UBS

Liquidity Perspectives—1Q17

Key policy dynamics: potential implications for cash management in 2017

- In this first issue of 2017, we discuss key policy dynamics that could affect the corporate cash management landscape this year.
- In terms of monetary policy, the path for normalization seems to be underway as the Federal Reserve raised rates in December 2016 and hinted at making additional increases this year.
- On the budgetary front, the long-term outlook suggests increasing governmental borrowing needs due to an expansionary fiscal policy that includes tax cuts and infrastructure spending.
- In the short run, Treasury issuance at the front end of the curve will remain constrained as the U.S. Treasury reduces its cash buffer in preparation for March 15, when the debt ceiling suspension is scheduled to expire. These dynamics should favor a continued widening of the spread between Prime and Government funds in the first quarter of this year.
- Corporate tax reform is another main item on Washington's agenda for 2017. We look at how cash management strategies could be affected.

The political backdrop

After years of accommodative monetary policy, 2017 may be the year we turn the page on sub-1% Fed Funds levels that have been in place since the financial crisis as we continue more aggressively on the path of rate normalization and reduced regulatory constraints. Although the path to higher rates has been hard-earned after years of quantitative easing, the prospect of deregulation from the Trump administration is certainly bound to challenge the status quo.

We believe the combination of an improving economic cycle and the prospect of regulatory reform has given financial markets a sense of optimism. Whether the excitement is justified has yet to be seen as market participants continue to gain a firmer grasp on how President Trump's rhetoric will translate into policy. The prevailing market optimism is furthered by recent Fed comments that hint at a steady path of rate normalization, which should be welcome news for cash investors.

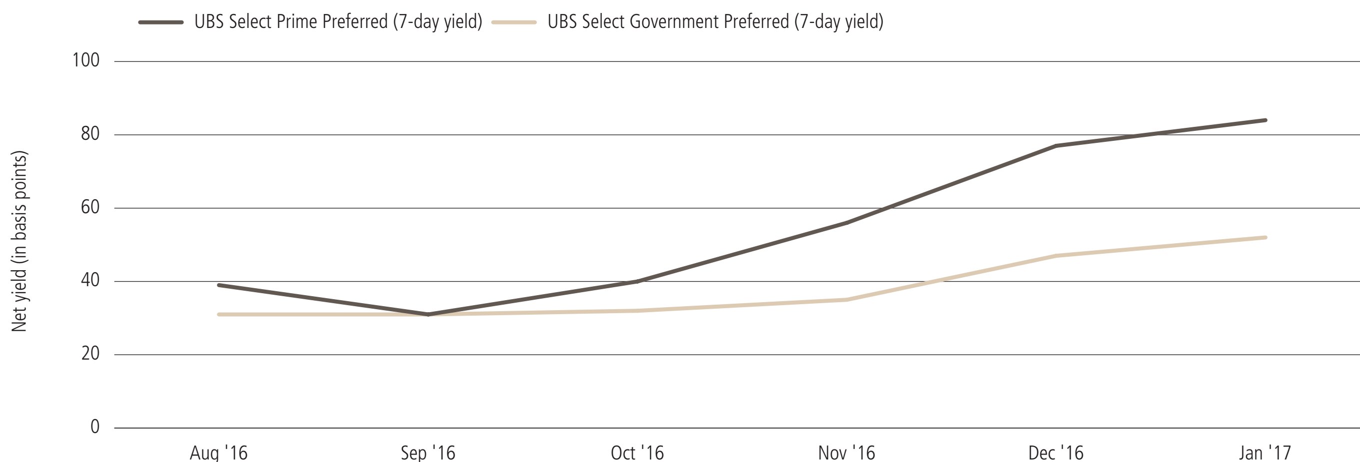
Against this backdrop, corporate cash managers are presented with a new set of challenges. Now that the bulk of regulatory changes affecting US-domiciled money market funds are behind us, we think the focus will shift to policy-related dynamics. The debt ceiling and unwinding of the Fed's balance sheet will be of heightened importance and will weigh significantly on the front end of the yield curve in early 2017. Taxes will also take a front-row seat as President Trump and Congress seek to enact legislation reducing corporate taxes to motivate multinational corporations to repatriate cash.

Front-end dynamics

On the budgetary front, the long-term outlook suggests an increase in government borrowing, primarily to support a potentially expansionary fiscal policy, which could include a combination of infrastructure spending and personal and corporate tax breaks. Furthermore, as part of its continuing effort to normalize monetary policy, the Federal Reserve is expected to gradually reduce the holding in its System Open Market Account (SOMA) portfolio. As a result, the amount of interest earned on the SOMA portfolio—which is transferred as income to the U.S. Treasury—will also decrease, further raising the government's long-term borrowing needs.

