

# Money Markets

With more stimulus on the horizon, Fed expects a strong recovery in 2021



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## KEY TAKEAWAYS

- The Federal Reserve in March raised its forecasts for GDP growth, inflation and employment, based on the \$1.9 trillion in new stimulus signed into law and an accelerated vaccine rollout.
- A proposal for roughly \$2.3 trillion more in stimulus for infrastructure, jobs, and family programs could result in further upgrades to Fed economic estimates.
- The Fed allowed a temporary exemption enacted during the COVID-19 crisis to ease capital requirements for banks to expire; the change could impact money market pricing.
- Money market assets under management climbed higher during the quarter, spurred on by a variety of factors: higher volatility in longer-dated Treasuries, an influx from bank balance sheets, corporate issuance, and additional quantitative easing and stimulus.
- Regulatory reform remains on the horizon as regulators spoke in stark terms about preventing the stress in liquidity markets that was seen during the pandemic.
- Plans for the sunset of LIBOR, the short-term benchmark, will proceed with a new timetable for the cessation of U.S. dollar issuance; LIBOR's obituary has been written.

## Outlook for recovery in 2021 improves

President Biden in March signed into law a \$1.9 trillion COVID-19 relief package and proposed roughly \$2.3 trillion in additional spending for infrastructure, jobs, expanded health insurance, and other family focused programs.<sup>1</sup> These latest initiatives follow unprecedented programs and spending in 2020 by the Fed, the Treasury Department, and Congress to counteract the effects of the pandemic on the U.S. economy.

The Federal Reserve at its March meeting noted that aggressive fiscal and monetary programs over the past year have helped to support a better than expected recovery in economic activity since the pandemic struck in early 2020. "Some of the very worst economic outcomes have been avoided by swift and forceful action—from Congress, from across the government, and in cities and towns across the country," said Chairman Jerome H. Powell.

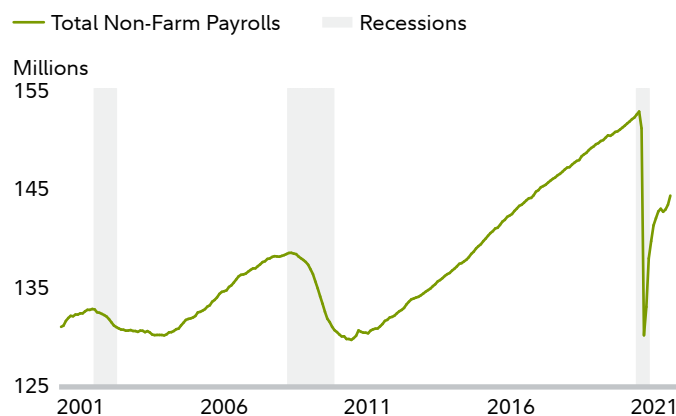
“More people held on to their jobs, more businesses kept their doors open, and more incomes were saved as a result of these swift and forceful policy actions,” Powell said.<sup>2</sup>

The Fed noted that indicators of economic activity such as household spending and employment had risen notably this year. For example, most recently, the March jobs report was dramatically higher than expected, with nonfarm payrolls at 916,000, well ahead of the 675,000 that economists had forecasted. Unemployment dropped to 6%, and the economy has now recovered 62% of the jobs lost as a result of the pandemic. The workforce now needs to gain 8.4 million jobs to return to pre-pandemic employment levels (Exhibit 1).

The Fed, noting the faster than expected recovery, revised its forecasts for the economy in its latest Summary of Economic Projections issued at its March meeting (Exhibit 2). Policymakers raised their forecast for GDP growth to 6.5% for 2021, up from 4.2% in their last projections in December 2020. However, they expect growth will moderate in 2022, to 3.3% (up from 3.2% in December 2020) and 2.2% in 2023

### EXHIBIT 1: The March jobs report came in much stronger than expected and the workforce needs to gain 8.4 million jobs to return to pre-pandemic levels.

