The Year of the Duration Dragon

Liquidity investors, fear not. While the Fed's interest rate tightening campaign likely ended this past summer, we believe it's not too late to slay the duration dragon by capturing attractive return opportunities further out the yield curve.

2023 was a remarkable year for fixed income markets, if not purely for its persistent volatility. As investors settled into the Federal Reserve's (Fed's) higher interest rate regime, they were relieved to close the door on the protracted period of near-zero rates and embrace higher yields. Liquidity investors faced a particular abundance of options, with soaring short-term yields last seen in the first quarter of 2001. However, for strategic liquidity portfolios, we have been cautioning against the lure of cash in favor of capturing more balanced risk-return opportunities further out the curve. While this argument held throughout the year, the Fed was still raising rates, adding to the siren song of cash's quick fix.

After raising rates an additional 100 basis points (bps) in the first half of 2023, the Fed paused its campaign in July to evaluate the "long and variable lags" of policy restriction on inflation and the economy. As economists and prognosticators sounded warnings of a looming recession, one has yet to materialize. Despite ongoing strength in labor markets, continued improvements in core inflation have propelled rate cut expectations, with the market calling for more than six cuts in 2024 — twice the number forecasted in the Fed's December economic projections. In fact, the rapid shift in expectations helped pressure yields on U.S. Treasuries (UST) with maturities of 2 years and longer, mostly lower by the end of the year.

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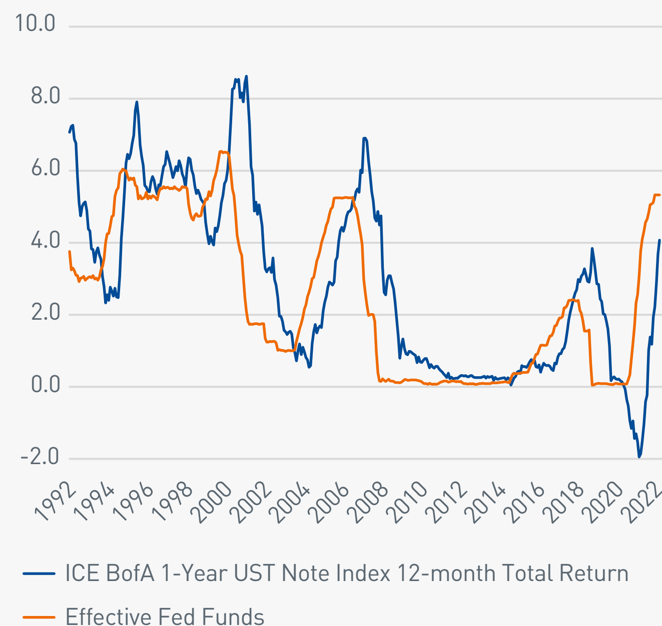
It is reasonable for investors to be concerned that recent market moves may have eliminated opportunities further out the curve. Instead, we urge investors to use the Fed's policy stance to frame potential returns. From a historical perspective, we believe there remains considerable total return potential, not only from carry yield, but also price appreciation as yields adjust to discount a lower future policy rate (**Figure 1**). Additionally, based on data going back to the mid-1970s, a starting yield between 4%-6% for the Bloomberg Intermediate Aggregate Index has resulted in an average 5-year annualized return of 5.37% (**Figure 2, page 2**).

Figure 1. ICE BofA 1-Year UST Note Index 12-month Total Return vs. Effective Fed Funds Rate, %

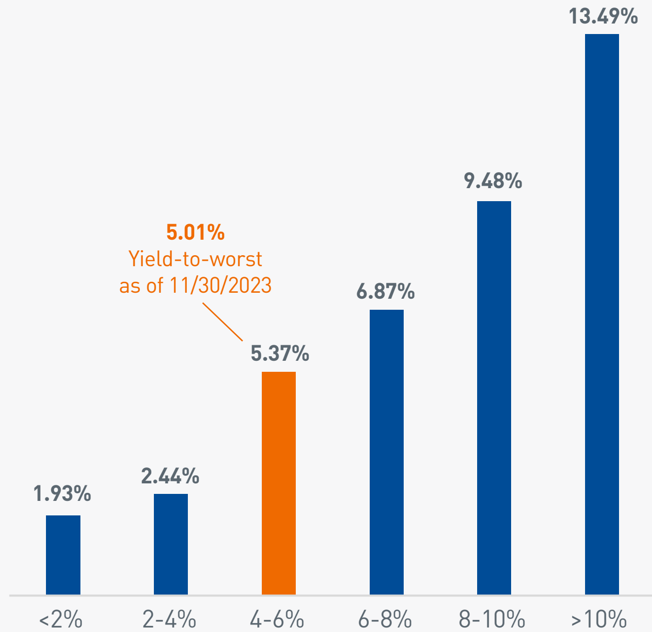
Total return potential remains as yields adjust to a lower future policy rate



As of 11/30/2023. Source: Bloomberg L.P.

