It's Time To Close Your Long Position In Long Duration Bonds

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Summary

- Both the probability of a recession (leading to sharply lower interest rates) and the probability of sharply rising interest rates are small.
- The yield on T-bills is close to that of long-term treasuries.
- Short duration treasury bonds offer a better risk/reward currently compared to long duration treasury bonds.
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A little over a week ago, I published an article titled Income Strategies for an Inverted Yield Curve. In it, I provided several ideas not for when a recession is looming - because while that is still possible but not likely - we can't know for certain. What we do know is that the yield curve has inverted. It might not have stayed inverted for long, but we could all agree that if it's not inverted, it is still quite flat. That means investors aren't getting any 'extra' return for longer dated securities - or if they are - it's not much.

The strategies I discussed in that article are relevant whether the yield curve stays inverted or relatively flat - they are based on the premise that short-term rates are likely to decline relative to long-term rates.

We have also posted articles on inflation expectations - not to be confused with actual inflation - and what implications a change in expectations will have on certain investments.

This article is an extension of the suggestion to invest in short-duration bonds presented in one of the earlier articles but also touches on inflation expectations and interest rate expectations.

It's Time To Close Your Long Position In Long Duration Bonds

Produced by The Belgian Dentist for The Income Strategist
“You don’t strike me as someone who wants to be here long term.”

Sometimes, the pendulum swings too much in one direction. In the middle of last year, this was the case with 10-year treasury rates. Everyone was convinced the only way was up for long-term rates. You probably remember Jamie Dimon declaring:

I think rates should be 4% today.... You better be prepared to deal with rates of 5% or higher.

We asked the question of whether “the only way is up” was more applicable to bond prices rather than interest rates. And, this was indeed the case.

This brings us to the question: What’s next?

The Only Way Was Up

Last year, we expected, contrary to the general consensus, long interest rates to decline due to disappointing economic growth figures and easing inflation numbers. And, this is exactly how things played out.

Exhibit 1: Interest rates

https://seekingalpha.com/article/4271158-time-close-long-position-long-duration-bonds
As a result, the **iShares 20+ Year Treasury Bond ETF (TLT)** outperformed the S&P 500 by more than 8% and posted a total return of more than 13%!

**Exhibit 2:**

**Interest rate expectations**

What will happen next? Will long-term rates keep falling, or will they go back up?

Let’s divide the question into three parts: real rates, inflation expectations, and the term premium.

First, **real rates.** The expectations of future short-term real interest rates are a fundamental determinant of long-term yields. Long-run expectations are determined and anchored by the equilibrium real interest rate, or r-star. This is the inflation-adjusted, short-
term interest rate that is consistent with the full use of economic resources and steady inflation near the central bank’s target level.

Standard economic models imply that r-star is linked to households’ degree of patience, which influences their willingness to save, and to the expected growth rate of potential GDP, which influences the rate of return from saving. Current r-star estimates hover around 0.65%.

Exhibit 3: Productivity growth

![Surging Productivity Causes Accelerating Potential GDP Growth.](chart)

Meanwhile, the year-over-year growth rate in productivity has risen to about 2.5%. Aside from the rebound out of the last recession, that’s the best showing in about 15 years!!

The low productivity growth in the first five years of this economic expansion, together with the slower labor-force growth implicit in an aging U.S. population, was the basis for the conventional wisdom that the U.S. “potential” growth rate had fallen below 2% (the sum of about 1% for productivity growth and slightly less than 1% for labor force growth). This secular stagnation view is still the conventional wisdom. For example, as recently as the past few weeks, Fed officials have referred to 1.8% as the U.S. economy’s potential growth rate. In this view, the potential for continued growth of the U.S. economy around 3% is not possible without eventually causing inflation to overshoot the Fed’s target. This was the basis for the aggressive rate-hiking campaign in 2018 that ultimately inverted the yield curve as inflation dropped below the 2% target starting last summer.
As Fed Vice Chair Clarida put it in a recent speech to the New York Economics Club:

While identifying inflection points in trend productivity growth in real time is notoriously difficult, a pickup in trend productivity growth relative to the pace that prevailed earlier in the expansion is a possibility that we should not, I believe, dismiss.

