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Money Market Flows Are on Fire

In response to stress in the banking sector, deposits are rapidly flowing into money markets. Markets repriced expectations for policy rates, forecasting a more dovish approach to maintain systemic financial stability.

What's Driving Markets…

1. **Fixed-income markets were roiled by the bankruptcy of Silicon Valley Bank (SVB) and the acquisition of Credit Suisse by UBS.** In short, the US witnessed a deposit run on the banking system, an event that was not supposed to happen in the post-Global Financial Crisis (GFC) era between Dodd Frank, enhanced Basel regulations, and new regulatory requirements. While SVB fell underneath the size threshold for enhanced regulations, the events of March echo the regulatory battles that were fought in the years immediately following the GFC. The consequences of the month's events are still being absorbed by capital markets and the halls of government:

   - The US banking system experienced a deposit run, with sizeable withdrawals out of regional and community banks and into larger (perceived safer) banks and money-market funds. The system has become, or is likely becoming, a tiered one: at the very top, the formidable "Global Systemically Important Banks" (GSIBs), with enhanced oversight, robust capital, and for better or worse, still bearing the label of "Too Big to Fail." And then there's everyone else. While we know deposit flight took place, it was likely uneven across the system, with the GSIBs and money-market funds becoming net recipients of funds. Deposit outflows appeared to slow near the end of March.
   - A domestic and global safety net deployed, albeit in a very uneven fashion:
     - In the US, the Secretary of the Treasury invoked the systemic risk exemption (with the support of a super majority of the Financial Stability Oversight Council) and, along with the FDIC and the Federal Reserve (Fed), guaranteed uninsured depositors at SVB and Signature Bank.
     - The Fed deployed a liquidity measure, the Bank Term Funding Facility, in order to ensure that banks could receive liquidity for the fixed-income securities held on their balance sheets. An interesting feature was that despite the market value of the securities being well below par, they could be treated as par collateral at the Fed facility.
     - The Swiss government arranged a merger between its two champion banks, UBS and the nearly failed Credit Suisse. In the process of rescuing Credit Suisse, the Swiss government believed it could wipe out AT1, or contingent-convertible[1] bond holders, without completely wiping out (what was believed to be) subordinated equity holders. This has injected uncertainty in the bank-capital market.
     - The New York Fed deployed its global swap lines, ensuring global liquidity for USD borrowing needs.

Insight from sub-adviser Wellington Management

Amar Reganti
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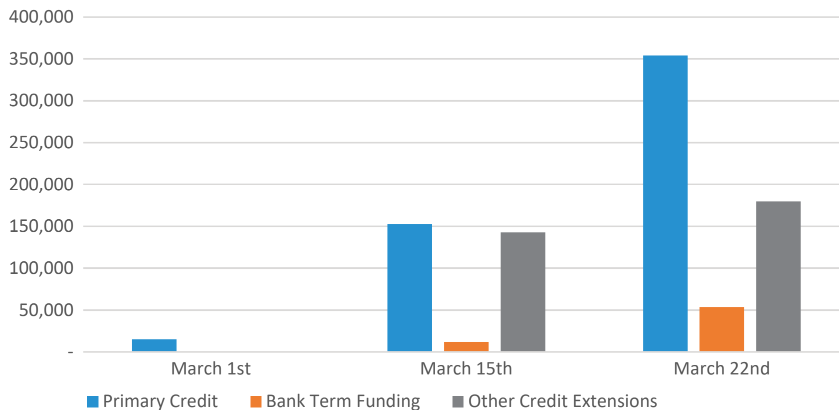
[1] High-yield, high-risk products created to help undercapitalized banks prevent another financial crisis such as the 2007–2008 global financial crisis.

