The Squeeze Play  
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- Reductions in Treasury bill and commercial paper issuance compounded by developments on the demand side mean the “squeeze play” is on for many short-term portfolios.

- Investors should consider the potential for substantive changes to liquidity conditions as banks contend with increases in capital requirements due to updated Basel III regulations.

- Active management of short-term investments is important: Don't rely on static regulatory frameworks or traditional indexes to determine a portfolio's unique liquidity needs.

Some people have no time for the sport of baseball, including PIMCO’s founder, Bill Gross, as he noted recently in his Investment Outlook. However, I suspect that many investors in the cash and money market realms of fixed income provide a fairly large fan base. Why, you ask? In a sense, baseball resembles liquidity management; these investors appreciate the strategic nature of a game in which the victors tend to be masters of managing downside risk while seizing upon opportune situations that have the potential to produce consistent gains – singles and doubles, not necessarily home runs – for their team.

One of the most exciting moments in baseball is the bunt – or, more specifically, the classic “squeeze play,” when a batter bunts to spread the defense while hoping to advance a runner from third base across home plate. As liquidity managers, we are always trying to advance our runners, so to speak – one base at a time. For successful teams this strategy does not mean always swinging for the fences, but instead is about trying to consistently put runners in scoring position, with the ultimate goal of getting them safely across home plate.

Most money market investors today are experiencing another kind of squeeze as their offensive “batting power” is being suppressed by near-zero interest rates and the confines of a stricter regulatory playing field. Along with the low yield environment caused by a federal funds rate that we expect will hover near zero until 2016, there are additional elements that may make it more difficult than ever for money market investors to manage today’s pressures. While baseball season might be coming to a close, the game of avoiding punitively low returns will likely continue for the markets until spring training commences, and beyond.
The Federal Reserve’s recent announcement that it will postpone tapering while suggesting a lower trajectory for growth and inflation for the foreseeable future was a boon to investors who were long duration and forward rates. For very short-term investors, yields closer to the policy rate target range were mostly unaffected by the recent volatility further out the yield curve. In fact, yields in the front end remain just as compressed as they were earlier this year. Most U.S. Treasury bills now yield less than 2 basis points (0.02%) for maturities as long as six months. Bottom line: These investors are generally paying more than ever for the privilege of maintaining daily liquidity in their portfolios.

But yields resulting from monetary policy are only one side of the equation. Supply and demand imbalances can also have a profound influence on outcomes. On the supply front, there is a dearth resulting from a reduction in T-bill issuance (a decline of over $100 billion in the past month alone) due to the Treasury’s deficit reduction, as well as a growing shift away from commercial paper (CP) issuance at financial institutions who prefer longer-term funding for their operations in light of altered capital and liquidity requirements. On the demand side, there is a trifold development that can only compound the supply-demand imbalance for liquidity investors: 1) inflows into government-only money market strategies due to expected money market reform measures that will likely discourage investments into prime (credit) strategies, 2) increased margin requirements to post for central clearing, which increases demand for high quality assets (i.e., agencies and T-bills) and 3) investors shifting farther out along the liquidity curve into short-term bond strategies. The third theme alone has added more than $63 billion in assets year to date to short-duration bond strategies around the world (EPFR Global data as of 31 August 2013, which includes short-term government bond, short-term corporate bond and short-term bond categories).

Moreover, investors should consider the potential for substantive changes to general liquidity conditions as the traditional liquidity providers – banks – contend with increases in capital requirements due to updated Basel III regulations. Specifically, U.S. institutions face proposed Supplemental Leverage Ratios, outlined by the Fed and the Office of the Comptroller of the Currency (OCC), that would create higher capital hurdles for low margin businesses such as repo funding and liquid products trading (e.g., T-bills or CP). Although still in its formative stages, such a proposal could impair these markets via reduced supply and reduced liquidity. While not an immediate threat, we expect this will be a top concern for cash and short-term portfolios as we approach 2014.

So the squeeze play is on for short-duration portfolios. And much like the best baseball managers adapt their game plans to put the odds back in their favor (think replacing a tried-and-true hitter with a pinch runner more suited to the situation), we believe the best investment managers should seek alternate strategies and look to reassess and reposition portfolios in an effort to put the odds back in their favor. Today’s short-term investors can consider the following ideas to adapt portfolios to the evolving market and regulatory conditions:

- Tactically take advantage of steep rates in the front end: Despite recent dovish comments and actions from the Federal Reserve, forward rates globally remain elevated, providing attractive opportunities not only for income but also capital appreciation – especially with major central banks around the world likely to be on hold for the next few years.

- Appreciate that while the economy continues to improve, albeit at a subpar pace,
opportunities in front-end credit are attractive for liquidity investors who have resources to underwrite the credit risk properly. Consider focusing on nonfinancials (which have lagged the recent rally that has primarily benefited financials), especially with maturities in 2015 and 2016.

- Don’t be complacent about previous sources of liquidity risks and contagion. The debt ceiling debates in D.C., as well as ongoing European sovereign concerns, will continue to oscillate waves of liquidity – ebbs and flows – into the broader marketplace. Investors should not assume current sources of liquidity or issuers of presumed "safe assets" will remain consistently stable – because they very likely will not.

- Collect liquidity premiums: Barbell portfolio strategies are designed to deploy cash strategically when liquidity premiums (including new issue concessions) warrant investment.

- Actively manage short-term investments: Don’t rely on static regulatory frameworks or traditional indexes to determine a portfolio’s unique liquidity needs. For example, traditional passive indexes are constructs of the larger market and may not be the best representative fit for liquidity-minded investors. Such indexes are often overweight higher-volatility financial securities (due to their higher issuance within the broader market) and can often exclude floating-rate securities, which may be attractive in an unexpected rising-rate environment as their income streams reset to the current rate level on a regular basis.

We at PIMCO continue to seek out these opportunities and adapt our game plan for short-term strategies, utilizing our deep bench of ideas on both offense and defense in an effort to outperform traditional liquidity money market strategies on a risk-adjusted basis. In doing so, we look to preserve liquidity and capital, and generate returns consistently – much like turning a squeeze play into a score, advancing our runners one base at a time to get them across home plate.

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