Caron's Corner Transcript – 8.7.2023

An Age-Old Question: Can the Market Handle Higher Bond Yields?

- One would think that as we near the end of the Fed rate hiking cycle that bond yields would be falling steadily, so, why isn't this so?
- We believe it's because the end of the policy hiking cycle does not mean the Fed will start cutting rates right away.
- Yields can no longer be relied upon to trend lower like they did for the past 40 years .
- Investors, not just in fixed income, need to realize bond returns may not be the stable and steady anchor to volatility as they once were in the traditional, passive 60/40 equity/bond allocation.
- Our goal has been to control for risk across our asset allocation strategy between fixed income and equities, and this remains the case today.

Jim Caron: Hello, this is Jim Caron, Co-CIO of the Global Balanced and Risk Control strategies. Last week was pretty significant in the sense that we started to see a movement higher in bond yields. And it raises that age-old question, "can the market handle higher bond yields?" The answer is that it really depends on why yields are rising. If the Fed is hiking excessively to create a recession, then the answer is no. But, if rates are rising, but not overly restrictive, then the answer is yes, that valuations and sector selection possibly do matter.

Yields are in fact rising. The U.S. 10-year Treasury did reach about 4.18% last week, approaching that ever important technical level of 4.25% which was the high reached on October of 2022. But that by itself is actually not all that interesting. What I did find interesting was that you have to go all the way back to the pre-global-financial-crisis period of 2007 – 2008, specifically June of 2008, to find the last time the U.S. 10-year exceeded 4.25%. This level is quite important to the market psyche about rising yield risks, and something we really need to focus on. What's most significant about the possibility of breaking above 4.25% in the U.S. 10-year yield is that it emblematically puts the final "nail in the coffin" and marks a symbolic end to an era of low yields. Of course bond yields are going to fluctuate, much like the economy, but the key takeaway is that yields can no longer be relied upon to trend lower like they did for the 40 years from 1981 to 2021. When thinking broadly about asset allocation, investors need to adjust and realize that bond returns may not be the stable and steady anchor to one's portfolio that they once were, especially in a traditional 60 equity/40 bonds allocation. So let's get into it.

Why are bond yields rising now? One would think that as we near the end of the Fed rate hiking cycle, that bond yields would actually be falling steadily. So why isn't this the case? We think it's because the end of the policy cycle doesn't necessarily mean that the Fed will immediately start cutting when the Fed rate hiking cycle ends. Bond yields are starting to price the following, and there are 4 things to be aware of: 1) The Fed may keep rates higher for longer, 2) The market is starting to really embrace and price a soft landing, 3) By definition, this significantly reduces the odds of a hard landing, and 4) as I always like to say, time is money, in the sense that owning lower-yielding, long-duration bonds is not

only an expensive hedge for recession, but it may not be a sure thing anymore. Meaning that bond yields may not start to come down very aggressively on the back end. Many might have thought that that was more of a sure thing and that might not necessarily be the case currently. We have to also take into account that the initial conditions matter and that longer-term bond yields have been very low and that the yield curve is also very inverted as part of these initial conditions, meaning that we've had a very low term premia on the yield curve. These initial conditions may now become a precondition to support a rise in longer-term yields. Let me explain.

If we look at the yield curve, defined in this case as the difference between the U.S. 10-year Treasury yield and the U.S. 2-year Treasury, aka the 2s/10s curve, it's inverted by about 73 basis points at the moment. Now let's say, for example, that the 2s/10s dis-inverts, to flat or zero basis points, then that would mean that the U.S. 10-year yield could actually rise 70 basis points from these current levels. If just the yield curve shape went from inverted to flat, that would emblematically mean that you would likely get a movement higher in 10-year yields, as long as the 2-year yield stayed relatively unchanged and the Fed wasn't moving policy. It's not unreasonable and this is not an insignificant risk.

Now, we're not calling for that. We are not making a forecast that 10-year yields are going to rise 70 basis points. We are just asking “what if the yield curve actually started to steepen and got to zero to flat?” That could actually mean that 10-year Treasury could start to move higher and it's not an insignificant risk. The reason why the curve has been so inverted is because investors have been willing to buy lower-yielding bonds for the benefit of increasing duration exposure in their portfolios, against what was a consensus view for a recession and harder landing. Now that the hard landing risks are receding, it makes mathematical sense that investors are less willing to pay up for that hedge of owning long-duration bonds. In fact, if we are in an inflationary environment – and I think we are - meaning that 2% inflation is no longer the ceiling but the floor and we're in a range of 2 - 4% inflation for the longer term. In this case then long-duration may actually increase risk in an asset allocation as opposed to reducing it. We need to think of this as a possibility and incorporate it into our asset allocation and risk decisions. This is what the market is doing right now and explains why yields haven't trended lower.

Now let's talk a about allocating assets in this environment. If higher yields are a headwind to growth equity sectors, then being underweight duration is a reasonable hedge to consider. We agree with this and have preferred to stay underweight duration relative to the index all year. Our target duration is about 3 years, shorter than the 5 - 7 years reflected by the index. In fact, owning high-quality, short-duration and money markets have been a good source of income - and I should really emphasize this - even out-yielding longer-duration bonds.

We have discussed this many times. This is our barbell strategy to own high-quality, short-duration assets alongside higher-yielding, high-yield credit, asset-backed securities and emerging markets for our bond allocation. For equities we like owning more value-sector oriented strategies as we think they will benefit in the non-hard-landing scenario, especially as the breadth of the market starts to widen, which we think it will. Additionally, holding some tech and growth sectors in a good balance also makes sense as we are not dismissing that sector of the market. We just want to have the right balance. Our goal has

been to control the risks across our asset allocation strategy between fixed income and equities and this remains still the case today.

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CRC 5856290 Exp. 8/31/2024