FIGURE 1: How Quick, and How Large, the Domestic Credit Extension Was

Federal Reserve Credit Extension (millions)



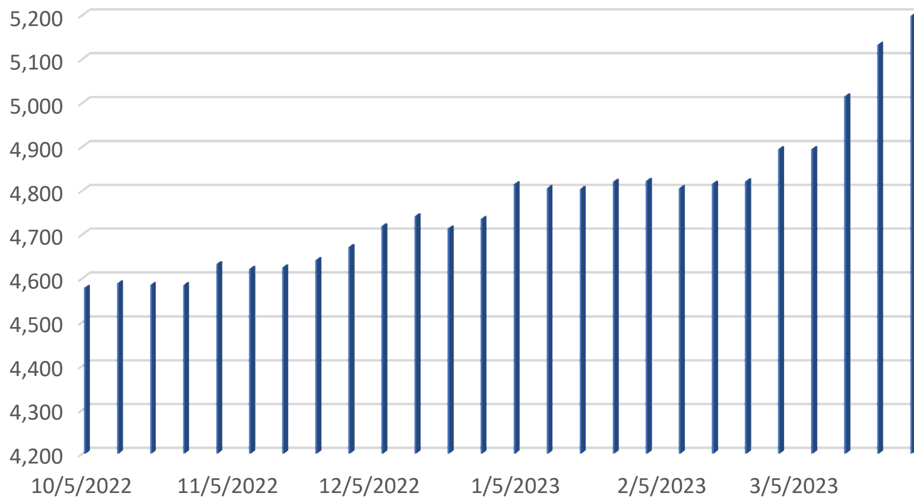
As of 3/29/23. Primary credit generally means the Federal Reserve's discount window operations. Other Credit Extensions extended to depository institutions established by the Federal Deposit Insurance Corporation (FDIC). Source: Federal Reserve.

The fixed-income market has had to digest the reality and news of possible sales by struggling banks.

- Fixed-income markets, particularly the agency mortgage-backed securities market, were roiled by the bank collapses. The market has had to digest the reality and news of possible sales by struggling banks. Moreover, other asset classes held by regional banks that require refinancing, such as commercial real estate, may continue to undergo a tumultuous period.
- There is a strong chance that overall bank lending within the US, which was already tightening, becomes substantially tighter in the near term.
- Right now, while the most recent data indicate that deposit flight has slowed, there is no comprehensive solution in place to mitigate the difference between the GSIB "haves" and regional bank "have nots," leaving the system fragile and still subject to runs unless comprehensive actions are taken by Congress and/or the executive branch.
- There will likely be new and/or expanded regulations put in place that cover banks underneath the $250 billion in assets threshold.
- There may be reform of bank supervision processes at the Fed and other prudential regulators.

2. **A big beneficiary of the deposit flight was money-market funds**. It's important to remember that flows into money markets are a form of reserve drainage. Why? Because following money-market reforms several years ago, the majority of money-market assets are in government-only money markets, which primarily buy US Treasuries or lend money to the Fed in a reverse-repurchase (selling assets to another party and agreeing to buy them back later at a higher price) facility. So, capital moves to money markets, and then is "drained" from the system by purchasing government securities or lending to the Fed.

FIGURE 2: Investment Company Institute Money-Market Assets (in Billions)

