BBH Strategy Insight

Brown Brothers Harriman

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As Interest Rates Move, Duration Is Only Part of the Equation

We recently wrote a piece about ultrashort credit investing in this current environment. The takeaway is that the recent rise in rates is *good* for investors because the benefits of higher rates should manifest in client portfolios over the shorter term due to the short duration profile of the portfolio.

However, many investors' bond portfolios are invested broadly across high-grade sectors with durations that can be as long as 7 – 8 years. Mainstream indexes that characterize investments in such portfolios have experienced notable declines year to date. Through February 15, 2022, the Bloomberg Aggregate Index (6.6 year duration) returned -4.17%. The magnitude of this decline is historic and nearly entirely attributable to the rise in U.S. Treasury rates. Investment-grade [1] corporate credit underperformed Treasuries marginally, but spreads (the extra yield compensation for credit) remain tight.

Exhibit I: Rising Rate Scenario Assumptions

Hypothetical Portfolio	Yield (%)	Duration (Years)
1 Year Credit	1.99	1.0
1 Year Treasury	1.00	1.0
4 Year Credit	3.18	4.0
4 Year Treasury	1.75	4.0
6.5 Year Credit	4.31	6.5
6.5 Year Treasury	2.07	6.5

Data as of February 15, 2022
Sources: Bloomberg and BBH Analysis

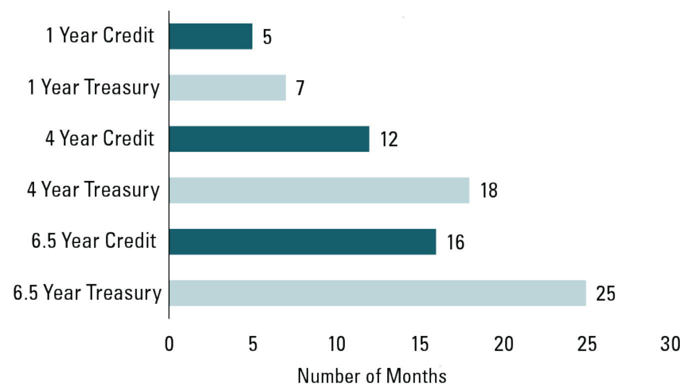
The same questions we pondered in our piece about ultrashort credit investing are salient here. One of the frequent questions we get is "everyone knows the Fed will raise rates – will we continue to lose money?" The short answer is that we do not know, but several elements point to a more-favorable outlook to investors. We examine the implications for fixed income portfolios that carry duration risk.

Credit adds a level of protection against higher rates

Bond yields have risen substantially thus far in 2022 as evidenced by the performance of mainstream bond market indexes. The higher yields across all tenors *increase* investors' expected returns (assuming constant portfolio duration). Investors are not indifferent to the pace of a rate rise. You would much prefer a swift, steep rise in interest rates to a slow, creeping rise that lands in the same place. Why? Because you experience the same price decline whether rates rise fast or slow. However, if rates rise swiftly, you immediately begin earning the higher yield, resulting in a higher end period total return.

The composition of a bond portfolio can also have a material impact on how it performs during periods of rising interest rates. Portfolios with heavier credit allocations may offer benefits relative to Treasury-oriented portfolios when rates rise.

Exhibit II: Performance Illustration - Hypothetical Time (Months) to Recover from a 1.0% Rise in Rates



Data as of February 15, 2022
Sources: Bloomberg and BBH Analysis

The graphs to the right demonstrate how credit-oriented portfolios add a level of protection against rising rates due to their higher levels of income. Exhibit I shows representative yields and durations that can be attained by different combinations of Treasuries and credit. For this illustration, we assume interest rates rise by 1.00% over the next month, but credit spreads remain constant. Then we assume Treasury rates remain at their new, higher levels, and we measure how long it takes

[1] "Investment-grade" refers to fixed income instruments with credit ratings assigned by a nationally recognized statistical ratings organization (NRSRO) of above Baa3/BBB- ("BBB or higher"). Investment-grade ratings signify that the instrument has relatively low risk of default.

for the portfolios to recover from the price decline. As Exhibit II shows, credit portfolios recover quicker than similar-duration Treasury portfolios. A fascinating insight is that the 6.5-year duration credit portfolio offers faster recovery than the shorter, 4-year duration Treasury portfolio.

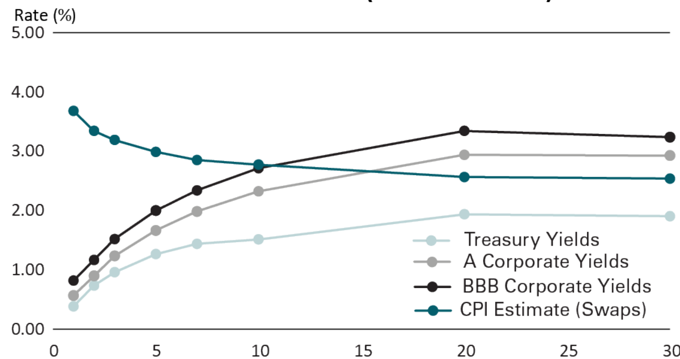
Longer-term conditions are uncertain

In our year-end commentary, we wrote about the disconnect between bond yields and inflation expectations. We did not intend to imply that we were certain that inflation expectations were correct and bond yields were wrong. After all, actual and expected yields and inflation expectations continue to fluctuate significantly.

