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Alert

Don't Be A Turkey the Day Before Thanksgiving

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You may have noticed we've recently sold some of the longer-dated bonds in your fixed income portfolio. In short, we believe the probability of a steady "grind higher" in yields is increasing and have tactically adjusted certain client portfolios.

In this Alert, we discuss the rationale behind these moves and demonstrate how we've gone about reducing portfolio sensitivity to interest rate fluctuations.

The Role of Duration

As portfolio managers, there are many variables we consider when setting fixed income strategy. For example, credit ("*What's the likelihood of default?*"), maturity structure ("*Should I favor 3 year or 20 year bonds?*"), and relative value ("*Is Bond A's risk/reward profile more attractive than Bond B's?*") are some of the decisions we confront.

One of the variables we monitor is the portfolio's average life or "duration." Simply put, duration measures how sensitive the portfolio's value is to changes in its yield (recall that as interest rates rise, bond prices fall, and vice versa). It is one of the central drivers of fixed income volatility. Generally speaking, bonds with longer maturities have a higher duration and are more price-sensitive to fluctuations in interest rates than bonds with shorter maturities. Accordingly, our recent actions to reduce duration are designed to guard against rising interest rates and declining prices.

Tactical Adjustment

Although it's exceptionally difficult to predict the future direction of interest rates, as active managers we make a conscious decision on how much duration risk is appropriate for client portfolios. Since we're close to a decade past the great financial crisis, economic conditions are signaling rising odds of a steady "grind higher" in rates. Many inter-related factors influence this outlook, including:

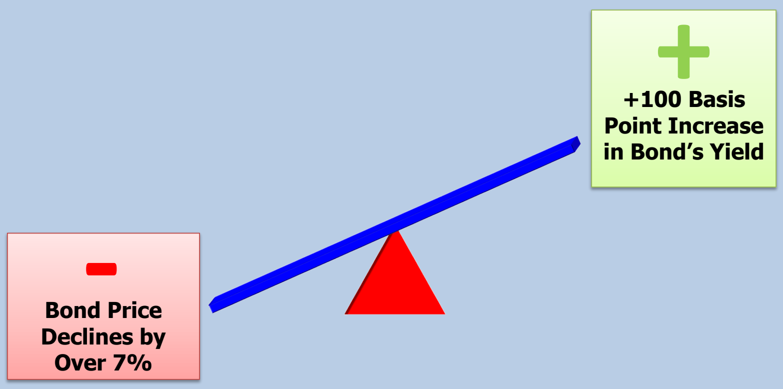
- The Federal Reserve and European Central Bank are set to gradually reverse or curtail their quantitative easing programs (the Fed via balance sheet runoff, the ECB via tapering its ongoing bond purchases).
- Global synchronized economic growth could pressure inflation.
- Potential tax reform providing additional economic stimulus and increased budget deficits requiring new Treasury bond issuance.
- Rebuilding efforts in the wake of Hurricanes Harvey, Irma and Maria leading to increasing demand for labor (boosting wages) and rising building material/commodity costs, both of which can further stoke inflation.
- The Federal Reserve is clearly communicating additional near-term rate hikes.

An Example of Duration’s Impact

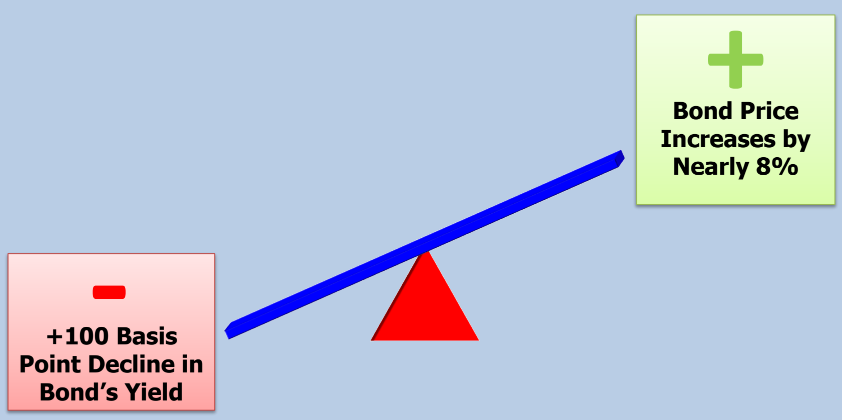
Here’s an example of how duration is useful (though inexact) in forecasting price fluctuations.

Assume you own a typical long-dated municipal – a New York City Municipal Water Finance Authority tax-exempt bond with a 2038 final maturity, 2026 call option, and 5% coupon, currently priced at $117.6 with duration of 9.8.[1] This implies a 1% change in yield results in a price change of app. 9.8%.

