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A WORD ON EURO MONEY-MARKET FUNDS

EURO MONEY-MARKET FUNDS ARE BACK WITH A VENGEANCE

Yannick Lopez, Head of Fixed-Income Investment and Cash Management Solutions, gives us some fresh insight into the outlook and opportunities in money-market funds and short-dated corporate bonds during the ECB's tightening cycle.

The euro zone money-market asset class went through a rough patch between 2016 and 2022. Why was that?

We are indeed coming out of six highly challenging years, which played out under the dual impact of a steep drop in central bank key rates and, more recently, a spike in inflation. Against this backdrop, money-market investors lost money in terms of real yields and even absolute yields.
This trend began to reverse itself in early summer 2022 after the European Central Bank (ECB) began a tightening cycle in July. This ultimately ended the unprecedented period of negative key rates. Over the past year, euro money-market funds have returned somewhat to normal, with positive yields.
With the spectacular spike in key rates in recent months, we believe that money-market funds are once again truly worthwhile, combining attractive yields and still very high liquidity, with a lower risk that is consistent with a short investment horizon.

How has this shown up in the performances of money-market funds?

2023 is shaping up as a positive year for the performance of euro money-market funds. Yields on our money-market funds, which are invested mostly in short-term negotiable debt securities (often maturing in 1 month to 1 year) are issued by companies and banks and yield between 5 and 20 basis points above €str, the overnight rate calculated by the ECB, which was around 3.65% in early September. In our view, this makes the money-market asset class especially attractive, given its level of risk.

Can we be sure that abnormal negative yields are behind us?

Yes, we very likely can. Of course, caution is still in order, given that 10 years back it was very hard to imagine negative rates and simply unthinkable that Germany's 10-year yield would one day fall as low as -0.90%, something that actually happened in 2020.
Nevertheless, we believe this is highly unlikely to happen again in the coming years, given that we have exited a decade of almost zero inflation, the result of globalisation and offshoring of production facilities, particularly to Asia. What change things was the two shockwaves of Covid and the war in Ukraine. These crises brought to light both our dependence on global logistical supply chains and certain commodities, food commodities in particular, of which Ukraine is a major producer. In reaction to these two shockwaves, Western countries revised their supply chains and instituted policies of reshoring their production facilities, which caused a structural rise in prices.
We expect inflation, once it is past its current peak, to remain sustainably high and possibly above the ECB's target, and that is likely to keep central banks from returning any time soon to an accommodative monetary policy.

Isn't there a risk that an ECB rate cut that would undermine the performance of money-market funds?

The possibility cannot be ruled out and this is even our baseline medium-term scenario. We are very likely at the peak or close to the peak of the monetary tightening cycle. Visibility nonetheless is still limited and calls for caution in making forecasts. In early

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2023, economists were unanimous in declaring that the US economy could plunge into recession in mid-year, and that this would cause inflation to recede drastically. So far, it's the opposite that has occurred, with an economy that has been especially resilient, and inflation that has stayed high, albeit while receding somewhat.

In Europe, in contrast, economic momentum was very sluggish and was an argument for the ECB to end its rate hikes. However, the ECB must deal with inflation that is still very high, due in part to services and wages.

Against this backdrop of reduced visibility, we feel that the money market is an asset class worth overweighting. Even if the central banks end up cutting rates within the next few quarters, investing in the money market as it is peaking makes sense as that locks in relatively high yields throughout the investment horizon.

We are now facing an inverted yield curve, with the 10-year German yield at about 2.65% in mid-September, whereas the money-market rate is 3.65%. That means that the markets are pricing in a cut in the ECB's key rates next year. Should that not happen, long bond yields would rise back, to the detriment of long-duration(1) assets. The money market accordingly offers a form of protection, as it is not affected by this type of shift.

What about short-dated corporate bonds?

The investment grade(2) euro credit asset class - meaning the lowest-risk corporate bonds - is currently yielding about 4.35 %(3), which is relatively close to money-market yields. However, it is more sensitive to shifts in interest rates, which is not good when interest rates are moving up. It may, however, be wise to take on exposure to investment grade corporate bonds, assuming a rate cut soon by central banks in reaction to an economic slowdown and normalisation of inflation. In our view, the slope of the yield curve and spreads(4) makes short-dated corporate bonds maturing in 1 to 3 years attractive.

Assuming an ECB rate cut, yields on money-market funds would gradually decline, while funds invested in investment grade corporate bonds, would, at constant spreads, retain the benefits higher-yielding issues for longer, due to their longer duration.

Investing in short-dated investment grade corporate bonds therefore looks like a worthwhile opportunity within a moderate risk framework, particularly as its interest-rate sensitivity is three times lower than "all-maturities" investment grade, in order to lock in yields on a slightly longer investment horizon than is available on the money market.

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(1) Duration: weighted average life of a bond or a bond portfolio, expressed in years.
(2) Investment grade (IG) bonds are bonds issued by those borrowers that are rated the highest by ratings agencies. Based on the classification of Standard & Poor's and Fitch, their ratings range from AAA à BBB-.
(3) Source: ICE BofA Euro Corporate Index as at 12 September 2023
(4) The credit spread is the interest-rate differential between a corporate bond and a benchmark bond of the same duration that is regarded as the least-risky (the benchmark government bond).

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