MARKETING COMMUNICATION

Allspring

The Opportunity Cost of Waiting for Goldilocks

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KEY TAKEAWAYS:

+ The impact of the U.S. Federal Reserve's (Fed's) rate-hike campaign and a strongly inverted yield curve has led investors to seek refuge on the very front end of the yield curve.
+ Wary investors may be waiting for a "Goldilocks moment" to add duration back into their portfolios, but market timing can be difficult to execute.
+ Investors who concentrate in short-duration allocations until rates begin to fall have historically realized high opportunity costs.
+ Allocating across duration exposures, or "riding the curve," can offer diversification and potential return benefits as the yield curve normalizes.

Fixed income investors are living through the most intense period of monetary policy tightening in nearly 50 years. Since March 2022, the Fed has raised front-end rates by 500 basis points (bps; 100 bps = 1.00%). Yields further out the yield curve have risen in sympathy, causing price return losses for many fixed income investors. Also, the yield curve has sharply inverted, leaving the income available at the front end of the yield curve at or near its highest point in 15 years. This has, understandably, led many investors to move to shorter-duration securities to capture income and to limit the impact of any further increases in yields. This is evidenced by money market mutual fund balances recently reaching a new all-time peak of $5.6 trillion, while total bank deposits in the United States totaled $17.7 trillion at year-end 2022. As the rate hike cycle nears its end, however, the questions of when and how to add duration back into an investment portfolio become most relevant.

The Goldilocks moment can be difficult to anticipate

Market timing is always difficult and the inflection points that offer the optimal catalysts for change are often best identified in the rearview mirror. In prior periods of monetary policy tightening, investors who waited for a "Goldilocks moment" to add duration to their portfolios realized substantial opportunity costs while hunkering down on the front end of the yield curve. Rather than waiting for an opportunity to materially extend duration at some specific point, we believe investors can take advantage of the income opportunities across the yield curve now. Investors can "ride the curve" by diversifying exposures from overnight cash rates to positions at the longer end of the yield curve. By taking this approach, investors can potentially harvest some of the highest yields available in over a decade and benefit from possible price appreciation as the rate cycle reaches its peak and the yield curve normalizes.

What can history teach us about finding the Goldilocks moment? During the past 30 years, the Fed raised rates in four separate time periods. In each case, the Fed subsequently lowered rates either because it achieved its desired outcome (a "soft landing"), responded to an unanticipated change in economic conditions, or reacted to an exogenous shock. Table 1 below provides background on these four monetary policy tightening episodes and the reasons why the Fed subsequently cut rates. Each of these periods is instructive to review as investors contemplate the optimal time in this cycle to add duration back into their investment portfolios.

TABLE 1: PERIODS OF TIGHTENING MONETARY POLICY

TIME PERIOD	REASON FOR CUTS	BACKGROUND
1	**1994 soft landing**	In 1994, the Fed hiked rates seven times, tightening monetary policy by 300 bps. Treasury yields rose; the Fed delivered a "soft landing"; and within a few months, the Fed cut its policy rate three times in a "mid-cycle adjustment," lowering rates by 75 bps.
2	**Tech bubble and 9/11**	A period of "irrational exuberance" led equity prices higher and prompted the Fed to raise its policy rate 6 times, totaling 175 bps. Following the collapse of the tech bubble and the horror of 9/11, the Fed lowered rates 11 times for a total of 475 bps. Within a year, it lowered the rate another two times, or 75 bps.
3	**Great Financial Crisis**	A boom in housing prompted the Fed to raise rates 17 times for a total of 425 bps from 2005 to 2006. The housing crash along with the Great Recession prompted two rounds of monetary policy easing with the Fed cutting rates 10 times by a total of 525 bps.
4	**COVID-19**	After nearly a decade of slow economic growth and zero interest rate policy, the Fed worked to restore normalcy by hiking rates nine times between 2015 and 2018 for a total of 225 bps. The onset of the COVID-19 pandemic prompted the Fed to cut rates back to zero in early 2020.

