Perspectives

JUNE 2022

Can Bond Investors Outsmart the Market?

While it is generally accepted that successfully and consistently timing the equity market is a loser's bet, the same sentiment is not heard as often in the bond market. However, timing interest rates is just as difficult as equity markets and can lead to the same patterns of underperformance over multiple market cycles. Nonetheless, the recent rate volatility may be a temptation to shorten duration[1] in anticipation of further rate rises. The following analysis examines why this strategy could be difficult to execute successfully, and why we recommend that clients stay the course and remain invested in line with their investment policies.

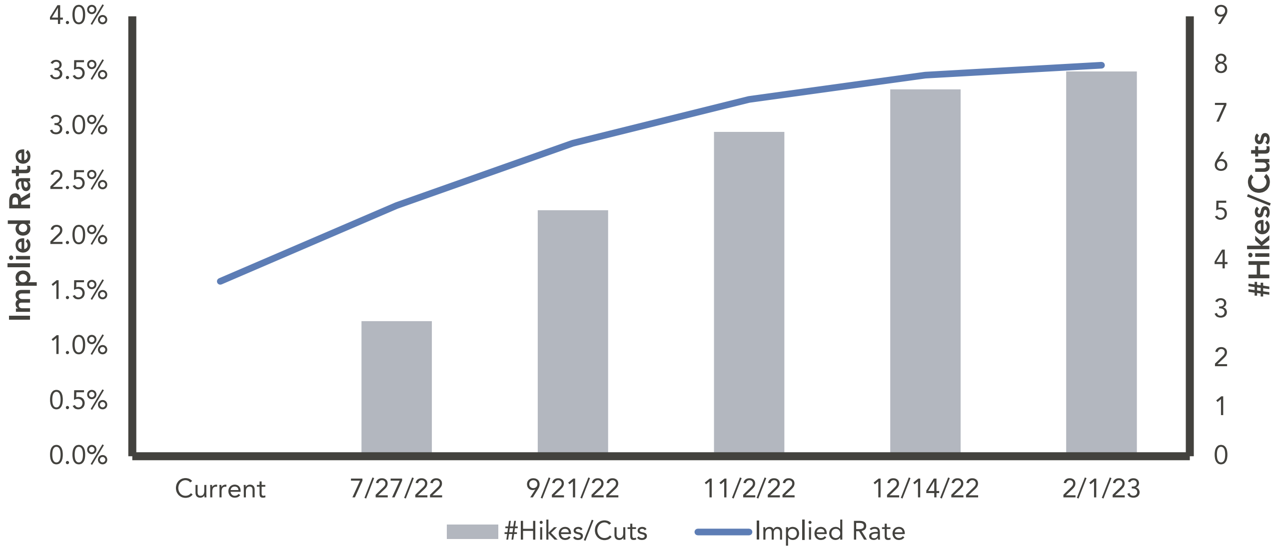
FED ACTION AND REACTIONS

The prevailing consensus among investors is that the Fed will continue to raise the fed funds rate until inflation is under control. Duration — the measure of a fixed income security's sensitivity to interest rate changes — is negatively correlated to rate movements; the higher a security's duration, the more the price drops when rates increase. The opposite is true when rates fall.

Given this relationship, it seems relatively straightforward to reduce the duration of a fixed income portfolio when rates are expected to move higher. Of course, it is not that unilateral and there are other costs to consider, including but not limited to reductions to diversification, purchasing power, and overall portfolio income, not to mention considerations for administrative costs and ultimate market unpredictability.

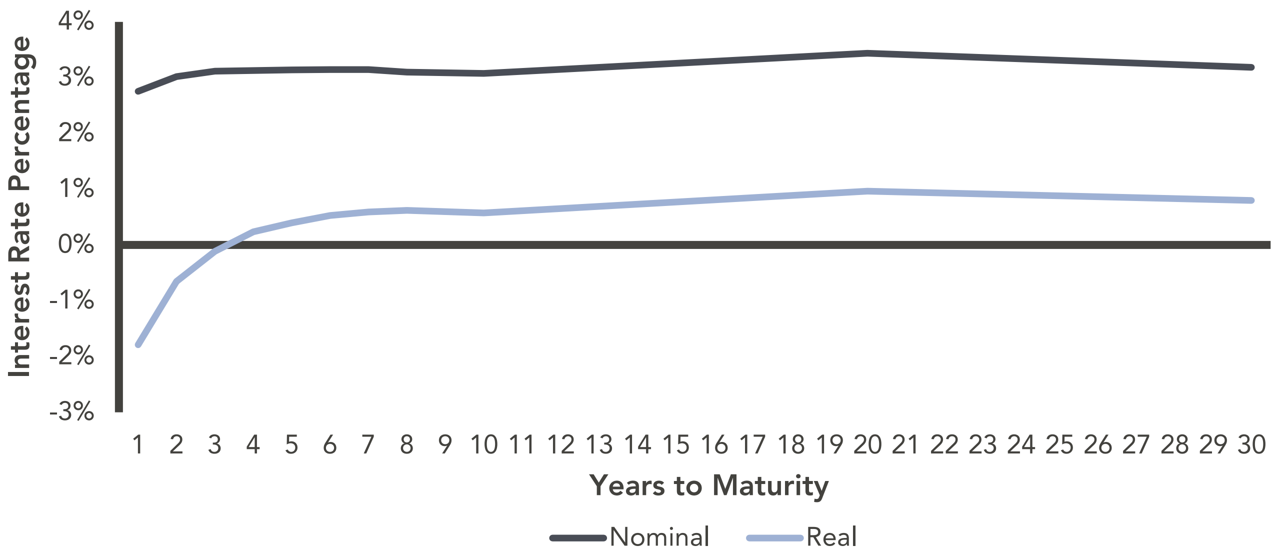
Exhibit 1 on the next page shows that the market is currently pricing in 7–8 additional rate hikes from the Fed by the end of the year, which implies a fed funds rate of 3.46%. For a strategy to outperform by shortening duration, rates would need to move in a parallel fashion faster (e.g., a 100 bps rate increase at the next meeting) and/or longer (75 bps for the next two or more meetings) than expected. However, the curve is unlikely to move in a parallel manner, with the front end more exposed to policy moves. If the curve continues to bear-flatten,[2] shorter duration bonds could perform poorly relative to longer duration bonds.

