Cash conundrum: Why the Fed's cut is a game changer

From the Field
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Key Insights

- Fed rate hikes boosted yields for cash-like instruments, but rate cuts signal declining yields, reducing the appeal of these options.
- Low duration bonds could offer the opportunity to capture elevated yields for longer compared with cash alternatives.
- Investors could consider transitioning from cash as yields fall and look to low duration bonds to proactively address reinvestment risk.

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Aggressive interest rate hikes from the Federal Reserve in 2022–2023 were a boon to cash-like assets, such as money market funds (MMFs), certificates of deposit (CDs), and Treasury bills. With their yields closely tied to the fed funds rate, these products benefited from the sharp boost to rates. As cash yields surpassed those on longer-maturity assets, investors piled into cash-alternative investments and remain invested there.

We believe this dynamic is set to reverse. At its September meeting, the Fed cut rates 50 basis points (bps),[1] and the accompanying Summary of Economic Projections illustrated that committee members believed conditions would warrant additional cuts, beginning a rate-cutting cycle. That means the yield earned on the record level of assets invested in MMFs will likely decline as the Fed lowers rates. With this in mind, we believe now is a good time for investors to consider transitioning out of cash and cash-like instruments and into low duration[2] bonds where they can potentially benefit from elevated yields longer.

Investor inertia: Slow reaction to Fed rate changes

According to the September 26, 2024, reading from the Investment Company Institute, a record USD 6.4 trillion remained

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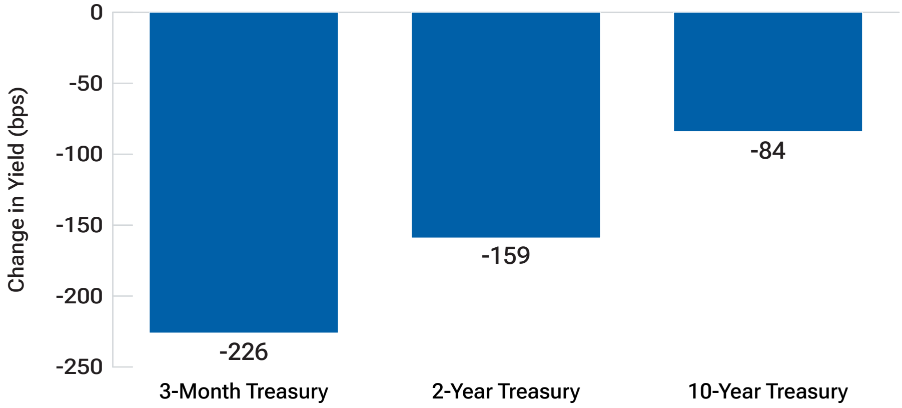
[1] A basis point is 0.01 percentage point.
[2] Duration is a measurement of a bond's sensitivity to interest rate moves.

Average change in yield 12 months after first Fed rate cut

(Fig. 1) Yields decreased more for cash alternatives following cuts



As of September 2024.
Past performance is not a reliable indicator of future performance.
Note: The cutting cycles analyzed include periods identified with initial Fed rate cuts: August 1981, September 1984, October 1987, June 1989, July 1995, January 2001, September 2007, and August 2019.
Source: Bloomberg Finance L.P.

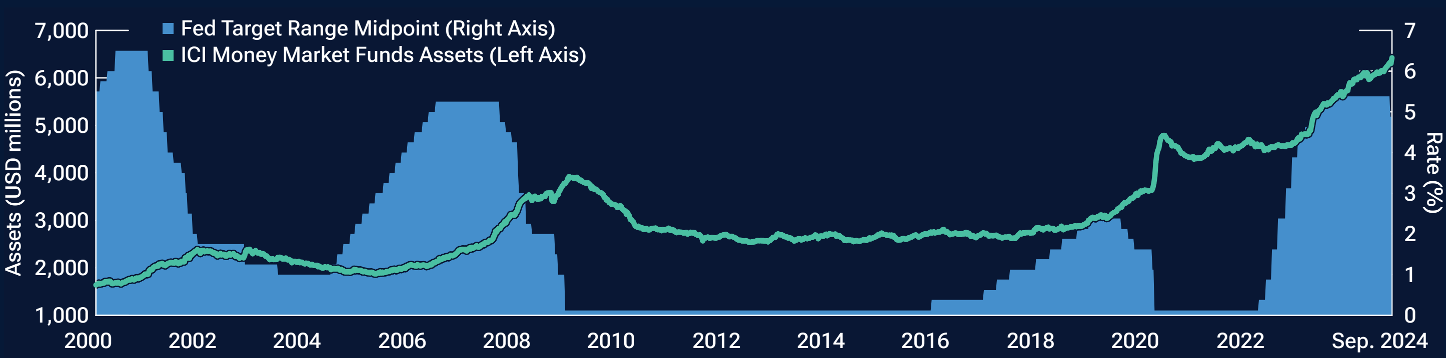
in MMF assets under management. Additionally, there is nearly USD 200 billion invested in short-term Treasury or cash alternative exchange-traded funds according to Morningstar Direct. When the Fed was raising rates, this positioning made sense—investors were benefiting from attractive yields, oftentimes above 5%, while assuming relatively low levels of risk.

