Fixed Income

On February 4, 1994, the Federal Reserve initiated its first interest rate hike in five years, increasing the federal funds rate by 25 basis points from 3.0%. Over the next year the Committee would hike another six times taking the policy rate to 6.0% and setting off what would become known as the "Great Bond Massacre."

Parallels are being drawn to today as the Fed's 75 basis point hike in June was the largest since November 1994, and, following the most recent meeting in September, the Committee has now increased rates by 300 basis points in the latest hiking cycle.

Simpler Times for Fed Watchers

Federal Reserve Release

Press Release

Release Date: February 4, 1994

For immediate release

Chairman Alan Greenspan announced today that the Federal Open Market Committee decided to increase slightly the degree of pressure on reserve positions. The action is expected to be associated with a small increase in short-term money market interest rates.

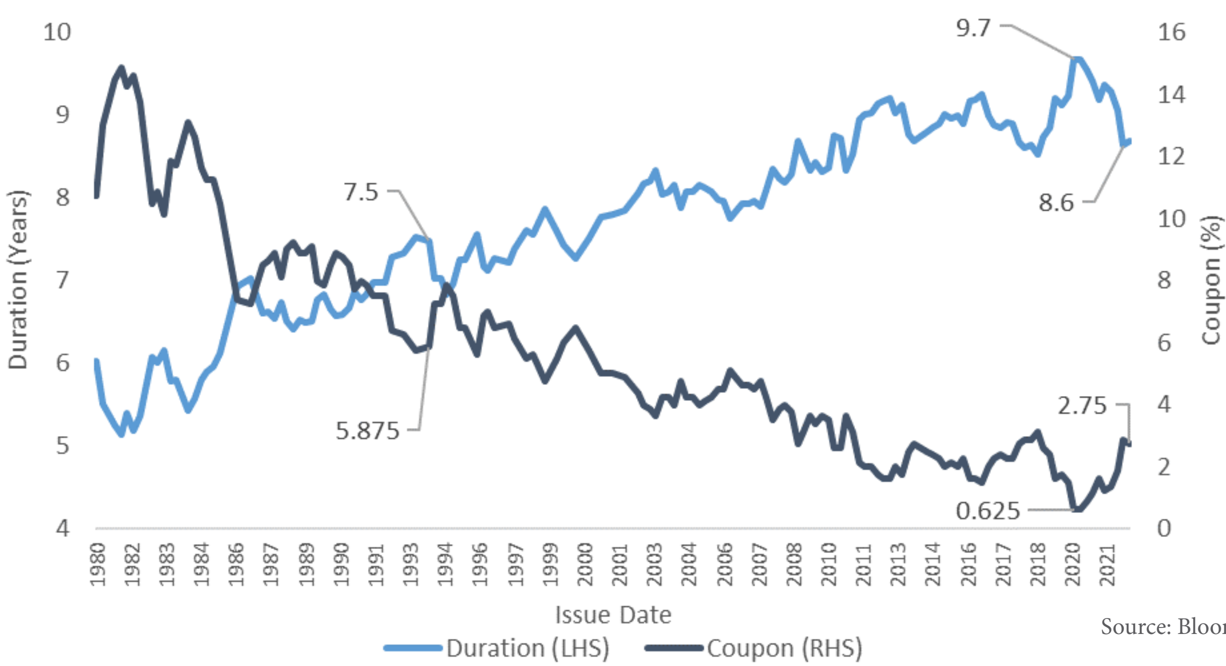
The decision was taken to move toward a less accommodative stance in monetary policy in order to sustain and enhance the economic expansion.

Chairman Greenspan decided to announce this action immediately so as to avoid any misunderstanding of the Committee's purposes, given the fact that this is the first firming of reserve market conditions by the Committee since early 1989.

Source: Federal Reserve

If that was a "massacre," what should we be calling 2022? During the 1994 hiking cycle, the US Aggregate Bond Index declined -2.0% and 10-year Treasuries lost -6.8%, while the S&P 500 Index eked out a small gain. Compare that to the year-to-date performance of these indices through September – the US Aggregate Bond Index is down -14.6% and holders of 10-year Treasuries have lost -16.7%, while the S&P 500 Index has tumbled -23.9%. The difference between these two periods? The starting point in rates (2022: 0.25% and 1994: 3.00%) and inflation (2022: 8.6% and 1994: 2.5%).

