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Corporate Cash Alert

Board the Plane

August 15, 2022

Introduction

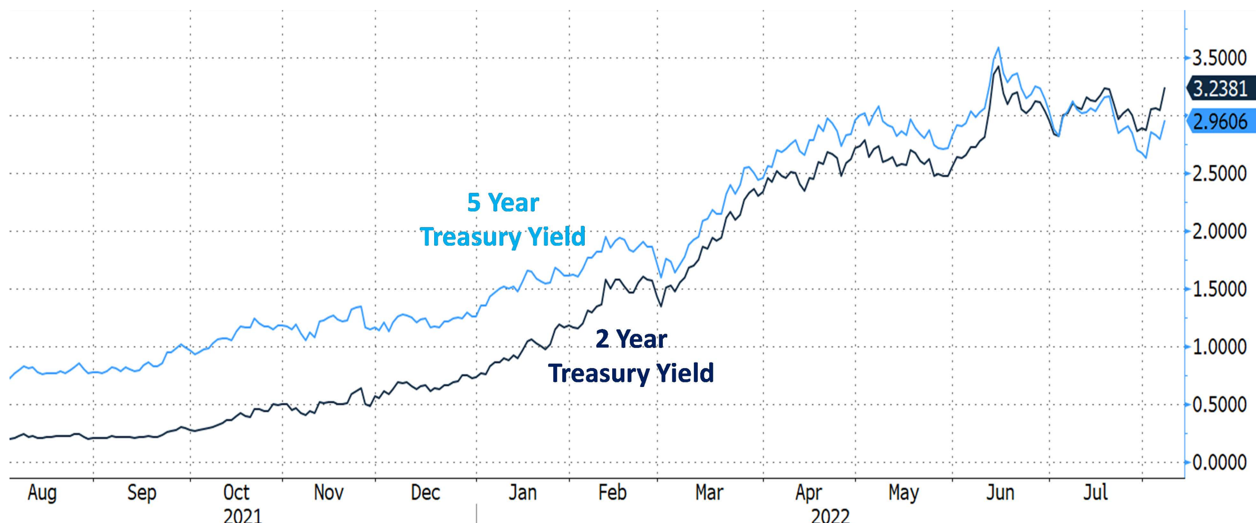
The extreme volatility in short-term markets has been nothing short of enormous. Two and five-year Treasuries have witnessed intraday moves of 20+ basis points as investors react to each signal and subtle hint from Fed officials. Read on for our latest thoughts on positioning corporate cash portfolios in these challenging times.

A Turning Point?

After decades as a dormant risk, inflation figures have now spent an entire year at levels not seen since the 1970s. An increasingly concerned Fed has been forced to pivot from dismissing it as 'transitory' to hurriedly implementing aggressive rate hikes.

The Fed Funds rate has now been raised to 2.50% (the peak of the last hiking cycle) while simultaneous Quantitative Tightening has further constricted liquidity (initially at a pace of $47 billion/month but soon accelerating to $95 billion/month). This has elevated market fears of a recession, generating much of the recent unprecedented volatility in front-end rates. Specifically, yields declined from their mid-June peaks as investors priced in growing recession fears and a potential Fed 'dovish pivot' before recently ticking back up.

