

Cash vs. Fixed Income: Time to Trade Up?

Money-market and CD yields have certainly been attractive. But if rates drop, bonds could outperform cash.

If you held money in money-market accounts or certificates of deposit (CDs) instead of bonds over the past 12 months, you're probably feeling pretty good about yourself. Trailing returns on cash-equivalent investments are approximately 3.59%¹ vs. -0.94% for core bonds.² Year-to-date, the returns are somewhat similar, but, since rates have remained volatile, you still probably feel pretty good about your choice. And why not? More than a year ago, the US Treasury yield curve³ inverted as two-year rates became higher than 10-year rates. The significant change in rates overall since the start of 2022 has helped cash investments begin to offer real returns after years of negligible results.

However, history would suggest that yield curves don't stay inverted forever, and cash rarely outperforms fixed income in the long run (**FIGURE 1**). If history is any guide, longer-dated rates will eventually be higher than shorter-date rates. Not surprisingly, many investors are now considering ways to get ahead of a possible momentum shift and make the move from cash to core bonds. They're also wondering about the risks of being wrong: What if rates continue to rise?



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Key Points

- Cash outperformed in 2022, but cash has historically been among the worst-performing asset classes.
- If interest rates decline, the incremental gains from holding bonds over cash may be meaningful.
- A move into an intermediate-duration core-bond strategy may provide opportunities for capital appreciation that cash can't provide.

FIGURE 1
Performance Leadership Changes Frequently
Asset-Class Returns % (2009-2022)

2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Average
High Yield 58.21	High Yield 15.12	Municipals 10.70	Int'l Equities 17.32	US Equities 32.39	US Equities 13.69	Municipals 3.30	High Yield 17.13	Int'l Equities 25.03	Cash 1.82	US Equities 31.49	US Equities 18.40	US Equities 28.71	Cash 1.52	US Equities 10.67
Int'l Equities 31.78	US Equities 15.06	Treasuries 9.81	US Equities 16.00	Int'l Equities 22.78	Balanced Portfolio 9.83	MBS 1.51	US Equities 11.96	US Equities 21.83	Municipals 1.28	Int'l Equities 22.01	Balanced Portfolio 12.95	Balanced Portfolio 13.58	Municipals -8.53	High Yield 7.43
US Equities 26.46	Balanced Portfolio 10.80	Corporates 8.15	High Yield 15.81	Balanced Portfolio 15.18	Municipals 9.05	US Equities 1.38	Balanced Portfolio 7.30	Balanced Portfolio 12.69	MBS 0.99	Balanced Portfolio 20.10	Corporates 9.89	Int'l Equities 11.26	High Yield -11.19	Balanced Portfolio 6.74
Corporates 18.68	Corporates 9.00	Bonds 7.84	Balanced Portfolio 10.11	High Yield 7.44	Corporates 7.46	Balanced Portfolio 0.97	Corporates 6.11	High Yield 7.50	Treasuries 0.86	Corporates 14.54	Treasuries 8.00	High Yield 5.28	MBS -11.81	Corporates 4.24
Balanced Portfolio 16.20	Int'l Equities 7.75	MBS 6.23	Corporates 9.82	Cash 0.05	MBS 6.08	Treasuries 0.84	Bonds 2.65	Corporates 6.42	Bonds 0.01	High Yield 14.32	Int'l Equities 7.82	Municipals 1.52	Treasuries -12.46	Int'l Equities 3.82
Municipals 12.91	Bonds 6.54	High Yield 4.98	Municipals 6.78	MBS -1.41	Bonds 5.97	Bonds 0.55	MBS 1.67	Municipals 5.45	High Yield -2.08	Bonds 8.72	Bonds 7.51	Cash 0.04	Bonds -13.01	Municipals 3.52
Bonds 5.93	Treasuries 5.87	Balanced Portfolio 4.98	Bonds 4.21	Corporates -1.53	Treasuries 5.05	Cash 0.03	Treasuries 1.04	Bonds 3.54	Balanced Portfolio -2.19	Municipals 7.54	High Yield 7.11	Corporates -1.04	Int'l Equities -14.45	Bonds 2.81
MBS 5.89	MBS 5.37	US Equities 2.11	MBS 2.59	Bonds -2.02	High Yield 2.45	Corporates -0.68	Int'l Equities 1.00	MBS 2.47	Corporates -2.51	Treasuries 6.86	Municipals 5.21	MBS -1.04	Balanced Portfolio -15.56	MBS 2.47
Cash 0.15	Municipals 2.38	Cash 0.07	Treasuries 1.99	Municipals -2.55	Cash 0.02	Int'l Equities -0.81	Cash 0.26	Treasuries 2.31	US Equities -4.38	MBS 6.35	MBS 3.87	Bonds -1.54	Corporates -15.76	Treasuries 2.35
Treasuries -3.57	Cash 0.13	Int'l Equities -12.14	Cash 0.08	Treasuries -2.75	Int'l Equities -4.90	High Yield -4.47	Municipals 0.25	Cash 0.82	Int'l Equities -13.79	Cash 2.21	Cash 0.54	Treasuries -2.32	US Equities -18.11	Cash 0.63

