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Fixed Income: Clear Opportunity or Just a Mirage

Investors have long turned to public fixed income investments for their traditional attributes of income generation, capital preservation, and safety during volatile markets. However, we now find ourselves navigating through an exceptional chapter of the bond market's story. The unprecedented phenomenon of three consecutive years of negative total returns challenges our conventional understanding, prompting a critical examination of where we go from here.

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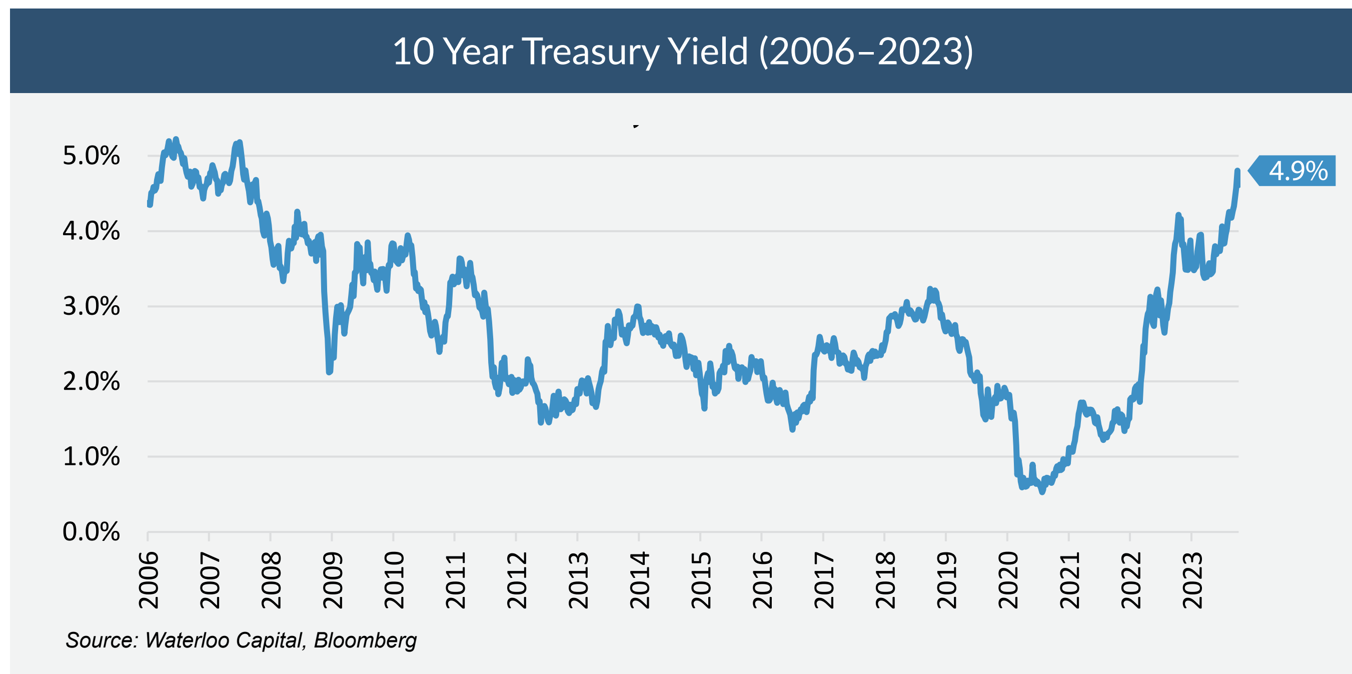
At the heart of this anomaly lies a notable shift in the trend of interest rates following the pandemic. This return of gravity, caused by a spark in growth and inflation, after years of Quantitative Easing and Zero Interest Rate Policy is having a substantial impact across markets and the economy. We can illustrate this shift using the benchmark 10-year treasury yield. Returning to levels last witnessed in 2006, the current rate of 4.9% stands in stark contrast to the 2.3% average observed during the post-GFC to pre-pandemic period as the Fed remains firm in their hiking cycle. The swift ascent in rates has reverberated through bond markets, impacting prices and producing negative returns.