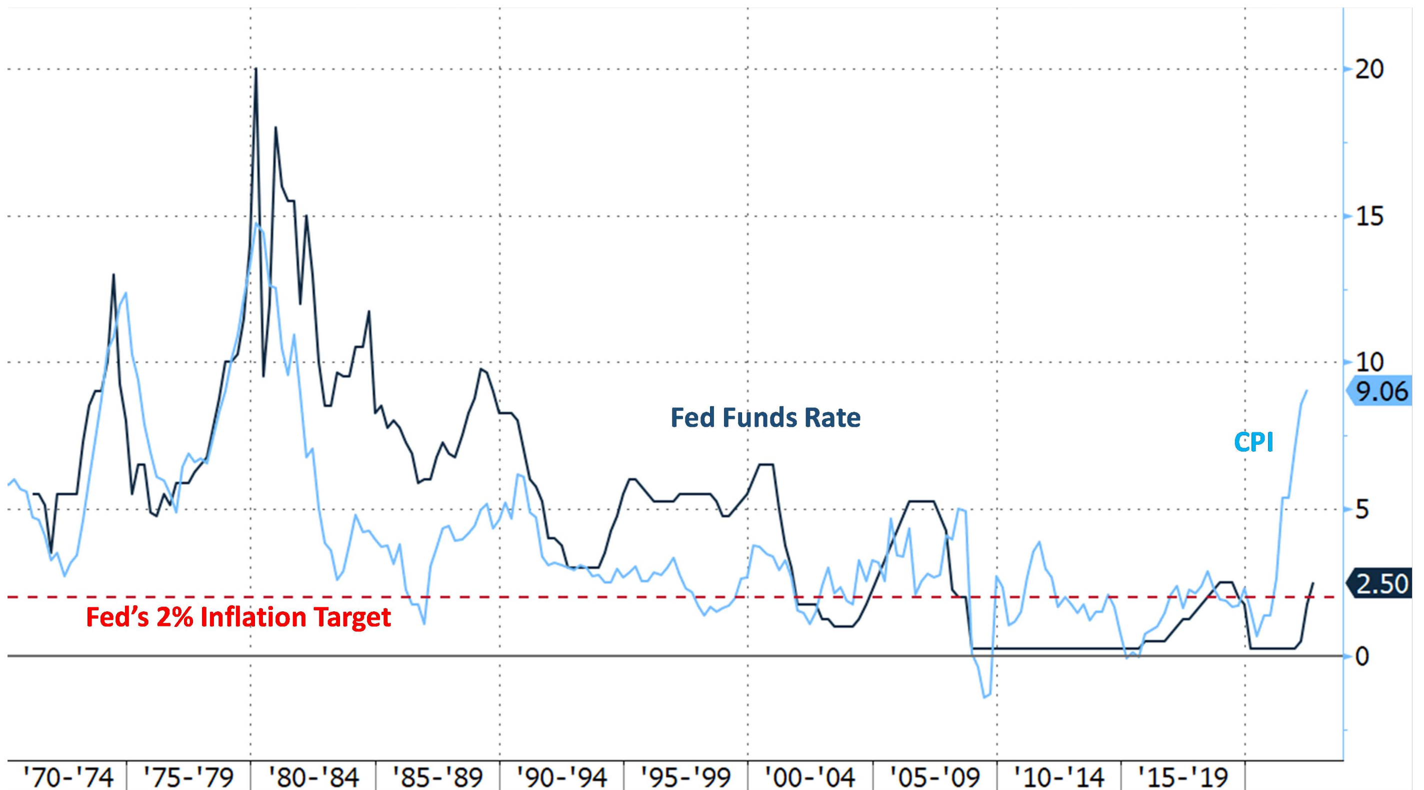
2 and 5-Year Treasury Yields



Source: Bloomberg

We disagree with the predictions of an imminent dovish Fed pivot. Chair Powell and other Fed officials appreciate the gravity of the inflation problem, and as such and we expect continued tightening. History indicates that the Fed typically does not stop tightening until the Fed Fundsrate matches or exceeds the rate of inflation. We are far from meeting that threshold at this juncture.

