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Short-Term Fixed Income

- **Invesco became the latest large money fund complex to present an initial strategy for dealing with money market reform**
- **Invesco's focus on its government MMFs exemplifies the role that these funds are continuing to take on within the industry**
- **On Wednesday, the SEC released a set of FAQs related to final money market fund reform rules passed last summer**
- **Notably, the FAQs address 60-day max maturity funds in two ways…**
- **First, a MMF subject to floating NAV may not advertise that it seeks to maintain a stable NAV by limitng its portfolio's assets to maturities of less than 60 days and valuing them at amortized cost**
- **Second, a 60-day max maturity fund that intends to use amortized cost valuation may not use "maturity shortening" provisions when determining the maturity date of its securities**
- **Lack of supply in the 60-day maturity space may push 60-day funds into eligible rates products such as bills, repo, and discos, adding to the supply/demand mismatch**

Market commentary

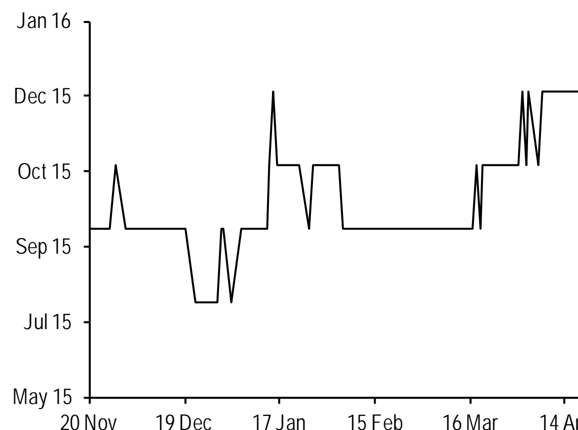
After last week's tax day-laden slump, activity in the money markets picked up and remained brisk throughout the course of this week. MMF flows were flat, and most short-term rates and spreads remained pinned at current levels, with the only exception being ON GC repo. In our last note, we called for technical MBS P&I dates and a continued cut to bill supply to be factors behind a softening in GC rates through the end of April. That came to fruition this week - Treasury GCF richened by 9bp and closed out Friday at 15bp.

In other news, Invesco recently became the latest large MMF complex to formally address its strategy for dealing with MMF reform in a client note entitled "Money Market Regulatory Reform[1]". Within the note, Invesco made two main announcements regarding the status and future of its government money fund suite, which currently has about $22bn in assets under management. First, the complex informed investors that all of its government money funds currently comply with the new 99.5% rule, meaning that at least 99.5% of each fund's assets are invested in eligible government securities or cash. Secondly, it also stated that it has no plans to implement gates or fees on any of its government MMFs.

[1] https://www.invesco.com/static/us/contentdetail?contentId=5363247feafac410VgnVCM100000c2f1bf0aRCRD&dnsName=us

Exhibit 1: Markets are pricing in a December lift off

Market-implied FOMC "first hike" meeting date*



*The first FOMC meeting date for which OIS forwards is greater than 34bp. We assume the first hike consists of moving the RRP/IOER corridor from [5bp,25bp] to [25bp,50bp], in which case the effective fed funds rate is likely to move to IOER minus an excess liquidity adjustment (eff funds after first hike =50bp – 16bp = 34bp)

Taken alone, this announcement should not have much of an impact as we suspect that most government funds will elect to not adopt gates and fees. However, it does advance the growing trend of large complexes coming forward with details on their reform-related strategies. Furthermore, Invesco's focus on government funds also exemplifies the role that government funds are beginning to take on within the industry. Because government funds will remain a fixed NAV product and will not be required to implement gates and fees, we continue to look for large inflows into this space over the next 12 to 18 months as money shifts out of prime funds and regulatory-induced deposit shedding pushes cash into the money markets.

