Reconsidering Duration

COMMENTARY
November 2023

Those investors pulled toward short-term Treasuries for their multi-decade peaks may wish to look beyond near-term highs at the front end of the yield curve to ensure they have a plan for those funds when maturities arrive. Such generous yields might not then be on offer. That "reinvestment risk" might mean that longer-term bonds may be a better fit for purpose in some situations, despite somewhat lower current yields and likely higher price volatility to maturity:

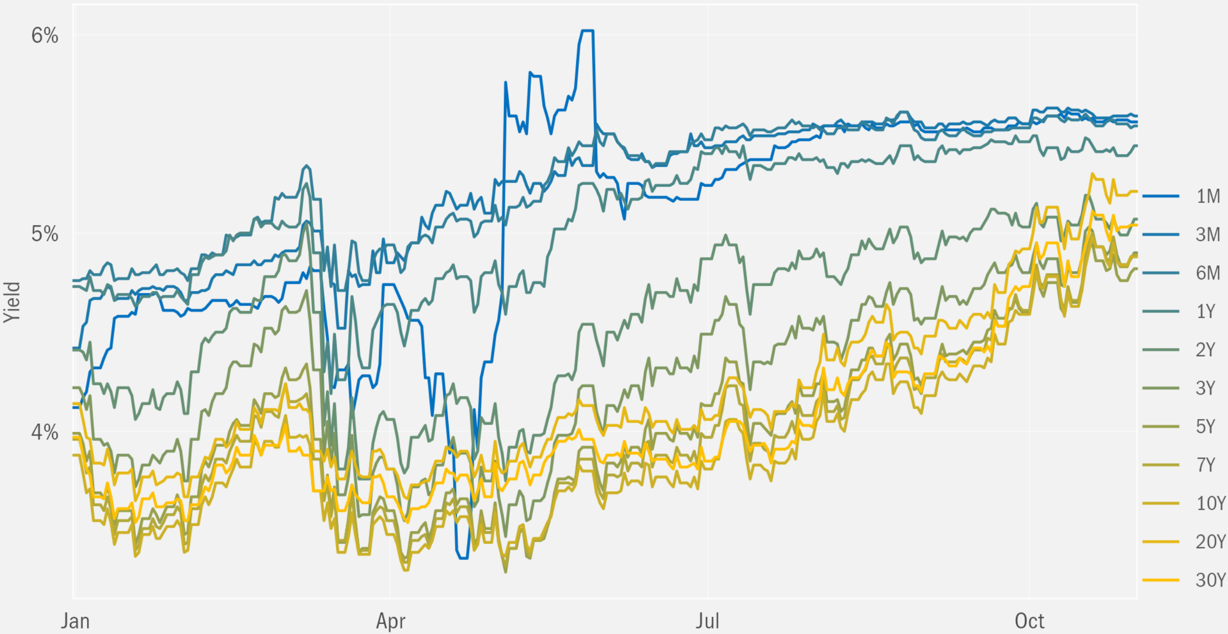
- A guaranteed 1-year 5.4% return is a tempting draw. What about 5.0% each year for the next 2, 20 or 30 years?
- Folks with higher aversion to risk, longer-term time horizons and no interim need for associated funds may wish to consider Treasury securities maturing well in the future, despite their comparatively lower yields
- Of course, those longer-term yields may only be realized when the bonds are held to maturity. And longer-term bond prices are likely to remain volatile on account of likely ongoing heightened volatility in interest rates
- Care thus should be taken to match any longer-duration holdings with the time horizons associated with specific expected uses for the invested funds once the bond(s) mature

Perhaps More Fitting...

After having been repressed for so long by monetary policy intended to offset a range of macroeconomic phenomena (the Great Recession, COVID-19 pandemic and others), interest rates began to advance in mid-2021 as investors foresaw central banks easing off their highly accommodative stances. Rates rose further through 2022 as monetary policy makers more aggressively sought to combat persistent inflation. Earlier this year, though, a question rose to top-of-mind for investors: would the shift higher prove short- or long-term? For much of this year, investors seemed to have projected a sense that no regime change was in the offing: that central banks would have to turn coat and resort to rate cuts to bolster the economy in the face of a recession spawned by their work to control inflation. By early summer, however, that stance had shifted, presumably on account of still-robust macroeconomic activity amidst taming inflation. As we show in Figure 1, longer-term rates have soared as a result.

