Riding the Curve: Beyond Goldilocks

+ The "Goldilocks moment" has arrived—use it as an opportunity to "ride the curve."
+ Bond investors should consider diversifying duration to position along the curve.
+ Curve opportunities exist at different maturity points and different levels of credit risk.

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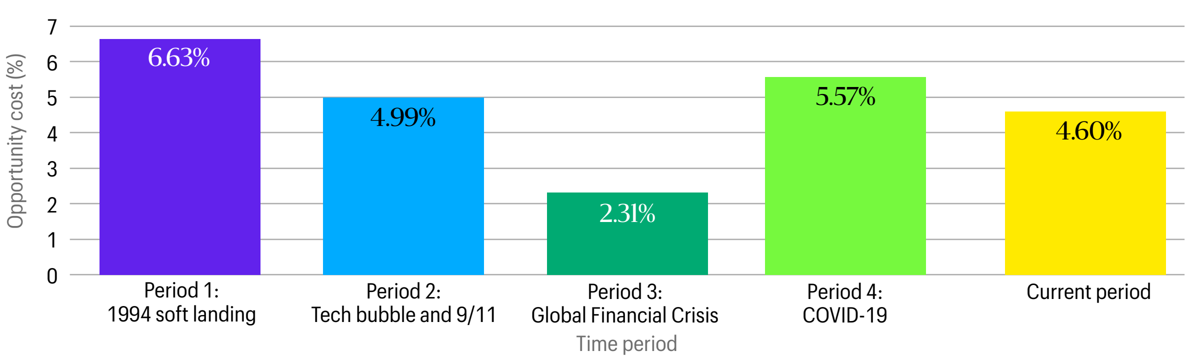
The much-anticipated "Goldilocks moment," when policymakers pivot toward an easier stance, has arrived. We believe bond investors should start to position portfolios for the next phase of the cycle, which is typically categorized by easier monetary policy, lower yields, steeper yield curves, and more volatile credit spreads. Diversified duration and a mix of credit allocations could position portfolios for capturing total and excess returns.

In December 2023, the U.S. Federal Reserve (Fed) confirmed that it had finally reached the terminal federal funds rate and did not expect any further interest rate hikes in its fight against inflation. The relief rally that ensued caused rates to fall meaningfully, resulting in a substantial boost for fixed income investors with diversified duration exposures. Investors concentrated in cash or on the very front end of the yield curve, however, underperformed longer-duration allocations. In fact, cash-only investors realized returns approximately **80% lower** than those of diversified fixed income investors since the peak in the U.S. 10-year Treasury bond yield in October 2023 (Exhibit 1). This underscores the importance of duration diversification when monetary policymakers pivot to easier policy.

EXHIBIT 1: CASH-ONLY INVESTORS HAVE REALIZED THE OPPORTUNITY COSTS OF "WAITING FOR GOLDILOCKS"

Opportunity cost: Total return of diversified portfolio less total return of 3- to 6-month T-bills



Past performance is no guarantee of future results.

Sources: Bloomberg Finance L.P. and ICE BofA, as of 29-Dec-23. 3- to 6-month T-bills = Bloomberg U.S. 3–6 Month Treasury Bill Index (LD21TRUU Index), 1- to 3-year gov/credit = Bloomberg U.S. 1–3 Year Gov/Credit Index (LGC3TRUU Index), U.S. aggregate = Bloomberg U.S. Aggregate Bond Index (LBUSTRUU Index), 10-year Treasury = ICE BofA Current 10-Year Treasury Index (GA10 Index), diversified portfolio = represents 25% in each of the four indexes above. Total returns displayed for the Waiting for Goldilocks period = peak of 10-year U.S. Treasury yield until first cut to the federal funds rate. Current period = 19-Oct-23 to 29-Dec-23.

Should the Fed follow its forecast and cut interest rates in 2024, the total return potential for money market funds and other cash-like products will fall. However, for investors who have allocations along the yield curve, we anticipate yields in their portfolios to remain higher for longer given the expected outsized impact on the front end of the yield curve from Fed policy. Those with diversified duration exposure in their portfolios would be positioned to benefit from a total return perspective as yields fall and prices rise.

