Trust must be earned

Amundi ASSET MANAGEMENT

April 2024

INVESTMENT TALKS

Bonds Take Center Stage

Short-term bonds may dominate cash in the next phase of monetary policy

Noah FUNDERBURK
Director of Securitized Credit;
US Portfolio Manager,
Ultrashort and Short Duration

Matt Cody, CFA
Vice President;
Client Portfolio Manager,
Fixed Income

Executive summary

- *With yields on cash currently elevated, we appreciate why cash allocations have swelled.*
- *However, as the US Federal Reserve considers pivoting its stance, so too should investors.*
- *Against the interest rate risk inherent in most fixed income securities, investors should consider the reinvestment risk inherent in cash.*
- *Shifting exposure from cash to short-term bonds may allow investors to "lock in" much of today's elevated income levels while also positioning their portfolios for price upside.*

Periods of elevated cash rates have historically been short-lived

Savers have been earning a reasonable return in cash for the better part of the last year. But how long can these compelling cash rates last? Historically, the answer has been: not very long. In every rate hike cycle since the 1970s, the US Federal Reserve has "paused at the peak" federal funds rate for a matter of months, not years. Six months have now passed since the Fed last raised interest rates in July 2023. History suggests the rate cuts could begin soon. Furthermore, once the Fed starts cutting its policy rate, cash rates could move hundreds of basis points lower in a very short period of time. These two historical facts – the "pause at the peak" tends to be short, and the "fall from the peak" tends to be precipitous – suggest the glory days for cash allocations may be numbered. Rotating from cash into short-term bonds can help investors reduce this reinvestment risk without taking on the full price volatility inherent in longer-duration fixed income exposures.

How long can compelling cash rates last? Historically, the answer has been: not very long.

Exhibit 1: History of the federal funds policy rate since 1970

Once the Fed stops hiking rates, it has historically begun to cut rates in a matter of months, not years. And when the rate cuts start, they tend to be large. The most recent rate hike was in July 2023.

Source: Bloomberg, March 31, 2024. Federal funds effective rate.

Amundi ASSET MANAGEMENT

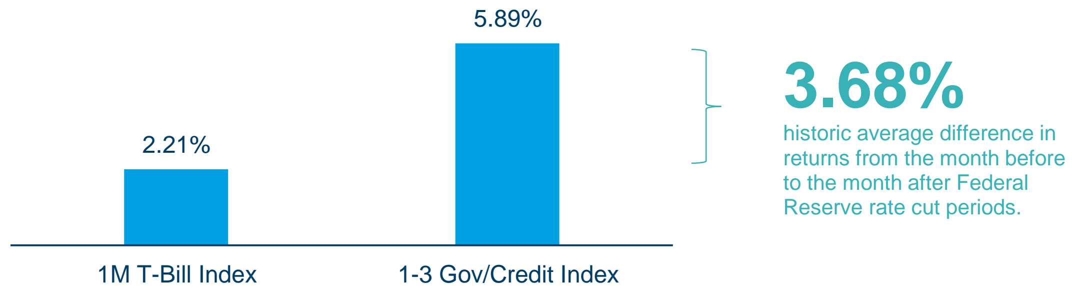
Even though rate cuts are often priced into the market before the Fed acts, short-term bonds have historically outperformed cash during Fed rate cut periods.

Short-term bonds historically outperform cash when the rate cuts start

When the Fed cuts rates, cash investors are left with lower yields without capturing any price appreciation upside. History provides context for how much investors might leave on the table by not rotating out of cash and into short-term bonds during the “easing” phase of monetary policy cycle. Since the year 2000, the 1-3 Year S&P US Gov/Credit Bond Index[1] has outperformed the 1 Month Treasury Bill Index by 3.68% over the time periods between the first rate cut and the last rate cut (see Exhibit 2). It is true that some rate cuts are already priced into the yield curve for 2024, but *some* level of rate cuts is *always* priced into the yield curve prior to when the Fed actually begins reducing its policy rate. This metric shows that investors have historically benefited from adding exposure to short-term bonds, even after the market has begun to price in a policy shift.

Exhibit 2: Average index returns from the month before to the month after Fed rate cut periods

Short-term bonds have historically outperformed cash markets during Fed rate cut periods.



