

# From Cash to Bonds: A Strategic Shift in Post-Pandemic Investing

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As cash yields dwindle, the case for fixed income becomes increasingly compelling.

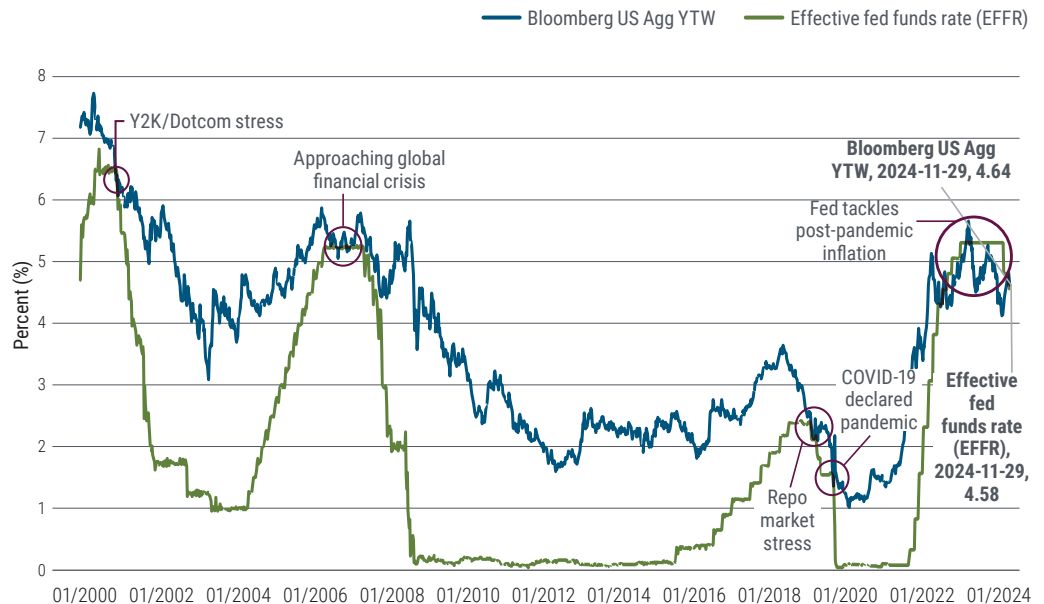
As post-pandemic disruptions to markets and economies recede, long-term trends are reasserting themselves. One key signal that markets are returning to historical patterns appeared in November, when a common yield measure on the Bloomberg US Aggregate Index climbed above the Federal Reserve policy rate for the first time in more than a year.

It's difficult to overstate how extraordinary it was to have a benchmark bond yield running below – sometimes well below – the federal funds rate for such an extended period.

Prior to the pandemic, this had only happened four times in this century, and never for more than a few weeks at a stretch (see Figure 1).

This prolonged reversal in the usual market trend reflected not only the Fed's restrictive policy, but also investors' response to the extreme inflation spike and other consequences of the pandemic. Many investors retreated into cash – which offered yields not seen in decades along with perceived safety – and stayed there.

**Figure 1: Benchmark bond index yield once again exceeds Fed's policy rate**



Source: U.S. Federal Reserve and Bloomberg as of 29 November 2024. Data shown are the Bloomberg US Aggregate Index yield to worst (LBUSYW) and the effective fed funds rate (EFFR).

### CHANGED CIRCUMSTANCES

Two years later, the market landscape has transformed. Now that the Fed has embarked on a rate-cutting path, over-allocating in cash creates reinvestment risk as the assets rapidly and repeatedly turn over into lower-yielding versions of themselves.

At the same time, we witnessed a profound shift higher in bond yields from pandemic-era lows. Relative to cash, where yields are dwindling as interest rates drop, bonds offer a more compelling opportunity: Consider the same core bond index yield measured against another common proxy for cash, the yield on the 3-month U.S. Treasury (see Figure 2). Both cash and bonds offered attractive yields over the past two years, but cash investors by nature can't lock in those yields for longer

time periods – and since September, when the Fed cut its policy rate by 50 basis points (bps), the outlook for cash yields relative to core bonds has diminished sharply.