Figure 2. Bloomberg U.S. Intermediate Aggregate Bond Index, 5-Year Forward Average Annualized Returns by Starting Yield Range (January 1976 - November 2023)

Yield profile has improved symmetry of returns



As of 11/30/2023. Source: Bloomberg L.P., PNC Capital Advisors

Figure 3. Comparison of Potential Returns

Short/intermediate indices have more favorable ratios of upside to downside

As of 11/30/2023. Source: Bloomberg L.P., PNC Capital Advisors

Last year, the trend continued to hold as the Intermediate index ended 2022 with a yield-to-worst of 4.63% and returned more than 5%.

The balance between risk and potential reward is another important consideration in our investment process and one that points to opportunities in the current market environment. **Figure 3** considers various short and intermediate segments of the Treasury and Aggregate markets through a symmetry lens, using a 3-month investment horizon and assuming a +/-50 bp change in interest rates. With yields generally around 5%, the accrual helps insulate portfolios against negative return outcomes, with a distribution skewed toward positive returns.

Beyond potential return considerations, moving out the curve to longer-maturity solutions can enhance diversification by broadening the investable universe. We believe employing a wider spectrum of sectors and security types helps improve risk-adjusted outcomes, based on historical return volatility and correlations. As risk spreads have narrowed in recent months, we continue to favor Structured Products, such as Agency mortgage-backed (MBS) and asset-backed securities (ABS). Within the high-quality areas of the sectors in which we focus, we believe there are compelling alternatives to corporate credit that offer incremental yield and strong risk-adjusted return potential. Overall, we believe the short/intermediate portions of the curve offer enhanced spread relative to investment portfolios that more closely resemble traditional money market funds (**Figure 4, page 3**).

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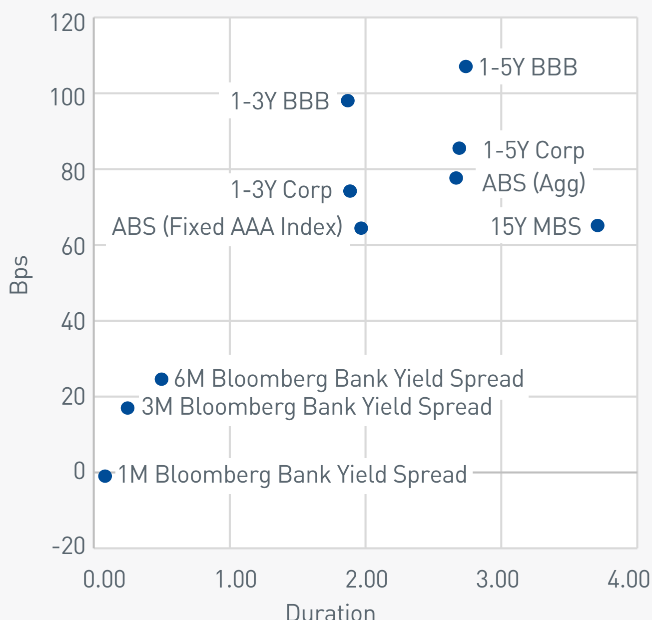
Figure 4. Sector Spread Comparison

Short/intermediate portions of the curve offer enhanced spread



As of 11/30/2023. Source: Bloomberg L.P.

The bottom line is we believe 2023 produced considerable evidence to support two tenets of our risk-focused approach: (1) It's a fool's errand to try to time markets, and (2) Active management can produce considerable alpha in fixed income portfolios. We remain steadfast in emphasizing shifts in risk-sector allocations based on historical valuation relationships to drive more balanced and consistent outcomes for our clients.

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The Bloomberg Intermediate Aggregate Bond Index measures the performance of investment grade, U.S. dollar-denominated, fixed-rate taxable securities with maturities of 1-10 years, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM passthroughs), ABS, and CMBS.

The Bloomberg Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and nonagency).

The ICE BofA U.S. 1 Year Treasury Bill Index is comprised of a single issue purchased at the beginning of the month and held for a full month. At the end of the month that issue is sold and rolled into a newly selected issue. The issue selected at each month end rebalancing is the outstanding Treasury Bill that matures closest to, but not beyond, 1 year from the rebalancing date. To qualify for selection, an issue must have settled on or before the month-end rebalancing date.

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