Money Markets

Record Liquidity Improves Market Conditions

Kerry Pope, CFA
Institutional Portfolio Manager

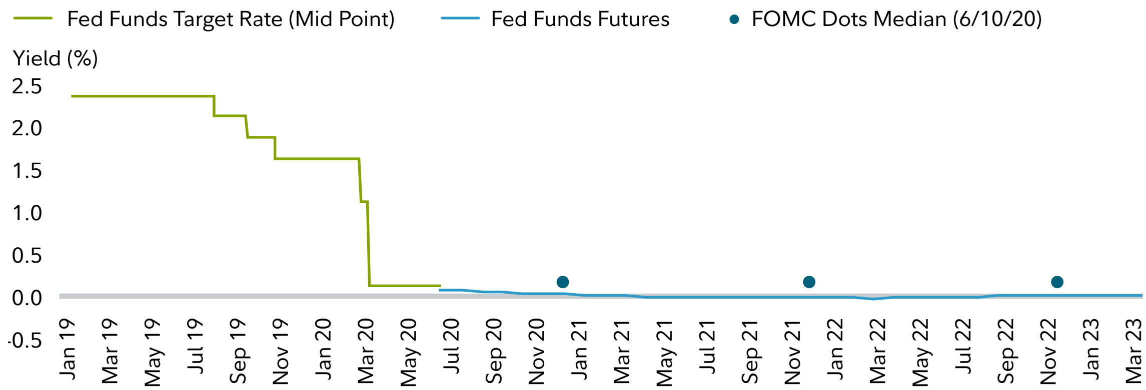
KEY TAKEAWAYS

- Historic monetary and fiscal liquidity programs have helped to improve market conditions following the COVID-19 pandemic, but economic normalization may be years away.
- Plans are on target to move from LIBOR to a new short-term benchmark, SOFR, by the end of 2021; whether markets will be ready for the transition remains to be seen.
- Strong Treasury issuance in the second half of the year may be offset by declines in agency securities and non-financial commercial paper.
- Fidelity has decided to exit the institutional prime money market segment and liquidate two funds; we believe institutional investors are better served with other cash management products.
- Money market flows, which surged in the first quarter, declined amid July tax payments, and more appetite for riskier investments.

Economic normalization may be years away

Markets have stabilized as the U.S. economy heads into the second half of the year, with the COVID-19 virus still rising in some parts of the country but extraordinary monetary and fiscal programs helping to restore liquidity conditions. The Federal Reserve at its June meeting noted that the global pandemic has continued to create significant hardships in the U.S. and around the world, and that it would continue to use all of its available tools to restore stability and limit long-term damage to the economy. Yet it also noted signs that normalization may be years away: The virus has caused a sharp drop in economic activity, with nearly 20 million jobs lost and unemployment hitting 13.3%, with a decline in real GDP likely to be the most severe on record.[1] The Fed's latest Summary of Economic Projections indicates no rate increases through the end of 2022, with the Fed Funds target range remaining at 0%–0.25% (Exhibit 1). Policymakers also are forecasting unemployment at 9.3% and negative GDP growth of -6.5% for 2020, with a slow recovery over the ensuing two years (Exhibit 2). Chairman Jerome Powell after the June meeting acknowledged the extent of the downturn and pace of the recovery remain "extraordinarily uncertain," with those least able to shoulder the burden most affected.

EXHIBIT 1: The Fed Funds rate declined 1.50% at two unscheduled meetings of the FOMC in early 2020, and is now likely to stay near zero through the end of 2022.



Source: Federal Reserve and Bloomberg Finance LP, as of June 30, 2020.

EXHIBIT 2: The Fed's Summary of Economic Projections suggests economic normalization may be years away.

FOMC consensus views	2H 2020	2021	2022
Fed Funds rate (target range at 0%–0.25% following cuts of 1.50% in March)	No change	No change	No change
Inflation (2% target)	0.8%	1.6%	1.7%
Unemployment (4.1% avg. run rate)	9.3%	6.5%	5.5%
GDP growth	-6.5%	5.5%	3.5%

Source: Federal Reserve, June 15, 2020.

Finally, the International Monetary Fund (IMF) recently downgraded its World Economic Outlook as a result of the COVID-19 virus, noting negative GDP growth in all world regions for the first time.[2] The IMF projects 2020 global GDP growth at -4.9%, or 1.9% below its April forecast. It noted a particularly adverse impact on low-income households, imperiling the significant progress made in reducing extreme world poverty since the 1990s. At the same time, the IMF noted its projections have a high degree of uncertainty given the unknown path of the virus, from the length of the lockdowns to the full impact on supply chains and spending.

