Allspring

Don't Wait for Goldilocks

Riding the Curve in fixed income

KEY TAKEAWAYS:

+ **Prepare for different outcomes.** Fixed income markets remain unsettled. Taking a measured approach to allocating across the yield curve, or "Riding the Curve," may help investors enhance the ballast of their portfolios and position for different economic environments and outcomes.
+ **Diversify duration exposures.** Yield curves have steepened recently, bringing longer-maturity yields more in line with those found on the front end of the curve—offering an attractive entry point for adding duration across the yield curve.
+ **Don't wait.** The opportunity cost for investors waiting for a "Goldilocks moment" to add duration has risen of late. In prior periods, those who waited to increase duration significantly underperformed those who diversified.

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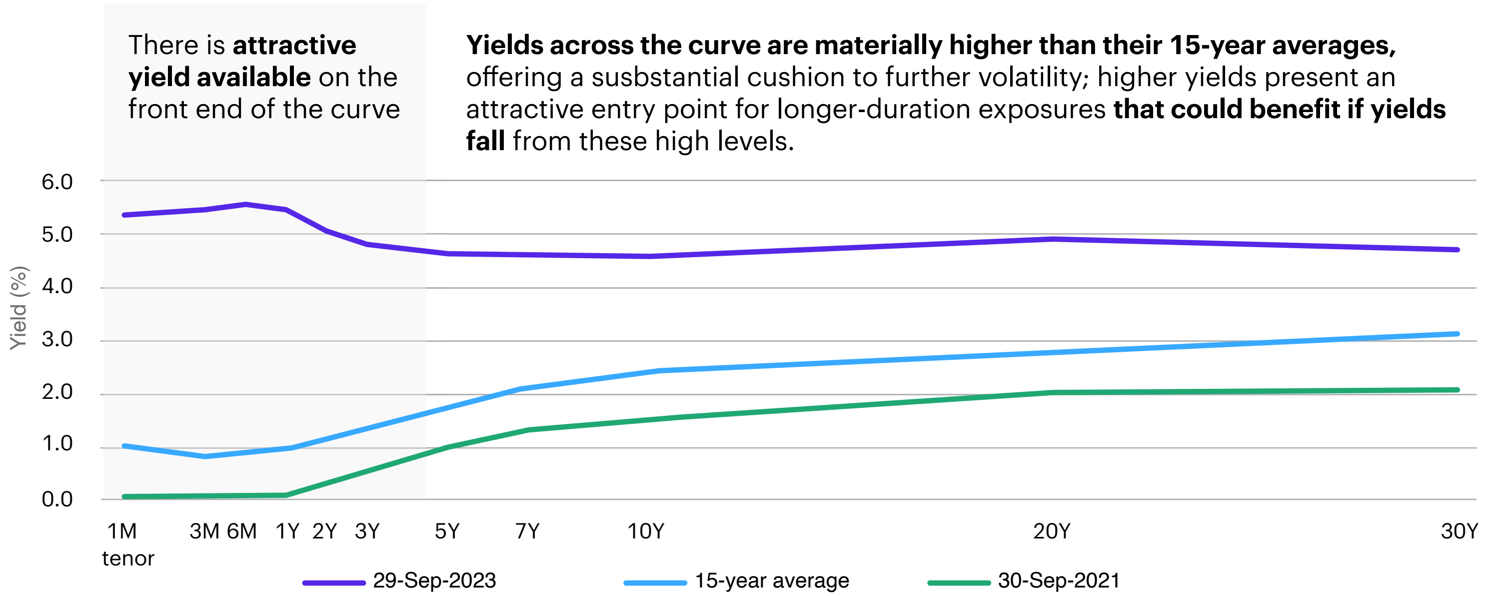
Preparing for a range of outcomes

Investors face a highly uncertain future. We believe this requires preparation for a range of outcomes rather than placing a single "bet" on a shift to a specific set of conditions. We see value in adding a broad mix of duration exposure, or "Riding the Curve" to prepare for a wide range of possible outcomes at this point in the economic cycle. Creating a more diversified portfolio ballast through adding duration in small increments along the yield curve may offer a better approach than solely targeting the long end of the curve.

Yields are currently at multiple-year highs across the yield curve. For example, yields at the front end of the yield curve are at their highest point in over 20 years. Nearly every spot along the curve is at the highest point in more than 15 years and well above its 15-year average (Exhibit 1). This higher level of income forms the basis for the total returns bond portfolios may generate over the coming years and may leave bond investors in a more advantageous position than nearly any time since the Global Financial Crisis.

