In the light of European money market reform, many questions remain surrounding the reform’s ripple effect on global markets and portfolio positioning. Sean Lussier, portfolio manager of US dollar Treasury and prime money market funds and Nick Pidgeon, portfolio manager of sterling and euro prime money market funds help further explain the coming changes.

A Range of Reforms are Set to Impact European-domiciled Money Market Funds. How are They Different from the US Reforms in 2016?

**Sean Lussier:** European money market fund reform is not generating the same reactions US money market fund reform received prior to their October 2016 deadline. There are a number of reasons for this.

In the US, all institutional prime money market funds had to convert to a variable net asset value (VNAV) pricing model. Only retail prime funds had the option to value assets using amortized cost accounting or constant net asset value (CNAV) pricing. US government and US Treasury funds also had the option to decline the use of liquidity gates and redemption fees. It was up to each fund’s management board to decide if they wanted to apply this requirement to those strategies, and almost all decided to decline.

These factors saw many US investors choose government funds; more than $1 trillion in assets moved out of prime funds into government funds.

In relation to European reform, regulators have listened to feedback from investors and investment managers and are allowing a new pricing structure for prime funds: the low-volatility net asset value (LVNAV). This structure will support a CNAV price valued at $1, as long as the “shadow price” or mark-to-market price of the fund remains within a 20 basis points range, called a “collar.” If the fund’s shadow price falls outside the collar, the fund will have to convert to VNAV. Eurodollar liquidity funds are a potential exception to this.

European reform will not give sovereign or government funds or their providers the option to decline the use of liquidity gates and redemption fees. All CNAV and LVNAV strategies will be subject to this rule, marking a divergence from US reforms.

European clients appear pleased with the rule changes and are likely to remain invested in their existing strategies. Although significant regulatory changes of this type have the potential to generate market volatility and uncertainty, to date the short-end credit markets have proven dynamic and flexible enough to accommodate them.

**How will You be Positioning the Funds as We Get Closer to the Deadline of 21 January 2019?**

**Sean Lussier:** Given the positive US economic backdrop of strong growth, steady labor gains, increasing wage pressure and a firming inflation outlook, the Federal Open Market Committee (FOMC) has continued to normalize rates, with hikes in March and June. In addition, the Federal Reserve’s (Fed’s) recently released dot plot and market sentiment are pricing in two additional hikes this year, most likely in September and December. During this hiking cycle, it has made sense to position the funds with a shorter duration and concentrated maturities around FOMC meeting dates in order to reinvest into higher rates. This natural market positioning will also coincide with the regulatory deadline of January 2019, and should provide the funds with increased liquidity and NAVs at or near par as we get closer to the fund-specific regulatory transition date. Given the increase in US Treasury bill and repurchase agreement collateral the market has experienced, in combination with attractive short-dated credit offerings, the supply available to the market should accommodate this cautious positioning ahead of the reforms. Post reform, as the new European money market fund landscape evolves, we will be able to deploy investments efficiently in the new landscape. The yield spread between LIBOR and overnight index swaps remains at the wider end of its historic range and, coupled with increased Treasury yields, has made US cash a very attractive asset class.
Despite the Upcoming European Money Market Reform, it Appears to be Business as Usual for Sterling Investors, Who Appear Likely to Remain in Their Current Funds as They are Converted into LVNAV Funds. Does that Cause You Any Concern?

**Nick Pidgeon:** It does appear to be business as usual regarding money market fund reform from a sterling perspective. There will be some exceptions but not enough to see significant sterling flows. In fact, State Street Global Advisors’ sterling fund has experienced robust growth over the past year and we would hope this growth remains on track.

In terms of the Bank of England and their policy rate, the period since November’s rate hike has been rather choppy. Markets were quite bullish leading up to November’s hike, in that they were pricing in several more rate increases before the end of 2018. But as the hike came with dovish rhetoric, yields six months out actually fell, as expectations of additional hikes were taken off the table. The Bank of England’s sentiment changed in February, when they began to bullishly target inflation. Market rate expectations jumped and again priced more than one hike in 2018, with an almost 100% probability that the first of those hikes would take place in May. These expectations were short-lived, however, as policymakers changed tack again in April, with Bank of England Governor Mark Carney’s comment, “There are other meetings beside May to hike rates.” This dovish pronouncement in combination with weaker UK economic data sent yields down again. By the time of May’s Monetary Policy Committee meeting, the market was pricing just a 10% probability of a rate hike.

