Beware of Locking in Rates in Today's Market

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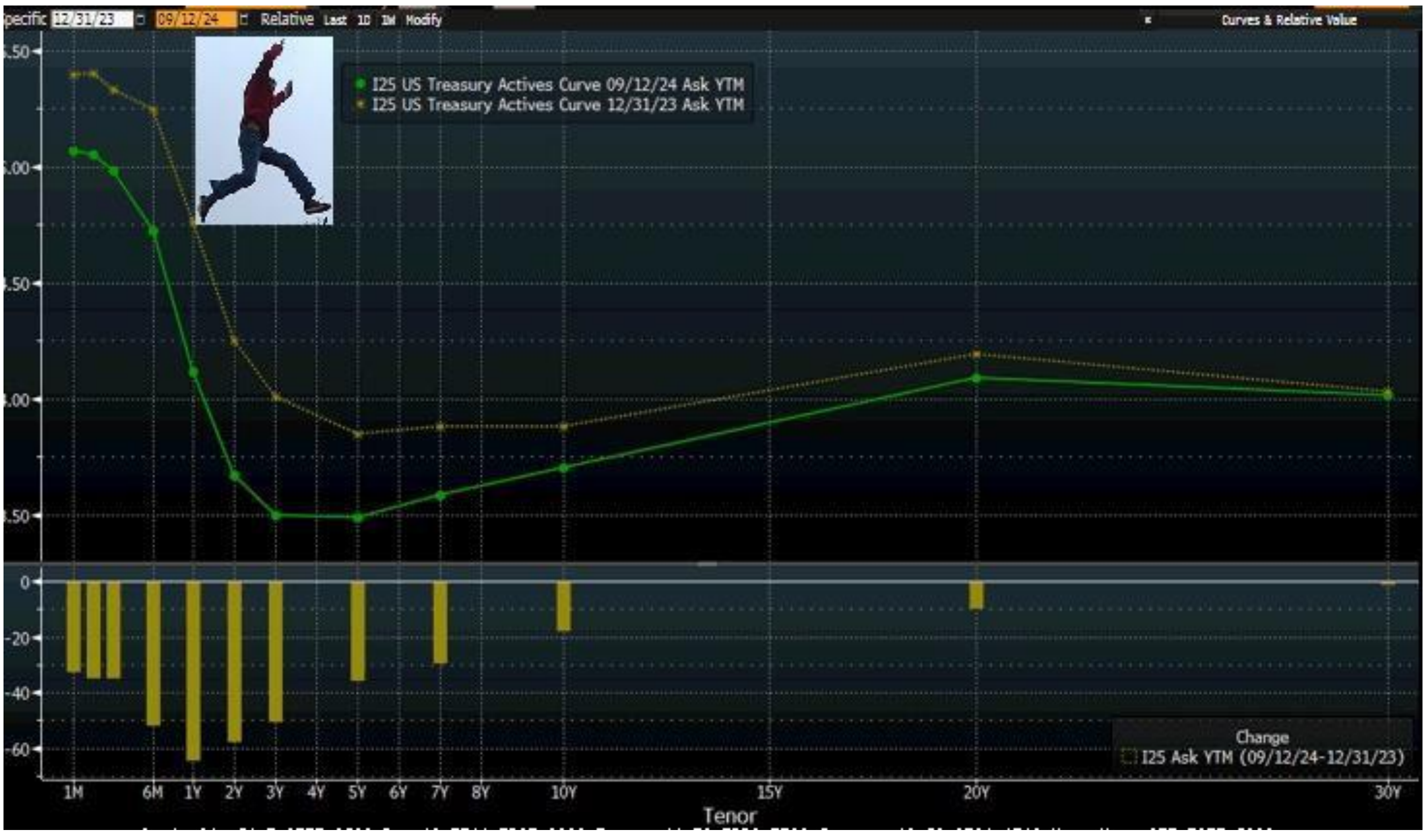
The yield curve (2-year to 10-year interest rates) just resurfaced from its longest inversion in history and the Fed has finally started its long-awaited cutting cycle. There is a chorus of analysts, strategists, and other advisors imploring investors to lock in rates now before they march lower. Let's review whether it makes sense to jump into the duration pool.

