Strategy
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One Shoe Dropped, Waiting on the Other
Three Trends in 2016

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Abstract
2016 will be a year of transition on many fronts for corporate cash investors. The Federal Reserve is expected to remain accommodative in removing monetary stimulus. There will be increased clarity following money market fund reform in October. Credit markets should also manage well through moderate credit deterioration and wider spreads. The primary job for corporate cash investors is to preserve portfolio liquidity through diversified sources beyond government money market funds.

Introduction
Now that the Federal Reserve finally delivered the biggest Christmas gift short-term markets could have hoped for by lifting the Fed funds target rate off of the ground, a whisper is in the wind: now what? In the days after the Fed's December interest rate decision, markets seemed to take the news rather calmly, but it may be months before we really know how the move ultimately will impact financial markets. Therefore, 2016 could be a critical and volatile year for many of us in the treasury investment community.

Every January, we discuss a number of key trends for corporate cash investors in the upcoming New Year. Last year, we identified the start of a tightening cycle, the consequences of supply shortage, and resurging geopolitical uncertainties in 2015. This time around, we will discuss the trajectory of interest rate normalization, the implementation of money market fund reform, and credit market development as the main themes for 2016.

A Tightening Cycle unlike Any Other in History
Yes, the Janet Yellen Fed has delivered. Many doubted the Fed's earlier communication on its resolve to act by the end of the year—especially when inflation was going in the opposite direction as oil prices continued to collapse just days before the meeting. Fed officials nonetheless hiked the fed funds rate by 0.25%. Will this be the start of a sustained tightening cycle?

Gradual Is the Operative Word: Not so fast. With its careful choice of words, the Fed communicated in its December post-meeting statement that the upcoming round of rate increases will be rather dovish. It will continue to consider "current shortfall of inflation from 2 percent," and it will also "carefully monitor actual and expected progress toward its inflation goal." As a result, we should expect "only gradual increases" in the Fed funds rate.

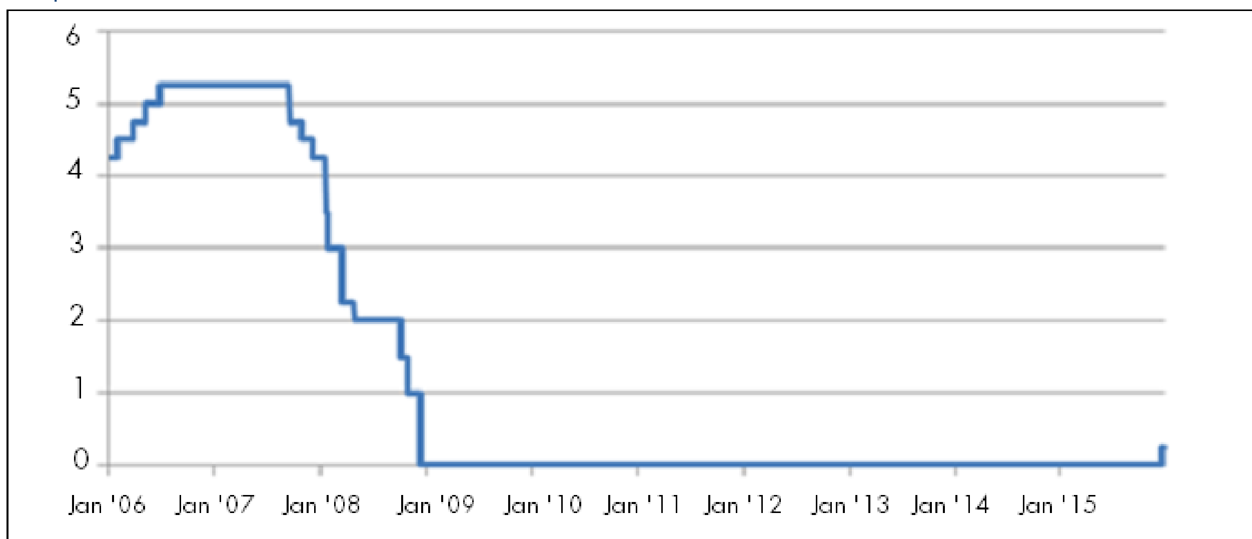
The central tendency of the "dots" on the dot graph accompanying Fed officials' Summary of Economic Projections predicts the funds rate to be in a range of 1.25% to 1.50% by the end of next year. This means that, if all goes according to their projections, rates may increase four times in eight meetings in 2016, a much slower pace than the 0.25% increase in each of the 17 Fed meetings between 2004 and 2006. The FOMC's statement

also closed the door on the possibility of a reduction in the Fed's balance sheet any time soon.

