TREASURY | PARTNERS

Client Update:
Heading Closer to Rock Bottom

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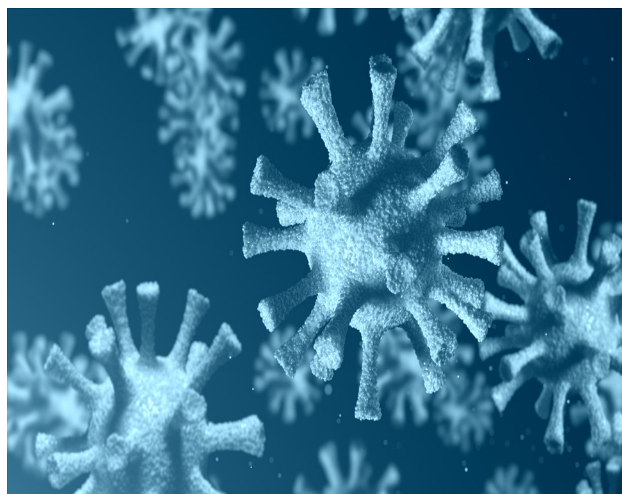
Alert: Heading Closer to Rock Bottom

A New Stage in the Declining Rate Environment

Longtime readers know that in August 2019 ("When the World Turns Upside-Down: Positioning Portfolios During a Bond Bubble", 8/20/19) and earlier this year ("2019 Review and 2020 Outlook: Go With the (Liquidity) Flow", 1/8/20) we emphasized our increasing concern of falling interest rates. Our rationale was simple: the combination of an elevated global debt burden and the apparent inability of central banks to raise rates without smothering economic growth foretold the next major move in rates could be lower despite their already-low levels.

We also pointed out how the overhang of trillions of dollars' worth of negative-yielding overseas debt is impacting US rates, as increased foreign demand for still-positive American debt raised the prices of domestic bonds and suppressed their yields.

That was our longer term, base case for rates.



Enter the Coronavirus. Over the past couple of weeks, mounting fear of a pandemic has triggered a significant downward shift in rates (and a global stock market selloff). Markets are concerned that the virus will lead to severely reduced economic activity.

Along with growing anxiety that the worst is yet to come, these worries are behind the "flight to safety" in bonds, leading to lower rates.

Current Environment

In the last 6 months, Treasury rates have dropped 15 to 40 basis points ("bps"), with the largest decreases in shorter-term maturities.

Maturity	Treasury Yield as of 2/28/20	Treasury Yield as of 8/30/19	Change
1 Year	1.00%	1.76%	-0.76%
2 Year	0.90%	1.51%	-0.61%
3 Year	0.90%	1.43%	-0.53%
5 Year	0.96%	1.39%	-0.43%
10 Year	1.17%	1.50%	-0.33%
30 Year	1.69%	1.96%	-0.27%

Source: Bloomberg

The change is far more significant over the past 1.5 years. Back in mid-2018, market sentiment was markedly different than today as the Fed was tightening and rates were higher. We've now made a 180-degree turn – rates across the curve seem to be sprinting back to zero, with all maturities except the 30 Year Treasury shedding over half of their previous yields. Amazingly, in the case of 10 and 30 year yields, they've breached their *all-time lows.*

Maturity	Treasury Yield as of 2/28/20	Treasury Yield as of 8/30/18	Change
1 Year	1.00%	2.45%	-1.45%
2 Year	0.90%	2.63%	-1.73%
3 Year	0.90%	2.69%	-1.79%
5 Year	0.96%	2.74%	-1.78%
10 Year	1.17%	2.86%	-1.69%
30 Year	1.69%	3.02%	-1.33%

Source: Bloomberg

Corporate and municipal bond yields have experienced similar declines. Both A-rated corporate and municipal rates have declined dramatically and are also setting absolute all-time lows in certain maturities.

Maturity	A-Rated Benchmark Tax-Exempt Muni Yield as of 2/27/20	A-Rated Benchmark Corporate Yield as of 2/27/20
3 Year	0.96%	1.50%
5 Year	1.03%	1.69%
10 Year	1.34%	2.21%
30 Year	1.81%	2.97%

Source: Bloomberg / Bloomberg BVAL Indices

Avoiding Mistakes

The implications of the current rate environment are rather extreme as the risks are asymmetrical. Consider what happens to the price of a bond bought at today's yields if market rates subsequently rise 0.50-1.00%. All else equal, longer-dated bonds have a higher duration (their price is more sensitive to changes in market rates), and prices and yields have an inverse relationship – rising yields mean falling prices, and vice versa.