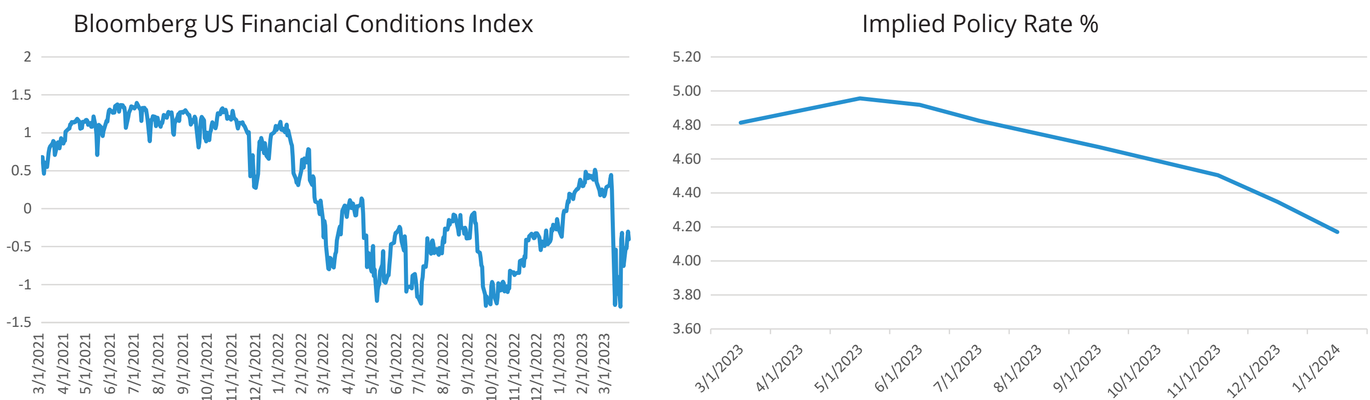


As of 3/31/23. Source: Bloomberg.

While its rapid hiking cycle was one of several factors leading to instability in the banking system, the Fed still remains tied to its dual mandate.

3. **The Fed continued its rate-hiking process** by increasing the federal funds rate by another 0.25%. The Fed found itself in a bind during March: While its rapid hiking cycle was one of several factors leading to financial instability in the banking system, the Fed still remains tied to its dual mandate of stable inflation and full employment. With inflation still well above its 2% target along with a tight labor market, the central bank felt that it must continue with a March hike. However, the Fed needed to avoid panic signaling: if it did not hike, it would send a message to the market that it was both deeply concerned about the banking system *and* that it might not have tools beyond interest-rate policy to manage those problems. Currently, the market expects barely one more hike this year before cuts begin (**FIGURE 3 - right**), likely in response to a significantly higher chance of recession combined with tighter financial conditions (**FIGURE 3**).

FIGURE 3: Financial Conditions and Policy Expectations



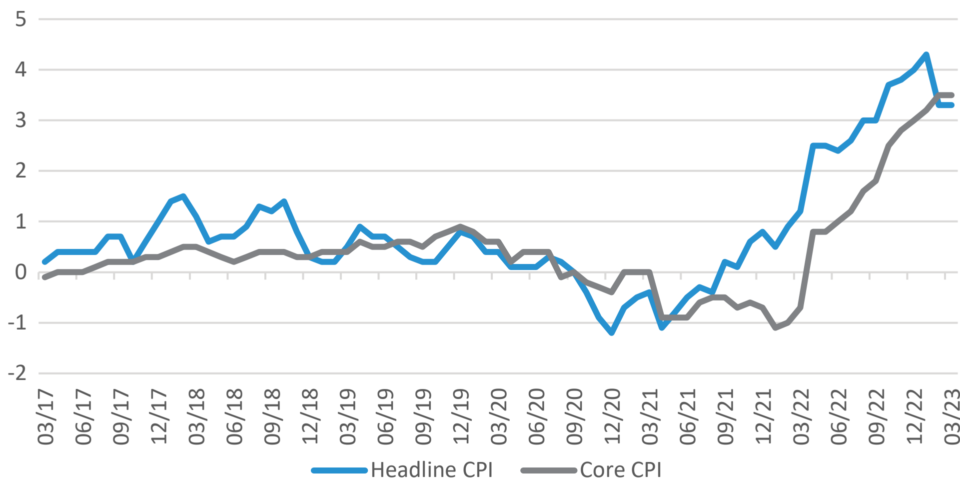
As of 3/31/23. The Bloomberg US Financial Conditions Index tracks the overall level of financial stress in the US money, bond, and equity markets to help assess the availability and cost of credit. Source: Bloomberg.

