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CIO continues to favor high-quality bond segments, where valuations look fairer compared to the higher-credit-embedded sectors that have outperformed year-to-date. (UBS)

Cash likely to deliver progressively lower returns over the coming two years

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Market optimism on slowing US inflation faded somewhat toward the end of last week, with the yield on the 10-year US Treasury standing 7 basis points higher than the day the April consumer price index (CPI) was released. The number of rate cuts fully priced in fed funds futures markets also fell back below two.

Recent comments from Federal Reserve officials have left open the possibility of higher-for-longer rates, with Fed Governor Michelle Bowman the latest to indicate her willingness to hike rates if "progress on inflation has stalled or reversed."

But we think it unlikely that the Fed will need to raise rates once again, while interest rates also look unlikely to stay higher for longer indefinitely. We therefore expect cash to deliver progressively lower returns over the coming two years, as data and recent developments support our view of rising and significant reinvestment risks for those who do not proactively manage cash holdings.

The disinflation trend in the US will likely resume, allowing the Fed to start cutting rates later this year. The much-anticipated April CPI report showed both headline and core inflation gauges slowed from the trend of the first three months of this year. Compared with a year ago, April's core CPI marked the slowest pace of inflation in three years. The producer price data was also encouraging, with several components feeding into the Fed's preferred inflation measure showing easing price pressures. Combined with other economic indicators including softer retail sales and labor data, we continue to believe that the US economy is on a path of deceleration toward a soft landing and that the Fed should be in a position to cut rates by 50 basis points this year, with further easing likely in 2025.

The Fed's move is a part of a broader global rate-cutting cycle. Last week, officials from the European Central Bank (ECB) affirmed that rate cuts are likely to start in June. Latvia's Martins Kazaks stated he was "relatively fine" with current market pricing of a rate cut in June, France's François Villeroy de Galhau commented the probability of a June rate cut is "significant," and Slovenia's Bostjan Vasle described the June timing as "reasonable, realistic." A cut by the ECB would follow similar moves by the Swiss National Bank in March and by Sweden's Riksbank earlier this month. We also expect the Bank of England to cut rates by 75–100 basis points this year.

Cash has underperformed historically over the long term. Based on data going back to 1926, a 60/40 portfolio of US large-cap securities and bonds beat cash around 80% of the time over a five-year period. In fact, cash only outperformed bonds early in the hiking cycle, with global bonds starting outperforming even before rates peaked. We also see the reinvestment risk from holding cash as greater than the potential gains from waiting for better bond prices.

So, we believe investors should limit their overall cash balances as falling interest rates this year and beyond will diminish returns on cash. We see value in building a liquidity strategy beyond cash and money market funds, including fixed-term deposits, bond ladders, and structured investment strategies to cover expected portfolio withdrawals over the next five years. We also recommend that investors hold strategic, diversified exposure across fixed income to realize the full return potential of the asset class. Tactically, we continue to favor high-quality bond segments, where valuations look fairer compared to the higher-credit-embedded sectors that have outperformed year-to-date.

Main contributors - Solita Marcelli, Mark Haefele, Daisy Tseng, Vincent Heaney, Jon Gordon

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