Liquidity programs help to restore stability

To address concerns about COVID-19's long-term impact on the economy, the U.S. government continued with a combination of fiscal responses in April, following up on the Fed's decision in March to cut the Fed Funds rate to essentially zero, a low last seen amid the financial crisis of 2008. Together, these moves began to usher in increasingly more-normal trading conditions as the second quarter progressed.

As part of the Fed's broad response to economic and market conditions, it continued to boost holdings of U.S. Treasuries and agency mortgage-backed securities in April. It also introduced measures to increase market liquidity, including a commercial paper funding facility. Moreover, the Fed made available $1.5 trillion of additional liquidity via its open-market operations, with an additional commitment of $1 trillion per week, if needed. However, Chairman Powell noted he does not see negative rates as an appropriate policy for the U.S. and said in April that he planned to do "whatever it takes for as long as it takes" to help improve market liquidity contributing to lower yields for risk assets and narrower spreads.[3]

By quarter end, yields again trended lower and spreads continued to tighten modestly, in a sign of stabilizing conditions.

The U.S. government has approved nearly $3 trillion in emergency funds as of the end of May, raising the fiscal deficit to roughly 18% of GDP. Amid a slow reopening and severe pressures in certain industries, including travel, gaming, and entertainment, Congressional support has grown for more economic stimulus. As of this writing, with the virus still surging in a number of states, expectations are rising for additional fiscal stimulus before the summer recess.

EXHIBIT 3: The amount of lending extended through Fed liquidity programs declined in June, in a sign of a return to easier financial conditions.

Facility/Purpose	Current Amount of Lending as of July 1, 2020	% Change (June 3–July 1, 2020)
Primary Dealer Credit Facility (PDCF)—Fed provides loans of up to 90 days to primary dealers	$2B	-57%
Central bank swap lines extended—unlimited U.S.D. swap lines	$225B	-50%
Discount window rate decreased on overnight loans to banks	$6B	-47%
Money Market Mutual Fund Liquidity Facility (MMLF)—allows prime and municipal money market funds to sell CP, CDs, and VRDNs to depository institutions, who then finance it at the Fed using the assets as collateral	$21B	-31%
Paycheck Protection Program Liquidity Facility (PPPLF)—funding collateralized with PPP loans provided by the Fed	$68B	23%
Corporate Credit Facilities (CCFs, both primary and secondary markets)—Provide bond and loan issuance for large employers and liquidity for corporate bonds	$10B	42%
Commercial Paper Funding Facility (CPFF)—allows CP to be issued to the Fed[4]	$4B	New Facility
Main Street New Loan Facility (MSNLF)—Fed provides funding to banks for small business loans.	$0B	New Facility
Municipal Liquidity Facility (MLF)—Fed purchases short-term muni debt from issuers	$1B	New Facility
Term Asset-Backed Securities Lending Facility (TALF)—loans provided by the Fed backed by asset-backed securities	$0B	New Facility

Source: Federal Reserve, Fidelity Investments. As of July 1, 2020. Please see "Government Responds with Extraordinary Measures," April 24, 2020, for more details on Fed liquidity programs. Amount of lending is defined as amount outstanding of facility asset purchases. This excludes Treasury equity contributions.

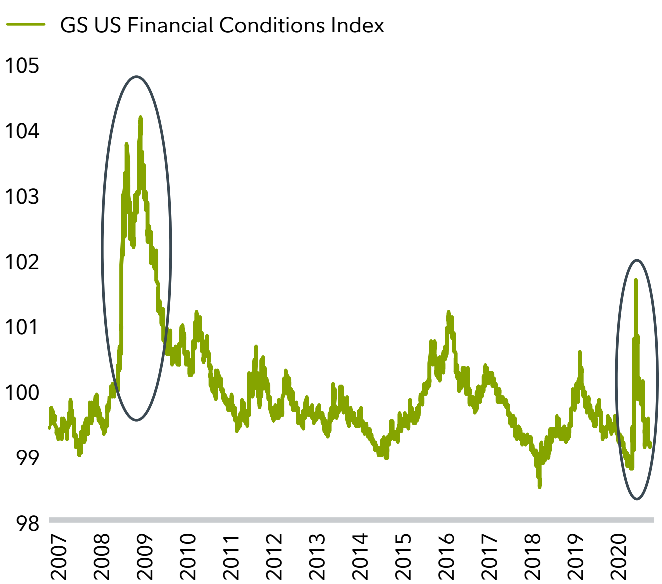
Meanwhile, conditions have eased so much that usage of some Fed facilities has abated significantly in recent weeks (Exhibit 3). Of note was a 50% decline to $225 billion in the U.S. dollar swap lines by the European Central Bank, and a 57% drop in Fed loans via the Primary Dealer Credit Facility (PDCF). In addition, new credit-lending programs such as Term Asset-Backed Securities Lending Facility (TALF) and the Main Street New Loan Facility (MSNLF) have barely been used.

