THE RISING RISK OF INVESTING IN CASH

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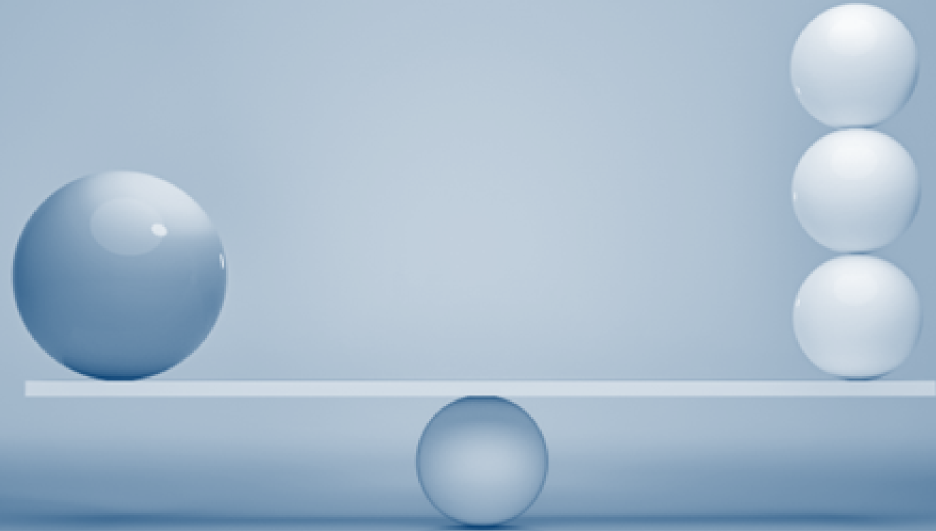
Pending Fed rate cuts mean reinvesting in cash equivalents or waiting to redeploy into bonds may be costly. But we believe there's still time to manage this mounting risk.

KEY TAKEAWAYS

- With the Fed likely to cut rates later this year, we believe reinvestment risk is a growing threat to fixed-income portfolios.
- Falling interest rates mean yields on cash equivalents will likely decline, reducing investors' monthly investment income.
- We believe this scenario highlights current opportunities among investment-grade bonds with exposure to a potentially changing interest rate backdrop.



WHY IS REINVESTMENT RISK RISING?

Peak Rates Have Been Short-Lived
When Rate Hikes Ended and How Long Rates Stayed at Peak Level

1-5 Months	6-10 Months	> 10 Months
1957		
1966		
1969		
1973		
1974		
1975		
1976		
1979		
1980		
1981		
1982		
1984		
1985	1960	1998
1989	2000	2007
1995	2019	2024?

Reinvestment risk is the possibility that investors may be unable to reinvest cash flows at the same yield they're currently earning.

This risk typically emerges when interest rates are falling, such as when the Federal Reserve (Fed) cuts rates. We think Fed easing is imminent.

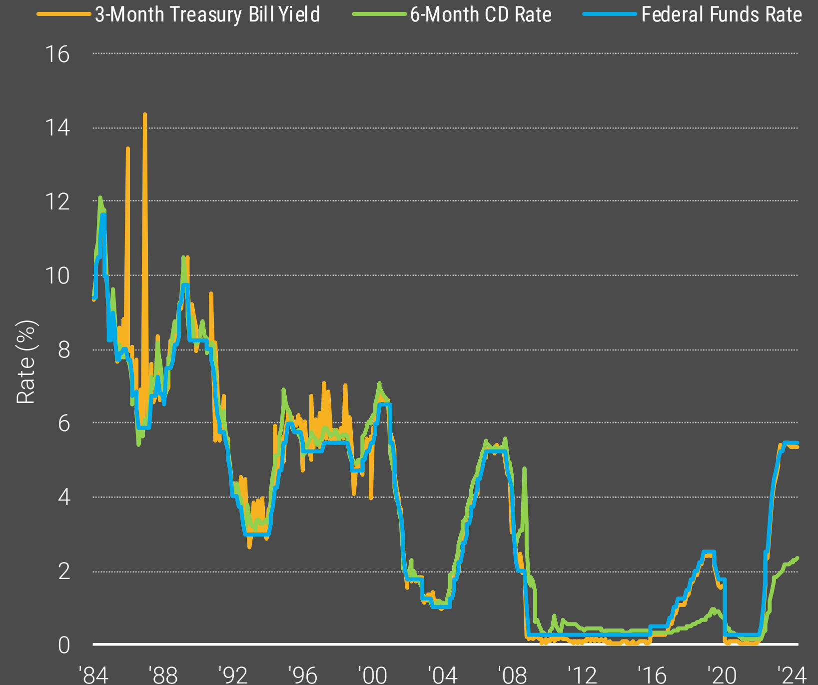
Looking at the 20 Fed tightening cycles from 1956 through 2019, the federal funds rate target remained at its peak level for an average of 4.2 months.

