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MONEY MARKET REFORM: IMPACT ON INVESTORS

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KEY TAKEAWAYS

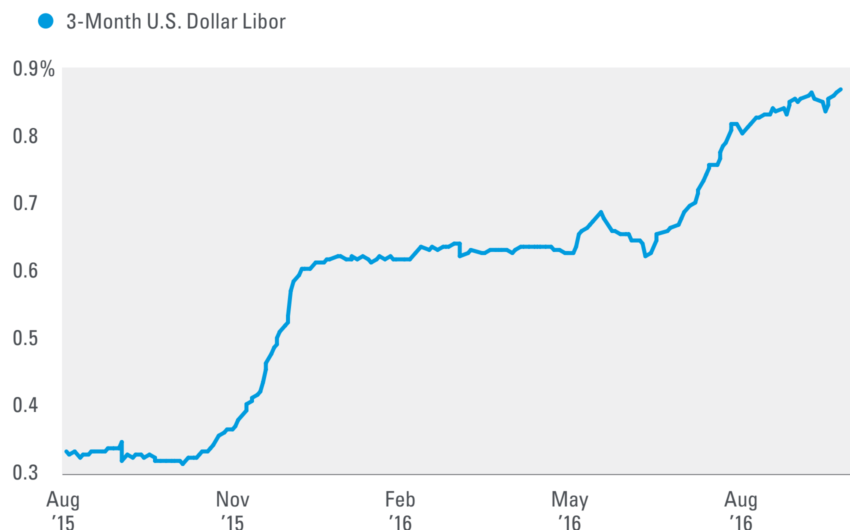
Markets have known about the upcoming money market reform (scheduled for October 14) for more than two years, and its impact may already be priced in.

The upcoming reform has helped push Libor higher, benefitting asset classes that depend on it, including bank loans.

Money market reform goes into effect this Friday, October 14, 2016, and its impact has already been felt by markets. Money market funds have historically offered a fixed net asset value of $1.00, giving investors an effective cash substitute that earns a small yield with little perceived risk. However, the failure of a well-known money market fund during the 2008 financial crisis brought increased scrutiny to the asset class and led the Securities and Exchange Commission (SEC) to mandate reforms. Although these reforms implemented many changes, a major one is that institutional money market funds (funds where ownership includes businesses, endowments, or other non-natural persons) will no longer have a fixed net asset value of $1.00, but will instead have a floating net asset value (NAV) based on the current values of the underlying positions. Government money market funds and retail funds (those that are only held by individual investors) will be allowed to keep the fixed $1.00 NAV.

This change has led institutions to reposition their holdings, leading to net outflows of more than $670 billion from institutional prime (non-government) money market funds year-to-date, with $632 billion of those assets moving into

1 3-MONTH U.S. DOLLAR LIBOR HAS INCREASED IN ANTICIPATION OF MONEY MARKET REFORM



Source: LPL Research, FactSet 10/07/16

Past performance is not an indication of future results.

A money market mutual fund investment is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although money market mutual funds have traditionally sought to preserve the value of your investment at $1 per share, it is possible to lose money by investing in such a fund.

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government money market funds. The pace of movement has increased in recent months, with net assets in institutional prime money market accounts falling by more than half since the end of August (based on data from the Investment Company Institute (ICI). These flows have caused institutional prime money market fund managers to sell assets, putting upward pressure on the yields of common holdings of these funds, including certificate of deposits (CD) and commercial paper.