Non-Farm Payrolls from January 2000–March 2021

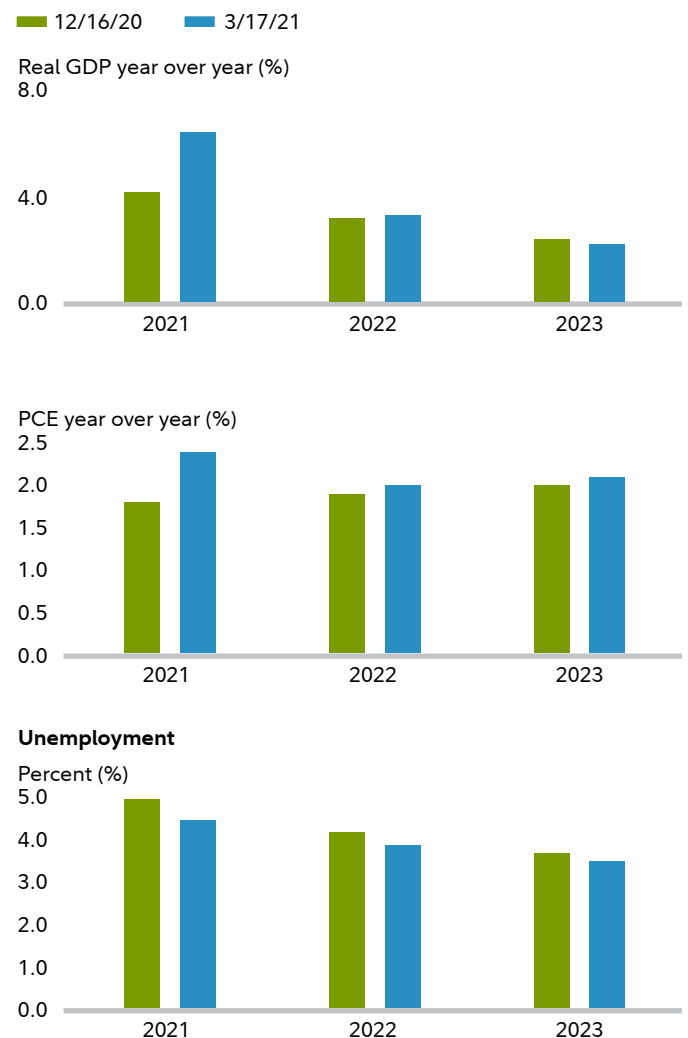


Source: Bloomberg, Bureau of Labor Statistics, and National Bureau of Economic Research as of March 31, 2021.

(lower than the prior forecast of 2.4%). Growth estimates are subject to change and will depend on the outcome of further fiscal stimulus measures.

Inflation, which has remained stubbornly below target through years of the Fed’s aggressive policies, is expected to increase to 2.4% in 2021 (up from 1.8% in the last forecast). Pricing will moderate in both

### EXHIBIT 2: The Fed raised its forecasts for growth, inflation, and employment in March due to a stronger than expected recovery as a result of new stimulus signed into law this year.



Source: Bloomberg Finance LLC. FOMC Median Forecast as of March 17, 2021. Core Personal Consumption Expenditures (PCE) Index represents core inflation without volatile food and energy.

2022 and 2023, but will remain at or slightly above the 2% target, according to the forecast. The forecast underscores the Fed's belief that any uptick in inflation will be transitory, and that disinflationary pressures will eventually return.

Unemployment is showing the largest signs of improvement, with a forecast of 4.5% in 2021, vs. 5% expected in the December forecast. Joblessness is projected to continue to fall to 3.9% in 2022 and 3.5% in 2023 (down from 4.2% and 3.7%, respectively).

In March, the Fed maintained the federal funds rate in a target range of 0% to 0.25% and expects rates to remain there until labor markets have achieved what it determines to be maximum employment and inflation stays at or slightly above a target range of 2%. Policymakers indicated through their statement of economic projections that most Fed officials anticipate keeping the target range unchanged through the end of 2023, while some believe that the Fed will need to raise the target range beginning in 2022.

One adjustment to the policy is that the Fed noted it will not rely on forecasts but would wait for "actual data" to fine-tune policy. Chairman Powell noted that the historic connection between unemployment and inflation is "long gone," and that policymakers would just need to see "substantial progress" on employment. The Fed at the March meeting also decided to leave unchanged its asset purchases of at least \$120 billion in Treasuries and mortgage backed securities (MBS) per month.

### 2021 and beyond: what may lie ahead

President Biden's proposed \$2.3 trillion stimulus package would feature sweeping infrastructure projects and job creation and would be paid in part by a proposed tax increase for businesses and wealthy Americans. The measure faces likely opposition in Congress from Republican lawmakers. Additional stimulus would likely spur the Fed to further raise its estimates for the economy, while current policy is likely to remain in place for the next six months, Chairman Powell said. The base case is for the recovery to be aided by stimulus and accelerated vaccinations, with an eventual taper announcement (where the Fed would pull back

from aggressive asset purchases and other programs). However, Powell noted that the economic recovery remains uneven and far from complete, and the path ahead is not without uncertainty.