As expected, policymakers kept rates on hold in May and the timing of the next rate hike was initially pushed out to August. Following a weak Consumer Price Index print in May the timing of the next rate hike was pushed out to November and then to the first quarter of 2019 after further dovish comments, related to Brexit, by Governor Carney. Subsequently, following a pick-up in UK data prints, market expectations moved to a hike in November this year. We remain active with regard to policy developments, having navigated through the past rate hike scenarios and market moves while remaining competitively positioned. We are confident that we will keep on top of any market rate hike changes while also negotiating the upcoming reform changes.

How will You Position the Sterling Fund for Reform?

**Nick Pidgeon:** The biggest adjustment will be to liquidity ratios, with some minor tweaks elsewhere, as most of the rules are pretty much in line with how we already run the funds. We already have a minimum 10% overnight liquidity and 30% one-week liquidity, which is in line with the new regulations. The new rules are more stringent about processes and the chain of events that could be affected if liquidity falls below these limits. For example, the tighter regulations will require an up-lift in liquidity provisioning to ensure ratios are maintained. This aligns with the use of amortized accounting within the context of pricing for an LVNAV fund. Although we will still aim to create a robust maturity ladder on investments, only securities with less than 75 days to maturity can use amortized accounting. We therefore expect a higher ratio of securities with 75 days or less to maturity, which will both assist in stable fund pricing and higher liquidity ratios in a laddered portfolio. We do not expect a significant difference in the fund’s weighted average maturity and weighted average life over the long-term against the daily average of the current CNAV offering.

Are Year-ends Problematic Because of the Lack of Liquidity Caused by Banks Pulling Out of the Money Markets to Trim Their Balance Sheets for Financial Reporting?

**Nick Pidgeon:** In relation to the sterling fund, year-end 2017 was better than year-end 2016, and perhaps year-end 2018 will be better still; better meaning more liquid, more to invest in and yields not being low or negative. Year-end planning never stops, with a series of mini year-ends each quarter-end to contend with three times a year. As we move through our positioning for one quarter, we are already working on positioning for the next one. Sterling repurchase agreement (repo) investments can be problematic at quarter- and year-ends. We have seen huge swings in yields offered over these periods and generally yields have turned negative. We could see less reliance on repo this year-end and more reliance on UK sovereign debt. The market technicals around the quarter ending 31 March this year saw some very rare cross-currency opportunities that increased sovereign issuance into sterling markets. This was a big help and an opportunity we will watch closely for again at the end of this year. It offers a better option than risking losing investments and trading negative, as banks trim their balance sheets going into year-end; it locks in liquidity, high-grade credit and yield early on.
In relation to the US dollar fund, cross currency opportunities around year-end have increased each year for the last several years. Because of Ireland’s Regulation S accessibility, our Dublin-based money market fund can and does participate in European-issued commercial paper. This paper offers very attractive yields for high-quality credits over their respective US financial commercial paper counterparts. The opportunity exists because European banks can fund more cheaply by raising US dollars and swapping them back to their base foreign currency than by accessing those money market funds directly in their base currency, due to regulatory constraints at month- and quarter-end.

The Regulatory Deadline for Funds to be Compliant with the New Rules is 21 January 2019. Many Fund Providers have Indicated that They will Convert Their Funds Before the End of 2018. Have You Discussed Conversion Dates?

Sean Lussier: Yes, we have heard from some fund companies that they will be converting in the fourth quarter. Only one company has announced their exact date. We continue to discuss the date that we will be converting our funds. It’s possible we will transition all four of our funds at once or stagger the transitions over a series of dates. Although we know the final rules or end state of euro funds has not been determined due to the negative interest rates in that currency, the transition dates will be fully vetted with our internal and external partners to ensure a smooth and seamless conversion. If, as expected, very little asset under management movement occurs, the conversion date should not have any meaningful impact on shareholders of the funds. Clients in euro funds could be forced to choose a NAV versus CNAV if the European Securities and Markets Authority’s (ESMA’s) decision on the reverse distribution mechanism (RDM) is not appealed.

