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Cash Negative

A year ago, the U.S. Federal Reserve was well on the way to policy normalization and the European Central Bank (ECB) was preparing to unwind some of the extraordinary measures it had put in place since the financial crisis.

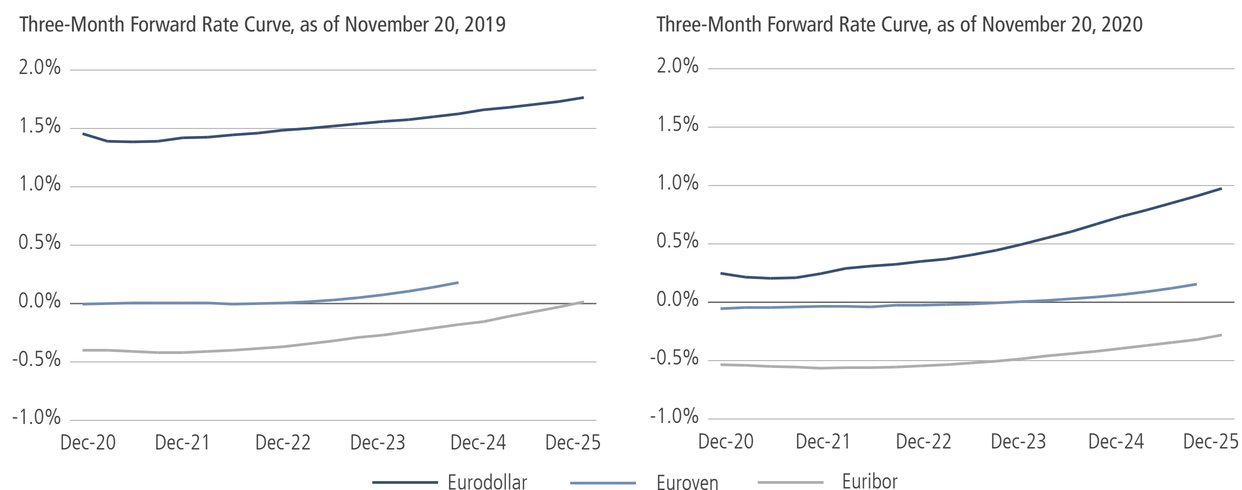
The coronavirus pandemic changed all that. It was met with an even greater policy response, which has substantially lowered U.S. dollar short-dated interest rates and suppressed the already flat forward rate curves for the euro and Japanese yen.

We believe these conditions are likely to persist for some time, presenting a formidable challenge for treasurers to maintain positive returns in their cash portfolios.

How can they meet that challenge?

Figure 1 shows the forward curves for the three-month Euribor, Eurodollar and Euroyen rates—that is, the three-month rate for borrowing in each currency, beginning at various points in the future out to December 2025. A year ago, the rate for borrowing dollars for three months starting in December 2020 was almost 1.5%. Today, that rate is 0.25%. The rate starting in December 2024 went from 1.66% to 0.74%. The euro and yen rates went negative back in 2015 and 2016, respectively, but even these curves have flattened further this year.

FIGURE 1. LOWER FOR LONGER: FORWARD RATES OUT TO FOUR YEARS HAVE COLLAPSED



Source: Bloomberg.

The knock-on effects can be felt in money markets. By the end of October, the yields of the Lipper Institutional Money Market Funds Index and Lipper Institutional U.S. Government Money Market Funds Index were both lower than 0.1%. In real terms, that is -1.1%. For euro investors, short-dated AAA government bonds have a -0.4% real yield, despite the Eurozone being in deflation.

The forward curves, and our own view, indicate that these conditions are likely to persist for years. The Federal Reserve's recent adoption of a more dovish decision-making framework raises the bar for any tightening of policy.

How can treasurers managing cash portfolios adapt to these conditions?

Diversification, Flexibility and Adaptability

Those managing euro cash portfolios have been living with this challenge for years. Already negative before coronavirus, Euribor has fallen another 10 basis points since. The ECB's Pandemic Emergency Purchase Program (PEPP) has spread the negative yields investors had become used to in German government bonds deep into the French government yield curve, too. Today, anything rated AAA or AA in Europe has a deeply suppressed and very flat yield curve.

Nonetheless, there are still opportunities—even before we move from sovereigns to corporate bonds.

