Market Insights
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The Big Mac on Cash Allocation[1]

Time to Retire the CD Player

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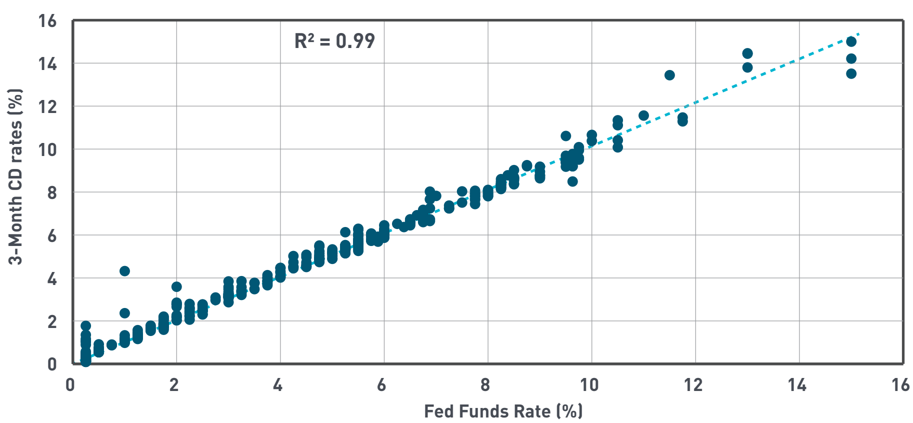
Cash has been a popular asset class in recent months. Under the "fear of the Fed" macro regime, cash has been able to offer some protection from rising rates and severe risk aversion shock while also providing meaningful yields. But the macro backdrop has radically changed. With the federal funds rate at or near peak levels, we believe that cash — as expressed as certificates of deposit (CD) — is likely to start underperforming credit in the period ahead. We favor deploying some credit risk as an attractive alternative to a cash allocation.

Given that the Fed tightening cycle is (virtually) over, we believe cash is likely to underperform credit going forward. The peak of central bank rates has historically been a major turning point with respect to the underperformance of cash relative to fixed income. In this report, we analyze cash performance using the 3-month US certificate of deposit (CD) rate, for which long-term data are easily available. As illustrated by Exhibit 1, there has been an extremely high correlation between the federal funds rate and the 3-month CD rate. In other words, the CD rate has historically been determined by the US Federal Reserve's policy rate.

Exhibit 1: Statistical Relationship Between the Federal Funds Rate and the 3-Month CD Rate

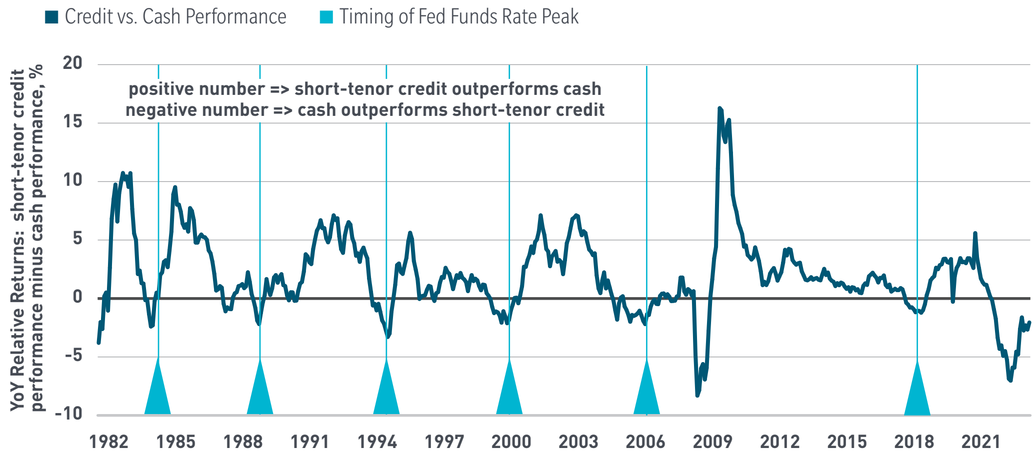


Source: Bloomberg, Fed, Fed Fred database. Federal funds rate: Cash = 3-Month or 90-day Rates and Yields: Certificates of Deposit for the United States, Percent, Monthly, Not Seasonally Adjusted. Monthly data from January 1982 to August 2023.

