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Corporate Cash Alert

A Tale of Two Curves

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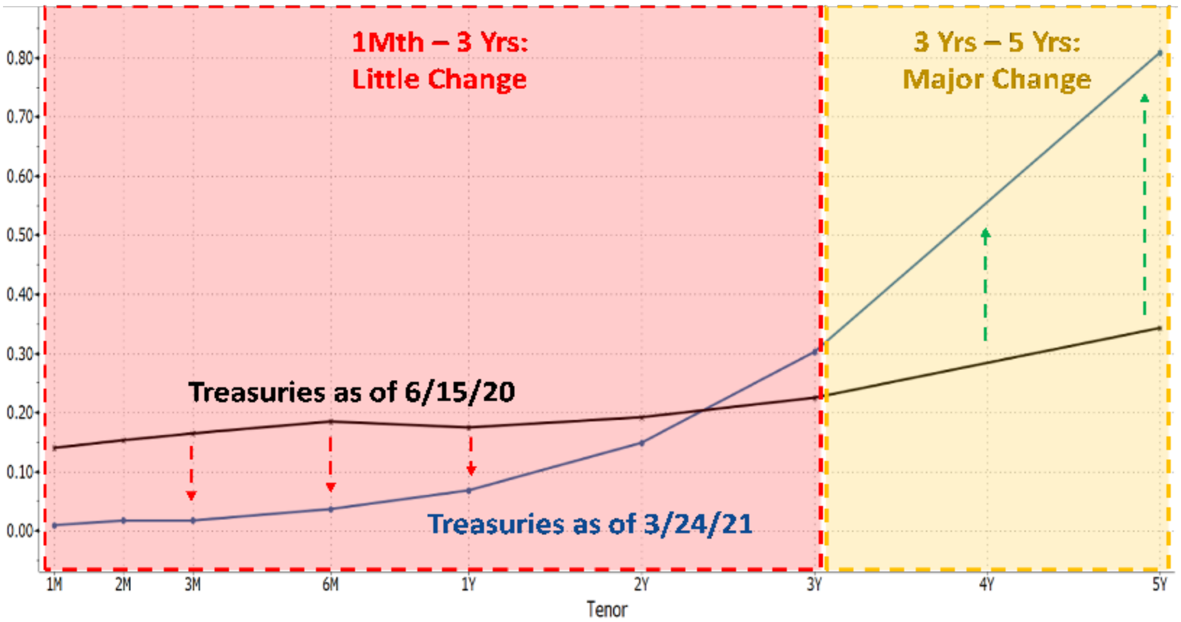
With vaccines finding arms and the economy reopening, rates are making moves. Read on for our most current thinking.

Rates Do the Twist

Throughout 2H 2020, an ultra-easy Federal Reserve and the ongoing pandemic resulted in very low and range-bound yields out to 5 years. This began changing as news of effective vaccines emerged in November and the prospect of victory against COVID-19 came into sight. With historically generous monetary and fiscal policy pumping torrents of liquidity, consensus rapidly pivoted towards assuming a booming expansion, causing the yield curve to pivot higher in maturities greater than 2.5 years.

As a result of this twisted curve, short-term rates remain lackluster while 3-5 year rates have doubled.