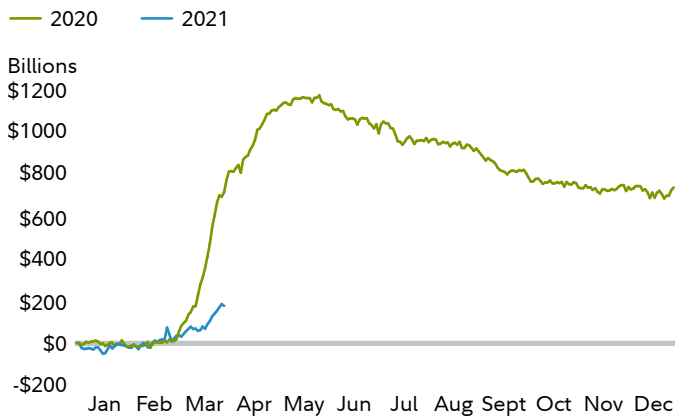
### Potential impact on money market industry

The Fed at its latest meeting also decided to allow the Supplemental Leverage Ratio (SLR), an exemption that eased bank capital requirements during the height of the pandemic, to expire at the end of March. The Fed had first introduced the rule in March 2020 to exempt bank holdings of Treasuries and Excess Reserves from their leverage ratios to enhance their ability to absorb the massive liquidity being created to stimulate growth during the pandemic. The expiration of the SLR exemptions means that banks will not be able to accommodate all the deposits and have started to reduce deposit rates to encourage alternative solutions. Money market funds (MMFs) are one of the few instruments that corporate treasurers widely utilize in seeking capital preservation and liquidity. As a result, MMFs may see a further increase in asset flows with the expiration of the SLR's exemptions.

In addition, the Fed increased the counterparty limit on its overnight reverse repurchase agreement operations from \$30 billion to \$80 billion. Policymakers said the move reflects the growth in government money market funds and evolution of U.S. dollar funding markets since the limit was last changed in 2014, helping to ensure the overnight reverse repo facility supports effective policy implementation. The increase creates a stronger floor to prevent rates from dropping below the lower end of the Fed's target range.

Taxable MMF assets experienced significant growth in March as a result of a number of factors, including Treasury volatility at the longer end of the yield curve, a shift from bank deposits to money market funds, flows from corporate bond issuance, and additional quantitative easing and Treasury stimulus payments that have increased the reserves in the banking system. Assets in retail and institutional funds experienced cumulative growth of \$165.9 billion during March alone, ending the quarter up \$172.4 billion, a robust increase given the large inflows seen in 2020 (Exhibit 3).

**EXHIBIT 3: Taxable money market funds experienced significant growth in March due to a number of factors.**



Source: iMoneyNet as of March 31, 2021. Note: includes retail and institutional share classes.

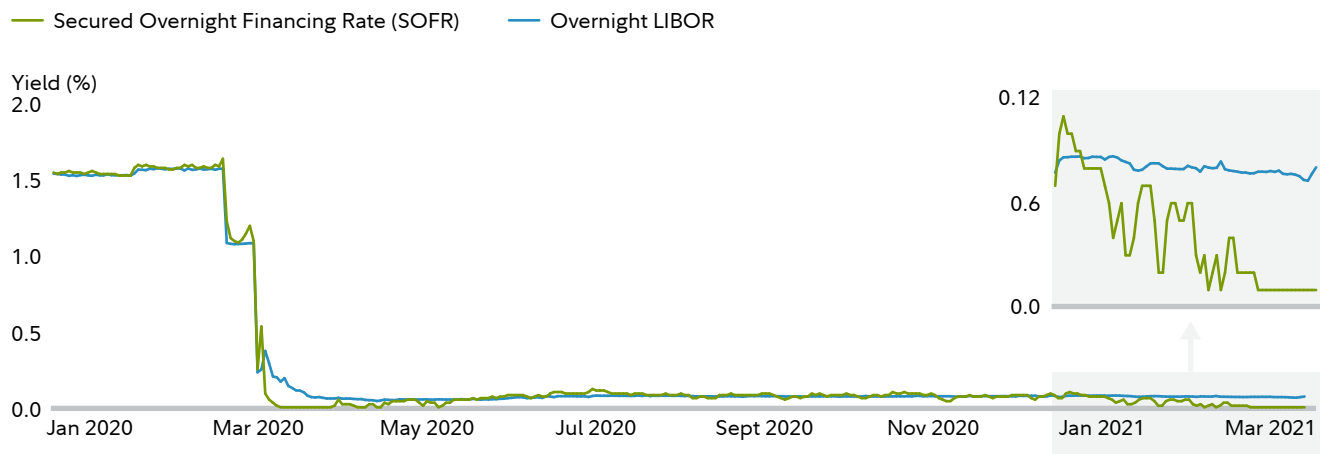
**Money market reform remains on the table**