The Fed’s low expectations for non-inflationary economic growth are also behind its big misses in estimating the neutral interest rate. These low expectations for the economy caused premature tightening and help explain why the U.S. economy persistently falls short of the 2% inflation target.

If this productivity growth would indeed pick up in the coming quarters then this will cause r-star to rise.

Second, we look at long-term inflation expectations. What matters are expectations over the entire 10 years, hence understanding the role of this expectations component requires a long-run perspective. Interestingly, long-term inflation expectations in surveys have remained firmly anchored at the Fed’s long-run inflation target of 2%, as noted in e.g. the Survey of Professional Forecasters. Overall, there is no survey evidence that suggests any meaningful downward shift in the inflation expectations underlying long-term yields.

Exhibit 4: Survey of Professional Forecasts Inflation Expectations
Our final building block is the term premium, which captures all factors other than expectations of future inflation and real short-term rates. The term premium is the compensation investors require for holding a long-term bond compared to rolling over a series of short-term bonds with lower maturity. In that sense, interest rates are driven by investors’ expected average level of the risk-free rate and a compensation for the longer holding period.

The term premium includes the inflation risk premium as well as any effects of changes in supply and demand that are unrelated to expectations, such as safe-haven demand for Treasuries.

New York Fed economists Tobias Adrian, Richard Crump, and Emanuel Moench (or "ACM") present Treasury term premium estimates from 1961 to the present.

**Exhibit 5: Term premium**

![ACM Term Premium](image)

Currently, the term premium is negative.

The biggest factor pushing down the term premium seems to be the inflation risk premium. An explanation that reconciles the stable survey inflation expectations with the decline in nominal yields is that the inflation risk premium has fallen. This risk premium compensates investors for the uncertainty about future bond returns due to changes in inflation. When
investors become increasingly worried about low inflation, this pushes the inflation risk premium into negative territory. Investors are paying a higher price for nominal bonds because they value them as a hedge against low inflation.

The Fed publishes option market-based estimates of the probabilities of rising or declining inflation expectations. We’ve shown you this chart before but will repeat it here.

**Exhibit 6: Option market-based inflation probabilities**

In the last months of last year and, again, more recently, there was a large drop in the probability of rising inflation and, at the same time, a large increase in the probability of falling inflation. In other words, the inflation risk premium fell. This resulted in a lower term premium and hence lower long-term interest rates.

Given the stable long-term inflation expectations (currently around 2.2%) and r-star estimate that could rise if productivity growth picks up and a very low term premium, we cannot see how the 10-year treasury yields could fall much further. The only possibility we see is a recession, but that’s not something we expect anytime soon.

**The Case for Continued Outperformance of Bonds Versus Stocks**

There’s only one scenario in which we expect a continued outperformance of bonds versus stocks: a recession. This would lead to lower equity prices and lower interest rates and hence bond outperformance.

We do not expect a recession, however.
When we look at James Picerno’s Recession Probability Estimate, we can only conclude that a recession is not around the corner.

**Exhibit 7: Recession Probability Estimate**

![ETI Recession Probability Estimates](image)

And, what about the inverted yield curve?

Economist Campbell Harvey is credited with discovering the predictive power of yield curve inversions in his 1986 PhD dissertation. He found that an inverted yield curve was bad news for the economy, foreshadowing a recession.

He looked at two parts of the yield curve, the 5-year note minus the 3-month bill, and the 10-year bond minus the 3-month bill. The crucial thing is to use a very short-term interest rate.

So, when the 10-year bond minus the 2-year note inverts, this is of no importance.

Campbell Harvey stressed in a recent interview that the inversion importantly needs to last for a quarter. If it’s a day, so what? GDP is measured quarterly, so we need to measure this quarterly also.
So, currently, there has not yet been a yield curve inversion that lasted a quarter, so we can only conclude again that a recession is not around the corner.

Given we expect no recession, we see no strong case for continued outperformance of long duration bonds versus equities.

**Inflation Cycles**

Inflation cycles occur far more frequently than business cycles, so the vast majority of inflation cycle downturns (like the one we are experiencing now) occur away from recessions.

