Short-Term Fixed Income in a Zero Rate Environment

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To combat extreme economic uncertainty and market volatility sparked by the COVID-19 pandemic, the Federal Reserve (Fed) slashed interest rates to near-zero with a series of emergency rate cuts. In addition to cutting its overnight target rate (in March) to a range of 0% to 0.25%, the monetary policymaking body also implemented a range of facilities meant to improve liquidity, stabilize markets and restore investor confidence.

Jeffrey Rowe, CFA, senior portfolio manager and co-head of our short-term fixed-income trading desk, looks at a few topics of note in the short-term sector.

The View From 10,000 Feet

Though the equity markets have improved dramatically over these last several months, new challenges are emerging as investors settle into the reality that 0% interest rates will likely persist for several years to come. In this environment, which shares similarities with the extended period of low rates following the financial crisis of 2008, money market participants will have to look beyond the Federal Open Market Committee (FOMC) and the associated lack of rate volatility to add value. There will, however, likely be key opportunities that emerge from other factors, including supply and demand shifts, regulatory changes, and unconventional FOMC tools (both rolling out and scaling back). Below, we highlight recent and specific market observations and trends that are relevant to short-duration investors.

U.S. TREASURY MARKET

A Deluge of T-Bill Supply is Met with Surging 2a-7 Money Market Demand

In addition to the aforementioned monetary stimulus provided by the Fed, an unprecedented fiscal stimulus was also pumped into the U.S. economy in response to the global pandemic. Most notable was the passage of the $2 trillion CARES Act in early 2020. The U.S. Treasury Department decided to initially meet this massive need, along with other funding initiatives, through the issuance of short-term maturity (less than one year) Treasury obligations known as Treasury bills (or T-bills). This led to a $2.4 trillion increase in outstanding T-Bills during Q2 2020, and in total, has pushed outstanding supply to more than $5 trillion. The enormous fiscally driven issuance in Q2 is an example of how supply changes can impact markets as this episode pushed 6-month T-Bill yields up from 0.00% in March to as high as 0.25% in April.

More recently, in Q3, T-bill yields have moderated to the middle of this range as supply flattened out. Looking ahead to Q4, there is an expectation that further net T-bill supply may hit the markets, and could perhaps total $1 trillion. That said, the timing and magnitude of increased issuance are highly dependent on the prospect of additional fiscal stimulus, along with a myriad of other variables.

The supply side is not the only aspect of the T-bill market equation that has changed this year. Demand for the largest, deepest and most liquid, fixed income market has seen a post-COVID-19 surge driven by several investor types. The largest source of demand has come from the U.S. Securities and Exchange Commission (SEC) regulated 2a-7 money market industry, which experienced growth of more than $1 trillion in assets under management (AUM) through the first six months of 2020. This occurred as investors flocked to the safety and liquidity offered by money market funds as the result of the global pandemic.

And, while nearly all of these net inflows occurred in Government money market funds, both government and prime funds have been active in adding T-bill exposure to portfolios in recent months. In addition to money market funds, other investors such as public entities, foreign institutions and non-financial companies appear to have been active in the T-bill market as well.

COMMERCIAL PAPER MARKET

Spreads Collapse Following Fed Intervention and SEC Regulatory Change Will Create Opportunities for Public Investors

Several emergency programs introduced by the Fed in March, including the Commercial Paper Funding Facility (CPFF) and Money Market Liquidity Facility (MMLF), were designed to calm short-term credit markets, which were experiencing historic volatility and ballooning credit spreads. For those unaware, credit spreads represent the yield difference between credit securities (e.g., Commercial Paper) and U.S. Treasury rates for a given maturity. And this difference indicates a premium above the risk-free rate that investors may expect to earn over a holding period.

The result: Commercial paper spreads, which ballooned to 150 basis points (bps) or more for 3-6 month maturities during March 2020, have since collapsed to pre-pandemic levels below 10 bps. It is important to note however that while narrow(er) spreads help lower funding costs for issuers, investors are left with only modest incremental benefit for taking on credit risk in an uncertain economic environment. This phenomenon is not unique to the commercial paper market, however, as spread compression near 0% target rate currently persists across fixed income asset classes.

Notable to commercial paper investors is a recent SEC regulatory change that is poised to expand access for state and local governments to certain commercial paper, negotiable bank deposits and corporate bonds. Amendments to the rules defining an “accredited investor” and a “qualified institutional buyer” (QIB) put governments on the same plane as corporations and not-for-profit entities. These changes will enable eligible investors access to commercial paper offerings covered by section 4(a)(2) of the 1933 Securities Act, which, based on our research, comprises more than 75% of the commercial paper market. Learn more on this topic here.

The End of LIBOR is Quickly Approaching

While regulators continue to aggressively push towards an end to the London Inter-bank Offered Rate (LIBOR) by the end of 2021, one could argue that market participants are less excited to see the well-established global benchmark fade. Investors in fixed income credit securities such as commercial paper, negotiable certificates of deposit and corporate notes have long flocked to LIBOR based instruments as a way to hedge interest rate risk with a credit-focused benchmark.

The “heir apparent” to LIBOR is the Secured Overnight Financing Rate (SOFR). SOFR is a secured, short-term (overnight) borrowing rate based on U.S. Treasury repurchase (repo) agreements and general collateral financing (GCF) data - basically an overnight risk-free rate. However, one might argue that many of the typical investors in floating-rate credit markets are reluctant to switch over to SOFR based securities because they lack the credit element offered by LIBOR. This characteristic may lead to underperformance in turbulent markets such as the one experienced in March.

Regulators have opined that SOFR does not need to be the exclusive replacement for LIBOR. In fact, many credit-sensitive benchmark alternatives have been considered in recent years, though many suffer from similar challenges faced by LIBOR and none have gained significant traction yet. With the end of LIBOR in sight, it may be unrealistic for a supplemental, credit-based benchmark to emerge by 2022.

To learn more or discuss in greater detail, please contact us:

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