# Short Term Investments Committee

## Market insights and investment views

**May 2024**

## Economic backdrop

Federal Reserve (the Fed) Chair Jerome Powell reiterated his belief that policy is currently restrictive and will, over time, be sufficiently restrictive in the battle with inflation. Fed futures contracts are currently showing expectations that the first cut in the target range of the federal funds rate won't come until November. This bodes well for liquidity portfolios which continue to take advantage of elevated yields. However, investors interested in total return opportunities may be looking to extend durations prior to the first cut. As expected, the Fed announced it would taper the amount of Treasurys rolling off its balance sheet by lowering the monthly cap from $60B to $25B starting in June. It kept the monthly cap for maturing mortgage-backed securities at $35B.

## Market insights

### Government ultrashorts

**Government ultrashort portfolios can be a favorable first step out for investors looking to extend duration.**

Government agency mortgage-backed securities are incredibly attractive right now. Portfolios will also likely benefit from banks entering back into the mortgage markets once we start to see a bull steepener in the yield curve.

### Municipal markets

**Municipal portfolios are preparing for the start of the summer note season.**

Municipal bond issuance has increased lately, and we expect this trend to continue which can lead to opportunities in the secondary market. Recently the airport bond sector has been particularly attractive across the money market yield curve.

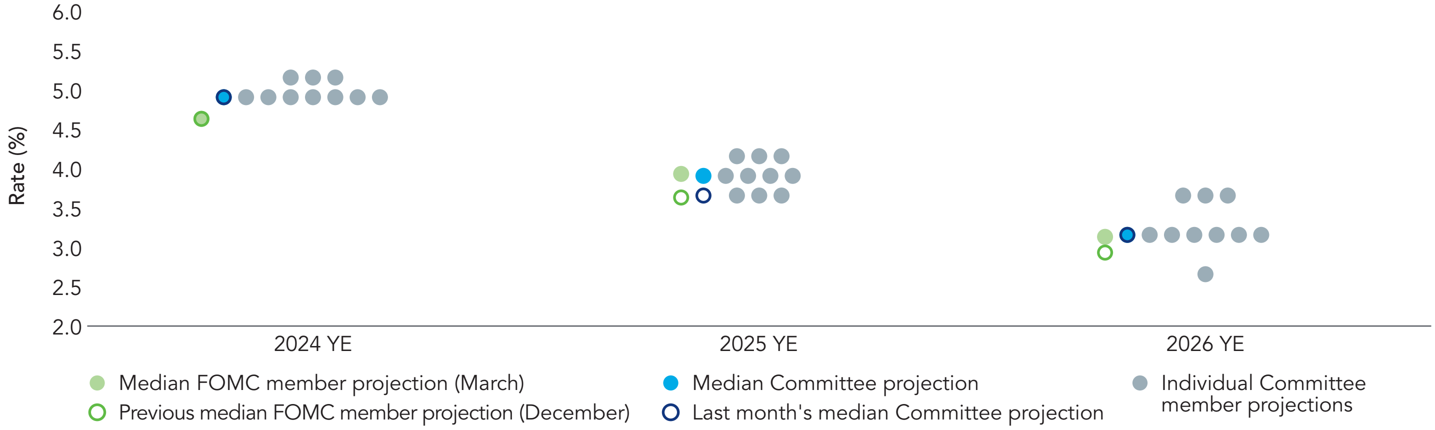
### Prime liquidity

**Prime liquidity portfolios are capitalizing on increased supply of floating rate commercial paper with roughly $25 billion in new issuance per week.**

As the potential for the first cut in the federal funds rate range drifts later in the year, floating rate paper has become more attractive. On the fixed side, most of the activity is in the 3-month area right now as investors contemplate an uncertain Fed outlook.

## Assessment of monetary policy

Results of the committee's poll estimating the midpoint of the target range for the federal funds rate



## Investment views

Relative to longer-term fixed income, the 0-3-year part of the yield curve is attractive.

These themes are guiding our investment views in the space:

- While money market yields are compelling, maintain a bias to lengthen duration.
- Take a balanced approach to credit due to tight valuations but a stable economic environment in the near term.
- Take a more balanced view on fixed vs. floating rate securities given current valuations.
- Use mortgage-backed securities where possible to capitalize on available carry and prepare for potential benefit of future spread compression.

## For investors diversifying across the 0-3-year universe

The asset classes and subsectors below represent the potential universe for a robust investment strategy that spans the 0-3-year space. Investments will vary depending on risk tolerance, maturity/duration needs, investment policies and more. Our relative value rankings and investment spotlights reflect the category we believe is the most attractive given general investment objectives or preferences and the current market conditions.

