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MAKE YOUR MONEY
MOVE
INVEST BEYOND CASH

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Cash Balances and Peak Rates: Is It Time to Make Your Money Move?

In the first quarter of this year, as short-term rates peaked, we flagged that the opportunity costs of holding excess cash were growing. While the prospect of slower growth and the transition in monetary policy has been raising the threat of market volatility, we think it is important for investors to look beyond the market's short-term ups and downs and invest for their long-term goals. If you didn't put your cash to work earlier in the year, we believe that now, more than ever, it is time to make your money move.

According to the Investment Company Institute, well over $1tn flowed into U.S. money market funds during 2023. In the U.S., total assets crossed $6tn during the second quarter of 2024, and stood at $6.15tn by the middle of July. Globally, money market fund assets total more than $10tn.

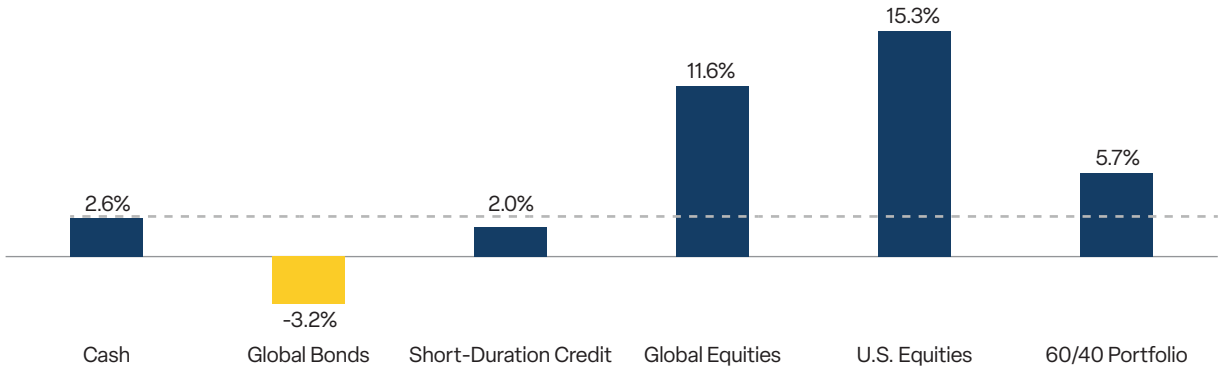
For much of the past 15 years, cash was a far from attractive investment. From the start of 2009 to the end of 2017, the cumulative—not annualized—return to U.S. dollar cash was less than 2.5%.[1]

However, the last two years have reminded us that cash sometimes does generate an attractive short-term return. As policy rates have risen to 5%-plus, the cumulative dollar cash return through 2022 and 2023 was around 7.5%.[2] Investors were being paid to be patient: if they had excess cash, there was no hurry to return to long-term asset allocations.

But is that sustainable? Today's cash rates can make it all too easy to keep waiting for a "better moment" to move back to long-term asset allocations. Even over the first half of 2024, however, when cash rates stayed at their peak and bond yields rose, a portfolio of investment-grade bonds and equities was the better performer.

FIGURE 1. RATES HELD UP IN H1 2024, BUT CASH STILL UNDERPERFORMED THE 60/40 PORTFOLIO

Total return, December 31, 2023 to June 30, 2024



Source: FactSet, Neuberger Berman. Cash is the USD SOFR three-month rate. Global Bonds is the Bloomberg Global Aggregate Index. Short Duration Credit is the ICE BofA 1-3 Year U.S. Corporate Index. Global Equities is the MSCI All Country World Index. U.S. Equities is the S&P 500 Index. The 60/40 Portfolio is 60% MSCI All Country World Index and 40% Bloomberg Global Aggregate Index, with no rebalancing.

Trillions of dollars of cash remain on the sidelines, even as investors become more confident that inflation is returning to target and a hard landing can be avoided as the economy slows down.

In our view, investors face three big questions:

1. Does cash remain more attractive than locking in bond yields?
2. Might it pay to wait before making new equity market allocations?
3. If not, where might excess cash be deployed?

Does cash remain more attractive than locking in bond yields?

Today's cash rate is considerably higher than the yields on U.S. Treasuries. It is even competitive with the yield of the average short-duration investment-grade corporate bond.

