Treasury bills back in favor

Cash Research Note | May 2023

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1. Takeaways

- Private wealth investors continue to increase cash allocations, mostly through direct Treasury bill purchases. Treasuries provide relative safety, lower transaction costs and access to longer maturities (6–12 months) not readily offered through money market funds.
- The fed funds forward rate curve[1] has inverted, indicating that the market expects rates to decline by the end of the summer. This inversion, coupled with reasonable probabilities that short-term rates will rise (curve flattening), is pushing investors to shorter-term paper.
- However, trading the short-end of the curve has become complex due to stalled debt ceiling negotiations and potential for a default. Investors have been stuck choosing between a volatile 1-month Treasury bill and risks related to going further out on the curve.

2. 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. Because interest rates are now substantially above zero and cash market dynamics are evolving rapidly, the impact on portfolio performance between a competitive cash management strategy and a poor one can be significant.

[1] See Definitions page.

In this note, we introduce the first of a regular quarterly update on key trends in cash markets and how private wealth investors are reflecting these dynamics in their portfolios.

3. Cash market trends

Many investors today are focused on how much Fed tightening is needed, and over what time frame, to contain inflation. The fed funds forward curve, which refers to market-implied expectations for future fed funds rates, provides a glimpse into the bond market's view into this question. Following the SVB run on deposits, forward rates started to price easing in 2023, indicating that the market assumes that the Fed has largely completed its inflation fight and will soon start to stimulate the economy (or perhaps at least end the rate increases).

Exhibit 1 shows the next 12 months of forward rates as implied by fed funds futures. These rates show a downward sloping curve. Managers are incented to buy shorter-term Treasuries because they offer higher yields and lock up capital for less time. More subtly, but also important, managers who expect a higher likelihood that inflation will remain high — implying that the Fed will keep rates higher for longer versus ramping down faster than the market currently expects — are doubly incented to stay on the short-end of the curve. If the Fed maintains rates higher for longer, then rates will rise and we should experience a rate-driven sell-off. In fact, the Fed's forward guidance is to keep the fed funds rate steady through the rest of the year (i.e. SEP dot plots).

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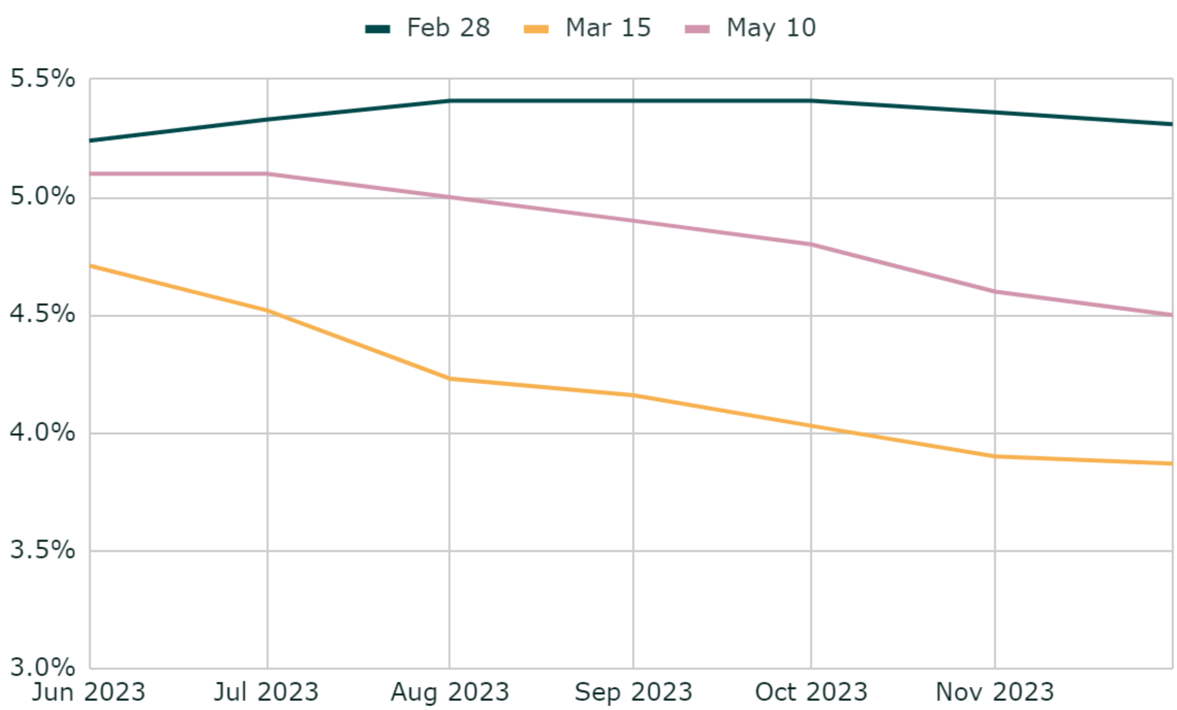
Exhibit 1