Figure 1: Current vs 12/31/23 Treasury Curve



Source: Bloomberg, LP, As of 09/12/24

Figure 2: 10-year minus 2-year US Treasury Yields

Source: Bloomberg, LP, as of 09/11/24

Consensus expectations are for the Fed to continue cutting interest rates and the yield curve to steepen. This is a reasonable expectation given the mean reverting nature of the yield curve throughout history and the fact that the yield curve has had a positive slope over 80% of the time since the late 1970s. Short-term rates, which are most influenced by Federal funds rates, are expected to fall as the Fed cuts. Longer term rates, which are driven by a combination of term premium, demand and inflation and growth expectations have been falling dramatically in pace with expected Fed cuts. Given the Fed cuts 2+% over the next 12 months as the market is predicting, the belly and long end of the curve must stay the same or rise for the curve to steepen from here.

Here's a live look at current interest rates, market-forecasted rates in one year from now and the implied total return, based on average yield and mark-to-market movement from the change in rates over the next year:

	Current	1-year				
Tenor	Yield	Future Yield	Duration	Carry	MV Change	Total Return
6-mo	4.74	3.07	0.49	3.91	0.81	4.72
1-year	4.12	3.10	0.96	3.61	0.98	4.58
2-year	3.64	3.10	1.88	3.37	1.01	4.39
3-year	3.46	3.19	2.83	3.33	0.76	4.09
5-year	3.45	3.34	4.51	3.39	0.47	3.86

7-year	3.54	3.48	6.09	3.51	0.33	3.84
10-year	3.65	3.67	8.18	3.66	(0.11)	3.55
30-year	3.96	3.94	17.13	3.95	0.47	4.42

Source: Bloomberg, LP. As of 09/11/24

Carry = Average (Current Yield, Future Yield)
MV Change = Duration x Yield change
Total Return = Carry + MV Change

Bonds generate income (yield) as well as capital gains (and losses) from interest rates falling (rising). The above chart incorporates carry and estimated market value change to arrive at total return in orange.

These numbers would suggest that owning six-month bonds would result in the best total return over the next year. Looking at where yields are today on each of these nodes, vs where they are headed, allows for visualizing both the upside in owning certain tenors as well as when the curve (from 6-mo to 30-year) may normalize. This chart does not account for potential volatility, which is implied by each node's duration. One can surmise that the longer duration, the higher the implied volatility and risk. The interest rate risk inherent in longer duration investments heightens the attractiveness of staying short. Locking in 3-handle interest rates today seems to be pure speculation that the Fed may cut more than 2% over the next year.

Present Curve	9/11/2024					move needed
Tenor	Yield	Duration	Yield Diff	Cap Gains	1yr Total Return	to beat bills
0	5.20	-				
1	4.12	0.96	(1.08)	(1.04)	3.08	(2.17)
2	3.64	1.88	(0.47)	(0.89)	2.75	(1.72)
3	3.46	2.83	(0.18)	(0.51)	2.95	(1.13)
4	3.46	3.62	0.00	0.00	3.46	(0.48)
5	3.44	4.51	(0.02)	(0.08)	3.37	(0.47)

2004 Curve	9/11/2004				
Tenor	Yield	Duration	Yield Diff	Cap Gains	1yr Total Return
1	2.18	0.97	-	-	2.18
2	2.50	1.89	0.32	0.60	3.10
3	2.82	2.75	0.32	0.88	3.70
4	3.13	3.63	0.31	1.13	4.26
5	3.40	4.51	0.27	1.22	4.62

Source: Bloomberg, LP, as of 09/11/24

Zooming into five-year and shorter tenor bonds, we must consider that these are all "negative carry" investments relative to investing in treasury bills. For example, if you buy a five-year, fixed rate bond you start earning 3.46% today instead of 5.20% which you can get on short duration bills. Not only is your fixed rate bond negative carry, but it also faces a headwind from "rolling up the curve." Combining all this, we can see that an investor who buys a five-year, fixed rate bond needs to see five-year interest rates fall by 47bps over the course of a year just to breakeven with Treasury Bills.

