T. Rowe Price

Investing solutions to consider in a higher rate environment

From the Field
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Key Insights

- The Fed's aggressive tightening cycle provided a natural yield advantage in cash products such as money market funds and certificates of deposit.
- However, history shows that there is an opportunity cost associated with eschewing front-end multi-sector bonds in favor of these types of traditional cash assets.
- At the same time, extending duration to intermediate and longer maturities does not adequately compensate investors for the increased risk, in our view.

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Embarking on its tightening campaign in March 2022, the U.S. Federal Reserve (Fed) hiked interest rates over 500 basis points (bps)[1] in just over one year. Cash-like instruments, such as money market funds (MMFs), certificates of deposit (CDs), and Treasury bill ladders have been the clear beneficiary of the Fed's tightening cycle, supported by sharply higher yields—in other words, cash has been king. As the Fed funds rate increased, investors enjoyed the opportunity to earn attractive yields on these cash investments. It's no surprise, recent readings from the Investment Company Institute put MMF assets under management at USD 6.1 trillion,[2] an all-time high.

Beware the opportunity cost of cash

While investors will continue to have liquidity needs, they need to be cognizant of the "opportunity cost of cash." Just as cash-like investments have enjoyed attractive yields courtesy of Fed rate hikes, yields on short-term, investment-grade bonds have increased and maintained a yield advantage over traditional cash vehicles. Over time, this yield advantage can accumulate and potentially result in noticeably higher returns. Fig. 1 shows the difference in USD 100,000 invested in an MMF versus low duration bond fund, highlighting the potential opportunity cost of staying in cash.

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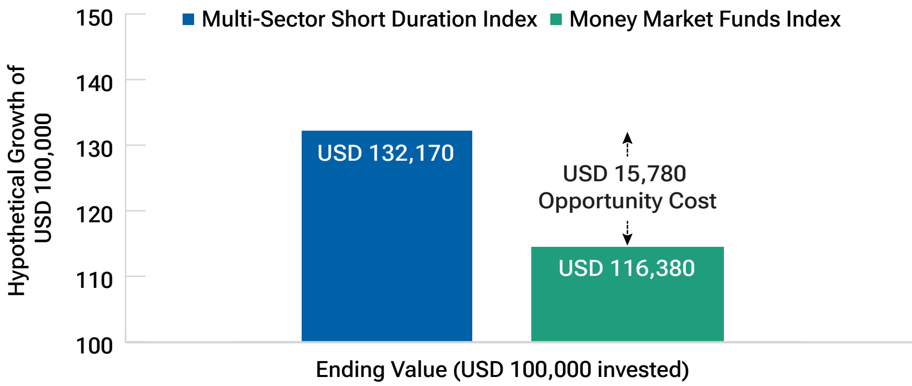
[1] A basis point is 0.01 percentage point.
[2] "Money Market Fund Assets," Investment Company Institute, April 3, 2024.

The opportunity cost of cash

(Fig. 1) Cumulative total returns for the period 12/31/2007–3/31/2024



As of March 31, 2024. **Past performance is not a reliable indicator of future performance.** Source: Bloomberg and Lipper Index data. Cumulative total returns for the period (12/31/2007–3/31/2024). Money markets funds representative index= Lipper Money Market Funds Index. Multi-sector short duration representative index = Bloomberg 1–3 Year U.S. Government/Credit Index. Index performance is for illustrative purposes only and is not indicative of any specific investment. Investors cannot invest directly in an index.

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Too short—The cost of cash

Low duration bond strategies present a potential solution to addressing this opportunity cost of cash. They enjoy incremental flexibility versus traditional cash vehicles that allows them to invest beyond the maturity limitations of an MMF and also diversify investments across sectors, including government, corporates, and securitized issues. This means investors can lock in compelling yield, while potentially mitigating future reinvestment risk. MMFs and other cash equivalents will see their yields immediately reset lower whenever the Fed begins cutting rates, while a low duration strategy can capture higher yields for longer and provide additional price appreciation potential as yields decline (bond yields and prices move in opposite directions).

The slightly longer maturities and wider range of assets in low duration bond strategies could provide a substantial yield cushion compared with MMFs over the long term. Expectations for Fed rate cuts have diminished, been pushed out, and, in some cases, reversed course, creating some uncertainty about near-term rates. Low duration bond strategies have increasingly offered higher yields that can potentially lead to higher returns in a variety of interest rate scenarios without requiring increased duration risk. (Duration is a measurement of a bond's sensitivity to interest rate moves.)

