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What's Happening with Recent Money Market Fund Flows?

By Brian Reid

Statistics on money market funds inflows and outflows are currently a hot topic in the financial world, so it's a good time to dig into the data and see if we can help explain the latest trends.

Money market funds today hold roughly $2.6 trillion in total assets. During the past two weeks, ICI data show $62 billion in total outflows from these funds—more than we would expect to see due to seasonal flows. The past two weeks' numbers are appreciably larger than the flows recorded in most prior weekly reports this year.

What accounts for the bump? Looking at the data, we believe there are five factors in play. The convergence of these factors and the fluid nature of the markets make it impossible to know which causes are having the biggest impact on outflows—but they are all worth exploring.

Obviously, one factor we can't rule out is that investor concerns about Congress's inability to reach an agreement on the federal debt ceiling may be contributing to the outflows. While the impasse over the U.S. debt ceiling has prompted some questions about the implications for money market funds, we believe those concerns are overstated. I don't know of any scenario in which money market funds would be disproportionately affected compared to other market participants by a failure to raise the debt ceiling. But, like all others in the asset management business, money market fund managers are preparing for market volatility that could arise if Congress doesn't act. Managers are making their funds more liquid and turning to shorter term instruments to prepare.

Four other factors may also be important in explaining the outflows during the past few weeks. First, the extended period of historically low interest rates has led to low yields on money market funds. During the past two years, some investors have shifted their cash to other investment vehicles in search of higher yield. Others may be moving to bank deposits.

Two other factors result from recent changes that are part of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Beginning in January, the Federal Deposit Insurance Corporation began to provide unlimited insurance to non-interest bearing checking accounts. In this low-rate environment, some investors may be choosing to park their cash in such checking accounts for the federal guarantee. During the past eight months, Federal Reserve Board statistics show that demand deposit balances have increased by nearly 20 percent, to more than $601 billion. In comments to regulators, ICI has described the new systemic risks this rule change could present.

The other regulatory change is that for the first time since the Great Depression, banks are allowed to pay interest on business checking accounts. This change went into effect on July 22, and in the past two weeks we have observed heavier-than-usual outflows from money market funds.

Finally, lingering concerns about the European debt crisis and its potential impact on prime money market funds may have also fueled investor concerns in the last two weeks. In fact, prime money market funds experienced a $24 billion outflow over the last two weeks, accounting for 38 percent of the total outflow from money market funds.

Given the fluid nature of markets and events, we cannot know which of these five factors is having the most impact in the larger-than-expected outflows from money market funds. We do know that money market fund managers are facing challenging and dynamic market conditions. Fortunately, their decisions seem prudent and reflective of the markets in which they operate.

Brian Reid was Chief Economist of the Investment Company Institute.