Actual Pace May Be Slower Still: Many market observers think that even the slow pace of four hikes in a year may be too aggressive. The spot Fed funds futures yield due in December 2016 of 0.85% at the time of this writing (December 18) suggest that the market is expecting only two more hikes (from the mid-point of 0.25% and 0.50%) by year-end 2016. We think there are plenty of reasons for the Fed to slow its pace or even pause as the year progresses.

Factors Supporting Gradual Increases: We expect that slumping commodity prices will keep non-wage inflation in check. The strong U.S. dollar should also hinder export activity, leading to only modest domestic GDP growth. On the international front, the European Central Bank (ECB) increased the scope of its monetary easing policy in December, pushing its asset purchase program out by six months to March 2017, and the Bank of England postponed its outlook for the first rate increase well into 2016. China continues to face headwinds in its structural reforms and currency liberalization, made more difficult by the Fed's rate increases. Finally, the impact of the first Fed rate hike has already started to reverberate among emerging economies, causing concerns with respect to capital flight, deteriorating credit and growth concerns.

Graph 1: Fed Funds Rate



Source: Bloomberg as of December 29th, 2015

In addition, we see little end to geopolitical risk in 2016. The Syrian refugee situation in the European Union still lacks resolution, and the issue of the UK's EU membership referendum looms large. The Russia-Turkey skirmish remains unresolved, and ISIS-inspired terror attacks in western countries may continue. In Asia, the strained Sino-North Korean relationship further complicates the Korean Peninsula standoff. China's territorial dispute with its southern neighbors, with Japan, and potentially with a new pro-independence Taiwan government could all involve diplomatic tangles, or even military tap dances, with the U.S. government.

2016 also happens to be a presidential election year, a time when the Federal Reserve typically tries to avoid being accused of pushing the country into recession, not that this possibility is in the forecast of mainstream economists.

Portfolio Implications: We think the current rate tightening cycle will be more mild and shallow than in past cycles, with fewer rate hikes than the Fed is projecting. Duration risk, or the risk of unrealized losses from rising

rates, will likely be lower for assets of moderate maturities. Investors may benefit more from slightly longer maturity positions on a positively sloping yield curve than staying short from Fed meeting to Fed meeting.

Focus on Liquidity while Navigating through Money Market Fund Reform

Now we move on to the second shoe that is about to drop: the issue of SEC money market fund reform. Much has already been said and written about the impending mandatory floating of the net asset values (NAVs) of institutional prime funds and the imposition of redemption fees and gates on all prime funds effective October 14, 2016. The new rule represents the most fundamental structural change in modern history, not only of the money market fund industry, but of the institutional cash management profession as a whole.

What interests us at Capital Advisors Group the most is how the industry will manage the initial phase of the structural reform. To us at this stage, it's beside the point to question what value floating NAV prime funds will still offer or what level of yield pickup will entice shareholders to stay. With essentially zero barriers to entry and exit, it should be an easy decision for shareholders to avoid uncertainty by parking liquid assets at a safe and sound place for a few weeks (or a few months) in advance of the coming changes, before they need to contemplate longer-term strategies.

ON RRP Alleviates Supply Shortage: Lately, one of the central questions being posed has been, "How will government funds accommodate the large influx of assets from prime funds?" Recent market developments may offer a glimpse of clarity on this front.