**Exhibit 8: The inflation cycle**

![The Inflation Cycle is Not the Business Cycle](https://seekingalpha.com/article/4271158-time-close-long-position-long-duration-bonds)

Most analysts – and the Fed – don’t understand that inflation cycles are different from business cycles. ECRI’s co-founder, Geoffrey H. Moore, who created the original leading index of the business cycle over half a century ago, developed the U.S. Future Inflation Gauge (USFIG) to predict those separate inflation cycle turning points. The USFIG also leads inflation expectations.

**Exhibit 9: U.S. Future Inflation Gauge**
This confirms our view that the lower treasury yields are caused by the lower inflation readings and not the expected arrival of a recession. The only way inflation can go even lower is when we do get a recession. But again, that’s not what we are counting on.

**Sentiment**

Among the various ways of measuring investor sentiment, the Bank of America Merrill Lynch (BAML) survey of global fund managers is one of the best, as the results reflect how managers are allocated in various asset classes. These managers oversee a combined $600b in assets.

This survey of global investors is useful because it often pays to do the opposite of the crowd. What the trading community wants to know is how long or short they are certain key segments of the market. Why? Because these are often… contrarian indicators. Even the authors of the report, which include Chief Investment Strategist Michael Hartnett, admit the value of its use as a contrarian.

In November, 70% of fund managers expected higher inflation over the next 12 months; this was near a 14-year high. Since then, inflation expectations have collapsed by the largest amount since the depths of the financial crisis. As in the past, a strong consensus view on inflation preceded a drop in US 10-year yields in the following months.

In the past, a rebound in inflation expectations also preceded a rise in US 10-year yields in the following months. And, that’s exactly what we see in the survey.
Exhibit 10: Inflation expectations

This again points in the same direction: we see no reason why treasury rates would drop further.

The Case for Short-Duration Bonds

A case for higher inflation can be made, and this would imply that short-term bonds outperform long-term bonds. That’s why we think the timing is right to close your long position in long duration bonds and to switch to short-duration bonds like e.g. the iShares Short Treasury Bond ETF (SHV).

Exhibit 11: Yield curve
A reversal from an inverted yield curve (as we witnessed the past weeks as you can see in exhibit 11) is for either short-term rates to decline or long-term rates to rise, or a combination of both. Since bond prices are inversely related to rates, that means short-term bonds are likely to appreciate in value relative to long-term bonds. That's not to say long-term bonds will decline in price, necessarily. The term premium on long-term rates seems to have disappeared, and while longer duration bonds are more positively impacted by rate cuts, long-term bond prices and rates are more driven by the market and expectations of future growth, while short-term bonds have a higher sensitivity to Fed rate decisions.

The iShares 20+ Year Treasury Bond ETF seeks to track the investment results of an index composed of U.S. Treasury bonds with remaining maturities greater than twenty years.

The iShares Short Treasury Bond ETF seeks to track the investment results of an index composed of U.S. Treasury bonds with remaining maturities between one month and one year.

Exhibit 12 compares the most important portfolio characteristics of both ETFs. The iShares 20+ Year Treasury Bond ETF has a much higher duration compared to the short duration bond ETF. The yield to maturity is very close despite the huge difference in duration.

**Exhibit 12: Portfolio characteristics**

https://seekingalpha.com/article/4271158-time-close-long-position-long-duration-bonds
The timing is right to switch from long duration bonds to short-duration bonds.

**Conclusion**

The expected decline in long rates due to disappointing economic growth figures and easing inflation numbers materialized. This led to a nice outperformance of long duration bonds. It also led to an inverted yield curve. We do not expect a recession anytime soon and do not exclude that we get a rebound in the inflation risk premium. A potential sustained pickup in productivity growth will enhance economic growth. If things play out this way, we see no reason for a further drop in long-term interest rates. That’s why we advise to switch from iShares 20+ Year Treasury Bond ETF to iShares Short Treasury Bond ETF.

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**Disclosure:** I am/we are long SHV. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.
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Comments (11)

womco
so you suggest move to shv expecting a cut which will move the price higher? kinda confused

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