MONEY MARKET FUND REFORM: INVESTOR IMPLICATIONS

Beginning in October 2016, institutional prime and institutional tax-exempt money market mutual funds (MMMFs) will use a variable net asset value (vNAV). In addition, should weekly liquid assets fall below the 30% threshold, the MMMF’s board of directors will have authority to impose a redemption gate or liquidity fee if it believes it is in the fund’s best interest.

The money market fund landscape is changing, and at least in the near term, prime funds will contribute a smaller portion to the overall industry, while government funds will be larger.

The majority of conversions that fund companies instituted into government funds from prime have already occurred.

– Jennifer Greca, CFP®
Short-Duration Fixed-Income Portfolio Manager

The majority of conversions that fund companies instituted into government funds from prime have already occurred. We anticipate additional outflows from prime and tax-exempt funds into government MMMFs and other investment vehicles, such as ultra-short fixed-income. There is uncertainty as to the size of the potential outflows that investors will initiate, as well as any additional conversions instituted by fund companies. However, these flows should be manageable, as fund managers are well-prepared for this
transition. Still, the next six months are pivotal and could be slightly volatile for the MMMF industry. Due to the uncertainty, MMMF managers will need ample liquidity.

**Conservative Management & Credit Spread Widening**

As a result, we continue to believe that credit spreads in the short end of the yield curve will tighten as prime money market funds shorten their maturities and build liquidity. For this article, we define “short end” as tenors that mature before the October 14 mandatory conversion date for vNav, liquidity fees and redemption gates. Credit spreads will widen for longer-dated tenors, such as those that mature beyond the conversion date. We would expect this phenomenon of widening of credit spreads for longer-dated tenors to continue beyond October, since it is possible that outflows could continue. Heightened demand for U.S. Treasuries and U.S. agency debt could ultimately push yields lower, and the spread between credit and agency debt would widen.

Fund companies also will continue to manage institutional prime MMMFs conservatively to help ensure the funds are well-positioned to avoid instituting a liquidity fee or redemption gate if weekly liquid assets fall below the 30% threshold. As a result, fund managers will increase their allocation to instruments categorized as daily and weekly liquid assets.

**EXPECT WIDER SPREADS BETWEEN PRIME AND GOVERNMENT FUNDS**

For a number of years, MMMFs only earned 1 basis point for investors. Essentially, there was no difference in the yield investors earned in a government fund compared to a prime fund or even a municipal fund, even with fee waivers in place. However, this dynamic has changed. Prime MMMFs on a gross yield basis are earning at least 15 to 20 basis points more than government MMMFs. They are passing along these earnings, even as fund managers are able to earn a much larger portion of the expense ratio of the fund. Historically, the spread between government and prime funds has been 10 to 15 basis points. We expect the spread between government and prime funds will continue to widen, since the government MMMFs will absorb much of the prime MMMF’s lost assets. Thus, there will be a greater demand for government securities.

However, the prime funds are in a unique position and must maintain a delicate balance. They must increase their liquidity while maintaining an elevated spread over government funds. If their yield is too low, it could ultimately cause more investors to transition to a government fund. The prime funds must have ample liquidity in the front end, should a need arise to raise cash to meet potential outflows as well as selectively purchasing longer credit tenors. Prime MMMFs are being paid to buy credit out the yield curve. So while U.S. Treasuries and agencies are the most-liquid assets, prime funds may not want to increase their exposure to this asset class much, since the fund’s yield will need to be enticing for investors to remain in the fund.
THE FEDERAL RESERVE’S IMPACT

In December 2015, the Federal Open Market Committee initiated its first rate hike since 2006. In addition, the Federal Reserve’s Reverse Repo Facility (RRP) essentially became uncapped, allowing $2 trillion of Treasury securities to be available. Since the Fed’s announcement, usage for this facility has averaged approximately $65 billion per day. This facility ultimately created a floor for rates, with the fed funds rate falling between the RRP and Interest on Excess Reserves. However, the Fed stressed that this is only a temporary tool. We expect that once the Fed eliminates this facility, U.S. Treasury and agency yields will fall, since the RRP facility will no longer be in place to provide a floor.

TRANSITIONAL PERIOD

We are currently in a transitional period for the MMMF industry. While there will be additional outflows from the prime business initially, we believe prime funds will continue to play a very vital role for fixed-income markets. In addition, we anticipate some investors will transition back into prime funds after becoming comfortable with the new regulations as they search for a higher return than government MMMFs can provide.

FOR MORE INFORMATION

To learn more, contact your Northern Trust relationship manager or visit northerntrust.com.