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Fed's More Flexible Inflation Target

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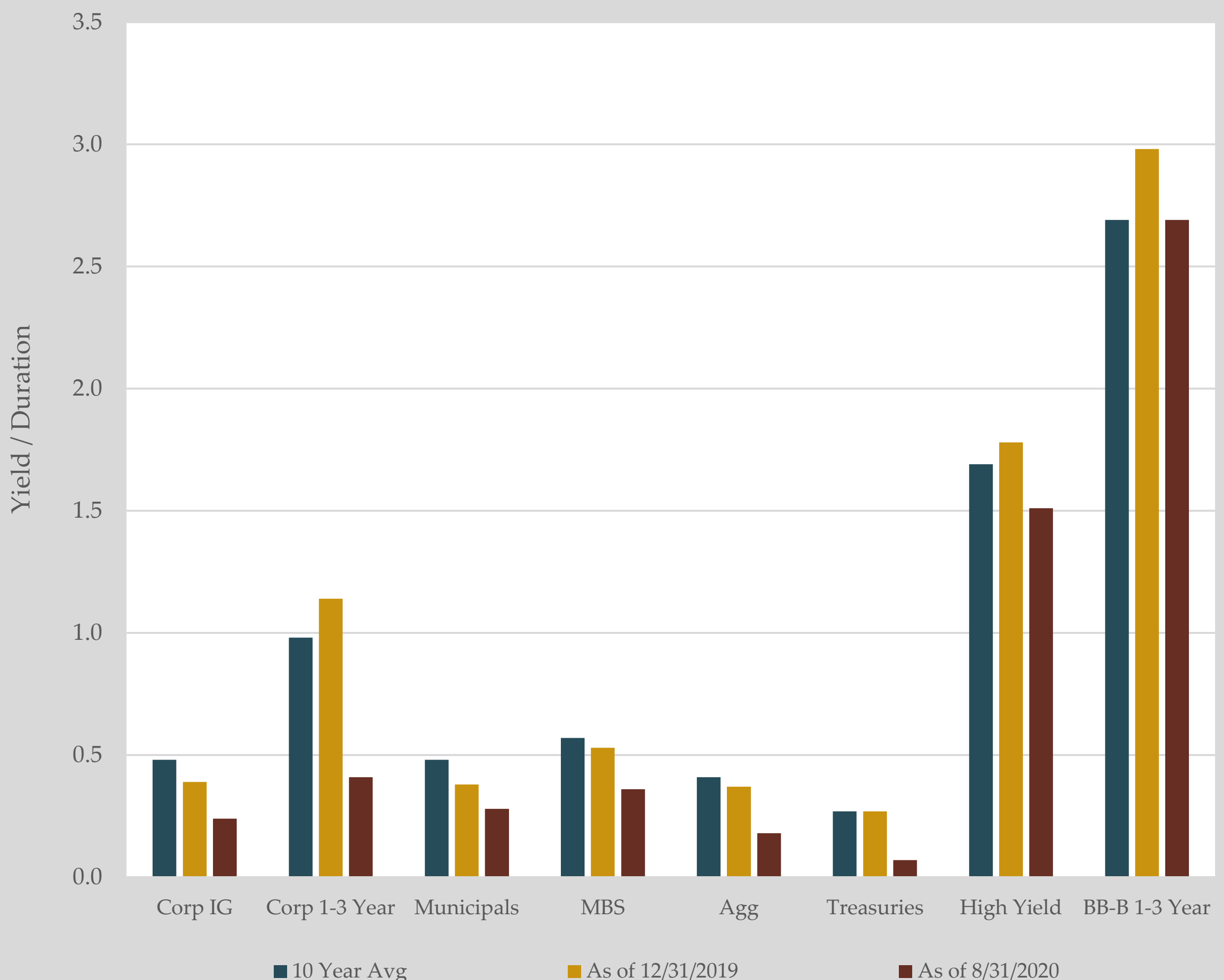
Last week the Federal Reserve ("Fed") officially announced what we already assumed; their desire to stoke inflation over 2%. Instead of taking proactive measures when inflation reaches 2%, or even prior to 2%, the Fed will now instead look at the "long-run" inflation average and act accordingly. The Fed may allow inflation to reach over 2.5% so long as they believe that over the long-run inflation will average down to 2%. That provides the Fed with enough discretion, and flexibility, that inflation expectations, not to be confused with actual inflation, might inch higher.