The market now expects that the Fed will start easing later this year

Fed funds futures implied rates



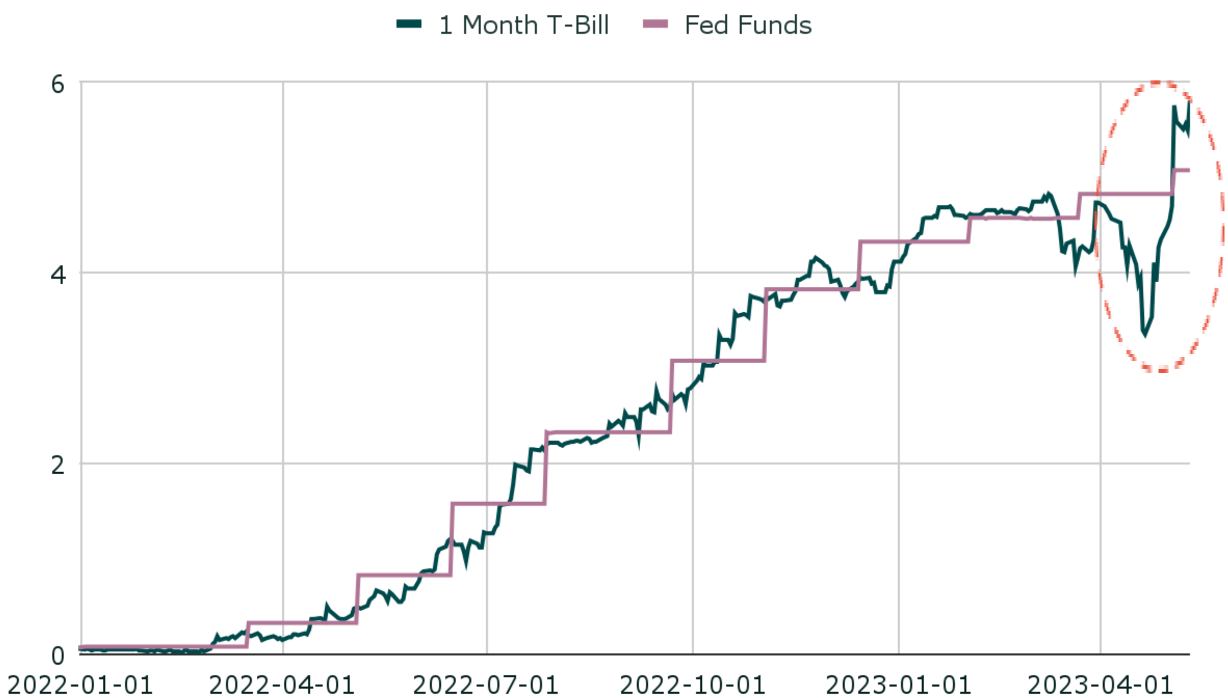
Source: CME Group

Stalled debt ceiling talks have given rise to volatility in 1-month Treasury bills. Exhibit 2 shows that 1-month Treasury bills traded at a premium throughout April and switched to a discount in May. Cash managers were forced to either buy the 1-month bills at a premium or take the risk of holding longer-maturities, which as discussed previously have other risk considerations. Please see our in-depth coverage of the debt ceiling here.