Exhibit 1: The market anticipates 7–8 additional rate increases by the end of the year



Source: Bloomberg

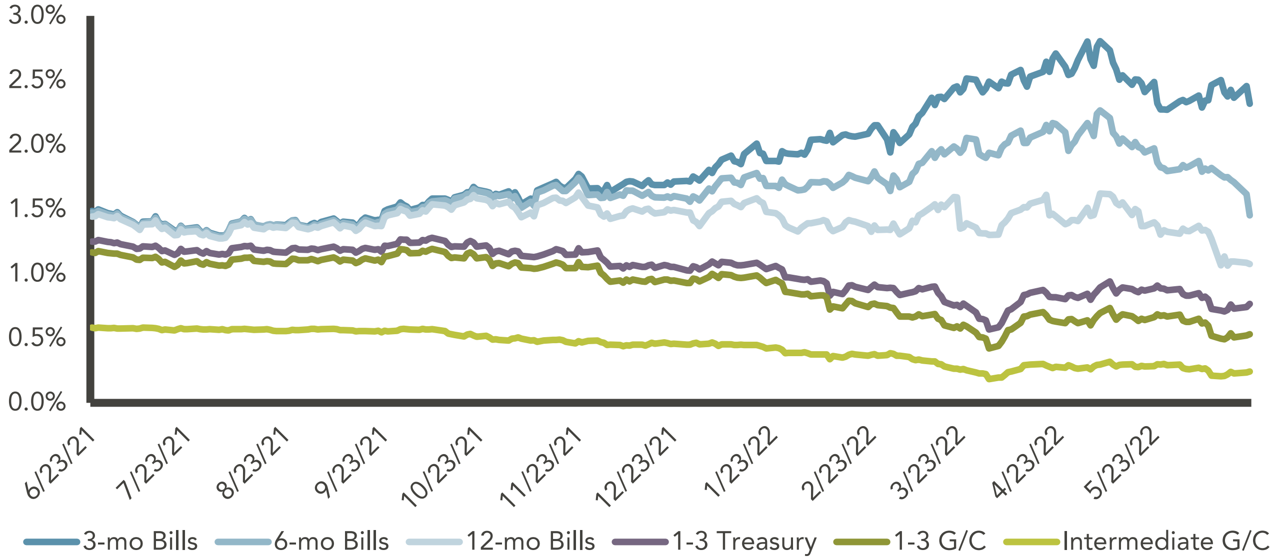
Exhibit 2: Par curves: Cash and short-dated bonds do not keep up with inflation



Sources: U.S. Treasury, Bloomberg. The real yield is the market yield using the on-the-run inflation protected par curve. The difference between the two curves is a naive estimate of forward-looking inflation expectations. They are not a pure estimate of inflation expectations due to the differences in risk premia of the two securities.

Nominal yields are positive across the curve; however, real yields remain negative inside of three years. Investing in bonds shorter than three years will fail to keep up with the rate of inflation and erodes purchasing power. The real yield on a 1-year TIPS is -1.79%. Hence, portfolio adjustments towards shorter duration strategies reduce the real yields once inflation is accounted for.

