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North America

Short-End Notes

Front-end reacts to Fed policy

- **Chair Yellen confirms wide IOER – RRP spread –** In congressional testimony Chair Yellen reaffirmed that IOER would be the primary exit tool with RRP acting as a "backstop." She also indicated a desire on the part of the Fed to limit RRP reserve draining to lower levels than what many in the market had expected. While front-end investors interpreted her comments as mildly hawkish, we viewed them as balanced.

- **Front-end appropriately pricing IOER-RRP spread –** We judge the approximately 10bp decline in forward rates on the back of the wider IOER-RRP spread revealed last week as appropriate. LIBOR – FF basis swaps have widened a few basis points which makes sense given that LIBOR is more closely tied to RRP than to IOER.

- **Expect SEC vote on MMF reform July 23 –** We expect the SEC to adopt a final rule on money fund reform July 23 that will, along with other reforms, likely require prime institutional money funds to transition to floating NAV. While we expect little day one effect, the reform will likely lead to cumulative flows in the hundreds of billions out of prime MMF and into government MMF over a significant period of time. The increased demand should put downward pressure on short-term government yields and may lead to increased use of the Fed's RRP facility.

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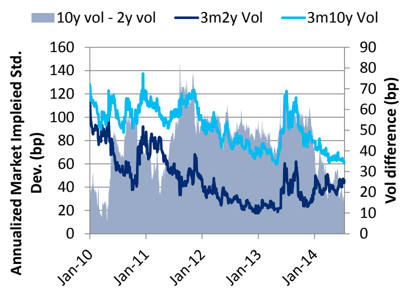
See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Front-end reacts to Fed policy

Figure 1. 2y rate vol moving closer to 10y vol



Source: Citi Research, Bloomberg

While the first half of this year has left both investors and policy makers puzzling over the low volatility across asset classes, volatility in front-end rates has continued to move higher. Markets currently expect 2y rate volatility to be the closest to 10y rate volatility at any time since 2010. (Figure 1) As potential rate hikes and other Fed policy moves fall into the 2y and even 1y windows, these rates should continue to be buffeted by changing investor expectations of likely Fed policy.

Indeed, Fed policy developments drove front-end yield movements over the last two weeks. (Figure 2) Last week, we saw forward rates across the front-end move meaningfully lower following the statement in the minutes that the Fed reverse repo (RRP) rate would be kept at a wider spread to IOER than was previously expected. We judge the approximately 10bp move lower on the week appropriate given that the minutes pointed to a 20bp or more IOER-RRP spread relative to market expectations of closer to a 10bp spread. This means 10bp lower repo rates and thus about 10bp lower forward rates.

LIBOR – FF OIS basis swaps likely reflect wider IOER – RRP basis.

In addition to the move lower in rates, expectations of a wider IOER-RRP spread provoked widening of LIBOR – Fed Funds OIS basis swaps. (Figure 3) All else equal, a wider IOER-RRP spread should imply a wider LIBOR – Fed Funds basis. However, the magnitude of this widening may be limited since in the current environment LIBOR is linked more closely to the RRP rate than the IOER rate.

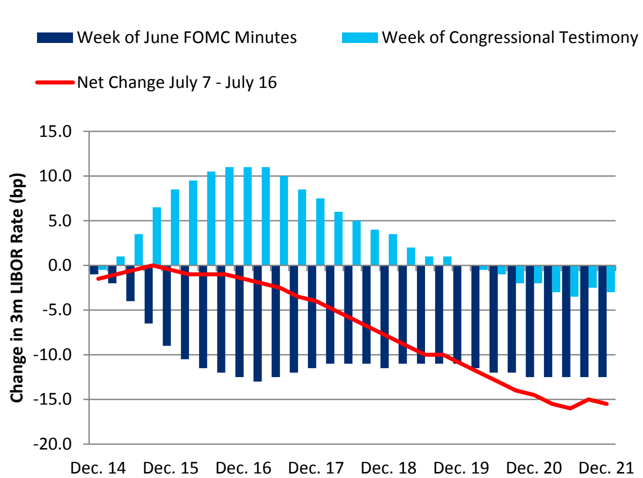
LIBOR is more tightly linked to RRP than to IOER.

Following regulatory developments, LIBOR submissions are likely at least partially based on the rates at which banks borrow cash from money funds (MMF) through commercial paper (CP) and certificates of deposit (CDs). CP and CD rates are in turn tightly linked to repo rates since MMF police the relative value between these investment options. As long as cash remains plentiful and short-term bank borrowing needs limited, CP and CDs should be priced more off of MMFs alternative investment option (RRP) than banks' cash investment option (IOER). This limits the sensitivity of LIBOR – FF basis swaps to the IOER-RRP spread.

The market viewed Chair Yellen's testimony as mildly hawkish.