Characteristics of 10 Year Treasury Bonds at Issuance

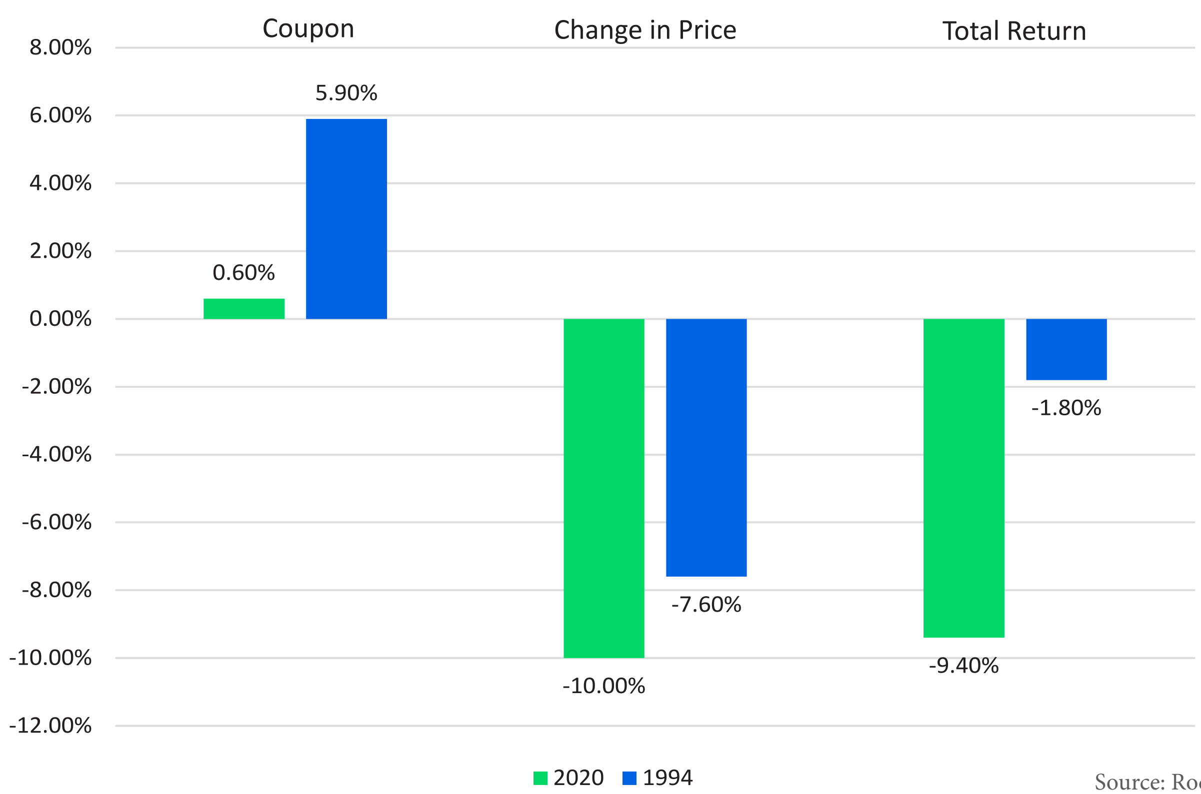


Source: Bloomberg

The duration of a bond is dependent on its maturity and periodic coupon payments. As a result, the interest rate sensitivity of a 10-year Treasury at issuance has grown as rates have declined steadily since 1994.

The starting point in rates is important as a bond issued in 1994 is significantly different than one issued in 2022 – even risk-free Treasuries of the same maturity. Shortly after the Fed's first rate hike in February 1994, the Treasury issued a 10-year note with a coupon of 5⅞ percent versus the ⅝ percent coupon 10-year notes issued in mid-2020. And because of the coupon differential, the interest rate duration of these bonds differed by approximately 2.2 years (7.5 years versus 9.7 years), i.e., the price of the bond issued in 2020 is much more sensitive to a change in rates. To illustrate – if the yield on 10-year bond increases 100 basis points during the year after issuance, a bond paying the 5⅞ percent coupon will have a total return of -1.8% versus -9.4% for the ⅝ percent coupon bond.

Hypothetical 1-Year Total Return of 10-Year Bond on 1% Rise in Yield



Source: RockCreek

The duration of a bond is dependent on its maturity and periodic coupon payments. As a result, the interest rate sensitivity of a 10-year Treasury at issuance has grown as rates have declined steadily since 1994.