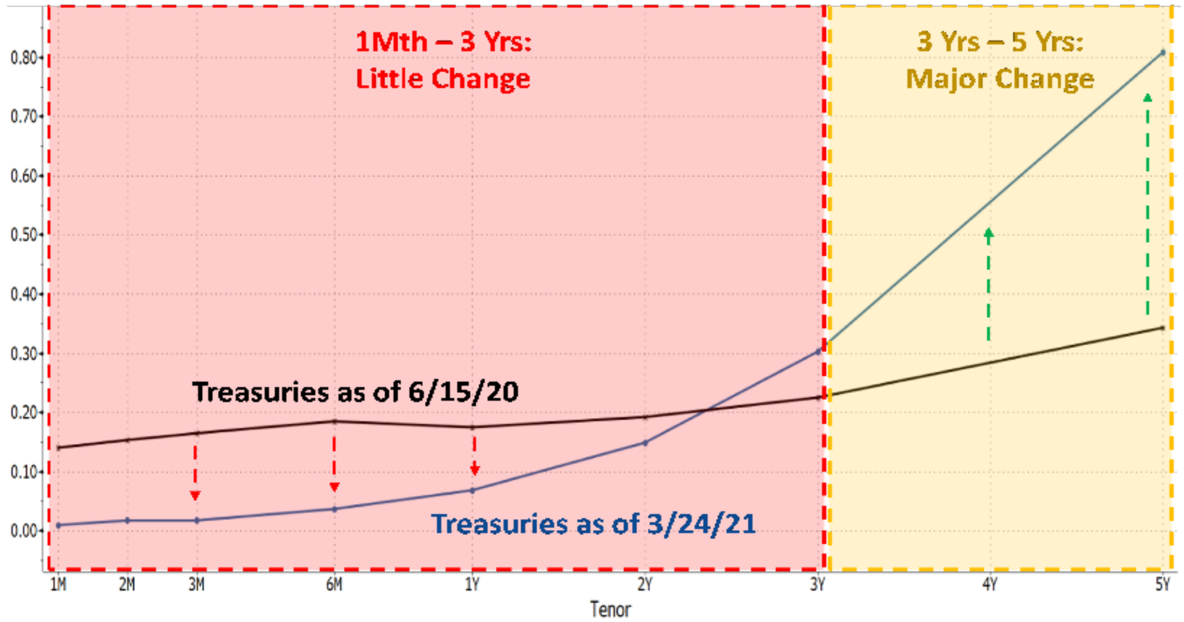
Source: Bloomberg

The bulk of the uptick in intermediate yields happened relatively recently, and opens up the possibility of extending maturities at much more attractive levels than those available last June, when we essentially limited new purchases to a maximum 2024 final maturity.

Source: Bloomberg

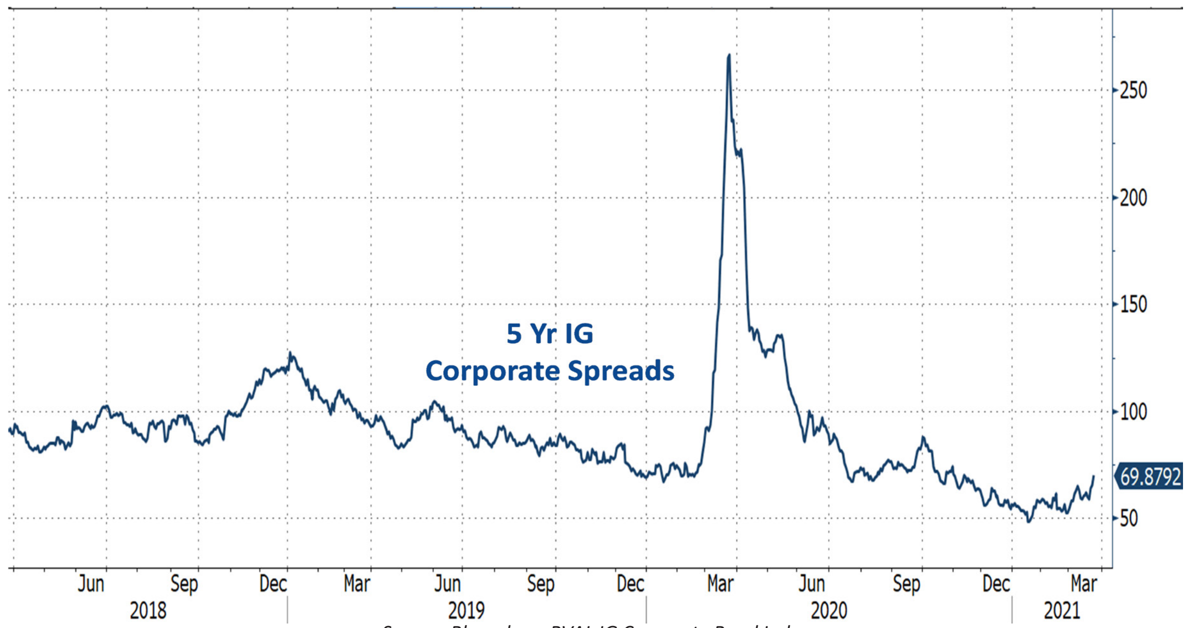
Spreads Don't Feel Like Dancing

Unfortunately, credit spreads haven't shown the same degree of increase as risk-free rates, a logical outcome given the improving economic climate. While spreads have bounced slightly off their mid-summer doldrums, they're merely back to their immediate pre-pandemic levels.



