For cash investors, the markets in which they operate are undergoing change. Some of this is incremental and reflects a natural evolution of financial markets in reaction to economic and policy changes. Others are more far-reaching in nature, with implications for investment choice. In the United States, potential adjustments to Treasury supply volume and duration is significant, as is the Fed's acceleration in the reduction of its balance sheet. How the debt ceiling negotiation is managed early in 2018 is important with additional supply a likely outcome at the end of the process. In Europe, change is also on the horizon amid regulatory changes and a slowing pace of central bank asset purchases; but for short-term investors, conditions are unlikely to change much as negative yields seem set to hold sway.

1. Gradual unwinding of Fed balance sheet to avoid market disruption
2. US Treasury to increase supply; bias towards short duration issuance
3. Europe money market funds to remain challenged by negative yields and Brexit
Treasury Issuance to Shorten

The US Treasury market is set to become a whole lot more interesting, with changes beginning to reshape the market over both the near- and longer-term. In the first instance, the make-up of US Treasury issuance could become more tilted towards shorter duration paper than has been the case. The Treasury Borrowing Advisory Committee’s (TBAC) has recommended an increase in the supply of two-, three- and five-year securities potentially see a reduction in the issuance of seven- and 10-year notes, and 30-year bonds. The TBAC’s suggestion also included an increase in the amount of two-year treasury floating rate notes issued.

Short-term investors would be expected to benefit from the extra issuance given this should push those yields higher than they might otherwise be. An increase in the supply of Treasury issuance might also drive rates higher in the repo market as more supply on the primary dealer balance sheets must be funded.

Balance Sheet Wind-Down

The Federal Reserve started the wind-down of its balance sheet in the final quarter of 2017 and this will continue to accelerate through 2018. Although the Fed ended its bond purchasing program at the tail-end of 2014, it has continued to reinvest maturing Treasuries and Mortgage Backed Securities. In the fourth quarter of 2017, the Fed did not reinvest up to US$6 billion of US Treasury securities and US$4 billion of US Agency Mortgage Backed Securities (MBS). This amount will increase by US$6 billion and US$6 billion respectively each quarter up to US$30 billion and US$20 billion by the first quarter of 2019, and continue at this level beyond then.

This gradual unwind of the Fed’s US$4.5 trillion balance sheet should not have any near-term impact on the money markets and we expect the pace to be gradual enough not to disrupt the markets. In the longer term, and similar to the aforementioned potential effect of an increase in supply, this could lead to increased yields in the repo market as primary dealers will have more debt to fund.

LIBOR — The Beginning of the End?

A notable new development in 2017 was the announcement that the Financial Conduct Authority (FCA) will not require the banks that collectively determine the London Interbank Offered Rate (LIBOR) to continue submitting rates past 2021, effectively mapping a timeline to its likely demise. The reputation of LIBOR had been hit in the aftermath of the global financial crisis amid allegations of collusion and rate manipulation in order to make profitable trades or else to give a misleading impression of their bank’s creditworthiness.

The FCA’s timeline recognizes a transition will take time, but central banks have been identifying alternatives to LIBOR that are anchored to actual borrowing activity. In Europe, the European Central Bank (ECB) has favored a move to the Euro Overnight Index Average (EONIA), while the Bank of England favors the sterling equivalent, or SONIA. Both institutions continue to research those rates to determine their robustness and what else can be done to ensure they best represent the cost of short-term borrowing.

In the US, the shift to a new short-term funding rate has not formally begun. This rate, which is preferred by the Alternative Rates Reference Committee (ARRC), is the Secured Overnight Financing Rate (SOFR) and will be calculated from the average of three rates: Tri-party General Collateral Rate, Cleared Bi-Party Repo rates and GCF repo rates. A key attraction is that the combined rate will have tens of billions worth of transactions behind it and represent overnight secured funding rates in the US.

Healthy Supply

The market does not appear concerned about the transition away from LIBOR as yet. We have seen a continued healthy supply of LIBOR-based floaters that mature after the December 2021 deadline; there has been some speculation that the LIBOR banks might continue to submit LIBOR rates even after that date. And therein lies a notable difference — the LIBOR market provides for term products, while the SOFR (and EONIA/SONIA) is by definition an overnight rate; some progress is required to provide a mechanism that will effectively allow for fixed terms linked to SOFR. A short-term curve will likely develop that will facilitate such term transactions, in a similar way to an Overnight Index Swap on the federal funds rate.
In the near term, the US will once again be dealing with a debt ceiling limit. While all previous debates have concluded with a resolution, there is still the potential for a technical default of a US treasury bill. We should stress that this is not our base case. We see it as an extremely remote scenario, but it nags at the consistency of US Treasury bill issuance and how the US Treasury manages its excess cash. In 2018, consensus estimates indicate an additional US$430 billion of new Treasury bill supply.

In a similar way to the shortening duration of US Treasury debt, this increase in bill issuance should generate higher yields versus other short-term benchmark rates. It would also generate a larger percentage of bills versus notes and bonds. Estimates around bill issuance indicate that it could increase from approximately 13% of total public treasury debt to over 15%; this would represent the highest percentage of debt since early-2013.

Prior to 2008, it would not have been unusual for the US Treasury to run over 20% of bills as a proportion of total public Treasury debt, as is evident in the figure below. It is unclear if we will move back to this ratio anytime soon.

In anticipation of additional Treasury bill supply and the expectation that those bill yields should increase relative to the federal funds rate, we will closely monitor the weighted average life of our government and treasury portfolios to ensure we can capture this cheapening when it occurs. At the same time, we will be mindful that term premiums could also push higher, with potential implications for the shape of the curve.
The ECB has also done a very effective job in providing term funding to the region’s banks. The Targeted Longer Term Refinancing Operations (TLTRO) has allowed the ECB to enable banks to lock up funding and reduce their reliance on less-stable funding sources.

Money Markets Challenge
Sourcing short-term debt at a reasonable price continues to be a challenge for European money markets. The repo markets have experienced significant dislocations around the end of every quarter and the year-end as a result of dealers withdrawing offerings and market liquidity freezing up. The ECB has reportedly considered implementing programs that would be similar to the US Federal Reserve’s Reverse Repo Program, but complexity around such activity persists. It seems more likely that the ECB would probably issue some type of short-term unsecured debt by the ECB to mop up excess liquidity in those periods. This will become more critical when the ECB ultimately decides it is time to raise interest rates, something we don’t anticipate occurring until 2019 at the earliest.

Credit conditions across Europe improved in 2017 and we see this trend continuing in 2018. But even with this improvement, the spread between Government and Prime money market funds has been at historic wide levels; prime fund yields can be 20-30 basis points higher than that of a government fund. There are few signs to indicate that the differential will not remain in place for 2018. European cash investors will likely continue to hunt for yield further out the yield curve, as well as further down in credit quality, in order to mitigate the negative returns.

Brexit Remains an Issue
The Brexit dynamic underlying the UK market ensures that uncertainty remains an ever-present feature. While the Bank of England in November 2017 implemented its first interest rate hike in a decade as inflation hovered around the 3% level, the move was largely seen as a reversal of the post-referendum emergency rate cut in August 2016. And it is Brexit and painstaking negotiations that remain the key factors for the UK in 2018. There are so many potential outcomes or delays that it continues to be challenging to call, with any conviction, what the yield curve will look like in the UK.
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