4. **The Bank of Japan (BOJ) maintained its low rate and yield-curve control policies**[2] at Governor Haruhiko Kuroda's last meeting at the helm. The transition to Kazuo Ueda, who will succeed Kuroda, is expected to mark a phase-out from ultra-loose monetary policy. Inflation has lifted sharply over the last year but any policy adjustments are likely to be gradual, and we anticipate Ueda will focus more on data dependence than the "reflation at any cost" policies of his predecessor (**FIGURE 4**).

[2] In 2016, the BOJ enacted a strict yield-curve control policy that limited yields on Japan's 10-year Treasury bonds to 0.25%. The BOJ recently relaxed the policy slightly.

FIGURE 4: Japanese Inflation

(%) Year-Over-Year



As of 3/17/23. CPI is the Consumer Price Index, a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Core CPI excludes food and energy prices. Source: Bloomberg.

5. **OPEC+ agreed to cut oil production by more than 1 million barrels per day** starting in May, adding to inflation pressures. Oil prices surged about 6% following the surprise announcement, which complicates the Fed's efforts to maintain financial stability in the wake of banking sector stresses. A Fed rate hike at the May Federal Open Market Committee meeting is now back on the table (though cuts are still priced for the second half of this year). Oil prices had declined earlier in the month (**FIGURE 5**) amid banking sector stress, yet the administration did not use the opportunity to re-fill the Strategic Petroleum Reserve (SPR), as they had indicated they would during a period of low demand. The SPR was used in order to smooth demand management and incentivize domestic marginal producers to invest in their physical assets. From a national-security perspective, this policy was enacted to make US and global energy markets less sensitive to the shock of energy sanctions on Russia. Energy shocks remain a persistent and ongoing risk for global fixed-income markets.

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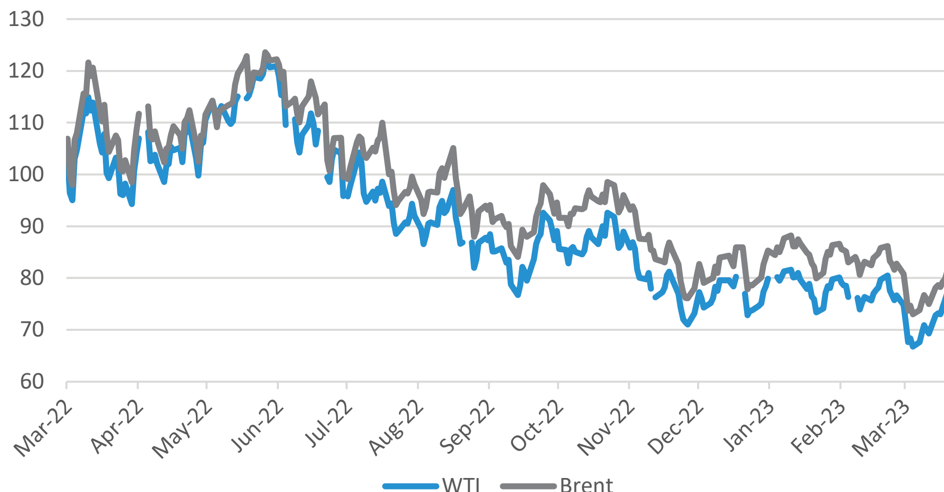
FIGURE 5: Crude Oil Prices

(US$ per barrel)



