2019 Corporate Cash Outlook

It's Time to Extend

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Clients are questioning whether we're seeing peak short-term rates and if we're close to the optimal time to extend maturities. Read on for our thoughts.

Follow the Fed

2018 witnessed significant moves in fixed income markets, as the upper-bound of Fed Funds increased from 1.50% to 2.50% while short-term Treasury rates generally followed in lockstep:

Maturity	Treasury Yield As of 12/31/17	Treasury Yield As of 12/31/18	Change Through 2018
3 Mo	1.39%	2.45%	**+1.06%**
6 Mo	1.53%	2.48%	**+0.95%**
1 Year	1.75%	2.61%	**+0.86%**
2 Year	1.91%	2.50%	**+0.59%**
3 Year	2.00%	2.46%	**+0.46%**

Source: Bloomberg

The short-end of the yield curve clearly remains largely driven by the Fed, which means investors must monitor the future path of Fed hikes. We're in the tail-end of a multi-year tightening cycle, and subsequent moves in 2019 will be more moderate due to the following reasons:

- While the US economy is growing, other major economies have slowed, leading to fears that the international weakness will impact the US
- The Treasury curve is inching uncomfortably close to inversion, a condition the Fed will seek to avoid
- Employment is strong but inflation still isn't a problem, which casts doubt on the need for further hikes
- Oil prices have nosedived, reducing inflation pressures
- The "on-again, off again" tariff and trade war developments are a significant wild card, threatening to dampen business' risk appetites

While 2019 economic activity will slow relative to 2018, our base case calls for moderate growth, rising corporate profits ("peak earnings growth" doesn't mean "peak earnings"), elevated consumer and small business confidence, and further employment gains. However, market sentiment has clearly pivoted to focusing on the more negative issues which argue for a "pause" in further tightening. How should treasurers and corporate cash investors interpret these contradictory signals and position portfolios?

Expect a Pause

Given prior tightening and recent stock market declines, we expect the Fed to pause the tightening cycle to "assess the impact of prior rate hikes." However, assuming we see continuing economic strength and no further escalation of tariffs and trade war threats, the Fed could resume up to 2 additional hikes in 2019, which would bring Fed Funds up as high as 2.75-3.00%. However, it's unlikely that they'll take any further action until a clear picture of economic activity emerges.

Unless we see a pickup in inflation which causes longer-term rates to rise, the Fed will be constrained in its options, as it wants to avoid inverting the yield curve (traditionally a harbinger of recession). The slope of the short-end of the curve (2 Year Treasury yield – Fed Funds) remained steady at close to 50 bps nearly all year, but fell to zero soon after the latest hike. The widely-watched 2 Year-10 Year Treasury yield differential has trended downwards throughout 2018 and is now close to zero as well. The 3 Year-5 Year portion of the curve has already inverted by a few basis points. This implies the market now expects the Fed to stop tightening immediately, even before it reaches the 2.75-3.00% that's essentially their estimated neutral rate.

Yield Curve Slopes Over Time

Source: Bloomberg

At the same time, the Fed's slow but steady balance sheet runoff is also incrementally tightening conditions in tandem with its headline rate hikes. This concurrent form of monetary tightening represents the most uncertain component of policy normalization. Currently, the Fed is allowing $50 billion of securities to 'roll off' their balance sheet each month, which has cumulatively led to a significant contraction in liquidity conditions.

Going forward, it's possible the Fed will recalibrate the degree to which it tightens via traditional rate hikes vs. Quantitative Tightening. For example, rate hikes will likely be paused to allow the current pace of balance sheet runoff to continue. Conversely, the Fed may instead decide to pause QT to provide more liquidity "breathing room" to squeeze in another hike or two prior to pausing.

Treasury Partners View

Longtime readers know that we've advocated maintaining short maturities for the last two years. The opportune time to fully extend durations is when the gap between Fed Funds and the 2 Year Treasury converges to zero – as is the case right now. Historically, Fed Funds typically rises further above the 2 Year Treasury yield before the entire yield curve begins shifting lower, providing a crucial tactical window before that takes place. Now that we're at convergence, we believe we're within this window and cash managers should be extending maturities.

Above all, stay vigilant with credit risk. If the economy slows, the weakest borrowers tend to be exposed faster and with more negative consequences than during the upswing and peak phases of the economic cycle. This means it's imperative to be selective and maintain proper diversification of issuers and industry groups. Investors can now comfortably earn 3%+ yields on high quality 2-year corporate debt. Although credit spreads have recently widened, they still pale in comparison to those seen during the height of the market's Q1 2016 oil-price decline turmoil. Despite this, the absolute level of yields available now are better than those in early 2016 because the base Treasury rates are significantly higher.

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