US 10 Year Treasury Bond: Total Returns

Year	Return	Year	Return	Year	Return	Year	Return
1944	2.6%	1964	3.7%	1984	13.7%	2004	4.5%
1945	3.8%	1965	0.7%	1985	25.7%	2005	2.9%
1946	3.1%	1966	2.9%	1986	24.3%	2006	2.0%
1947	0.9%	1967	-1.6%	1987	-5.0%	2007	10.2%
1948	2.0%	1968	3.3%	1988	8.2%	2008	20.1%
1949	4.7%	1969	-5.0%	1989	17.7%	2009	-11.1%
1950	0.4%	1970	16.8%	1990	6.2%	2010	8.5%
1951	-0.3%	1971	9.8%	1991	15.0%	2011	16.0%
1952	2.3%	1972	2.8%	1992	9.4%	2012	3.0%
1953	4.1%	1973	3.7%	1993	14.2%	2013	-9.1%
1954	3.3%	1974	2.0%	1994	-8.0%	2014	10.7%
1955	-1.3%	1975	3.6%	1995	23.5%	2015	1.3%
1956	-2.3%	1976	16.0%	1996	1.4%	2016	0.7%
1957	6.8%	1977	1.3%	1997	9.9%	2017	2.8%
1958	-2.1%	1978	-0.8%	1998	14.9%	2018	0.0%
1959	-2.6%	1979	0.7%	1999	-8.3%	2019	9.6%
1960	11.6%	1980	-3.0%	2000	16.7%	2020	11.3%
1961	2.1%	1981	8.2%	2001	5.6%	**2021**	**-4.4%**
1962	5.7%	1982	32.8%	2002	15.1%	**2022**	**-17.8%**
1963	1.7%	1983	3.2%	2003	0.4%	**2023**	**-5.3%**

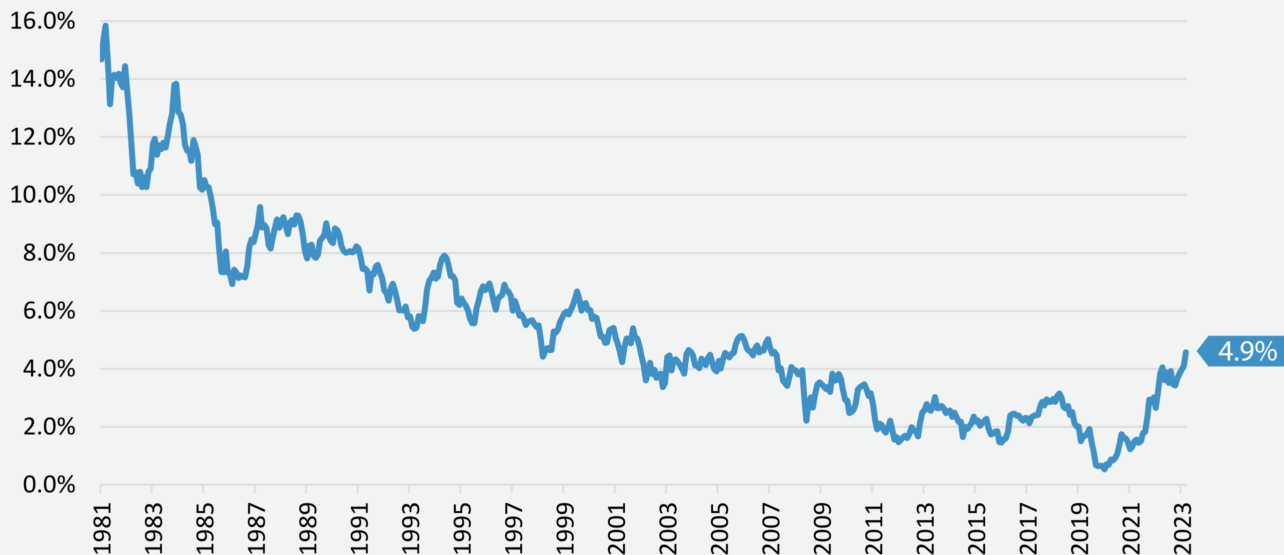
source: Charlie Biello, data as of October 18, 2023



Source: Waterloo Capital, Bloomberg

Now that we find ourselves back at these higher levels, many investors are starting to clamor at these higher yields after experiencing nearly zero for so many years. Yet, a more thorough analysis reveals a stronger historical context. Yes, we have returned to heights not seen in recent years, but viewed from a broader lens, the current yield remains moderate. The preceding post-GFC era of ultra-low interest rates was a segment of an extended bond bull market that spanned over four decades, starting in the early 1980s and arguably concluding in 2021. The current uptrend, while presenting challenges, also signals a potential turning point and an opportunity for investors to reevaluate their strategies for fixed income.