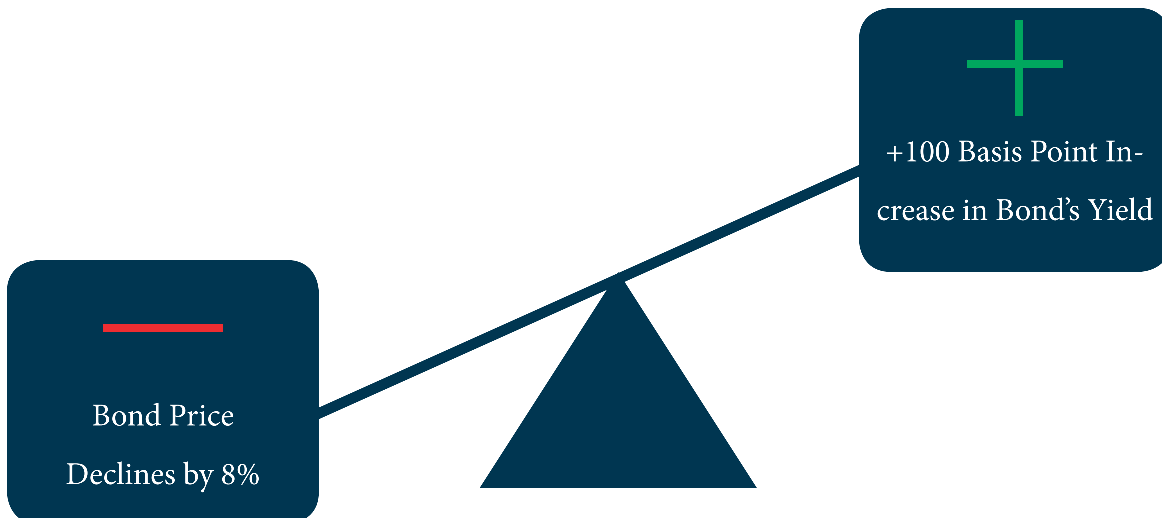
Holders of longer bonds will suffer the most and minor yield spikes could lead to a price drop that wipes out several years' worth of interest income.

Maturity	Yield	Estimated Duration
5 Year	1.03%	4.25
10 Year	1.34%	8
30 Year	1.81	11.5

If Rates Rise	Price Loss Incurred	Years of Lost Income Return
5 Year		
+0.50%	-2.1%	2 Years
+1.00%	-4.25%	4 Years
10 Year		
+0.50%	-4%	3 Years
+1.00%	-8%	6 Years
30 Year		
+0.50%	-5.75%	3.2 Years
+1.00%	-11.5%	6.4 Years

Source: Bloomberg / Treasury Partners Estimates

For example, consider a 10 year bond which currently yields 1.34%. An investor who buys the bond at this level and subsequently experiences a +1.00% increase in market rates (i.e. to the levels we last saw in April 2019) will see that bond's price drop by 8%. An 8% drop in price causes enough damage to wipe out the equivalent of 6 years' worth of that bond's income return.



Conclusion

Given our rate outlook heading into 2020 and where we've already positioned portfolios, we seriously considered adding long-term (30 year) zero-coupon bonds to protect against falling rates. As it turns out, this would have been a timely move, as the recent drop in market yields would have driven the price of such bonds significantly higher. This would have significantly boosted our portfolio total returns.

However, our primary responsibility is to protect your wealth, especially with the safe fixed income assets. When viewed in this context, it's clear that buying the zeroes would have been a form of speculative protection and outside our core mandate. We therefore elected not to add this type of protection against falling rates.

We remain very concerned with the significant negative impact of ultra-low interest rates will have on our clients' lifestyles and financial goals. Although this is a major challenge without an easy answer, the solution doesn't involve reaching for yield irrespective of risk.

As a result, our strategy has been to add intermediate maturity corporate bonds with attractive spreads over Treasuries and shorter-dated municipal bonds, while maintaining existing longer-term positions. While the absolute level of yields in such purchases is unsatisfying, they provide a minimal baseline of income without taking on added price risk.

After a decade of excellent equity returns and declining interest rates, the investment climate is sure to become more challenging. We remain very focused and are immensely grateful for the trust and confidence you place in us. Feel free to reach out to discuss how these trends affect your individual portfolio.

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