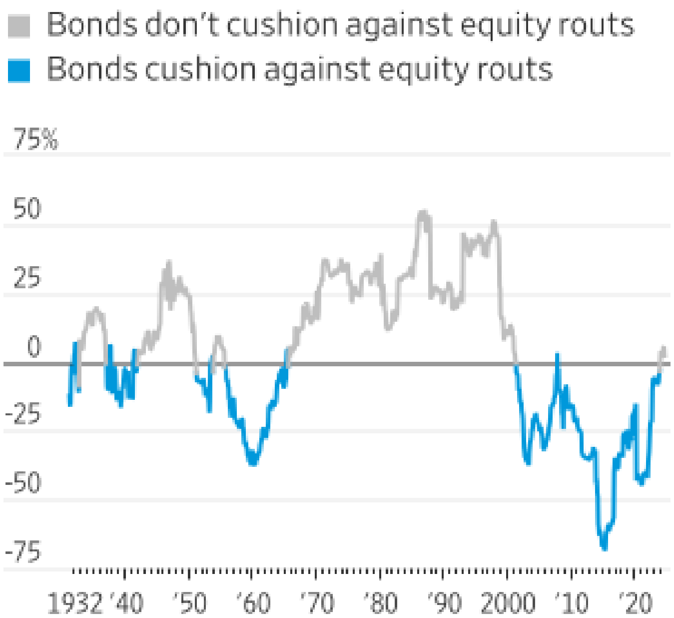
Figure 3: US Treasury Curve, 2024 vs 2004

Source: Bloomberg LP, as of 09/11/24

The inverted yield curve provides another reason to rethink traditional approaches to fixed income. The chart above demonstrates this by putting today’s opportunity set alongside the opportunity set from twenty years ago. 5-year rates were almost the same 20 years ago, but the curve afforded investors the advantage of lower yields (higher prices) as bonds shortened (rolled down the curve). Today, the opposite is true. If the curve stands and short-term rates are persistently higher than long term rates, investors will lose value by rolling up the curve as time passes.

Bonds used to cushion equity routs in the post-1990s period of low inflation...

Five-year correlation between monthly changes in the S&P 500 and 10-year Treasurys