10 Year Treasury Yield (1981–2023)



Source: Waterloo Capital, Bloomberg

Given the recent rise, many people are divided. Is this an opportunity to finally secure yield in public fixed income, presenting an alternative to higher valued stocks with the added potential price appreciation once interest rates ultimately decrease? Or could this be a mirage in the distance, one in which investors pile in prematurely only to see interest rates continue their march higher, driving the final stake in the infamous 40-year bond bull market?

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Why Rates May Fall – The Bull Case

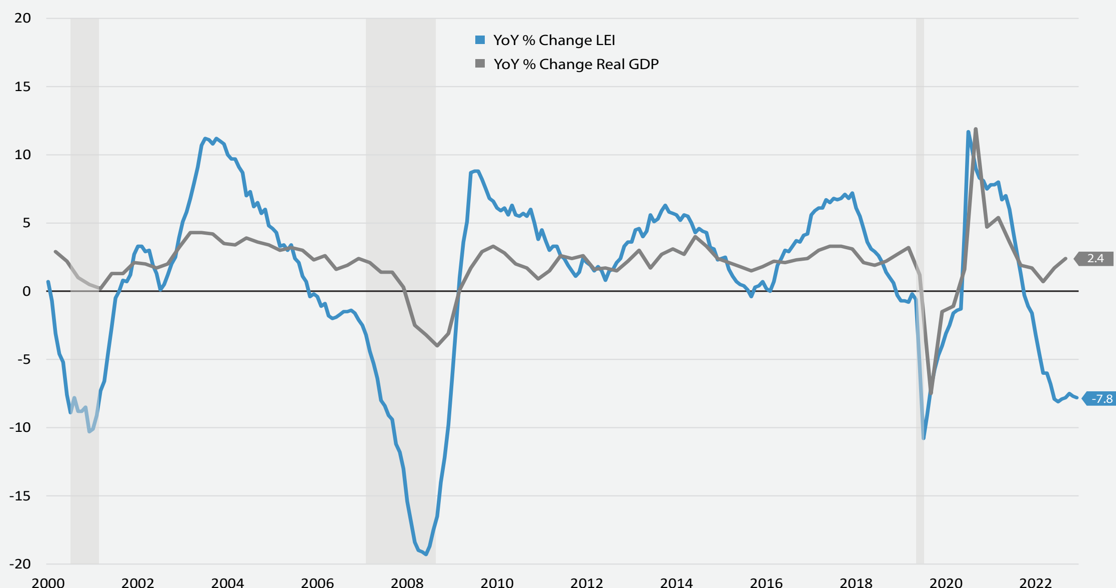
Federal Reserve Policy: The Federal Reserve's future monetary policy exerts a pivotal influence on the overall level of interest rates in the economy. Its role to set the overnight lending rate shapes the foundation from which all other interest rates are referenced against. This is the primary driver behind the surge in rates observed over the past year and a half, as the Federal Reserve implemented a series of rate hikes to combat inflation.

A substantive decline in interest rates over the immediate and intermediate future would be predicated on a pause in their hiking cycle, as witnessed at the last two FOMC meetings, and cuts to the Fed Funds rate in the months and years ahead. Fed Chairman Powell's latest statements further solidify the possibility of this hiatus. If the economy starts showing tangible signs of slowing down and inflationary concerns are effectively addressed, we could soon witness interest rates embarking on a downward trend.

Economic Deterioration: The current environment of elevated interest rates applies pressure on the economy, as it raises the cost of accessing funding and servicing debt. Businesses and households are now forced to obtain funding at higher rates of interest, diminishing their impulse to borrow for investment and consumption. Fewer dollars to spend translates to reduced revenue for businesses setting the stage for a slowdown in economic activity.

This cause-effect relationship between a quick rise in interest rates and economic deceleration is not mere conjecture but is grounded in empirical evidence. For illustration, consider the Leading Economic Index (LEI). This index, by consolidating data from 10 prominent economic indicators, serves as a barometer for economic health. Historically, the ebb and flow of the LEI have provided insightful previews into the course of actual economic growth. After peaking in 2021, we can observe a consistent decline in the change of the index, though during 2023, real GDP has not yet fully reflected this significant downward shift. Notably, since a component of interest rates is tethered to real growth, a decline in the latter could very well usher in a descent in interest rates.