### Our relative value rankings

Yield potential

| 4th Money Market | 3rd Microshort | 2nd Ultrashort | 1st Low Duration |
|---|---|---|---|
| Yields are attractive due to the recent rising rate cycle, especially compared to other cash-like investment options | Lengthening duration can be beneficial given the likely end of the rising rate cycle from the Fed | We have seen net asset value appreciation contribute to improved total returns and expect this trend to continue | Attractive versus longer and shorter portfolios in anticipation of Fed rate cuts later this year |
| WAM: 60-day max | WAM: 180-day max | Duration: 1-year max | Duration: 1-3 years |

### Investment spotlights: for varying investor outcomes

| | | | | |
|---|---|---|---|---|
| **Government** | **Government Money Market**<br>Low-to-no duration risk is attractive, especially for risk averse investors. | | **Government Ultrashort**<br>Risk sensitive investor<br>Yields are compelling and longer duration exposure may benefit total return if the Fed begins to cut rates. | **Short-Term Government**<br>Highest relative value seeking investor<br>Lack of credit offers lower potential total return, however, longer duration exposure makes this compelling if the Fed begins to cut rates. |
| **Credit** | **Prime Money Market**<br>Liquidity seeking investor<br>Yields have attractive spreads to Treasurys. Credit conditions on the short end of the curve remain solid. | **Microshort**<br>Yield seeking investor<br>Yields are becoming more attractive and we expect this trend to continue given the likely end of the rising rate cycle from the Fed. | **Ultrashort**<br>Total return seeking investor<br>We are constructive on credit in the near-term given resilient economic conditions. | **Short-Term Income**<br>Given a Fed Pause, we see higher total return potential within this asset's longer duration and constructive credit dynamics. |
| **Municipal** | **Municipal Money Market**<br>Despite recent moves in SIFMA, municipal money markets can still be attractive for tax sensitive investors. | **Municipal Microshort**<br>Tax sensitive yield seeking investor<br>Microshorts offer a smaller incremental step out if you don't want to jump from money markets to ultrashorts yet. | **Municipal Ultrashort**<br>Tax sensitive total return seeking investor<br>Yields are compelling compared to both longer and shorter duration municipal securities and credit remains solid. | **Short-Term Municipal**<br>Credit quality remains high and investments here may be useful when the Fed potentially starts cutting rates in 2024. |

"WAM" is weighted average maturity.

## Detailed sector/security rationale driving rankings

Within the short end of the curve, each sector and security type has specific nuances that should be considered when making investment decisions.

| | Sector/security type | Rationale |
|---|---|---|
| Liquidity | Repurchase Agreements (Repo) | With the Fed's Reverse Repo Program (RRP) providing a soft floor for the market at 5.30%, overnight repurchase agreements are the preferred investment vehicle for liquidity in government portfolios. This can also be a valid option for prime portfolios when demand for very short CDs and CP exceeds supply. |
| Liquidity | T-Bills, T-Notes, Coupons | Fixed-rate Treasury securities can typically provide a low-risk, efficient means of potentially capturing higher yields by extending beyond overnight. Since last month, the Fed Funds futures curve is now pricing in closer to two Fed rate cuts by year-end. This has pushed the peak in the bill curve from 2-months out to 3-months with a similar inversion as you move out to 1-year. After a welcomed few weeks of positive new bill supply this month, it is expected to return to negative for the month of June. This should keep downward pressure on yields across the curve, continuing to make the search for value difficult. The extension trade can provide protection against an easing Fed, so opportunities should be continually assessed. Treasury floating rate notes remain a viable option for current income, but should be used cautiously when the outlook includes rate cuts. |
| Liquidity | U.S. Government Agencies | Issuance by U.S. government agencies has picked up in recent weeks, however discount notes continue to offer little to no value versus bills. Structured coupon securities, such as callable notes, continue to be a staple in the offerings and, depending on your rate outlook, can be a source of relative value. Agency issuance can also provide exposure to Secured Overnight Financing Rate (SOFR) based floating-rate securities and in much shorter tenors than Treasury floating-rate notes. |
| Liquidity | Certificates of Deposit (CDs) and Commercial Paper (CP) | The prime securities curve is roughly flat from 3-months to 1-year. Supply remains healthy and should provide support to yields across the curve. With the appropriate credit work, bank CDs, corporate CP and asset-backed CP can potentially enhance portfolio yield while maintaining minimal credit risk as the credit quality of banks and corporations continues to be strong. In addition, they can provide exposure to floating-rate securities based on indices such as SOFR, Overnight Bank Funding Rate (OBFR), and the Fed Funds rate. With expectations for a patient Fed, activity in floaters has increased significantly as they can offer value relative to fixed rate securities. Although the increased demand has caused spreads to narrow slightly, value can be still be found in the 6-month and 1-year areas. |
| Liquidity | Variable Rate Demand Notes (VRDNs) | With a par optional tender and regular rate reset (both typically either daily or weekly), VRDNs are the preferred investment vehicle for liquidity in municipal portfolios. Given the tax-exempt interest, rates are usually lower than short-term taxable interest rates and can display more inconsistency during certain, regular periods of supply/demand imbalances but, on average (we suggest a 4-week view), offer fair value for tax sensitive investors. |
| Fixed Income | Asset-Backed Securities (ABS) | Prime and sub-prime auto ABS delinquencies are up year-over-year, but this modest weakening has been expected as used car prices have decreased and higher inflation and interest rates have stretched some borrowers. However, ABS structural features, which provide protection to bondholders, remain very strong for most issuers. A plethora of new ABS deals have been issued recently and met with great demand causing credit spreads to tighten even further. We continue to see good value in ABS vs. most other investment grade sectors but have been more selective recently given more expensive valuations. |
| Fixed Income | Investment Grade (IG) Corporates | Although investment grade corporate spreads are very tight from a historical perspective, credit quality is sturdy and 1Q24 earnings are off to a good start. New issuance has been robust YTD and well received. Investment grade corporates are supported by better-than-expected economic growth, solid earnings, and attractive yields but security selection remains important given tight spreads and current valuations compared to other investment grade sectors. |
| Fixed Income | Government/ Mortgage-Backed Securities (MBS) | Spreads in the short duration government mortgage space remain at multi-year wides and are extremely attractive. With the next FOMC rate move very likely to be a cut we expect that rate declines and curve steepening will bias mortgage spreads tighter over the next 12 months. The wide spreads, attractive income and strong potential for capital appreciation available in government guaranteed floating rate collateralized mortgage obligations warrant active portfolio addition. |
| Fixed Income | Municipal Bonds/ Notes | State and local municipal government credit quality generally remains solid, benefiting from historically large financial reserves and strong management. After declining in recent years, issuance of 1-year notes has gradually increased and portfolios are benefitting from higher rates. Further out the short-term municipal curve, the higher rate environment has contributed to historically attractive yields that offer fair value on a ratio-basis when compared to U.S. Treasuries. |

