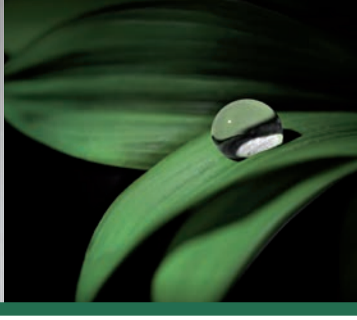
Goldman Sachs Asset Management

Managing Liquidity in Today's Low Rate Environment



With short-term interest rates at or near their lowest levels in history, earning an attractive return on money market investments or other highly liquid strategies remains a challenge. In the interview below, David Fishman, James McCarthy and Jason Granet, of the Goldman Sachs Asset Management Global Liquidity Management team, discuss the outlook for short-term yields, why today's yields may represent a new paradigm that could last for the foreseeable future, and strategies that may offer higher returns in today's environment.

Economic growth appears to have slowed significantly in many parts of the world. What is your outlook for growth over the next 12 months?

David Fishman: We've seen ebbs and flows in economic growth since the financial crisis in 2008, but we have yet to see any sustainable run of growth that would set us up for what we could call a typical recovery. In a typical recovery, the economy is going to grow above trend for a period of time and start to reduce the output gap.

In this recovery, every time the economy has started to turn higher, we've hit setbacks. In 2010, the first round of the European sovereign crisis contributed to a slowdown that wasn't technically a double dip, but certainly looked like one in terms of the shape. Growth picked up pace again with the Fed's second round of quantitative easing, but has slowed once again, thanks in large part to a stubbornly high unemployment rate. Our base case is that the US will avoid another recession, but we don't think it's clear yet what would be the impetus for a reacceleration, so we expect only modest growth for now.

Jason Granet: The European story is different because of the different levels of economic growth among the countries in the Eurozone. Germany has clearly generated some very strong growth and unemployment has fallen to record levels. However, the economic situation across the so-called "peripheral" countries has deteriorated over the last two years, raising global concerns about the European banking system. We don't expect a recession in Germany but we do think growth will be slower and the risks are probably to the downside. The UK is somewhere in the middle between the US and Europe. We believe Europe has a significant influence on UK growth, but so does the US.

James McCarthy: Throughout this cycle, the Fed has handled monetary policy by the so called "crisis playbook", which says that you should lower interest rates until you can't ease any more and then you should do quantitative easing and anything else you can do to make financial conditions easier in a crisis.

What are the implications of these different approaches for market rates?

Granet: The implication for European rates has been increased volatility, whereby overnight and very short rates are moving dramatically in wide ranges. The market has had to adjust potential for ECB rate hikes even as the central bank provides unlimited liquidity for banks. We think this volatility in European short-term rates will continue as long as there are significantly different growth rates within the Eurozone, because that situation creates uncertainty about how the ECB will react to inflation or growth in different areas of the Eurozone.

Fishman: In the US, volatility has been lower because the Fed has committed to holding rates at low levels for an extended period, and has now made that commitment more explicit by stating its expectation that rates will need to remain at current levels until 2013.
Looking out over the longer-term, the timing of any rise in rates is incredibly uncertain, but our view is that it's not a matter of whether US rates will move sharply higher, but when it will happen.

Granet: The UK is between the ECB and the Fed. The BOE has been unconventional in its dealing with inflation but appropriate in its dealing with macroeconomic conditions, which has led to relatively stable market rates and very little volatility.

What is your strategy as portfolio managers for navigating these conditions?

McCarthy: Our philosophy is to deliver liquidity and stability. Because we see the potential for significant volatility, even if the timing is unclear, we have reduced risk more severely than we would otherwise, and we are staying conservative. We don't think it makes sense to take risk in volatile areas of European markets and we don't want to be exposed to a potential spike in US rates. In the more stable UK markets, we've had the ability to be a little more aggressive in taking duration risk because of our comfort level with BOE policy. But our focus is on managing liquidity. Although money market flows have stabilized after some recent volatility, we always need to be able to deliver liquidity to our investors.

Against this backdrop, are you seeing changes in the traditional approach to money market investing?

Fishman: We think money market investing has experienced a paradigm shift. Traditionally, the three key objectives in money market investing have been liquidity, preservation of capital, and yield. We have always considered liquidity the top priority, and we think most investors in money market strategies probably have the same priority. However, at today's yields, investors are sacrificing more in terms of yield than they ever have before to get liquidity and preservation of capital.

Today's yields appear lower by historical standards, but this might be the new reality. We think one of the things that investors came to realize during the financial crisis was that if you have too much liquidity, the cost is probably small, but if you end up with too little liquidity, you might be out of business. So corporations and other types of investors have taken a little bit of an "all or nothing" approach, and the result has been a virtual wall of money invested in strategies that offer daily liquidity. And in a world where policy rates in the major currencies are unlikely to increase very much for the foreseeable future, investors seeking daily liquidity can probably expect to continue to receive very low yields.

How can investors adapt to this new paradigm in money market investing?

McCarthy: We think investors are going to have to manage their liquidity a bit more efficiently and look for risks that offer an attractive yield premium relative to the risk. If you accept that daily liquidity is going to be very expensive, having too much liquidity is going to be expensive in terms of low yields, while having too little could be expensive as well in terms of business risk. But we don't think liquidity management is an all-or-nothing proposition.

In fact, one of our key priorities today is strategies that focus specifically on capturing liquidity risk premiums, with very little exposure to credit or duration risk, which we think can fit very well with other strategies to form an overall liquidity management strategy.

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