Annual Growth Rate of Leading Economic Indicators Suggests Weaker Future Economic Activity



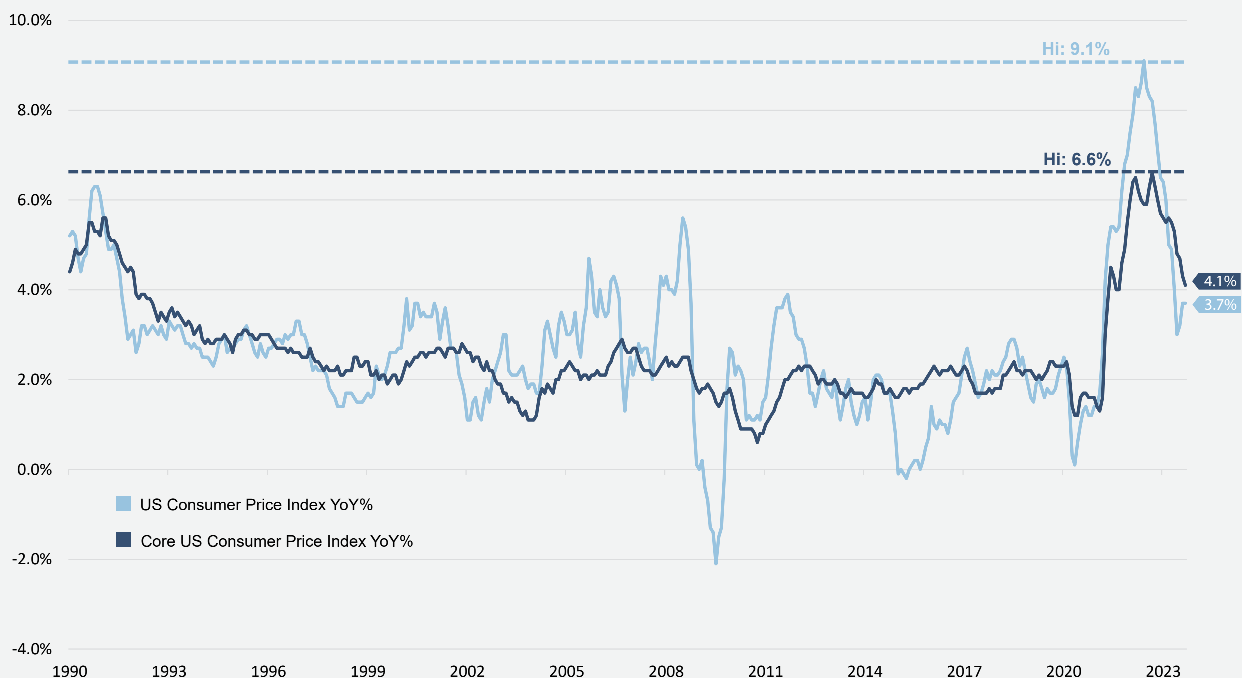
Source: Waterloo Capital, Bloomberg. Shaded gray bars denote recessions as determined by NBER.

The linchpin sustaining the observed growth this year has undeniably been the American consumer. However, household data presents a case that this strength may turn to weakness. The excess savings accumulated on household balance sheets have been rapidly diminishing as credit card usage surges. The mounting interest cost associated with credit cards, coupled with the resumption of student loan repayments, are poised to curtail discretionary spending and soften this key support for the economy. Lastly, we can draw upon the yield curve for guidance as it suggests the lower growth and lower inflation scenario in the future.

Disinflation: In response to the decades-high inflation experienced during the pandemic recovery, global central banks mounted in a concerted counteroffensive, ushering in a regime of higher rates. An eventual normalization in inflation would enable central bankers to pivot from their current restrictive stance towards neutral or even accommodative posture if the economy indeed slows. While inflation rates are yet to fully align with the targets set by most central banks, the tide seems to be turning in their favor. Both headline and core US Consumer Price Index (CPI) figures have substantially declined since their peak last summer. The core reading, which excludes volatile energy and food prices, has been more moderate, falling from a peak of 6.6% to 4.1%.

This trend could persist due to several factors: decreased demand from consumers and businesses, a relaxation of supply constraints that had driven prices higher, a deceleration in wage growth as evident in recent data, and the impending deflationary pressure within the housing market. The housing component of CPI represents nearly one third of the headline number. Historically, housing market prices have exhibited a delayed response, and their anticipated alignment with the broader disinflationary trend could bolster the shift toward lower CPI reads. If these dynamics materialize, inflation should trend towards more normalized levels, enabling central banks to ease their hawkish policies and, consequently, heralding a decline in yields.

