
Adjusting to a changing market

Cash management research note | July 2023

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Introduction

Cash management is a topic of increasing importance to investment managers. Approximately 11% of holdings across the Addepar client base are in cash instruments, up 30% from the last quarter of 2021. As cash market dynamics continue to evolve rapidly, the impact on portfolio performance between a competitive cash management strategy and a poor one can be significant. In this note, we share insights into cash market dynamics and how that reflects in portfolios.

Key takeaways

Economic data in June and the first week of July moved markets to price in higher rates for longer, minimizing the incentive to take on duration exposure in cash markets. Additionally, volatility experienced earlier in the quarter has subsided and compressed credit spreads to historically low levels.

Some additional key trends include:

- Cash positions peaked in March and subsequently declined.
- Flows show a steady picture of investors rolling Treasuries into longer maturities, outflows from cash accounts and net flat flows (and therefore positions) in money market funds.

Cash market trends

The Federal Reserve has implemented significant tightening measures since 2021, which seem to be resulting in a noticeable deceleration in inflation. Nevertheless, economic growth indicators and income/wage levels continue to show strength, even as inflation remains above the Federal



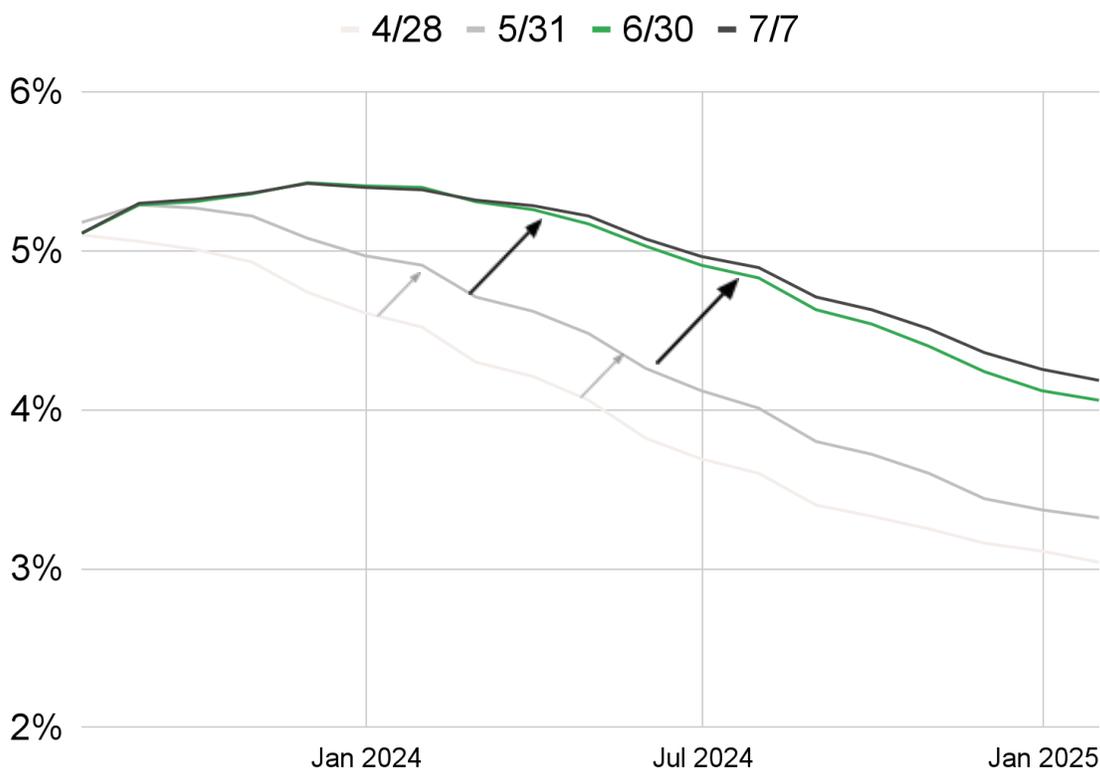
Reserve's targeted level of 2%. The market is pricing in what the Fed has been communicating recently — that the fed funds rate will have to remain high for a long time. As Exhibit 1 shows, the fed funds forward rate curve, which refers to market-implied expectations for future fed funds rates, continues to become less inverted and is now priced to peak at the end of this year. As a result, 2-year bond yields are now at rates not seen since 2006, further inverting the yield curve.

Interest rates are relatively similar at the front end and then downward sloping, implying no additional yield for taking on extra duration exposure. For managers, the incentive remains to stay invested in shorter maturities.

