APPLETON PARTNERS, INC.

THE CASE FOR ADDING DURATION

Value on the Curve

As an active fixed income manager, one of the most frequent questions we've been asked in the past year is, with shorter bonds out-yielding longer ones, why wouldn't you just buy the shorter ones? For much of that time, it has been hard to find serious fault with this logic. Short term rates have been undeniably attractive, and as a result, a tremendous amount of money has been parked in Treasury bills and money market funds while investors wait out market volatility. To the degree our investment mandates allow, we have made active moves to capture value here as well. However, in the last few months the balance has begun to shift and the argument for extending is now stronger than it has been in many years.

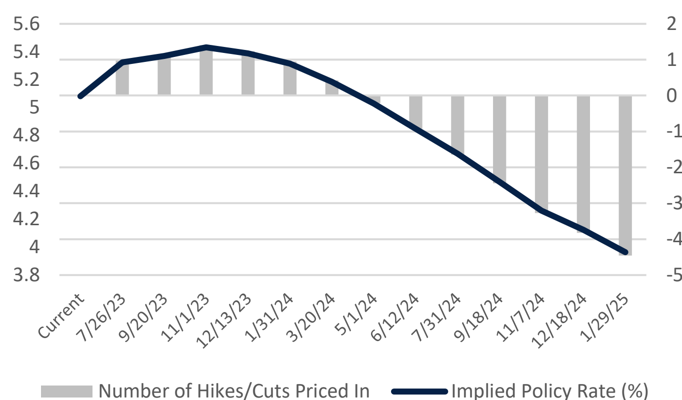
A Shift In Monetary Policy May Be Coming

After 500bps of interest rate hikes over the past eighteen months, we believe the end of the Federal Reserve's tightening campaign is approaching with a 0.25% July increase likely and possibly one more. Short term rate policy has entered restrictive territory, and the Fed's debate has increasingly become whether policy is *sufficiently* restrictive. This has led them to adopt a more gradual, cautious pace of tightening. While we think there are reasons to expect the Fed to be somewhat more hawkish than the single rate hike the market is currently pricing, the exact terminal rate has become less important to longer rates. The 10Yr Treasury has essentially been rangebound for the past nine months, only briefly trading outside of a 3.50-4.00% band, and as a result, the Fed's last several hikes have only deepened the yield curve's inversion. This has brought greater attention to the front of the yield curve, but paradoxically this has strengthened the arguments to extend.

Consider Reinvestment Risk

First, reinvestment risk is becoming a larger concern. The Federal Reserve has committed to holding short term rates in place for a period of time after they finish hiking, but at some point, they will begin to cut. A 6-month Treasury bill now yields just under 5.5%; an investor buying one today likely has confidence in their ability to replace it with another 6-month bill with a comparable yield at maturity. However, that expectation weakens over time, and Fed Funds futures market pricing suggests rates will eventually fall to a level where today's 10Yr Treasury looks attractive by comparison. Extending maturity may result in an incremental drop in a portfolio's yield today but is likely to lock in yields that are substantially higher than those available several years from now. We would argue that this is a favorable tradeoff and one preferable to rolling short term bills at prevailing rates.

Markets Do Not Expect Short Term Rates to Last

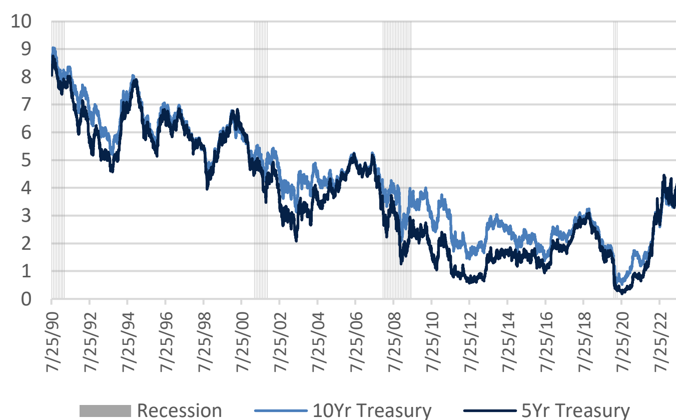


Source: Bloomberg

Positioning For Capital Gain Potential

Second, yield is only one component of total return. Not only does failing to account for the length of time to maturity when comparing yields expose investors to reinvestment risk, it also limits potential upside from falling rates. Duration is the most widely used measure of fixed income interest rate sensitivity, with the inverse of a change in rates times a bond's duration representing a rough estimation of the return on that bond. Put another way, if rates fall, longer duration bonds will outperform shorter duration ones. Historically, longer rates have typically fallen before or during recessions, as investors flee risk assets for safe-haven securities such as high-quality bonds. And, while the market has grown more confident in the prospect of a "soft landing", we still believe the more likely outcome is that the Fed hikes rates until at least a mild recession tames inflation. Locking in longer rates now manages the reinvestment risk of falling short term rates, while also offering an opportunity to capture gains should long term rates fall.

Long Yields Generally Fall Before or During Recessions (%)



Source: US Treasury and National Bureau of Economic Research

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A Considerable Cushion Is Now In Place

Third, and most importantly, the cost of being wrong has dropped substantially since the start of the Fed's hiking campaign. One of the things that made 2022 so abnormal was that long term rates began the year at generationally low levels; the 10Yr Treasury was yielding 1.52%. A bond's yield more or less represents the "carry return" of the bond, or what you can expect to earn in a year simply by holding it. The higher this carry return, the more of a cushion there is to absorb interest rate changes before a bond is at a loss, and at the start of 2022 this buffer was extremely low. With the on-the-run 10Yr Treasury having a duration slightly more than 9 years at the end of 2021, an increase of only 17bps would have been enough to generate an annual loss; over 2022, we eventually saw rates rise nearly 240bps. Today, after those rate increases, the carry return is a lot higher. Currently yielding 3.86% and with a duration of around 8 years, rates would have to rise nearly 50bps before the 10Yr Treasury bond would be at a loss one year from now. While this is certainly possible, rates have not been this high since before the Great Financial Crisis, and this is not our outlook. Lastly, investors often turn to bonds to help offset risk present in other parts of their portfolios, and it is important to remember that periods in which rates have risen sharply are often ones when stocks have done very well.

It Could Be An Opportune Time To Make Portfolio Adjustments

Attempting to time the markets is never a good idea, and in practice rarely works. However, prudent investment management involves responding to changing probabilities, and when they move enough, tactical changes may make sense. With that being said, we feel that the upside of longer maturity bonds has increased, while their downside risk has declined considerably. An investor's individual investment situation, risk tolerance, and liquidity needs will ultimately determine what investment allocation is most appropriate for them. But, for investors with an investment horizon greater than a year or two and sufficient risk tolerance, we believe reducing exposure to short term bonds and extending duration has become a lot more compelling.

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