THE CASE FOR ADDING DURATION

Drew Peterson, CFA, CIPM®, Corporate Bond Research Analyst and Macro Strategist

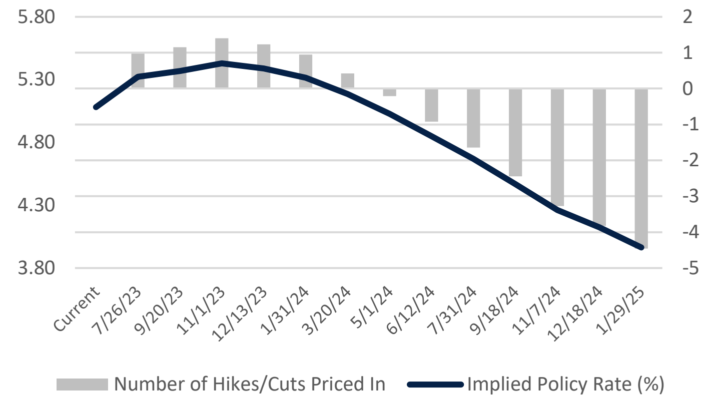
Value on the Curve

As an active fixed income manager, one of the questions we have frequently 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, this has been a hard argument to fault. 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. To the degree our investment mandates allow, we have made active moves to capture value here as well. However, we believe that balance has begun to shift. **This summer we started suggesting investors consider rethinking their bond portfolio duration. After abrupt selling pressure subsequently pushed longer yields up another 70 bps at the end of Q3 and into early October, more support for our view appears to have developed. If the argument was strong then, it is even more compelling now, with bond yields higher than they have been in nearly 20 years.**

A Shift In Monetary Policy May Be Coming

After 525 bps of interest rate hikes over the past eighteen months, the end of the Federal Reserve's tightening campaign is likely approaching. We still expect a 0.25% increase in December or January but feel that short term rate policy is already in restrictive territory, and that the Fed's debate is now whether policy is sufficiently so. This has led them to adopt a more cautious pace of tightening. While an unexpectedly resilient consumer provides some upside risk to our forecast, the exact terminal rate has become less important to longer rates. Instead, the market is now focusing on how long the Fed will hold rates in restrictive territory ("higher for longer.") The Treasury curve has flattened significantly in response; 10Yr issues briefly exceeded 4.80% in early October before stabilizing inside of 4.75%, while 2Yr yields have risen to 5.05%. An inverted curve generally gradually turns upward sloping before a recession; as of late summer, this process had begun as the 2-to-10-year inversion shrank from more than -100 bps to -70 bps. Today, the differential stands at less than -30 bps.

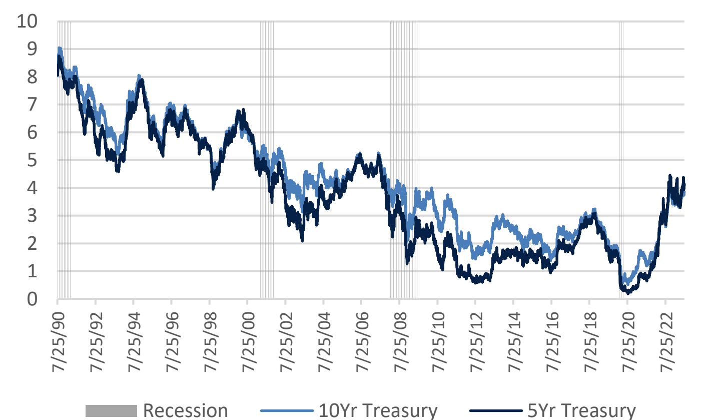
This appears to reflect the onset of a shift in Federal Reserve monetary policy, as they move from raising to an appropriately restrictive level, to determining how long rates need to be restrictive before they can return to neutral. If so, it would suggest now is a time to revisit decisions around fixed income exposure. Parking cash in short-maturity bonds made sense for the last eighteen months, but the costs of being underweight duration are rising in our view. **Timing is extremely difficult to predict, yet we see a favorable risk-return tradeoff to adding duration at this point in the cycle.** Here are a few reasons why.



