CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

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Italy, Money Funds, Rising Short-Term Rates

The rise in short-term interest rates, occasioned by the Fed's slow process of raising the Fed funds rate, has made money market funds a viable investment. For years after the financial crisis, money funds yielded essentially nothing. Now the yield is roughly equal to the rate of inflation and those yields are rising.

By

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I wrote most of what follows in the letter below a week ago and was on the point of sending it when the latest drama in Italy's long history of unstable governments shook financial markets around the world. A rather brief and somewhat ill-informed synopsis: In its March elections, the rather strange Five Star party and the far-right Northern League party won, between them, fifty percent of the vote and allied to form the new government. Italy's president, whose duty it is to approve ministers of new governments, refused to permit the man nominated to be finance minister, because he is outspokenly opposed to the Euro. Although many Europeans and others in the West were discomfited by the notion that these two rather unusual parties would be forming Italy's government, the prospect of an immediate new election, after the impasse with the finance minister, was even more alarming. It was feared that the two parties would likely gain more support under these circumstances.

Markets around the world fell very sharply on Tuesday, especially in Europe, as this drama unfolded. Then came a resolution on Wednesday among the two parties and the president, leading to a relief rally. Meanwhile, in Spain, the long-serving prime minister, Mariano Rajoy, lost a parliamentary vote of no confidence, leading to the appointment of the Socialist party's Pedro Sanchez. The week ended calmly enough, but geo-political risk made itself clear. It is generally the case the markets ignore events that would appear to be unsettling to investors. We got a reminder last week that political events can have harsh consequences. We have not heard the last from Italy and Spain.

Short-term interest rates and money market funds. After a turbulent period in late January and February, stocks have drifted fairly quietly in recent months, gaining a bit of ground but still standing below the highs set in January. Our president, with his typical impulsiveness and upending of long-standing agreements, practices and alliances, has caused instances of short-term dizziness in stock markets, but, for better or worse, the world and investors seem to have become inured to Trump chaos. By contrast, action in short-term bond markets has been striking. Yields on the two-year treasury have climbed steadily for the last year, from around 1.25% a year ago to 2.50% now. This reflects ongoing Federal funds rate increases by the Federal Reserve and the prospects for more ahead At its meeting later this month, the Fed is likely to raise Fed funds by another 0.25% increase from the current 1.75%.

This increase in short rates has consequences for the broad economy and the markets. Among other things, it has caused the dollar to rise against major foreign currencies, after its depreciation from January 2017 to January 2018. The increase in Fed funds has lead to a corresponding increase in money-market funds, at least those pegged to short-term rates. (More on this latter point below.) Financial conditions generally have become slightly tighter over this last year. This so-far modest tightening of financial conditions may presage conditions that can have an adverse effects on the economy. After several years with inflationary pressure non-existent, US inflation is slowly moving up and now stands near 2%, which the Fed considers an appropriate level. Because money funds are now offering a decent yield and with higher rates ahead, we can once again treat money fund holdings as a viable investment position.

Schwab's money fund decisions. In the years after the financial crisis, during which the Fed cut rates essentially to 0%, companies like Schwab that issue and maintain money-market funds found themselves in a losing position. Such companies maintained the fixed dollar price of their money-market funds, but had to bear the costs of operating them and could pay a yield only infinitesimally above 0%. In the last year, with the modest, but steady increases, money-market funds can pay the companies like Schwab their costs in managing them, and still pay a decent yield to investors. For example, one of Schwab's principal money funds now yields 1.74% and it pays Schwab 0.39% for its management of the fund. Thus, fund sponsors and the investors both make money now. Investors will earn more, as the Fed continues to raise rates.

Schwab has decided to keep the benefits of rising interest rates to itself. For a couple of years, it has required that all new accounts accept a Schwab Bank managed fund as its 'sweep' money fund. (A 'sweep' fund is one that automatically receives all proceeds of securities sales and other money kept in 'cash.') The Schwab Bank sweep fund pays 0.15% per annum. Schwab has no plans to raise that payout, even as the Fed continues to raise rates. Within a few weeks, Schwab will transfer to its Schwab Bank sweep fund the money market fund balances for all Schwab accounts. I have had extensive conversations with Schwab executives about this. They admit it is contrary to their customer's interests and contrary to Schwab's longstanding practice. But, Schwab makes no apologies and is adamant about sticking with the new policy and capturing for itself the benefits of rising interest rates.

The work-around. Schwab continues to manage several 'normal' money-market funds, by which I mean funds that purchase short-term commercial paper and government securities, and, after normal expenses, pass on the investment income to its investors. The one I refer above, Schwab Value Advantage Money Fund, symbol swvxx, is one such fund. We are able to purchase this fund for Core's clients so that our clients will receive the benefits of the rising short-term yields. We have begun this practice. We make our estimate of the short-term cash needs for given accounts of our clients, and use the excess to purchase swvxx. By this, we will achieve for our clients most of the benefits of rising rates they would expect if Schwab had not decided upon its new policy.

A caveat. We are aware of the client accounts from which regular distributions are made and those against which clients write checks from time to time. We intend to maintain sufficient cash in the Schwab Bank sweep fund to fund those distributions. However, we request that you contact us if you write a check of an unusual amount against an account that we manage, so that we may assure that funds are available in the sweep account to fund the check payment. The risk is that an unexpected check may give rise to a debit balance on which Schwab will impose somewhat high margin interest rates, or that the check will not be paid. If you have questions about any of this, please contact us.

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