Exhibit 1

Following the conclusion of the debt ceiling crisis, the market has pushed back its expectations of easing into 2024

Fed funds futures implied rates as of April 28, May 31, June 30 and July 7



Source: CME Group

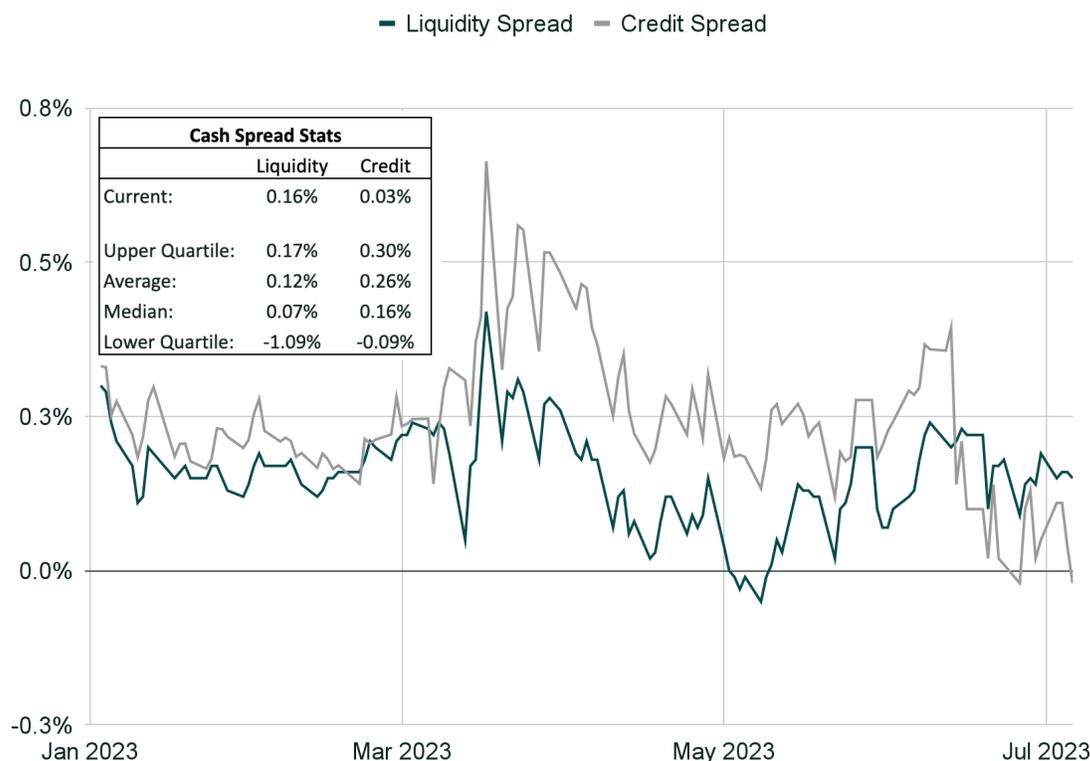


Earlier this quarter, we reported on distortions in Treasury bill rates and other premia due to stalled debt ceiling talks. Those distortions have now subsided. Liquidity premiums are near their long-term averages while credit premiums stand at historical lows.

Exhibit 2

Liquidity spreads are higher than usual while credit spreads are near zero, significantly reduced from their peaks in April

Liquidity and credit spreads, Jan. 1–July 6, 2023



Source: Federal Reserve Bank of Saint Louis, Thomson Reuters

Liquidity spreads are calculated as the difference between 90-day fully collateralized repos and 13-week Treasury bills. Note that this spread historically aligns with spreads at the 1-month term point. Credit spreads are calculated as the difference between 30-day commercial paper rates and 4-week Treasury bill rates.

Investor trends

Total cash positions peaked in March, largely attributed to the roll-off of Treasury bills without re-investment. Broadly speaking, private wealth investors continue to hold elevated levels of cash at roughly 11% of their portfolios on average, compared to a 9.7% historical average. Investors are