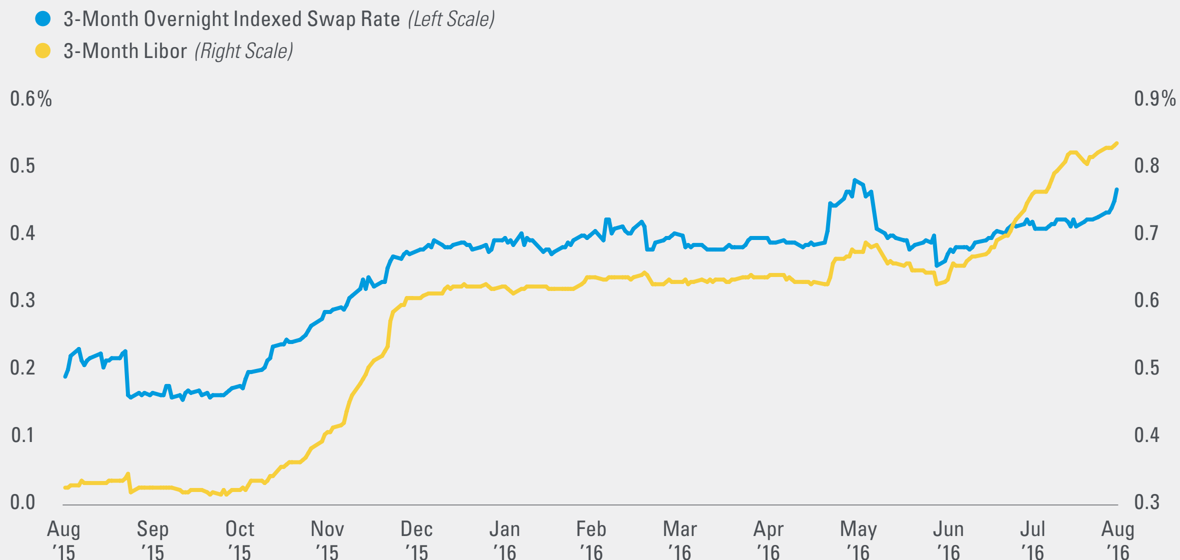
IMPACT ON INVESTORS

Selling pressure in CDs and commercial paper has led to higher yields for these assets, a potential positive for investors, though a small one given the limited maturity of these types of investments. The impact on the London interbank offered rate (Libor), a well-known benchmark rate that impacts more than $350 trillion in debt and contracts worldwide, potentially had a larger impact on the broader market. The yield on 3-month U.S. dollar Libor has increased by just over 0.22% since the beginning of July 2016, with the impact nearly matching the increase seen in the lead-up to the Federal Reserve's (Fed) rate hike in December of 2015 [Figure 1].

Bank loans, which pay a floating rate of interest determined by adding a fixed percentage to Libor, are one asset class that may benefit from the recent increase in the benchmark rate. Approximately 92% of the bank loan market (as measured by the S&P/LSTA U.S. Leveraged Loan Index) has a Libor floor that averages 1%. Libor has been below 1% since May of 2009, which means that the average bank loan investor hasn't benefitted from the rise in Libor yet, but may begin to soon.

Bank loans are loans issued by below investment-grade companies for short-term funding purposes with higher yield than short-term debt and involve risk.

2 FED RATE HIKE EXPECTATIONS MAY BE RESPONSIBLE FOR JUST OVER 40% OF THE RECENT INCREASE IN LIBOR



Source: LPL Research, Bloomberg, FactSet 10/07/16

Past performance is not an indication of future results.

3-Month Overnight Index Swap (OIS) futures and options track the overnight effective Federal Funds rate. While the Fed Funds contracts track to the average effective Fed Funds rate over the course of a calendar month, the 3-Month OIS contracts track the compounded Fed Funds rate over a 3-month period.

Derivatives employ sophisticated strategies that may amplify volatility and losses, involve additional risks, including interest rate risk, credit risk, the risk of improper valuation, and the risk of non-correlation to the relevant instruments they are designed to hedge or to closely track.

