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Cashing In on the Short End of the Curve

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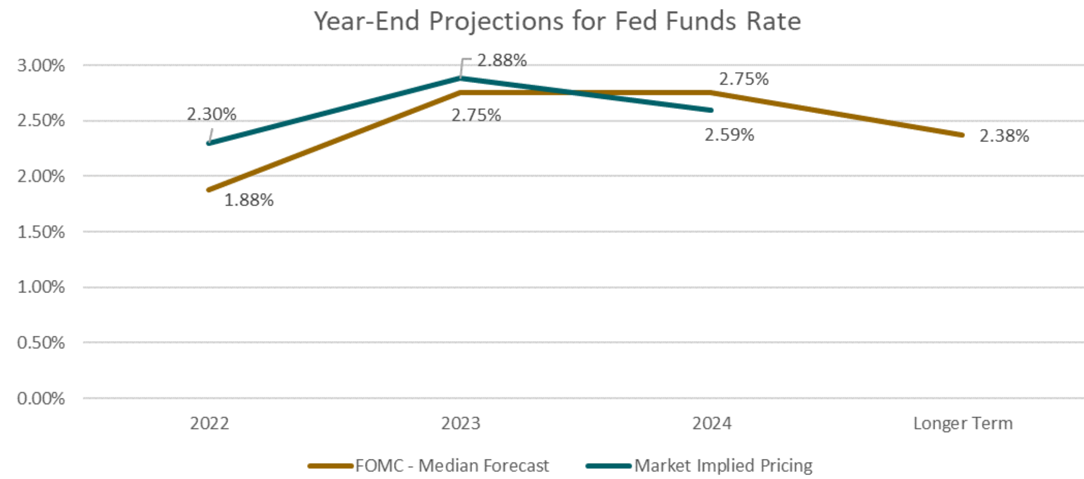
In March 2020, as the Covid-19 pandemic spread and governments around the world imposed lockdown measures, the U.S. Federal Reserve (Fed) cut the Federal Funds – or policy – rate to near zero and began an unprecedented asset purchase program (known as quantitative easing or (QE). These actions provided liquidity to financial markets, allowing companies to raise cash to insulate balance sheets from the uncertainty of the pandemic. An unfortunate consequence of this policy is its impact on savers as yields on traditional banking products and money market funds also declined to near zero.

However, with inflation running at the highest level in four decades, global central banks – including the Fed – are now focused on removing monetary accommodation in an effort to contain higher prices.

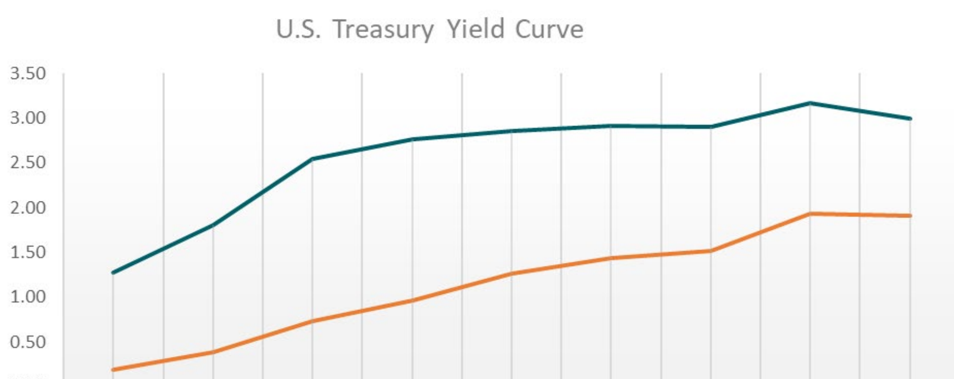
At its March meeting, the Fed met expectations by increasing the policy rate by 25 basis points (bps). More impactful was the release of the Fed's 'dot plot,' which provides projections for the year-end level of the Federal funds policy rate for the next three years. The updated dot plot showed that Fed officials had significantly increased their outlook for the policy rate, expecting an additional 150 bps of rate hikes over the course of 2022, followed by another 90 bps of rate hikes in 2023. If realized, the policy rate would stand at 2.75% by the end of 2023, above the 2.4% level that policymakers view as the 'neutral rate,' or the rate at which monetary policy is neither accommodative nor restrictive.



