When cash isn't king.

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It's been a torrid time for fixed-income investors, whichever way you assess the numbers. After record declines in 2022, the Bloomberg Barclays U.S. Aggregate Index is flirting with an unprecedented third consecutive negative year.

Throughout this "bond bath," cash has been a beacon of light in many portfolios. Indeed, cash holders were the primary beneficiary last year when the U.S. Federal Reserve (Fed) raised interest rates by 425 basis points. Underscoring the extent of the recent performance divergence between cash and bonds, the ICE BofA U.S. 3-Month Treasury Bill Index outperformed the Bloomberg Barclays U.S Aggregate Bond Index by more than 7% over the past three years (annualized) ending October 2023.

Several headwinds persist for the fixed-income market: U.S. inflation remains well above the Fed's 2% target rate; supply-and-demand dynamics for the U.S. Treasury market is pressuring bonds prices; and the front-end of the yield curve remains inverted.[1]

Why consider reducing cash in favor of fixed income?

No one can consistently predict the future—not the greatest investors or even the Fed. As displayed a number of times in 2023, market sentiment can turn on a dime, including in early March, when regional bank concerns caused the U.S. 2-year Treasury yield to drop by roughly 100 basis points in a matter of days.

Despite the market challenges, we believe there are several positive elements that are tipping the performance scales in favor of fixed-income investors:

- The Fed is nearing the end of its interest-rate hiking cycle
- Treasury yields generally shift lower prior to the end of a Fed hiking cycle
- Fixed-income markets are offering the most attractive yields in well over a decade (Exhibit1)

[1] Yield-curve inversion reflects the 2-year U.S. Treasury versus the 10-year U.S. Treasury.

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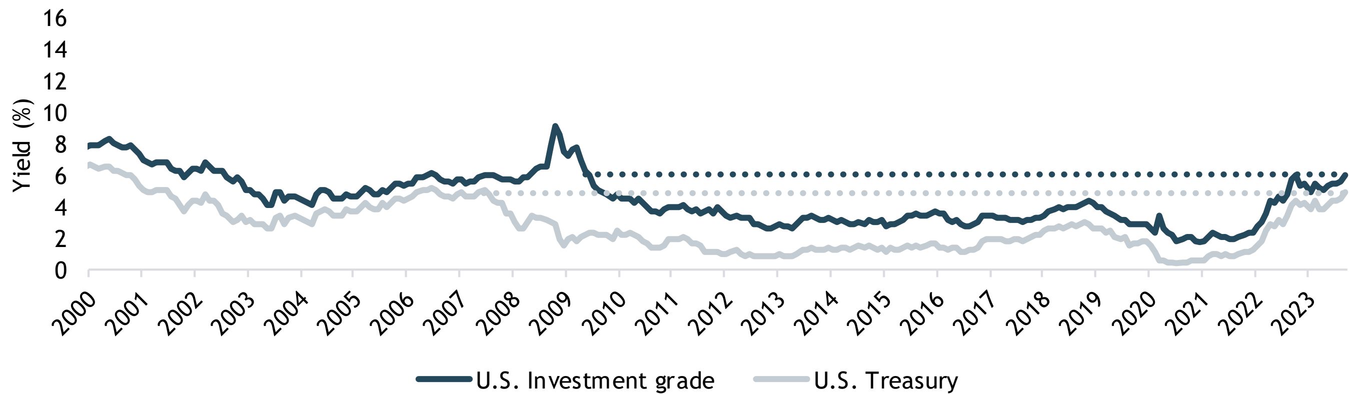
Exhibit 1: Historical investment-grade yields