Source: Bloomberg, May 31 2000 (data inception) through March 31, 2024. ICE BofA Treasury Bill 1 & 3 Month Indices, Bloomberg 1-3 Year Treasury Index. Performance calculated starting the month before through the month after Fed cuts. The returns shown here are holding period returns; they are not annualized. Indices are unmanaged and their returns assume reinvestment of dividends and do not reflect any fees or expenses. It is not possible to invest directly in an index.

Today’s elevated yields provide a cushion against potential price volatility

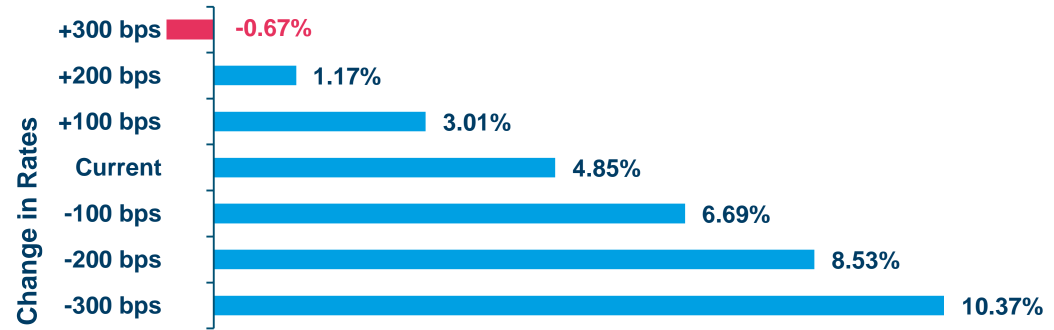
Two additional factors should motivate investors to move out of cash and into short-term bonds in 2024. First, today’s elevated yields provide a cushion against potential price volatility that didn’t exist in the bond market two and three years ago. Using the yield to maturity and duration of the 1-3 Year Gov/Credit Index as a guide, Treasury yields would need to rise more than 200 bps before the price impact of such a rate move would cause total returns to dip into negative territory over a 12-month investment horizon (see Exhibit 3).

Second, with respect to potential yield curve moves, we believe the skew to the distribution of potential outcomes is attractive. Given that the Fed is openly discussing the timing of its first policy rate cut, we believe that if the yield curve were to shift 200 bps in either direction over the next 12 months, it would likely be a move lower, not higher.

[1] Indices are unmanaged and their returns assume reinvestment of dividends and do not reflect any fees or expenses. It is not possible to invest directly in an index.

Today's elevated yields provide an attractive upside-vs-downside total return potential.

Exhibit 3: Approximate 12-month index returns for given levels of US Treasury yield changes



Source: Amundi US Analytics. Returns approximated by a widely accepted method of duration multiplied by the change in rates plus the starting level of yield. Returns do not account for spread level changes or possible defaults. Defaults would lower returns and spread changes could either increase or decrease returns. As of Jan 31 2024.

Conclusion

While interest rates on cash are relatively high today, those elevated levels may not last very long. With the Fed now contemplating the timing of its first policy rate cut, the exposures that have worked well during the rate-hike cycle may not be the exposures that will work well in the next phase of monetary policy. With history as a guide, we believe investors may benefit from locking in some of today's historically elevated interest rates by moving out of cash and into short-term bonds.

Index and Term Definitions

- ICE BofA Treasury Bill 1 & 3 Month Indices: Tracks the performance of US dollar-denominated US Treasury Bills publicly issued in the US domestic market.
- Reinvestment risk: The chance that cash flows received from an investment will earn less when put to use in a new investment..
- US Federal Reserve: The central banking system of the United States, created on December 23, 1913, with the enactment of the Federal Reserve Act.
- Volatility risk: The risk of a change in the price of a portfolio or holding.

Important information

Unless otherwise stated, all information contained in this document is from Amundi Asset Management as of Jan 31, 2024. Diversification does not guarantee a profit or protect against a loss. The views expressed regarding market and economic trends are those of the author and not necessarily Amundi Asset Management and are subject to change at any time based on market and other conditions, and there can be no assurance that countries, markets or sectors will perform as expected. These views should not be relied upon as investment advice, a security recommendation, or as an indication of trading for any Amundi product or service. This material does not constitute an offer or solicitation to buy or sell any security, fund units or services. Investment involves risks, including market, political, liquidity and currency risks. Past performance is not indicative of future results. Amundi US is the US business of Amundi Asset Management.

RO ID# 3476222

©2024 Amundi Asset Management US, Inc.