Source: Allspring

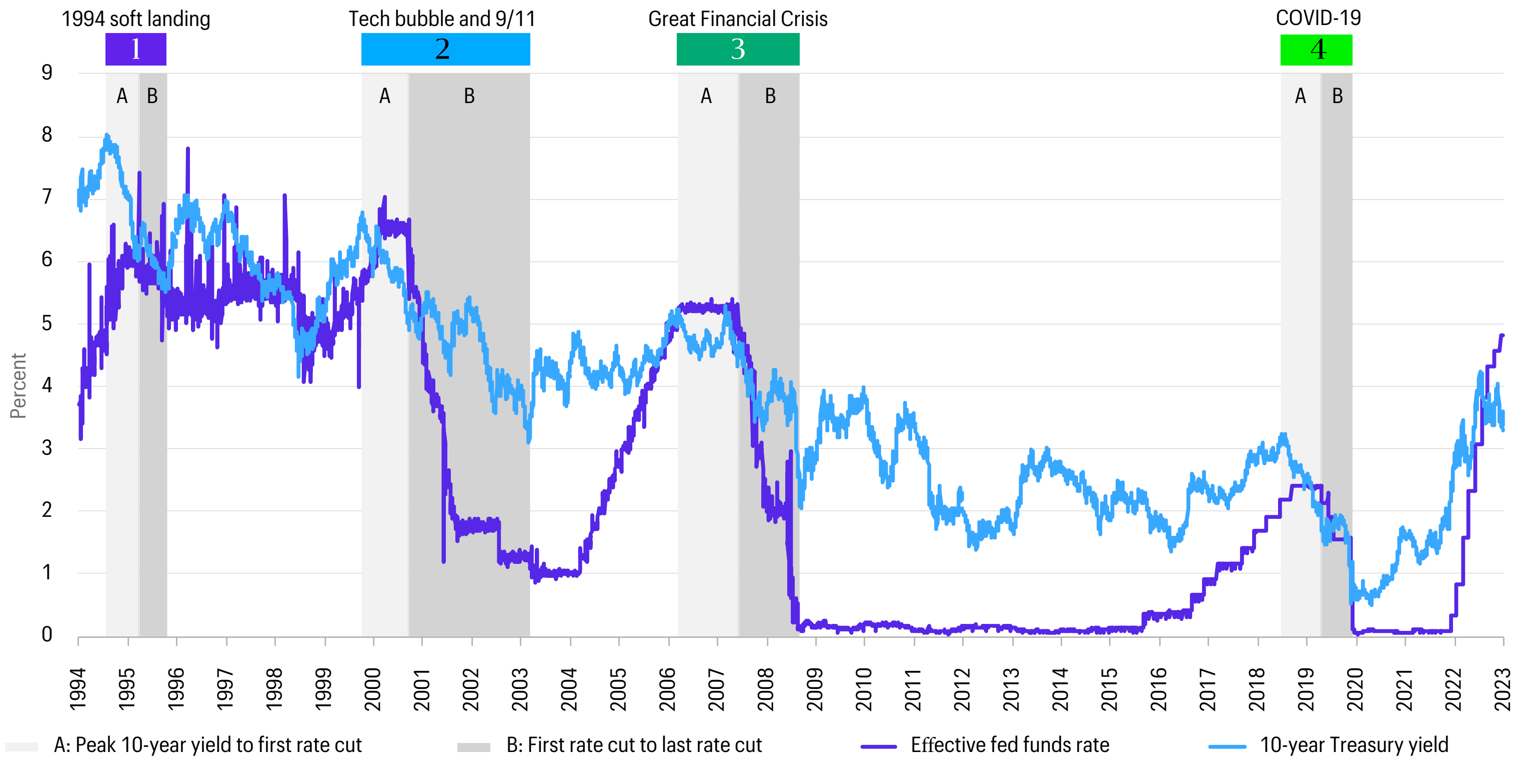
Waiting for the perfect entry point can lead to substantial opportunity costs

Chart 1 plots the yield on the 10-year U.S. Treasury and the effective federal funds rate over time since early 1994. The chart highlights the periods near the end of each Fed rate-hike cycle during this time period.

