

Enter the  
Dragon!!!  
aka  
Zero Coupon  
Treasuries

Fixed Income Insights  
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## **Enter the Dragon!!! aka Zero Coupon Treasuries**

*Expectations of declining bond yields, as the FED embarks on a monetary easing cycle, favor extending duration in fixed income investments. While some of the opportunity has played out, with the FED expected to ease c200bp over the next 12 months, our base case is for yields to compress further. While there are multiple ways to express this directional view, popularly through long-dated treasuries, corporate bonds or related ETFs, we focus this note on an additional opportunity that represents duration in its purest form through zero coupon treasuries. The isolation of the duration opportunity (and risk) is designed to generate asymmetric upside as yields decline, with the necessary corollary being a higher associated risk should yields reverse up.*

*Investors with a view on further compression in treasury yields, may consider allocating to zero coupon treasuries as complementary opportunity to fixed income portfolios.*

## What are Zero Coupon Bonds?

Zero coupon bonds, as the term says do not pay any coupon. These bonds are issued at a discount to par value and would converge to par value upon maturity thereby providing the investor with the price appreciation the only means of return. Hence interest rates and/or change in Treasury yields dominate the price movements of such securities. Since they do not pay any coupon, they carry the highest interest rate risk (concept recap-Everything else constant, higher the coupon, lower the interest rate risk and vice versa). Zero coupon bonds can be issued by corporates and sovereigns alike.

## Why Zero-Coupon US Treasuries?

Corporate bond prices are impacted by two main factors i) interest rates and/or yields and ii) credit spreads. In face of an impending slowdown, credit spreads widen (bonds start trading at higher yields relative to the benchmark) leading to adverse price movements. This neutralizes to some extent the price appreciation a long duration bond might see if rates/yields fall. Easy liquidity conditions have pushed **credit spreads, across the credit spectrum, near record lows. Treasuries help to isolate credit risk.**

*In essence, **zero coupon treasuries deliver duration exposure in its purest form, with greater sensitivity to yield movements (vs. treasuries or corporate bonds for the same maturity).***

An illustration of the above statement can be seen in the comparative performance between PIFKSA 5.375% 2054 ( Gaci First), USTreasury Bond 4.25% 2054 (Coupon paying US Treasury Bond) and SP 0 2054(Zero Coupon US Treasury Bond) and the TLT US. Please note that the 4.25% USTreasury bond was issued in August 2024 and hence the 40-day comparison. This time period however does provide a preview on to the comparative performance as yields decline. (please refer to the Total returns column - **a detailed sensitivity calculator is available on request**)).

## Why Zero-Coupon US Treasuries now?

Irrespective of whether the FED front loads the easing cycle, and more importantly, the expected easing in FED Funds Rate is c200bp over the next 12 months **is likely to further drive down treasury yields**. Extending duration at the beginning of this expected easing cycle is likely to provide a tailwind for bonds in general and specifically more for zero coupon treasuries.

## Risks

**Zero-coupon treasuries are extremely sensitive to interest rates/yield movements and any adverse yield/rate movements could result in severe drawdowns.**



Source: Bloomberg

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