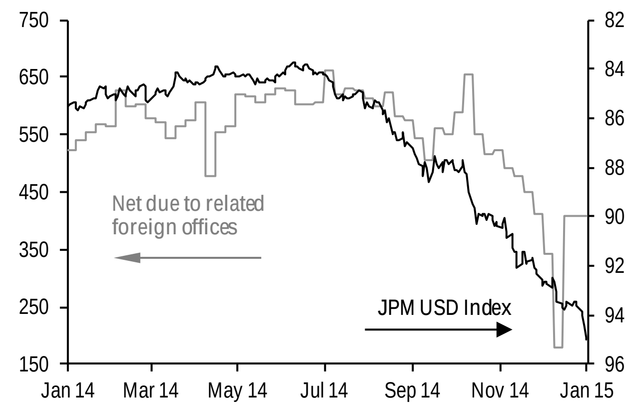
Exhibit 5: There's a strong correlation between the USD exchange rate and the amount of funding foreign banks leave in their US branches

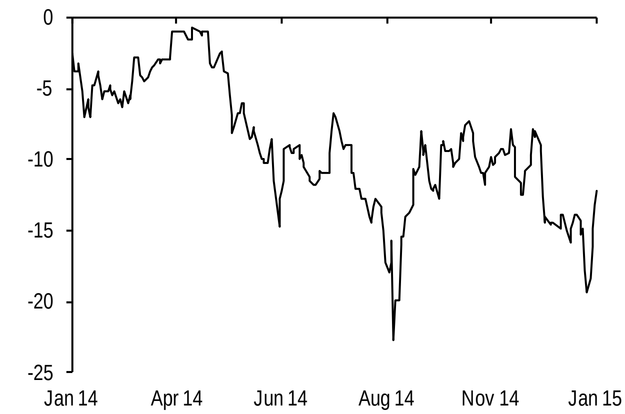
Foreign bank's net due to related foreign offices ($bn) vs. JPM USD Index (inverted)



Source: J.P. Morgan

Exhibit 6: In spite of the regulations and the appreciating USD, we have not seen a material impact on short-term cross currency bases…

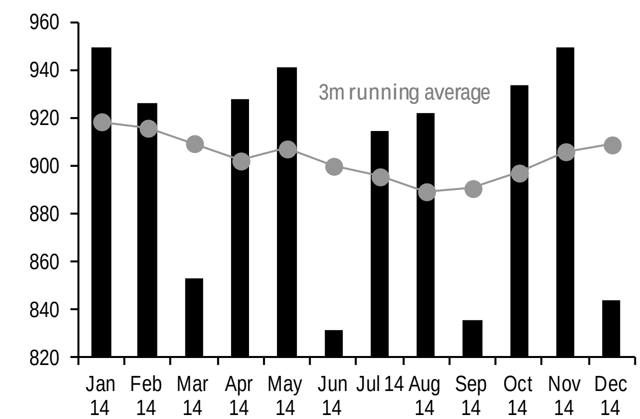
3m EUR/USD cross currency basis (bp)



Source: J.P. Morgan

Exhibit 7: …nor on the level of bank holdings in prime MMFs

Prime MMF holdings of Yankee banks ($bn)



Source: J.P. Morgan, fund holdings reports

Coming attractions

- The 2-year Treasury FRN will auction on 1/27 for an offering amount of $15bn.
- The FOMC will meet next week from 1/27 to 1/28.
- The first estimate for 4Q14 GDP will be released on 1/30.
- The January employment report will be released on 2/6.

Trading Themes

We expect short-term rates to drift upwards in 2015 in response to the beginning of a Fed tightening cycle. However, the details of how monetary policy is implemented and impact of regulations will have different effects on the various short term interest rates.

Additionally, given the immense demand for short-term product and the lack of investible supply, we do not foresee spreads on money market instruments widening significantly this year, and hence do not expect high returns to be found in the money market space in general. With the prospect of rising front-end rates, we believe that floating rate instruments will perhaps offer the best relative value as the year progresses.

- **Overweight Treasury coupons versus bills**

  In spite of the immense demand for high-quality liquid assets, Treasury coupons continue to trade cheap to bills. Although the current spread is only 1-3bp, it's possible that this spread could widen as a large amount of Treasury coupons are expected to roll into the 2a-7 space. In the coming year, we expect 2a-7 Treasury coupon balances to increase by $191bn while bills to increase a moderate $17bn.

- **Overweight collateralized CP versus bank unsecured CP and ABCP**

  Collateralized CP programs are structured such that CP notes issued are guaranteed by the sponsoring bank. This asset class is an attractive way to gain direct bank exposure than they would otherwise via CP/CDs and ABCP while picking up 2-7bp in yield.

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- **For Moody's matrix considerations, overweight fully supported ABCP with long-term sponsor ratings above Aa3 versus partially supported programs.**

  Under the Moody's matrix MMF rating methodology, funds are rated on the basis of the tenor and credit rating assigned their portfolio's underlying assets. In the case of ABCP, partially supported programs by default receive a Moody's LT rating of Aa3, whereas fully supported programs receive the LT rating of the program's sponsor.