As of 4/3/23. Data not available for all dates. Source: Bloomberg

What's Keeping Us Up at Night…

1. **Instability in the banking system** – As mentioned above, higher rates and an inverted yield curve[3] are proving to be a multi-faceted challenge for some parts of the banking system. The upward movement of the rates complex over 2022 has impacted available-for-sale and hold-to-maturity bonds, while the inverted curve makes it more expensive to retain deposits and likely increases funding costs while putting pressure on net interest margins. Overall, this is likely to be a net drag on lending conditions (which were already becoming more stringent prior to the bank collapses).
2. **The end of yield-curve control** may be drawing nearer as the leadership change takes place at the Bank of Japan. A change in yield-curve control by incoming Governor Ueda that is perceived as poorly implemented could have unintended consequences on global fixed-income markets, including spikes in volatility, so proper execution of a policy change will be paramount.
3. **The Ukraine/Russia conflict** took a darker turn as Russia announced that it will begin staging nuclear weapon logistics in nearby Belarus.
4. **The "X" date for the US debt ceiling, when the government will run out of creative ways to fund itself**, creeps closer—yet a deal remains elusive. The White House has rejected Speaker Kevin McCarthy's proposals for discussions. Currently, market pricing is not reflecting market concerns, as of yet, but we expect that to change with the clarity of April tax receipts.
5. **Commercial real estate (CRE) headwinds are being exacerbated** by the recent stresses in the banking sector, particularly weaker properties. CRE had already been facing challenges from the substantial increase in borrowing costs, declining asset values, and slowing US economy. Regional banks have been among the largest providers of CRE financing, and slowing credit availability from these banks will further restrict borrowers' access to capital, making it more difficult to refinance a CRE loan and adding to downward pressure on property prices. Performance is likely to vary greatly by property type and submarket. We are most negative on office and regional malls while we remain more constructive on the industrial and multifamily sectors.

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Investment Implications

- We continue to think that we're in the right environment for **global sovereign and currency strategies** to shine: from a total-return perspective, a risk-diversifier approach, and a soundness perspective. This is another, more diversified approach to monetize the ongoing and expected volatility of global capital markets. This can be implemented either via some liquid global rates strategies with relative-value capabilities or through macro-oriented alternatives. The growing drumbeat of macroeconomic instability and volatility may make this type of allocation even more critical.
- Given the overall slowdown in some sectors of the economy, it may also start to make sense to consider **CORE/CORE+ positions**[4] as we move later in the tightening cycle. The sell-off in dollar rates, a slowing pace of inflation, rising geopolitical risk, and a slowing economy can make higher-quality fixed income attractive from a recessionary perspective, as well as for a positive relationship between bond prices and bond yields.
- **Shorter-duration[5] credit** has paid well given the ongoing volatility and uncertainty in markets. For low-risk appetite thresholds, the opportunity cost of this approach has diminished substantially over the last several months.
- **Securitized credit**[6] may be able to mitigate some rate volatility because it currently has attractive risk-adjusted spreads. Senior parts of the capital structure, in particular, seem attractive in case the cycle turns faster than expected.