HIGHLIGHTED PERIODS ARE PRESENTED AS FOLLOWS:

- Period A starts with the peak of the 10-year Treasury yield and ends when the Fed began to cut the federal funds rate.
- Period B starts with the first rate cut and ends with the last rate cut.

CHART 1: TRANSITIONARY PERIODS IN MONETARY POLICY



Source: Bloomberg, L.P., as of 31-Mar-23

Table 2 below shows the total returns for various segments of fixed income during both the "A" and "B" periods noted above.

Investors who reduced duration during the rate-hike cycle and then added duration back to their portfolios when the Fed began cutting rates would have experienced the total returns in the "B" periods. By waiting until the Fed began cutting rates to add duration, however, they would have missed out on total return opportunities historically available during "A" periods.

We think of these missed total returns as the opportunity cost of waiting to add duration until the Fed starts to cut rates.

In each rate cycle, having duration exposure beyond the front end of the curve, as represented by 3- to 6-month Treasury bills, would have resulted in stronger total returns in all "A" periods. Treasuries, short-duration investment-grade securities, and the broad investment-grade bond market each produced more superior total returns than short bills in all "A" periods.

TABLE 2: TOTAL RETURNS BY TIME PERIOD (%)

	PERIOD 1: 1994 SOFT LANDING		PERIOD 2: TECH BUBBLE AND 9/11		PERIOD 3: GREAT FINANCIAL CRISIS		PERIOD 4: COVID-19	
	A	B	A	B	A	B	A	B
3- to 6-month T-bills	3.82	3.44	6.14	7.41	6.88	4.30	2.10	1.60
1- to 3-year gov/credit	6.88	4.90	8.41	17.67	7.82	7.50	4.30	2.59
U.S. aggregate	13.05	7.01	12.84	24.41	9.92	7.11	9.82	4.87
10-year Treasury	18.03	7.72	17.12	26.82	11.55	24.25	14.47	11.83
Diversified portfolio	10.45	5.77	11.13	19.08	8.99	10.79	7.67	5.22

Sources: Bloomberg L.P. and ICE BofA. 3- to 6-month T-bills = Bloomberg U.S. 3-6 Month Treasury Bill Index (LD21TRUU Index), 1- to 3-year gov/credit = Bloomberg U.S. 1-3 Year Gov/Credit Index (LGC3TRUU Index), U.S. aggregate = Bloomberg U.S. Aggregate Index (LBUSTRUU Index), 10-year Treasury = ICE BofA Current 10-Year Treasury Index (GA10 Index), diversified portfolio = represents 25% in each of the four indexes above. As of 31-Mar-23.