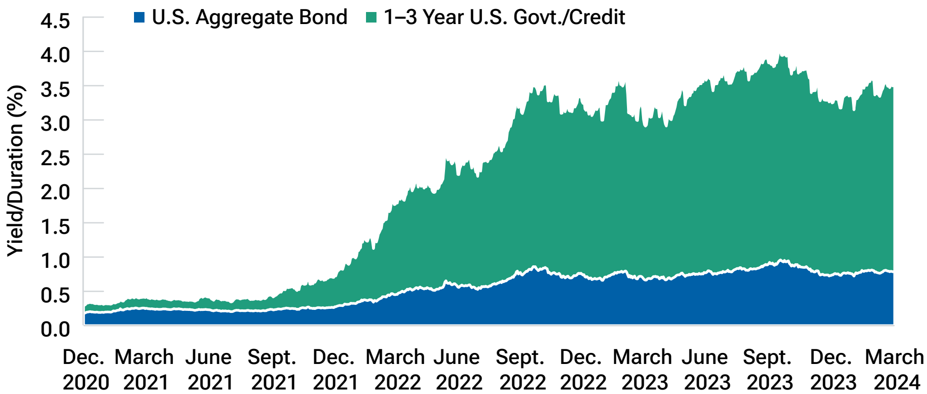
Too long—Duration risk

However, even in a higher-for-longer rate environment where yields do not fall, the low duration asset classes benefit from an inverted yield curve, meaning shorter-dated interest rates are higher than their longer-dated tenors. Extending out the curve to longer-duration assets not only exposes investors to lower yields, but also increased interest rate risk. Low duration bond strategies can offer competitive yields in a higher rate environment while reducing the duration risk presented by longer-duration funds. Fig. 2 illustrates the yield earned per unit of duration, highlighting the opportunity to earn yield in a low duration strategy.

Despite uncertainty around the direction and timing of Fed funds rates, the current backdrop is broadly supportive of the low duration asset class. Fig. 3 shows that following a pause in Fed rate hikes, low duration bond strategies historically have generated positive returns and outperformed MMFs.

Unique opportunity for low duration

(Fig. 2) Yield compelling for low duration bonds

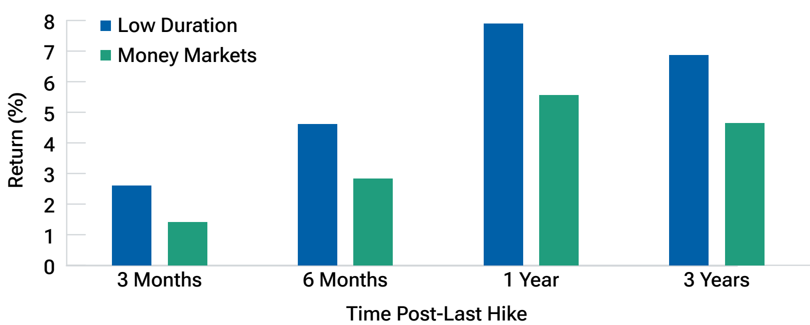


As of March 31, 2024.
Source: Bloomberg Index data. Yield of index/duration of index. Multi-sector short duration representative index = Bloomberg 1–3 Year U.S. Government/Credit Index. Multi-sector longer-duration representative index = Bloomberg U.S. Aggregate Bond Index.

Money market funds and fixed income strategies have different risks including the possible loss of principal. It is important that you carefully review the risks to determine if it is an appropriate investment. Fixed income strategies involve more risk than a money market fund and are not subject to the same diversification and maturity standards.

Low and longer-duration bonds in different rate environments

(Fig. 3) Comparing returns of low- and longer-duration indexes



As of March 31, 2024. **Past performance is not a reliable indicator of future performance.**
Source: Bloomberg and Lipper Index data. Money markets funds are represented by the Lipper Money Market Funds Index, and Low duration is represented by the Bloomberg 1-3 Year U.S. Government/Credit Bond Index. Historical average performance in the 3-month, 6-month, 1-year, and 3-year periods after the last hike of a cycle. Dates used for last hike in cycle are: 9/30/1987, 2/28/1989, 2/28/1995, 3/31/1997, 5/31/2000, 6/30/2006, 12/31/2018, 7/31/2023. Cumulative returns used for < 1-year periods, and annualized returns used for 3-year period. Index performance is for illustrative purposes only and is not indicative of any specific investment. Investors cannot invest directly in an index.

The right fit

Low duration bond strategies could provide a unique opportunity for investors seeking competitive yields with reduced interest rate sensitivity. Elevated short-term yields amid an inverted yield curve provide a meaningful tailwind for low duration bonds. With a broad universe of investments, including Treasuries, corporates, and securitized issues, low duration strategies could benefit from diverse performance drivers. Although investors now have choices when it comes to cash, we believe it is time to consider the opportunity cost of remaining in cash when overlooking the diversified yield potential in a low duration bond strategy.

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