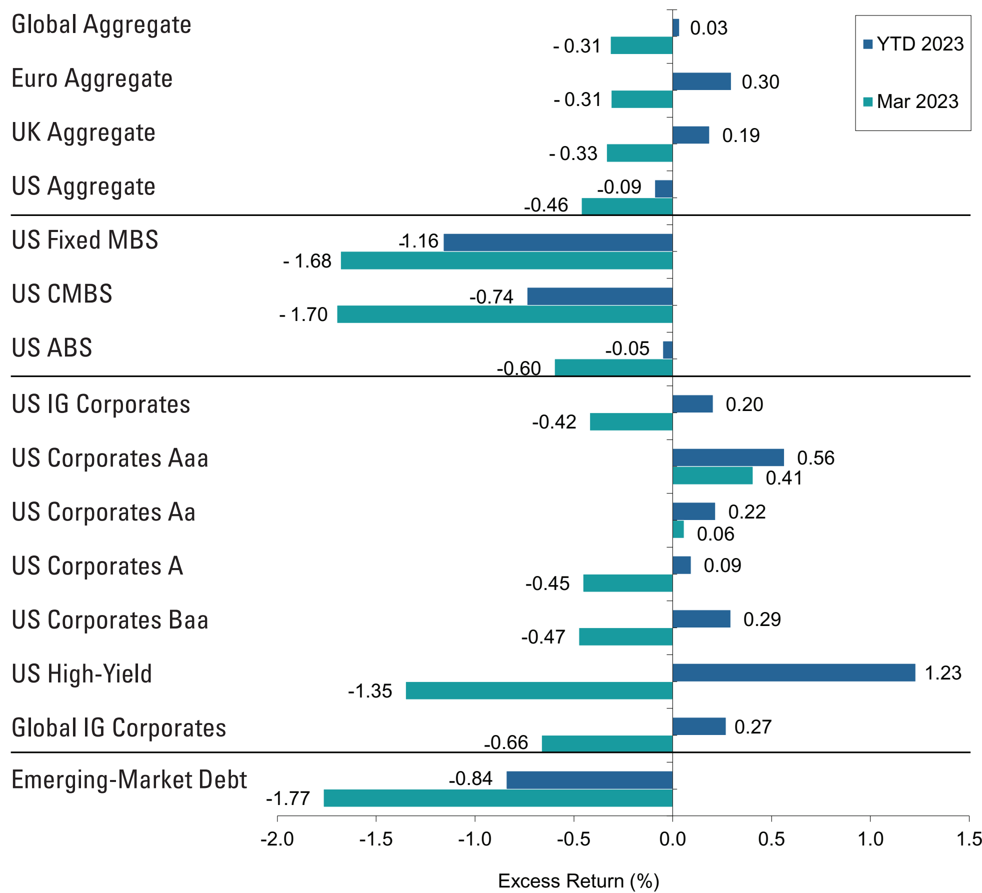
[3] Yield curve is a line that plots interest rates of bonds having equal credit quality but differing maturity dates; its slope is used to forecast the state of the economy and interest-rate changes.

[4] Core funds typically invest in a baseline of investment-grade bonds such as government, corporate, and securitized debt. Core plus funds can take that baseline and add additional sectors such as corporate high-yield, emerging-market debt, or non-US currency exposures to enhance returns.

[5] Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

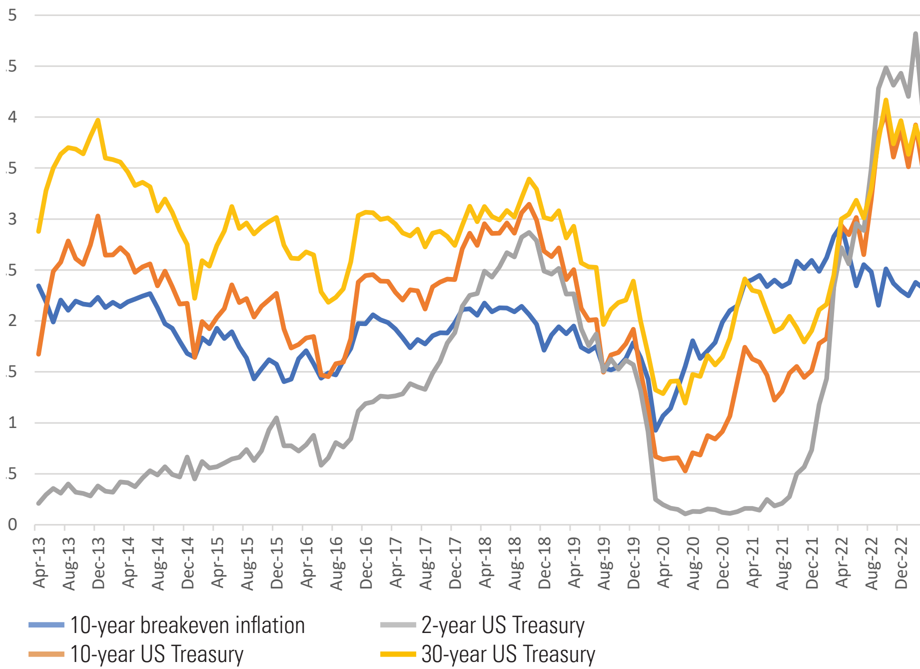
[6] Securitized credit involves pooling a large number of loans into an investable asset. Examples include mortgage-backed or asset-backed securities.