In the current cycle, the rate target has been in a range of 5.25% to 5.5% for a year, unusual by historical standards.

In our view, history suggests reinvestment risk is rising, making it a key consideration for investors seeking to maximize investment income and total return potential.

SHORT-TERM YIELDS HAVE MOVED IN SYNC

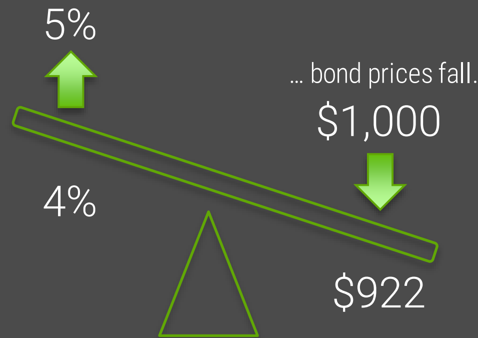
- Yields on Treasury bills, CDs and other cash equivalents typically move in tandem with the federal funds rate.
- So, when the Fed starts cutting rates, yields on these popular vehicles should follow suit.
- This dynamic can lead to less monthly income for investors who hold these assets.

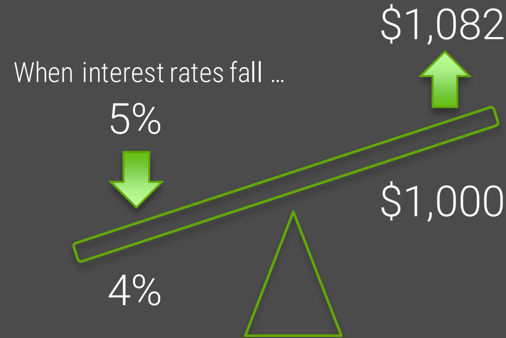


A DUAL CHALLENGE FOR INVESTORS

Reinvestment risk can create two challenges for fixed-income investors:

1. They may see a drop in monthly income from cash equivalents.
2. They may pay more to redeploy cash assets into longer-maturity, higher-yielding securities.





Bond prices typically rise in declining interest rate environments. So, boosting total return potential by moving into higher-yielding alternatives may cost more after rates start to drop.

For illustrative purposes only. Assumes a bond paying 4% with a fixed semiannual coupon and a 10-year maturity.

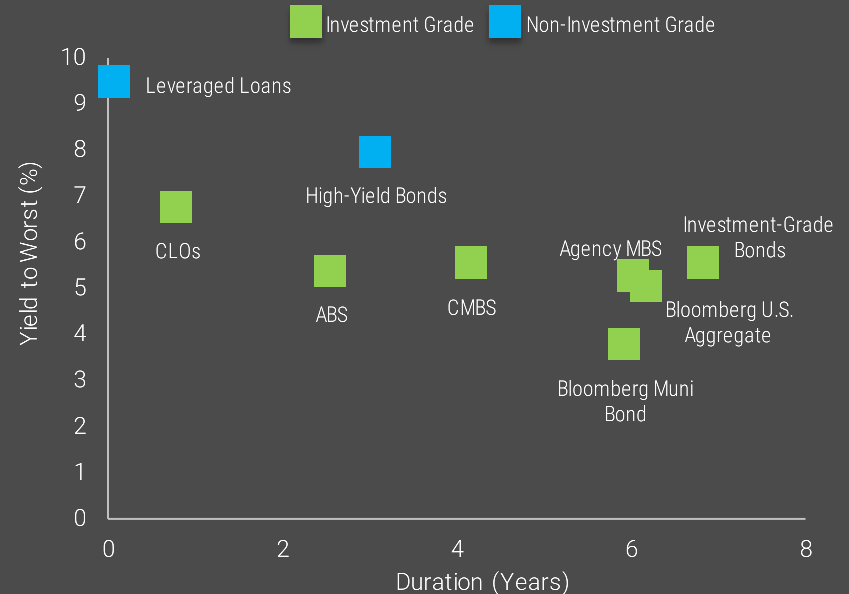
BOND YIELDS HIGHLIGHT OPPORTUNITIES

Persistent inflation and high interest rates have lifted yields across the bond market. In our view, this backdrop means most investment-grade bond sectors may help mitigate reinvestment risk by:

- Securing and locking in today's potentially attractive yields.
- Adding duration, which can generate price appreciation when interest rates fall.