Consumer Prices are Showing a Disinflationary Trend



Source: Waterloo Capital, Bloomberg

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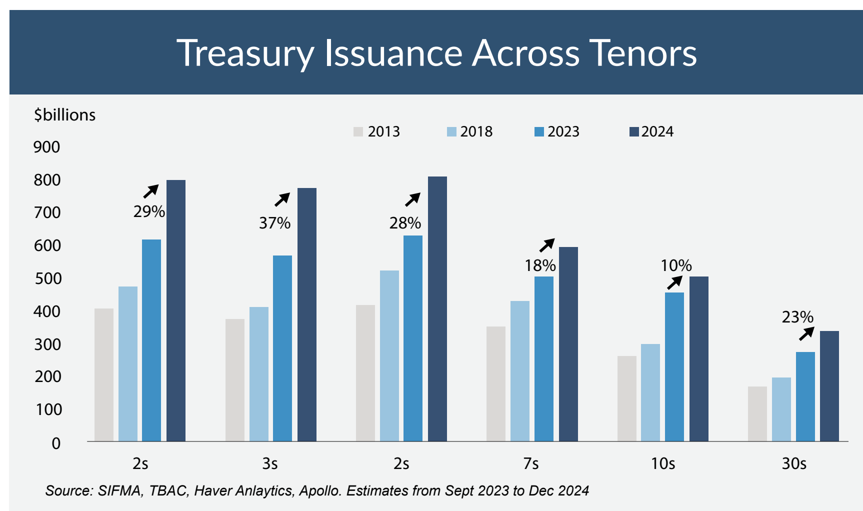
Why Rates May Rise – The Bear Case

Economic Resiliency and The Fed: In the US, we continue to demonstrate economic resiliency as hard data surprises to the upside. Models out of the Fed for GDP are forecasting promising growth, with consumers and businesses leveraging their savings to stimulate economic activity. Notably, the Atlanta Fed's GDPNow forecast projects 5+% growth for the third quarter. This is a significant leap from the 2.1% in the second quarter and is the highest in the past two years. The market had anticipated a sharper decline in economic indicators, which would justify lower yields. However, the slowdown is happening at a more moderate pace than previously expected.

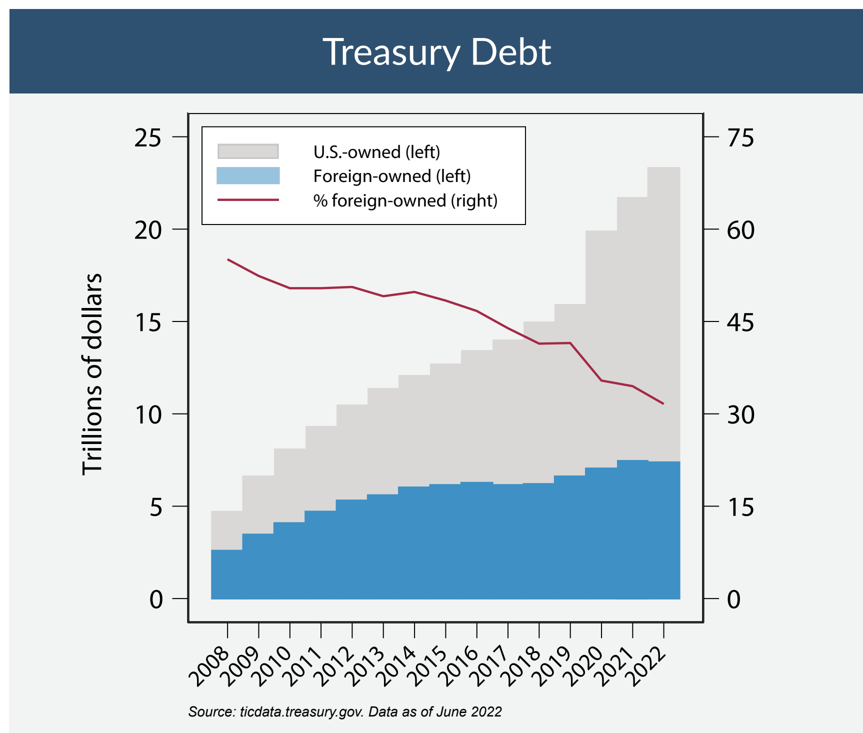
A reset is occurring and if the data remains robust, the Fed will keep rates higher for longer. Recent Fed communications, as reflected in their dot plots, suggest a commitment to a hawkish stance given the unexpectedly strong economic data. The Fed faces a conundrum in which a premature paring back of their hawkish rhetoric could inadvertently boost demand, leading to an inflation surge. This could, in turn, drive rates even higher.