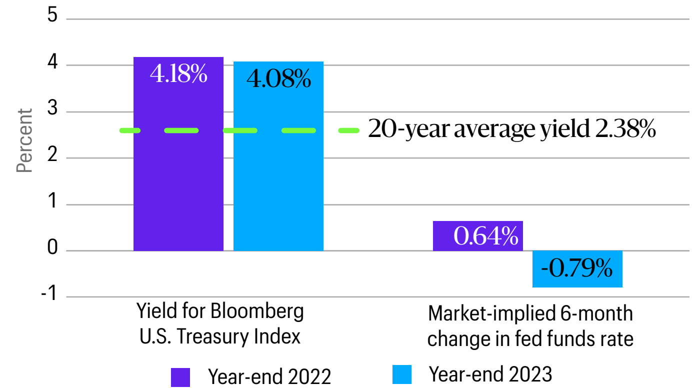
The entry point remains attractive

Investors who were waiting on the sidelines have incurred some of the opportunity costs of waiting for Goldilocks. The rally at the end of 2023 prompted yields to fall across the yield curve, resulting in stronger total returns for investors with broad duration exposure in their portfolios. The drop in yields was significant. However, it simply brought yields back to where they were just a few months prior. For context, the last time yields were at these levels was 15 years ago in 2008. In other words, even after this recent decline, yields remain more attractive today than they have in years.

Interestingly, despite the broad swings that were experienced in 2023, yields closed the year remarkably close to where they began. For example, the yield to worst on the Bloomberg U.S. Treasury Index finished 2023 just 10 basis points (bps; 100 bps equal 1.00%) below where it had started, still well above its long-term average (Exhibit 2).

While yields experienced limited year-over-year change, the outlook for fixed income investors changed substantially. In early 2023, markets were pricing several additional rate hikes by the Fed. Now, in early 2024, market participants have expressed confidence that the Fed has completed its hiking cycle and is likely to begin cutting rates, providing a tailwind for bond investors.

EXHIBIT 2: THE FED HEADWIND SHOULD BECOME A TAILWIND IN 2024



Past performance is no guarantee of future results.
Source: Bloomberg Finance L.P. Yield to worst for the Bloomberg U.S. Treasury Index and market-implied change for the Effective Federal Funds Rate. As of 29-Dec-23.

A time to diversify duration

In our opinion, this is not the time to simply "go long duration." We still see this environment as one in which investors would benefit from "riding the curve" or diversifying their duration exposure. Fed policy maintains greater influence over rates at the very front end of the yield curve while market forces and a variety of global economic factors typically drive longer-maturity yields. The second half of 2023 saw rates further out on the yield curve rising more than the front end for several reasons, all of which remain as possible pressures keeping the longer end of the curve steady or causing yields to bounce modestly higher than current levels in 2024.

Move beyond Goldilocks and "ride the curve"

The Fed has reached an important milestone in its monetary policy efforts by pivoting from raising rates to holding them steady with the expectation that it will begin easing policy in 2024. We believe a diversified approach across the curve would allow investors to capture attractive levels of income, build resiliency into their portfolios, be better prepared for a wider range of economic outcomes, and benefit from anticipated lower rates. We believe this is a suitable time to consider moving beyond waiting for Goldilocks and ride the curve.

For further information

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Index Definitions:

The Bloomberg U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment-grade, U.S.-dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, mortgage-backed securities (agency fixed-rate and hybrid adjustable-rate mortgage pass-throughs), asset-backed securities, and commercial mortgage-backed securities. You cannot invest directly in an index.

The Bloomberg 3-6 Month U.S. Treasury Bill Index is designed to measure the performance of public obligations of the U.S. Treasury that have a remaining maturity of 3-6 months. You cannot invest directly in an index.

The Bloomberg U.S. 1–3 Year Gov/Credit Index includes all medium and larger issues of U.S. government, investment-grade corporate, and investment-grade international dollar-denominated bonds that have maturities of between 1 and 3 years. You cannot invest directly in an index.

The ICE BofA Current 10-Year Treasury Index is designed to measure the performance of U.S. dollar-denominated, 10-year Treasury securities. You cannot invest directly in an index.