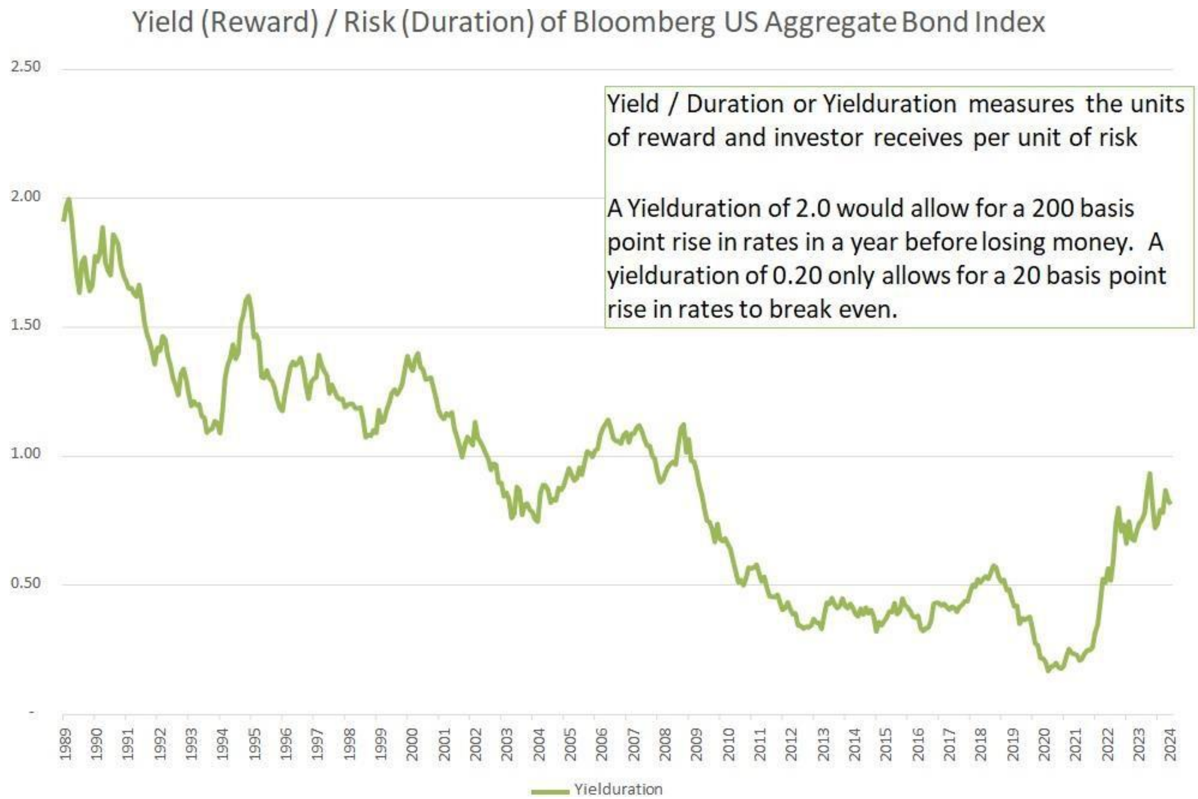
Sources: Robert Shiller, WSJ calculations

Investors also buy bonds as a form of insurance and for portfolio diversification; it is unusual to think of bonds as speculative. We recently experienced a change in the correlation between stocks and bonds which shook the foundation of long-held portfolio management orthodoxy and has caused many investors to rethink their fixed income investments.

Odds are favorable for floating rate securities as they start out with higher yields and provide positive carry relative to the rest of the yield curve. While that yield will drop as the Fed lowers interest rates, waiting for a flatter curve may allow for a better entry point to ladder out the curve and into duration.

It is important to point out that this analysis is not a prediction of future interest rates. We are incorporating current rates, future rates and bond math. It may seem counterintuitive to advocate for shortening duration as we are entering a Fed interest cutting cycle, but the math shows that value is skewed against locking-in current fixed interest rates.

We have shown some of the factors that contribute to the risk-reward options in the bond market: 1) the absolute level of interest rates, 2) the shape of the yield curve, and 3) the historical trend of interest rates and the yield curve. While interest rates are higher than they have been in recent history, they are still on the lower end of the historical range and more importantly have historically low compensation for duration risk (see chart below). As investors may be offered better value in the front end of the curve and the inverted curve penalizes longer duration, fixed-rate investors, perhaps investing in floating-rate bonds may prove prudent.



Source: Bloomberg, LP, as of 06/30/24

As we see in the chart above, the yield (return) for the duration (risk) of the US Aggregate Bond Index has increased off its 2021 lows but is still historically low. The extreme reading of 0.20 in 2021 was a contributing factor to the correlation regime change we experienced in 2022 and has caused investors worldwide to reconsider the merits of the traditional 60/40 portfolio. At that time, a mere 20 basis point rise in interest rates would have wiped out an entire year of gains from yield. As of today, investors can only handle a 66-basis point move higher in interest rates before getting wiped out for the year. After a historic rate hiking cycle, fixed rate bond investors are not being adequately compensated for interest rate risk.

Floating rate bonds are an underappreciated segment of the global bond market that many index-based managers simply ignore or cannot invest in. The current risk-reward opportunity set in the market leans heavily in favor of floating rate bonds compared to fixed rate bonds. US floating rate bonds are a $3 trillion market but comprise only 6% of the outstanding fixed income market. Given the small percentage of the market, any small shift in investor allocations could result in additional price appreciation for these securities given the size of the market and low overall issuance.

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