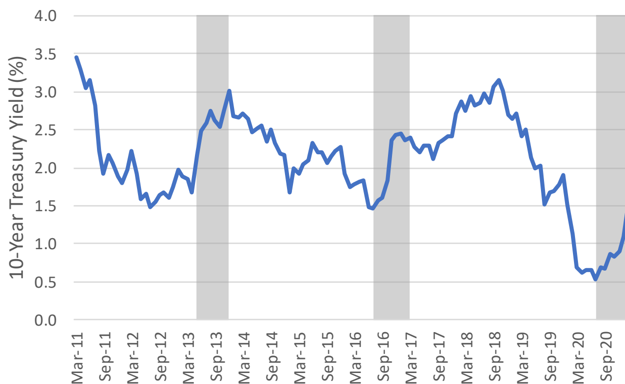
SKYView: The Duration Debate

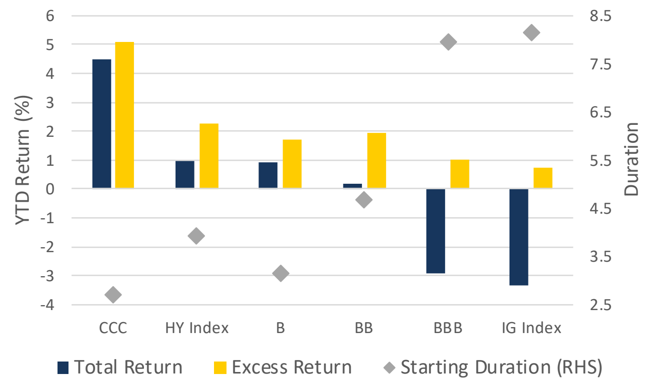
Fed Chairman Powell's speech did little to ease concerns over rising rates at Thursday's Wall Street Journal Jobs Summit (March 4, 2021), with yields on the 10-Year reaching 1.55% (+ 8 basis points or "bps" on the day) despite his expressed view that the economy is not at risk of overheating. In the interview, Powell noted his expectation for an uptick in economic activity as the re-opening progresses, which would likely cause consumer prices to increase in the coming quarters. Despite his belief that employment and inflation would remain below levels necessary to elicit an Federal Open Market Committee (FOMC) rate hike for "some time," yields on US Treasuries continued to climb toward levels not seen since the onset of the pandemic. In this *Weekly Briefing*, we take a closer look at the toll heightened growth and inflation forecasts have had on duration since the start of the year, and update our views on risk compensation in the current environment.

Expectations for stronger economic growth and a pickup in inflation have directly led to higher Treasury yields, with the 10-Year up over 60 bps since the start of the year. Looking back over the last decade, we find only three periods in which rates have risen more than 50 bps within a three-month period, and denote them in grey shaded areas within the chart below (left side). During those periods, US high yield bonds outperformed the 10-Year Treasury Index, the Bloomberg Barclays Global Agg, US investment grade credit, mortgage backed securities, and emerging market sovereign debt. More granularly, the shorter duration part of the high yield market performed best. Those trends appear consistent with what we have seen on a year-to-date basis, with both total and excess returns negatively correlated with cohort duration at the start of the period (right side).

Third Period in Last Decade Where Rates Increased Rapidly
grey = periods in which rates sustainably increased 50bps+ in a six month period



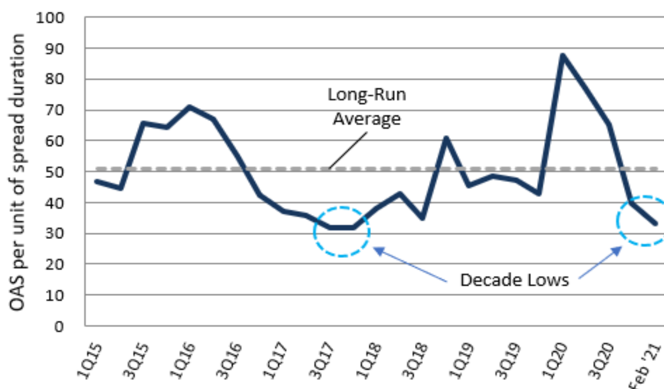
YTD Returns Clearly Show Duration Penalization
as of March 3, 2021