The Fed's trajectory is not a foregone conclusion, and indeed we may see some upward revisions in officials' rate projections following the December meeting, but the data and the communications to date suggest the most likely scenario is one of gradually lower rates. The Fed is looking to secure a soft landing for the U.S. economy – with labor markets healthy and inflation near target – and it has flexibility to pursue its goals despite expected or unexpected obstacles (e.g., trade policy, geopolitics, price surprises). This rate environment is highly favorable for bonds.

**Figure 2: U.S. core bonds outyielding cash equivalents**

Difference between YTW on Bloomberg US Aggregate Index and yield on 3-month U.S. Treasury bill



Source: Bloomberg data as of 6 December 2024. Bond yields are represented by yield to worst on the Bloomberg US Aggregate Index (LBUSYW); cash yields are represented by the 3-month U.S. Treasury yield.

## BONDS FOR THE LONG RUN

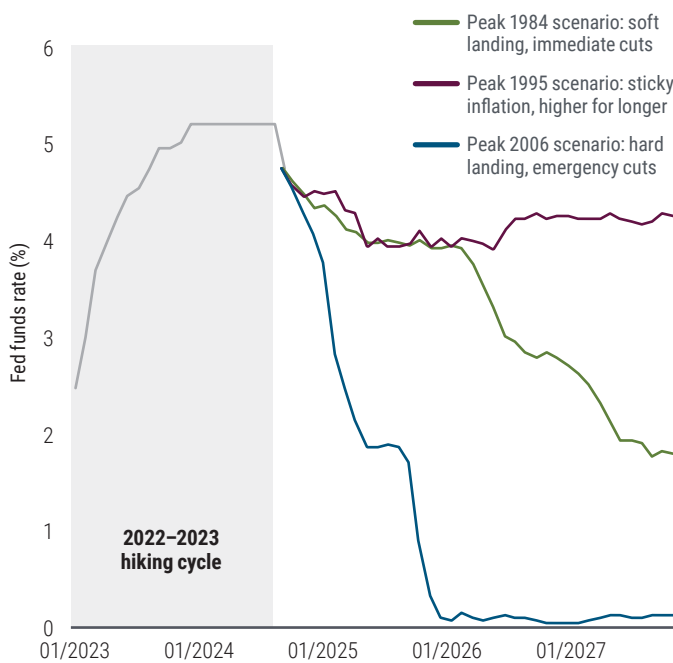
Based on current relative valuations and market conditions, we believe there is compelling value in high quality, liquid public fixed income. Starting yields are attractive compared with other assets across the risk and liquidity spectrum – including cash – and historically, starting yields have been a strong indicator of long-term fixed income performance.

Also, bonds are well-positioned to withstand a range of scenarios outside the baseline. Historically, high quality