One sign that the Fed's liquidity programs have helped to normalize conditions is the path of the Goldman Sachs Financial Conditions Index, which tracks conditions of money, debt, and equity markets. The index hit a peak of nearly 102 on March 23 but has since come down to normal levels (Exhibit 4). The index evaluates how different financial variables beyond policy rates affect the economy.[5] Of note, financial conditions were worse at the peak in 2008 and took much longer to normalize.

Healthy Treasury supply continues

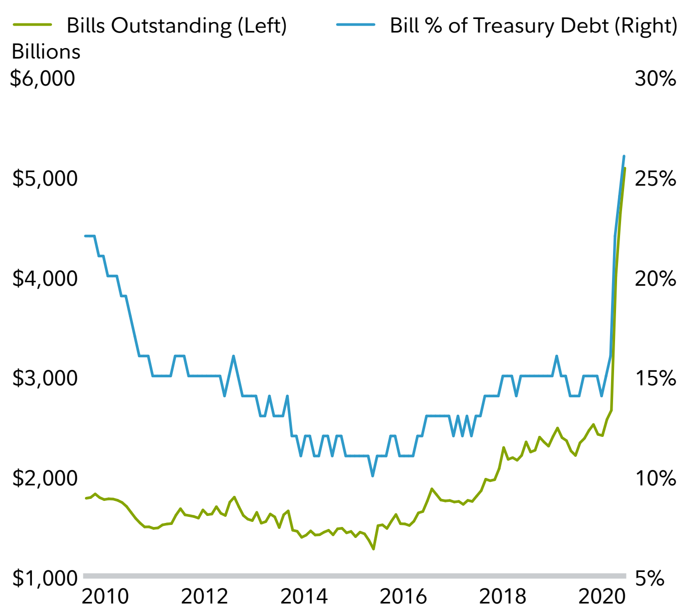
As a result of copious monetary and fiscal programs to support the economy, issuance of Treasury bills almost doubled to more than $5 trillion in the second quarter, or more than a quarter of all Treasury debt outstanding (Exhibit 5). However, outside of Treasury bill growth, we expect credit supply in money markets to be flat in the second half of the year, as well as year over year from 2019, for several reasons. First, corporations have issued over $1.2 trillion year to date in term debt after being shut out from the commercial paper markets in March, resulting in a sharp decline in non-financial commercial paper. Additionally, bank deposits have spiked at most major institutions, resulting in lower levels of bank and agency issuance necessary to fund new asset growth. As a result, bank funding costs have remained low, as seen in the narrowing spread between the three-month Treasury and three-month LIBOR (Exhibit 6). We expect in this backdrop that three-month LIBOR may remain below 30 bps for the rest of the year.

EXHIBIT 4: The GS U.S. Financial Conditions Index indicates conditions have normalized following significant Fed liquidity programs—a faster recovery than the period following the 2007–2008 financial crisis.



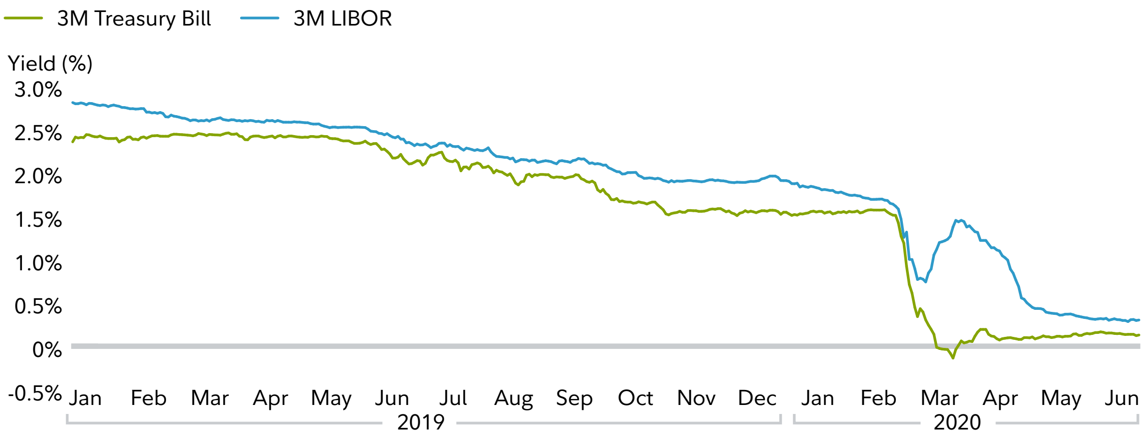
Source: Goldman Sachs, as of July 10, 2020.