Source: Bloomberg L.P., 4/19/2022

Investors see the Fed moving even faster, with current market pricing suggesting 50 bps rate hikes in May and possibly June, and for the policy rate to end this year at 2.3% and increase by another 58 bps in 2023. Interestingly, markets are pricing in a rate cut in 2024.

With future rate hikes widely anticipated, yields on bonds across the yield curve have already repriced. Short-dated bonds, those with 3 years or less to maturity, are particularly sensitive to changes in Fed policy. A clear example of this 'front-running' is the 2-year U.S. Treasury note, which has seen its yield increase by over 170 bps since the start of the year to reach 2.55%, just 20 bps shy of where the Fed believes the policy rate will peak in this cycle.



	6M	1Y	2Y	3Y	5Y	7Y	10Y	20Y	30Y
4/19/2022	1.27	1.80	2.54	2.76	2.86	2.91	2.90	3.17	2.99
12/31/2021	0.19	0.38	0.73	0.96	1.26	1.44	1.51	1.94	1.90

Source: Bloomberg L.P., 4/19/2022

The balance of risks is more attractive at today's higher yield levels. While yields could still move higher, which would adversely impact price, the additional coupon income means the rise in yields would need to be significant to produce a negative total return over the next 12 months.

To quantify this risk, investors can calculate the "breakeven yield" to see what level interest rates would need to reach in order for the price decline to more than offset the income earned over the next 12 months, resulting in a zero total return. For an investor who purchases a 2y UST with a yield of 2.54%, the yield on the 12-month UST bill on 04/18/23 would need to be higher than 5.30% to produce a negative return (a 2-year UST purchased today would be priced against a 12 month UST bill in a year since it would only have 12 months remaining until maturity).

Lastly, it is important to remember that U.S. Treasury bonds are assured a minimum total return that is equal to the yield-to-worst at the time of purchase (in this example, 2.54%) if the bond is held until maturity.

Corporate Bonds:

Corporate bond yields have re-priced substantially higher, due not only to higher U.S. Treasury yields but also as a result of an increase in the credit risk premium or credit spread.

Since its inception in 1977, the ICE BofA 1-3 year U.S. corporate bond index (which we use as a proxy for short-duration corporate bonds) has only experienced two annual declines, returning -2.7% and -0.01% in 2008 and 2021, respectively. A key reason for the consistent performance has been the combination of coupon income and less sensitivity to changes in interest rates (i.e., lower duration).

At the time of writing, the duration of the index is 1.86 years, meaning an additional 1% increase in interest rates, *above what has already been priced in*, would result in a ~1.86% decline in price. However, with a yield-to-worst of 3.08%, the index would still have a positive total return over the remainder of this year as the coupon income would more than offset the price decline.