Fed Funds Rate (Upper Bound) vs. CPI



Source: Bloomberg

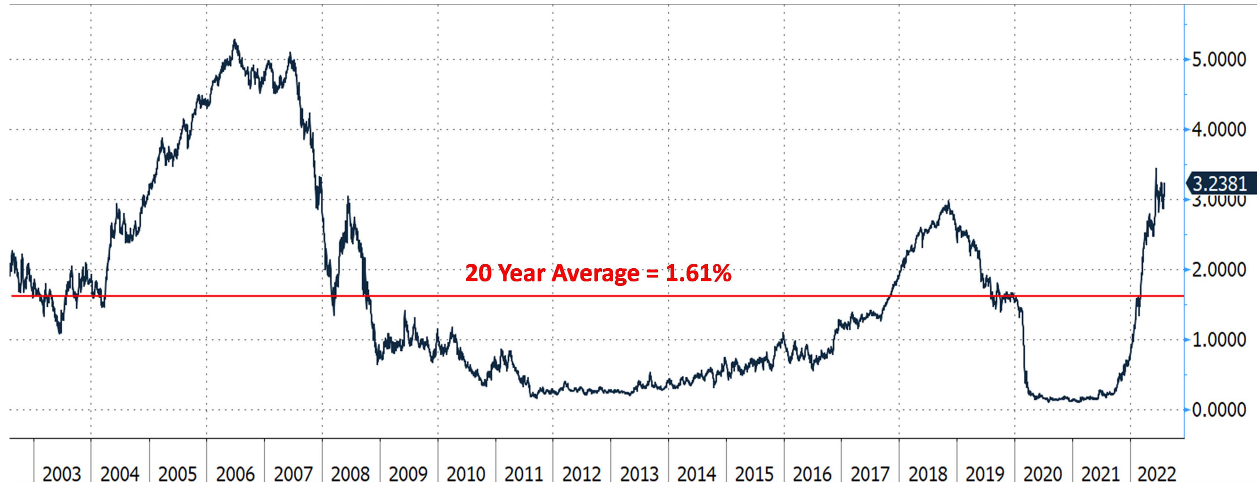
The believe that the market is still underestimating both the peak and length of this tightening cycle. The Fed continues to signal its determination to bring inflation down despite the risk that tighter monetary policy will damage real economic growth. Even if the next few months bring 'cooling' inflation data, CPI is highly unlikely to fall to 3-4% in such a short period of time – and we expect further rate increases, especially given the very low (3.5%) unemployment rate.

> ***Reporter:*** *"Given the uncertainty and the sort of paradoxical flow of data you've been getting, if you're going to make a mistake would you rather make the mistake of doing too much, raising too much, than raising too little?"*
>
> ***Fed Chair Powell:*** *"We're trying to not make a mistake. Let me put it this way, we do see that there are two-sided risks. There would be the risk of doing too much and, you know, imposing more of a downturn on the economy than was necessary. But the risk of doing too little and leaving the economy with this entrenched inflation, it only raises the cost. If you fail to deal with it in the near term, it only raises the cost of dealing with it later…so I really do think that it's important that we address this now and get it done."*
>
> **Post-Meeting Press Conference, July 27th, 2022**

Keeping Perspective

Although we anticipate more tightening, we cannot ignore the fact that front-end Treasury rates are near decade-plus highs, and are even comfortably above their longer 20-year average.

