Insights
Cash

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Everything You Needed to Know About Negative Rates to Impress Your Boss

There has been a lot of discussion on negative rates. Can you help me understand what is going on?

Two types of negative rates could exist in the US: negative monetary policy rate(s) and negative market rates. The first is set by the Federal Reserve (Fed) and the second is set by market participants (supply and demand for short-term fixed income).

Ok, let's start with monetary policy. What is the current view on the Fed's monetary policy rate? Will they implement a negative policy rate?

The Fed has been very clear they do not support a negative policy rate framework at this time. In fact, the Board of Governors and the Regional Federal Reserve Bank Presidents are unanimous and no Fed officials, voting or non-voting, support negative policy rates.

Why?

Asking why is a good question given we have seen negative policy rates from the European Central Bank and the Bank of Japan. There is a general view that negative rates don't work to stimulate growth or inflation. Remember though the US capital markets are much larger (public debt) and thus have more money market debt than Europe and Japan. The potentially highly disruptive impact negative rates could have on the US markets is unclear. It's possible the disruption could inhibit the flow of credit, exactly the opposite of what the Fed and US Treasury are trying to achieve with their monetary and fiscal stimulus programs.

But couldn't they still do it?

Possibly but very unlikely, as there are certain rules that make implementing negative rates difficult. One major rule being US Treasury bill auctions cannot come at a negative rate. As such, if the Fed wanted to impose negative rates, the US Treasury auctions would be contradicting this effort. It's also unclear if the Fed could charge negative rates on required reserves that its member banks must hold at the Fed.

That sounds like a few simple rule changes. Is there more to it?

Yes, money market funds. There are $4.7 trillion invested in these funds with $3.9 trillion invested in Government and Treasury funds. If rates went negative, money market fund investors would look to avoid negative yields and potentially pull money out of those funds. This could significantly reduce the demand for US Treasuries and government agency debt, including Federal Home Loan Bank (FHLB) debt. The FHLB was created to support housing finance and community investment. 60% of short-term FHLB debt is owned by money market funds. Negative rates could reduce the demand for this type of debt which could inhibit the flow of credit to local communities. And thus causing a political "hot potato".

This is getting complicated and seems like a negative policy rate won't happen with this Fed. But what if the leadership changes and the new Fed Chair wants to use negative rates as a tool?

If there is a sudden change in leadership and the new Chair of the Fed is a strong proponent of negative policy rates, the voting members of the Federal Open Market Committee (FOMC) — the committee that votes on policy rates — would need to be convinced a negative policy rate is effective and should be used. Given current personnel, this seems unlikely or would at least need considerable time and effort to change people's opinions. Also note the rotation amongst the FOMC voters: The Board of Governors are always part of the FOMC (and are appointed) but regional Fed Presidents rotate through the FOMC. So the Fed Chair would have to convince most, if not all, of the Board of Governors and regional Fed Presidents.

So it won't happen or be many years in the making, but let's just say it did happen and policy rate range is -0.50% to -0.25%. Now what happens to my money market fund yield?

If gross yields of money market funds turn negative then fee waivers that allow for a 0.00% fund yield would be ineffective. Fund managers would be, in effect, paying investors to invest in their funds. So fund managers would need to pass along negative rates and determine how they would do this. They could use the reverse distribution mechanism or a variable NAV to account for the negative yield.

What is reverse distribution mechanism? Isn't it also called 'share cancelation'?

Yes, it has been referred to as share cancelation but we think reverse distribution mechanism (RDM) sounds better. It is a process by which the fund administrator (transfer agent) removes or cancels shares from your holdings to account for negative yields. This is done daily. So if on Day 1 you had 1,000,000 shares of a fund, priced at $1.00, then on Day 2 you may have 999,999 shares (or whatever the negative yield was worth in share value) still priced at $1.00.

How would a variable net asset value (NAV) work?

It would work in a similar way except it would be reflected in the price of the fund. So on Day 1 the fund's price would be $1,000.0000 and on Day 2 $999.9999. It would be necessary to have a multi-digit price to accurately reflect the daily drop in value. For example, our EUR money market fund's price was €993.1903 on June 12, 2020.

What is preferable? Are you leaning one way or the other?

RDM might be a little easier because it allows the Government and Treasury money market funds to remain at their steady $1.00 price. Operationally this might also be easier for clients, particularly corporate treasury and sweep clients. We still need to hear from US regulators. They will have an opinion. We are still discussing and engaging our various business partners on what might be the best method.

USD and GBP UCITS money market funds would have to use a variable NAV. RDM has been banned for those funds. It's a long story. We can get a coffee and I'll explain.