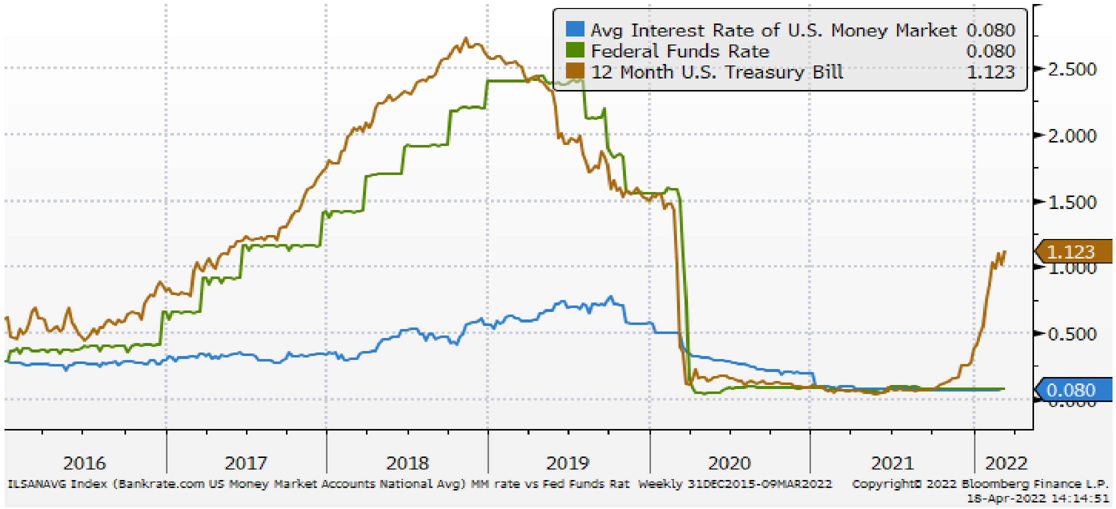
Source: Bloomberg L.P., 4/19/2022

While we use index yields to describe the opportunity in short-maturity corporate bonds, our preference for implementation is to use individual securities that mature, rather than index funds that are evergreen. In addition, active management and issuer selection provide an opportunity to enhance returns over those provided by the board index.

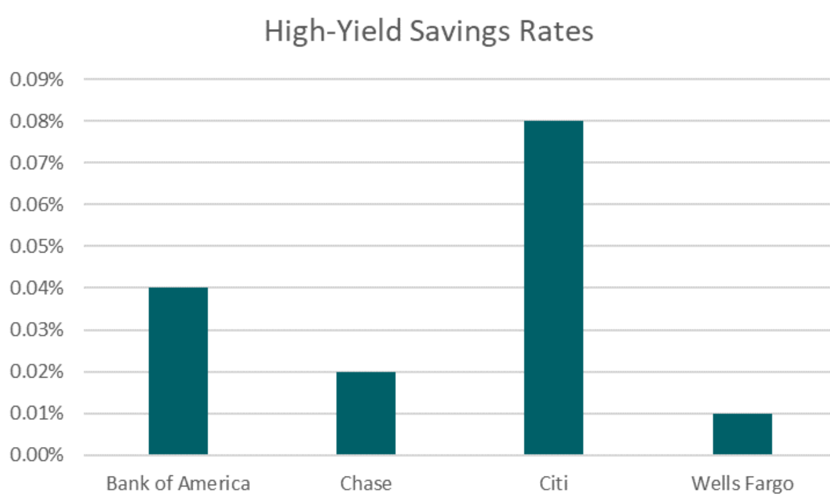
Other Short-Term Rates:

Unlike market-based rates (such as Treasurys and corporate bonds), which move in advance of actual changes in the Fed Funds rate, the interest rate paid on banking products, such as savings accounts and certificates of deposit (CDs), significantly *lags* rate hikes. The chart below shows the average yield of U.S. money market accounts (blue), the Fed Funds rate (green), and the 12-month U.S. Treasury bill (gold). Between December 2015 and December 2017, the Fed increased its policy rate by 125 bps (5 rate increases of 25 bps), yet the average money market yield remained unchanged, only beginning to reflect the higher interest rate environment in early 2018.

Conversely, markets anticipated and priced in upcoming rate hikes by the Fed with the yield on the 12-month U.S. Treasury bill increasing in advance of policy adjustments.



The dislocation between monetary policy and interest rates on banking products exists for two main reasons: first, banks are initially reluctant to pass on higher rates to customers as they seek to maximize profits. Second, large banks already have an abundance of reserves (cash) and don't need (or want) additional deposits and, therefore, don't need to attract new customers, who typically are attracted by offering higher rates. In short, even after the Fed begins hiking interest rates, the prospect of earning near-zero returns on traditional bank products will linger for the foreseeable future.



Source: Informa Research Services. Rates reflect high yield savings rates for products offered at the select banks with a minimum balance of at least $2,500. As of 04.12.2022

In summary, the recent volatility and repricing of short-dated interest rates have resulted in opportunities for investors with the ability to expand their liquidity toolkit to earn *significantly* higher yields in short-dated U.S. Treasurys and corporate bonds relative to traditional bank products.

Disclosures

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