SEPTEMBER 2022

BOND iQ

Intra Quarter Update

Interest Rates: Are We There Yet?

Without a doubt, 2022 has been an extremely tough year for bonds. The unprecedented pace and magnitude with which bond yields have risen has resulted in deeply negative returns across duration mandates. In fact, the Bloomberg Aggregate Index (“AGG”) is off to its worst start in history, down more than 12% mid-way through September. The good news is that bond yields are approaching multi-year highs. The yield on the AGG is now 4.39% - the highest level since mid-2009. As a result, we believe that the outlook for high-quality fixed income has brightened meaningfully. Based on recent conversations, many investors seem to share this optimism but are still reluctant to make allocation changes or duration adjustments for fear that the near-term timing is still questionable. While we are never advocates of trying to time the market, it is tempting to wonder how close we might be to a cyclical peak in rates. In this month’s “BondiQ”, we explore prior interest rate cycles for clues that can help answer the question on every bond investor’s mind, “Are we there yet?”.

The shape of the yield curve is consistently one of the most powerful and accurate leading indicators of all the economic and market related indicators that we follow. While the yield curve is widely accepted to be one of the best recession predictors, it can also offer valuable information about the timing of interest rate cycles. The table below shows prior instances when the yield curve has inverted as measured by the spread between the 2 Year and 10 Year Treasury rates. As you can see, on average bond yields have peaked within a few days of yield curve inversions - with a limited range between both extremes. The earliest interest rate peak occurred in 2019 when bond yields reached their highest levels 126 trading days before the yield curve inverted. In contrast, 2006 was the latest peak occurring 106 trading days (or about 5 months) after the yield curve inverted.

		Days After/(Before) Curve Inversion for Yield Peaks*		
Date	Max Inversion (bps)	2-Year	5-Year	10-Year
1989	-44	50	50	50
1989	-18	(102)	(102)	(102)
1990	-14	35	35	35
1998	-7	(36)	(36)	(36)
2000	-51	69	61	(16)
2006	-16	106	106	106
2006	-19	14	14	14
2007	-6	29	29	29
2019	-5	(126)	(126)	(126)
Average	-20	4	3	(5)
Median	-16	29	29	14

2/10s Curve as of 9/22: -41 bps

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If this historical pattern were to hold today the yield curve is telling investors to expect yields to reach their cycle highs by the first quarter of next year. Of course, past performance is never a perfect predictor of the future, but fundamental evidence also supports the yield curve's bullish outlook for bonds. Sharply higher interest rates have at least partially accomplished the Fed's goal of tightening financial conditions. Early-cycle, cyclical parts of the economy are being impacted, with housing the notable laggard. In fact, existing sales of single-family homes are down almost 26% from their peak earlier this year – a sign that higher interest rates have been effective in curbing demand. While labor market data has been more resilient, we're watching employment data closely for early signs of moderation which may signal a more protracted economic downturn.

While there is growing evidence that a cyclical peak in yields may be drawing closer, we conclude with a word of caution. Timing the market is always a difficult and dangerous game to play. For investors looking for clues to support allocation shifts or duration adjustments in favor of fixed income, focusing on valuation instead of timing can often lead to more reliable and successful outcomes. After all, the best predictor of future fixed income returns (particularly over three-to-five-year horizons) is the starting yield of portfolios. With yields at or near their highest levels in more than a decade, return expectations have also risen correspondingly. For investors with long-term time horizons, the compelling valuation opportunity offered in high-quality fixed income should help improve future fixed income returns, regardless of the exact timing.

Should you have any questions, please don't hesitate to reach out to any member of the Johnson Asset Management Team.

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