- **Overweight front-end floating versus fixed rate instruments**

  We believe that floating rate instruments offer better relative value over their fixed rate counterparts as Libor and other short-term rates begin to drift upwards in response to MMF reform-related flows and a Fed tightening in 2015.

- **Overweight Financial bonds vs. Non-Financials**

  We expect bank spreads to outperform non-Bank in 2015 as rising rates is a positive for bank earnings. Also, banks are not at risk for M&A and higher leverage, they are actually de-leveraging to meet capital requirements. We believe these factors will more than offset the increased bank bond supply that will be issued in the next few years to meet Total Loss Absorbing Capital (TLAC rules). (*See High Grade Outlook*)

- **Initiate outright short duration positions in the front end as we approach the onset of the first rate hike**

  Front-end yields are expected to rise considerably as we approach the timing of the first rate hike. Given the punitive cost of holding short duration trades, we suggest investors be tactical in positioning for higher yields, and recommend initiating short duration positions in the front end 2-3 months before the first hike. (*See Treasuries Outlook*)

- **Unwind long current 2s versus old 2s**

– Current 2s have started to cheapen as we approach next week's 2-year auction and we unwind this trade at a modest loss.
– Unwind short 100% risk, or $125mn notional of T 0.5% Nov-16s
Unwind long 100% risk, or $121.7mn notional of T 0.625% Dec-16s
(*US Treasury Market Daily*, 12/18/14). P/L since inception: -0.4bp of yield.

- **Overweight 1-3y AAA credit card ABS versus agencies**

  Both asset classes are rated AAA, but ABS trade much wider than agencies do. Currently, AAA-rated 2y credit card ABS is offered at the equivalent of swaps +27bp versus 2y agency at swaps -15bp. Furthermore, our Agency strategists note that losses on credit card ABS master trusts are at record lows, while credit support levels are at record highs. The credit card ABS sector is fundamentally cheap and least vulnerable to technical volatility. Consequently, ABS should provide a safe haven to investors looking for relatively higher-yielding cash surrogates. (See *ABS Outlook*)

- **Consider senior tranches from off-the-run subprime auto ABS issuers for spread pick-up**

  Senior tranches from off-the-run subprime auto ABS issuers offer spreads of up to 100bp for very short (<2y WAL) bonds that are highly rated (from AAA down to A). That is a significant concession versus comparable short high investment grade credits. Additionally, our Agency strategists believe these senior bonds are very well protected structurally and investors are being very well compensated for the illiquidity and credit risk. (See *ABS Outlook*)

- **Front-end steepeners are likely to perform well over a range of probabilities across spanning interest rate scenarios, as are intermediate belly-cheapening flys**

  Our framework for identifying trades that are "convex" over a range of probability distributions on Fed rate hike scenarios suggest that front-end steepeners (2s/5s, 3s/5s, White/ Blues, Reds/Greens, and Reds/Blues) and intermediate belly-cheapening flys (2s/5s/10s, 3s/7s/10s) are likely to do well early next year. (See *Interest Rate Derivatives Outlook*)

- **Look for wider swap spreads across the curve; front and intermediate spreads are likely to lead the widening**

  Spreads across the curve appear tight; front-end spreads should widen as a result of lower front-end Treasury supply and regulatory demand. Intermediate spreads should widen on the back of increasing yields and a widening mortgage basis. Long-end spreads will likely

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widen given our forecasts for reduction in hedging needs from VA accounts and a flattening yield curve. (See *Interest Rate Derivatives Outlook*)

- **Buy Libor basis wideners and FF/Libor tighteners; be aware of the impact of new reserve draining initiatives and regulations**

  A range of reforms like NSFR and MMF rules are likely to result in wider Libor bases over the course of next year. While many reforms and Fed initiatives point to tightening of the FF/Libor basis, the Fed is still tinkering with various reserve-draining mechanisms—the efforts bear watching as they could have a big impact on this basis. (See *Interest Rate Derivatives Outlook*)

- **Maintain EDM5/Z5 steepeners**

  – Stay long1000 EDM5 contracts versus staying short 1000 EDZ5 contracts (*Interest Rate Derivatives*, 12/19/14). P/L since inception: loss of 10.7bp of yield.

- **Continue to pay in 2Y matched-maturity OIS-Treasury spreads**

  – Continue to pay in 2-year matched-maturity OIS spread of -3.25bp. (Stay long in $200mn notional of the 0.375% of Oct 2016, and continue to pay fixed in $197.2mn notional of a 10/31/2016 OIS swap) (*Interest Rate Derivatives*, 11/7/14). P/L since inception: loss of 3.2bp of yield.

- **Over the next quarter, overweight short-lockout, short-maturity callables versus duration-matched bullets to enhance yield**

  Short-dated callables offer the highest call probability and largest rate and rate volatility breakevens. However, a sell-off in front-end yields ahead of the Fed hike and pickup in volatility in the front end of the curve could lead to underperformance beyond 1Q15. (*See Agencies Outlook*)

- **Diverging monetary policies should be supportive of USD-denominated SSA issues versus US Agencies**

  USD-denominated EIB/KfW issues should be supported by continued easing from the ECB, while the Fed is expected to begin raising the policy rate in June 2015. However, very near term supply technicals remain a headwind. (See *Agencies Outlook*)

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