

## U.S. money market funds - a safe haven?



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### IN A NUTSHELL

- U.S. money market funds have seen strong inflows recently, with volumes reaching record highs.
- Investors are looking for near-term safety and are being drawn by relatively attractive interest rates.
- We do not expect big outflows in near term but the risk that they will occur should be monitored.

### Massive inflows in recent years

U.S. money market funds (MMFs) have experienced massive inflows since the end of 2022. At just above USD 6 trillion, they currently stand at an all-time high.<sup>1</sup> In our view this isn't about to change: big outflows are unlikely in the shorter-term. But what has driven the enormous interest in this short-term investment opportunity is an important question. As is what would need to happen for capital to be withdrawn equally suddenly. These investments are, by their very nature, short term, and (overly) rapid outflows, reallocating the funds to other asset classes, can certainly happen, making markets volatile.

Money market funds have also seen inflows in the Eurozone recently, but the volumes appear relatively small. The chief reason, in our view, is that European investors place much less emphasis on the security aspect of funds than their U.S. counterparts. Given the much lower importance of money market funds in Europe and the Eurozone, we are only looking at the U.S. instruments in this publication.

## 1 / U.S. money market fund volume reaches record high

### 1.1 Money market funds as a short-term parking option for capital

Money market funds are generally defined as investment funds that invest their assets in liquid money market securities. They are assumed to offer a high level of security for investors. Besides that, their most important feature is their short-term nature. Money market securities include certificates of deposit, time deposits, bank or corporate notes and bonds, and shares in other money market funds. These securities usually have a maturity of twelve months or less.

Money market funds are generally used by a wide variety of investor groups to park money before it is allocated to other, typically longer-term investments. Banks, governments, and corporations have long been among the largest investors in MMFs and currently account for about 60% of the total. In recent years, however, it has become increasingly clear that retail

<sup>1</sup> All data, unless otherwise stated, Bloomberg Finance L.P. as of 5/10/24

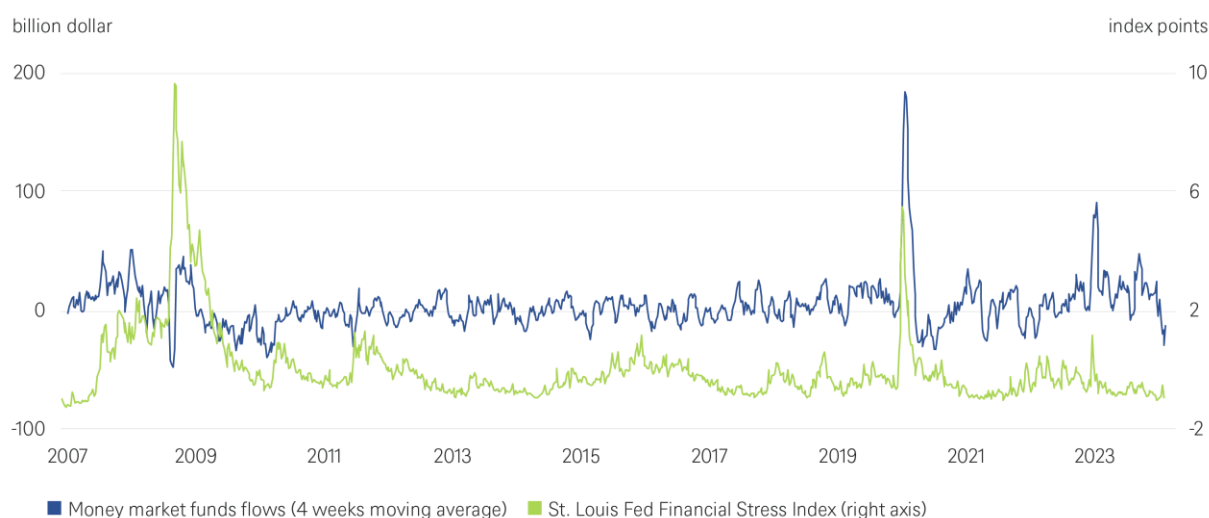
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investors are also making much greater use of this vehicle. Their holdings have increased by around 75% over the past 24 months. As one of the main characteristics of MMF investments is their short-term investment horizon, the securities held in the fund are highly liquid and permit quick portfolio rebalancing.