Source: Bloomberg

Consider Reinvestment Risk

First, many investors underappreciate reinvestment risk. The Fed 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 5.57%; an investor buying one today may still have confidence they will be able to reinvest in another 6-month bill with a comparable yield at maturity. However, that may become increasingly less likely thereafter, and Fed Funds futures market pricing suggests rates will steadily fall to a level where today's 10Yr Treasury looks attractive by comparison. Extending maturity today may result in an incremental drop in market yield, although it locks in these yields for a longer term, rather than merely a few months. We believe this is a favorable tradeoff, as rolling shorter bills at prevailing rates has a significant cost in a falling Fed Funds environment. **Simply put, the current level of yield isn't the only factor to consider; the length of time you receive that yield also matters.**



Source: US Treasury and National Bureau of Economic Research

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Positioning For Capital Gain Potential

Second, yield is only one component of total return. Not only does investing in shorter-maturity bonds expose investors to reinvestment risk, it also limits potential upside if yields decline. 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. In practice, if rates fall, longer duration bonds will outperform shorter duration ones. Historically, longer rates have typically fallen shortly before or during recessions, as investors seek safe-haven securities such as high-quality bonds.

The market has grown more confident in the prospect of a "soft landing," yet we still believe the more likely outcome is that the Fed, as the old bond industry saying goes, "hikes rates until something breaks" and we experience at least a mild recession. A rapid un-inversion of the Treasury curve suggests this may be happening. **Locking in longer rates now manages the reinvestment risk of falling short term rates and offers an opportunity to capture gains should long term rates drop.**

Furthermore, with investment grade bond allocations traditionally seen as offsetting equity volatility, continuing to underweight duration may begin to increase overall portfolio risk by not providing sufficient duration stabilizing benefit.

A Considerable Cushion Is Now In Place

Third, the cost of being wrong has dropped substantially since the start of the Fed's hiking campaign. One of the developments that made 2022 so abnormal was that long term rates began the year at generationally low levels as 10Yr Treasuries yielded 1.52%. A bond's yield essentially 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 on-the-run 10Yr Treasuries having a duration slightly more than 9 years at the end of 2021, an increase of only 17 bps would have been enough to generate an annual loss; over 2022, rates rose nearly 240 bps. Today, after further sustained yield increases, the carry return is a lot higher. A current 10Yr Treasury yielding 4.75% with a duration of nearly 8 years could withstand almost 60 bps of yield increases while still having positive performance over a one-year period. While this is certainly possible, rates have not been this high since early 2001, and this is not our expectation. **What this means for investors is that it's not necessary to believe yields have peaked before extending duration. Rather, we believe the "carry return" on a portfolio of bonds is now high enough that you have the flexibility to be early in adding duration** without jeopardizing a bond allocation's risk reducing benefits.

It Could Be An Opportune Time To Make Portfolio Adjustments

Beyond those factors, here are two final observations. First, with the sheer amount of money in short Treasury bills (estimates are approaching $6 trillion in Treasury money market funds alone), **we expect that when duration comes back in vogue, the market will move fast**, and investor demand will push longer bond yields down. And second, in asset classes such as municipals where supply is often momentum sensitive, it may be difficult to efficiently transact once longer bonds return to high demand.

Our arguments draw a clear distinction between market timing – which is typically futile – and prudently responding to changing probabilities and risk-return tradeoffs. The latter to us reflects reacting to an arguably increased upside to intermediate and longer maturity bonds, as well as downside risk we feel has declined. 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 the case for reducing exposure to short term bonds and extending duration back towards longer term strategic norms has become a lot more compelling.

ONE POST OFFICE SQ. BOSTON, MA 02109 TEL. 617.338.0700 WWW.APPLETONPARTNERS.COM

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