Looking ahead, the FOMC will meet next week, releasing a statement on Wednesday afternoon. The meeting will be absent a press conference and updated "dots". With "patient" already out of the statement, our US economist does not foresee much change to the Fed's forward guidance and on balance is calling for the meeting's

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outcome to be relatively uneventful[2]. Away from the Fed, our economist also revised his forecast for Q2 GDP down from 3.0% to 2.5%[3], citing dollar headwinds as a possible factor dragging on growth. All things considered, we maintain our call for a September hike, although markets are currently pricing in a first hike to occur during December (Exhibit 1).

SEC provides guidance on MMF reforms

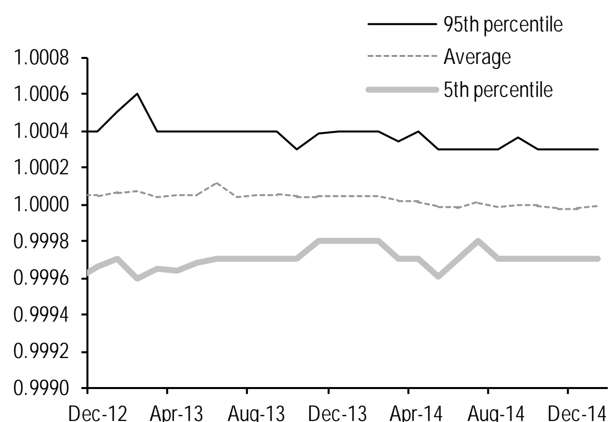
This past Wednesday, the SEC released a set of frequently asked questions related to final money market fund (MMF) reforms that were adopted in July 2014[4]. Long-awaited by the industry, the 53 FAQs address various issues related to disclosure requirements, compliance requirements and does more to help fund complexes comply with the rule by October 2016. While most of the questions represent minor technical and legal topics, there were a couple questions that we think have broader implications for the short-term fixed income market, particularly as it relates to 60-day prime MMFs.

In particular, the SEC clarified two aspects with respect to the establishment of 60-day MMFs. First, a MMF that is subject to a floating NAV may not advertise that it will seek to maintain a stable NAV by limiting its portfolio securities to a maturity of less than 60 days and valuing those securities using amortized cost. The SEC staff believes that such a statement would be confusing or misleading to investors, particularly during periods when the security's amortized value differs from the security's mark-to-market value. This could happen during credit events or sudden market moving events. Under such a scenario, the MMF's NAV will fluctuate and not remain stable.

While NAVs do fluctuate in value, over the past few years they have not deviated much from the $1.0000 stable NAV (Exhibit 2). Even during those circumstances, the lowest shadow NAV value carried among the prime funds was 0.9976. Still, the SEC advises that a floating NAV fund must advertise that the fund's share price will fluctuate, which we suspect will deter at least some existing and potential institutional shareholders from participating.

Exhibit 2: NAVs have not deviated much from the $1.0000 stable value over the past few years

Monthly 95th percentile, average, and 5th percentile of prime MMF shadow NAVs



Source: Crane Data, Form N-MFP

Second, a 60-day MMF that intends to use amortized cost to value its securities may not use "maturity shortening" provisions of Rule 2a-7 to determine the maturity date of those securities. Currently, Rule 2a-7 allows MMFs to shorten the maturities of variable and floating rate securities and repurchase agreements to their reset date or demand date for purposes of calculating their weighted average maturities. For example, MMFs are able to deem 1-year floaters whose benchmark resets every 90 days or 1-year floaters that are putable within 60 days or 3m repos that are putable within 7 days as having a maturity of 90 days, 60 days and 7 days respectively. However, for purposes of determining inclusion eligibility for 60-day MMFs, the funds would have to use the securities' legal final maturity.