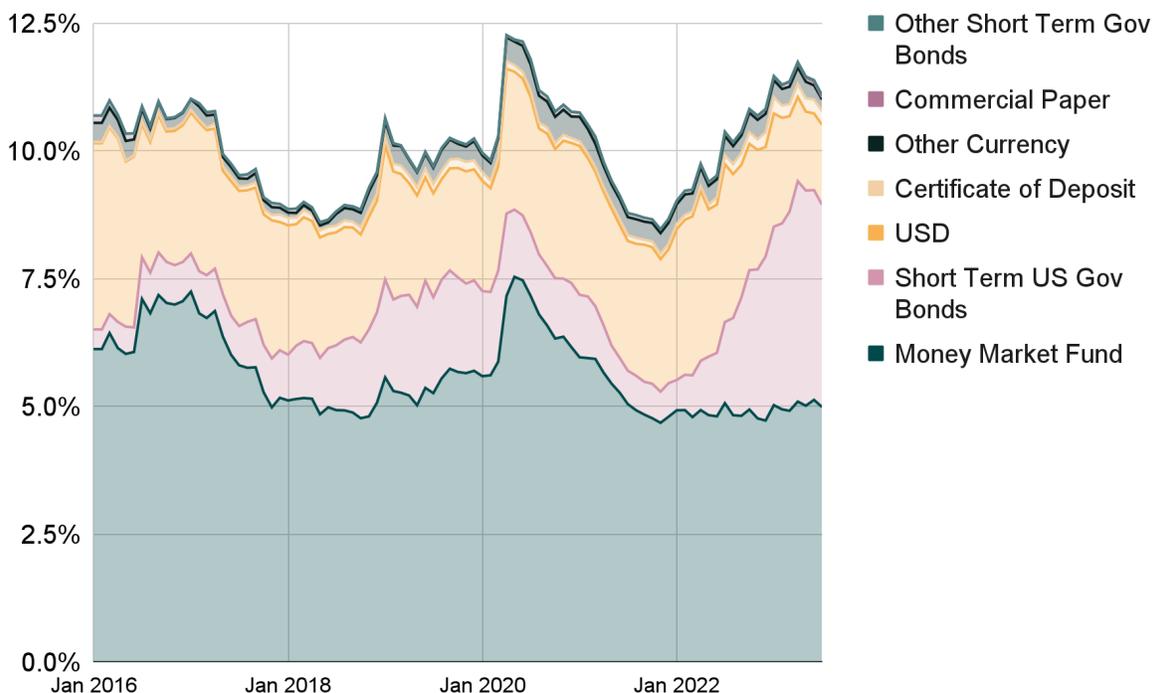


allocating 5% of their cash to money market funds, 4% to direct trading of short-term Treasuries and the remainder to depository and other types of cash instruments.

Exhibit 3

Allocations to cash remain high, but fell slightly from a peak in March 2023

Cash holdings by investment type, % of total assets, Jan. 2016–June 2023



Source: Addepar

USD and other currency are defined as paper money and cash held at banks. Money market funds are ETFs and mutual funds that invest in safe fixed-income instruments with maturities of one year or less. Short-term U.S. government bonds are Treasury bills and off-the-run Treasury securities set to mature in one year or less.

June flows show relatively consistent long-term trends. We highlight these trends below for your reference:

- Although values are quite small, investors are moving money out of cash bank accounts, perhaps due to the large dispersion in returns between securities and bank products. Flows into CDs are also negligible, likely for similar reasons.
- While in aggregate, money market flows are relatively flat since 2022, these flows do tend to be somewhat seasonal and higher at quarter-end, probably due to mechanical sweeping



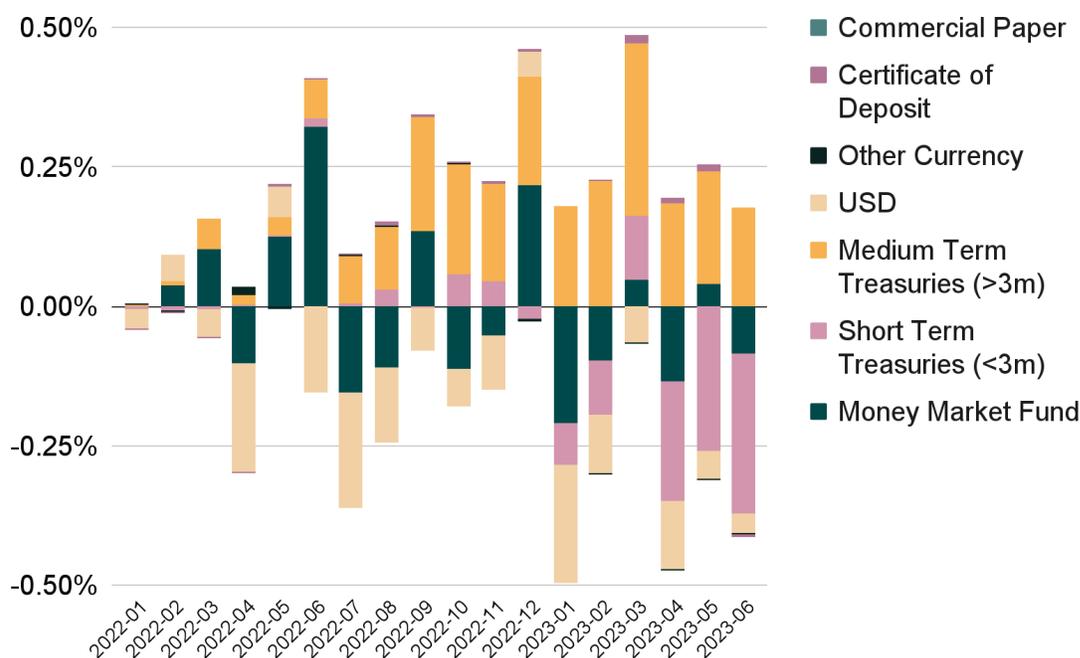
of dividends. However, despite this seasonality, money market flows were modestly negative in June.