The Federal Reserve has removed the $300 billion overall cap for its overnight reverse repurchase agreement facility (ON RRP) to facilitate its interest rate management, which will allow some government funds to accommodate a temporary influx of cash from prime shareholders. Please note that the $30 billion per counterparty restriction remains in place. At our last count, 48 of the approved counterparties are either currently money market funds with "Treasury" or "government" association, or expected to be by October 2016. Theoretically, total government fund capacity could grow to $1.4 trillion ($30 billion * 48), a level sufficient to cover the entire market of $1.265 trillion in prime fund assets today (as of December 18, 2015). Rest assured that we do not expect the ON RPP will grow to this level, as not all funds are open to all shareholders, and the Fed cannot conceivably allow the private funding markets to be decimated as cash floods the reverse repurchase (RRP) market. Nonetheless, the removal of the RRP cap alleviates one major government supply concern.

Implementation Complexity: While fund families and intermediaries devote tremendous resources to ensure compliance and a smooth transition during this time of upheaval, some key questions still lack clear answers. For example:

- How will floating NAV funds provide intra-day liquidity?
- How will pricing vendors deliver accurate securities prices on volatile market days for the funds to accurately price intra-day NAVs?
- What lag time will there be for floating NAV trades to flow through fund portals?
- What will happen if a prime fund fails to comply with the SEC's requirements by October 14, 2016 deadline?

We think questions like these will remain until after we've crossed over to the other side of "Day Zero." Until we reach that point, prime fund shareholders may not have the level of comfort they would prefer other than diversifying their liquidity amongst several vehicles.

Portfolio Implications: The short answer to these questions from Capital Advisors Group is: Liquidity is King. In a year of major transition for the cash investment world, portfolio liquidity takes the upmost priority over other

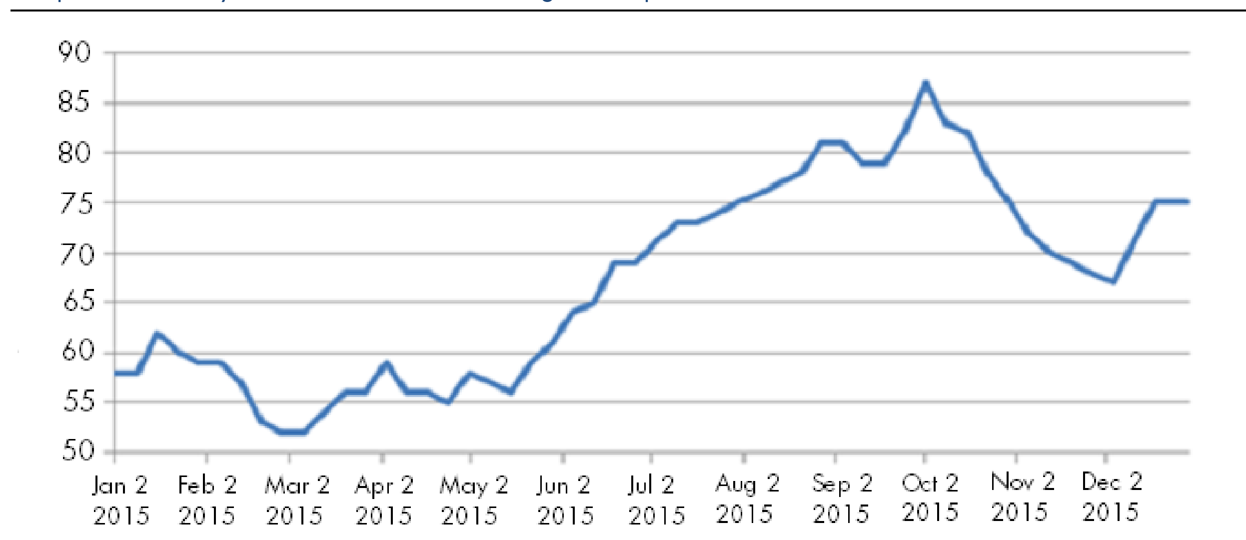
initiatives. Already, we can see that money market fund portfolio weighted average maturities (WAM) have grown shorter in recent months, partly in anticipation of the Fed's December move on rates, but more so to take a defensive position against potential asset outflows. Investors, likewise, should take cues from fund managers and devise liquidity strategies well in advance. As we have written in earlier commentaries, cash managers need to have a diversified liquidity strategy that may include government and prime funds, deposits, and individual holdings of government and high grade credits.

