Stepping out of cash with short-term bonds

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Kris Moreton: Hi, I'm Kris Moreton and I'm here with my colleague Katy Nuss. Katy and I are fixed income client portfolio managers at Columbia Threadneedle.

Katy Nuss: We're here to talk about opportunities in short-term bonds — specifically, why they're a good get-back-into the market solution for investors who are still counting on cash.

Katy: So, Kris, with money market rates still hanging around 5%, why should investors consider short-term bonds, and why now?

Kris: Up until October of last year, cash made a lot of sense. It was beating bond funds across the board. But the situation turned quickly in the last two months of 2023. When Treasury yields dropped by as much as 100 basis points, bonds rallied. In fact, we got what would typically be a year's worth of return in just one month during November. That shift was driven by the market's expectation that the Fed has likely stopped hiking rates, and that the next major move will be a cut.

Katy: Kris, this a great example of why investors should try to move sooner rather than later. The market is forward-looking and prices in Fed moves before they happen. But after this rally, many investors may wonder if they've already missed out on the recovery. We think there's plenty of value in fixed income, and that short-term bonds offer a particularly compelling opportunity.

Kris: Much of that perspective hinges on our starting point: Yields across the maturity and quality spectrum are still at their highest level in over a decade. Starting yield is the single most important predictor of a bond's future total return. Bonds with shorter maturities capture this total return sooner and with less volatility than longer maturity bonds, which can make them an attractive option for investors looking for more certainty in the near term. Katy, what would you say to investors who want to step out of cash but are still concerned about fixed-income volatility?

Katy: I would say that with starting yields where they are right now, the income from bonds functions as a shock absorber that can mitigate the risk of future price moves. Here's one way of looking at it. I call this the "what could go wrong" chart, and it shows that it would take a massive — and highly unlikely — reversal in the current direction of yields to derail short-term bond total returns in 2024. We would have to see interest rates increase more than 300 basis point from where they are today, for a bond with a starting yield of 6% and a duration of two years to post a negative return. The other thing I would say, when looking at this chart, is that if you believe that the Fed is going to cut, you should be in the markets with some — even low — duration so you can get a price upside from yields moving lower.

Kris: Let's recap. If investors are looking to step out of cash, short-term bonds could provide a soft-landing, at least as a first move:

- There's an opportunity to lock-in today's high starting yields over a longer time horizon than cash.
- Those high starting yields also provide a meaningful cushion for volatility-wary investors.
- You don't need to wait for the cut, you can make a strategic move now.

The bond market tends to get ahead of news, so get in there before the event. Thanks so much for tuning in.

There are risks associated with fixed-income investments, including credit risk, interest rate risk, prepayment and extension risk. In general, bond prices rise when interest rates fall and vice versa. This effect is usually more pronounced for longer term securities. Yields may vary.

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