ASSET
MANAGEMENT

When Cash isn't King

By Thomas Hansen, CFA

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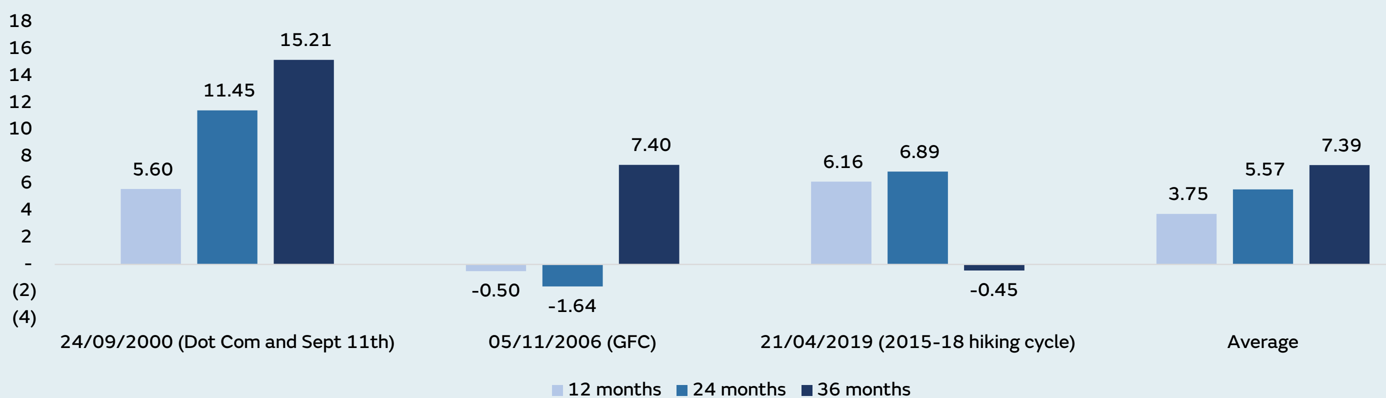
The well-known investment mantra of staying invested has not worked very well for fixed income investors over the last couple of years. In fact, investors sitting on the side-lines in cash or money market funds have made around 17%[1] more than investors in global aggregate funds since the end of 2021, and this while enduring much less volatility and taking less credit risk.

History, maths and the Federal Reserve all tell us it is time to take the plunge and ditch cash

While the allure of cash remains intact on an absolute basis, there are several reasons why the relative value of holding longer duration assets such as investment grade credit should be compelling to most investors with a medium term to long term investment horizon.

1. History tells us to buy bonds

Fixed income tends to underperform in a hiking cycle and just around the time of the last hike. However, if we assume we have seen the last hike (big assumption, granted) we can safely say that if history were to repeat itself, fixed income investors should be optimistic. Assuming we are now 4 months after the last hike we have examined returns of the Global Agg relative to USD cash for the subsequent 12, 24 and 36 months:



Source ICE Indices. LUS0 index vs LEGATRUH Index. 24 and 36 month data not annualised.

While the picture is not uniformly positive for all periods, the average outperformance of the global aggregate after the last 3 hiking cycles is compelling. It is also clear that on average, the next 12 months should be the best, after which the outperformance gradually declines. Please see appendix for more detailed time series returns for all three periods.

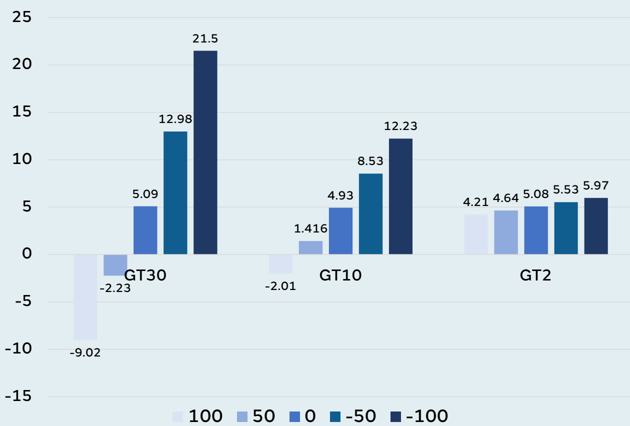
[1]ICE BofA US Dollar Overnight Deposit Offered Rate Index (LUS0) returned 5.81% from December 31st 2021 to October 20th 2023, the Bloomberg GlobalAgg Index (LEGATRUH) returned -11.22%

2. The maths add up

Thanks to convexity and, to a lesser degree carry, we are currently looking at roughly a 2:1 pay-off in absolute terms for the current 30 year US Treasury, assuming a 100 bps move over 12 months. Should the 30-year bond yield continue to rise by 100 basis-points we stand to lose 9.02%, however, should yields fall by 100 basis-points the gain would be 21.5%.

