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The forces shaping the ultra-short market

Key takeaways

As the ultra-short fixed-income landscape reacts to and absorbs U.S. policy and regulatory change, more changes are ahead in 2018.

A key issue is how the effects of tax reform and cash repatriation could potentially create selling pressure in short-dated assets.

Additional issues include Fed interest-rate policy and the further effects of balance sheet normalization, the potential partial repeal of money market reform, and LIBOR replacement.

Stay informed on the evolving ultra-short-term bond investment landscape

Putnam offers three commentaries to keep you updated on changes to investing at the short end of the yield curve.

1 **CHANGING CURRENTS: THE MONEY MARKET SINCE REFORM**

Discusses the impact of the SEC reform on the behavior of industry participants.

2 **THE NEW TERRAIN OF THE ULTRA-SHORT MARKET**

Describes the decline of prime money market funds, the increase in commercial paper, and T-bill demand as the market reacted to reforms.

3 **THE FORCES SHAPING THE ULTRA-SHORT MARKET**

Addresses tax reform, Fed policy, and potential for future regulatory reforms and LIBOR replacement.

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Look-alikes now, but not forever: The ultra-short universe and prime money market funds

As a result of the shifting demand and supply dynamics at the short end of the yield curve, as well as the curve flattening that occurred in 2017, investors are finding that more conservative ultra-short funds and prime money market funds look a great deal alike these days. But that will not always remain the case. Conservative ultra-short funds have more flexible investment parameters, giving them greater ability to capture new short-end market opportunities that may materialize as a result of changes stemming from policy and regulatory dynamics.

Potential effects of policy and regulatory changes

The year 2018 has the potential to put the short end of the curve into the spotlight again. Here are our thoughts on some of the potential forces at work:

1. Tax reform and cash repatriation

With the passage of the Tax Cuts and Jobs Act, the incentive just became much greater for corporations to bring back roughly $3 trillion in offshore earnings. The last time there was a cash repatriation effort, in 2004, companies were only taxed if they brought the earnings back on shore. This time, offshore earnings currently held will be deemed to be repatriated and will be taxed at 15.5% for liquid assets and 8% for illiquid assets, payable over eight years. This will happen regardless of whether the assets are actually repatriated or not. Future foreign earnings won't be subject to additional repatriation taxes. Once the earnings are taxed, companies lose the incentive to keep the earnings offshore any longer.

Many corporations hold their "offshore" cash in U.S. custodial banks and also hold U.S. securities as well as European money market funds. There may not be a rush to liquidate these portfolios; there certainly wasn't in 2004. However, even if there isn't a synchronous unwinding of positions, this does not necessarily mean that there won't be an impact. Apple announced that the company plans to bring back most of the $252 billion in offshore cash held "abroad." For example, Apple is only one instance of a company with significant earnings to be repatriated, and it is most certainly not the only major global corporation with material offshore cash holdings.

There is potential for materially less demand in the short end; corporations may be letting positions mature and not reinvest, as well as selling money market and other short-term assets, leading to spread widening on credit assets. The selling activity won't necessarily be a result of liquidations in order to bring cash back to the United States, but more likely will be due to the need to raise the cash in order to pay the repatriation taxes as well as take actions that are widely expected: capital expenditures, share buybacks, dividend payments, and employee bonuses and pay raises.

It is difficult to forecast when short-end selling might occur, but we have already seen some large bid lists in the marketplace. These were easily absorbed, but if activity accelerates and/or increases in magnitude, it certainly has the potential to create market volatility and underperformance in the ultra-short market.

2. Fed interest-rate policy and balance sheet normalization

Expect a hawkish tilt to the Fed in the first part of 2018. In addition, recall that balance sheet normalization ramps up in 2018. Putnam's internal inflation forecasts currently show core inflation rising in the next few months as a reflection of dollar weakness, the increase in commodity prices, and some seasonal effects. This makes it easy to see how the combination of continued solid growth and rising inflation will generate a drumbeat for the Fed to move more aggressively. The Fed has a risky game to play, and given the central bank's track record, the overall chance of getting it wrong is reasonably high.

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3. Partial repeal of money market reform

Interestingly, there is a bill under consideration to repeal some of the aspects of the 2016 money market reform, and it appears to have bipartisan support. The bill allows (assuming certain parameters are met) any Rule 2a-7 money market fund to elect the option of a stable or floating NAV and for stable NAV funds to possibly be exempt from the default liquidity fee requirements, though it is unclear regarding the redemption gates. Lastly, it prohibits the federal government from bailing out money market mutual funds.

As of the end of January, it has been reported that the bill is stalled in the House of Representatives and is not ready to be sent to the floor for a vote. Even if the bill eventually passes at some point down the road — which we think is a long shot — we believe many of the players have money market reform fatigue, and we don't expect to see as dramatic an asset shift as that which occurred in 2016.

- Defined contribution plans have already made changes to their investment option lineup; it is difficult to see them rushing to change back only a year or two later.
- Corporations may have more incentive to revert back to prime money market funds once the yield differential between prime money market and government money markets funds is greater than it is today.
- Individual retail investors were less motivated to make changes with the initial reform so it is unlikely that a major shift will occur in this investor base.

4. LIBOR replacement

We don't expect major disruption related to the replacement of LIBOR as a benchmark rate given the lead time provided in making the transition. LIBOR may or may not remain viable past 2021, but there is a clear move toward alternatives. In the United States, the preferred alternative, the Secured Overnight Funding Rate (SOFR), will likely begin to be published along with two other possible benchmarks. This is expected to lead to futures and other derivatives trading on these benchmark rates. Additionally, there will likely be greater efforts to amend the provisions regarding the use of alternative benchmark rates in existing securities and derivatives documentation.

Asset movement mattered more than reform

The major shift out of prime money market funds and into government money market and other ultra-short funds spurred more indirect change than the actual reform itself. The asset shift created different relative value choices, drawing new investors into the ultra-short market and altering supply/demand technicals. Market conditions have been such that the key elements of the reform — floating NAV and redemption fees/gates — have not yet been truly tested.

The indirect effects of reform have generally been positive, with deeper market participation and better-than-anticipated supply in commercial paper and, in 2016, U.S. T-bills. The Fed's overnight reverse repo facility is being tapped and is operating as anticipated. As the effects of additional policy and regulatory change begin to become apparent in 2018, they will also work to shape the ultra-short market.

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