Most investment-grade sectors have offered yields of at least 5%. Combined with their duration exposure, we believe the total return potential is sound, given our expectations for rates to fall.

And even if the economy performs better than expected and interest rates move higher, we believe current yields may offer a total return cushion.



Data as of 6/30/24. Source: Bloomberg, J.P. Morgan, Credit Suisse. For the Bloomberg Muni Bond Index, taxable-equivalent yields may be higher, depending on your income tax bracket. Past performance is no guarantee of future results.

DURATION CAN MAKE A DIFFERENCE

- Duration, or a bond's price sensitivity to interest rate changes, is a gauge that investors use to manage interest rate risk.
- When interest rates drop, bonds with longer durations tend to experience greater price appreciation.
- Conversely, when rates rise, prices on longer-duration bonds typically drop more.
- Because we expect interest rates to decline in the coming months, we believe modestly adding duration may be prudent.

Duration Influences Bond Prices

How a 1% decline in interest rates affects hypothetical bonds with different durations; assumes initial bond value of $1,000.

Duration	% Price Change	Resulting $ Value
1 Year	+1%	1,010
5 Years	+5%	1,050
10 Years	+10%	1,100

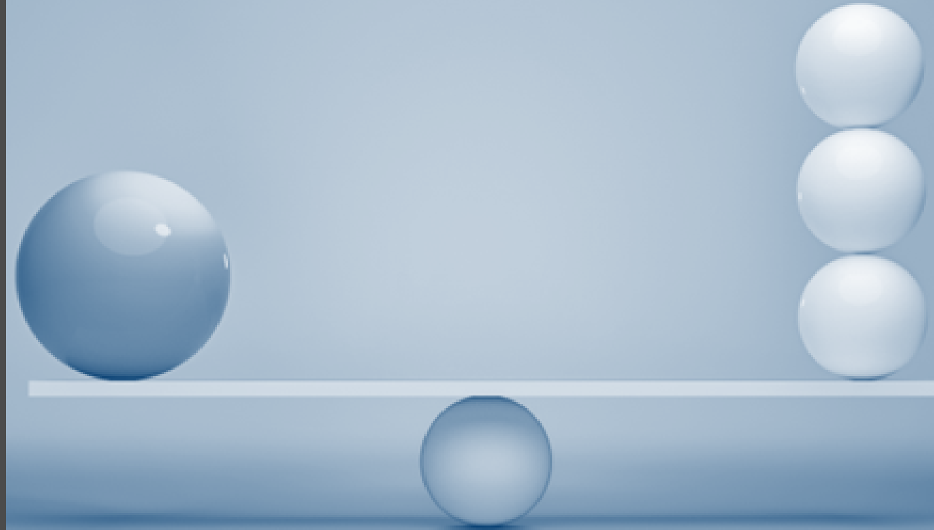
How a 1% rise in interest rates may affect hypothetical bonds with different durations; assumes initial bond value of $1,000.

Duration	% Price Change	Resulting $ Value
1 Year	-1%	990
5 Years	-5%	950
10 Years	-10%	900

For illustrative purposes only.

THE BOTTOM LINE

- The Fed has indicated its next policy move will likely be a rate cut. With inflation moderating and economic data slowing, the first cut may occur before year-end.
- We believe this outlook has elevated reinvestment risk for many fixed-income investors.
- In our view, higher-quality bonds with attractive yields and intermediate durations may help investors manage this risk.



GLOSSARY

Agency MBS: Mortgage-backed securities (MBS) issued by U.S. government agencies.

Asset-backed securities (ABS): A form of securitized debt, ABS are structured like mortgage-backed securities (MBS). But instead of mortgage loans or interest in mortgage loans, the underlying asset may include auto loans, home equity loans, student loans, small business loans and credit card debt.