2-Year Treasury Yield



Source: Bloomberg

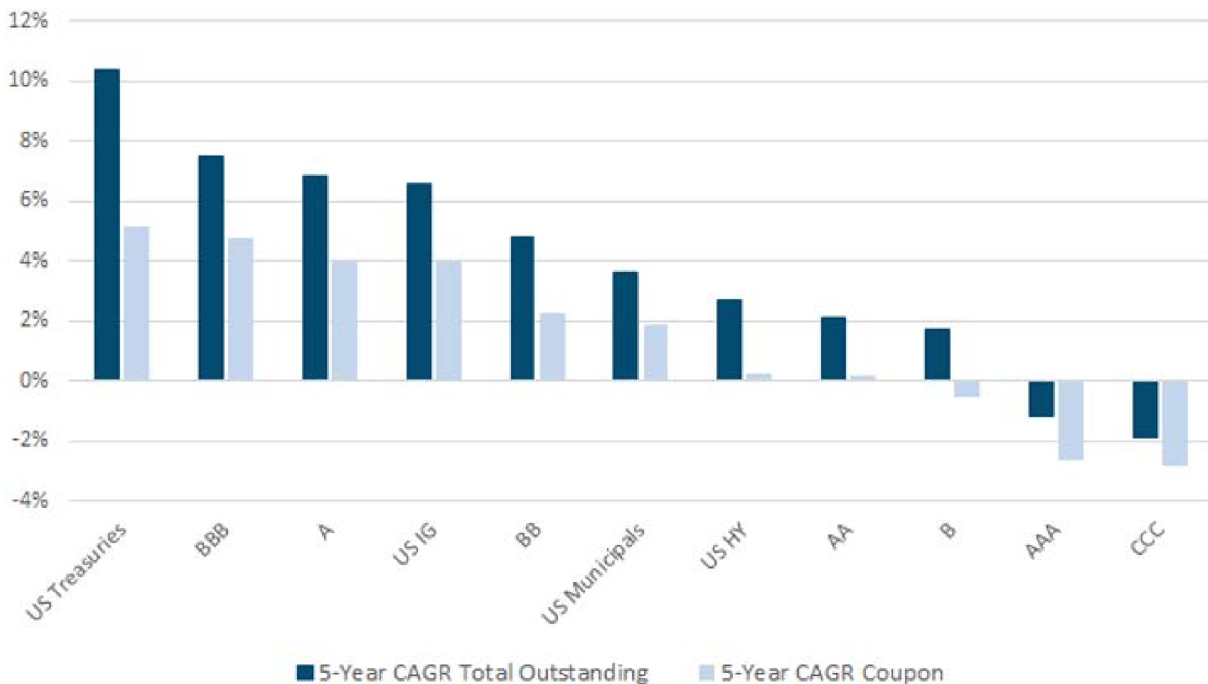
5-Year Treasury Yield

Source: Bloomberg

For clients who can purchase corporate bonds, credit spreads have widened to reflect a potential slowdown in economic activity.

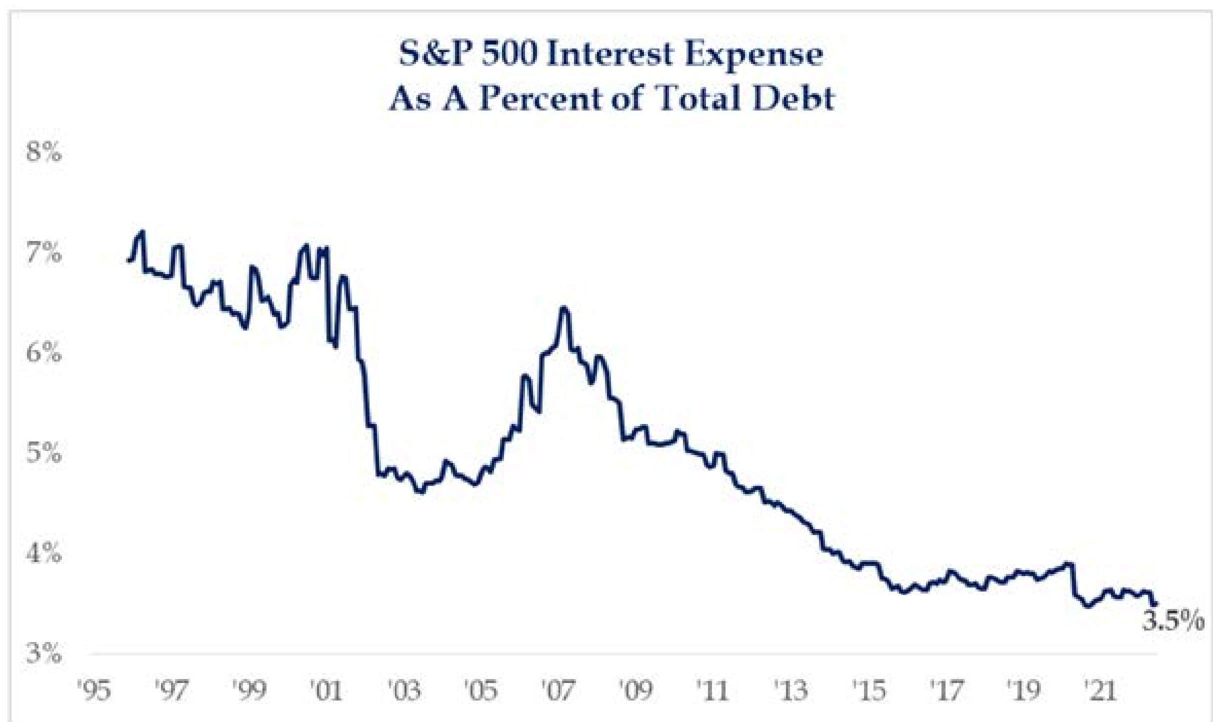
Source: Bloomberg

At the same time, the ability to capture such opportunities has improved. The absolute amount of Treasury and investment-grade corporate debt outstanding has increased considerably over the past several years, expanding the size of the investable universe.



