Liquidity solutions in a falling rate environment

Craig Inches
Head of Rates & Cash

Craig Inches, Head of Rates and Cash at Royal London Asset Management, discusses the UK's interest rate outlook for the coming months, the implications for short-term money market funds, and why rate cuts could prompt treasurers to look at longer-term liquidity solutions.

As 2024 progresses, there is little doubt that interest rate cuts are on the horizon. In August 2023, the Bank of England increased the base rate to 5.25% to combat soaring inflation. But with UK inflation falling to the target rate of 2% in June, there is a clear expectation that interest rates will be reduced in the coming months.

"Our view is that there will be two interest rate cuts this year," says Craig Inches, Head of Rates and Cash at Royal London Asset Management. "We expect the first cut will come in August, and the second towards the end of the year. We're looking to finish the year with base rates in the UK at 4.75%."

Liquidity funds and short-term money market funds (MMFs) tend to be focused on assets with a maturity of three months or less, meaning that the rates they achieve are broadly compatible with base rates. "So when the Bank of England starts to cut rates, I think you'll see those rates fall in unison with the base rate cut – they may even fall slightly below 5%, because of the high probability that rates will be cut again in the near future," Inches notes.

But for longer dated funds which can invest further out on the yield curve, Inches predicts that yields could start to diverge from MMF yields, "because there will be an upward sloping yield curve. So once banks start cutting interest rates, you're going to get this differential between overnight and longer dates."

Weighing up longer-dated cash funds

For some corporate treasurers, this could prompt a review of their short-term investments. In the current environment, treasurers are able to achieve capital preservation and an attractive yield on their liquidity funds and short-term money market funds. But when interest rates start to fall, Inches expects that treasurers may start looking at the yield differential between short-term MMFs and longer-term cash funds.

Rates are not expected to fall back to the low levels seen before the pandemic, meaning that treasurers may still be happy with the yield on offer when the base rate is 5%. "But if that differential becomes significant, treasurers may well be tempted to move into longer-dated cash funds. This is something that we are likely to see play out over the next six months."

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When it comes to weighing up short-term fixed income funds and longer-term liquidity strategies against the perceived safety of MMFs, Inches says it is important to take a step back. "When you look at the assets in a short-term MMF, remember that you're investing on an unsecured basis – ultimately you're hoping the managers do a good job to diversify the portfolio and minimise default and downgrade risk."

In contrast, Inches says that longer-dated cash products, such as Royal London's Short Term Fixed Income Fund and Short Term Fixed Income Enhanced Fund, have security built into their portfolios. "We've got a very high percentage of assets in AAA-rated covered bonds, so you have assets securing the cash flows," he explains. "They're regulated and exempt from bail-in, so if a bank does get into difficulty, these assets are not bailed into the wind-up process. They're still liquid and available to pay cash flows to the bond holder."

Likewise, Royal London's Short Term Fixed Income Enhanced Fund has other assets that have security backing the cash flows. "Whether that's corporate bonds, or prime residential mortgage-backed securities, all of those assets tend to be outside of that bail-in regulation. So, you are taking additional credit risk and slightly longer duration risk within your portfolios, but you're doing it on a secured basis."

Preparing for the unexpected

Recent years have demonstrated the need to be ready for unexpected eventualities and risk events. And while interest rates are expected to decline in the coming 12-18 months, there are a number of factors that could change that trajectory, including elections in the UK, US and France, as well as the risk that geopolitical conflict in the Middle East and Ukraine could disrupt supply chains and prompt upward pressure on inflation. As such, an alternative view could be that central banks opt to leave rates higher for longer.

"In that scenario, you may want to be invested more in floating rate instruments," says Inches. "Some of these instruments pay base rate plus a spread, so they give you a bit of protection, both in a rising rate environment and in a falling rate environment." He adds that Royal London's Short Term Fixed Income and Short Term Fixed Income Enhanced Funds are increasingly including floating rate notes.

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Last but not least, ESG analysis is playing an increasingly important role in helping investors avoid risk events.

"Credit Suisse is a good example – it was a robust organisation with positive assets and cash flows, but poor governance," says Inches. "Due to our ESG analysis, we didn't have any exposure to Credit Suisse in our short term MMF." As such, he notes that it may be beneficial for treasurers to use funds that include ESG analysis in their portfolio construction, "because it's quite hard for treasurers to do that on an individual basis."

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