EXPERTS SAY U.S. MMFs RESILIENT, POISED FOR GROWTH

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Money-market funds demonstrated remarkable resiliency this year to accommodate regulatory reforms that took full effect in October, industry experts told Money Fund Report®, with expectations that economic growth and rising interest rates bode well for the money-market-fund industry in 2017.

"This year has been one of tremendous changes for the U.S. money-market fund industry" as it anticipated the compliance date for "significant changes to Rule 2a-7 – specifically, the floating net asset value on (institutional) prime funds and the related liquidity fee and redemption-gate provisions of the new regulation" – and as it addressed "enormous flows from prime to government funds," observed Stephen Cohen, a partner at international law firm Dechert LLP and member of iMoneyNet's Advisory Board.

Just as regulatory reform posed challenges for the industry, prospects for continued recovery in the broader economy and for rising interest rates pose opportunities in the year to come, Cohen said. "Persistently low yields for the past several years have reduced sponsor revenue," he noted. The Dec. 14 Fed funds rate hike had the dual effect of increasing rates in the short term and of raising expectations for additional rate hikes in 2017, which Cohen said could lead to a welcome "reversal in flows as government money-market-fund investors seek the higher returns" that prime funds are likely to provide.

Rate-Hike Projections

Although it's clear that money-fund providers prepared for October's reform deadline far in advance, "the ramifications of reform were" – and perhaps will remain "uncertain," said Richard Rokus, director and senior portfolio manager at Great Lakes Advisors, also an iMoneyNet Advisory Board member.

Last December's rate increase, the first in seven years, presaged additional increases in 2016, he noted, "but tepid growth prevented that from happening." Despite this year's elusive growth, Rokus observed that the market seems to believe that the Trump administration may have the answer: "Plans for a combination of deregulation and stimulus have equity markets off to the races." However, only time will tell, he added, "whether the market's optimism over growth in 2017 is justified or whether we have yet another false start in what has been a slow but steady economic recovery."

Following on from the December 2015 quarter-point Fed funds rate increase, after years of near-zero rates, last week's matching hike, will also be good for the mutual-fund industry, Niels Holch, founding partner at law firm Holch & Erickson, told iMoneyNet. "After the (2008) crisis, the Fed lowered its main rate in order to encourage banks to lend and businesses to borrow, and data clearly show that economic activity has increased, so there's much less need for the Fed to keep rates artificially low," he commented.

"As the Fed lets go of the role it has played since the crisis in moving the economy toward its target inflation rate, we'll see the rate of inflation grow, however slowly, toward pre-crisis levels," Holch predicted. "For mutual funds generally and for money-market funds specifically, rate increases will be beneficial because they'll mean less reliance on fee waivers, some actual profitability, and overall higher returns for savers and investors."

Debbie Cunningham, iMoneyNet Advisory Board member and vice president and chief investment officer at Federated Investors, told MFR that she and her colleagues "think the improving U.S. economy and the likelihood for fiscal stimulus from the Trump administration, in whatever form it takes, will lead to higher growth, inflation, and rates." That scenario, she noted, "won't play out until at least mid-2017," but she added that "expectations are growing for three 25-basis point hikes, instead of two. Whether two or three, Cunningham said that the main instruments of cash managers – including Treasury and agency securities and commercial paper – have begun to price (those increases) in."

Flows Back to Prime Funds?

Asset flows from prime to government funds in the run-up to the Oct. 14 deadline were an expression of investor caution, and that approach was "only natural as investors seemed to prefer watching from the safety of a government MMF," stated Joan Ohlbaum Swirsky of law firm Stradley Ronon Stevens & Young LLP, and an Advisory Board member. High levels of liquidity held by prime money funds also "pushed cash to government MMFs." Swirsky pointed out that "may have created an unfortunate circularity."

Swirsky explained that "during the transition to the floating-NAV structure, institutional prime funds kept historically-high levels of liquidity in order to be ready for whatever redemptions might occur." High liquidity levels "contributed to prime MMFs’ less attractive returns," she noted, and "the less attractive returns may in turn have prompted some redemptions." If yields from prime funds increase "due to normalized liquidity levels or rising rates generally," Swirsky anticipates that "some assets may revert back to prime funds," although she stressed that any such shift is unlikely to be as "massive" as that from prime to government funds prior to the reform deadline.

Among circumstances that "may encourage investors to dip their toes back into floating-NAV money funds," Swirsky includes ample but more normalized levels of liquidity in institutional prime funds; investor satisfaction with the smooth transition to prime-fund floating NAVs; investor awareness that floating NAVs have not moved significantly; and rising interest rates, which she said "should allow prime money funds to better distinguish themselves from government funds."

However events unfold, the prospect of rising rates has "poised the industry for growth in 2017," Cunningham predicted. "We at Federated believe government funds will continue to experience strong flows, although at the same time we expect to see relief from the disenfranchisement of prime and municipal funds that resulted from reforms," and investors, she concluded, will likely leverage yield spreads available in those products. "Adapting to money-fund reforms was a long and rough road for both clients and managers," Cunningham stressed, "but it didn’t lead to calamity, and the future looks bright." - Paul Adams

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