[1] The Big Mac, which is a hint at big macro, is a periodic global fixed income note that discusses relevant topics in the global fixed income/global macro environment.

Historically, cash has started underperforming short-tenor credit shortly after a federal funds rate peak. Analyzing the historical data of the Fed's monetary policy since 1982, we have identified six different Fed tightening cycles. Overall, cash performance fell below that of short-tenor credit three months after the peak of the federal funds rate on average, as shown in Exhibit 2. The relative returns of credit against cash indeed tended to recover to positive territory shortly after the Fed rate has reached its cycle peak.

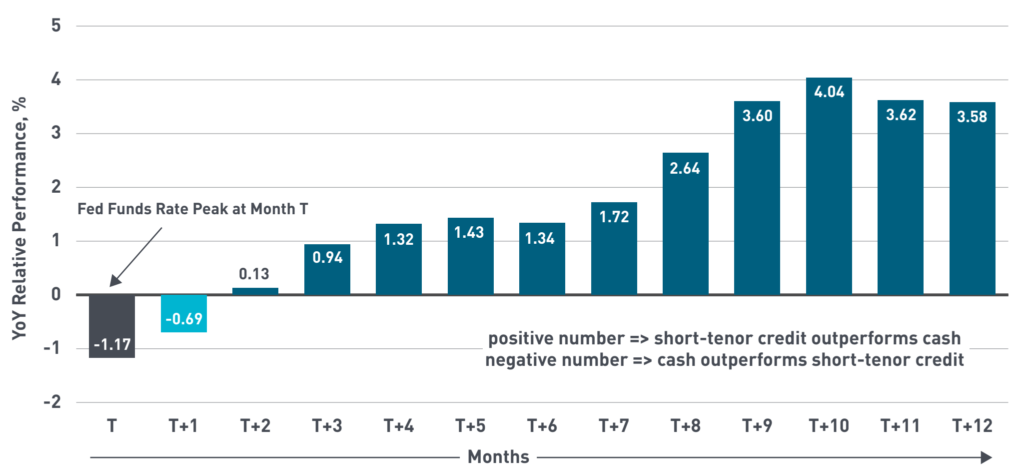
Exhibit 2: Short-Tenor Credit Relative Performance Against Cash and Federal Funds Rate Peaks



Source: Bloomberg, Fed Fred database, ICE BofA. Federal funds rate: Cash = 3-Month or 90-day Rates and Yields: Certificates of Deposit for the United States, Percent, Monthly, Not Seasonally Adjusted. Short-tenor credit = ICE BofA, 1-3 year US IG corporate credit (C1A0 index). Monthly data from January 1982 to August 2023. Annualized returns stepped monthly.

The magnitude of the cash underperformance has tended to increase with time. In the early months following the end of a Fed tightening cycle, historically, cash underperformance was modest. Three months after the peak for instance, short-tenor credit outperformed cash by only 0.94% on average. But the cash underperformance then became more significant and reached an average of 3.6% by month nine and stayed elevated thereafter (Exhibit 3).

Exhibit 3: Magnitude of Short-Tenor Credit Relative Performance Against Cash Following Fed Rate Peaks