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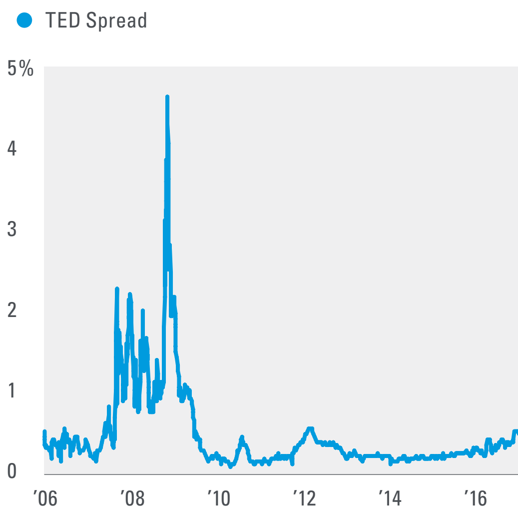
COULD THE RISE IN LIBOR BE DRIVEN BY SOMETHING OTHER THAN MONEY MARKET REFORM?

The last major increase in Libor came on the back of a Fed rate hike in December of 2015, and with the market pricing in a 68% chance of a rate hike at the Fed's December 2016 meeting, rate hike expectations are responsible for at least part of the recent increase in Libor. Overnight indexed swaps (OIS), which tend to track with rate hike expectations, can be used to quantify the impact, and show that just over 40% of the uptick in Libor is coming from an expected increase in the fed funds rate [Figure 2].

Libor, at its core, is a measure of the rates that banks charge each other for loans in the interbank market. For this reason, the spread between Libor and OIS have historically been used as a measure of bank stress. If Libor increases faster than overall interest rate expectations, it could mean that banks are charging each other more for short-term loans, a sign that they may be losing confidence in each other. This concern has caused some to question whether the recent rise in Libor is more connected to bank fears out of Europe, or some other systemic risk.

Although this theory can't be completely discounted, we do not believe systemic bank fears are the major driver of the recent move in Libor. The TED spread (3-month Libor minus the 3-month T-Bill yield [Figure 3]), another measure of bank stress, has ticked slightly higher in recent weeks, which isn't surprising given concerns surrounding a major German bank. However, the overall level remains subdued compared with its level in the run-up to the 2008 crisis. Credit default swaps (CDS), a measure of the cost of insuring against default, for major U.S. banks also remain benign, suggesting bank fears are not at the heart of the recent increase in Libor. Additionally, stronger bank balance sheets in the U.S., and supportive policy from global central banks in Europe and Japan will likely act as a tailwind for banks, reducing the risk of systemic problems like those seen in 2008.

3 THOUGH THE TED SPREAD HAS INCREASED SLIGHTLY, IT REMAINS SUBDUED RELATIVE TO THE 2008 CRISIS



Source: LPL Research, FactSet 10/07/16

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CONCLUSION

Though Fed rate hike expectations and European bank fears are both likely to be a part of the story behind the recent rise in Libor, the absence of an increase in other measures of bank fears such as the TED spread and CDS makes it less likely that bank concerns are driving the rise.

For these reasons, we believe money market reform is the major driver behind the rise in Libor. These reforms have been known to markets for more than two years, giving institutional investors who may be affected plenty of time to reposition assets, meaning any impact is probably already priced in and may not likely to lead to a severe market dislocation. ■

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The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

Investing in mutual funds involves risk, including possible loss of principal.

The London interbank offered rate (Libor) is an interest rate at which banks can borrow funds, in marketable size, from other banks in the London interbank market. The Libor is fixed on a daily basis by the British Bankers' Association. The Libor is derived from a filtered average of the world's most creditworthy banks' interbank deposit rates for larger loans with maturities between overnight and one full year.

INDEX DESCRIPTIONS

The S&P/LSTA U.S. Leveraged Loan 100 Index is designed to reflect the largest facilities in the leveraged loan market. It mirrors the market-weighted performance of the largest institutional leveraged loans based upon market weightings, spreads, and interest payments. The index consists of 100 loan facilities drawn from a larger benchmark, the S&P/LSTA (Loan Syndications and Trading Association), Leveraged Loan Index (LLI).

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