

Investors in Cash Vehicles at Risk of Not Locking in Rates

Note: This is an update to "Investing When Yield Curve Is Inverted" originally published by Freedom Advisors in June 2023 and "When the Rate Levee Breaks in February 2024.

The first half of this year saw bonds sell off over concerns that inflation was not slowing enough and that the U.S. economy was reaccelerating, with investors pulling back expectations that the Federal Reserve would ease policy as had been communicated towards the end of 2023. However, slowing inflation readings and a cooling labor market have brought forward expectations that the Fed would start cutting its benchmark rate, starting at the September FOMC.

As short-term rates remain elevated around 4.5-5.0%, investors continue to park assets into money market funds and other cash instruments, with money market fund assets reaching nearly \$6.3 trillion at the end of August 2024, up from \$4.5 trillion prior to the 2022-2023 Federal Reserve rate hike cycle. Some of this demand for money market funds can be attributed to bank deposit outflows as deposit holders, particularly business corporate accounts, seek to earn higher yields than what they were earning on their bank deposits.

The popularity of money market funds can also be attributed to investors seeking a safe harbor from the volatility experienced over the post-COVID period when interest rates rose sharply in reaction to high inflation. Despite investment grade fixed income returning over 5% in 2023, long-term rates continue to be susceptible to rate volatility as witnessed in the first half of 2024 with the 10-year Treasury rate rising as high as 4.7% this past April before settling down to 3.6% as of 9/10/2024.

Although the market implied magnitude and pace of expected rate cuts differs from that of the Fed's projections, we are likely on the verge of a rate cut cycle expected to last through 2025 and into 2026 as the Fed seeks to bring rates down to a theoretical neutral level of around 3.00-3.50%.

One may be surprised to find on the pages that follow that locking in a lower rate for a few years compared to remaining in money market funds, despite their current higher yields, can pay off over the long run, especially if we see a dramatic drop in short-term rates as implied by market pricing.

Looking at the yield curve and available fixed income strategies, the most important factor to weigh is your client's investment objective and time horizon. Align client spending time horizons with portfolio maturity schedules. Short-term spending needs are usually funded with short-term maturity instruments. If your clients don't have short-term spending needs, you have an opportunity to lock in high inflation-adjusted rates over a longer time period.

			Growth of \$100,000		
Term	3 Month Implied Forward Rates (SOFR)	5-Year Treasury Bond Yield	Term	Money Market Proxy	5-Year Treasury Bond
1M	4.89	3.42	1M	\$100,398	\$100,281
2M	4.47	3.42	2M	\$100,798	\$100,563
3M	4.06	3.42	3M	\$101,167	\$100,845
4M	3.73	3.42	4M	\$101,503	\$101,129
5M	3.73	3.42	5M	\$101,813	\$101,413
6M	3.41	3.42	6M	\$102,125	\$101,698
7M	3.23	3.42	7M	\$102,410	\$101,983
8M	3.23	3.42	8M	\$102,681	\$102,270
9M	3.05	3.42	9M	\$102,954	\$102,557
10M	2.97	3.42	10M	\$103,212	\$102,845
11M	2.97	3.42	11M	\$103,463	\$103,134
12M	2.88	3.42	12M	\$103,716	\$103,424
2-Years	2.84	3.42	2-Years	\$106,659	\$106,965
3-Years	2.85	3.42	3-Years	\$109,701	\$110,628
4-Years	2.98	3.42	4-Years	\$112,970	\$114,416
5-Years	3.13	3.42	5-Years	\$116,509	\$118,333

			Growth of \$100,000		
Term	3 Month Implied Forward Rates (SOFR)	5-Year A-Rated Corporate Bond	Term	Money Market Proxy	5-Year A-Rated Corporate Bond
1M	4.89	4.09	1M	\$100,398	\$100,334
2M	4.47	4.09	2M	\$100,798	\$100,670
3M	4.06	4.09	3M	\$101,167	\$101,006
4M	3.73	4.09	4M	\$101,503	\$101,344
5M	3.73	4.09	5M	\$101,813	\$101,683
6M	3.41	4.09	6M	\$102,125	\$102,023
7M	3.23	4.09	7M	\$102,410	\$102,364
8M	3.23	4.09	8M	\$102,681	\$102,706
9M	3.05	4.09	9M	\$102,954	\$103,050
10M	2.97	4.09	10M	\$103,212	\$103,394
11M	2.97	4.09	11M	\$103,463	\$103,740
12M	2.88	4.09	12M	\$103,716	\$104,087
2-Years	2.84	4.09	2-Years	\$106,659	\$108,341
3-Years	2.85	4.09	3-Years	\$109,701	\$112,769
4-Years	2.98	4.09	4-Years	\$112,970	\$117,378
5-Years	3.13	4.09	5-Years	\$116,509	\$122,175

*Source: Bloomberg. Data as of 9/10/2024. For illustrative purposes only. This analysis assumes 3-month annualized rates are realized as projected by SOFR interpolated pricing as of 9/10/2024 and a flat yield curve for the reinvestment of the 5-year Treasury Bond and A-Rated Corporate Bond (no default) held to maturity.

The 3-month Secured Overnight Financing Rate (SOFR) serves as a valuable surrogate for gauging both current and anticipated money market fund rates. By examining the implications of diminishing yields, particularly when manifesting an inverted curve, as reflected in the SOFR curve, this table illuminates the consequential disparities in income generation. A comparative analysis is drawn between the income derived from the money market fund proxy and that emanating from a fixed 5-year maturity Treasury Bond or a 5-year A-Rated Corporate Bond*.

Initially, the income from the money market fund rates surpasses that of the 5-year bond, offering a higher return in the first/current year.

However, the trajectory shifts, and the income from the money market fund proxy falls behind that of the 5-year bond. This disparity starts with the anticipation of lower interest rates, underscoring the need to look ahead as well as at current markets.

Conclusions

- Short-term fixed-income has greater reinvestment risk.
- Longer-term fixed-income allows investors to lock in rates.
- Aligning investor time horizons with portfolio maturities helps address both reinvestment risk and total return risk resulting from interest rate volatility.

Guidance

[Read our recent guidance](#) regarding how to restructure fixed-income portfolio duration.

Freedom Advisors has a diversified lineup of fixed-income strategies including strategies that take on the management of duration and diversification, as well as specific duration and sector strategies. The portfolio models below are a few suggestions available today in Freedom Advisors:

Managed Duration:

- [EQIS 5yr Corp Bond Ladder ETF Strategy](#)
- [EQIS 7yr Muni Ladder](#)

Managed Income:

- [PIMCO Income Fund](#)
- [SignalPoint Stable Income](#)

Flexible Fixed-income:

- [Financial Trust Flexible Income](#)
- [SignalPoint Stable Income](#)

ESG Fixed-income:

- [Calvert ESG Bond Fund](#)
- [EQIS ESG High Yield Debt ETF](#)

Short Duration:

- [EQIS Short Term credit ETF](#)
- [Calvert ESG Short Duration Income Fund](#)

If you would like to discuss the fixed income markets or the model offerings above, please reach out to your Freedom Advisors Consulting Team.



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