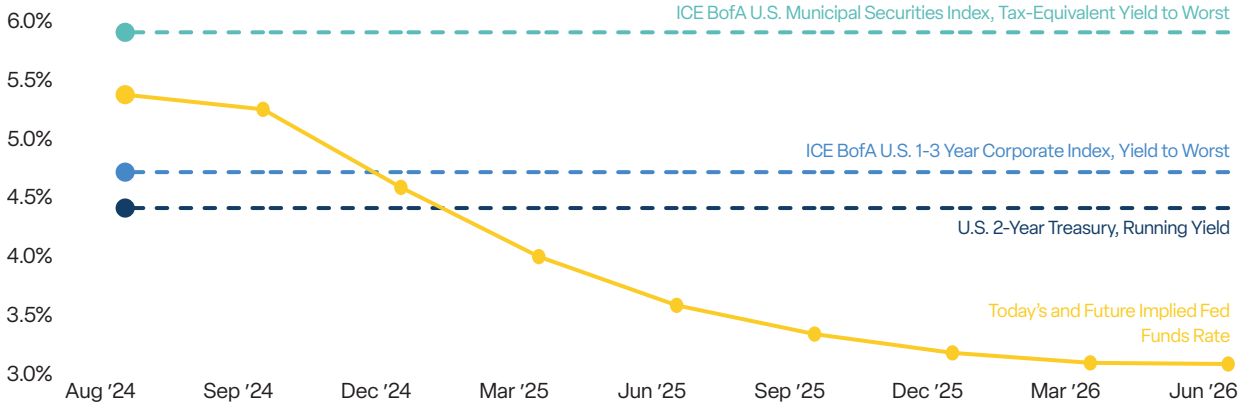
But market participants think cash rates are on their way down, from around 5.5% today to more like 3.5% in a year's time. In comparison, investing in longer duration bonds today offers the opportunity to enjoy that yield until the bonds mature.

[1] The picture is not much better even over the very long term. Since 1900, Treasury Bills have generated 3.4% per annum—only just ahead of inflation at 2.9%. U.S. equities have done much better, returning around 9.5% per annum. Bonds returned around 4.7% per annum. See the Credit Suisse Global Investment Returns Yearbook 2023, at https://www.credit-suisse.com/about-us-news/en/articles/news-and-expertise/global-investment-returns-yearbook-2023-202302.html.

[2] Solactive Overnight USD Cash Index. Source: Refinitiv.

FIGURE 2. CASH RATES MAY HEAD DOWN, BUT INVESTORS CAN LOCK IN YIELDS WITH LONGER-DURATION BONDS

Fed funds future rates versus bond market yields



Source: FactSet, Neuberger Berman. Data as of August 27, 2024. Two-year U.S. Treasury is the 4.375% July 31, 2026 note. Short-duration IG corporate bond index is the ICE BofA 1-3 Year U.S. Corporate Index. U.S. municipal bond index is the ICE BofA U.S. Municipal Securities Index. Tax equivalent yield for Municipals is for an investor paying the highest marginal rate of federal income tax of 37%, plus the federal net investment income tax of 3.8%, with the Index yield to worst at 3.47%. The tax equivalent yield would be higher for investors paying additional state and local income taxes.

Recent weeks have seen government bond yields in the intermediate part of the curve decline meaningfully, as markets have again started to price for faster rate cuts. This has been positive for those who moved out of cash earlier in the year; now, those bonds appear fairly priced to us. We see more attractive value in municipal bonds, once tax advantages are taken into account, and credit, where spreads have widened as yields have declined.

Unless cash rates decline much more slowly than the market currently anticipates, or short-duration investment-grade defaults rise substantially, we think these bonds now look more attractive next to cash. In addition, at inflection points such as these, we believe active management of a fixed income portfolio can benefit investors, as taking more or less risk at various points on the yield curve and across the credit spectrum are important levers in periods of transition.

Might it pay to wait before making new equity market allocations?

When cash is paying 5% and equity valuations are quite high, it is very tempting to wait for a market "correction"—especially when bouts of volatility, such as those that erupted during early August and early September, suggest that this correction may be right around the corner.