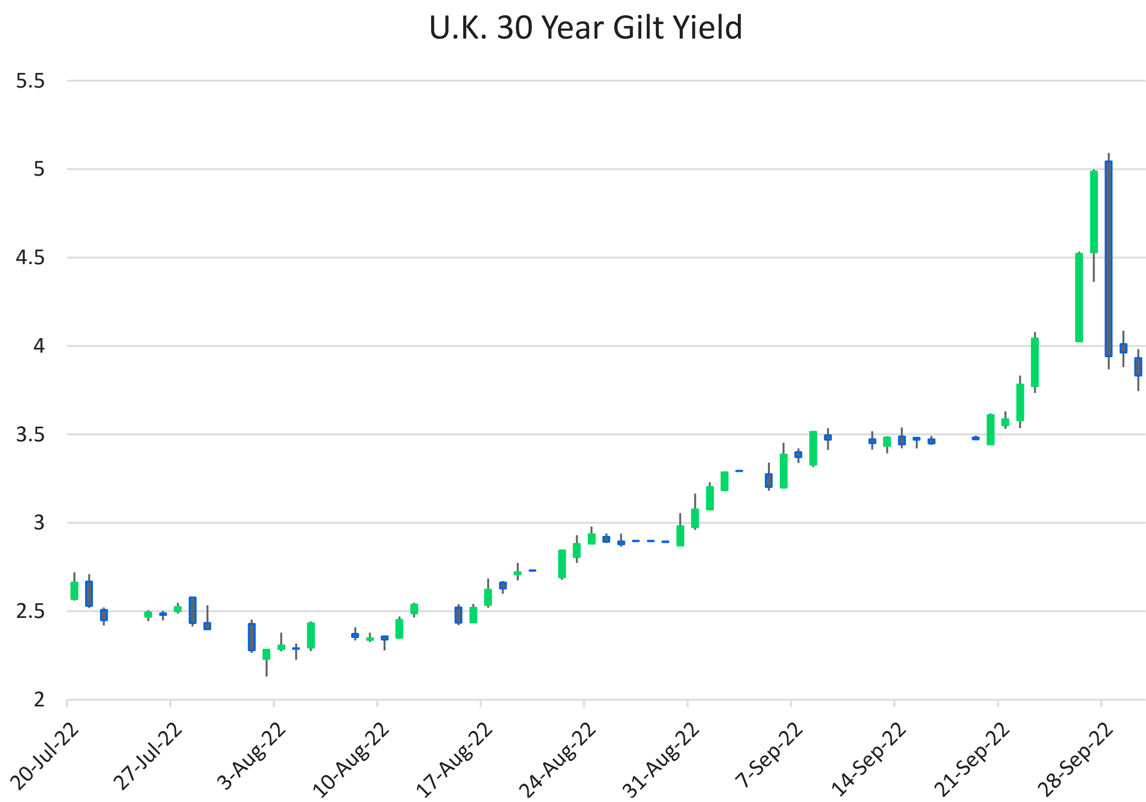
When the Treasury issues its next batch of 10-year notes in November, the coupon is likely to be in the 3½ to 4 percent range and with the fed funds rate on its way to 4%, the 1994 scenario may now be more instructive of go forward risks to fixed income than a parallel to 2022.

As is illustrated above, the risks are much more symmetric as compared to a year or two ago when the base rate was sitting near zero. TINA - “There Are No Alternatives” - no longer applies with TARA - “There Are Reasonable Alternatives” – recently being introduced to the financial nomenclature. With real yields near 2% and nominal yields on short- to intermediate-term Treasuries exceeding 4%, investors should be rethinking cash management as well as their risk tolerance in relation to these higher risk-free yields.

The Bloomberg U.S. Aggregate Bond Index declined -4.8% during the quarter as sharply higher real rates drove performance, not just for bonds but most other financial assets. The 10-year real yield jumped 103 bps to 1.68% because the Fed and other global central banks continued to hammer home their commitment to squash inflation through tighter monetary policy without a hint of letup. Breakeven inflation rates contracted to 2.15% as the 10-year nominal yield increased 85 bps to finish the quarter at 3.83%.

The MOVE Index, a measure of volatility for the U.S. Treasury market, jumped to its highest levels since the Global Financial Crisis. The dramatic pickup in volatility at the end of September was due in large part to knock-on effects of what occurred in the Gilt market. The new U.K. government released its “mini-budget” on September 23rd which included a proposal to abolish the 45% additional rate of income tax bracket. Capital markets reacted fiercely to the proposal as the benchmark 10-year Gilt yield jumped as much as 116 bps to 4.61% in the three business days following the release.

Just like in Q2, this environment of slowing economic growth expectations due to tighter financial conditions resulted in the outperformance of cash.



Source: FactSet

Long bonds saw their yields go parabolic as the initial reaction triggered a chain of margin calls on the nation's pension plans that get leverage via derivatives tied to these bonds to hedge their interest rate risk as part of LDI (liability driven investing) portfolios. The spiral forced the Bank of England to step back into the market on September 28th with an offer to buy Gilts in the secondary market with the objective of staving off "dysfunction" in the long-dated UK government debt market and reducing the risk of "contagion to credit conditions for UK households and businesses." While the operation was successful in avoiding a catastrophe, U.K. borrowing rates have resumed their march higher through mid-October.