EXHIBIT 5: Treasury bill supply has nearly doubled in the second quarter to more than $5 trillion, or more than a quarter of outstanding Treasury debt.



Source: U.S. Treasury and Bloomberg Finance, LP, as of June 30, 2020.

EXHIBIT 6: Robust Treasury issuance and banks flush with cash means that the spread between the 3-month Treasury bill and 3-month LIBOR has narrowed significantly.



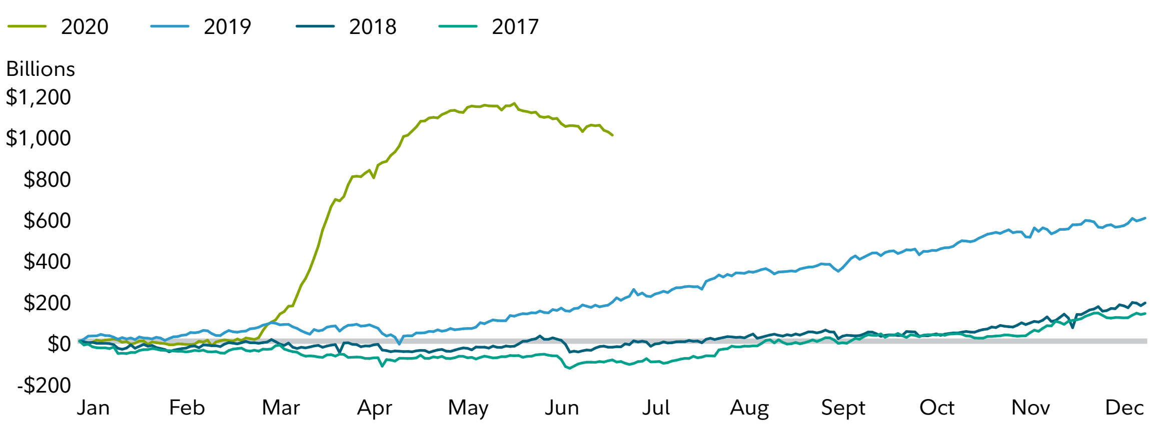
Source: Bloomberg Finance LP, as of June 30, 2020.

While total money market fund assets have remained much higher in 2020 than in the three prior years, money market flows have declined since a May peak as investors returned to riskier assets (Exhibit 7).

SOFR to LIBOR on track

Plans are underway to phase out LIBOR, the widely used global interest rate, and replace it with a new short-term benchmark rate by the end of 2021. In the U.S., the proposed replacement rate is the secured overnight financing rate (SOFR). Exhibit 8 summarizes some key differences between the two benchmarks that investors should keep in mind.

EXHIBIT 7: Institutional taxable money market assets peaked in late May and have since declined.



Source: iMoneyNet as of June 30, 2020. Note: Includes both retail and institutional share classes.

EXHIBIT 8: Some key differences between LIBOR and its likely replacement benchmark, SOFR.

	LIBOR	SOFR
What is it?	Unsecured rate at which banks borrow from each other; used to determine interest rates on a broad range of financial products	Secured rate representing the cost of borrowing the U.S. Treasury repurchase agreement market (repo market) where banks/institutions borrow and lend
Estimate or actual?	Estimated (forward looking), calculated via a survey sent to banks, mostly based on hypothetical borrowing	Actual (backward looking), based on overnight borrowing
Risk profile	Unsecured rate, reflects credit and counterparty risks	Risk-free rate reflecting borrowing collateralized by Treasury repos
Term/interest rate curve	Term rate (overnight/spot; one week; one, two, three and six months; and one year)	Overnight rate; longer-term rates will be introduced after the SOFR futures market takes hold
Rate	Likely to be higher than SOFR because it is unsecured and included credit risk, and has a term longer than overnight; prone to widening in times of credit market stress	Likely to be lower than LIBOR and may stay stable (or potentially fall) in periods of credit market stress, but has seen some volatility since its inception

Source: Fidelity Investments, as of July 1, 2020.