FIGURE 6: Fixed-Income Sector Excess Returns



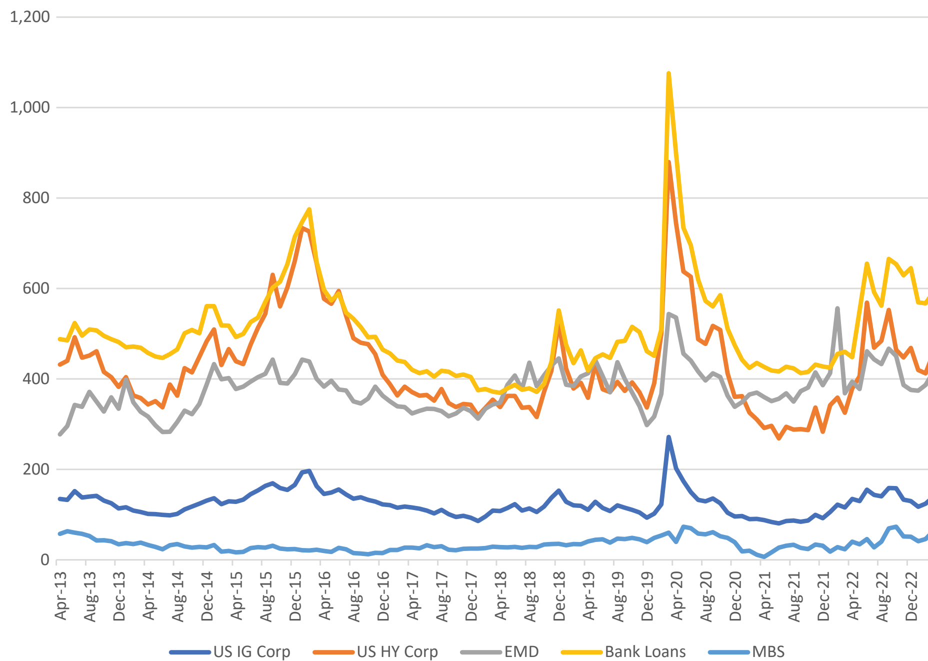
As of 3/31/23. **Past performance does not guarantee future results.** Investors cannot directly invest in indices. See last page for index definitions. Sources: Bloomberg, JP Morgan, Wellington Management

FIGURE 7: US Yields (%)



As of 3/31/23. **Past performance does not guarantee future results.** Source: Bloomberg

FIGURE 8: Fixed-Income Spreads (Basis Points)



As of 3/31/23. Spreads are the difference in yields between two fixed-income securities with the same maturity, but originating from different investment sectors. A basis point is a unit that is equal to 1/100th of 1%, and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indices and the yield of a fixed-income security. US IG Corp is represented by the Bloomberg US Corporate Bond Index; US HY Corp is represented by the Bloomberg US Corporate High Yield Index, EMD is represented by the JP Morgan EMBI Plus Index, Bank Loans are represented by the LSTA Leveraged Loan Index; and MBS is represented by the Bloomberg US MBS Index. See last page for representative index definitions. Sources: Bloomberg, JP Morgan, Morningstar LSTA.

To learn more about opportunities in fixed income, please talk to your financial representative.