The liquidity crisis of March 2020 has kept the prospect for more money market reform top of mind. Some regulators and industry watchers have argued that reforms made in 2010 and 2014 may not have gone far enough to protect the industry from requiring Fed support for the second time in as many decades. Interestingly, the President’s Working Group (PWG)

on Financial Markets Report on the topic also expresses concern about some previous money market fund reforms. It found that elements of the 2014 regulatory reform—liquidity fees and gates tied to the 30% weekly liquidity threshold—may have actually had the “unintended effect of triggering preemptive investor redemptions as funds approached the relevant thresholds.”<sup>3</sup> The report included a range of money market reform measures which, it suggested, regulators may want to consider.

More recently, Randal Quarles, vice chairman for supervision at the Fed, spoke in stark terms about the need for further capital market reform. Quarles is a member of the Fed’s Board of Governors and chairman of the Financial Stability Board (FSB), an international watchdog for the global financial system. Quarles noted that the “dash for cash” in early 2020 was more extreme than what was seen during the start of the great financial crisis in late 2008, with publicly offered institutional prime funds especially hard hit. The FSB is scheduled to publish a report in July with policy proposals to improve MMF resilience, likely touching on government intervention, taxpayer support, and a reconsideration of the relationship between MMFs and short-term funding markets.

**EXHIBIT 4: Supply/demand of government securities has resulted in SOFR yields falling relative to LIBOR yields.**



Source: Bloomberg Finance LLC, as of March 31, 2021.

Fidelity on April 12 filed a comment letter with the Securities and Exchange Commission (SEC), providing its perspective on the range of potential reform measures for money market funds that were included in the PWG report. Although no specific measures have yet been proposed by the SEC, the letter encouraged the SEC to narrow the range of options under consideration by eliminating those options that have no nexus to the events of 2020 and, therefore, would not achieve any of the goals for reform stated in the PWG Report.

### LIBOR to SOFR

Plans are on track for the transition away from the short-term benchmark, the London Interbank Offered Rate (LIBOR). Indeed, LIBOR's obituary has been written, with the integration of its U.S. replacement, the Secured Overnight Financing Rate (SOFR).

Since SOFR was first introduced in July 2018, \$1.15 trillion in SOFR-linked debt has been issued.<sup>4</sup>

While many terms regarding LIBOR have been set for some time to sunset at the end of this year, the Financial Conduct Authority (FCA) and ICE Benchmark Administration (IBA) announced specific dates when LIBOR will cease U.S. dollar issuance (along with issuance linked to other currencies). For the U.S., the publication of the overnight, 1-, 3-, 6-, and 12-month USD LIBOR issuances will end immediately after June 30, 2023. The 2023 dates will allow for a smooth transition, and will trigger language fallback protocols developed for legacy issuance. Meanwhile, market conditions have caused SOFR rates to fall relative to LIBOR rates (Exhibit 4). Increased demand along with reduced supply of government securities has caused the yield for repurchase agreements to tighten relative to the credit-sensitive LIBOR index, driving SOFR rates lower.



## Author

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Kerry Pope is an institutional portfolio manager in the Fixed Income division at Fidelity Investments. In this role, he is responsible for communicating portfolio strategy and positioning, designing customized liquidity-management solutions for institutional clients, and providing portfolio reviews.

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*Fidelity Thought Leadership Vice President Martine Costello provided editorial direction for this article.*

<sup>1</sup> Source: Fidelity Investments, fixed income macro team, USA Facts.org, Whitehouse.gov, as of April 15, 2021.

<sup>2</sup> Federal Reserve press conference transcript, March 17, 2021.

<sup>3</sup> President's Working Group on Financial Markets Report, "Overview of Recent Events and Potential Reform Options for Money Market Funds," Dec. 22, 2020.

<sup>4</sup> Bloomberg Finance LLC, as of March 31, 2021.

All information unless otherwise noted is as of 4/19/21.

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