- Investors roll maturing Treasury bills largely into 3- and 6-month maturities, as we illustrate in Exhibit 5.

Exhibit 4

Investors in June continued a trend established over the past three months, flowing into medium-term Treasuries (>3m) and out of short-term Treasuries (<3m)

Average portfolio flows* into cash, Jan. 2022–June 2023



Source: Addepar

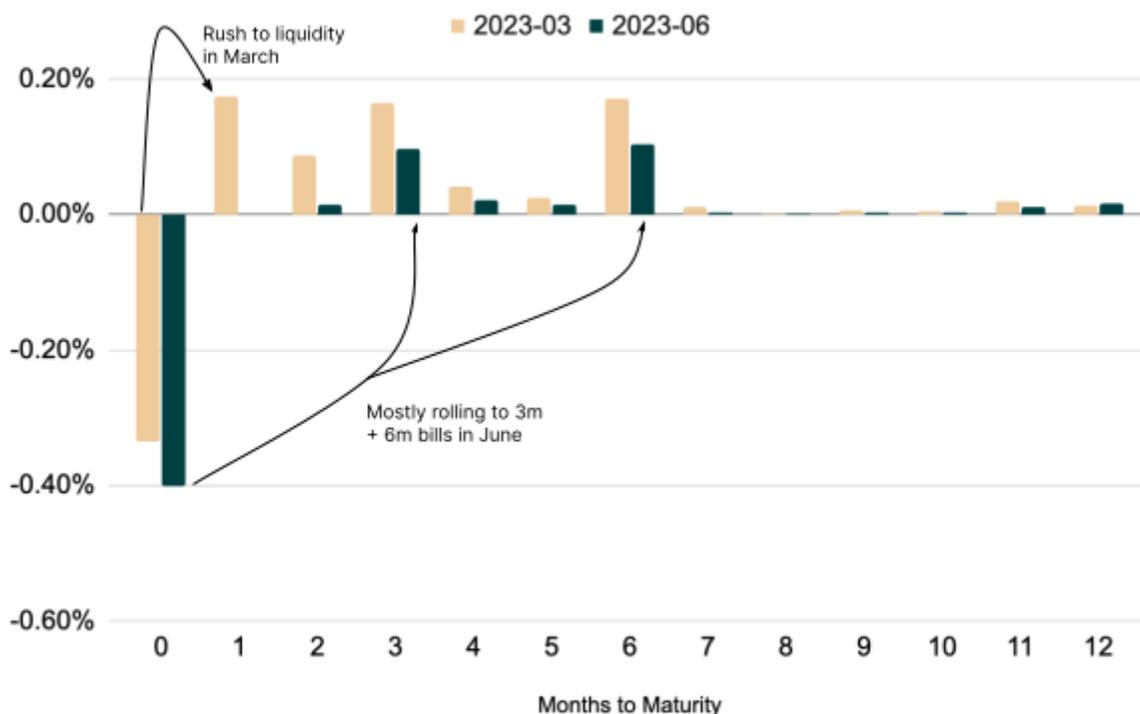
*To measure the flow into an asset class, we take the difference between the end-of-period assets and beginning-of-period assets and remove the impact of price effects. We then normalize this dollar flow by the average amount of assets at the beginning and end of the period (again, adjusted for price effects).



Exhibit 5

Investors are now primarily rolling their maturing Treasuries into 3-month and 6-month T-bills, as compared to a wider range of maturities in March

Flows into Treasury bills by months to maturity, March 2023 and June 2023 comparison



Source: Addepar

4. Conclusion

In this note, we’ve shared some key dynamics in cash markets and how investors are positioning their cash portfolios. Please read our companion notes on cash optimization or reach out to us with any questions on this topic.

5. Definitions

The **fed funds forward rate curve** is a graphical depiction of expected fed funds interest rates in the future as priced by futures contracts. Typically, the curve is upward sloping, indicating that longer-term securities have higher yields than shorter-term securities. Generally, the central bank is more likely to tighten policy than ease. This pattern also reflects the market’s expectation of



higher compensation for holding longer-term bonds due to factors such as inflation uncertainty and interest rate risk. The shape of the curve can change based on economic conditions and market expectations. At present, U.S. markets are pricing in a few more rate hikes in 2023, followed by rate cuts in 2024–2025.



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