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Bond Market Update: Weighing Duration vs. Potential Performance At this Time of the Rate Hike Cycle

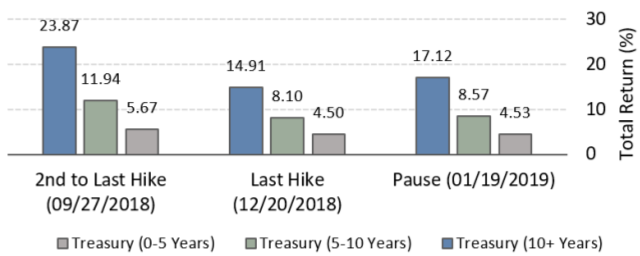
By Bill Smith, Fixed Income Trader and Portfolio Manager

Does it make sense to avoid duration until this rate hiking cycle is complete? With the Federal Reserve (Fed) telegraphing two additional rate hikes in 2023, investors may question the efficacy of adding longer maturities to their fixed income portfolios.

Analysis of Previous Hiking Campaigns

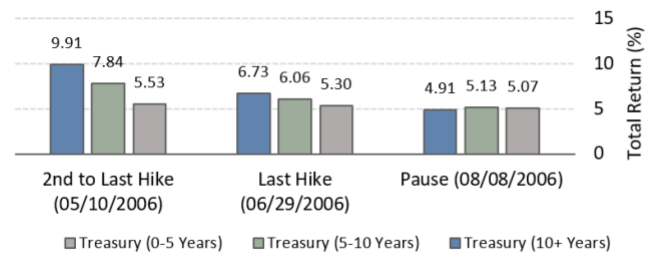
To help answer this question, we analyzed the one-year total returns for short (0-5 year), intermediate (5-10 year) and long (10+ year) Treasury indexes, focusing on the final innings of the last four hiking cycles (below). As you might expect, one-year total returns were compelling for intermediate and long duration. Interestingly, returns were often higher when hiking cycles were near completion (last two hikes), as opposed to fully complete (paused).

One-Year Total Returns (2015 - 2018 Tightening Cycle)



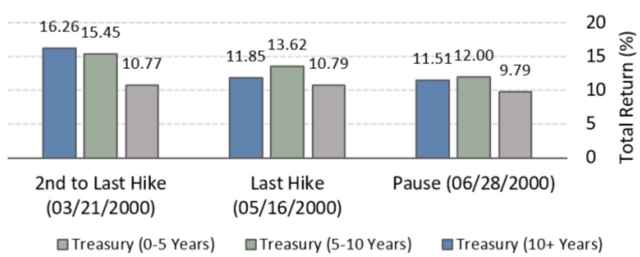
Source: ICE BofA Indexes / Bloomberg

One-Year Total Returns (2004 - 2006 Tightening Cycle)



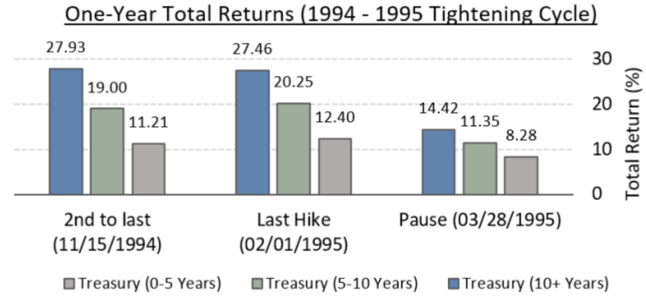
Source: ICE BofA Indexes / Bloomberg

One-Year Total Returns (1999 - 2000 Tightening Cycle)



Source: ICE BofA Indexes / Bloomberg

One-Year Total Returns (1994 - 1995 Tightening Cycle)



