Money Markets: Tail Risks Resurface in Eurozone

During the past several years, the troika (European Central Bank, International Monetary Fund, and European Commission) has authorized bailout packages for Greece, Ireland, Portugal, and Spain without impacting depositors. The troika’s support helped form a period of stability, significantly lowered tail risks, and reduced the probability of adverse outcomes. European Central Bank (ECB) president Mario Draghi’s “whatever it takes to preserve the euro” speech in July 2012 contributed to a sanguine environment that facilitated improved market conditions. The recent implementation of the European Stability Mechanism and discussion of the Outright Monetary Transactions program, which were designed to provide a safety net for deteriorating banking systems and countries experiencing widening sovereign credit spreads, has comforted short-end market participants. Since June 2012, money market fund managers have almost doubled their exposures to the largest banks located in core eurozone countries of Germany, Netherlands, and France.

However, despite the progress in reducing financial contagion concerns, the region has experienced five consecutive quarters of negative GDP growth exacerbated by significant austerity measures enforced on the eurozone’s peripheral economies. Its weakened economic state leaves the region susceptible to damaging tail risks that arise quickly and restrain positive economic momentum. Two examples of tail risks occurred in March—the uncertain outcome of Italian elections and the resolution of the Cyprus bailout. While neither of these idiosyncratic events will likely cause financial contagion, the concept that depositors will bear the brunt of a failed banking system gave investors pause. The real concern is not that the Cypriot banks failed, but rather that other regimes would look for depositors to pay for their failed banking systems. Less than eight months following Draghi’s “whatever it takes” speech, the ECB threatened to end emergency liquidity assistance to Cypriot banks. Cyprus and the troika ultimately reached a last minute deal that spared depositors holding less than €100,000, while imposing a significant haircut (40%-80%) on large depositors. This result marks a substantial change in the ECB’s rescue approach, as both investors and depositors may participate in the cost of failed institutions. Furthermore, deposits in weaker countries may be subject to capital controls that would prevent deposits from being transferred out of the country and lead to greater capital flight during future crises. These events serve as a reminder that the fundamental problems in the eurozone have not been resolved.

Despite developments in Cyprus and Italy, LIBOR (London Interbank Offered Rate) fell month over month as central banks around the world continued to flood the market with liquidity (see Exhibit 1, page 2). LIBOR’s stability reflected the ability of systemically important banks to access sufficient capital and liquidity to withstand the aftershocks stemming from the failure of the relatively small Cypriot banking system.
While uncertainty increased in Europe, market participants were also heavily focused on the potential volatility arising from U.S. government affairs. The much-anticipated sequester officially kicked in and, as seemed to be the case with the fiscal cliff, had a smaller initial impact than the market expected. In the medium term, sequestration is expected to be a 1.5% drag on GDP in 2013, but market participants understand that less government spending is probably beneficial to long-run economic growth.

Although the government continues to operate without a budget, it avoided a March 27 shutdown as both the Senate and House of Representatives passed a continuing resolution to fund the federal government through September 30. The next date that could potentially cause market volatility is May 18, when the Treasury once again approaches the debt-ceiling limit. However, if Congress does not increase or extend the debt limit, the Treasury will likely use certain accounting measures through late August or early September in order to meet its obligations.

Impact on money market investment strategy

While Cyprus is an extremely small economy and its debt is not held by any money market mutual fund investors, the events in the country reinforced the importance of sovereign credit research when making investment decisions. During the past several months, Fidelity’s sovereign analysts have been focusing on the Cyprus banking system and Italian elections, projecting likely scenarios and worst-case outcomes in the eurozone as a whole. Our analysts determined that Cypriot banks would eventually require a bailout or some form of restructuring stemming from their exposure to Greek private debt, which was more than 100% of the country’s total GDP.

The depositor write-down in Cyprus could cause concern in other weak eurozone countries, including deposit flight similar to that which Greece and Spain experienced during the apex of the European debt crisis. Considering the uncertainty of the Cyprus crisis resolution and the potential for subsequent volatility stemming from Cyprus, Slovenia, Greece, or other weak peripheral economies, we continue to implement a conservative approach to managing Fidelity’s money market funds. The funds’ eurozone bank exposures are limited to short-dated maturities in the highest quality banks located in the region’s core economies. As of month end, the eurozone bank exposure in Fidelity’s largest nonrated institutional general purpose fund had a weighted average maturity of less than three days, while our largest rated institutional prime fund had no unsecured exposure to eurozone banks. Although we don’t think the current situation in Europe is likely to deteriorate to a point where U.S. money markets are significantly impacted, we believe that this conservative approach is prudent—considering that these types of events can develop quickly and unexpectedly. Fidelity’s investment team remains extremely comfortable with positions in the funds given the volatile environment.

U.S. fiscal policy update: sequestration, continuing resolution, debt ceiling

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Before investing, consider the funds’ investment objectives, risks, charges, and expenses. Contact Fidelity for a prospectus or, if available, a summary prospectus containing this information. Read it carefully.

An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the fund seeks to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in the fund. Interest rate increases can cause the price of a money market security to decrease.

Past performance is no guarantee of future results. Current and future portfolio holdings are subject to risk.

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It is not possible to invest directly in an index. All indices are unmanaged.

Endnotes
2 Fitch Ratings as of Mar. 31, 2013.
4 Congressional Budget Office.

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