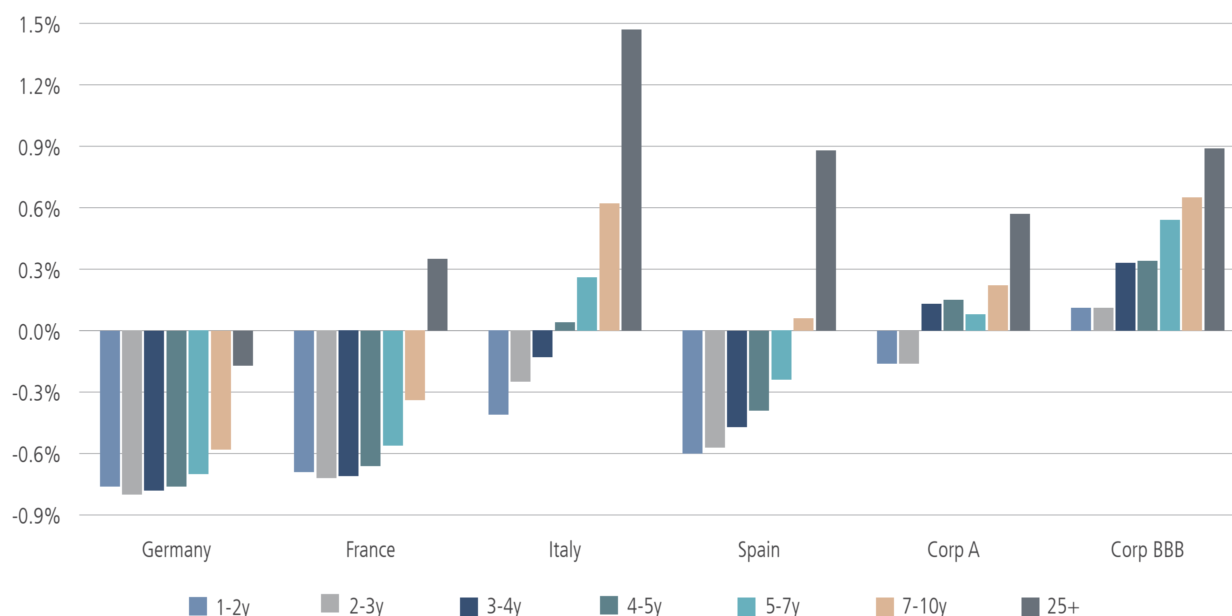
The size of the ECB's asset purchases is determined by the "capital key:" the more capital a country contributes to the ECB's balance sheet, the more of its bonds the ECB can buy. Because Germany and France are large capital providers, the ECB can buy a large proportion of their sovereign bond markets. It cannot purchase the same volume of Italian and Spanish bonds, however, despite these being very large markets.

That means there is still some credit premium available in the Italian and Spanish yield curve, even at relatively short maturities, which makes those curves steep enough to support some positive carry and roll-down return (figure 2).

Once we look beyond sovereigns, we see that there are also relatively steep curves in financial and corporate bonds rated below AA, where the knock-on effect of ECB purchases remains modest.

FIGURE 2. THE EUROPEAN OPPORTUNITY SET: CARRY AND ROLL-DOWN FROM STEEP CURVES

Yield to Worst



Source: FactSet. Data as of November 26, 2020. Indices used: ICE BoA Europe Corporate.

There are two lessons to take away from the European experience.

The first is about diversifying into markets other than core government bonds—in this case, short-dated peripheral Eurozone sovereigns and investment grade credit.