As of 12/31/22. Past performance does not guarantee future results. Indices are unmanaged and not available for direct investment. See last page for representative index definitions. For illustrative purposes only. Data Source: Morningstar, 4/23.

Yields as a Dampener

Predicting the direction of rates is always a challenge. Fortunately, today's higher yields help to serve as a dampener if rates keep climbing. The rate backup in 2022 that wreaked havoc on bond funds left investors with a yield-to-worst⁴ on the Bloomberg US Aggregate Bond Index (the "Agg") of 4.81% as of 6/30/23. You'd need to go back to the mid-2000s to find a comparable entry point. But, if you were among those impacted by last year's fixed-income losses, it's worth remembering that as yields have reset higher, more breathing room has been created between today's levels and zero. A 100-basis-point (bp)⁵ rise can more readily be absorbed in a market when the yield-to-worst, as of 6/30/23, is closer to 4.81% vs. 1.86% at the start of 2022.

Of course, the counterargument goes like this: I'm already getting a similar 5% on my cash account, so why not simply stick to cash and eliminate the risk of rising rates altogether? The answer to that question lies in where you think the bond market is headed.

Where Are Rates Headed?

None of us has a crystal ball, but many signs point to a weakening economy. Take your pick:

- The Fed's attempt to cool the economy with interest-rate hikes
- An increase in jobless claims
- Tighter lending conditions
- Cracks in commercial real estate

With those signals in mind, do you think rates are going higher or lower over the short to medium term? If you said higher, it would be very hard to argue you out of your cash position. But if you said lower, the incremental gains from holding bonds over cash could be meaningful.

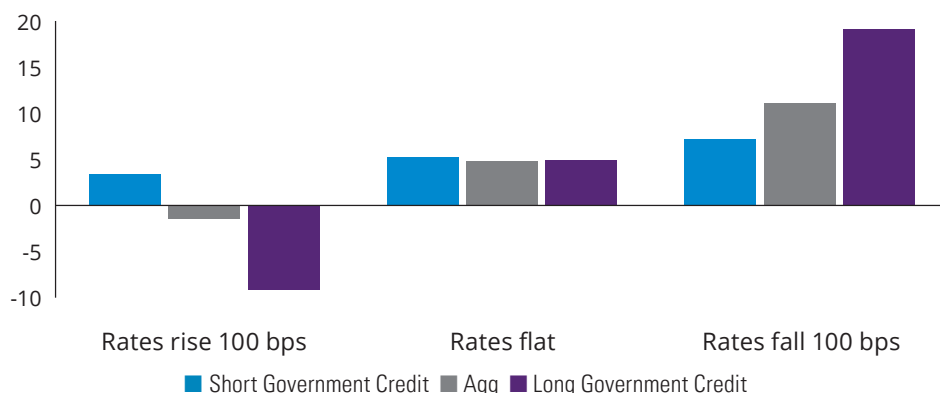
A 100-bps decline in rates can potentially result in capital appreciation 6% for an intermediate-duration strategy (assuming the duration is six years).⁶ Cash can only stay flat and can even trend lower as the level of rates reset lower—a reality that ultimately creates serious reinvestment risk⁷ for investors.

Today's higher yields can serve as a dampener if rates keep climbing.

