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INVESTMENT MANAGEMENT

Mitch on the Markets

Portfolio Manager Investing Insights

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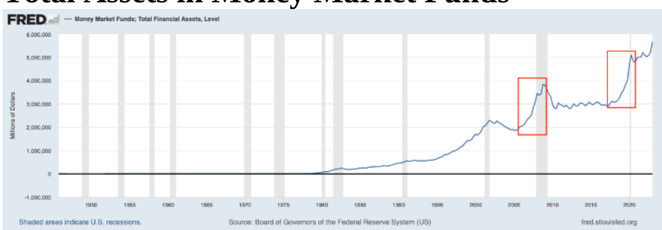
Money Market Flows and the Stock Market

Investors have recently been embracing an asset class that in years past hasn't received much attention at all: money market funds.

Indeed, flows into money market funds have been soaring over the past several months. By the end of Q1 2023, cash parked in money market funds grew to a record-high $5.7 trillion, following several weeks of positive fund flows. As the chart below shows, the last two occasions when cash in money market funds increased so substantially was before the 2008 Global Financial Crisis and again before the pandemic.[1]

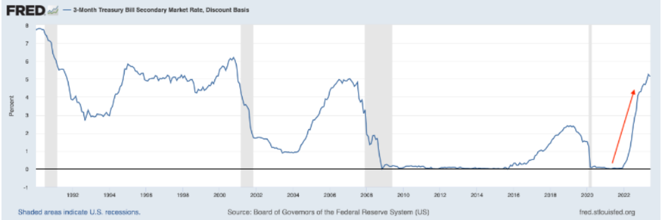
Total Assets in Money Market Funds



Source: Federal Reserve Bank of St. Louis[2]

As a quick refresher for readers, money market funds are a type of mutual fund that invests in various liquid instruments, like cash, short-term U.S. Treasuries, cash equivalent securities, and others. For this reason, they are largely considered safe, but they are not risk-free like U.S. Treasuries. And since money market funds are generally managed, they also tend to have expense ratios associated with them – which can cut into returns slightly.

There's a pretty straightforward reason money market fund flows have jumped substantially over the past several months. It's because yields have gone up substantially, too. A good proxy for money market yields is the 3-month Treasury bill, which is primarily guided by Federal Reserve monetary policy. 2023 has also been unique for short-duration T-bills because of the debt ceiling standoff, the uncertainty of which drove yields even higher. All told, and as seen in the chart below, 3-month Treasury bills have seen a historic surge in yields, which has also pulled money market fund yields higher.



Source: Federal Reserve Bank of St. Louis[3]

With many money market funds now sporting yields of ~5% or higher, active investors increasingly see 'cash' as a viable asset class next to equities, bonds, real estate, etc. And for investors wondering if this could act as a headwind for risk assets in the near term, the answer from a historical perspective is yes.

Two examples come to mind. In the lead-up to the 1987 Black Monday Crash, short-duration T-bills were paying high single-digits, which many historians would argue contributed to a rapid shift out of equities and into fixed income. There was also the 1994 bond market crisis when the Fed quickly and unexpectedly raised interest rates at several meetings, which in turn drove up money market yields and led to a sharp shift away from stocks and bonds and into cash.

What's notable about these two examples – and the point I want to drive home to readers – is that both events resulted in market corrections, not prolonged bear markets. The real insight of money market fund flows, in my view, isn't that higher yields may result in stock and bond market volatility. It's that surging levels of money market funds tell us how much cash is available to flow into risk assets *on a forward basis*. In my view, more cash on the sidelines equates to more ammo for future returns in risk assets. Money market yields may be attractive now, but they don't size up to risk-adjusted long-term returns investors have historically earned from stocks.

Some of the historical numbers bear this point out. In the years following the 1987 Black Monday Crash, the S&P 500 rose +16.54% (1988) and +31.48% (1989), and following the 1994 bond market crisis, stocks were up +37.20% (1995), +22.68% (1996), and +33.10% (1997). Money market funds were in those cases a viable alternative to stocks, as they are now, but they did not serve as headwinds for long.

Bottom Line for Investors

Higher yields in money market funds and short-term Treasury bills are largely by design. The Federal Reserve's goal is to lower inflation, and part of that job entails trying to get investors to move funds away from economically sensitive assets. Recent trends in money market funds suggest the Fed's actions are having an effect, but forward-looking investors should see the data in another light—more cash on the sidelines means more cash available to invest in risk assets over time.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Forbes. May 31, 2023. https://www.forbes.com/sites/michaelcannivet/2023/05/31/money-market-yields-are-attractive-and-investors-are-taking-notice/?sh=641a845761b9

[2] Fred Economic Data. June 8, 2023. https://fred.stlouisfed.org/series/MMMFFAQ027S#