But these cash alternative products that had been the direct beneficiaries of the Fed's aggressive hiking campaign were acutely affected in past rate-cutting cycles given their sensitivity to monetary policy. As Figure 1 highlights, the three-month Treasury bill, a cash alternative, experienced a more pronounced decrease in yield than the slightly longer-maturity two-year Treasury note. In this illustration, the two-year Treasury note preserved more yield when compared with the three-month Treasury bill. For the same cushion in yield, an investor would need to significantly extend maturity to the 10-year note from the two-year one, which does not adequately compensate investors for the increased risk, in our view.

Despite yields closely tracking changes in the fed funds rates, money market investors have typically been slow to react to Fed moves in the past. Figure 2 shows

Record level of assets in money market funds...

(Fig. 2) ...that historically have been late to move following Fed rate cuts.



As of September 2024.
Fed Target Range Midpoint is the median of the federal funds rate—the target interest rate range set by Fed policy.
Sources: Investment Company Institute, Bloomberg Finance L.P.

Results in previous rate-cutting cycles

(Fig. 3) Multi-sector low duration outperformed cash alternatives

Rate-cutting cycle	Low duration bond (%)	Cash (%)	Low duration bond vs. cash (%)
August 1981 to December 1982	23.47	13.32	10.15
September 1984 to August 1986	15.13	8.27	6.86
June 1989 to September 1992	9.91	6.67	3.24
July 1995 to January 1996	4.49	2.91	1.58
January 2001 to June 2003	6.71	2.66	4.05
September 2007 to December 2008	5.76	2.67	3.09
August 2019 to March 2020	2.23	1.24	1.00
Average	**9.67**	**5.39**	**4.28**

As of August 2024.
Returns are annualized. Periods under 1 year are cumulative.
Past performance is not a reliable indicator of future performance.
Low duration bond = Bloomberg 1–3 Year U.S. Government/Credit Index.
Cash = Bloomberg US Treasury Bellwether 3M Index Total Return USD Unhedged.
Index performance is for illustrative purposes only and is not indicative of any specific investment nor does it reflect fees associated with an actual investment. Investors cannot invest directly in an index.
Source: Bloomberg Finance L.P.

that in past Fed rate cycles, the change in MMF asset levels lagged moves in the fed funds rate—investors were slow to react.

Opportunity cost of staying in cash

As yields reset lower, the opportunity cost of staying in cash products could begin to add up. Therefore, we think it is important to look for ways to lock in yields in somewhat longer-maturity bonds to maintain a yield cushion as the Fed is expected to continue to drive short-maturity yields lower. Figure 3 shows that low duration bonds outperformed cash (as represented by 3-Month Treasuries) by over 400 bps on average during previous cutting cycles.

Low duration bond strategies enjoy incremental flexibility versus traditional cash vehicles, which allows them to invest beyond the maturity limitations of an MMF and diversify investments across sectors, including government, corporates, and securitized issues. This means investors can potentially lock in compelling yield and potentially mitigate future reinvestment risk. MMFs and other cash equivalents will likely see their yields continue to reset lower as the Fed cuts rates, while a low duration strategy can capture higher yields for longer and provide additional price appreciation potential as yields decrease.[3]

Why low duration bonds make sense now

Of course, expectations for Fed rate cuts have evolved, creating some uncertainty about near-term rates. Low duration bond strategies could provide a unique opportunity for investors. The slightly longer maturities and wider range of assets—including Treasuries, corporates, and securitized issues—in low duration bond strategies could provide a substantial yield cushion compared with MMFs over the long term, even if the Fed reverses course. Low duration bond strategies have increasingly offered

“ Low duration bond strategies enjoy incremental flexibility versus traditional cash vehicles....

[3] Bond yields and prices move in opposite directions.

higher yields that can potentially lead to higher returns in a variety of interest rate scenarios without requiring increased duration risk.

Although investors now have choices when it comes to cash, we believe it is time to consider the opportunity cost of remaining in cash and not to overlook the diversified yield potential in a low duration bond strategy.

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