In the short term, however, Treasury Bill issuance is constrained as we approach the expiration of the debt ceiling suspension in mid-March. The U.S. Treasury is under pressure to lower its cash buffer to the pre-suspension level of approximately USD 25 billion. One measure it has taken to achieve this is to let Treasury Bills mature without replacing them. The reduced Treasury supply has put downward pressure on Government yields, further widening the spread between the yields on Prime Money Market Funds and Government Money Market Funds (see Figure 1).

Figure 1: Spreads between Prime Money Market Funds and Government Money Market Funds



Source: UBS Asset Management, as of January 31, 2017.
The returns shown above are based on currently available information and are subject to revision. Past performance is no guarantee of future results. Performance figures are net-of-fees. Returns are in USD. For more information please visit www.usmoneymarketfunds.com/daily-yields.html.

Widening spreads will also be driven by Prime Money Market Funds' increased ability to manage further out on the curve now that assets under management in this space have started to increase after stabilizing in late 2016.

Given that many Government Money funds have access to the Federal Reserve's reverse repo program (RRP) facility, there is effectively a "soft floor" that we don't think Government fund yields will fall below. Additionally, once the debt-ceiling hurdle clears, Treasury Bill issuance should spike higher, providing Government funds an opportunity to stay competitive.

Tax reforms

One of the key items on Trump's policy agenda for 2017 is corporate tax reform. Never has the political landscape—a Republican President and a Republican-controlled Congress—been so well aligned for a change to take place. It is likely that a compromise will be achieved, with the aim to reduce corporate taxes to motivate firms to bring cash back to the US. The tax windfall, however, will fall short of the USD 1 trillion increase in infrastructure spending that the Trump administration intends to roll out over a 10-year period. The Institute on Taxation and Economic Policy estimates that US companies will collectively pay an estimated USD 206 billion in taxes under Trump's proposal that could reduce the corporate tax rate from 35% to 10%.[1]

It is worth mentioning that not all companies will benefit from tax reforms. The UBS Equity Strategy team indicated that industry groups such as food and staples retailing and health care equipment may benefit the most due to currently high effective tax rates.[2] Other industry groups such as telecom and media may benefit less because they currently have relatively lower effective tax rates. Other regulatory proposals to simplify the tax code, such as the treatment of interest tax deductibility and bonus depreciation, may complicate the repatriation calculus even further.

In the end, the decision to repatriate cash may prove to be a more basic business consideration, which in large part has to do with whether the cash at play is operating, reserve or strategic. Once various layers of cash are well-understood, a cost benefit analysis can be conducted to determine the most economically efficient way to maximize shareholder value.

Layers of cash: impact and likelihood of repatriation:

- **Operating cash:** Operating cash is least likely to experience any changes because it typically relates to working capital needs of foreign entities and will most likely continue to be held offshore.
- **Reserve cash:** Reserve cash has the potential to be partially repatriated. Multinationals use reserve cash for capex, acquisitions and R&D. It is expected that firms will continue to deploy

[1] Source: The Institute on Taxation and Economic Policy, Multinational Corporations Would Receive Half a Trillion in Tax Breaks from Trump's Repatriation Tax Proposal, January 18, 2017.
[2] UBS Securities LLC.

reserve cash for similar purposes regardless of jurisdictions, unless the tax benefit brought forth by the new reforms outweighs the potential long-term returns that could be generated. Although this may be true in certain cases, we believe it is likely that a greater portion of reserve cash will not be subject to change.

- **Strategic cash:** Strategic cash may be most likely to be repatriated. Strategic cash accumulates in companies when they generate more liquidity than they could spend and is deployed in short-duration investments, such as corporate bonds and structured fixed income products. A more favorable tax rate in the US may entice companies to repatriate strategic cash, as the economics of tax reforms may favor shareholder distribution (dividends and buybacks) over short-duration investments of cash.

The shift away from regulatory reforms, which had a profound impact on cash management strategies in the years that followed the financial crisis, is a welcome change. However, the renewed focus on policy-related dynamics comes with significant challenges as well, especially against a highly uncertain geopolitical backdrop. Cash managers will find it more important than ever to stay on top of these policy changes and develop scenarios that will help them prepare for extreme outcomes.

Figure 2: Sample cash management framework post-tax reforms/repatriation

Cash type	Current usage	Post reform usage	Post reform jurisdiction	Deployment
Operating cash	Working capital	Working capital	Remains offshore	Offshore bank deposits and money markets
Reserve cash	Capex and M&A	Capex and M&A	Moves onshore in part	Ultra-short investments (duration less than 1 year)
Strategic cash	Short-term investments	Dividends and share buyback	Moves onshore	Onshore bank deposits and money markets

The views and opinions expressed were current as of February 2017. We encourage you to consult your Financial Advisor regarding your personal investment program.

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