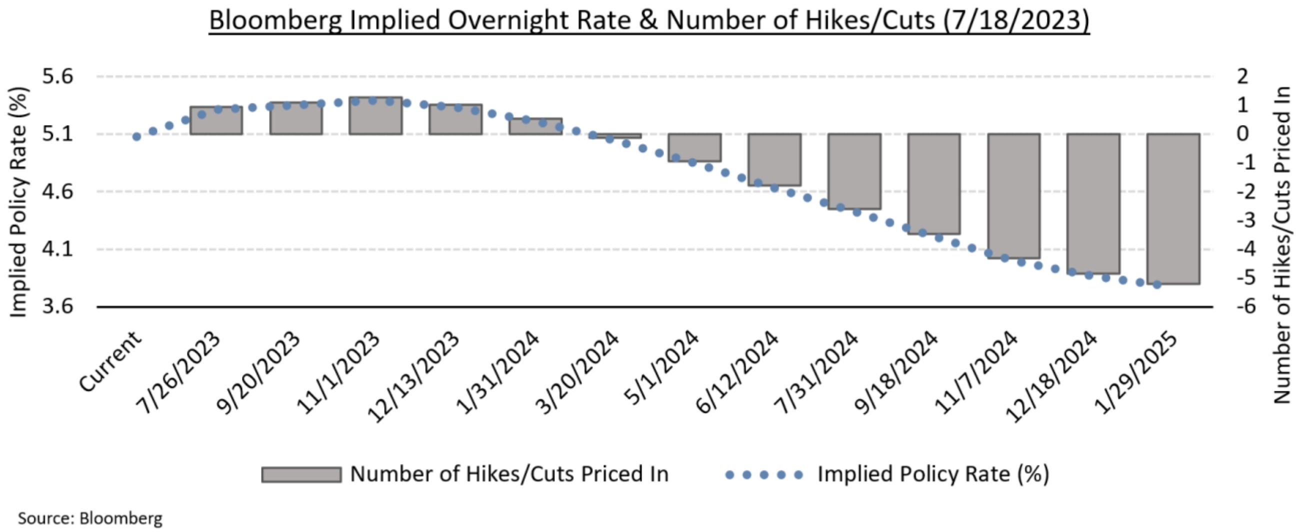
Source: ICE BofA Indexes / Bloomberg

Source: ICE BofA Indexes/Bloomberg. Past performance is no guarantee of future results.

We believe this diminishes the argument for a wait-and-see approach. Timing the end of a hiking campaign is challenging, and more importantly, it may not provide superior returns.

Markets Remain Unconvinced of Significant Future Tightening

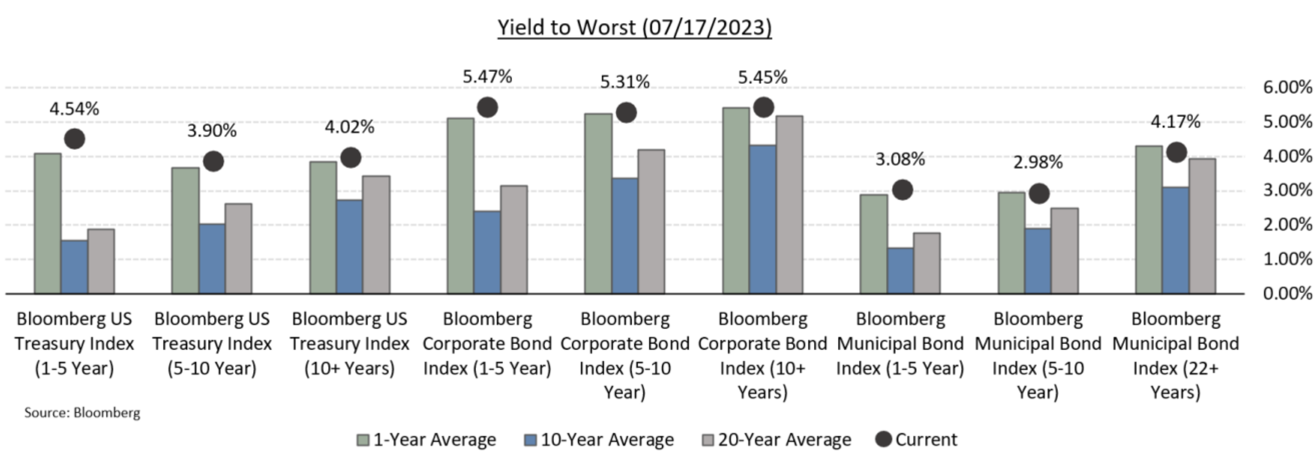
According to Bloomberg's current interest rate probability model, expectations for the future path of interest rates have deviated from Fed guidance. While the model anticipates the probability of a 25bp hike in July at 96%, the outlook for additional tightening has dropped. Furthermore, the futures market appears to be calling for significant rate cuts in 2024. If this scenario plays out, the window for adding longer bonds at current yields could be closing.



Source: Bloomberg 7/18/2023. Past performance is no guarantee of future results.

A Compelling Time for Fixed Income

While we think intermediate and long bonds are particularly interesting in this environment, it's important to note that bonds are attractive across the curve. Yields for most fixed income asset classes remain above their one, 10 and 20-year averages. Regardless of the future path of interest rates, now is an exciting time for investors to consider fixed income.



Source: Bloomberg 7/17/2023. Past performance is no guarantee of future results.

A prudent approach to fixed income investing calls for diversification across both credit and duration exposure. As always, Dynamic recommends staying balanced, diversified and invested. Despite short-term market pullbacks, it's more important than ever to focus on the long-term, improving the chances for investors to reach their goals.

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