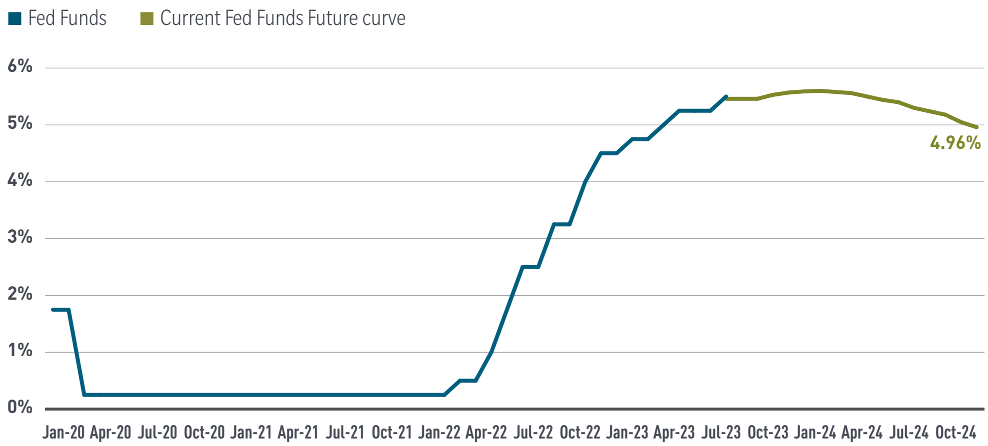


Source: Bloomberg, Fed Fred database, ICE BofA. Federal funds rate: Cash = 3-Month or 90-day Rates and Yields: Certificates of Deposit for the United States, Percent, Monthly, Not Seasonally Adjusted. Credit = ICE BofA, 1-3 year US IG corporate credit (C1A0 index). Monthly data from January 1982 to July 2023. YoY returns. Based on the average of the six rate peak episodes since 1982.

We are potentially already in month T+2. There is still an ongoing debate about whether the Fed has already completed its tightening cycle or not, following its most recent rate hike in July, but we have essentially either reached the end or are very near the end of this tightening cycle. As we see it, there are plenty of compelling arguments that support the view that the Fed has already reached its cycle rate peak. In particular, substantial progress on the disinflation front has provided a much higher degree of comfort for the central bank. If indeed this is month T+2, this suggests that, based on our historical data analysis, cash underperformance may be just around the corner.

Based on current Fed policy pricing, cash rates are set to decline over the next few quarters. As discussed above, the main driver of cash rates is the federal funds rate. Now, the federal fund futures curve points to the possibility of the federal funds rate cut to 4.96% by the end of 2024, with rate cuts beginning in Q3. This rate move would undermine the outlook for cash performance.

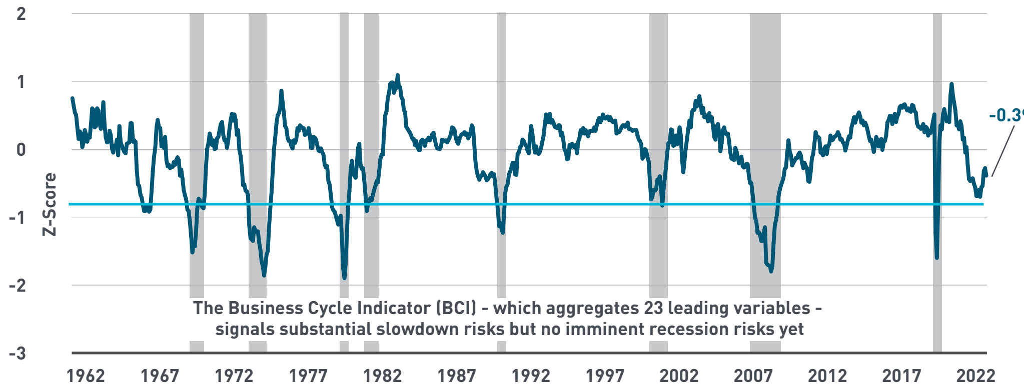
Exhibit 4: Federal Funds and Federal Fund Futures Curve



Sources: Bloomberg. Monthly data from January 2020 through August 2023. Implied policy rates based on federal fund futures monthly contracts from Sept 2023 to December 2024, adjusted by 0.125% to reflect upper-bound federal funds. Data as of 21 Sept 2023.

Looking at the macro backdrop, deploying more credit risk makes sense, in our view. This is because the macro-outlook has improved over the past few weeks, with fears of recession now receding — somewhat. Indeed, the case for a soft landing has strengthened, which is less supportive of a highly defensive bias. This is an important development for fixed income as it potentially reduces the risk of severe spread widening in the event of a recession. However, given the speed and magnitude of this hiking cycle, the risk of further aggressive tightening appears low, which would be constructive for fixed income. Our business cycle indicator now shows that the risk of recession has declined markedly even though the risk of a significant growth slowdown remains present (Exhibit 5).