**1.2 Market stress as a potential trigger for inflows into MMFs** In principle, MMFs do not differ from other investment funds in the way they work, and this is also an important reason why retail investors are increasingly using them to park their capital. When investor nervousness and volatility are high in the markets, money market funds tend to become more popular. Funds that invest exclusively in U.S. government or government-related securities, which are generally seen as safe investments, are by far the largest group of MMFs, because of the perceived safety of these securities.

Looking at flows into U.S. money market funds over the past decade and a half, it is easy to see that periods of financial market stress have often led to a noticeable increase in volumes. The underlying source of the nervousness, whether geopolitical or from market stresses, did not seem to matter. The overall level of stress in U.S. markets can be seen in the Financial Stress Index produced by the Federal Reserve Bank of St. Louis. As defined by the bank, the index “measures the degree of financial stress in the markets and is constructed from 18 weekly data series: seven interest rate series, six yield spreads and five other indicators. Each of these variables captures some aspect of financial stress. Accordingly, as the level of financial stress in the economy changes, the data series are likely to move together.<sup>2</sup>

### Over the past decade, in times of market uncertainty, money market flows tended to be higher (January 2007 – May 2024)



Sources: Bloomberg Finance L.P., Federal Reserve St. Louis, DWS Investment GmbH as of 5/10/24

The development of the index in early 2020 was particularly striking. The global outbreak of Covid-19 sent shockwaves through the financial markets and prompted many investors to allocate capital to the perceived safety of money market funds. The increase in weekly inflows into these funds in early 2023 was also striking, as concerns about the stability of U.S. regional banks drove volatility sharply higher. This was not just a general flight to safety. Large amounts of deposits held at the troubled regional banks and other smaller regional banks were moved as investors feared for the safety of these funds. Not only did capital shift towards money market funds; deposits in larger U.S. banks, which were perceived to be safer, were also very popular.

<sup>2</sup> St. Louis Fed Financial Stress Index St. Louis Fed as of 5/10/24

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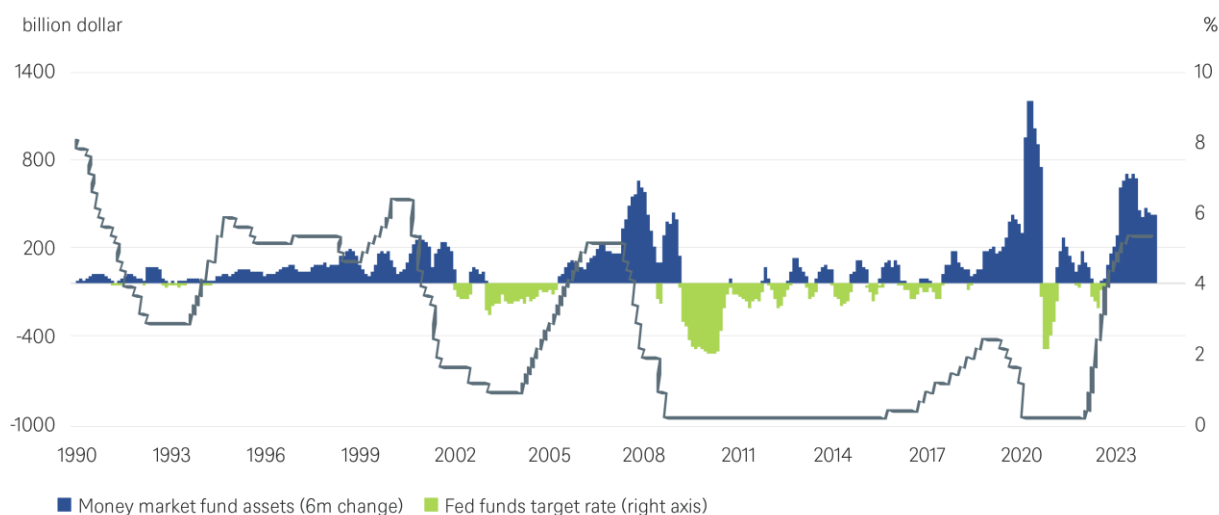
### 1.3 Money market funds as a "safe haven" with attractive interest rates