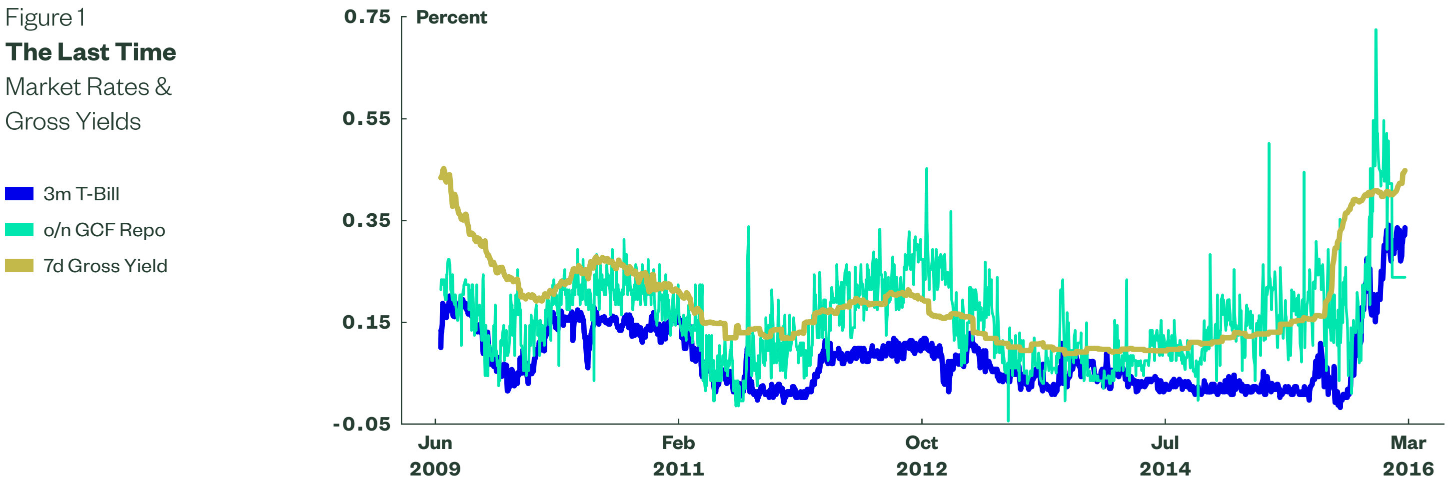
Thanks, you did say this would only take two minutes. Now let's discuss market rates. What happens if market rates go negative? Even if policy rate is 0.00%–0.25% won't that impact money market yields?

We define market rates as the Federal Funds Effective rate and overnight repurchase agreement (repo) rates. These are the rates that are highly correlated with policy rates. The Fed is motivated to keep market rates inside the policy rate range. The Fed's credibility is dependent on being able to do this. Historically, the Fed has used a variety of policy tools to add or drain cash in the markets in order to keep rates within their rates range. If market rates tested the current lower bound (0.00%) the Fed would want to drain cash, reduce demand, from the markets. In other words there would be too much liquidity and not enough supply (US Treasury bills, repo, etc.). One of their policy tools, the Reverse Repo Program, does this. At a specified rate (currently 0.00%) Primary dealers, Government agencies and US SEC-registered money market funds can loan cash to the Fed at a rate of 0.00% and receive US Treasuries as collateral. When this program was introduced in 2013 it was very effective at draining cash from the markets and pushing repo rates higher by. This prevented prolonged periods of negative market rates.

That makes sense but what about US Treasury bill rates? If they go negative, like in March, won't those rates drag money market fund yields lower?

Yes, they could have an impact on money market funds' yields but the majority of money market funds have the ability to invest in repo or government agency debt. So if Treasury bill yields go negative or are stuck at 0.00%, then the portfolio manager would have the ability to shift the allocation into repo or government agency debt. **Figure 1** shows what 3-month Treasury bills, Overnight General Collateral Repo and the average of 10 Government funds' gross 7-day yields from 2009 to 2015. As you can see, the funds' yields followed Treasury bill and repo yields lower in 2011 and back higher in 2012. But in the later part of 2013, after the Fed had rolled out the reverse repo program to drain excess market liquidity, Treasury bill and repo yields diverged. Repo yields moved higher while Treasury bill yields stayed close to zero. The money market yield moved higher with repo rates as managers shifted their allocations to invest in more repo.

Figure 1
The Last Time
Market Rates & Gross Yields



Source: iMoney, Federal Reserve, Bloomberg as of June 15, 2020.

This has been helpful. Anything else to know?

As long as the Fed does not believe in negative policy rates, we won't have to worry about negative rates in money market funds. With that said, keep an eye on overnight repo rates (**The Fed's SOFR**) and **3-month Treasury bill yields**. Those are a good proxy for the direction of money market fund yields as the chart illustrates.

If you have any further questions please do not hesitate to reach out to your State Street Representative or visit ssga.com/cash.

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