DON'T FIXATE ON YOUR SHORT DURATION

Kevin Flanagan – Head of Fixed Income Strategy
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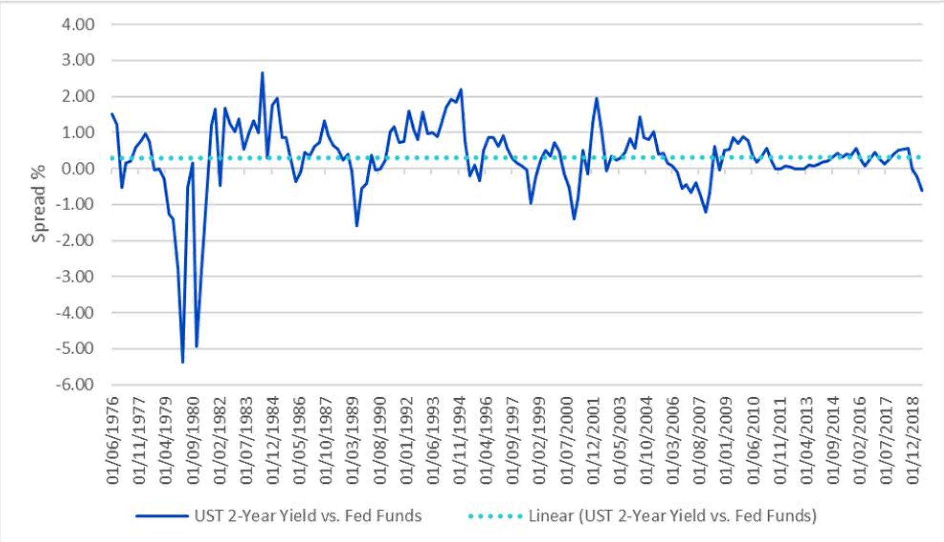
The landscape for the fixed income arena can be defined by two key factors. The first, of course, is the current, as well as prospective, shape of the yield curve. The second is that according to Federal Reserve data, households have been stashing away large amounts of cash. These two forces have placed a premium on short-term government investments in bond-land, but instead of going into products that are 'fixed' in nature, perhaps investors should look to floating rate strategies instead. Let's examine why.

When people talk about interest rates, the focus is usually on what the Federal Reserve (Fed) is doing and what is the US Treasury (UST) 10-year yield doing. As I just mentioned the flat and/or inverted shape of the UST yield curve (a topic I've written quite a lot about), makes investing in short duration instruments more attractive because investors can capture the same or even better yield levels without taking on the interest rate risk. Although, the markets seem to be embracing a rate cut for this year and next, based upon our outlook, the more likely scenario could just place the Fed in a holding pattern on the rate front.

Figure 1: US Treasury 2-Year Note vs. Fed Funds



Source: Bloomberg, as of 3 Jun 2019.

Historical performance is not an indication of future performance and any investments may go down in value.

The second point, a Fed on hold, is a very important factor to consider when looking to put cash to work. I've made the case that the UST market has already cut rates for the

Fed, and interestingly, there has been nothing from the Fed to suggest that they are contemplating such a move any time in the foreseeable future (see the latest Federal Open Market Committee minutes). Against such a backdrop, I would argue that short-term Treasury yields may be vulnerable to some potential upside risk if the economy doesn't falter and inflation stops decelerating (our base case).

The accompanying graph highlights the historical spread relationship between the UST 2-year yield and the fed funds rate. As you can see, the latest downside move in the two-year yield puts it into negative territory by 60 basis points (bp) as of this writing (UST 2-year yield is 1.90% and the top end of fed funds target is 2.50%). Conversely, the historical mean spread between these two instruments is around +30bp.

Conclusion

A 2% to 2 ½% US growth rate with unemployment at, or below 4%, (sound familiar), and an easing of US/China trade tensions in any form would seem to me a recipe for the UST 2-year yield to rise from its current levels, notwithstanding some geopolitical event. Conservatively, if the two-year yield moves back towards the top end of the current fed funds target, that would place it at 2.50%, a level it resided as recently as March. But what if there was a 'mean reversion' then the rate increase would be more like 90bp from here. Fixed short-term government solutions would be vulnerable in either scenario while Treasury floating-rate strategies would be insulated. Where would you want to put your cash?

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