EXHIBIT 1: RIDING THE CURVE OFFERS SEVERAL ADVANTAGES



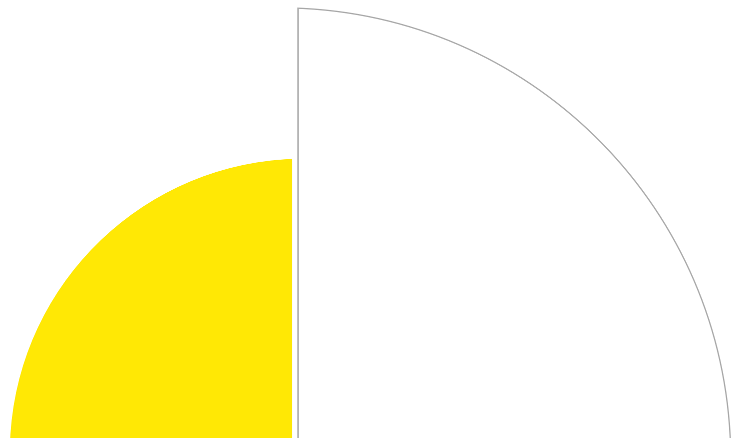
Source: Bloomberg L.P. As of 29-Sep-23.

By diversifying exposures across the yield curve, investors can position for different economic outcomes. If yields decline and the yield curve normalizes, then bond prices would rise, helping boost total returns. However, if bond yields were to rise, then current yields would likely provide a significant "volatility cushion" against lower bond prices (Exhibit 2).

EXHIBIT 2: CURRENT YIELDS PROVIDE A GENEROUS BUFFER AGAINST FUTURE VOLATILITY

	Short duration	U.S. Aggregate	Municipal
Yield breakeven[1] (basis points)	**302**	**89**	**68**
Last time yield breakeven was this high	2007	2009	2000

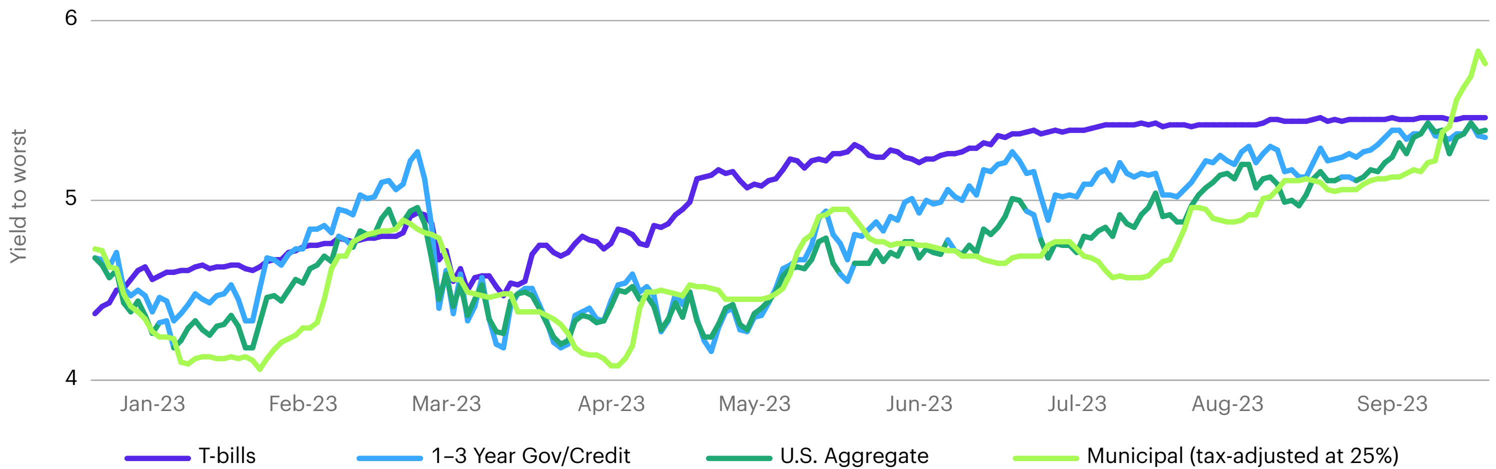
Source: Bloomberg. 1. Yield breakeven = amount yields can rise (in bps) without generating a negative total return over a one-year holding period. Short duration = Bloomberg 1–3 Year Gov/Credit (LGC3TRUU Index), U.S. Aggregate = Bloomberg U.S. Aggregate (LBUSTRUU Index), Municipal = Bloomberg Municipal (LMBITR Index). As of 29-Sep-23.



