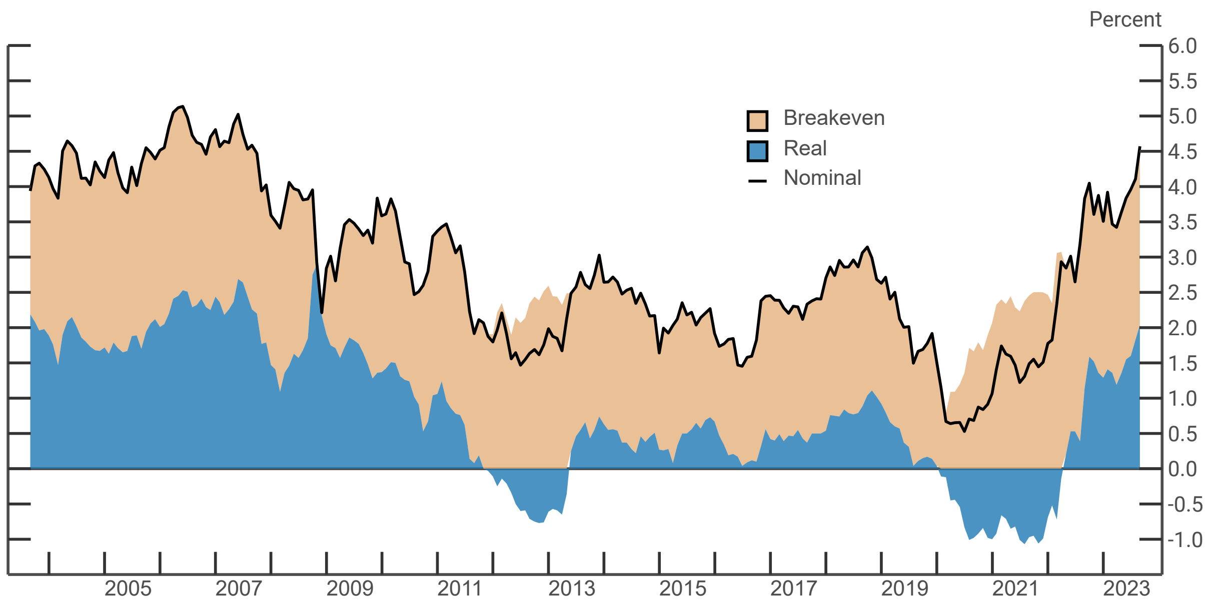
FIXED INCOME

The sell-off in bonds continued in Q3 with rising real rates and sharply higher oil prices. inflation expectations. The Bloomberg US Aggregate Bond Index declined 3.2% as the 10-year TIPS yield rose 65 bps to 2.2% and the headline nominal 10-year yield climbed 78 bps to 4.6%, the highest level since 2007 (Figure 8). Unlike the prior two years that saw rates pushed higher by front-end rate expectations, this sell-off was most pronounced in the long-end as markets priced a “higher for longer” regime. Base rate expectations were not much changed as the market maintained a

Figure 8. Ten Year yields climb above 2% as markets reprice the longer-term economic outlook

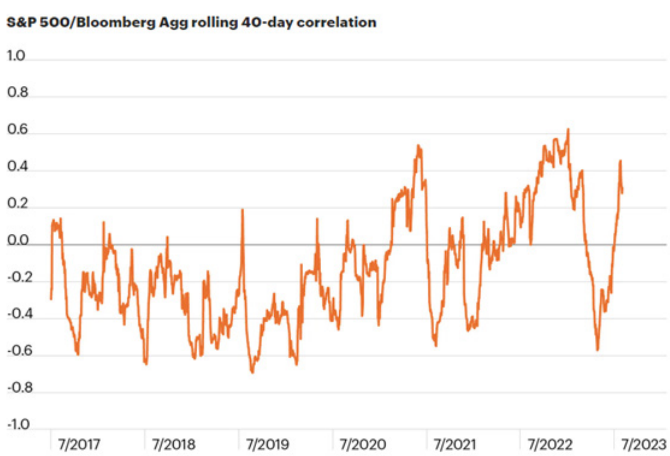


Source: RockCreek, Bloomberg.

year-end fed funds rate of 5.5%. As a result, we saw a rare bear steepening of the yield curve - the spread between the 2-year and 10-year Treasury ("2s10s spread") narrowed by nearly 59 bps to -0.47%. Credit outperformed for the quarter as investment grade spreads tightened by 5 bps to 1.25%.

Driving rates higher was a confluence of monetary and fiscal dynamics. As described above, the surprisingly resilient economy in the U.S. reignited hopes for the coveted "soft landing," pushing out expectations for when the Fed may cut rates. At the same time, the U.S. government's credit rating was downgraded by Fitch in August as a response to deficit spending plans that require the Treasury Department to issue even more long-term debt than previously anticipated. There were also technical market dynamics at play as speculative short positioning in Treasury futures reached record levels, which raised the alarm of the Bank for International Settlements (BIS) in their quarterly review.

Figure 9. The spike in correlation between stocks and bonds reflects the current challenge in building diversified portfolios



Source: Bloomberg. As of August 11, 2023.

The last six months have been painful for those who have extended duration. Cash has been king. Not only have the absolute returns of longer maturity bonds been abysmal, but the diversification benefit of interest rate duration has vanished (Figure 9). Is it time to throw in the towel and retreat to the 5.5% yield on cash? We think that might be short sighted.

We said last quarter that "with real yields near [now well through] cycle highs, credit spreads well off their recent tights, and a very low or negative equity risk premium, there is a bullish setup for spread products as we head into the second half of the year." We obviously spoke too soon, but timing these things is difficult. hard! The third quarter has simply provided the opportunity to buy at a better price.

There seem to be two reasons cited to remain short duration – one monetary and one fiscal: 1) real rates will continue to rise as the Fed hikes further and/or holds rates higher for longer; and 2) government spending and related debt burden remains unsustainable.

As it relates to the monetary outlook, the market may well be underestimating the Fed. While we believe the hiking cycle has largely run its course, it would be wise to keep some dry powder if we're wrong. In this case, buying shorter maturity spread products is attractive. The Fed is unlikely to be hiking into an environment where credit spreads are widening materially, and a deeply inverted yield curve still offers a significant yield premium in the front-end.

Fiscal concerns can push up real and nominal equilibrium interest rates, although there is little practical credit risk. The U.S. government can always pay its debt, which is denominated in dollars, whether by raising taxes, issuing bonds or printing money, via the Fed. But additional public borrowing will crowd out private borrowing, leaving real interest rates higher than otherwise. This is the opposite of the phenomenon of "secular stagnation" or the "savings glut" that was thought to be holding down equilibrium real interest rates in the period after the global financial crisis. If real interest rates are held down by monetary policy, or some form of printing money, inflationary pressures are likely to arise, making inflation protected bonds, i.e., TIPS, attractive. Earning 2.4% annually on 30-year paper that is free of credit and inflation risk seems like an effective way to get duration exposure.