FIGURE 2

Falling Rates Could Significantly Benefit Long-Duration Bonds

Performance of bonds in rising, falling, and flat rate environments



As of 6/30/23. Past performance does not guarantee future results. Indices are unmanaged and not available for direct investment. See last page for index definitions. Short Government Credit is represented by the Bloomberg 1-3 Year US Government/Credit Index, which had a duration of 1.79 years and a yield to maturity of 5.16%. The Bloomberg US Aggregate Bond Index (Agg) had a duration of 6.31 years and a yield to maturity of 1.87%. Long Government Credit is represented by the Bloomberg US Long Government/Credit Index, which had a duration of 14.25 years and a yield to maturity of 4.75%. Data Source: Morningstar, 7/23.

Here are some considerations when comparing potential outcomes for core bonds vs. cash in different rate environments:

- Investor could enjoy more capital appreciation and less reinvestment risk in core bonds if the economy takes a downturn and rates decline
- Investors could be indifferent between core bonds and cash if rates remain flat
- Investors could be worse off in bonds if rates go significantly higher and the economy takes a downturn, but we think the losses are unlikely to match the magnitude of losses experienced in 2022

A bond investor is much better off from a capital-appreciation and reinvestment-risk perspective if the economy falters and rates decline.

But What About That Curve?

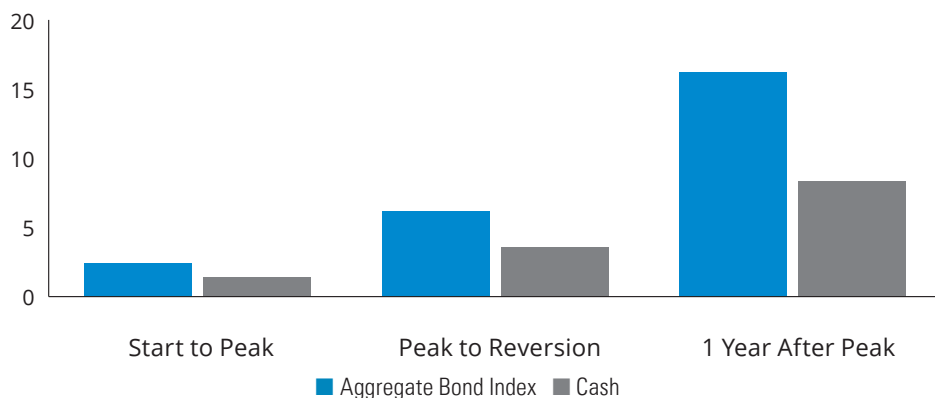
Coming back to where we started: The curve is still inverted. We can debate whether or not an inverted curve means a recession is imminent. What can't be debated is that you are being paid more to be short than long—but only at this point in time. When might current circumstances change? Could it be only when the curve finally returns to its normal shape? Or could it be at some point during the journey back to the traditional upward slope?

Since 1980, there have been seven inversions lasting longer than three months. As you'd expect, cash has historically outperformed at the start. But moving forward in time, once the two-year and 10-year Treasuries experienced their largest gap and the curve reverted to its normal upward-sloping shape, core bonds outperformed.

FIGURE 3

Bonds Significantly Outperformed Cash When the Yield Curve Normalized

Returns (%) for cash vs. the Agg during yield-curve inversions lasting > 3 months



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The drivers of outperformance are, generally, twofold. First, in the majority of cases, the change in the shape of the yield curve is a result of rates going lower—not higher. Simple bond math shows that, as rates drop, bond prices rise. Second, as rates drop, the amount you can expect from investing in cash drops along with it. However, cash doesn't give you the benefit of capital appreciation in a falling-rate environment.