Exhibit 2

1-month Treasury bills traded at a significant premium to fed funds rate and now are at a discount

Liquidity, duration and credit premiums, January 1–April 28, 2023



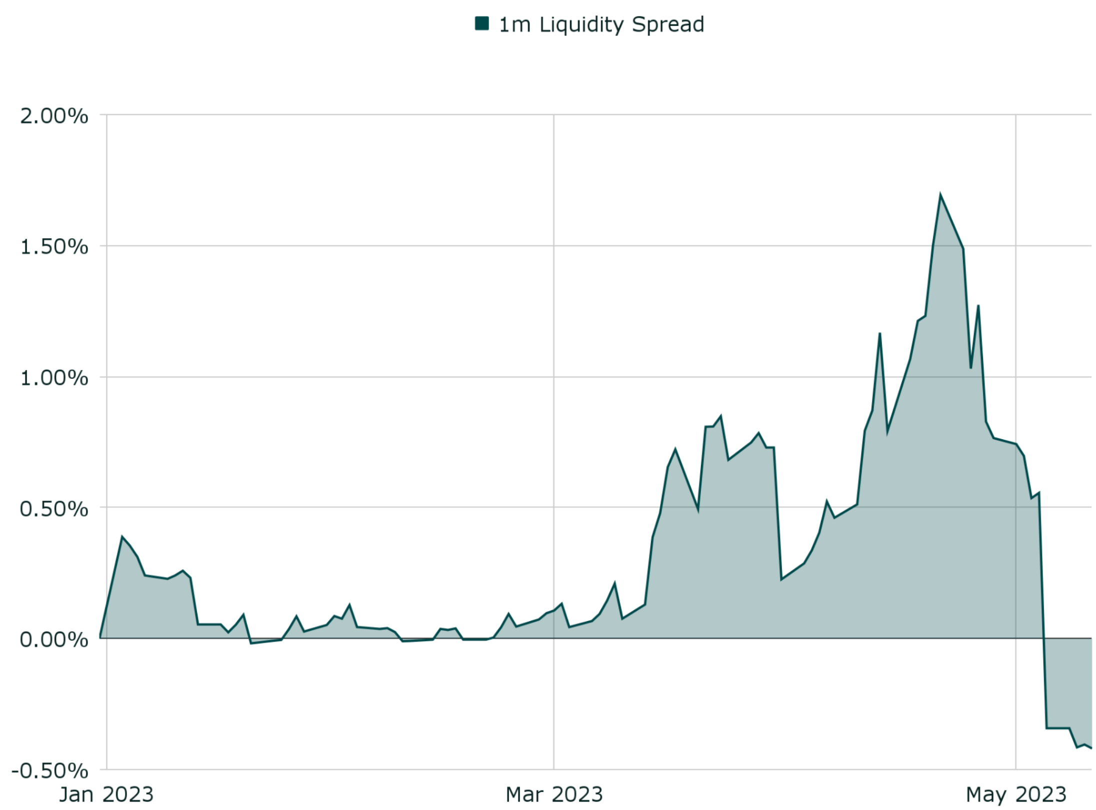
Source: Federal Reserve Bank of Saint Louis.

Echos of worry over the debt ceiling negotiation were felt in other corners of the cash market. Liquidity spreads blew out to historic highs. On April 21, coincident with the peak pricing of 1-month Treasury bills, liquidity spreads were priced at 170 bps. It goes without saying that these moments are quite special and those with cash management capabilities and excess liquidity had the opportunity to take advantage of these rich spreads.

Exhibit 3

Liquidity spread peaked on April 21, 2023

Liquidity spread, January 1–April 28, 2023



* Spread of 1-month USD repo and 1-month Treasury bill
Source: Thomson Reuters, Federal Reserve Bank of New York