The supposed relative attractiveness of investments in money market funds compared to the available alternatives is an important factor influencing inflows into this asset class, but just one of many. And the degree of attractiveness varies considerably in market phases, depending heavily on the monetary policy of the U.S. Federal Reserve.

After the 2008 financial crisis central banks around the world kept interest rates at rock bottom, creating a capital market environment that was extraordinary in many respects. Yields in international bond markets fell to unprecedented lows and even negative territory in some sub-markets and segments.

In March 2022 the Federal Reserve began to raise interest rates in an attempt to curb runaway inflation. About two months later the U.S. yield curve inverted, with shorter maturities yielding more than longer maturities. The inversion of the Treasury curve continues to this day. Against this backdrop it has been more attractive to invest in shorter maturities, offering higher yields. As a result, even before the outbreak of the regional banking crisis in the U.S. in March 2023, the volume of money market funds had risen in line with money market yields, although the increase was still quite modest. From the start of the rate hike cycle in March 2022 until just before the start of the banking tensions, money market fund assets increased by around USD 330 billion, or around USD 28 billion per month. In our view, this seems to be a good representation of typical investor behavior during a Fed tightening cycle.

#### Money market fund volumes tended to have a response lag to Federal Reserve interest rate cuts (January 1990 – May 2024)



Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 5/10/24

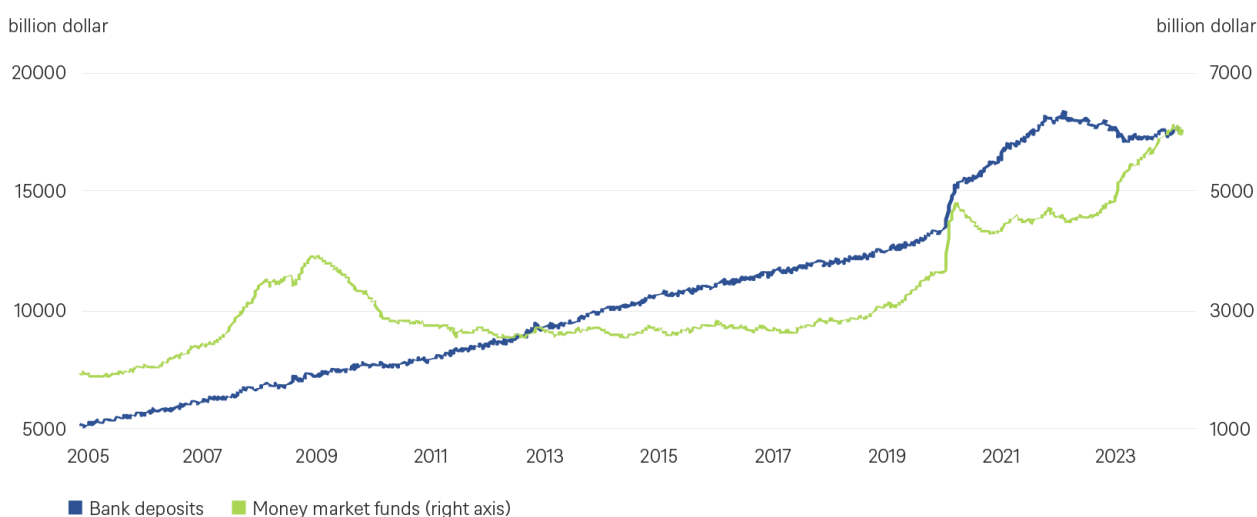
Research by the Federal Reserve Bank of New York has shown that, in the past, a one percentage point increase in the effective federal funds rate led to a 6-percentage point increase in fund assets over a two-year period because of the close correlation with money market fund yields.<sup>3</sup> This shows that money flows are generally quite slow to react to changes in yields. In our view, however, it is also important to note that the relationship often does not hold during periods of financial stress. A pertinent example is the Covid-19 outbreak in 2020, when a massive increase in money market fund inflows coincided with a sharp decline in policy rates.