Exhibit 5: The Business Cycle Indicator: Aggregating Selected Leading Indicators for the US



Source: Data from Bloomberg. Monthly data from Jan 1962 to Aug 2023. The BCI aggregates z-scores of 23 variables. The shaded areas designate official US recessions as defined by the National Bureau of Economic Research (NBER). A Z-score is the number of standard deviations a given data point lies above or below the mean. The horizontal line designates a z-score of minus 0.75, which signals a significant deviation from the mean. See end note for full source details.[1]

Market rates have risen recently for the right reasons. Last year, the rate correction was primarily driven by inflation shock. This is no longer the case. We would now argue that the recent rate move reflects the improvement in the growth outlook. But looking ahead, we do not believe that the rate correction is sustainable. Our rate view is that market rates will stabilize at a higher level and rate volatility will moderate, which is supportive of long-term fixed income returns.

In our view, the valuation picture of short-tenor credit looks quite favorable. For a start, the current yield on short-tenor credit stands at around 6.0%, which is quite high by historical standards, and some 60 basis points higher than current CD rates (Exhibit 6). This means that with a duration of 1.8, the short-tenor credit index would have to suffer a 30 bp upward rate move for the performance to break even with that of the 3-month CD rates (assuming that the CD rate remains unchanged during the same period). The higher starting yield helps lower the risk of lower returns. Exhibit 7 displays the various combinations of one-year return projections for 1-3 year US IG credit under multiple rate and spread move scenarios. Overall, only an extreme scenario (shown in red) would lead to a negative return over a one-year period.

Exhibit 6: Short-Tenor Credit Yields

Source: Bloomberg, ICE BofA. Short-Tenor Credit = ICE BofA, 1-3 year US IG corporate credit (C1A0 index). Weekly data from 13 Sept 2013 to 21 Sept 2023.

Exhibit 7: 1-Year Return Projections for US Short-Tenor Credit Under Various Rate and Spread Move Scenarios (%)

