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SUMMARY

- The short end of the curve has high reinvestment risks.
- The long end of the curve takes on more price sensitivity to interest rate moves.
- The sweet spot to invest on the yield curve is in 3 to 10-year maturities, in our view.

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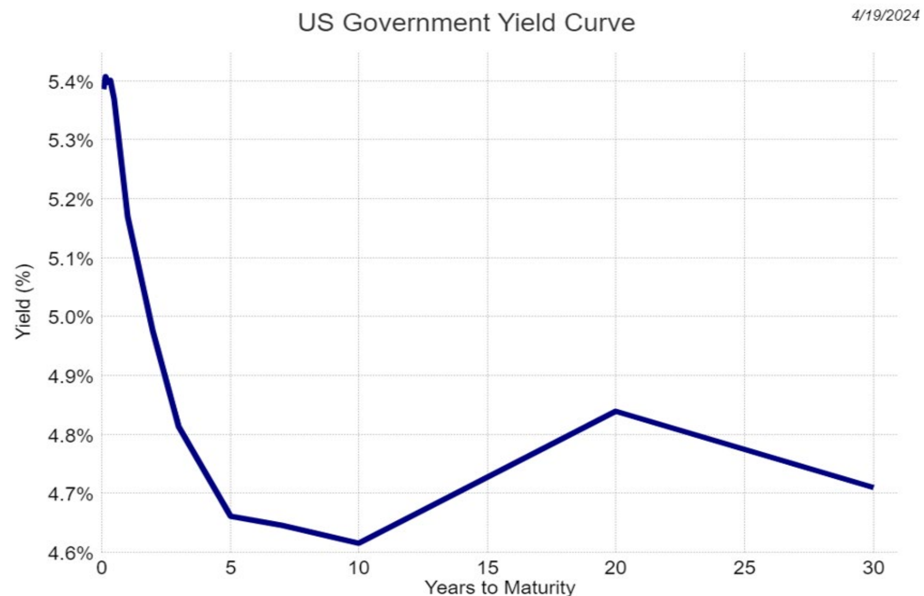
Intermediate Treasuries: The 'Sweet Spot' on the Yield Curve

The bond market has risen from the ashes like a phoenix the last few years as interest rates have risen from 1% to over 4% on 10-year US Treasury. During this time, many conversations have arisen regarding the yield curve, which describes the yields on government securities from less than a year to 30 years' maturity (chart below). **We believe that the 'sweet spot' on the yield curve to invest in currently is between 3 and 10-years given the present economic environment.**

Historically, investors have been able to gain valuable insights about the economy from the yield curve based on its shape and steepness. The various shapes of the yield curve can be upward sloping, downward sloping (inverted), or flat. An upward sloping curve is when shorter rates are lower than longer rates, and vice versa for a downward sloping curve, while a flat curve is when short and long rates yield roughly the same. Currently, the yield curve incorporates all three shapes due to the uncertainty around the path of interest rates, as shown in the chart below.



Source: LSEG Datastream, RiverFront. Data daily as of April 19, 2024. Chart shown for illustrative purposes only. Past performance is no indication of future results. You cannot invest directly in an index.

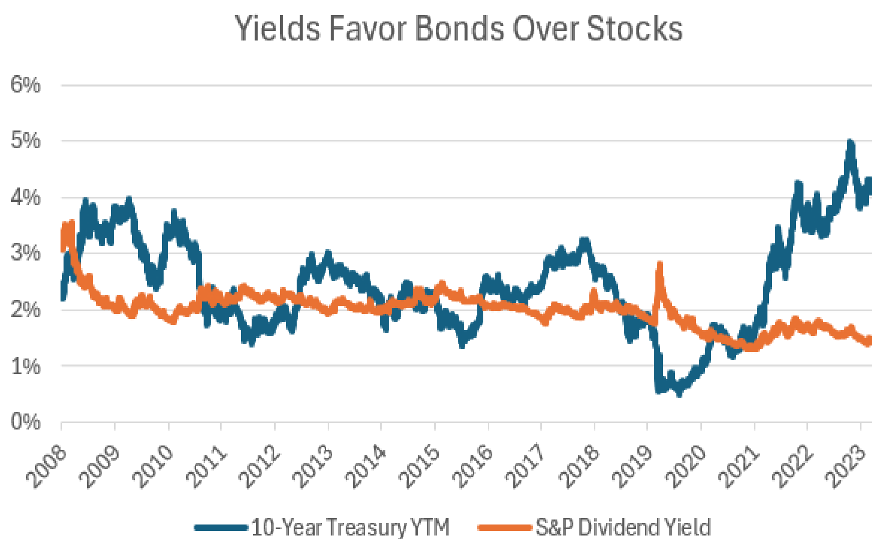
Short End of the Curve: Reinvestment Risks and Limited Upside

The belief at RiverFront is that interest rates will remain higher for longer. Higher rates for longer can trick investors into thinking that they have plenty of time to remain invested in short-term securities like money markets (see *Weekly Views* from 4/2/24 and 3/5/24 for more on this). As data can change quickly and given the Fed's bias towards cutting rates, we see little reason for investors to prolong the move out on the yield curve and lock in higher rates of return. Investing in the short end of the curve introduces reinvestment risk, as yields may be substantially lower when it is time to reinvest the proceeds from a Certificate of Deposit (CD) or bond that has matured.