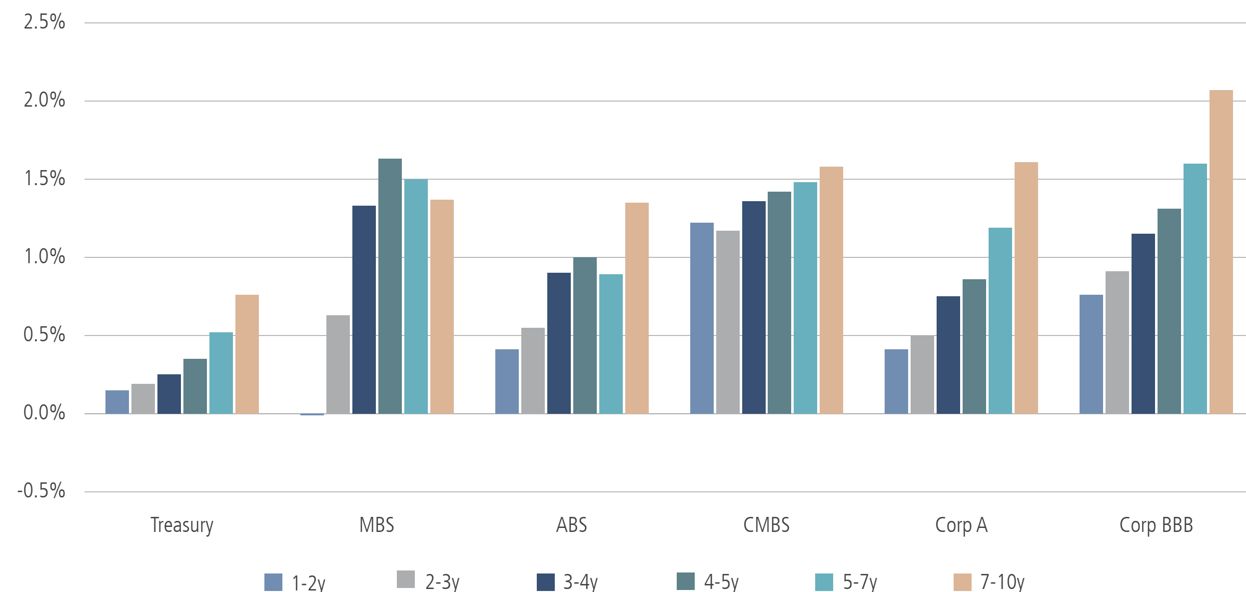
The second is about flexibility and adaptability. A year ago French government bonds might have been part of a euro "enhanced cash" strategy; today they are not. The toolbox may be different again in another year's time because so much depends on central bank decisions. The PEPP looks likely to be extended beyond its planned expiry date of June 30, 2021—but that remains uncertain. Similarly, the market had to wait some weeks for confirmation that the PEPP's flexibility will not be applied to the ECB's other asset-purchase programs. In our view, cash portfolio managers need to be able to adapt quickly to these changes in official policy.

Capital Preservation and Liquidity Are Non-Negotiable

In the U.S. dollar context, diversification means exploring this market's wide variety of deep, liquid investment grade credit opportunities. As figure 3 shows, alongside investment grade corporate bonds, we have agency mortgage-backed securities, commercial mortgage-backed securities (MBS, CMBS) and other asset-backed securities (ABS) as a source of short-dated yield well in excess of Treasury rates.

FIGURE 3. THE U.S. OPPORTUNITY SET: DIVERSIFIED CREDIT

Yield to Worst



Source: Bloomberg. Data as of November 26, 2020. Indices used: Bloomberg Barclays U.S. Treasury, U.S. MBS, U.S. Aggregate ABS, U.S. Aggregate CMBS, A Corporate and Baa Corporate Statistics Indices.

Flexibility and adaptability here mean the ability to invest in these alternative sources of yield without compromising the capital preservation and liquidity that is non-negotiable for a cash portfolio.

In our view, that requires skills in both valuation and fundamental credit and liquidity analysis.

Valuation requires a genuinely "apples-to-apples" framework for comparing credit risk pricing across different sectors and rating bands. As an asset manager with many years of multisector credit experience, Neuberger Berman has developed a tried-and-tested methodology for doing just that.

Fundamental analysis requires a focus on markets where one has special insight and expertise. This "edge" can help investors identify, with greater confidence, opportunities that marry yield pick-up with robust credit quality and reliable liquidity. At Neuberger Berman, we are fortunate to have an unusually broad and deep fixed income capability, which includes long experience structuring securitized products as well as investing in them, and a genuinely global credit research presence.

Customize

Perhaps most importantly, we think an effective enhanced cash portfolio manager needs to be able to customize solutions for individual clients.

Negative real yields mean that off-the-shelf money market funds no longer serve their purpose well. A standardized enhanced cash strategy may be suitable for some investors, but it also has limitations. When margins are as tight as they are today, every basis point of yield pick-up counts. We think that makes the case for using up every bit of an investor's credit, duration and liquidity risk budget—and those budgets will vary considerably depending on the client's individual profile.

The coronavirus crisis has been a shock felt almost universally—including in central bank policy and interest rates. Cash portfolio managers across the entire developed world now face the same challenge that euro and yen cash managers have struggled with for years.

We believe the lessons of those years now need to be applied broadly: diversify your opportunity set, backed by rigorous credit and liquidity analysis; stay flexible, to take advantage of short-term opportunity and to adapt to the changing policy environment; and customize, to squeeze the most out of every bit of your risk budget.

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