Source: Bloomberg BVAL IG Corporate Bond Index

The comparison is even less flattering when looking back further. Recall that pre-pandemic spreads were already trading tight to historical levels, as years of aggressive interventionism from global central banks had forced investors to compete for ever-scarcer positive yields. The incremental reward for bearing credit risk remains meager.



Source: Bloomberg BVAL IG Corporate Bond Index

Treasury Partners View

When we generally suspended longer-dated purchases in June 2020, our rationale was straightforward; with a nearly-flat curve hugging 0% and little relief available in spread markets, the risk-reward tradeoff was poor. This meant accepting painfully low returns but maintaining reinvestment flexibility versus reaching out longer for a tiny bump in yield and less flexibility. Given massive fiscal and monetary intervention creating a tsunami of easy money, we thought the curve would eventually steepen while the short-end would remain firmly anchored to a 0% Fed Funds rate.

Overnight to 3 Year Maturities

That curve steepening has indeed come to pass, and the yield pickup from extending maturities is now far higher. However, since many clients don't have the flexibility to consider longer-term maturities, our strategy for portfolios with limits inside of 3 years is to continue extending maturities and guide portfolios closer to their max WAMs. While returns remain meager, our expectation is that the Fed maintains a 0% Fed Funds rate into 2023. This will continue to durably keep shorter-term yields near their current low levels, but also minimizes the risk of sudden increases. We continue to favor corporate over government bonds given their incrementally higher returns versus base risk-free rates.

3 to 5 Year Maturities

For those clients with IPs that permit longer-term maturities, our prior restraint has preserved the ability to take advantage of a more favorable environment in 3-5 year investments (while minimizing unrealized losses). We're not quite ready to lift those limits and add longer-dated exposures (although we're getting closer). However, it's an opportune moment for readers to ponder their overall portfolio duration targets and weigh the merits of extending maturities.
Consider the yield breakeven calculations below.

At the current 3 year Treasury yield of 0.34%, an investor who instead buys a 1.5 year Treasury at 0.12% will come out ahead if, when that original bond matures, they can reinvest into another 1.5 year Treasury yielding over 0.55%. Similarly, with the 5 year now at 0.91%, 2-2.5 year Treasuries would have to rise to more than 1.57%-1.77% in a couple of years from now to be better off than locking in the 0.91% today.

Current 3 Year Treasury Yield	Current 1.5 Year Treasury Yield	1.5 Year Yield Needed 1.5 Years from now to Breakeven
0.34%	0.12%	0.55%
Current 5 Year Treasury Yield	**Current 2.5 Year Treasury Yield**	**2.5 Year Yield Needed 2.5 Years from now to Breakeven**
0.91%	0.25%	1.57%
Current 5 Year Treasury Yield	**Current 3 Year Treasury Yield**	**2 Year Yield Needed 3 Years from now to Breakeven**
0.91%	0.34%	1.77%

Source: Treasury Partners calculations, Treasury yields as of 4/1/21

The current economic expansion has all the makings of a strong one, and booming real economies tend to create upward rate pressure. Moreover, the next several months are likely to bring unusually-high inflation readings (skewed by base effects from an easy comparison to pandemic-ravaged 2020). At these low nominal yields, the most significant threat to longer-dated bond returns is a sustained uptick in inflation, which is not our base case.

As a result, we're holding off on fully extending into 3-5 year positions for now, waiting to see if the next few months bring an "inflationary scare" that creates an opportunity to add more aggressively at higher book yields. However, investors with low durations and ongoing free cash flow should consider the merits of extending maturities on any rate spikes over the next few months.

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