Bloomberg Municipal Bond Index: A market value-weighted index designed for the long-term tax-exempt bond market.

Bloomberg U.S. Aggregate Bond Index: This index covers the U.S. investment-grade fixed-rate bond market, with index components for government and corporate securities, mortgage pass-through securities and asset-backed securities.

Collateralized loan obligations (CLOs): A form of securitized debt typically backed by pools of corporate loans and their payments.

Commercial mortgage-backed securities (CMBS): MBS that represent ownership in pools of commercial real estate loans used to finance the construction and improvement of income-producing properties, including office buildings, shopping centers, industrial parks, warehouses, hotels and apartment complexes.

Corporate securities: Debt instruments issued by corporations. Corporate securities typically have these features: 1)they are taxable; 2) they tend to have more credit (default) risk than government or municipal securities, so they tend to have higher yields than comparable-maturity securities in those sectors; and 3) they are traded on major exchanges, with prices published in newspapers.

Credit quality: Credit quality reflects the financial strength of the issuer of a security and the ability of that issuer to provide timely payment of interest and principal to investors in the issuer's securities. Common measurements of credit quality include the credit ratings provided by credit rating agencies like Standard & Poor's.

Credit ratings: Measurements of credit quality provided by credit rating agencies. Those provided by Standard & Poor's are typically the most widely quoted, ranging from AAA (highest quality, perceived as least likely to default) down to D (in default).

Federal funds rate: An overnight interest rate that banks charge each other for loans. It's an interest rate that's mentioned frequently within the context of the Fed's interest rate policies.

Federal Reserve (Fed): The Fed is the U.S. central bank, responsible for monetary policies affecting the U.S. financial system and the economy.

High-yield bonds: High-yield bonds are fixed income securities with lower credit quality and lower credit ratings. High-yield securities are those rated below BBB- by Standard & Poor's.

Inflation: Inflation (aka headline inflation) reflects rising prices for consumer goods and services or, equivalently, a declining value of money.

Investment-grade: Fixed-income securities that possess relatively high credit quality and have credit ratings in the upper ranges of those provided by credit rating services. Using Standard & Poor's ratings as the benchmark, investment-grade securities are those rated from AAA at the highest end to BBB at the lowest. To earn these ratings, securities, in the judgment of the rating agency, are projected to have relatively low default risk.

GLOSSARY

Leveraged loans: Loans extended to companies with significant debt or poor credit ratings (below investment-grade). These loans typically have higher interest rates to reflect the higher level of risk in issuing them.

Mortgage-backed securities (MBS): A form of securitized debt that represents ownership in pools of mortgage loans and their payments. Most MBS are structured as “pass-throughs” — the monthly payments of principal and interest on the mortgages in the pool are collected by the financial entity servicing the mortgages and are “passed through” monthly to investors.

Securitized debt: Debt resulting from the process of aggregating debt instruments into a pool of similar debts, then issuing new securities backed by the pool (securitizing the debt). Asset-backed and mortgage-backed securities (ABS and MBS) and collateralized mortgage obligations (CMOs) are common forms of securitized debt. Credit quality can vary significantly, depending on the underwriting standards of the original debt issuers, the credit quality of the issuers, economic or financial conditions that might affect payments, the existence of credit backing or guarantees, etc.

Total return: For bonds and other fixed-income securities, total return is a standard performance measurement that incorporates income (primarily from interest payments) and changes in the prices of the securities. It is viewed as a more complete measurement of performance than yield alone.

Treasury Bills: Debt securities issued by the U.S. Treasury, maturing in one year or less and backed by the full faith and credit of the U.S. government.

Yield: The rate of return for bonds and other fixed income securities. There are various types of yield calculations. Current Yield is a measure of the annual income (interest or dividends) earned from a bond, expressed as a percentage of its current market price. Yield to Worst (YTW) is the lowest yield an investor can expect to receive if the bond is called or redeemed by the issuer before its maturity date. It takes into account various possible scenarios, including the bond being called, put, or reaching maturity. YTW is useful for investors to assess the worst-case scenario in terms of yield, providing a more conservative estimate than other yield measures. To calculate YTW, an investor would determine the yield under each possible call or redemption scenario and then select the lowest one. This metric is particularly relevant for bonds with callable features, as it helps investors understand the potential downside risk if the issuer decides to redeem the bond early.

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