March 2023

Key Questions

Is Cash Still King, or Are Bonds Back?

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2022 left investors few places to hide. Stocks entered a bear market. Bonds had their worst year ever. Inflation ran rampant. The prospects of recession grew throughout the year. The Federal Reserve's (the Fed) commitment to combat inflation resulted in its most aggressive rate-hiking period in over 40 years, with the Federal funds rate increasing from effectively zero to 4.50% by year end.

The pace at which the Fed increased this policy-controlling interest rate can be seen as the chief driver of the weakness in stock markets and the plunge in bond markets in 2022. Quite simply, investors have not seen the Fed increase rates this much, this quickly.

While this meteoric rise in short-term interest rates has caused capital depreciation in both stocks and bonds, it has also brought cash back as a viable income-producing asset class. Money market mutual funds are yielding approximately 4.50% on average, and 6-month and 1-year Treasury bills (T-bills) have yields at 4.30%. After a tumultuous 2022 and indications of a recessionary economic environment awaiting, is it time to just hide in cash?

The global financial system operates under the core tenet that US treasuries are risk-free investments. Treasuries are backed by the full faith and credit of the US government and the US has never missed an interest payment or defaulted on its debt. T-bills are short-term treasuries with maturities between 4 weeks and 1 year and are most often found in money market funds along with other short-term debt obligations. Money market fund balances have increased dramatically since 2020, with nearly $5 trillion in assets at the end of 2022. Yield-starved investors accustomed to earning next to nothing on cash are now earning approximately 4.5% in money market funds. They also have the option of buying 6-month or 1-year T-bills and earning a risk-free rate of return of 4.57% or 4.28%, respectively.

An allocation to cash is prudent and plays an important role within an asset allocation strategy as part of a sound financial plan. Cash can act as ballast to riskier asset classes, enable opportunistic investments, serve as a safety net, or simply provide peace of mind to an investor. Unfortunately, cash on its own has little chance of keeping up with inflation over the long term. Inflation, as measured by the Consumer Price Index (CPI), reached 9.10% on a year-over-year basis in June 2022. While inflation has slowed to a rate of 6.40% as of January 2023, it is still well above the Fed's long-term target of around 2.00%. A 4.50% return on cash when cash is losing 6.40% of its purchasing power is not a recipe for growing wealth.

Economic forecasts see the Fed raising rates an additional 0.75% by June 2023, bringing the Federal funds rate to 5.50%. The same forecasts also see the Fed lowering rates to 2.50% in 2024, with the thesis being that the Fed's commitment to drive down inflation with higher rates will create a recession that will then force the Fed to pivot to an accommodative monetary policy, ergo lowering rates to stimulate economic growth. In short, short-term rates will be higher, but only in the short-term. Some may argue that is even more the reason to go to

cash now or lock in these T-bill rates while they last. While you can enjoy a higher rate in the short-term, it is unlikely that these T-bill rates will be at the same rate or higher at time of maturity thereby creating a significant "reinvestment risk" for investors. Interest rates and bond prices are inversely related, so the value of bonds will increase in a declining rate environment, meaningfully enhancing total return. Cash investments do not receive the same benefits during these periods. As such, investors may be better served to invest slightly further out on the yield curve, especially in this current market environment.

With the prospects of US entering a recession in the next 6 to 12 months, it is important to consider an allocation to investment grade fixed income. Recessions typically see a "flight to quality" as investors seek haven in bonds, thereby pushing yields lower. What is noteworthy in the current environment is that corporate and municipal credit spreads have remained relatively firm amid tightening financial conditions. The sell-off in bonds in 2022 was not credit-driven but rather due to interest rates rising at a breakneck pace. A 10-year treasury is yielding approximately 3.50% today after averaging 2.42% over the past 15 years. Investment grade corporates of the same maturity yield 5.40% and 10-year AAA municipals offer a taxable equivalent yield of 3.80%. After a long period of bonds offering low yields, it is safe to say there is income in fixed income again.

Short-term returns upwards of 4.50% in cash and T-bills look quite appealing after a year of double-digit declines in both stock and bond markets. It is important to focus on the long-term investment horizon. With the increasing possibility of US recession approaching, it may be prudent not to hide in cash, but we think it is also prudent and may be quite timely to consider putting some of your cash to work in bonds.

For more information, please contact your advisor.

About the Author

Tim McDonough, CFA® is Vice President, Senior Portfolio Manager specializing in municipal investments with Key Private Bank's Fixed Income team. He is the lead professional on the team responsible for purchasing individual municipal securities for client portfolios. Tim helps manage approximately $2.5 billion in municipal assets on behalf of Key clients.

Tim has more than 17 years of experience in the financial services industry. Prior to joining the Fixed Income team, Tim was a Senior Equity Trader at Key Private Bank and held roles of increasing responsibility in investment operations at Key and McDonald Investments. He has a wide range of experience in investments and serving individual and institutional clients.

Tim earned a Bachelor of Arts (BA) in history from Ohio University and a Master of Business Administration (MBA) with a finance concentration from Cleveland State University, where he was inducted into Beta Gamma Sigma, the international business honor society. He also holds the Chartered Financial Analyst (CFA) designation. His professional memberships include the CFA Institute and CFA Society Cleveland.

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