All too often, however, with the past 18 months being perhaps the latest example, investors have found themselves missing out on the equity market's steady cumulative returns while waiting for a sell-off that never arrived. As the well-worn saying puts it, "Investing is about time in the market, not timing the market."

High valuations have often been followed by high returns

Many investors consider today's S&P 500 Index valuation multiple, at 21 times the next 12 months' estimated earnings, to be high, making new investments risky. However, over the past 25 years, when the S&P 500 Index multiple was between 20 and 22 times, the median subsequent one-year excess return over cash was 3.6% and in one instance the subsequent return was 42.2%. The highest ever multiple, 28.3 times in March 1998, was followed by a one-year excess return of 16.5%. As 2023 and the first half of 2024 showed, it can be difficult to tell whether high valuations are a sign of an overstretched market or a sign of booming business.

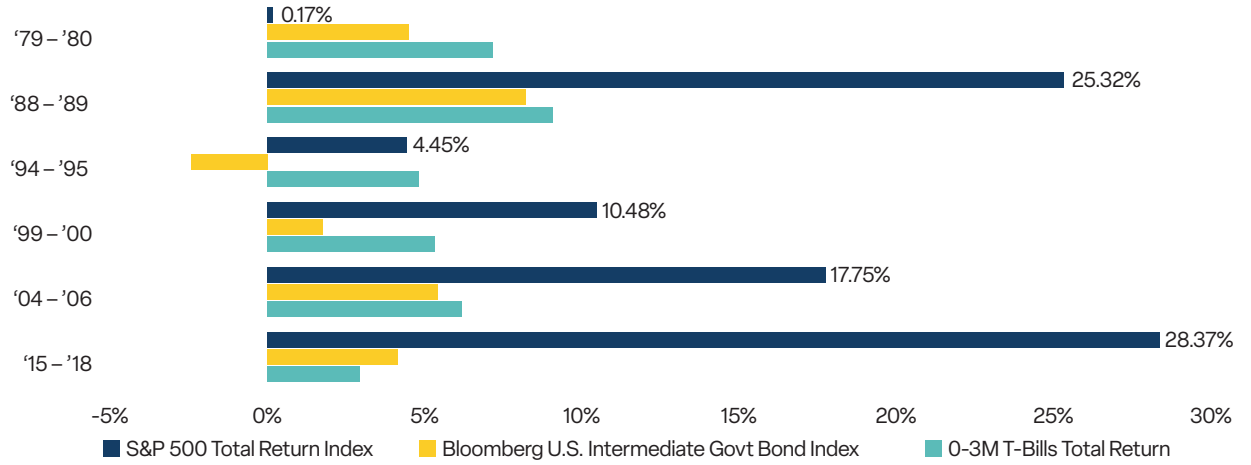
That said, in our view, you can take off some of the pressure to be right by avoiding concentration in highly valued stocks and seeking out those at more attractive valuations. Investors may want to consider value stocks and higher quality small caps, not because we anticipate a boom in the economic cycle and the time is right to be heavily weighted to those markets, but to ensure that an equity portfolio is adequately balanced against more fully valued large-cap growth exposures.