<sup>3</sup> Monetary Policy Transmission and the Size of the Money Market Fund Industry New York Fed as of 4/3/23

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Another factor in this context is the sometimes stronger, sometimes less pronounced competition between money market funds and investors' deposits at banks. Until the outbreak of Covid-19, bank deposits showed a rather dull momentum of their own, with growth rates that were comparatively constant for well over a decade. It was only the extreme reduction in key interest rates in the wake of the pandemic that provoked a marked interest in not only money market funds but also bank deposits, with the zero-interest rate policy then making deposits more attractive. This lasted almost until the problems of the U.S. regional banks became apparent. This crisis, which, at least for a brief moment, was seen as a threat to the entire banking system, proved something of a spark for money market funds. Their volume catapulted to the levels we see today without any major setbacks.

### Money market funds and bank deposits compete only occasionally (January 2005 – May 2024)



Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 5/10/24

To summarize, relative attractiveness of course influences inflows into money market funds, but the relationships are complex. Which influencing factor dominates the inflows into money market funds depends very much on the broad market constellation.

## 2 / No massive outflows expected at present

### 2.1 Sustained outflows are unlikely in the short term ...

At the beginning of the year many market participants expected the Federal Reserve to embark on a cycle of interest rate cuts relatively soon, with up to seven cuts for the federal funds rate in 2024. This expectation has since been significantly revised; the first full cut is no longer priced in before November and, based on current pricing, the Fed is likely to cut only once this year. A change in market conditions, should it occur, is likely to have a noticeable impact on the record volumes in money market funds. But for now, we do not expect an imminent change in the picture.

If we look at the past five Fed rate cut cycles, money market fund inflows increased in anticipation of the first rate cut, only to slow significantly once the Fed began to cut rates. Historically, however, outflows have typically begun twelve months after the start of a rate cut cycle. If we now assume that the Fed's first rate cut will be delayed further and that the number of cuts will be far fewer than recently expected, we believe there are still good reasons to hold capital in money market funds, especially given their relative attractiveness. In addition, the U.S. is in an election year and numerous serious geopolitical

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tensions are unlikely to be resolved any time soon. Investor nervousness is therefore likely to remain high. There is also the question of whether a significant market correction is imminent, given the high valuation of U.S. equities, in particular.

## 2.2 ... nevertheless, developments should be monitored closely

Given that a large portion of the money in MMFs might be described as "fast" money – ready to move out as quickly as it has moved in – we believe there is a certain risk if too much capital is suddenly divested out of these funds. It could mean that MMFs would have to liquidate part of their holdings extremely quickly in order to meet the high liquidity demands. In addition, funds that are divested at very short notice, but perhaps also in a very targeted manner, might cause unwanted volatility in the market segments into which they flow. It is therefore advisable to keep a close eye on the record volumes in U.S. money market funds and to be aware of the risk of future volatility.

## Glossary

The **Eurozone** is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

**Fed Financial Stress Index** of the St. Louis is an index measuring the degree of financial stress in markets published by the Federal Reserve Bank of St. Louis.

**Federal Reserve Bank** is a regional bank of the Federal Reserve System, the central banking system of the United States. There are twelve in total.

**Inflation** is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

**Money market fund** is an open-end mutual fund that invests in short-term debt securities such as US Treasury bills and commercial paper.

The **U.S. Federal Reserve**, often referred to as "**the Fed**," is the central bank of the United States.

**Volatility** is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

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