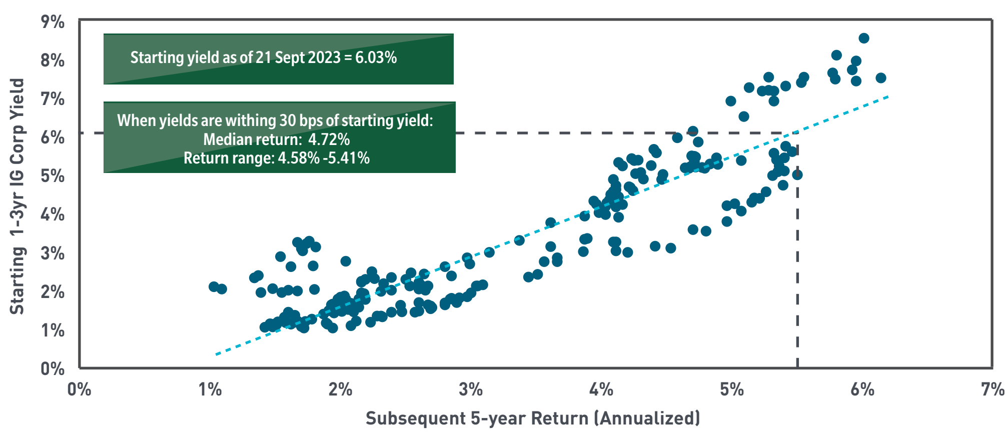
Spread moves over the next year

US IG 1-3yr — Rate Moves Over the Next Year (bp)	-150	-120	-90	-60	-30	0	+30	+60	+90	+120	+150	+180	+210
+150	5.98	5.43	4.96	4.42	3.88	3.35	2.81	2.28	1.74	1.21	0.67	0.14	-0.40
+120	6.54	5.98	5.49	4.96	4.42	3.88	3.35	2.81	2.28	1.74	1.21	0.67	0.14
+90	7.09	6.54	6.03	5.49	4.96	4.42	3.88	3.35	2.81	2.28	1.74	1.21	0.67
+60	7.65	7.09	6.56	6.03	5.49	4.96	4.42	3.88	3.35	2.81	2.28	1.74	1.21
+30	7.65	7.65	7.10	6.56	6.03	5.49	4.96	4.42	3.88	3.35	2.81	2.28	1.74
0	8.76	8.20	7.63	7.09	6.54	**6.03**	5.43	4.87	4.32	3.76	3.21	2.65	2.10
-30	9.31	8.76	8.17	7.63	7.10	6.56	6.03	5.49	4.96	4.42	3.88	3.35	2.81
-60	9.87	9.31	8.70	8.17	7.63	7.10	6.56	6.03	5.49	4.96	4.42	3.88	3.35
-90	10.42	9.87	9.24	8.70	8.17	7.63	7.10	6.56	6.03	5.49	4.96	4.42	3.88
-120	10.98	10.42	9.77	9.24	8.70	8.17	7.63	7.10	6.56	6.03	5.49	4.96	4.42
-150	11.53	10.98	10.31	9.77	9.24	8.70	8.17	7.63	7.10	6.56	6.03	5.49	4.96

Source: Bloomberg, ICE BofA: US IG 1-3yr = ICE BofA, 1-3 year US IG corporate credit (C1A0 index). Current yield of 6.03% as of 21 Sept 2023. Current duration as of 21 Sept 2023. 1-year return projection is estimated as current yield + net change between rate and spreads x duration. References to future expected returns and performance are not promises or estimates of actual performance that may be realized by an investor and should not be relied upon. The forecasts are for illustrative purposes only and are not to be relied upon as advice, interpreted as a recommendation, or be guarantees of performance. The forecasts are based upon subjective estimates and assumptions that have yet to take place or may occur. The projections have limitations because they are not based on actual transactions but are based on the models and data compiled by MFS. The results do not represent nor are indicative of actual results that may be achieved in the future. Individual investor performance may vary significantly.

Historically, starting yields have tended to be correlated with subsequent returns. Historical data suggest a strong relationship between entry yields and subsequent returns. In historical periods when the short-tenor credit starting yield was between 4.6% and 5.2% — a 30 bp range around the current yield — subsequent 5-year returns ranged between 4.4% and 5.46%, with a median return of 4.72% (Exhibit 8).

Exhibit 8: US 1-3yr IG Corp: Starting Yield vs. Subsequent 5-year Total Return



Source: Bloomberg. ICE BofA. Short-Tenor Credit = ICE BofA, 1-3 year US IG corporate credit (C1A0 index). Monthly data from January 2000 through August 2023. Past performance is no guarantee of future results.

Overall, with the end of the Fed's tightening cycle upon us, we believe it may be time to retire the CD player. Indeed, we believe cash is likely to underperform short-tenor credit in the period ahead. We are constructive about deploying some credit risk as an alternative to the cash allocation, reflecting the attractive valuation, the improved growth backdrop and the favorable inflation dynamics.

Endnotes

[1] The BCI incorporates the following variables: Initial jobless claims (Department of Labor), Building permits (US Census Bureau), Philadelphia Fed business outlook survey diffusion index (Philadelphia Fed), New home sales (US Census Bureau), Consumer sentiment index (University of Michigan), Consumer sentiment index Conference Board), Capex expectations index aggregated from the Fed regional surveys (New York, Richmond, Dallas, Kansas City, Philadelphia), ISM new orders (Institute for Supply Management), Corporate profit margin changes (Bureau of Economic Analysis), Corporate profit growth (Bureau of Economic Analysis), Corporate profit margin level (Bureau of Economic Analysis), Output gap (Congressional Budget Office), US Consumer Price Index – Energy (Bureau of Labor Statistics), Empire State manufacturing survey (New York Fed), National Association of Home Builders Market Index (NAHB), NFIB Small Business Optimism Index (NFIB), Housing starts (Census bureau), Senior Loan Officer Opinion Survey, Net % of Domestic Respondents Tightening Standards for C&I Loans for Small Firms (Fed), ISM manufacturing (Institute for Supply Management), ISM Services (Institute for Supply Management), Investment ratio: Fixed investment as % of GDP, transformed into monthly series through interpolation (Bureau of Economic Analysis), Compensation Ratio change. Personal Income Compensation of Employees Received as % of GDP. 12-month change in the ratio (Bureau of Economic Analysis), Unit labor cost (Bureau of Labor Statistics).