Despite the Fed delaying rate cuts due to a stronger economy, we expect the economy to slow down within the next year, leading eventually to rate cuts. Maturities two years and shorter should benefit from rate cuts with their yields falling and prices rising. However, the upside appreciation will be limited given the short time until maturity, as bonds trade closer to par as maturity approaches. Thus, the shorter the maturity, the lower the benefit of a rate cut. Hence, we see little value in adding additional fixed income exposure at the front end of the yield curve - even when we consider taking credit risk by buying corporate bonds that command a risk premium above Treasuries which only offer interest rate risk.

Intermediate Part of the Curve: The 'Sweet Spot'

As we move beyond the two-year part of the yield curve, we see additional opportunities. **We believe that maturities ranging from 3 to 10 years provide investors with the best opportunities to generate income by locking in higher yields for longer.** As an asset manager that manages balanced portfolios, we believe locking in yields north of 4% for 3 to 10 years will help our clients meet their investment objectives and allow them to rely less on more volatile instruments like stocks. For example, in a 50 percent equity and 50 percent fixed income portfolio in 2020, if the investor needed to receive an annual total return of 6 percent, the equity portion of the portfolio had to return 11 percent, when the 10-year Treasury yielded 1 percent. Fast forward to the present day, where 3 to 10-year Treasuries yield approximately 4.6 – 4.8%, the fixed income portion of the balanced portfolio will deliver more than 2 percentage points of the investor's 6 percent return. Thus, by locking in current yields for longer investors receive a better risk adjusted return. Chart 2 (above, on right) shows how the S&P dividend yield has been steady since the Great Financial Crisis while the yield on the 10-year Treasury has had a dramatic improvement, making bonds more attractive to hold in a balanced portfolio.



Source: Bloomberg, RiverFront. Data daily as of April 19, 2024. Chart shown for illustrative purposes only. Past performance is no indication of future results. You cannot invest directly in an index.

Long End of the Curve: Presents Too Much Duration Risk, in Our View

Beyond 10-year maturities, investors take on significantly more price volatility because the long maturities are more sensitive to changes in interest rates. Currently, we do not see a catalyst for yields on the long end of the curve to decline, as inflation is starting to reaccelerate and show its stickiness. We believe that if inflation does continue to trend higher, the Fed will hold rates higher for longer, thus alleviating the incentive for investing at the long end of the curve. Furthermore, investors are not being adequately compensated for purchasing maturities beyond 10 years due to the flat yield curve, in our view. For example, the 30-year Treasury yields roughly 4.70%, while the 10-year Treasury yield is right around 4.60%. Thus, it generally does not behoove investors to tie their money up for an additional 20 years to pick up an incremental 10 basis points per year. While our preference is in in the 3-to-10-year range, it is important to recognize that long-duration treasuries have a unique role to play in balanced portfolios, primarily as a 'shock absorber' against recession and potential downside moves in stock markets.

Conclusion:

The fixed income market remains volatile due to the uncertainty surrounding the timing and the magnitude of the Fed's interest rate cuts. Thus, the front end of the curve is not appealing to us due to the reinvestment risk the investor faces if the Fed goes through with cutting interest rates in 2024, as intimated by the Fed's most recent median interest projection of 4.625% by the end of the year. Combine that with a long end of the yield curve that is not compensating investors adequately for the added risk and lacks a catalyst for significant price appreciation. We believe that 3-to-10-year is the 'sweet spot' of the curve because investors reduce reinvestment risk, they lock in higher yields for longer, without tying money up for years beyond their investment time horizon.

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Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.

In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa). This effect is usually more pronounced for longer-term securities). Fixed income securities also carry inflation risk, liquidity risk, call risk and credit and default risks for both issuers and counterparties. Lower-quality fixed income securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer. Foreign investments involve greater risks than U.S. investments, and can decline significantly in response to adverse issuer, political, regulatory, market, and economic risks. Any fixed-income security sold or redeemed prior to maturity may be subject to loss.

Index Definitions:

Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.

Definitions:

The dividend yield, expressed as a percentage, is a financial ratio (dividend/price) that shows how much a company pays out in dividends each year relative to its stock price.

Treasury bond yields (or rates) are tracked by investors for many reasons. The yields are paid by the U.S. government as interest for borrowing money via selling the bond. The 10-year Treasury yield is closely watched as an indicator of broader investor confidence. Because Treasury bonds (along with bills and notes) carry the full backing of the U.S. government, they are viewed as one of the safest investments.

A yield curve is a line that plots yields, or interest rates, of bonds that have equal credit quality but differing maturity dates. The slope of the yield curve can predict future interest rate changes and economic activity. There are three main yield curve shapes: normal upward-sloping curve, inverted downward-sloping curve, and flat.

A certificate of deposit (CD) is a type of savings account that pays a fixed interest rate on money held for an agreed upon period of time. Offered by both banks and credit unions, CDs differ from standard savings accounts in that CD funds must remain untouched for the entirety of their term—or you'll incur a penalty. CDs usually pay a higher interest rate than savings accounts as an incentive for giving up your withdrawal flexibility.

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