Source: CreditSights

The increase in absolute debt loads has not come at the expense of a lockstep increase in debt service costs – note from the preceding chart that coupon payouts actually grew at a far slower rate. The core finding that these higher debt loads haven't translated into proportionately higher financing costs is corroborated by other datasets – for example, the S&P 500's interest expense ratio remains near multi-decade lows.



Source: Strategas

Moreover, the rest of Corporate America's balance sheets remain relatively well-positioned to weather a potential recession – cash reserves are barely off their multi-decade high points.

Source: Strategas

In summary, both yields and underlying credit quality remain attractive, a compelling combination which we have not seen in years.

Treasury Partners View

Market Explanation

Corporate cash investors should recognize that although the Fed is expected to continue raising the Fed Funds rate, short term yields may not rise in lockstep. Markets are forward-looking, and history shows that rising rate cycles typically reach a point where the curve starts looking past the near-term tightening outlook to reflect the future consequences of a slowing economic climate.

This dynamic is shaping today's 2s5s curve. Despite the consensus of more hikes in the coming months, cuts are already being priced in over the next couple of years. As a result, investors should carefully consider how to optimize strategies to take advantage of the current environment.

Strategy

For existing laddered portfolios, now is the time to extend maturities (subject to liquidity needs). The very steep upward slope of the short end of the curve, when combined with noticeably widened credit spreads, allows us to lock in attractive 3.5-4% yields in 2-5 year maturities. If rates continue to rise, upcoming maturities will be used to reinvest in the higher rate environment.

While unrealized mark-to-market losses are certainly possible as the Fed continues to tighten, these could also flip to unrealized gains if/when the market prices in the prospects of a slowing economy. For the first time in years, yields are high enough to justify the risk.

Another important consideration is one we discussed in our previous communication – the protective benefit of "roll-downs."

> *"By roll-down, we mean the natural process whereby bonds purchased today eventually season into shorter-maturity holdings while retaining the same book yield (e.g. holders of today's [3.23%] 2-Year Treasury will, in a year, be holding what will become a 1-year maturity carrying that [3.23%] purchase yield, priced accordingly by the market). This automatic process of seasoned positions 'rolling down the yield curve' offers a degree of natural protection against rising rates…*
>
> *If an investor locks in a [2.96%] 5-year position today and rates rise 1.00% over the next year, the bond 'rolls down' into a [2.96%] 4-year position which may reflect then-current market levels, depending on the slope of the curve…*
>
> *Investors with established bond ladders are particularly well-suited to take advantage of this strategy. The nature of ladders takes full advantage of roll-down benefits, while also providing a steady stream of ongoing liquidity. Moreover, if rates continue to rise, natural maturities can always be reinvested into higher-yielding positions."*
>
> **Fixed Income Alert: The Biggest Decision Facing Bondholders Today, 4/25/22**

For investors without existing positions, we suggest implementing a modified barbell portfolio. As an example, an investor with a 2-year maximum maturity and 1-year maximum average life, we would position the portfolio to emphasize 3-6 month maturities (e.g. ladder Treasuries) along with longer term holdings in the 12-24 month range (accordingly de-emphasizing holdings that fall between these timeframes). This strategy locks in today's elevated longer-term levels while providing flexibility to keep reinvesting a proportion of the portfolio into a rising rate environment as the 3-6 month positions naturally roll off.

To summarize, short term rates will continue to be extremely volatile and potentially trend higher. Current yields and spreads are at absolute levels that are too attractive to ignore, and portfolios can be structured to both lock in today's opportunities while preserving flexibility for future tactical shifts. Don't miss your flight just because there might be turbulence - prioritize getting to your destination!

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Richard Saperstein
Chief Investment Officer
Email: rsaperstein@treasurypartners.com
Phone: (917) 286-2777

Daniel Beniak
Director
Email: dbeniak@treasurypartners.com
Phone: (917) 286-2783

Treasury Partners
505 5th Ave, 14th Floor
New York, NY 10017

(917) 286 2770

info@treasury partners.com
www.treasurypartners.com

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