Exhibit 3: Yield differentials: Shorter duration, less yield

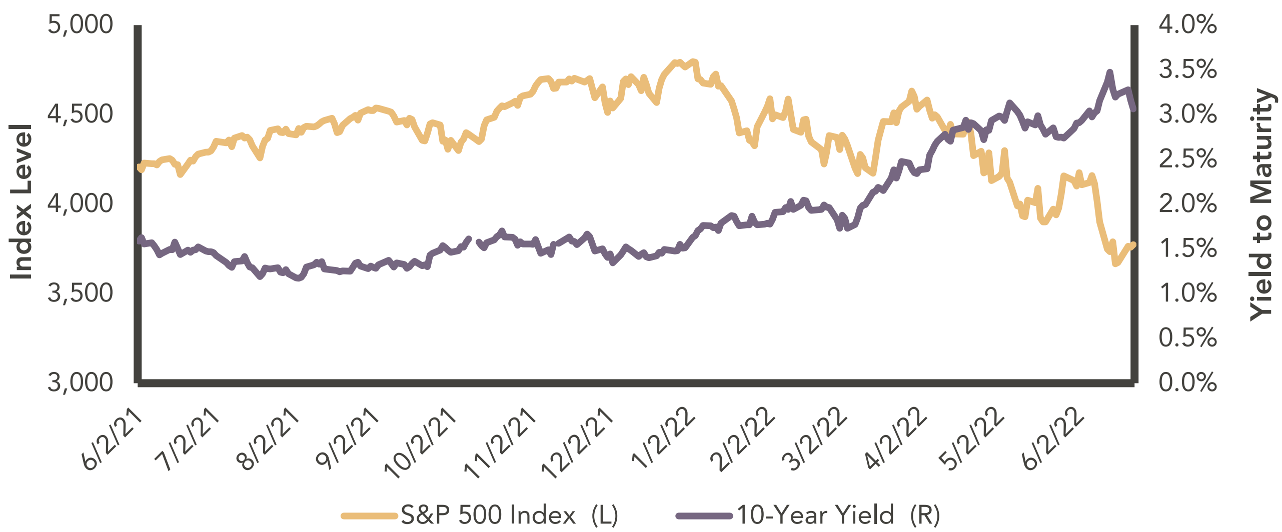


Source: Bloomberg as of June 23, 2022

The Bloomberg Aggregate Index offers a yield advantage over cash and shorter duration securities because yield curves are slightly upward sloping and include a degree of credit risk. The yield give-up to hold 1-year T-Bills has fallen slightly to 100 bps. Shorter-duration fixed income indices yield pickups have declined since the Fed began taking action, but the Aggregate still offers a pickup of 25 to 75 bps.

The cumulative effect of shortening duration is that if the timing is wrong, the portfolio will under-yield what the investment policy targets would have delivered for income, and it is difficult to recover this lost income over subsequent timeframes. For every day that the investor's shorter-duration portfolio under-yields a benchmark, the higher the magnitude move needed to compensate for the lost income. Relying on subsequent rate increases to justify previously missed timing is likely to further compound losses rather than atone for poor timing.

Exhibit 4: Shortening duration offers less protection



Source: Bloomberg as of June 23, 2022

Inflation and rate increases have driven a negative year for both stocks and bonds, which is an anomaly given that bond performance is typically positive when stocks struggle. For most of 2022, yields and equities have moved in almost lockstep, as shown in the chart in Exhibit 4; yields rose while equity prices fell. However, once the 10-year Treasury yield crossed 3%, we saw a return to the more normal behavior of bond returns offsetting negative equity returns.

More broadly, shortening duration provides less portfolio protection than holding longer-dated bonds in the event of an unexpected market sell-off; this is what has been so surprising about the downward trend of both stocks and bonds this year. Typically, as an economy stumbles, interest rates fall. For example, a par bond with a duration of 6.5 will see its value rise by approximately 6.5% when the yield curve falls by 100 bps. A shorter-duration bond of 1.75 would need to see interest rates fall by almost 400 bps to have the same 6.5% gain in value. The gains from fixed income can be used to offset the losses in risk assets and as a source of liquidity to pay benefits and/or rebalance into depressed risk assets; shortening duration can reduce the diversification benefit of bond allocations in times of market stress.

Astute readers may challenge the previous paragraph and assert that in times of rate rises, doing the opposite of the above would limit losses to fixed income: the shorter the duration, the lower the price losses. However, the prior points in this article have documented not only the utter difficulty of getting the timing right, but also the surrender in yield and purchasing power, particularly in the current high inflation environment. Ultimately, investors are best served by adhering to their long-term investment policy targets, both in terms of asset allocation and duration targets within their fixed income composites. After all, fixed income portfolios are utilized for income, liquidity, and diversification purposes — long-term attributes which are best delivered with consistency, discipline, and without bets on the future direction of rates.

NOTES

[1] Done by shifting bond allocations to shorter duration strategies or allowing active bond managers to take duration bets versus their respective benchmarks

[2] Shorter-maturity rates rise while mid- to longer-term rates remain relatively unchanged: the overall tenor of the curve is flatter; the rate increases lead to price losses for shorter-term instruments; hence a "bear market" due to a flattening of the curve

About Operose Advisors

Operose Advisors LLC is a Wisconsin-based investment adviser working in partnership with independent investment consulting irm, Marquette Associates, Inc. Our purpose is to deliver an institutional approach to individuals, families, trusts and closely held businesses with planning, execution, and feedback of investment programs. For more information, please visit www.operoseadvisors.com.