We presented a graph that showed the relationships between bond yields and inflation expectations (Exhibit III). Exhibit IV shows how those relationships changed after six weeks of trading in 2022. There are some fascinating points to highlight. Longer-term inflation expectations (10+ years) remained stable, while longer-term U.S. Treasury bond yields rose to levels that approximate longer-term inflation expectations.

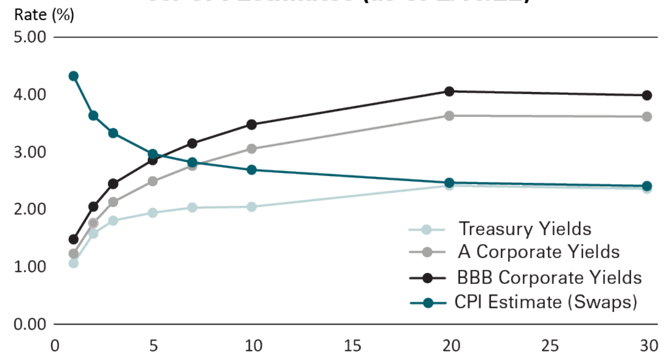
We are not in the business of predicting what will happen next. But it is fair to observe that longer-term yields are now in closer alignment to longer-term inflation expectations. With the market anticipating the Fed will act aggressively to curb inflationary pressures, it is even less certain to predict the directions that longer-term inflation expectations and bond yields will move. It is not radical to suggest that a successful Fed tightening cycle could bring inflation expectations down, while long-term bond yields remain stable.

Exhibit III: Select US Investment-Grade Bond Yields vs. CPI Estimates (as of 12/31/21)



Sources: Bloomberg and BBH Analysis

Exhibit IV: Select US Investment-Grade Bond Yields vs. CPI Estimates (as of 2/15/22)



Sources: Bloomberg and BBH Analysis

In the decades prior to the Global Financial Crisis, each tightening cycle by the Fed precipitated a recession, wherein rates then decreased rapidly. Investors and Fed officials are all aware of the same history, which may lead the Fed to react a bit more dovish this time……at the risk of underestimating the breadth and depth of the cyclical rise in inflation. This uncertainty leads us to focus our time and resources on valuations and fundamentals, and not on macro forecasting.

BBH Fixed Income Portfolios

Fixed income likely plays a strategic role in your portfolio, with a duration set to reflect the risks you wish to manage. Duration is an important determinant of your portfolio's fixed income performance, but the portfolio's allocations to Treasury securities and credit instruments will impact the portfolio's yield and how it weathers different interest rate regimes. Our approach has resulted in client portfolios that emphasize credit instruments (when appropriately compensated) and are often more durable in periods of rising rates.

We focus our work on identifying durable credits at attractive yields and constructing portfolios bond-by-bond. A byproduct of this approach is that it may create benefits for investors concerned about an extended rise in rates. We continue to believe that a carefully selected, credit-oriented portfolio, can provide benefits through this uncertain environment.

Andrew P. Hofer
Managing Director
Head of Taxable Fixed Income

Duration is a measure of the portfolio's return sensitivity to changes in interest rates.

Yield to Maturity is the rate of return a bond would achieve if held to maturity, assuming all coupon and principal payments are received as scheduled and reinvested at the same yield to maturity.

The Bloomberg U.S. Aggregate Bond Index is a market value-weighted index that tracks the daily price, coupon, pay-downs, and total return performance of fixed-rate, publicly placed, dollar-denominated, and non-convertible investment grade debt issues with at least $300 million par amount outstanding and with at least one year to final maturity.

Issuers with credit ratings of AA or better are considered to be of high credit quality, with little risk of issuer failure. Issuers with credit ratings of BBB or better are considered to be of good credit quality, with adequate capacity to meet financial commitments. Issuers with credit ratings below BBB are considered speculative in nature and are vulnerable to the possibility of issuer failure or business interruption.

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RISKS

Investors should be able to withstand short-term fluctuations in the fixed income markets in return for potentially higher returns over the long term. The value of portfolios changes every day and can be affected by changes in interest rates, general market conditions and other political, social and economic developments.

Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, maturity, call and inflation risk; investments may be worth more or less than the original cost when redeemed. Bond prices are sensitive to changes in interest rates and a rise in interest rates can cause a decline in their prices. “Bloomberg®” and the Bloomberg indexes are service marks of Bloomberg Finance L.P. and its affiliates, including Bloomberg Index Services Limited (“BISL”), the administrator of the indexes (collectively, “Bloomberg”) and have been licensed for use for certain purposes by Brown Brothers Harriman & Co (BBH). Bloomberg is not affiliated with BBH, and Bloomberg does not approve, endorse, review, or recommend the BBH Strategy. Bloomberg does not guarantee the timeliness, accurateness, or completeness of any data or information relating to the strategy.

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