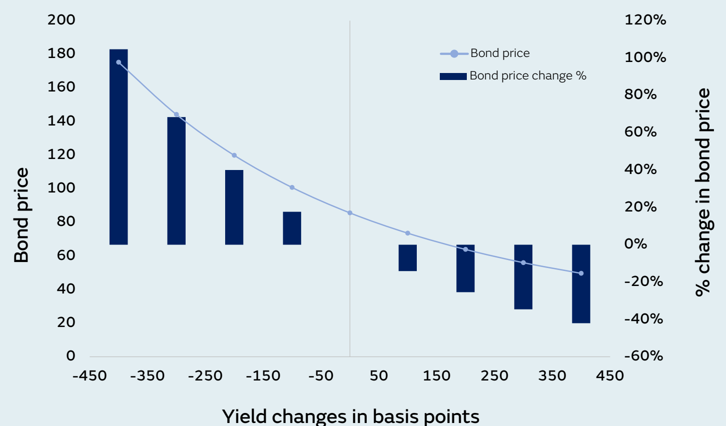
This asymmetry favours bond holders greatly and will be key to total returns going forward.

12- month scenario analysis for on-the-run US Treasuries



Source: Bloomberg, Total returns vs yield change

Spot scenario analysis for the 30 yr US Treasury: convexity helps



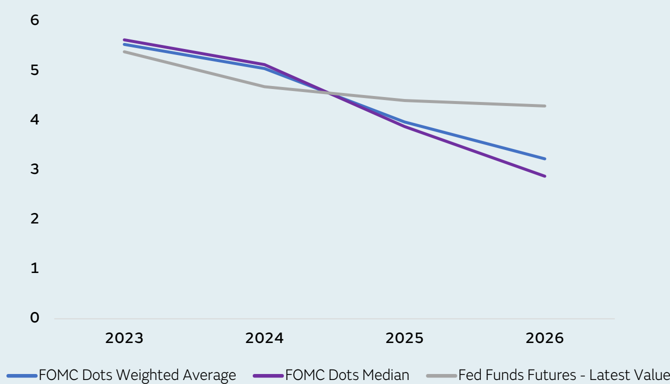
Source: Bloomberg, T 4.125 15/08/2053

3. The Fed is probably done, and curves are flat

The market and the Fed largely agree on the direction of rates from here.

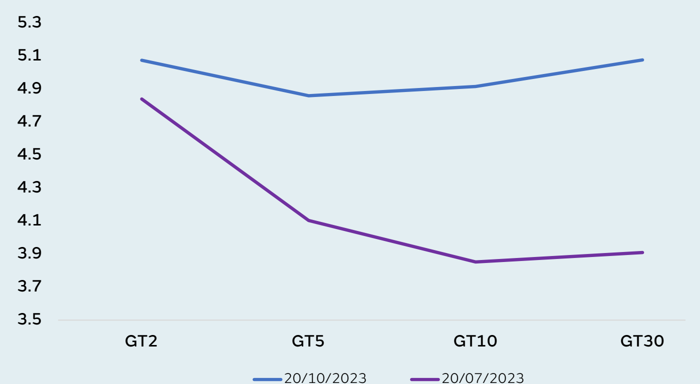
While supply and demand imbalances are likely to drive US treasury volatility in the short term we are now in a situation where both the Fed and the market are expecting rates to have peaked. This is by no means a guarantee for positive bond returns; however, this should give investors some comfort when it comes to future returns from fixed income, most of all because curves are now relatively flat: pricing has improved meaningfully compared to 3 months ago.

Fed dots[2] and current market pricing Oct 20th 2023



Source: Bloomberg

US yield curve comparison



Source: Bloomberg

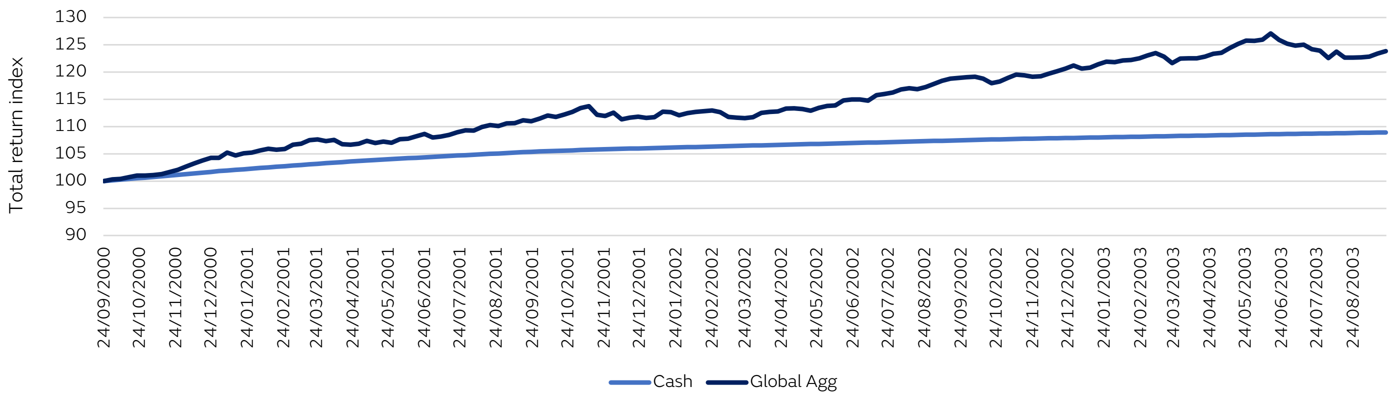
[2] Fed dots are from the September 2023 meeting