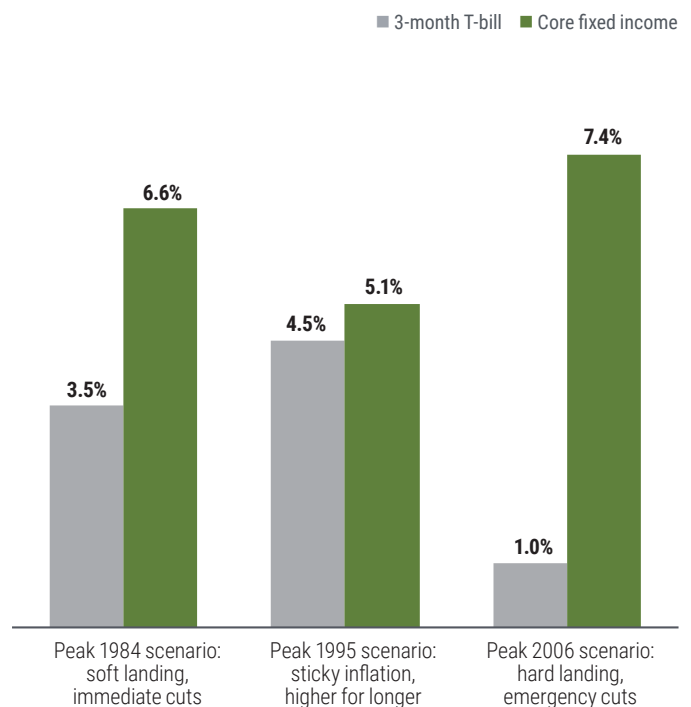
bonds tend to perform well during soft landings – and even better in recessions, should that scenario play out instead. Bonds also have performed well historically across a range of different rate-cutting scenarios (like snowflakes, no two monetary cycles are alike) – see Figure 3. Whether the Fed took a very gradual (“higher-for-longer”) approach, or initiated a drastic drop, or took a downward path somewhere between those extremes, bonds subsequently outyielded cash in each of those historical rate environments.

**Figure 3: Bonds have outpaced cash after the Fed initiates rate cuts, regardless of the path**

Potential cutting cycle scenarios:  
Replaying three distinct historical cycles over the next three years<sup>1</sup>



Falling long-end yields support fixed income performance:  
Hypothetical 3-year return (annualized)<sup>2</sup>



Source: Bloomberg data, PIMCO calculations as of 30 September 2024. **For illustrative purposes only. Figure is not indicative of the past or future results of any PIMCO product or strategy. There is no assurance that the stated results will be achieved.**

1 Hiking cycles are defined as periods where the Federal Reserve embarks on a sustained path of increasing the target fed funds rate and/or target range. We define the end of a hiking cycle as the month where the Fed reaches its peak policy rate for that cycle (i.e., it either pauses rate hikes or cuts). Hiking cycles include (start to peak): 1984 (Feb. 1983 to Aug. 1984), 1995 (Jan. 1994 to Feb. 1995), 2006 (May 2004 to Jun 2006). We select three historical case studies to illustrate three very different outcomes for the path of the fed funds rate after rates hit their peak level in each cycle. The 1984 cycle is based on the rate of change given significantly higher starting yields versus today.

2 To simulate performance over the next three years, we assume long-end rates follow their historical pattern in each cycle over the next three years. Core fixed income is represented by the Bloomberg US Aggregate Index. 3-month T-bill returns are estimated using the historical monthly changes in the fed funds rate starting from the current level. In the analysis contained herein, PIMCO has outlined hypothetical event scenarios that, in theory, would impact the yield curves as illustrated in this analysis. No representation is being made that these scenarios are likely to occur or that any portfolio is likely to achieve profits, losses, or results similar to those shown. The scenario does not represent all possible outcomes and the analysis does not take into account all aspects of risk. Total returns are estimated by repricing key rate duration replicating portfolios of par-coupon bonds. All scenarios hold option-adjusted spread (OAS) constant.

