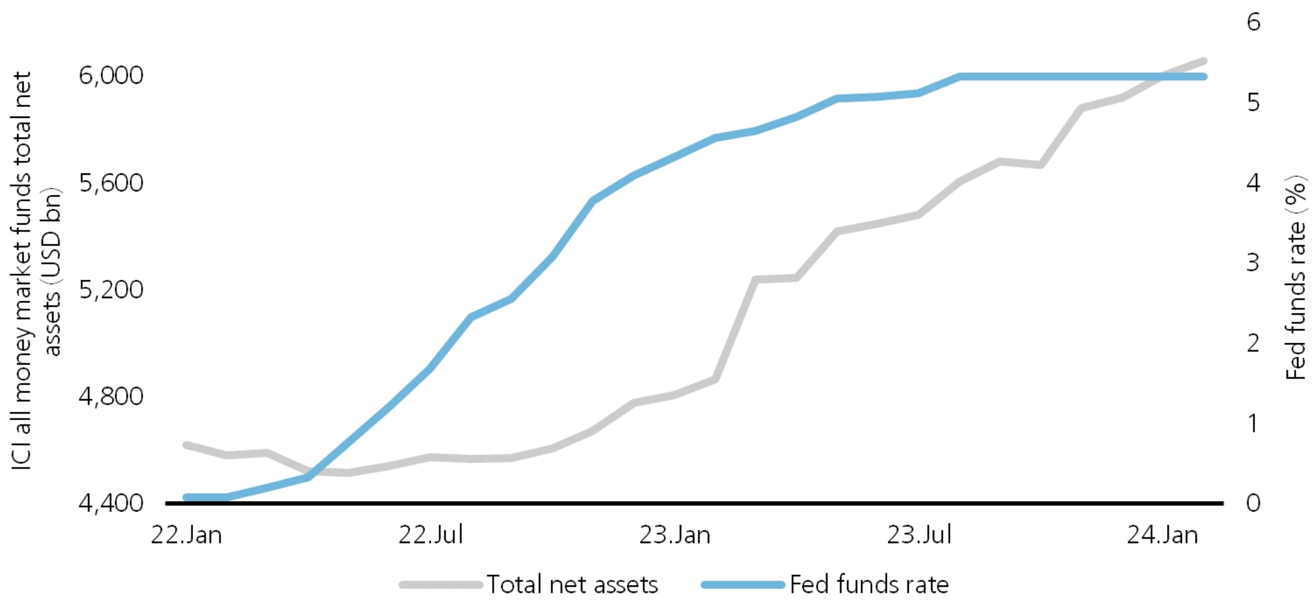

Cash piles have grown with higher rates. (UBS)

Cash piles are at a record high, but it is time to put cash to work

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Investors added billions into money-market funds, but it is time to put cash to work.

Is it time to reduce cash holdings? Yes, since we expect rate cuts in 2024, we recommend investors diversify beyond cash and money market funds through a combination of fixed term deposits, bond ladders, and structured investment strategies.

Record net assets in money market funds. According to the Investment Company Institute (ICI), total money market net flows climbed to nearly USD 6.1 trillion by the end of February 2024 after the Federal Reserve hiked rates, which elevated yields on cash accounts. Nearly USD 1.1 trillion were added by investors to US money market funds in 2023, with an additional USD 191 billion of inflows since the start of 2024.

With rate cuts expected in 2024, investors face potential loss of income. As economic growth slows and inflation continues to moderate, interest rates on cash are poised to fall in 2024. Comments from Fed officials point to rate cuts later this year, but the timing of the cuts is data dependent. The minutes for the January FOMC meeting showed "most officials remained more worried about the risk of cutting interest rates too soon than keeping them high for too long and damaging the economy." Policymakers want to see more evidence inflation is firmly on a path to their target before lowering interest rates. Nonetheless, Federal Reserve Chair Jerome Powell recently said policymakers were "not far from" the confidence needed "to begin to dial back the level of restriction."

Markets have dialed back expectations for rate cuts. Fed fund futures are now pricing in nearly 100 basis points of cuts (four cuts of 25bps), with the first cut likely in June. This has declined from the mid-January expectation for 170 bps of rate cuts.

When the Fed starts to cut rates, falling yields will favor bonds over cash.

Investors will face reinvestment and duration risks.

- Reinvestment risk: the chance that cash flows received from an investment will earn less when put to use in a new investment. When yields fall, cash will experience more reinvestment risk than bonds, because their return comes from income. By contrast, bonds have a higher duration risk than cash, so they will experience price appreciation due to falling yields.
- Duration risk: the risk that a change in interest rates will either increase or decrease the market value of a fixed income investment. In past market cycles, high-quality bonds have experienced a much larger benefit from falling yields than cash due to their higher duration risk, even though short-term bond yields tend to fall more than longer-term yields and credit spreads tend to widen (which dampens high-quality bonds' tailwind from falling Treasury yields).

We believe this is a good time to lock in higher yields. We recommend investors lock-in currently high yields since our base case remains that the Fed will begin to cut rates in June, with 75 basis points of total easing by the end of this year.

We recommend a well-diversified liquidity strategy for investors who wish to manage liquidity:

- Fixed-term deposits. Since we expect interest rates to fall in 2024, we believe investors who are interested in covering potential expenses and liabilities up to 12-months-out should use fixed-term deposits to lock in currently high yields on cash. Investing in fixed-term deposits of different maturities can also help match liabilities and reduce interest rate and reinvestment risks.
- Bond ladders. We recommend investors lock in currently attractive bond yields. For expected portfolio withdrawals over the next 12-60 months, bond ladders involve buying a series of individual short-duration bonds of varying maturities, staggered to provide a steady stream of income, and aligned with the size and timing of expected portfolio withdrawals.
- Structured strategies with capital preservation features. These strategies are recommended for investors who intend to use cash in three to five years time, but wish to participate in further equity gains while also limiting losses. The currently low equity market volatility improves the pricing of such strategies. Since costs may apply if investors need to sell before maturity, we suggest using these tools to cover longer-term liabilities.

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