MONEY MARKET REFORM: THE SHOT CLOCK IS TICKING

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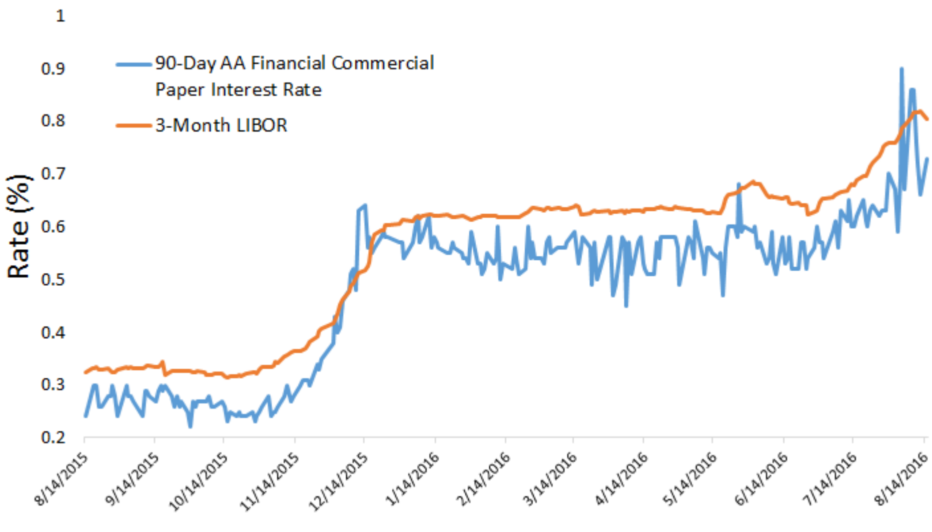
On October 14, 2016, money market reform here in the U.S. is slated to be implemented. And the potential repercussions are already being witnessed, as investors do not seem to want to wait until implementation day to begin making adjustments to their money market portfolios. The upcoming money market reform had its genesis in the financial crisis. During the height of that crisis, a money market fund "broke the buck" and repriced its shares below the $1.00 threshold. As a result, prime institutional money market funds experienced heavy redemptions, as investors withdrew "approximately $300 billion (14% of their assets)," according to the U.S. Securities and Exchange Commission (SEC). These redemptions continued until the U.S. Treasury provided another one of its government guarantees, and they ultimately led to the reform measures that will become activated in mid-October. For the record, there are a variety of different money market funds (MMFs), and they can invest primarily in government securities, tax-exempt securities or corporate debt securities. Prime funds are money market funds that invest mainly in corporate debt. The most noteworthy change is that institutional prime MMFs will be required to have a floating net asset value (NAV) and can impose liquidity fees and redemption gates during periods of stress. (A floating NAV utilizes market-based factors to value securities within the portfolio. Redemption gates are the ability to suspend withdrawals temporarily if a fund's level of weekly assets falls below a certain threshold.) These rules will also apply to institutional municipal money market funds. Retail MMFs will not be required to use a floating NAV but will have the ability to impose liquidity fees and redemption gates in periods of stress as well. Government MMFs (funds that invests at least 99.5% of their total assets in cash, government securities and/or repurchase agreements collateralized by government debt or cash) will also not be required to have a floating NAV and would not be subject to the liquidity fees/redemption gate rules. **Recent Trends in Three-Month LIBOR and Financial Commercial Paper Markets**



Sources: Federal Reserve, Bloomberg, as 08/16/2016. Past performance is not indicative of future results.

As mentioned, there are clear signs that investors have already begun the process of adjusting to these new rules, as cash has been leaving prime MMFs and moving into government funds. As a result, the markets have been witnessing lower demand for short-term corporate debt, such as financial commercial paper (CP). In order to compensate for this reduced demand, CP issued by financials has seen a rather visible rise in rates just over the last four to six weeks. Since adjusting to the Fed's first rate hike in December, 90-day financial CP rates climbed another 36 basis points (bps) to a high of 0.90% in early August. There has been some retreat from this high watermark, but as of this writing, the increase was still in the 25-bps vicinity. These elevated CP rates have spilled over into the LIBOR arena, pushing three-month LIBOR up by roughly 15 bps since the end of June. **Conclusion** As investors continue the process of reallocating funds from prime MMFs to government funds, further dislocations, and potentially higher CP and LIBOR rates, could ensue. Why does this matter? With many borrowing arrangements tied to LIBOR, any sustained increase can actually serve as a non-Fed-related "stealth" tightening. Thus far, Fed officials have not publicly stated any concerns on this front, but it is certainly a situation that will bear continued monitoring.

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DEFINITIONS

Money Market : a market for highly-liquid assets generally maturing in one year or les.

SEC : U.S. Securities and Exchange Commissio.

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

Money Market Fund : A fund that Invests in high quality, liquid short-term debt securities and monetary instruments such as US Treasury bills and commercial paper.

Corporate debt : Bonds a company issues in order to raise money.

Floating Rate Treasury Note : a debt instrument issued by the U.S. government whose coupon payments are linked to the 13-week Treasury bill auction rate.

Net Asset Value (NAV) : The calculated assets minus liabilities divided by shares outstanding. NAV is the straightforward account of the actual assets in the fun.

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.

London Interbank Offered Rate (LIBOR) : the average rate that major banks offer to lend to each other for short-term unsecured funds in a particular currency for a particular maturity in the wholesale money market in London. It can range from overnight to one year and is utilized as a benchmark for various loans and in the capital markets.

Basis point : 1/100th of 1 percent.

Monetary tightening : A course of action undertaken by the Federal Reserve to constrict spending in an economy that is seen to be growing too quickly or to curb inflation when it is rising too fas.