4. Investor trends

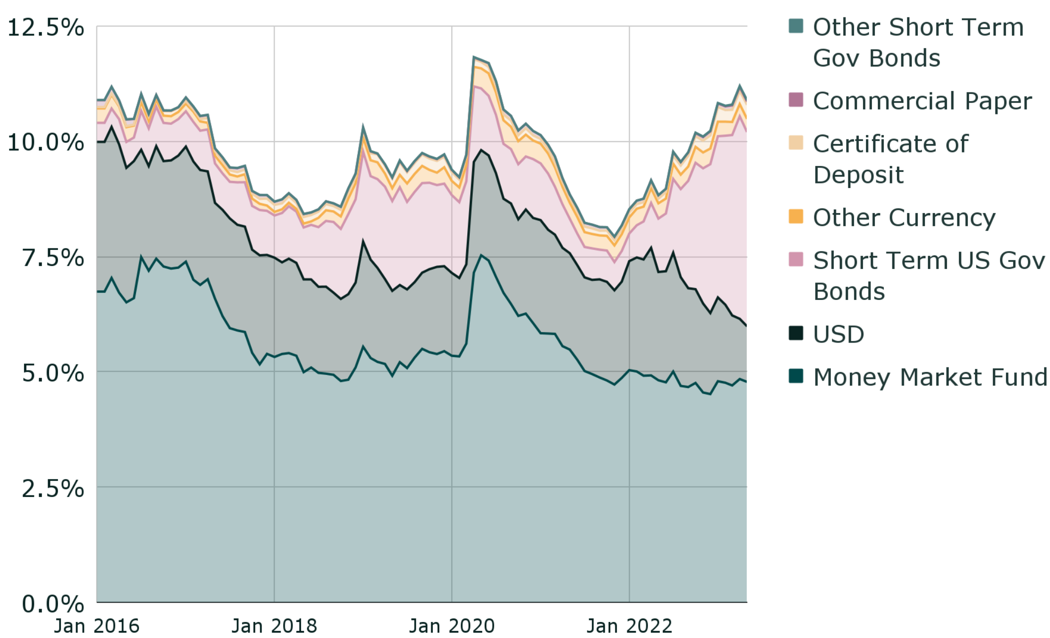
Private wealth investors are allocating heavily to cash, now holding almost 11% of their portfolios relative to a 9.7% historical average. Much of the growth is fueled by direct holding of short-duration Treasuries,[2] which now account for almost half of cash positions. This trend began with rising rates in the beginning of 2022 and has quickened this year. Meanwhile, allocations to money market funds and deposits are declining.

[2] Up to 1-year maturity.

Exhibit 4

High allocations to cash fueled by direct holdings of short-duration Treasuries

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



Source: Addepar

Currency is defined as paper money and cash held at banks. Sweep vehicles are programs that automatically invest end-of-day capital held at custodians into higher earning instruments. Money market funds are ETFs and mutual funds that invest in safe fixed income instruments with maturities of one year or less. Treasuries are Treasury bills and off-the-run Treasury securities set to mature in one year or less.

The largest category of cash management vehicles for private wealth investors is money market funds, which offer daily liquidity and a yield that's competitive with the shortest maturity Treasury bills, because money market funds generally hold underlying securities with maturities of less than one month.[3] Rising rates throughout 2022 and a relatively steep yield curve incentivised managers to move from money market funds into Treasury bills directly, in order to access the higher yields of longer maturity bills. As Exhibit 5 shows, almost all the inflows to Treasury bills throughout the tightening cycle have been in the 4M+ range.