The end of rate-hiking cycles have often been followed by high returns

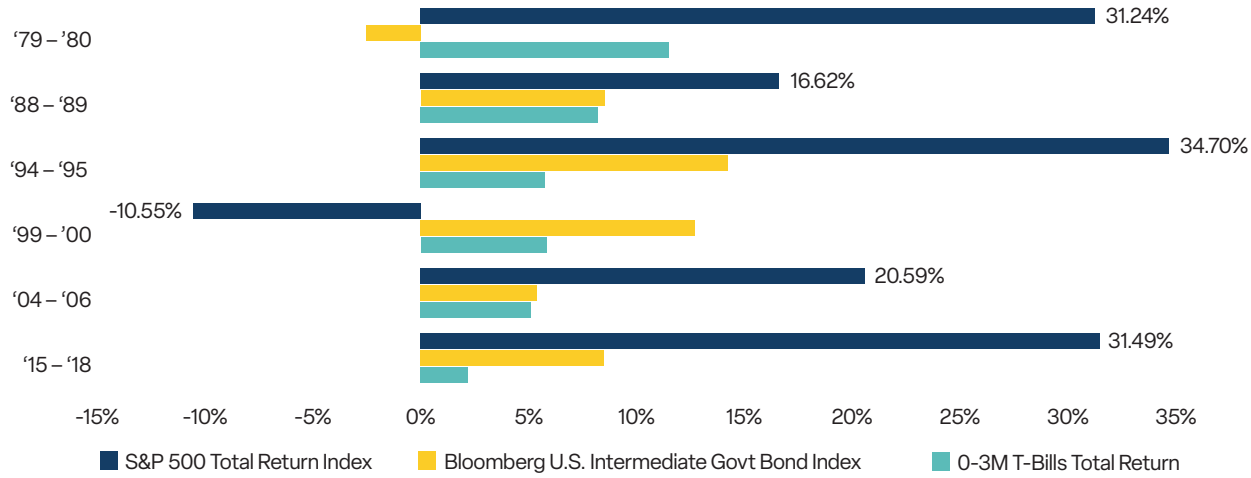
Some investors are concerned about the economic cycle as well as valuations. While we caution against trying to time the market or economic cycles, we believe it is worth applying the assumption that rates are on their way down to the equity context as well as the fixed income context. Below, we look at the performance of the S&P 500 Index during periods when that rate has been rising and during the 12 months following the final hike of the cycle.

FIGURE 3. EQUITIES HAVE HISTORICALLY PERFORMED WELL DURING AND AFTER RATE HIKES

Total returns during periods when the U.S. policy rate was rising



Total returns during the 12 months following the final raise of the U.S. policy rate



Source: Bloomberg, Neuberger Berman. Data as of December 31, 2023. **Past performance is not indicative of future results.**

Since 1979, the equity return has always been positive as rates have risen, and in four out of the six periods it strongly outperformed bonds and cash. The same has been true in the current cycle.

If rates have peaked, the historical data suggests to us that equities are likely to outperform over the next 12 months: since 1979, the only exception has been the 1999 – 2000 period that coincided with the bursting of the dotcom bubble.

To sum up, if it is difficult to know what valuations are telling us about shorter-term return potential, and if peak rates suggest the next 12 months' equity returns could be positive and well ahead of cash or bonds, in our view it becomes harder to justify holding cash rather than equity.

We know that the recent volatility makes it tempting to stay on the sidelines just a little longer, but don't forget that there were similar wobbles in the third and fourth quarter of 2023 and in April this year. "Averaging in" over a period of a few months can help to remove psychological barriers and reduce the impact of volatility on entry points.

Where might excess cash be deployed?

Over recent months, investors have become more confident in the outlook for lower inflation, lower rates and the avoidance of a hard landing as the economy slows down. We think this reinforces the case for equity exposure—but we believe it should be broader than the concentrated mega-cap growth names that characterize U.S. and even many global indices. We also caution that this economic outlook does not necessarily mean lower bond yields further out on yield curves, or strong performance for broad fixed income indices, particularly when that generally positive outlook is accompanied by growing concerns about longer-term debt sustainability.

We think an investor looking to make their money move is likely to have one or more of the following objectives:

1. Generating income (with modest duration and/or diversifying characteristics)
2. Getting equity market exposure (without concentrated risk)
3. Seeking diversifying assets