The ESMA is Not Allowing RDMs for Funds that are Negative Yielding, Meaning that Fund Providers will be Unable to Remove Client Shares to Account for Negative Returns. What Impact will this Have on Euro Money Market Funds?

Nick Pidgeon: The door for RDM funds is still slightly open with options for RDM still being discussed by the competent authorities to assess whether it is possible to agree a way forward. As it stands, however, ESMA has directed that RDM will not be allowed for CNAV and LVNAV funds because those funds are negative yielding. Therefore current euro CNAV money market fund investors could have fewer options open to them while we remain in a negative rate environment in the Eurozone. Euro fund investors may have to assess whether short-term VNAV or standard VNAV funds meet their needs, as well as review their internal policies and possibly adapt their internal accounting and record systems. Of the two, most clients have indicated they prefer the short-term VNAV fund, which is the next step along the ladder of money market funds. While the short-term VNAV fund has the same constraints as the LVNAV fund in terms of weighted average maturity, weighted average life and eligible instruments, it can carry lower liquidity ratios and has no gates and fees, which will appeal to many clients. The standard VNAV fund has many features of the short-term VNAV but is longer in duration with a six-month weighted average maturity and 12-month weighted average life. To date, the responses we have received from our clients suggest that they favor short-term VNAV. We will be offering a full range of funds across all currencies, but in the Eurozone, our public debt and LVNAV offerings may be delayed until a solution can be found for the RDM or until euro yields turn positive. At present, the short-term VNAV fund appears to be the lead candidate.

Will You Manage the Euro Fund Any Differently than the Dollar or Sterling Funds?

Nick Pidgeon: The outlook in the Eurozone differs from that of the US and UK. Eurozone interest rates are likely to remain in negative territory until the fourth quarter of 2019 at least, with a first rate hike not priced until mid-2019 and the deposit rate returning to positive territory sometime after that. The European Central Bank (ECB) is still working through managing down its Asset Purchase Program and excess liquidity at the ECB is not far short of €2 trillion. This has given us a different dynamic in terms of managing the euro fund compared with the US dollar and sterling funds and will continue to do so. We know the rules change around RDM and conversion to VNAV are more significant for some investors, but others feel comforted by the lack of liquidity gates and fees. We have a robust process in place to identify what each fund investor intends to do with their balances and liquidity requirements for the short-term VNAV funds are slightly lower than those for LVNAV. The main change in managing the fund will likely relate to liquidity, which is likely to be elevated approaching the conversion date and until we become more comfortable with client positioning under the new reforms. As always, we will continue to manage a well-laddered liquid portfolio in line with the current ECB outlook for markets.
Conclusion

While European money market fund reform will no doubt impact the economy in the coming months, we remain dedicated to providing educational and insightful advice. We offer further explanation on fund attributes and an expanded glossary of terms on our website, ssga.com/cash.

Glossary

3 month LOBOR The 3 month US Dollar (USD) LIBOR interest rate is the average interest rate at which a selection of banks in London are prepared to lend to one another in American dollars with a maturity of 3 months.

Inflation Inflation is a sustained increase in the general price level of goods and services in an economy over a period of time.

OIS An overnight indexed swap (OIS) is an interest rate swap where the periodic floating payment is generally based on a return calculated from a daily compound interest investment. The reference for a daily compounded rate is an overnight rate (or overnight index rate) and the exact averaging formula depends on the type of such rate.

Regulation S When an offering of securities is deemed to be executed in another country and therefore not be subject to the registration requirement under section 5 of the 1933 Act a safe harbor must be defined with an issuer safe harbor and a resale safe harbor. The regulation stipulates offers and sales of the securities be made outside the United States and that no offering participant employ directed selling efforts. Issuers whose securities hold a substantial US market interest, the regulation also requires that no offers and sales be made to US persons (including US persons physically located outside the United States).