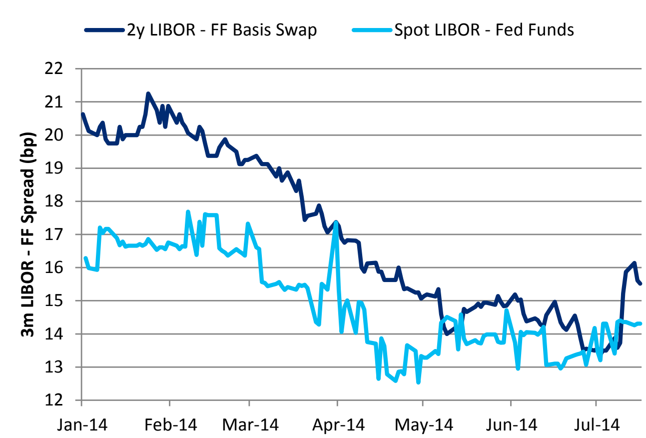
The move lower in near forward rates was largely reversed earlier this week (Figure 2) as congressional testimony from FOMC Chair Janet Yellen was perceived by the market as mildly hawkish. While we viewed Chair Yellen's comments as balanced, many investors felt she underemphasized labor market concerns, at least relative to expectations and earlier statements, and took this as a hawkish signal.

Figure 2. Fed policy expectations drive front-end rates



Source: Citi Research, Bloomberg

Figure 3. LIBOR-FF basis widening reflects wider IOER – RRP spread



Source: Citi Research, Bloomberg

IOER as the primary tool with RRP as a "backup tool."

In terms of the Fed's exit procedure, Chair Yellen's comments were in line with the substantial information in the June FOMC minutes released last week. In particular, Chair Yellen affirmed that in hiking rates "the main tool we will use is the interest rate we pay on overnight reserves" whereas she sees RRP as a "backup tool." She also stated that the wide IOER-RRP spread should limit facility usage and that coupled with a potential aggregate cap on the facility risk of potentially destabilizing flows out of cash and into the facility would be controlled.

More evidence Fed will drain fewer reserves than previously expected.

While this is not new information, the comments from Chair Yellen are more evidence that the Fed is likely to seek to cap facility usage at levels potentially not much higher than those we have seen recently. To Representative Mick Mulvaney's (R-SC) question about the risk of funding being pulled from the private sector and flowing into RRP, Chair Yellen replied that there would be a financial stability risk if RRP is "available on a very large scale and can be expanded and contracted quickly…And we absolutely intend to make sure that we address those risks."

Aggregate RRP cap is likely but details unclear.

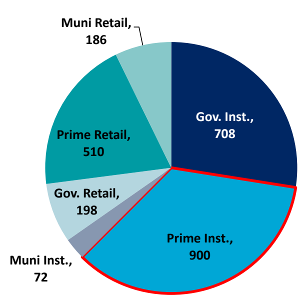
While an aggregate cap now seems likely, the details of how the cap would be implemented remain uncertain. On the one hand the facility needed to grow in size to $340 billion over last quarter end to maintain the 5bp floor on rates, which argues for a large cap. On the other hand, a sudden unexpected outflow of $340 billion from private sector funding is large enough to pose a financial stability concern. One solution would be to allow the aggregate cap to vary over time, perhaps allowing for a larger cap over quarter end or only imposing a cap during times when the Fed judges cash outflows a concern.

Money Fund Reform on the Horizon

SEC votes on MMF reform July 23.

After a few weeks of conflicting press reports, the SEC announced it would consider a final rule for money fund reform on July 23. The current proposal would require prime institutional money funds to either adopt a floating share price or use liquidity fees and redemption gates in times of stress or possibly both.[1] The SEC may not be able to achieve unanimous consent on the final rule as it is difficult to reconcile the views of the two Republican members of the 5 person commission. While Commissioner Michael Piwowar is opposed to adopting floating NAV together with gates and fees, Commissioner Daniel Gallagher has stated that he would support floating NAV only if paired with gates and fees. We continue to think that other details aside, prime institutional money funds will be required to transition to floating NAV, quite possibly paired with gates and fees.

Figure 4. Around $900 billion in MMF assets are likely to be affected by MMF reform



Source: Citi Research, ICI

While some institutional investors will be willing to leave assets in prime money funds, many others are likely to seek out a constant asset value alternative. From the $900 billion in prime institutional cash, it's certainly possible that we will see flows eventually cumulating to hundreds of billions out of prime institutional funds and into government funds. Since these funds are restricted to investing in Treasury and agency debt and repo, we expect agency discount note spreads to remain at very tight levels, T-bill and FRN rates pressured lower, and could see usage of the Fed's reverse repo facility increase to maintain the same floor on short-term rates.

We note that the final rule will likely include a significant phase in period and that we should see little day one effect from the reform. However, some institutional investors may begin the process of reallocating out of prime and into government money funds ahead of full implementation and the downward pressure on short-rates will likely build over time.

[1] For a detailed discussion of the current reform proposal, please see our publication from June 2013. "Short-End Notes: Will "Government Plus" replace "Prime" money funds?"

Appendix A-1

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