Fixed Income Commentary
Fall 2017

The Federal Reserve ("Fed") and the bond market remained at odds this quarter. In September, the Fed reiterated its plan to raise the federal funds rate one more time this year to 1.5%, and announced that it will officially start unwinding its $4.5 trillion balance sheet in October. In theory, both announcements should hurt bond prices since short term bond yields are expected to increase when the federal funds rate goes up, and one of the largest bond holders in the world, the Federal Reserve, has now turned into a net seller. However, the bond market's reaction has been relatively muted. The market is only pricing in a 70% probability that the Fed follows through with another rate hike this year, and longer term yields are largely unchanged since the Fed originally unveiled its plan to unload the bonds on its balance sheet this past June. The yield on the thirty-year Treasury bond increased by less than 0.1% over that period.

One trend that has persisted this year is the "flattening" of the yield curve. In a "normal" yield curve environment, short-term rates are lower than long-term rates since investors expect to be compensated for the extra risk of locking in yields for longer maturities. When the yield curve flattens, the difference between short-term rates and long-term rates shrinks. In September, the yield difference between ten-year Treasuries and one-year Treasuries fell to 0.8%, the narrowest gap since the 2008 financial crisis (illustrated in the following chart).

Flat yield curves are typically found in recessionary environments. Expected economic growth rates and inflation rates are depressed, so long-term bond yields reprice lower accordingly. However, current market conditions do not fit the standard mold. The economy is on relatively healthy footing, and the ten-year Treasury is already trading for a lowly 2.2% yield as of quarter-end. In this case of a flattening yield curve, the main driver is that short-term rates are rising towards today's already low longer-term rates as the Federal Reserve has tightened monetary policy (caused short-term interest rates to increase) over the course of the year.

Due to the meager incremental yield offered by the market for assuming incremental interest rate risk, we decided to modestly shorten the duration of our bond ladders in September. If interest rates remain at current levels, clients should start noticing a heavier concentration of purchases on the shorter end of our eight-year bond ladders, as opposed to the longer end.

As interest rates rise, fixed-rate bond prices fall, and vice versa. Duration is a measure of that interest rate sensitivity, so we're assuming less risk by shortening our duration. As is customary in the investment world, less risk typically means less return. Yet the main driver of our decision is that the current bond market's juxtaposition of rising short-term interest rates, while long-term rates falter, has created a rare opportunity to substantially decrease interest rate risk without sacrificing much return. Specifically, if the current environment persists, we believe we can reduce the duration of our clients' bond ladders by roughly 20% to 3 years while only foregoing 0.1% of yield across a typical portfolio. While we don't attempt to predict how interest rates will move in the future, we strive to seek out opportunities that we believe will improve the risk-adjusted returns of our clients' bond portfolios. We believe making this small sacrifice in yield in exchange for this degree of reduction in portfolio risk represents just such an opportunity.

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