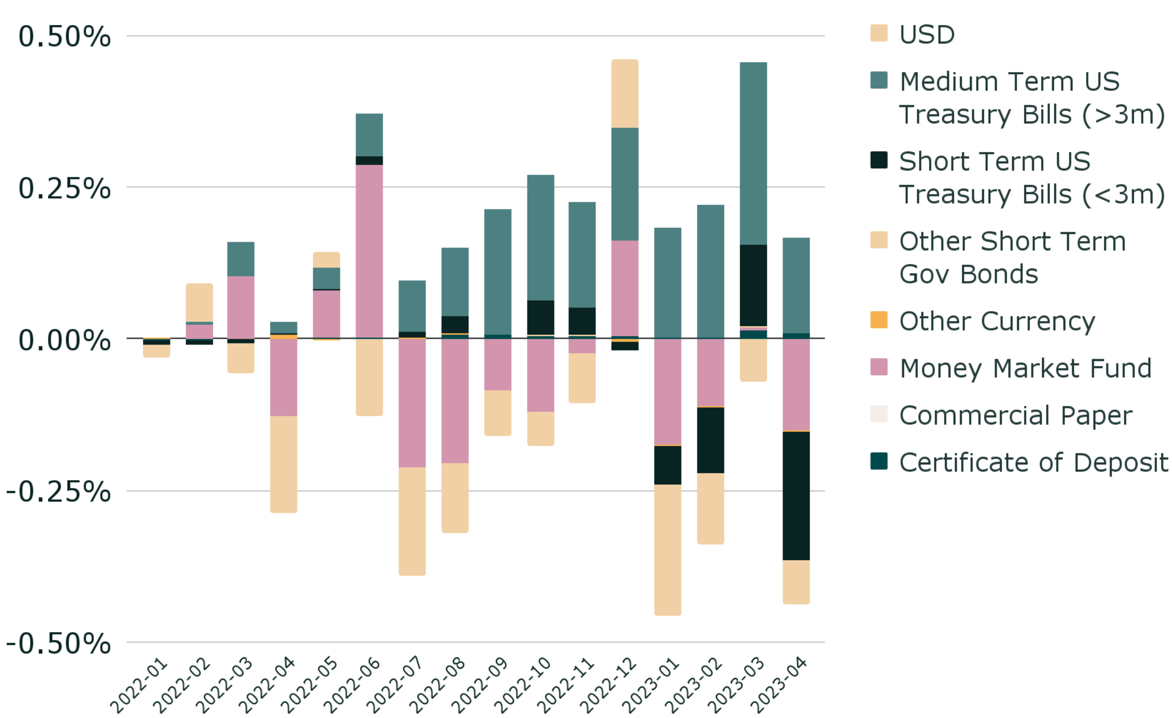
[3] See analysis in the appendix.

While we believe that accessing higher yields at higher maturity has driven most of the inflows into Treasury bills, it's noteworthy that the single biggest month of inflows was at the height of the SVB crisis in March of 2023. In that month, investors allocated to medium-term and short-term bills alike, suggesting that broader financial conditions and the ultimate safety of Treasury bills were motivating that short-term move.

Exhibit 5

Investors began rotating out of money market funds and into Treasuries significantly in July 2022

Average portfolio flows into cash, Jan 2022–April 2023



Source: Addepar

Both of the conditions driving private wealth investors into Treasuries and out of money market funds — the banking fears and the steep yield curve — started to recede in April. That month had the lowest inflows into direct Treasury bills since last September. With the yield curve flattening further and the debt ceiling adding uncertainty to the short-term Treasury bill market, one may expect fewer inflows into Treasury bills in the near term.

4. Conclusion

Cash markets offer substantial yields and are quite dynamic, as we've shown in this note. Managers who are investing in cash management best practices have the potential to demonstrate value to clients and outperform their peers. Please reach out to us for additional research on cash.

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. This pattern reflects the market's expectation of a 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.

An **inverted rate curve** refers to the situation in which forward rates further out in the future are pricing yields to be lower than nearer forward rates. The curve in this case is downward sloping instead of the more typical upward slope.

6. Appendix

Exhibit 6

10 largest money market funds comprise a third of the market. On average, they are less than 20 days of average maturity.

April 28, 2023

Name	Symbol	AUM (B)	Fees %	Weighted average maturity (days)
Vanguard Federal MM	VMFXX	241.9	0.11%	12
Goldman Sachs FS Gov	FGTXX	238.3	0.13%	22
Fidelity Gov MMF	SPAXX	235.5	0.25%	21
Fidelity Gov Cash Reserves	FDRXX	213.2	0.08%	20
JPMorgan US Gov MMF	OGVXX	142.1	0.03%	19
Morgan Stanley Instit. Lq Gov	MVRXX	141.6	0.07%	25
Fidelity MMF Gov Institutional	FRGXX	121.1	0.04%	14
Schwab Value Advantage MF	SWVXX	117.5	0.16%	15
Blackrock Lq Funds FedFund	TFDXX	115.9	0.12%	21
Vanguard Cash Reserves Federal	VMRXX	103.5	0.10%	11

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