If the bond’s yield rises 1.00%, investors face a significant price decline:



Of course, bond prices can also rise in value. If the bond’s yield declines by 1.00%, investors will benefit from a large price increase:



Two takeaways:

- **Higher duration = higher sensitivity.** Taking on higher duration requires accepting greater volatility. In the above example, a $1mm investment in this 9.8 year duration bond will decline in value by $71k, assuming a 1% increase in yields.
- **Yields subject to market and credit risk.** Shifts in both perceived credit risk and interest rates will impact a bond’s price.

[1] CUSIP 64972GKG8, all calculations/indicative pricing assumes values as of 10/27/17 from Bloomberg.

There also appears to be very little "margin for error" built into current fixed income valuations, leaving a thin "cushion" in case rates move higher. In a higher-rate environment, typically a bond's coupon income can help offset price drops, resulting in potentially positive total returns. However, given the very low interest rate environment, coupon rates are potentially too low to offset any meaningful price drops caused by higher interest rates.

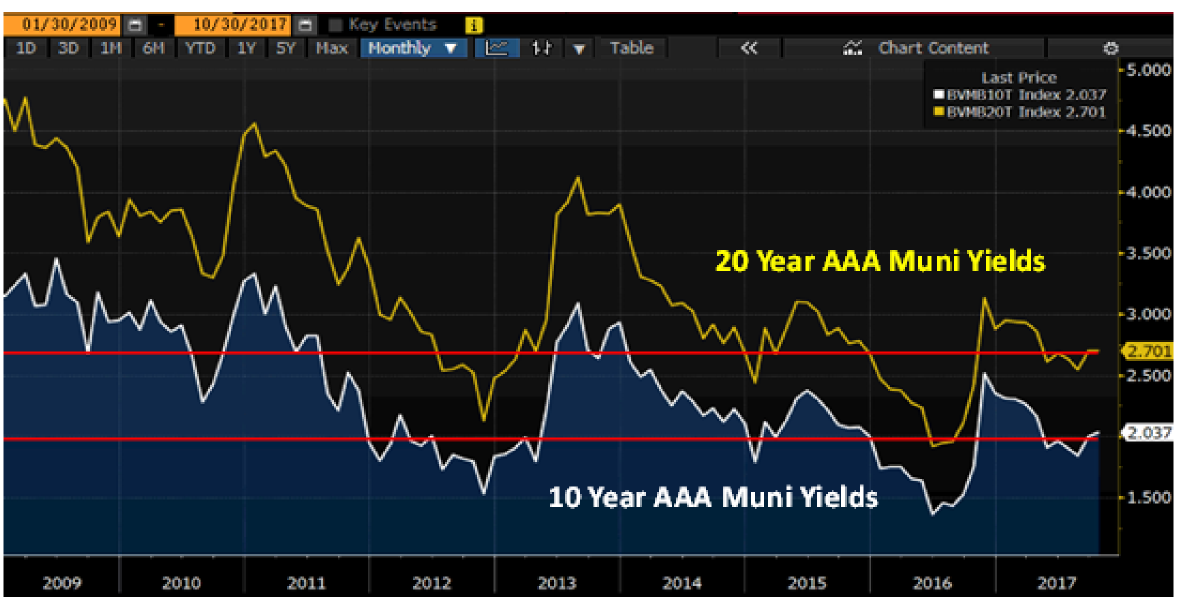
Consider the below chart, which shows the price-duration tradeoff in the Bloomberg Barclays US Aggregate Bond Index. The wider the "gap", the more duration investors must accept for a given increase in yield – that is, the larger the risk-reward tradeoff. That gap is currently the widest it's been in nearly 30 years.

Bloomberg Barclays US Aggregate Bond Index

Source: Bloomberg, as of dates shown

Yields on benchmark municipals also clearly remain near their recent post-crisis troughs.

Bloomberg AAA Municipal Benchmark Yields



Source: Bloomberg, as of dates shown

With corporate bonds, credit spreads have steadily declined throughout 2017 and are now exceptionally low.

US Corporate Investment Grade Credit Spreads

Source: Bloomberg, as of dates shown

The 2 year decline in high yield spreads has been even starker.

US Corporate High Yield Credit Spreads

Source: Bloomberg, as of dates shown

Taking the whole picture into account, current fixed-income yields and spreads regardless of sector are simply not attractive enough to merit taking on above-average durations.

The risk of our cautious outlook on rates is that the disruptive forces of technology continue to keep a lid on inflationary pressures, lessening the probability of corresponding yield increases. Further, if the long post-crisis economic recovery we’ve experienced begins to roll over, it may cause the Fed to shift to a more accommodative stance more quickly than anticipated.

Conclusion

The post-crisis years have witnessed a remarkable decline in yields, leading to a long period of bond price appreciation. It's certainly understandable if this unrelenting bond bull market has encouraged a measure of complacency. We’re now raising the flag of caution and don’t want to end up being a turkey on the day before Thanksgiving.

As always, please feel free to reach out to your advisor if you'd like to discuss how this affects your portfolio.