Global Aggregate is represented by the Bloomberg Global Aggregate Index, a broad-based measure of the global investment-grade fixed-rate debt markets. **Euro Aggregate** is represented by the Bloomberg Global Aggregate Index - European Euro, which includes fixed-rate, investment-grade Euro denominated bonds. **UK Aggregate:** Bloomberg Global Aggregate Index - United Kingdom which includes fixed-rate, investment-grade sterling-denominated bonds. **US Aggregate:** Bloomberg US Aggregate Bond Index is composed of securities from the Bloomberg Government/Credit Bond Index, Mortgage-Backed Securities Index, Asset-Backed Securities Index, and Commercial Mortgage-Backed Securities Index. **US Fixed MBS:** Bloomberg Agency Fixed-Rate MBS Index tracks fixed-rate agency mortgage backed passthrough securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). **US CMBS:** Bloomberg CMBS ERISA Eligible Index, which measures the performance of investment-grade commercial mortgage-backed securities, which are classes of securities that represent interests in pools of commercial mortgages. The index includes only CMBS that are Employee Retirement Income Security Act of 1974. **US ABS:** Bloomberg Asset-Backed Securities Index, the ABS component of the Bloomberg US Aggregate Index, which has three subsectors: credit and charge cards, autos, and utility. **US IG Corporates:** Bloomberg US Corporate Bond Index covers all publicly issued, fixed rate, nonconvertible, investment-grade debt. **US Corporates Aaa:** Bloomberg Aaa Corporate Index designed to measure the performance of investment-grade corporate bonds that have a credit rating of Aaa; **US Corporates Aa:** Bloomberg Aa Corporate Index; **US Corporates A:** Bloomberg A Corporate Index, designed to measure the performance of investment-grade corporate bonds that have a credit rating of Aa; **US Corporates Baa:** Bloomberg Baa Corporate Index; designed to measure the performance of investment-grade corporate bonds that have a credit rating of Baa; **US High-Yield Corporates:** Bloomberg US Corporate High Yield Index is an unmanaged broad-based market-value-weighted index that tracks the total return performance of non-investment grade, fixed-rate, publicly placed, dollar denominated and nonconvertible debt registered with the Securities and Exchange Commission. **Global IG Corporates:** Bloomberg Global Credit - Corporate Index is an unmanaged index considered representative of fixed rate, non-investment grade debt of companies in the US, developed markets, and emerging markets. **Emerging-Markets Debt:** Bloomberg Emerging Markets Hard Currency Index includes USD-denominated debt from sovereign, quasi-sovereign, and corporate EM issuers. **Bank Loans**: LSTA Leveraged Loan Index, which is a market-value-weighted index that is designed to measure the performance of the US leveraged loan market based upon market weightings, spreads, and interest payments. **JP Morgan Emerging Markets Bond Index Global Index** is a broad-based, unmanaged index which tracks total return for external currency denominated debt (Brady bonds, loans, Eurobonds and US dollar-denominated local market instruments) in emerging markets. **Bloomberg US MBS Index** tracks fixed-rate agency mortgage backed pass-through securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

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Important Risks: Investing involves risk, including the possible loss of principal. • Fixed income security risks include credit, liquidity, call, duration, and interest-rate risk. As interest rates rise, bond prices generally fall. • Investments in high-yield ("junk") bonds involve greater risk of price volatility, illiquidity, and default than higher-rated debt securities. • Mortgage-related and asset-backed securities' risks include credit, interest-rate, prepayment, and extension risk. • Loans can be difficult to value and less liquid than other types of debt instruments; they are also subject to nonpayment, collateral, bankruptcy, default, extension, prepayment and insolvency risks. • Foreign investments may be more volatile and less liquid than US investments and are subject to the risk of currency fluctuations and adverse political, economic and regulatory developments. These risks may be greater, and include additional risks, for investments in emerging markets. • The value of the underlying real estate of real estate related securities may go down due to various factors, including but not limited to, strength of the economy, amount of new construction, laws and regulations, costs of real estate, availability of mortgages and changes in interest rates, • Investments in the commodities market and the natural-resource industry may increase the Fund's liquidity risk, volatility and risk of loss if adverse developments occur. • Diversification does not ensure a profit or protect against a loss in a declining market.

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