GENERATING INCOME (with modest duration and/or diversifying characteristics)	
Core Fixed Income: Short-Duration Credit and Municipal Bonds	• Shorter maturities would benefit more from the curve steepening that is likely to result from lower inflation and positive, albeit potentially slower, growth • Credit spread and tax advantages over government bonds makes the yield of corporate and municipal bonds more attractive relative to cash
Extended Fixed Income: Flexible Fixed Income	• Active managers have the flexibility to allocate to different parts of fixed income curves (including short duration and cash) and different parts of the credit and liquidity spectrum, depending on evolving market conditions
Alternatives: Collateralized Equity Index Put Writing ("PutWrite" Strategies)	• One source of PutWrite income is the (currently high-yielding) short-duration government bond collateral • The other source of income is the premium from option buyers, who tend to overpay for downside protection: this premium increased during the volatility in August 2024 and could remain elevated in the event of further volatility-inducing rotations away from U.S. mega-cap growth stocks
Alternatives: Insurance-Linked Strategies	• Securitized reinsurance against natural catastrophe losses, such as catastrophe bonds, generates income with price volatility that diversifies against traditional financial risks • A shortage of risk capital in reinsurance has resulted in attractive yields
GETTING EQUITY MARKET EXPOSURE (without concentrated risk)	
Equity: Quality smaller caps and value stocks	• Small- and mid-cap companies and value stocks have underperformed mega- and large-cap growth stocks for many years, leading to high mega-cap growth concentrations in equity indices and an attractive relative value opportunity for investors • While this suggestion is primarily about balancing large-cap growth exposures, we do think a return to lower inflation and rates, combined with positive growth, is likely to ease interest payments for smaller companies and encourage investors to look beyond the safety of mega-cap growth stocks • We think active stock selection and high quality is key in a small-cap universe with more than its fair share of lossmaking companies
Alternatives: Long-Biased Long/Short Equity Hedge Funds	• Price movements of short positions tend to offset partially those of long positions • Long/Short Equity strategies tend to have a bias toward smaller-company and value-stock risk exposures

SEEKING DIVERSIFYING ASSETS	
Alternatives: Diversifying Asset Classes and Strategies	• Hedge fund-style strategies with low, neutral or highly flexible equity and bond market exposure, or strategies seeking exposure outside of traditional financial markets, provide access to manager skill or diversifying risks
Alternatives: Commodities	• Commodities in general respond to idiosyncratic supply-and-demand dynamics • Commodities tend to perform well during unexpected spikes in inflation (regardless of the broader growth backdrop), when equities and bonds tend to underperform; they can also help hedge against geopolitical risk
Alternatives: Private Credit	• Direct lending to private equity-sponsored companies is not marked to market, which means it is less volatile on an investor's balance sheet than public assets • Private lending to smaller (but often high quality) companies provides exposure that is increasingly unavailable via public high yield bond or broadly syndicated leveraged loan markets • Attractive yields relative to risk in the current market
Alternatives: Private Equity	• Private equity is not marked to market, which means it is less volatile on an investor's balance sheet than public assets • Private equity provides exposure to thousands of often high quality, highly innovative companies that are not included in even the small- or micro-cap sectors of stock exchanges

Time to make your money move

The cash yield has become increasingly attractive over the past two years. Today, however, rates appear to have peaked. We therefore think bonds now look more attractive than cash. In equities, while current valuations and recent market volatility might dissuade some investors from quickly moving back to their long-term allocations, that raises the risk of repeating the experience of missing out on the returns of 2023 and the first half of 2024. Moreover, not all parts of the equity market appear so expensive and, in our view, the economic outlook is beginning to favor some of the segments—particularly smaller companies and value stocks—that are more attractively priced.

That is why we think it is time to consider taking some first steps back to risk-taking, and to identify the market levels that would trigger action—including price points that are higher and yield points that are lower than today's, to minimize the risk of holding cash should the equity market continue to climb or bond yields begin a more persistent decline.

If you are still overallocated to cash, we believe that now, more than ever, it is time to make your money move.

Index Definitions

The **ICE BofA 1-3 Year U.S. Corporate Index** measures the market capitalization-weighted performance of public debt of investment-grade corporate issuers, with maturities of between one and three years, issued and denominated in U.S. dollars.

The **ICE BofA U.S. Municipal Securities Index** tracks the performance of U.S. dollar-denominated investment grade tax exempt debt publicly issued by U.S. states and territories, and their political subdivisions, in the U.S. domestic market. Qualifying securities must have at least one year remaining term to final maturity, at least 18 months to final maturity at the time of issuance, a fixed coupon schedule and an investment grade rating (based on an average of Moody's, S&P and Fitch).

The **S&P 500 Index** consists of 500 U.S. stocks chosen for market size, liquidity and industry group representation. It is a market value-weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value.

The **MSCI All Country World Index** captures large- and mid-cap representation across 23 Developed Markets and 24 Emerging Markets countries.

The **Bloomberg Global Aggregate Bond Index** is a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded worldwide.

The **Bloomberg U.S. Intermediate Government Bond Index** measures the fixed-rate government-related U.S. bond markets with a maturity greater than one year and less than 10 years.

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