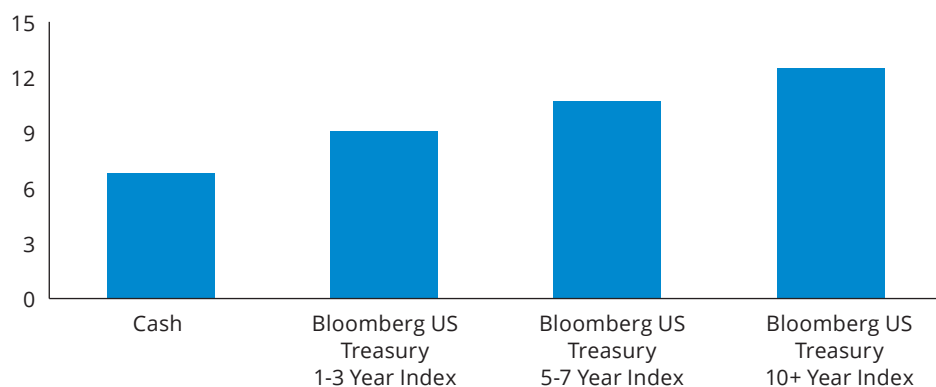
Bonds vs. Cash When the Fed Stops Hiking

As we near what's likely the end of the current rate-hiking cycle, how have bonds and cash performed once the Fed has stopped hiking? We examined what happened after the past six Fed hiking cycles and found that investors benefited significantly by holding long-duration bonds relative to cash and short-duration bonds.

FIGURE 4

The End of Fed Hikes Has Benefited Longer-Duration Bonds vs. Cash

Cash and Bond Performance (%) One Year After the End of the Past Six Hiking Cycles



Past performance does not guarantee future results. Indices are unmanaged and not available for direct investment. Cash is represented by the IA SBBI US 30 Day TBill USD Index. See last page for index definitions. For illustrative purposes only. Data Sources: Ned Davis Research, Morningstar, and Hartford Funds.

As with any investment, there are relative risks to be considered. Cash or cash equivalents, such as money-market funds or CDs, generally involve the least amount of risk but also offer the least potential return. Short-term bonds are likely to offer higher potential yield than cash equivalents and are also typically less sensitive to interest-rate movements than other securities.

Bonds tend to carry greater risk than cash equivalents, including the risk that a bond's lender may be unable to make interest or principal payments on time. Bonds with longer maturities (e.g., 10 or more years) can offer higher returns but can lose value when interest rates rise. Bonds are also subject to the risk that the lender may choose to pay off the bond early, which could deprive investors of potential interest income. When rates are falling, lenders sometimes choose to pay off bonds ahead of maturity in order to reissue bonds at lower prevailing rates.

Summary

Many savers and investors have enjoyed the success of being in cash over core bonds during the past year. However, there are advantages to staying focused on the potential benefits for bond investors in the current environment: (1) more breathing room if rates go higher; (2) the most attractive valuations since the mid-2000s, and (3) the ability to participate in capital appreciation—something cash can never provide. Furthermore, history is likely on the side of core bonds, given that cash was the best-performing asset class in 2022—something that's only happened once in 15 years—and that yield curves historically have sloped upward.

Instead of trying to predict the right time to move into core bonds, it might be an even better time for investors to remind themselves of all the reasons why a move into core bonds may make sense regardless of timing.

Talk to your financial professional to make sure your portfolio is properly allocated for your goals and risk tolerance.

¹ As of 6/30/23. Represented by the **ICE BofA 3-Month US Treasury Bill Index**. See last page for index definition.

² As of 6/30/23. Represented by the **Bloomberg US Aggregate Bond Index**. See last page for index definition. A core bond fund is the name given to bond funds that act as the centerpiece of a bond fund investment. They are generally well-diversified across the US investment-grade bond market, which includes the US government, corporate, agency, and mortgage-related bonds.

³ The yield curve is a line that plots interest rates of bonds having equal credit quality but differing maturity dates; its slope is used to forecast the state of the economy and interest-rate changes.

⁴ Yield to worst is the minimum yield that can be received on a bond assuming the issuer doesn't default on any of its payments.

⁵ A basis point is a unit that is equal to 1/100th of 1% and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indices and the yield of a fixed-income security.

⁶ Intermediate debt is a type of bond or other fixed-income security that has a maturity date set for between two and 10 years. Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

⁷ Reinvestment risk refers to the possibility that an investor will be unable to reinvest cash flows received from an investment, such as coupon payments or interest, at a rate comparable to their current rate of return.

