Pallas Perspective

January 26, 2024

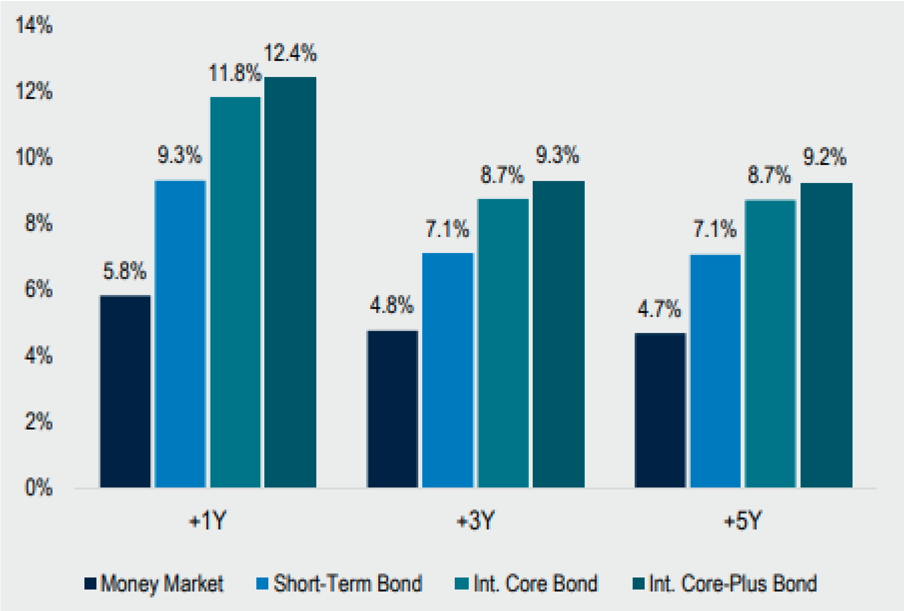
Money Market Fund Yields are Attractive; However, History Rewards Duration at Peak Fed Fund Rate

A money market fund invests in highly liquid, near-term instruments. These instruments may include cash, cash-equivalent securities, and high-credit-rating, debt-based securities with a short-term maturity (such as U.S. Treasuries). Money market funds are intended to offer investors high liquidity with a very low level of risk. Due to the significant increase in the Fed Funds rate over the course of 2022 and 2023, money market funds that are widely used for holding cash within investment portfolios are yielding around 5%, up from near zero in 2021 and the first half of 2022.

While the money market yield is attractive, the current level will likely be unsustainable. The Federal Reserve has recently signaled the end of the current hiking cycle may be near, with the consensus being that either we've seen the last rate hike of the cycle (on July 26, 2023) or potentially there is one more to come. However, market consensus is for multiple rate cuts starting in 2024 and continuing through 2025. While the exact timing is uncertain, perfect timing is not required to benefit from extending duration.

Over the last seven interest rate cycles dating back to 1983, higher duration portfolios have provided stronger returns than money markets on a 1-, 3-, and 5-year basis following either the last rate hike or 2nd to last rate hike.

Average Returns Following the Last Hike of a Cycle



Source: PGIM Investments

While bonds rallied on the news of a Fed pivot into the end of 2023, bond returns have pulled back year-to-date in 2024 as expectations for the level of rate cuts in 2024 likely were stretched. History may suggest that now might be an appropriate time to reallocate cash on the sidelines and short-term investments into longer-duration fixed income. Pallas Capital Advisor fixed income models have been extending duration in a measured manner over the past year, and expectations are for this rebalanced allocation to continue.