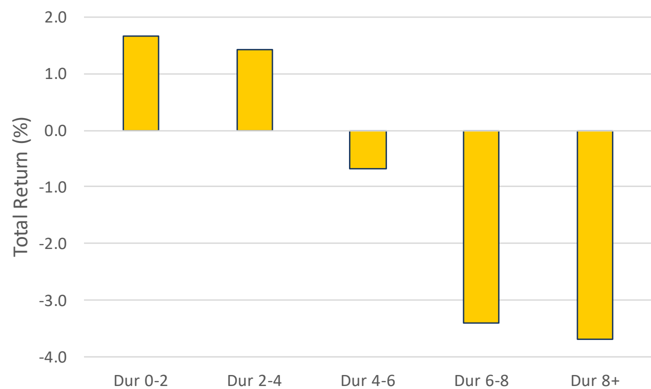
Source: SKY Harbor, ICE Data Indices. (RHS is Right Hand Side. See Credit Ratings for definitions of B, BB, BBB and CCC. HY Index is the ICE BofA US High Yield Index. IG Index is the ICE BofA US Corporate Index.)

Our past work on the negative correlation between high yield spreads and rates (see "*The Threat of Rising Rates,"* found here) and the positive impact inflation has had on leveraged credit issuer fundamentals (see *"It's All Relative,"* found here) underpin our sanguine view of the asset class. However, though we continue to believe high yield will tighten further before year end, our estimation of compensation by risk factor leaves us biased toward picking up excess spread via credit or liquidity risk rather than extending duration. As demonstrated in the chart below (left side), regression analysis of compensation afforded investors for taking on duration (term risk), after accounting for differences in credit quality and issue size (liquidity risk), is well below historical norms. In fact, OAS per unit of spread duration now matches a decade low, recently falling to a level not seen since Q4'17 despite well-telegraphed concerns by Treasury markets. As shown in the chart below (right side) longer duration returns suffered in the six months that followed the Q4'17 term risk trough. Notably, that period also coincided with modestly rising Treasury yields, not dissimilar to current expectations.

Spread Duration Compensation (Term Risk) Below Average
compensation after adjusting for credit quality and issue size



Duration Didn't Perform Well The Last Time Comp Was This Low
6 months ended June 30, 2018



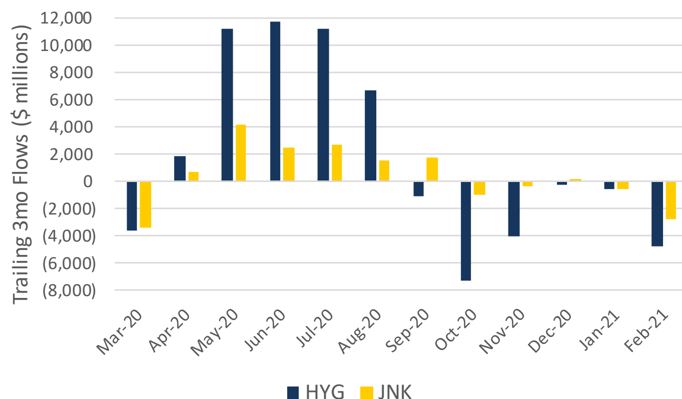
Source: SKY Harbor, ICE Data Indices

While spread duration compensation appears meager, illiquidity premiums (compensation to hold less-liquid bonds, after accounting for differences in credit quality and duration) remain above-average. Peaking in April 2020, the subsequent reduction in illiquidity premiums via outperformance of small vs.

large bonds, in our view, still has room to run, and may even accelerate should high yield ETF outflows persist. Historically discounted and more comfortably removed from technical selling pressures, our high-conviction preference for smaller issues appears well justified in the current market environment.