Fidelity is managing the transition from LIBOR to SOFR. Investment teams have already assessed and invested in SOFR-based securities since their initial issuance. In addition, we have a multidisciplinary team that is monitoring the related developments and is preparing for the discontinuation of LIBOR and the changeover to SOFR to ensure a smooth transition for our shareholders, clients, and investment processes. This team has been actively working on the effort since early 2019, assessing replacement ("fallback") language, engaging with industry participants to encourage SOFR adoption, and monitoring the replacement of certain other non-U.S. denominated inter-bank offered rates, among other efforts.

While we will continue to monitor developments to help mitigate risks, there is still some uncertainty about the details and timing of the transition away from LIBOR and the establishment and acceptance of a replacement rate, which could create market volatility. This volatility could ultimately present investment opportunities for certain funds. Operational interruptions throughout the market are possible with the need to update technology platforms and to amend legacy holdings to accommodate SOFR. Our cross-functional team is actively engaged in technology readiness assessments in anticipation of the changes.

The floating rate market has already begun to adjust to LIBOR's discontinuation through both the introduction of replacement ("fallback") language in new LIBOR issuances and growth in SOFR-based security issuances. We are actively participating in the developing SOFR market and updating our investment process and tools to prepare for a post-LIBOR world.

Fidelity exits institutional prime fund segment

We have decided to liquidate our two institutional prime money market funds: Fidelity Investments Money Market (FIMM) Prime Money Market Portfolio and Fidelity Investments Money Market (FIMM) Prime Reserves Portfolio. Both funds will remain fully accessible to investors until their liquidation on or about August 14, 2020. There are no restrictions on investments in or redemptions from the funds until, as part of the liquidation process, the funds close to new investments as of the close of business on August 12, 2020.

Our decision to liquidate the two institutional prime money market mutual funds is specific to these two funds and was taken after thoughtful review and consideration of our experience with investor behavior in institutional prime money market funds during periods of market stress, evolving institutional investor preferences, and our broader money market business. We are choosing to exit the institutional prime segment of the money market mutual fund industry because we believe we can better meet institutional investors' needs with other cash management products. This decision does not affect any of our other money market funds.

We look forward to working with our institutional prime fund investors between now and August 12, as they determine the alternative cash investment product that works best for them. We have a broad range of options for investors who currently use institutional prime money market funds to consider, including government, retail municipal, and retail prime money market funds, as well as low-duration (a measure of interest-rate risk) bond funds and separately managed accounts.

In addition, we are continuing to monitor market conditions and yields on three Fidelity Treasury money market funds that we closed to new investors in March seeking to protect returns for existing shareholders. We are pleased to report that we expect to reopen the three funds, Treasury-Only Money Market Fund, FIMM Treasury Only Portfolio, and FIMM Treasury Portfolio, in the coming months. Restricting inflows has helped reduce the amount of new Treasury securities that the funds have needed to purchase, which is important because the newer issues generally have lower yields than the funds' existing holdings.

Endnotes

[1] U.S. Federal Reserve, June 10 press conference. https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20200610.pdf

[2] International Monetary Fund, World Economic Outlook, June 2020 update. https://www.imf.org/en/Publications/WEO/Issues/2020/06/24/WEOUpdateJune2020

[3] *Barron's,* April 29, 2020. "The Fed Will Do Whatever It Takes for as Long as Necessary. It Still Isn't a Cure." https://www.barrons.com/articles/the-fed-will-do-whatever-it-takes-for-as-long-as-necessary-it-still-isnt-a-cure-51588198969

[4] The $4 billion includes injected capital.

[5] Goldman Sachs, July 16, 2018. The GS U.S. Financial Conditions Index is constructed as a weighted average of short-term interest rates, long-term interest rates, the trade-weighted dollar, an index of credit spreads, and the ratio of equity prices to the 10-year average of earnings per share. https://www.goldmansachs.com/insights/pages/case-for-financial-conditions/report-the-case-for-financial-conditions-index.pdf

Author

Kerry Pope, CFA

Institutional Portfolio Manager

Kerry Pope is an institutional portfolio manager in the Fixed Income division at Fidelity Investments. In this role, he is responsible for communicating portfolio strategy and positioning, designing customized liquidity-management solutions for institutional clients, and providing portfolio reviews.

Fidelity Thought Leadership Vice President Martine Costello provided editorial direction for this article.

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