FIGURE 1 Index Definitions

Balanced Portfolio is represented by 50% S&P 500 Index/50% Bloomberg US Aggregate Bond Index. US Equities are represented by the S&P 500 Index. The **S&P 500 Index** is a market capitalization-weighted price index composed of 500 widely held common stocks. Bonds are represented by the Bloomberg US Aggregate Bond Index. The **Bloomberg US Aggregate Bond Index** is composed of securities that cover the US investment-grade fixed-rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. Cash is represented by the **Bloomberg US Treasury Bill 1-3 Month Index**, which is designed to measure the performance of public obligations of the US Treasury that have a remaining maturity of greater than or equal to 1 month and less than 3 months. Corporates are represented by the **Bloomberg US Corporate Index**, a market-weighted index of investment-grade corporate fixed-rate debt issues with maturities of one year or more. High Yield is represented by the **Bloomberg US Corporate High Yield Total Return Index**, an unmanaged broad-based market-value-weighted index that tracks the total-return performance of non-investment grade, fixed-rate, publicly placed, dollar-denominated and nonconvertible debt registered with the Securities and Exchange Commission. International equities are represented by the **MSCI World ex USA Index**, a free float-adjusted market-capitalization index that captures large- and mid-cap representation across developed-markets countries excluding the United States. MSCI performance is shown net of dividend withholding tax. Mortgage backed-securities (MBS) are represented by the **Bloomberg US MBS Index**, which tracks fixed-rate agency mortgage-backed passthrough securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). Municipal bonds are represented by the **Bloomberg Municipal Bond Index**, an unmanaged index that is considered representative of the broad market for investment-grade, tax-exempt bonds with a maturity of at least one year. Treasuries are represented by the **Bloomberg US Treasury Index**, an unmanaged index of prices of US Treasury bonds with maturities of one to 30 years.

FIGURE 2 Index Definitions

The **Bloomberg 1-3 Year Government/Credit Index** is a broad-based benchmark that measures the non-securitized component of the US Aggregate Index. It includes investment-grade, US dollar-denominated, fixed-rate Treasuries, government-related and corporate securities with 1 to 3 years to maturity. The **Bloomberg US Government/Credit Bond Index** is a broad-based flagship benchmark that measures the non-securitized component of the US Aggregate Index with 10 or more years to maturity. The index includes investment-grade, US dollar-denominated, fixed-rate Treasuries, government-related and corporate securities. See above for a definition of the Bloomberg US Aggregate Bond Index.

FIGURE 3 and 4 Index Definitions

The **ICE BofA 3-Month US Treasury Bill Index** is an unmanaged index comprised of a single US Treasury issue with approximately three months to final maturity, purchased at the beginning of each month and held for one full month. The **IA SBBI US 30 Day TBILL USD Index** measures the performance of a single issue of outstanding Treasury bill which matures closest to, but not beyond, one month from the rebalancing date. The issue is purchased at the beginning of the month and held for a full month; at the end of the month that issue is sold and rolled into a newly selected issue. The **Bloomberg US Treasury 1-3 Year**

Index measures the performance of US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury. It is the subset of the US Treasury Index includes bonds with maturities of 1 to 3 years. The **Bloomberg US Treasury 5-7 Year Index** measures the performance of US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury. It is the subset of the US Treasury Index includes bonds with maturities of 5 to 7 years. The **Bloomberg US Treasury 10+ Year Index** measures the performance of public obligations of the US Treasury with maturities of 10 years and greater, including securities roll up to the US Aggregate, US Universal, and Global Aggregate Indices.

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Important Risks: Investing involves risk, including the possible loss of principal.

- Fixed-income security risks include credit, liquidity, call, duration, event and interest-rate risk. As interest rates rise, bond prices generally fall.
- Foreign investments may be more volatile and less liquid than US investments and are subject to the risk of currency fluctuations and adverse political, economic and regulatory developments. These risks may be greater, and include additional risks, for investments in emerging markets.
- Investments in high-yield ("junk") bonds involve greater risk of price volatility, illiquidity, and default than higher-rated debt securities.
- Obligations of US Government agencies are supported by varying degrees of credit but are generally not backed by the full faith and credit of the US Government.
- Municipal securities may be adversely impacted by state/local, political, economic, or market conditions. Although municipal securities are exempt from federal income taxes, investors may be subject to the federal Alternative Minimum Tax as well as state and local income taxes. Capital gains, if any, are taxable.
- Mortgage-related and asset-backed securities' risks include credit, interest-rate, prepayment, and extension risk.

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