

Global Matters Weekly

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Siren call

by Alex Harvey, CFA

I recently returned from a client trip to Asia, during which I visited Hong Kong for the first time. The 'Fragrant Harbour', to coin its literal name. From my short time there I found it to be a fascinating and vibrant melting pot of 'East meets West', with a can-do and pro-business attitude. Yes, the city has witnessed major politically motivated unrest and change in recent years, which has undoubtedly had knock-on effects, but as an outsider visiting for the first time, I could feel the city's welcoming energy.

Markets have clearly been challenged over the last couple of years as the confluence of post COVID-19 inflation, geopolitical instability and sharp policy tightening have dented investor sentiment and lowered valuations across a swathe of financial asset classes. This has led us to a juncture where cash looks highly appealing, but we'd argue that investors should not succumb to the quick fix of cash, and instead focus on longer term returns. Three-month US treasury bills yield 5.4%; the equivalent maturity UK and German bills yield 5.2% and 3.6% respectively (in sterling and Euro terms). Savers can get instant access deposit rates of 5.2% in the UK; 5.5% on three month notice accounts. Two years ago, these rates were rooted around zero in the US and UK, and were negative in the Eurozone. In the eyes of many of our clients, 'cash is king' today. And after a year like 2022 when barely any major asset class made a positive return, who would blame them? Flows into money market funds have surged this year, hitting \$722bn through to August end, surpassing 2020's \$684bn (which was the best year since 2010)¹. The clamour for cash has almost become deafening. And when something is so consensus, it is usually time to start moving to the other side of the room.

Beyond this more intuitive feel though, how well has cash rewarded investors after previous rate cycle peaks? Going back forty years (30 June 1983), there have been six observable peaks in the 3-month US Treasury bill yield. In the subsequent post peak twelve months, US treasury bonds outperformed cash on every occasion, by an average of almost 9 percentage points (ppts)*. Three and five years post these peaks treasury bonds outperformed by 4.5ppts and 4ppts, respectively. For equities the picture is slightly different with the average 12 month post peak return being 3.5%** (underperforming US T-bills), and with very wide dispersion (min -25.2% post October 2000 peak, max 25.5% post January 1995 peak).

Longer term however, over three and five years, global equities outperformed both cash (by an average 5.1ppts) and US treasury bonds (by an average 0.9ppts), as one might expect. So, if we are at or close to peak rates, as many economists are suggesting, then history would suggest cash should be usurped from its throne.

'Reinvestment risk' is the term used to describe the financial risk whereby the proceeds of an investment (in this case a cash deposit) cannot be reinvested at the same rate on a forward-looking basis. After such a big move higher in cash rates over the last two years, and with market expectations that we are near peak levels today, this reinvestment risk is currently very high. It is partly for this reason that in recent weeks and months we have extended the duration of our multi asset portfolios ('duration' being the technical term for increasing interest rate risk, usually through buying longer maturity bonds) to take advantage of the attractive yields embedded into future cash rates before any actual policy easing starts. The 1.375% 11/15/40 treasury bond – one of several bonds added during in the third week of October, has already delivered an 8% return since purchase. This serves not only to add incremental return to the portfolios but also adds ballast to diversify portfolios should higher risk assets such as equities come under pressure.

The siren call of cash is all around us right now. It pulls you in under a veil of comfort and security, but rarely is cash king for long. The average 12 month change in the 3-month US treasury bill yield of those six observable post peak cycles was 2.4ppts lower. And nominal cash returns are of course eroded further by inflation, which remains high by historical standards today. Cash of course has its rightful place in portfolios, and we have flexed our allocation to it over the last few years, but more recently have brought it down and extended duration. As Odysseus told his crew in Greek mythology, block your ears with wax, don't be lured in, and sail on. And if cash really isn't king, then perhaps bonds will sing.

* As measured by the ICE BofA US Treasury index.

** As measured by the MSCI World TR index in USD.

Source

1 Money market mania! The winners and losers from investors' dash to cash, <https://citywire.com/pro-buyer/news/money-market-mania-the-winners-and-losers-from-investors-dash-to-cash/a2426355>

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