At various times, we have expressed our concern about the difficulty in establishing 60-day prime MMFs given the challenge in finding suitable supply to meet its specific type of demand. The inability to use current maturity shortening provisions raises further challenges. We estimate the elimination of this provision removes on average about $266bn of eligible supply based on money market floating rate note and putable note issuance over the past five years (Exhibit 3). Alternatively, funds may buy other short-term credit products such as CP or bank time deposits, but the stock of those assets don't fare much better. Indeed, as of April 17 the Fed reports that only about 56% or $568bn of CP outstanding mature in less than 42 days, consistent with the theme of banks trying to push out their short-term borrowings for liquidity purposes. With respect to bank time deposits, while most

[2] M. Feroli, "FOMC Preview", April 24, 2015
[3] M. Feroli, "Looking for less of a Q2 bounce", April 24, 2015
[4] http://www.sec.gov/divisions/investment/guidance/2014-money-market-fund-reform-frequently-asked-questions.shtml

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of these deposits are done on an overnight basis, banks are currently looking to shed their exposure given the deposits' regulatory burden.

Conceivably, given the supply constraint it's possible that returns on 60-day MMFs could yield very close to government MMFs, particularly considering there are a host of other short-term investors (e.g., 397-day max prime institutional MMFs, retail prime MMFs, corporations, hedge funds, etc.) competing for the same credit supply that is eligible for 60-day MMFs in order to meet their liquidity requirements. The lack of sufficient, suitable credit products could encourage them to buy more eligible rates products such as bills, repo, and discos.

Faced with the choice to shift money into 60-day MMFs or government MMFs with no yield differential between the two, institutional shareholders could be inclined to choose the latter given the absence of a floating NAV and more importantly liquidty fees and gates. If this scenario is realized, we suspect this will incrementally increase the demand for short-term government securities. Fortunately, the SEC also clarified in the FAQs that the Fed's overnight repurchase agreements (ON RRP) are considered a government security and is not subject to issuer diversification limits. However, bank certificate of deposits, which are insured up to the $250,000 FDIC insurance limit, are not considered a government security.

Coming attractions

- First quarter GDP results will be released on 4/29.
- The FOMC will conduct its April meeting from 4/28 to 4/29.
- The April employment report will be released on 5/8.

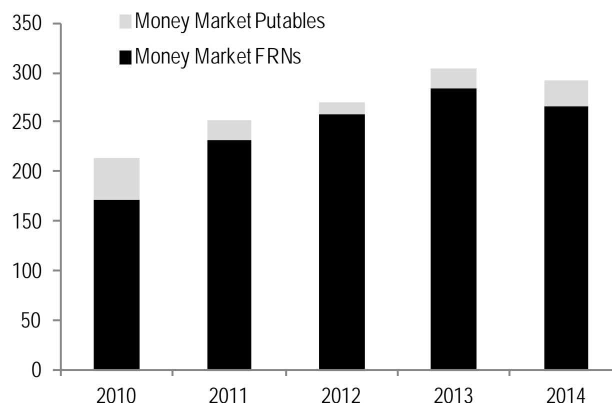
Trading Themes

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.

Exhibit 3: We estimate that the inability to use maturity shortening provisions in 60-day MMFs removes on average about $266bn of supply from the funds

Money market eligible floating rate note and putable note issuance ($bn)



Source: Bloomberg, J.P. Morgan

- **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.

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

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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*)

- **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 +25bp 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 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 1Yx1Y FF/Libor basis narrowers**

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– Continue to pay Libor in $1bn notional of a 1Yx1Y Fed Funds/Libor basis swap (*Interest Rate Derivatives*, 4/10/15). P/L since inception: profit of 0.1bp of yield.

- **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 17.3bp of yield.

- **Maintain synthetic 2Yx1Y forward Treasury/OIS narrowers**

– Stay $1bn notional of 1% Mar 2018s, sell $1bn notional of 0.5% Mar 2017s and continue to pay fixed in $982mn notional of a 3/31/2017x3/15/2018 OIS swap (*Interest Rate Derivatives*, 3/27/15). P/L since inception: loss of 1.1bp 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*)

- **Remain neutral on European SSAs versus Agencies**

  USD-denominated EIB/KfW issues have outperformed US Agencies on asset swap over the last month. However, this outperformance is unlikely to reverse given ECB QE and the eventual Fed rate hike. Given competing factors, we turn neutral on USD-denominated EIB/KfW debt versus US Agencies on asset swap.

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