Supply/Demand Dynamics: In response to the pandemic, governments worldwide, notwithstanding the US, rolled out substantial stimulus measures to bolster their economic recoveries. Such initiatives naturally result in increased cash outlays from the US Treasury. As the Treasury issues more bonds to fund these initiatives, it leads to a supply surge, which typically translates to higher interest rates.

Several factors such as evolving Demographics (HHS & SSA), aiding in war efforts (defense), and new legislation are prone to amplify the government's borrowing needs, add to the pace of new supply, and could push yields higher. At the same time, the supply/demand balance has been disrupted as foreign borrowers are decreasing their appetite for US bonds. If the major buyers of US bonds continue to decrease their demand, the upward pressure on rates could continue. Over the last decade, the percentage of foreign owned treasury debt has notably declined.



Source: SIFMA, TBAC, Haver Anlaytics, Apollo. Estimates from Sept 2023 to Dec 2024



Source: ticdata.treasury.gov. Data as of June 2022

Quantitative Tightening: During the GFC, under the leadership of Ben Bernanke, the Federal Reserve adopted an unconventional monetary strategy known as Quantitative Easing (QE). One of the objectives was to suppress yields, thereby fueling the economy to launch out of torment. For over a decade, QE was a key tool in the Fed's monetary policy yet, current dynamics prompted a shift to Quantitative Tightening in the past year plus. This shift involves the Fed reducing its vast holdings of Treasuries and mortgage-backed securities by approximately $75 billion each month with the intent to curtail excess cash reserves within the banking system. It's noteworthy that the Fed had previously attempted to implement QT in 2018, but faced significant challenges, particularly the urgent need to provide liquidity to stabilize the repo market. Lessons from this experience are fresh, and the Fed is treading with caution this time around.

A recent report detailing the Fed's open market operations revealed that reserves are currently at 12% of GDP. The Fed remains committed to its QT agenda, with plans to reduce this percentage to 10%, even if this coincides with broader economic deceleration. Such a firm stance could have implications, potentially exerting upward pressure on interest rates and elevating the bond term premium which is an additional yield that investors require for longer-term lending. Bill Dudley, the former president of the New York Fed, recently offered a perspective on the timeline of these potential effects. He postulates that if QT continues at its current pace without interruptions, the upward pressure on interest rates might persist until 2025.

Clear Opportunity or Mirage?

The debate is fueled by a plethora of compelling arguments on either side, yet one undeniable truth is that the past three years have tested the resilience of the asset class and the resolve of its investors. To get a better understanding of where we sit, we highlight the estimated returns for the next 12 months across various tenors, based on potential yield scenarios.

It's important to highlight that this analysis, while insightful, doesn't capture the opportunity cost linked to holding shorter-term bonds. Investors have the potential to reap 5+% over a 12-month span, while remaining cushioned from volatile price movements due to longer duration maturities.

Bond's Risk/Return

Estimate of 12 Month Total Return Based on Yield Changes

yield change/maturity	2YR	5YR	10YR	30YR
-1.50%	8.0%	11.4%	16.8%	28.9%
-1.0%	7.0%	9.3%	12.8%	20.9%
-0.50%	6.1%	7.1%	8.8%	12.9%
No change	5.2%	4.9%	4.9%	4.9%
+0.5%	4.3%	2.7%	0.9%	-3.0%
+1.0%	3.4%	0.5%	-3.1%	-11.0%
+1.5%	2.5%	-1.6%	-7.0%	-19.0%

source: Waterloo Capital, Bloomberg. Table uses duration and chg of yield, does not account for convexity. As of Oct 2023.

At Waterloo, we tactically manage our portfolios' interest rate sensitivity, adapting to prevailing market conditions. Given the uncertain outlook on rates, we remain substantially underweight interest rate risk, allowing us to capture elevated rates at the front of the yield curve while prudently managing the potential upside risks outlined in this discussion. That being said, we are in the early stages of gradually normalizing our duration exposure given the significant run up in rates and a more balanced assessment of both the potential for rates to rise or fall. Should we observe either of the two scenarios presented materializing, we are prepared to adjust our bond allocations to benefit from the resulting environment. As we gaze into the future, the intricate dynamics of the bond market will inevitably unfold, and we anticipate shedding additional light on this in our 2024 Market Outlook.

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