Stepping Out of Cash: The Case for Short-Term Bonds

Cash has been king for the past two years, as a perfect storm of economic uncertainty and post-pandemic inflation pushed the Federal Reserve to hike interest rates to their highest levels in decades, leading yield-hungry investors to pour a record $6 trillion into money market funds. But with inflation easing and growth expectations retreating, the era of unusually generous money market rates is likely drawing to a close.

For those looking to lock in attractive yields beyond cash, there's still time. Interest rates are only beginning to edge downward, creating a window for investors to lock in yields in short-term bonds. If you're among the many investors sitting on the sidelines, we think now's the time to consider an allocation to short-term bonds as an alternative to cash.

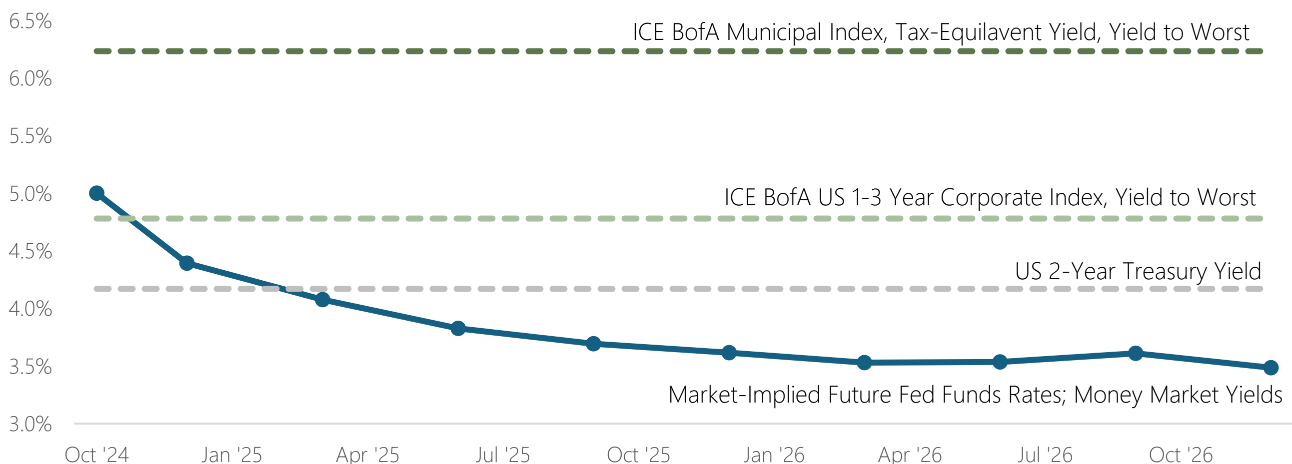
Cash Yields Likely to Disappoint

Parking funds in money markets has been a safe investment through the uncertainty of the past two years, but it's unlikely to produce sustained income over the long term. As the Federal Reserve moves toward lowering interest rates, cash yields are expected to follow suit. Federal Funds Futures—reflecting market expectations for rate moves—suggest that money market yields could dip below 3.5% by mid-2025.

Unless interest rates hold up better than expected, stepping out of cash into short-term bonds now presents a more attractive alternative. And with the market at an inflection point today, diversifying risk across the yield curve and credit spectrum through an active approach could boost returns, offering a unique opportunity for yield-seeking investors willing to step beyond cash.

Cash Rates Are Expected to Head Lower, but Investors Can Still Lock In Higher Yields Today

Fed Fund Futures vs Current Bond Market Yields



Source: Bloomberg, ICE BofA, Crescent Grove Advisors. As of October 31, 2024. Tax-equivalent yield for municipals is for an investor paying the highest federal income tax rate of 37%, plus the federal net investment income tax of 3.8%. The tax equivalent yield would be higher for investors paying additional state and local income taxes.

Leveraging Diversification to Capture Yield

Investors seeking yield beyond money markets are turning to mutual funds and ETFs focused on short-term fixed income securities. With average durations between one and three years, short-term bond funds offer flexibility that money markets lack, tapping into a broader opportunity set like corporate bonds, government debt, mortgage-backed securities, and other asset-backed instruments. This versatility enables them to invest in securities with longer maturities and varying credit qualities, often resulting in higher yields than money market instruments. Thanks to their short maturity profiles, these funds remain relatively liquid and price-stable, making them a compelling alternative for investors seeking a yield advantage.

Of course, it's important to remember that any investment beyond cash carries risk. Short-term bond funds are no different, and returns can fall short of their headline yields, especially if interest rates climb higher. Ultimately, the right choice hinges on individual goals, risk tolerance, and current market conditions.

Key Takeaway

After a two-year rise, cash yields have reached their peak, and short-term bonds are beginning to look like the stronger alternative. For those still overallocated to cash, we believe now is great time to step out and lock in attractive yields provided by short-term bonds.

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