Diversifying exposures can reduce opportunity costs

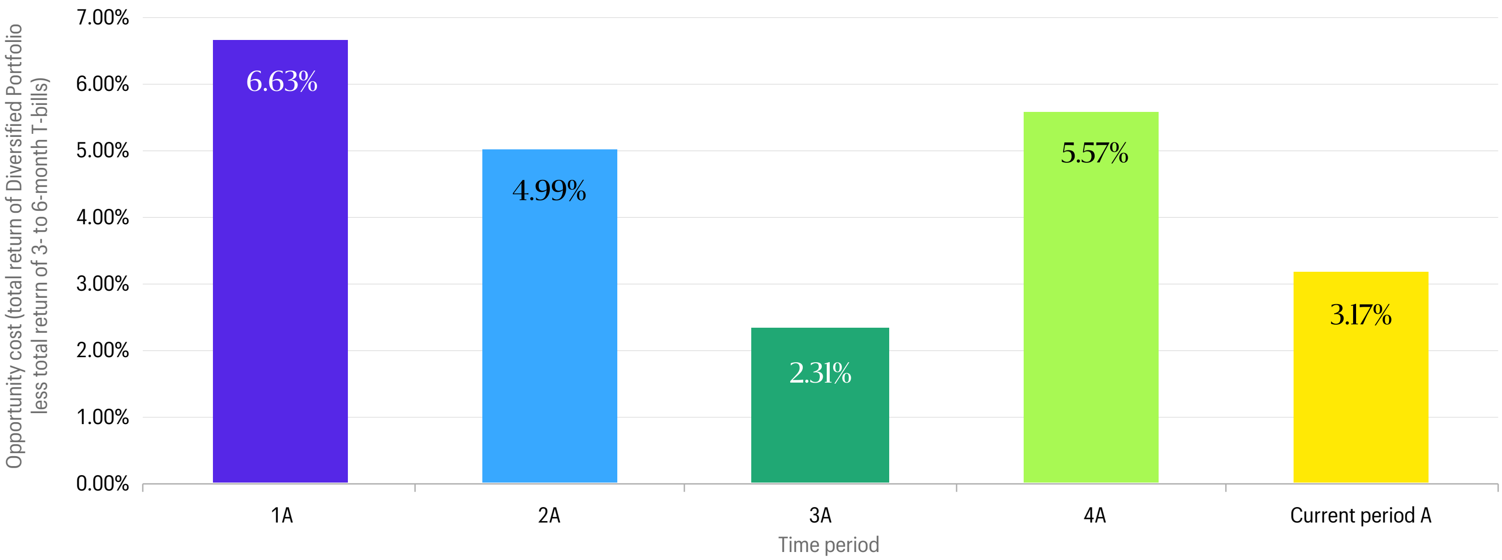
In response to the Fed's current effort to combat inflation, bond investors are finding some of the most attractive income levels they have seen in the past decade at nearly every spot on the curve. We believe this provides the opportunity to benefit from diversifying duration exposures rather than trying to pick a particular spot on the curve at which to invest.

For example, an investor who diversified their exposures by allocating 25% to each of the four segments of fixed income shown in Table 2 following the last four periods of Fed rate normalization (the "Diversified Portfolio") would have outperformed those investors who remained fully invested in short Treasury bills.

Chart 2 below shows the excess returns of the Diversified Portfolio above what an investor would have earned in 3- to 6-month Treasury bills. This excess return represents the opportunity costs borne by investors allocated only to short-duration fixed income in each Period "A."

The chart also shows the current period "A" with the yield on the 10-year U.S. Treasury having reached a near-term peak on October 24, 2022, in which the Diversified Portfolio has outperformed the front end of the curve by 3.17%. That is the opportunity cost short-duration investors who are waiting for Fed cuts to begin adding duration have borne from that date through the end of the first quarter of 2023. We see value in "riding the curve" and avoiding an attempt at market timing an entry point for longer-duration exposures.

CHART 2: THE OPPORTUNITY COST OF WAITING FOR GOLDILOCKS



Source: Allspring.

Total return of "Diversified Portfolio," which is made up of 25% each of the Bloomberg U.S. 3-6 Month Treasury Bill Index (LD21TRUU Index), Bloomberg U.S. 1-3 Year Gov/Credit Index (LGC3TRUU Index), Bloomberg U.S. Aggregate Index (LBUSTRUU Index), and ICE BofA Current 10-Year Treasury Index (GA10 Index), less the total return of the Bloomberg U.S. Treasury Bill 3-6 Month Index (LD21TRUU Index) for each time period noted "A" in Table 2. Current period = October 24, 2022 – March 31, 2023.

Over the past 30 years, allocating to a variety of duration exposures has offered investors meaningful value over those who kept their duration short and waited for Goldilocks. As the Fed appears to be nearing the end of its latest rate-hike cycle, we encourage investors to learn from lessons of the past and diversify along the yield curve.

For further information

We want to help clients build for successful outcomes, defend portfolios against uncertainty, and create long-term financial well-being. To learn more, investment professionals can contact us.

Contact details

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