Figure 1: Treasury Yields Across the Maturity Spectrum

Range-bound earlier in the year, longer-term yields have soared over the second half as expectations for "higher-for-longer" have gained credence



From 12.31.22 through 11.01.23. SOURCE: SRCM using data from Bloomberg

...In the Long Run

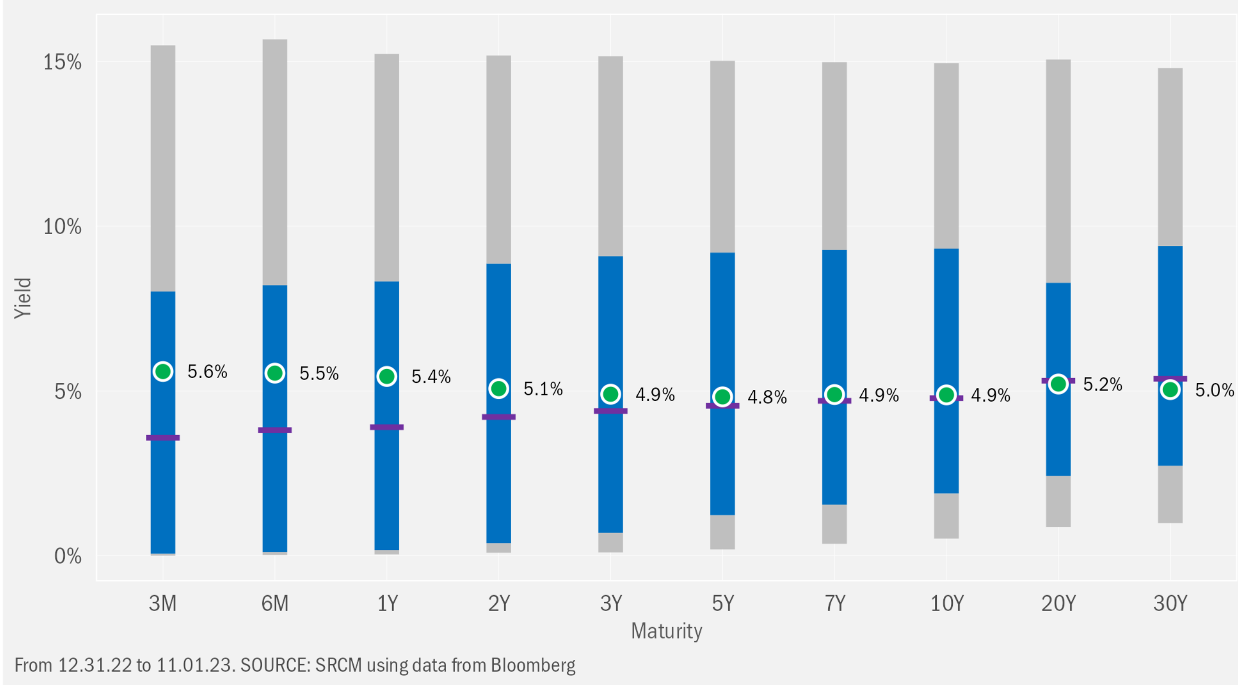
That surge will have proved costly for owners of bonds with longer maturities, at least in terms of their unrealized losses. Even so, the potential for such nearer-term losses may have been understood and accepted when investors purchased those bonds. As we have discussed in other recent commentaries and podcasts, investors have many reasons for owning bonds of specific maturities. In the case of longer-maturity bonds, investors may have been content to secure the assurance of a guaranteed "held-to-maturity" total return (income plus capital gain/loss), despite the potential for "marked-to-market" interim losses over the remaining life of the bond.