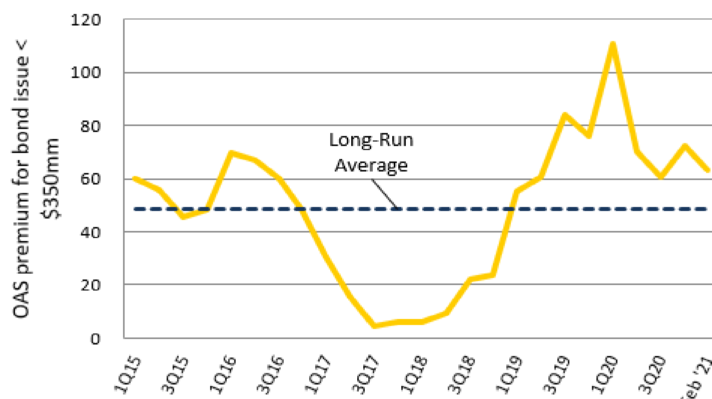
High Yield ETFs Suffering Outflows…

monthly data, trailing 12 months



…While Illiquidity Premiums Are Elevated

compensation after adjusting for credit quality and duration



Source: SKY Harbor, Bloomberg, ICE Data Indices. HYG (iShares iBoxx High Yield Corporate Bond ETF) and JNK (SPDR Bloomberg Barclays High Yield Bond ETF) are the two largest US high yield bond ETFs and are often cited as a proxy for US high yield ETFs given their size.

We also view the potential for a large stimulus package in the coming weeks as being further supportive of a sharp improvement in credit fundamentals. Strong Gross Domestic Product (GDP) growth expectations – driven by re-opening momentum and with additional upside from fiscal measures – continue to ease default concerns in the near and intermediate term. In our view, the inherent rate risk associated with BB credit more than offsets the benefit of principal preservation in a market characterized by rising inflation and a drop in bankruptcies. The same can be said as justification for moving out of investment grade and into high yield in general.

Despite the Fed's best efforts, market forces continue to push rates higher, causing duration to underperform across credit markets thus far in 2021. These pressures notwithstanding, we expect further spread compression through year end, primarily driven by improving high yield market fundamentals. Furthermore, we think stimulus negotiations are likely to result in a relief bill sized at the upper end of the expectation range, providing the next positive catalyst on the horizon. The implications of heightened stimulus spending (most notably lower defaults and higher rates), along with our statistical analysis of factor compensation, lead us to believe that the compression theme is best expressed through credit and liquidity risk-taking. As such, we do not yet think it is the time to step in and buy the part of the market most impacted by rates – better quality longer duration.

Definitions

Basis points (bps) refer to a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01%, or 0.0001, and is used to denote the percentage change in a financial instrument.

Bloomberg Barclays Aggregate Bond Index (the "Agg") is an index used by bond traders, mutual funds, and ETFs as a benchmark to simulate the universe of bonds in the market, including government securities, mortgage-backed securities, asset-backed securities and corporate securities.

Credit Ratings are used by the S&P and Fitch credit agencies for long-term bonds and some other investments. They range from the highest rating of AAA (the borrower's capacity to meet its financial commitment the obligation is extremely strong) to D (the borrower is in default). Ratings in order of quality include AAA, AA, A, BBB, BB, CCC, CC, C and D.

Duration is a measure of the sensitivity of the price of a bond or other debt instrument to a change in interest rates.

Duration risk (also referred to as interest rate risk) is the possibility that changes in interest rates may reduce or increase the market value of a fixed-income investment.

Exchange traded fund (ETF) is a type of security that tracks an index, sector, commodity or other asset, but which can be purchased or sold on a stock exchange the same as a regular stock.

ICE BofA US High Yield Index: An index that tracks the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the US domestic market. The index is further defined by sub-indexes associated with credit ratings (e.g., the CCC sub-index).

iShares iBoxx High Yield Corporate Bond ETF (HYG) is an exchange-traded fund (ETF) that seeks to track the investment results of an index composed of U.S. dollar-denominated, high yield corporate bonds.

Gross domestic product (GDP) is the total monetary or market value of all the finished goods and services produced within a country's borders in a specific time period.

Liquidity Premium is additional value demanded by investors when any given security cannot be easily and efficiently sold or otherwise converted into cash for its fair market value.

Option-Adjusted Spread (OAS) is the measurement of the spread of a fixed income security rate and the risk-free rate of return, which is then adjusted to take into account an embedded option.

Right hand side (RHS) refers to the offer price in a currency pair and indicates the lowest price someone is willing to sell the base currency.
SPDR Bloomberg Barclays High Yield Bond ETF (JNK) is an exchange-traded fund (ETF) that seeks investment results that correspond to the price and yield of the Bloomberg Barclays High Yield Very Liquid Bond Index.

Important Disclosures and Disclaimers
Past performance does not guarantee future results. The referenced indices are shown for informational purposes only and are not meant to represent the AXS Investments Funds. Investors cannot directly invest in an index.

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