

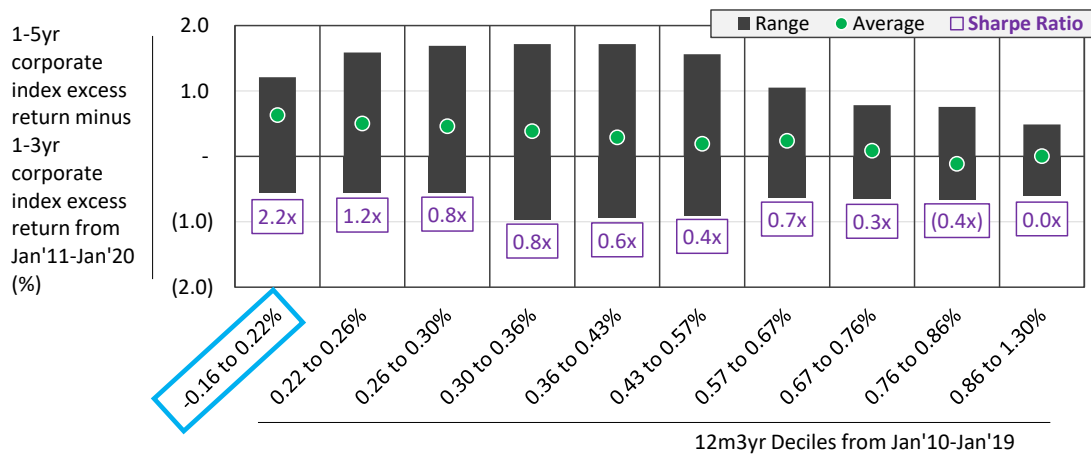
ZIRP Returns! – Extend Duration in Short Corporate Bond Portfolios

Following the June FOMC meeting, the Fed released its first summary of economic projections (“SEP”) incorporating impacts from the Covid-19 pandemic. For market participants, the SEP served to reemphasize that economic conditions will take several years to recover regardless of the rapid rebound in risk assets. Investors should anticipate the federal funds rate to remain near zero at least through 2022, and continued Treasury and Agency MBS buying at a monthly pace of about \$80bn and \$40bn, respectively, with no scheduled end date.

Fed officials do not foresee any material increases in inflation during the projection period – a view perhaps biased by the failure of inflation to stay above 2% even as labor markets tightened pre-pandemic. Median core PCE inflation projections for 2020, 2021 and 2022 of 0.8%, 1.5% and 1.7%, respectively, are well under the Fed’s symmetric target. If these projections hold true, the short-end of the Treasury curve (3-years and in) will likely be anchored near zero for several years.

In a yield environment where the slope of the short-end Treasury curve is at its flattest, our post-GFC experience suggests that extending duration in short corporate bond portfolios might result in better risk-adjusted returns. In the chart below we break up into deciles the spread between the 3-year Treasury bond and 12-month Treasury bill (“12m3yr”) from January 2010 through January 2019. We then show the out/under performance of extending duration for each decile by matching incremental excess returns (“IER”) over a 1-year horizon (e.g., 12m3yr spread of -0.14% on 12/31/18 corresponded to an IER of 1.03% on 12/31/19). IER is the difference in excess returns between the 1-5 year corporate index (~3 year duration) and the 1-3 corporate year index (~2 year duration).

Incremental Excess Returns (1 Year Forward) Bucketed by 12m3yr Steepness



Source: Bloomberg, Clearwater Advisors

Starting in the left column of the chart, the 1st decile (blue box) – when the 12m3yr curve is the flattest or inverted – produced the highest average and risk-adjusted IER (Sharpe ratio of 2.2x). As the curve steepened (2nd through 4th deciles), variability in IER increased, but continued to produce good albeit less favorable risk-adjusted results. Risk-adjusted results started to deteriorate as the curve steepened even more (5th through 7th deciles), and when the curve was at its steepest (7th through 10th deciles), extending duration led to poor risk-adjusted results. With the 12m3yr spread currently in the 1st decile (~0.04% as of 6/11/20), we think it is an opportune time to extend duration.