[3] Fred Economic Data. June 13, 2023. https://fred.stlouisfed.org/series/DTB3#

Weekly Market Update

Important Market News We Think Worth Considering

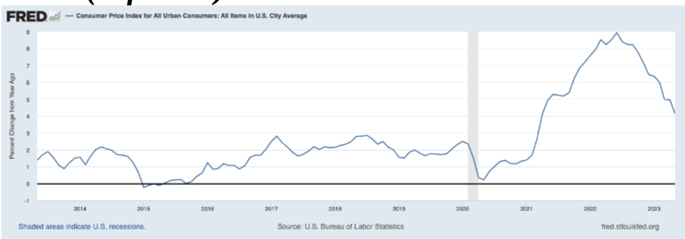
STEADY INVESTOR WEEK

- **The Federal Reserve pauses rate hikes**
- **The cost of rent is falling fast**
- **Saudi Arabia announces oil production cuts**

The Federal Reserve Pauses Rate Hikes, But Signals More Tightening Ahead

Starting in March 2022, the Federal Reserve raised interest rates at every meeting, pushing the benchmark Fed funds rate up by 5% in 10 meetings. The pace of monetary tightening was the fastest the U.S. has seen since the 1980s, when inflation was running at double-digits. At the latest June meeting, the Fed decided that it was appropriate to take a pause, leaving the fed funds rate at 5% to 5.25% and agreeing to monitor economic data over the coming weeks to see if inflation and economic activity continue cooling. Earlier in the week, the Labor Department reported that inflation, as measured by the consumer-price index, had risen by 4% year-over-year in May. This was a significant decline from April's 4.9% increase, and well below the peak of 9.1% reached last June (see chart below). But it also still doubles the Fed's target of 2%, which is partly why Fed Chairman Jerome Powell signaled that more hikes could come in 2023 following this June pause. Indeed, the Fed released projections for the Fed funds rate for the remainder of 2023, and 12 of 18 officials indicated that rates would need to rise to 5.5% to 5.75% or even higher, if the economy continues growing at its current clip. These projections imply two or three more rate hikes in 2023, which is higher than just about anyone – including this publication – had expected for the year. Just a few months ago, in March, a majority of officials had projected that no additional increases would be needed in 2023, but a stubbornly strong labor market and economy have shifted their thinking.[1]

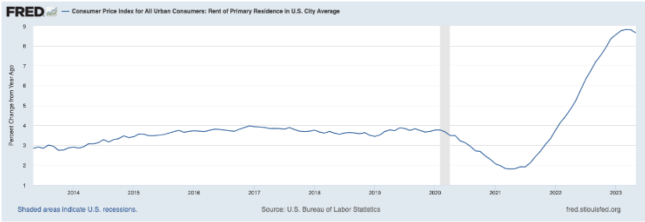
Year-over-Year Change in Consumer Price Index (Inflation)



Source: Federal Reserve Bank of St. Louis[2]

Rents are Falling Fast, Good News for Households and Inflation

As we've written in this space before, housing is a major component of the consumer price index, and its contributions to date have been negative – i.e., high housing costs are putting upward pressure on the inflation print. We've also written that actual changes to rents work on a lag, since both new and *existing* leases are factored into the inflation reading. The chart below shows how rent CPI has lagged trends in overall CPI:



Source: Federal Reserve Bank of St. Louis[3]

A look under the hood reveals that apartment rent growth has been declining at a much faster pace, however. The average of six national rent-price measures from property data companies indicates that rents for new leases rose less than 2% for the year ending in May, which marks a plummet from the double-digit increases last year. In the coming months, this rapid decline in rent growth will factor into the CPI reading, which should pull inflation down even further towards the Fed's goal – assuming other goods and services prices continue trending in the same direction.

Saudi Arabia Announces Oil Production Cuts, But Prices Move the Other Way

Another key factor for U.S. inflation is energy prices – namely the prices Americans pay at the pump. It follows that oil markets are the major determinant of energy inflation, which can make news of production cuts from the world's second-largest oil producer seem counter-productive. But in this case, it hasn't been – Saudi Arabia last week announced it would cut oil production by 1 million barrels a day in July, on top of previously announced cuts earlier in the year. Crude oil prices fell on the news, and are now hovering around 2023 lows[4]:

Global Price of Brent Crude Oil

Source: Federal Reserve Bank of St. Louis

The Saudis pushed for production cuts because they want to see upward pressure on prices, but they got the opposite. Why? For one, oil production is global, with the U.S. as the world's top producer. More Russian and African oil has also made its way into the market than expected in 2023, which has kept downward pressure on prices. There are also demand forces, i.e., the fact that global economic growth has been very modest so far in 2023, with the eurozone sliding into a recession and China's post-zero-Covid recovery faltering. Demand from the U.S. has remained firm, but rising interest rates and the possibility of additional credit tightening later in the year are expected to produce a slowdown.

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[1] Wall Street Journal. June 14, 2023. https://www.wsj.com/articles/fed-holds-rates-steady-but-expects-more-increases-b1be87f2

[2] Fred Economic Data. June 13, 2023. https://fred.stlouisfed.org/series/CPIAUCSL#

[3] Fred Economic Data. June 13, 2023. https://fred.stlouisfed.org/series/CUSR0000SEHA#

[4] Fred Economic Data. June 15, 2023. https://www.wsj.com/articles/saudi-arabia-sought-to-push-oil-prices-higher-markets-had-other-ideas-30583af6?mod=djemRTE_h

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