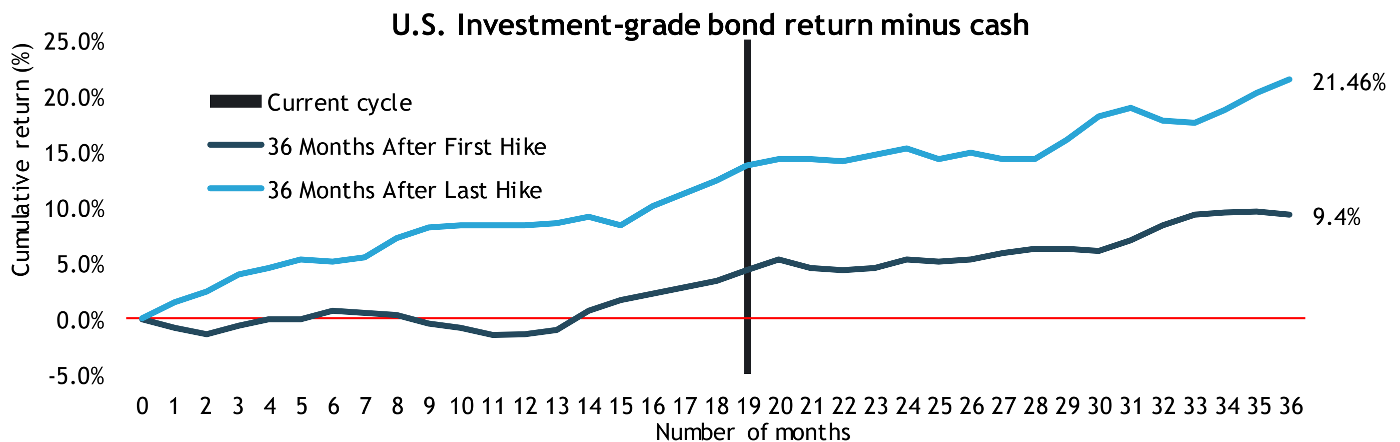


Source: SEI, Bloomberg. U.S. Investment grade = Bloomberg Barclays U.S. Corporate Investment Grade Index; U.S. Treasury = Bloomberg Barclays U.S. Treasury Index. Past performance is no guarantee of future results. This chart contains back-tested index performance. Please see disclosures under Important Information regarding the limitations of back-tested performance.

In the absence of a crystal ball, we often look to the past for clues as part of our market analysis. Given our current view that the Fed is nearing the end of its hiking cycle, we examined historical fixed-income market returns relative to cash—both during and at the end of hiking cycles over the past 40 years. Exhibit 2 displays the cumulative performance of cash relative to the Bloomberg Barclays U.S. Corporate Bond Index (U.S. Investment Grade) over the 36-month period after the Fed 'starts hiking' and the 36-month period after the Fed 'stops hiking'.

Notably, the fixed-income market outperformed cash over both 36-month periods, even during the period that captures the Fed's hiking cycle. The level of outperformance versus cash grows even further when you consider the 36 months after the Fed stops hiking, a phase we believe we are currently nearing.

Exhibit 2: Fixed income vs. cash historical returns before and after the first Fed hike