Similarly, now that yields on offer are vastly more generous across the curve, investors that might otherwise had retained a focus on short-term yields may find that longer-term yields are sufficient for specific goals. And, generally speaking, one should want to choose greater confidence in a particular expected return (e.g., yield to maturity on a Treasury) over the potential for even larger upside (e.g., unknowable long-term performance of stocks), where the surer return seems to meet intended goals. That thinking is furthered by the notion that, given the magnitude of the recent surge in rates and the level of present rates in a longer historical context, one might conclude that the outlook for rates over the medium term (i.e., the lifetime of much of the bonds space in question) may be more balanced. Even more, now that rates are higher, any subsequent increases in rates of similar magnitude may have less of a negative effect on total returns, given the now far more plush cushion the increased income provides.

Even so, rates are likely to remain volatile as investors digest macroeconomic trends as they evolve. Key to the magnitude of that volatility likely will prove ongoing progress against inflation (Will inflation continue to decline, or might we see a resurgence?) within the context of the future pace of change in the global economy (Will tighter monetary policy succeed in taming inflation without inciting a recession?). Investors there still may wish to review how comfortable they might be with the possibility of further large shifts in bond prices, even as they might welcome higher yields over a longer time horizon from their fixed income holdings.

Figure 2: Key Interest Rate Historical Ranges

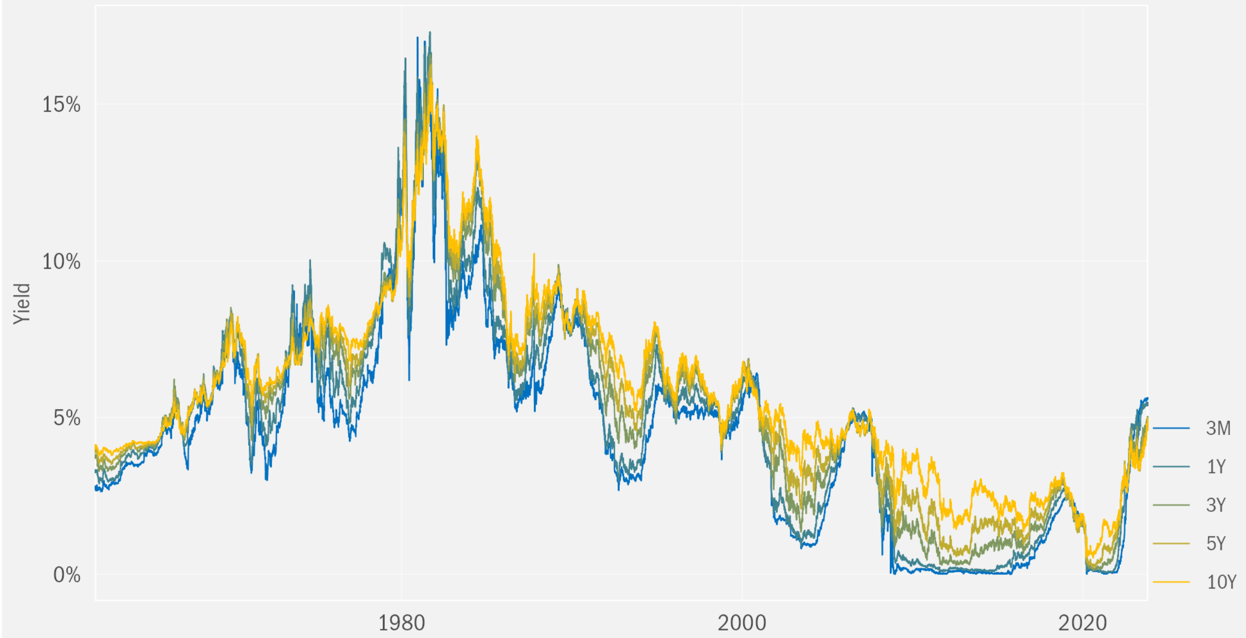
Green dots reflect latest values for each period. Purple line represents the median value. 80% of the values for each period fall within the range represented by the blue boxes



From 12.31.22 to 11.01.23. SOURCE: SRCM using data from Bloomberg

Figure 3: Long-Term Trends in Treasury Yields

While longer-term rates remain well below peaks in the 1980s they are now at levels not seen since the Great Recession



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