As of 8/31/2020. Source: Bloomberg. Based on weekly data.

This is for informational purposes only and is not a recommendation to buy or sell a specific security.

The Fed's comments come at a somewhat precarious time for the longer end of the US Treasury curve since the Federal government, already in deficit-spending mode pre-COVID-19, is teed up to borrow trillions for pandemic relief. **So what does all of this mean for the bond markets?** First, short-term interest rates, which follow the Fed's lead, should be well anchored for the foreseeable future. Second, since the Fed does not control long-term interest rates (inflation expectations do), you may see a sustained steepening of the US Treasury curve where longer term rates trend higher while the short end of the curve is less impacted.



As of 8/31/2020. Source: Bloomberg.

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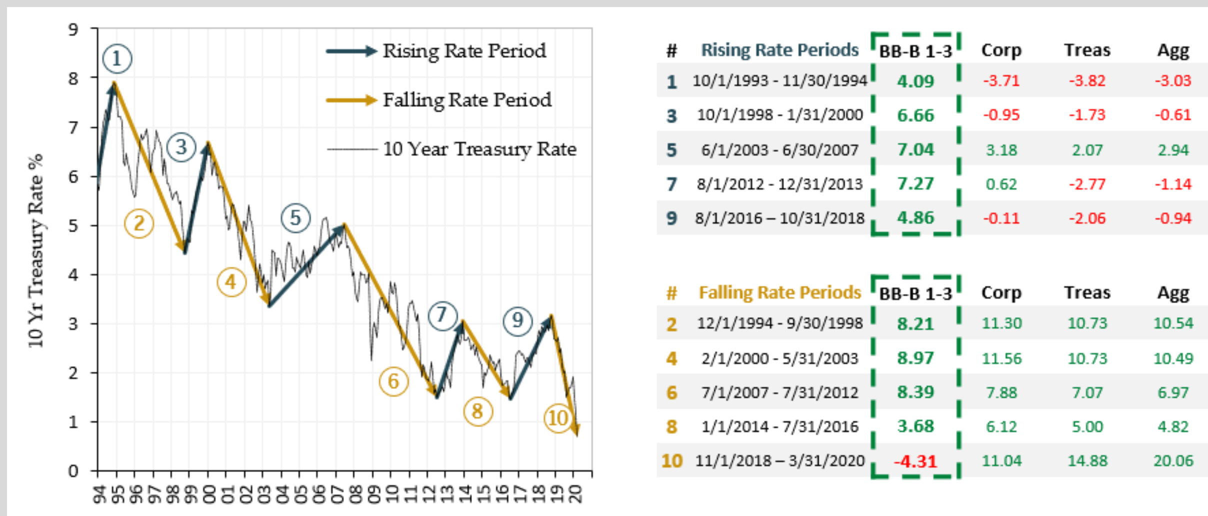
In turn, that means credit exposure should be monitored for its duration. Duration has long been the friend of the corporate bond market. Other than a few blips, the 10-year minus 2-year Treasury yield curve has been flattening consistently since the beginning of 2014. The temptation may be to assume that this trend continues, but what if it doesn't? **What if the steepening "blip" that we have seen here in 2020 continues?**

Credit Performance Over the Last 10 Rising/Falling Interest Rate Periods



#	Rising Rate Periods	BB-B 1-3	Corp	Treas	Agg
1	10/1/1993 - 11/30/1994	4.09	-3.71	-3.82	-3.03
3	10/1/1998 - 1/31/2000	6.66	-0.95	-1.73	-0.61
5	6/1/2003 - 6/30/2007	7.04	3.18	2.07	2.94
7	8/1/2012 - 12/31/2013	7.27	0.62	-2.77	-1.14
9	8/1/2016 – 10/31/2018	4.86	-0.11	-2.06	-0.94