The falling opportunity cost of diversifying across a steepened yield curve

Making a significant shift in portfolio duration at the optimal time can be very difficult, and making such a move during a period of economic stress can be even more challenging. Allocating across duration exposures may offer a better approach where there can be diversification and return benefits as the curve normalizes. It may also help reduce the inertia that can lead to suboptimal investment returns. As yield curves have steepened recently, longer-maturity yields are now more in line with those found on the front end of the curve. This has reduced the relative yield cost investors may be willing to give up to diversify their duration exposures (Exhibit 3), creating a potentially compelling entry point. Curve steepening has also occurred in the municipal bond market, offering investors the opportunity to capture the highest tax-exempt yields since 2009.

EXHIBIT 3: LOWER COST OF DIVERSIFICATION



Source: Bloomberg. T-bills = Bloomberg U.S. Treasury Bills (LD20TRUU Index), 1–3 Year Gov/Credit = Bloomberg 1–3 Year Gov/Credit (LGC3TRUU Index), U.S. Aggregate = Bloomberg U.S. Aggregate (LBUSTRUU Index), Municipal = Bloomberg Municipal (LMBITR Index). Municipal yield to worst is adjusted for 25% federal tax rate. As of 29-Sep-23.

The rising opportunity cost of waiting for Goldilocks

Attempting to time the market is always difficult, and the inflection points that offer the optimal catalyst for change are often best identified in the rearview mirror. In prior periods of monetary policy transition, investors who waited for a "Goldilocks moment" to make a substantial shift in their duration positioning incurred significant opportunity costs and realized returns approximately 58% lower on average than those with a diversified duration portfolio during the period of transition (Exhibit 4). Data also shows that industry-wide money market fund (MMF) assets continued to climb during these periods even as the Federal Reserve (Fed) cut rates (Exhibit 4).

EXHIBIT 4: RETURNS DURING TRANSITIONARY PERIODS IN MONETARY POLICY

Transitionary period[1] in monetary policy	31-Oct-94 to 31-Jan-96	20-Jan-00 to 25-Jun-03	28-Jun-06 to 16-Dec-08	05-Oct-18 to 16-Mar-20
Total returns for cash-only[2] investors (%)	7.38	14.01	11.27	3.73
Total returns for diversified investors[3] (%)	16.91	32.62	20.88	13.48
Opportunity cost (return difference) for cash-only investors	**56% less**	**57% less**	**46% less**	**72% less**
Growth in MMF assets while the Fed was cutting the federal funds rate	11%	9%	34%	29%

Sources: Allspring, iMoneyNet, and Bloomberg L.P. Data as of 29-Sep-23. 1. Transitionary period = peak of 10-year U.S. Treasury yield until last cut to the federal funds rate for the period. 2. Cash-only investors are represented by the Bloomberg U.S. Treasury Bills 3–6 Month (LD21TRUU Index). 3. Diversified investors are represented by an allocation of 25% portfolio value in each of the following four indexes: Bloomberg U.S. Treasury Bills 3–6 Month (LD21TRUU Index), Bloomberg U.S. 1–3 Year Gov/Credit (LGC3TRUU Index), Bloomberg U.S. Aggregate (LBUSTRUU Index), and ICE BofA Current 10-Year Treasury (GA10 Index).

Potential benefits of **"Riding the Curve"**

Preparing your portfolio for a broader range of outcomes. A "soft landing" scenario has become more widely accepted by investors throughout 2023, but history tells us that monetary policy cycles often meet a more abrupt end and the benefit of being prepared ahead of time for bond investors can be significant.

Diversifying your exposures. By staking positions across the yield curve, investors can diversify their portfolio and may increase the number of environments in which the portfolio can thrive.

Increasing the volatility buffer afforded through positive real yields. Yield and credit spread volatility may persist as the impact of higher rates flows through the economy. Yield breakeven points are high across the curve, affording investors the biggest cushion for volatility in more than 15 years.

For further information

We want to help clients build for successful outcomes, defend portfolios against uncertainty, and create long-term financial well-being. To learn more, investment professionals can contact us.

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