

Investors At Risk of Earning Lower Rates on Cash Vehicles

Note: This is an update to "Investing When Yield Curve Is Inverted" originally published by Freedom Advisors in June 2023.

As short-term rates remain elevated around 4.5-5.5%, investors continue to pour assets into money market funds and other cash instruments, with money market fund assets reaching nearly \$6 trillion at the end of 2023, up from \$4.5 trillion prior to the current Federal Reserve rate hike cycle. Some of this surge 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 surge in money market fund assets can also be attributed to investors seeking safe harbor from the volatility experienced over the past two years. Despite investment grade fixed income returning over 5% in 2023, long-term rates continue to be susceptible to rate volatility as witnessed in the second half of 2023 with the 10-year Treasury rate rising as high as 5% in early October before settling down to 3.8% at the end of the year.

However, fixed income markets are now seeing more disinflationary tailwinds than inflationary headwinds as various readings of core inflation progress towards the Fed's long-term target of 2%. Even with the U.S. economy running above trend, powered by personal consumption and investments, and the unemployment rate running at near historically low levels, pricing across the bond market is indicating that the Fed is closer to cutting.

Although the market implied magnitude and pace of expected rate cuts differs from that of the Fed's projections, the next couple of years we are expected to experience a new rate cut cycle.

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	5.35	3.85	1M	\$100,435	\$100,315
2M	5.17	3.85	2M	\$100,872	\$100,631
3M	4.99	3.85	3M	\$101,296	\$100,948
4M	4.75	3.85	4M	\$101,707	\$101,267
5M	4.75	3.85	5M	\$102,101	\$101,586
6M	4.52	3.85	6M	\$102,497	\$101,906
7M	4.31	3.85	7M	\$102,875	\$102,227
8M	4.31	3.85	8M	\$103,237	\$102,549
9M	4.10	3.85	9M	\$103,600	\$102,872
10M	3.91	3.85	10M	\$103,947	\$103,197
11M	3.91	3.85	11M	\$104,280	\$103,522
12M	3.73	3.85	12M	\$104,614	\$103,848
2-Years	3.40	3.85	2-Years	\$108,169	\$107,844
3-Years	3.10	3.85	3-Years	\$111,519	\$111,994
4-Years	3.20	3.85	4-Years	\$115,082	\$116,303
5-Years	3.36	3.85	5-Years	\$118,943	\$120,779

			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	5.35	4.44	1M	\$100,435	\$100,363
2M	5.17	4.44	2M	\$100,872	\$100,727
3M	4.99	4.44	3M	\$101,296	\$101,092
4M	4.75	4.44	4M	\$101,707	\$101,459
5M	4.75	4.44	5M	\$102,101	\$101,827
6M	4.52	4.44	6M	\$102,497	\$102,196
7M	4.31	4.44	7M	\$102,875	\$102,567
8M	4.31	4.44	8M	\$103,237	\$102,939
9M	4.10	4.44	9M	\$103,600	\$103,313
10M	3.91	4.44	10M	\$103,947	\$103,687
11M	3.91	4.44	11M	\$104,280	\$104,064
12M	3.73	4.44	12M	\$104,614	\$104,441
2-Years	3.40	4.44	2-Years	\$108,169	\$109,079
3-Years	3.10	4.44	3-Years	\$111,519	\$113,923
4-Years	3.20	4.44	4-Years	\$115,082	\$118,983
5-Years	3.36	4.44	5-Years	\$118,943	\$124,267

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.

*Source: Bloomberg. Data as of 12/31/2023. For illustrative purposes only. This analysis assumes 3-month annualized rates are realized as projected by SOFR interpolated pricing as of 12/31/2023 and a flat yield curve for the reinvestment of the 5-year Treasury Bond and A-Rated Corporate Bond (no default) held to maturity.

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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