#	Falling Rate Periods	BB-B 1-3	Corp	Treas	Agg
2	12/1/1994 - 9/30/1998	8.21	11.30	10.73	10.54
4	2/1/2000 - 5/31/2003	8.97	11.56	10.73	10.49
6	7/1/2007 - 7/31/2012	8.39	7.88	7.07	6.97
8	1/1/2014 - 7/31/2016	3.68	6.12	5.00	4.82
10	11/1/2018 – 3/31/2020	-4.31	11.04	14.88	20.06

Source: Bloomberg

As of August 25, 2020, the yield-to-worst ("YTW") on the ICE BofA US Corporate Index was 1.98% and duration stood at 8.1 years. That results in a yield per unit duration of 25 basis points; about half of its 2014 starting value since both yields have fallen and duration has increased since then (YTW of 3.21% and 6.9 years). As of August 25th, a similar reduction in yield per unit of duration can be seen in the Bloomberg Barclays US Aggregate Bond Index ("Agg"); YTW was 1.16% and duration was 6.3 years compared to the start of 2014 when the Agg sported a YTW of 2.48% and duration of 5.6 years. **That is low compensation for taking such duration risk, which is why those higher quality fixed income asset classes perform relatively poorly against shorter duration credit-sensitive assets during periods of rising rates.**

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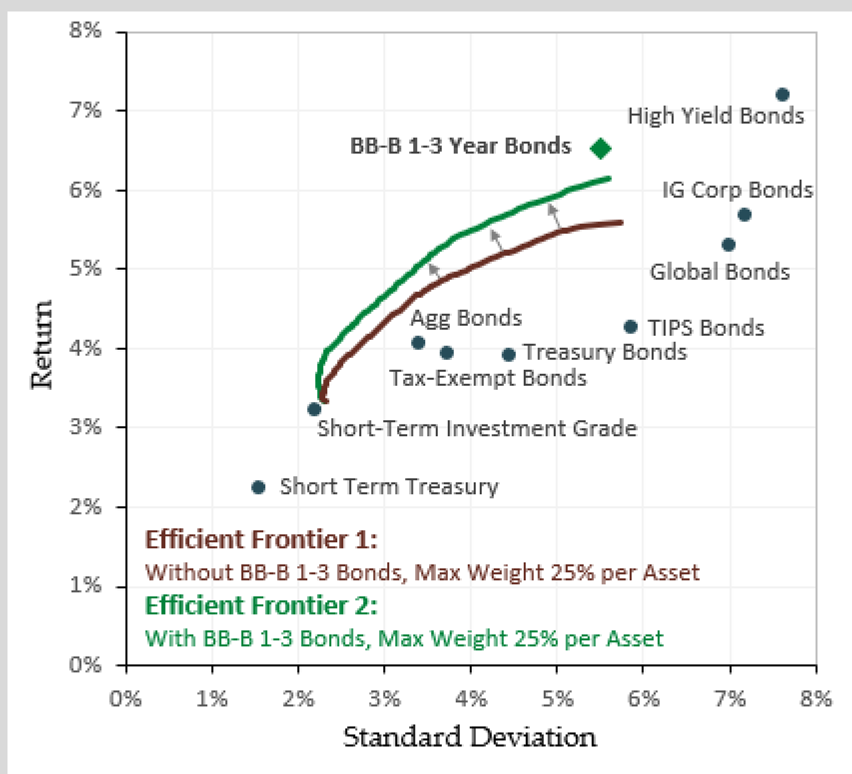
The extension of duration and declining yield environment was met head-on with the aftermath of a massive market dislocation where the Fed was more aggressive than ever. This allows fixed income asset allocations ripe for reassessment, especially when it means being contrary to consensus views that long-term rates will never break out to the upside. **With strong current yields coupled with duration below 2 years, adding a high-quality high yield short duration sleeve may help to optimize a fixed income asset allocation that suffers from longer durations and lower yields.**

Enhancing the Efficient Frontier (Last 20 Years)



As of 6/30/2020. Source: PortfolioVisualizer.com. Past performance does not guarantee future results.

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