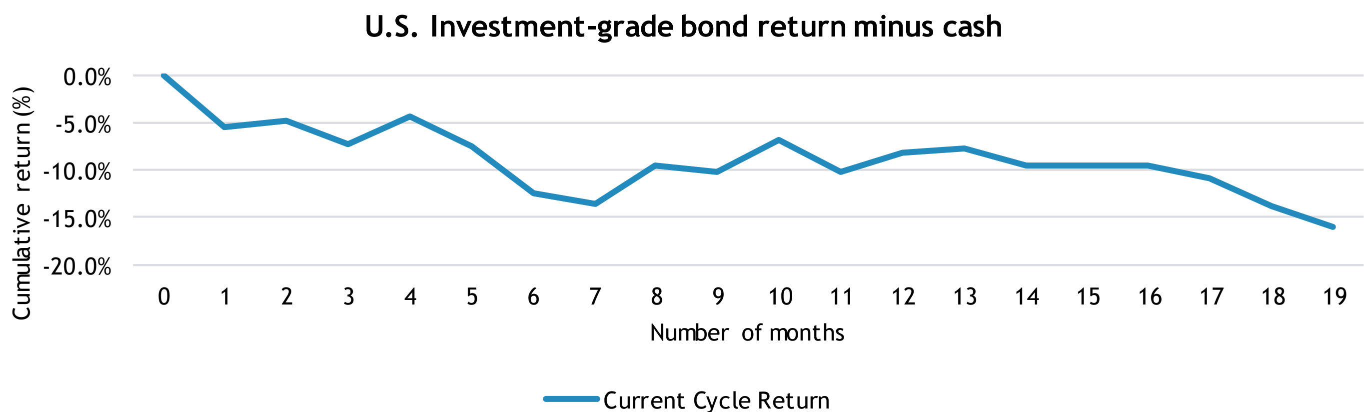
Source: SEI, Wellington, Bloomberg. U.S. IG = Bloomberg Barclays U.S. Corporate Investment Grade Index; Cash = ICE BofA U.S. 3-Month Treasury Bill Index Hiking cycles: May 1983-August 1984; March 1988-May 1989; February 1994-February 1995; June 1999-May 2000; June 2004-June 2006; December 2015-December 2018. Periods were calculated using month-end data beginning in the month after the first or last hike of a cycle. Returns are cumulative monthly returns. Past performance is no guarantee of future results. This chart contains back-tested index performance. Please see disclosures under Important Information regarding the limitations of back-tested performance.

What has historically contributed to the outperformance of bonds?

Several factors are at play when it comes to the outperformance of bonds, including reinvestment risk—which refers to the concept that when interest rates fall, shorter-maturity cash investors tend to reinvest at a lower rate than the fixed rate achieved by the fixed-income investor. The 36-month periods that we assessed capture both interest-rate hikes and cuts. Bond price appreciation occurs when interest rates end the period lower than where they started. This occurred in three of the six cycles we assessed for the '36-months after first hike' period, and, not surprisingly, in all six 36-month periods that followed the end of Fed hikes.

The Fed started the current tightening cycle in March 2022. Therefore, we are currently around 19 months into the cycle. While the fixed-income market has historically outperformed cash at around 14 months after the first hike, this has not been the case in today's cycle (Exhibit 3).

Exhibit 3: Fixed income vs. cash historical returns current cycle performance



As of October 2023. Source: SEI, Wellington, Bloomberg. U.S. IG = Bloomberg Barclays U.S. Corporate Investment Grade Index, Cash = ICE BofA U.S. 3-Month Treasury Bill Index. Past performance is no guarantee of future results.

At SEI, we acknowledge that each interest-rate cycle has its own nuances, and that the path to lower Treasury yields may take time given the Fed's current higher-for-longer monetary policy. We also expect interest-rate volatility to persist as the market digests geopolitical concerns, market technicals, and economic crosswinds.

With that said, the fixed-income market now offers an attractive "yield cushion." To illustrate this point, let's look at a generic 10-year U.S. Treasury security that yields 4.85% with a duration of 7.90 years. If Treasury yields hypothetically have an instant rise of 50 basis points from their current level, the value of the Treasury will generally decline by around 3.95%. Once you consider the higher yield offered in the market, the aggregate return (4.85%-3.95% = 0.90%) remains positive. This highlights the benefit of the yield cushion offered in the market that was not available only a matter of months ago. Conversely, if yields decline, the value of the bond increases to the same extent.

For context, the Federal Open Market Committee, the Fed's policy-making arm, projects one more 25-basis-point hike in 2023 followed by two cuts in 2024, as represented by the median 'dot plots.' As of October 31st, the overnight-index swap market is pricing in a small chance of one more hike in 2023, with a number of cuts in the following year. Therefore, both the Fed and the fixed-income market have pointed to limited hikes on the horizon, with cuts priced in for next year.

While we don't expect history to repeat, we do expect it to rhyme. The most recent spike in bond yields created new market cycle highs and notably increased the prospect of the fixed income outperforming cash. While it is difficult to predict the exact peak in yields, we believe that investment grade nominal bonds offer attractive value over the medium term.

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