Talking point

Euro area money market funds: turning the corner?

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Euro area money market funds have returned to growth, according to the latest ECB data. By March 2015, they managed EUR 1,032 bn in assets, up by EUR 120 bn from a year earlier. A similar surge in assets was last seen before the financial crisis, which marked the beginning of a prolonged decline. Amazingly, the upward trend in assets occurred while money market yields hit record lows, especially for the euro. So what is really behind MMF asset growth?

Assets managed by euro area money market funds rose above the EUR 1 trillion mark in Q1 2015. Net inflows amounted to a respectable EUR 34 bn over the past four quarters. Before 2008, however, inflows were many times higher than this. Rather, it was mainly the euro's depreciation which inflated foreign currency assets. In the euro area, half of all MMF assets are denominated in foreign currencies. The ECB reports MMF statistics in EUR, though, i.e. half of MMF assets "grow" in line with falling EUR exchange rates.

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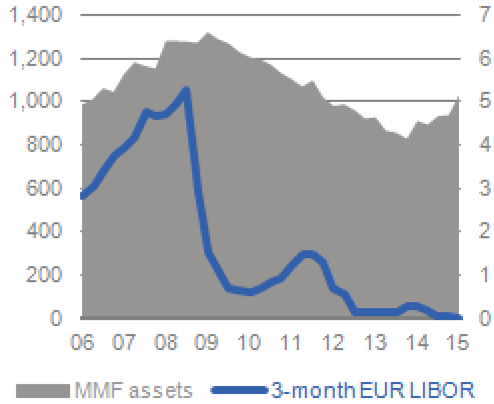
Assets, EUR bn (left), 3-month EUR LIBOR, % (right)



Annotation: Due to statistical reclassifications, AuM were reduced by about EUR 194 bn between Q2 2011 and Q1 2012, and increased by EUR 69 bn in Q1 2014.

Sources: ECB, WEFA, Deutsche Bank Research

While USD assets declined in USD terms during the past four quarters, they grew significantly when stated in EUR. In March 2015, euro area MMFs held USD 294 bn in USD-denominated debt, which was equivalent to EUR 273 bn. However, converted using the exchange rate of a year earlier, the value would have only been EUR 213 bn. GBP assets increased both in GBP and EUR terms, but the increase in the EUR figure was much more pronounced as it was inflated by about EUR 25 bn due to the depreciation of the euro. Of course, changes in asset volumes can also arise from price revaluations or statistical reclassifications but there are no signs of these factors having had a substantial impact between Q1 2014 and Q1 2015.

The liability side of MMFs' balance sheets also provides evidence of a notable foreign exchange impact. Investors from the euro area placed a net EUR 13 bn in fresh funds with euro area MMFs and their outstanding claims on MMFs grew in the same range. Similarly, foreign investors (i.e. those based outside the euro area) put about EUR 12 bn in new money into euro area MMFs. However, the total value of their investment in MMFs rose by a staggering EUR 95 bn. This mismatch is largely explained by the appreciation (measured in EUR) of the MMF shares issued in USD and GBP that are largely held by foreign investors. (A remaining EUR 9 bn of inflows cannot be allocated by investor residence.)

The extremely low EUR money market rates – below the USD and GBP rates – are starting to trigger some changes in MMFs' portfolio structure. For instance, it has become attractive even for companies and institutions which are not based in the euro area to raise funds in EUR. Thus, it is not surprising that MMFs increased their investments in EUR-denominated paper issued by foreign debtors. Another gradual change is underway regarding MMFs' foreign currency exposure. Usually, MMFs use only their base currency for both accepting money and investing the funds received. Now, there are signs that EUR-denominated MMFs are trying to enhance their wafer-thin returns by diversifying their investments into some other currencies as well – and simultaneously hedging the greater risk. The ECB has already observed an increased usage of FX swaps.

In sum, it is too early to say that MMFs in the euro area have turned the corner, as most of the recent asset increase reported in EUR was driven by the exchange rate effect. Nevertheless, MMFs' business model has proven to be resilient in the face of low and even negative interest rates. Although below pre-crisis levels, the recent inflow of fresh investor money was encouraging. Cash-rich investors still have to place funds regardless of the interest rate environment. Alternative investments directly in money market instruments or bank deposits do not promise better returns than MMFs, and MMFs still offer risk reduction based on diversified and liquid portfolios. Banking regulation might play into MMFs' hands as well, since banks increasingly refuse to accept big sums of short-term deposits from corporates. This promises higher net inflows for the MMF industry. In the medium term, though, the greater challenge may be on the asset side. Pending MMF regulation will redefine what debt MMFs are allowed to invest in, and Basel III will probably induce banks to issue less short-term debt – hitherto the dominant asset class in MMFs' portfolios. MMFs will have to adjust their portfolios more than they did so far due to the low interest rates.

Please see also:

EU Monitor "Money market funds – an economic perspective: Matching short-term investment and funding needs", February 2015

EU Monitor "Geldmarktfonds: Wie sie funktionieren und wer sie nutzt", May 2015

Presentation "Geldmarktfonds - Wie sie funktionieren und wer sie nutzt", July 2015

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