### HEDGE AND DIVERSIFY RISK

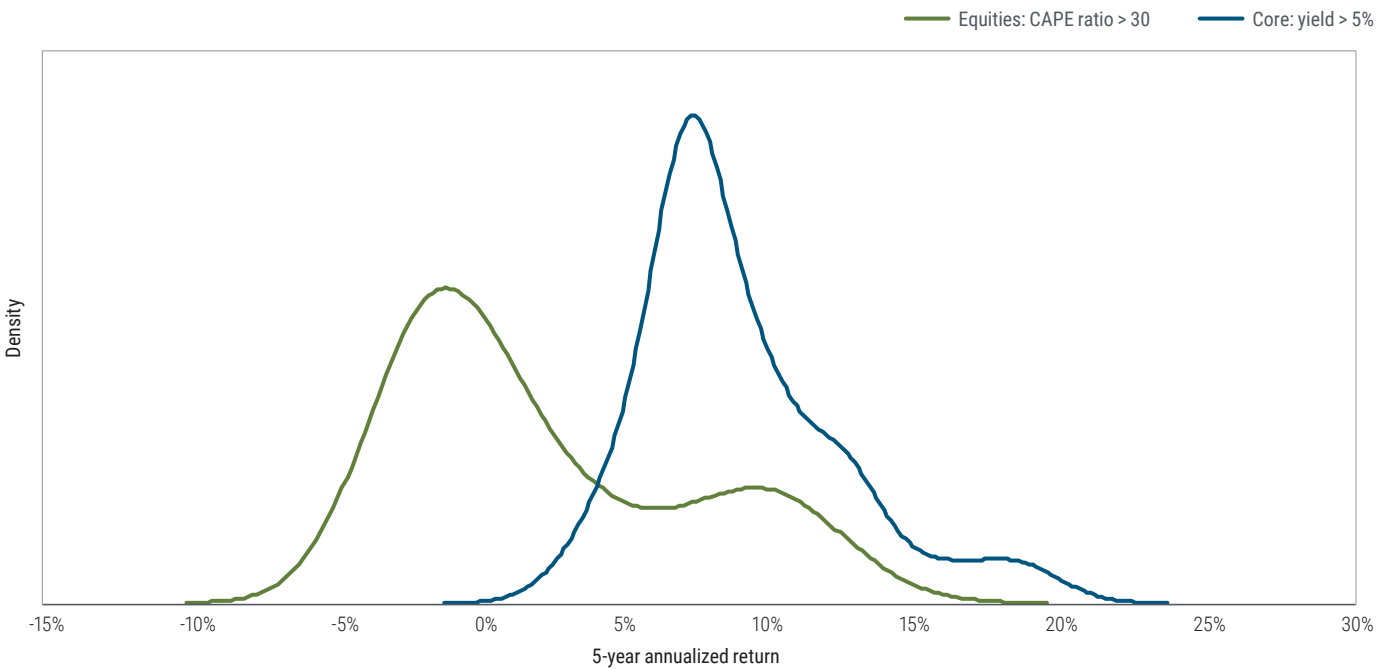
The bond market is effectively paying investors to hedge and diversify risk. Equity markets have a more checkered history with rate-cutting cycles, and indeed generally higher volatility over time – and we are in a period of heightened geopolitical unrest, along with leadership changes in major economies around the world.

Bonds and equities are negatively correlated today, after moving more in tandem during the post-pandemic inflation shock. A negative stock/bond correlation amplifies bonds’ potential to be a stable anchor for portfolios.

Historical trends also support bonds as an attractive risk hedge. Looking back at bond and equity markets on average since 1973, during periods when U.S. core bonds are yielding around 5% or greater while U.S. equities’ earnings ratios are above 30 – as they are today – bonds have offered higher five-year subsequent returns (see Figure 4), and with potentially lower volatility.

A fixed income allocation offers attractive yields, potential for price appreciation, and a liquid hedge against the risk that equities or other more volatile assets see a sustained contraction.

Figure 4: Historically, bonds at today’s yields have outpaced equities at today’s valuations



Source: Bloomberg data, PIMCO calculations as of 30 September 2024. **For illustrative purposes only.** Chart uses data back to January 1973. Core refers to the Bloomberg US Aggregate Index. CAPE refers to the cyclically adjusted price-to-earnings ratio for the S&P 500. **There can be no guarantee that the trends mentioned above will continue. Statements concerning financial market trends are based on current market conditions, which will fluctuate.**

## Takeaway

Market signals and Fed moves mean that bond yields have turned a corner. The combination of high starting yields and anticipation for lower rates creates an attractive outlook for a wide variety of bonds. Investors lingering in cash may want to consider fixed income.

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