# Short Term Investments Committee

## Federated Hermes' strength on the short end of the curve

The **Short Term Investments Committee** is a collection of investment professionals with in-depth experience investing across the 0-3-year part of the yield curve. On a monthly basis, the committee meets to provide insights, strategize and discuss investment opportunities.

The Committee is headed by Nicholas Tripodes, CFA and Mark Weiss, CFA. Nick is senior vice president, senior portfolio manager and head of Low Duration/Structured Products Group. He is responsible for portfolio management and administration of low duration multi-sector portfolios with concentrations in investment-grade securities, as well as management and administration of structured product allocations. Mark is vice president and senior portfolio manager. He is responsible for portfolio management and research in the fixed-income area concentrating on liquidity portfolios.

### Committee members:

- consist of portfolio managers and investment analysts with product managers and more also attending meetings
- manage $619 billion in assets in the 0-3-year space (as of 3/31/24)
- average over 25 years of investment experience
- include multi-asset solutions professionals skilled at investing and research in the global asset allocation area
- are subject matter experts in government liquidity, prime liquidity, municipal liquidity and short-term fixed-income including investment-grade securities, asset-backed and mortgage-backed securities and other short duration securities



Views are as of May 2024 and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

Variable and floating rate loans and securities generally are less sensitive to interest rate changes but may decline in value if their interest rates do not rise as much or as quickly as interest rates in general. Conversely, variable and floating rate loans and securities generally will not increase in value as much as fixed-rate debt instruments if interest rates decline.

Yields quoted are for illustrative purposes only and not representative of all securities or any specific investment.

Bond prices are sensitive to changes in interest rates and a rise in interest rates can cause a decline in their prices.

Diversification does not assure a profit nor protect against loss.

**Past performance is no guarantee of future results.**

Yield curve is a graph showing the comparative yields of securities in a particular class according to maturity. Securities on the long end of the yield curve have longer maturities.

Bond credit ratings measure the risk that a security will default. Credit ratings of A or better are considered to be high credit quality; credit ratings of BBB are good credit quality and the lowest category of investment grade; credit ratings of BB and below are lower-rated securities; and credit ratings of CCC or below have high default risk.

Ultra-short and microshort bond funds are not "money market" mutual funds. Some money market mutual funds attempt to maintain a stable net asset value through compliance with relevant Securities and Exchange Commission (SEC) rules. Ultra-short and microshort funds are not governed by those rules, and their shares will fluctuate in value.

The value of some mortgage-backed securities may be particularly sensitive to changes in prevailing interest rates, and although the securities are generally supported by some form of government or private insurance, there is no assurance that private guarantors or insurers will meet their obligations.

Duration is a measure of a security's price sensitivity to changes in interest rates. Securities with longer durations are more sensitive to changes in interest rates than securities of shorter durations.

The value of some asset-backed securities may be particularly sensitive to changes in prevailing interest rates, and although certain securities may be supported by some form of government or private guarantee and/or insurance, there is no assurance that private guarantors or insurers will meet their obligations.

Income from municipal funds may be subject to the federal alternative minimum tax and state and local taxes.


G85035-33 (5/24)
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