When the Interest Rate Cycle Turns, Credit Problems Follow

Despite the welcome news of higher interest rates for savers, from a cyclical perspective those higher rates often lead to a deterioration of credit quality. As we've discussed, this rate cycle may be slower and flatter than in most previous cycles, but with leaner years ahead, some of the side effect of debt-financed mergers and acquisitions and share buybacks are likely to eventually appear. Slumping oil and commodity prices present credit challenges to energy, mining and other cyclical sectors and to their lenders and suppliers. Subprime auto loans, student loans, home equity, credit cards, leverage finance and commercial real estate are also areas that may experience higher delinquencies and losses. As emerging market economies fight economic slowdowns amidst capital flight, multinational corporations and lenders may not escape unscathed.

Third Avenue Focused Credit Fund: Some investors may have noticed the troubles at Third Avenue Focused Credit Fund, the second largest fund run by hedge fund firm Third Avenue Management. With total net assets of $2.1 billion (as of July 31, 2015), the mutual fund specialized in distressed credits. It wasn't able to satisfy shareholder redemptions this October, eventually halting all redemptions and shutting down on December 9. Although it is unlikely that institutional cash accounts were involved with this fund, the lack of liquidity in a high-yield bond fund and its inability to satisfy redemptions in the current credit environment may be symptomatic of reduced market liquidity on less creditworthy investments. Whether the demise of this fund serves as a weathervane of what is to come in the world of below-investment-grade tier credits remains to be seen.

Graph 2: Merrill Lynch 1- to 3- Year A and Higher Corporate Index



Source: Merrill Lynch Global Index System as of December 29th, 2015

Index Spread: The Merrill Lynch 1- to 3- Year A-rated and Higher Corporate Index, a major benchmark for short-term credit markets, shows the composite index option-adjusted spread (OAS) climbed steadily over the comparable-maturity Treasury yield from 0.52% last February to 0.87% through October (when the Fed declined to raise interest rates). After dropping down to 0.67% in early December, spreads resumed an upward

movement after the strong November payroll data made it all but certain that the Fed would lift rates at their December meeting. We expect this trend to continue into 2016.

Portfolio Implications: For those who considered reaching down the credit ladder to add yield when short-term rates were essentially zero, this is the time to re-evaluate this strategy. Both higher interest rates and money market fund reform, by way of reduced demand for credits, will result in higher volatility and reduced liquidity in the credit sectors. While credit resilience through gradually higher rates and orderly money fund transitions is still the base case scenario, cash investors are better advised to be more vigilant on credit selections and refrain from reaching for yield when spreads are likely to widen as the year progresses.

A Journey towards Normalization Requires an Eye on Liquidity

2016 will be a year of transition on many fronts for corporate cash investors. With the accommodative Federal Reserve gradually removing monetary stimulus, a few potholes should not derail economic growth and financial market stability. Short-term markets should endure money market fund reform with better clarity on the way forward post-October. High-grade credit markets also should navigate through moderate credit deterioration and wider spreads. The primary job for corporate cash investors is to remain calm, with preserving portfolio liquidity the highest order of priority. Diversified sources of liquidity should include solutions other than deposits and government money market funds.

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Drawing upon almost a quarter of a century of experience through varied interest rate cycles, the firm has built its reputation upon deep, research-driven investment strategies and solutions for its clientele.

Capital Advisors Group manages customized separate accounts that seek to protect principal and maximize risk adjusted returns within the context of each client's investment guidelines and specific liquidity needs. Capital Advisors Group also provides FundIQ® money market fund research, CounterpartyIQ® aggregation and credit analysis of counterparty exposures, risk assessment on short-term fixed income securities and portfolios, and independent debt financing consulting services.

Headquartered in metropolitan Boston, Capital Advisors Group maintains multiple U.S. regional offices.

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