In conclusion, it is highly likely that we have now arrived at a juncture where investors who are able to take a medium-term view will do better holding high quality fixed income as opposed to cash. The reign of cash is ending and the reign of fixed income is about to begin.

Appendix

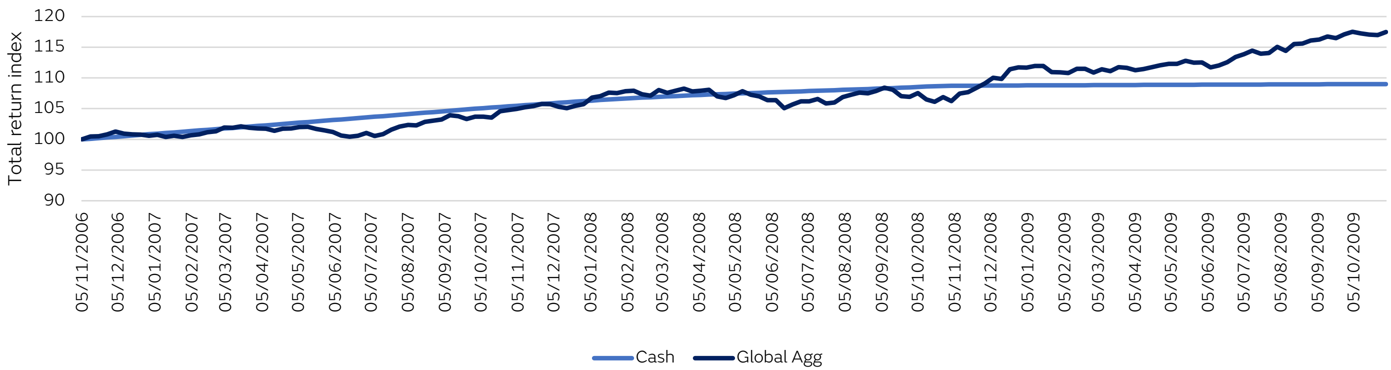
Times series of returns. Start dates are 4 months after the last hike

Global agg versus cash after Dot.com crash and Sept 11th



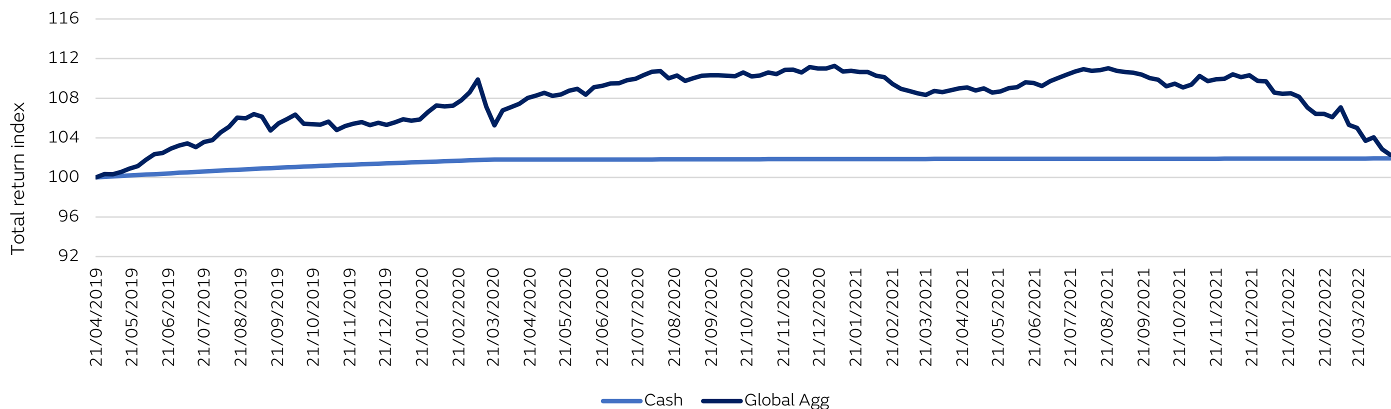
Source: Bloomberg

Global agg versus cash after GFC



Source: Bloomberg

Global agg versus cash after 2015-18 hiking cycle



Source: Bloomberg

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