Richard Bernstein Advisors

RBA Fixed Income Insights

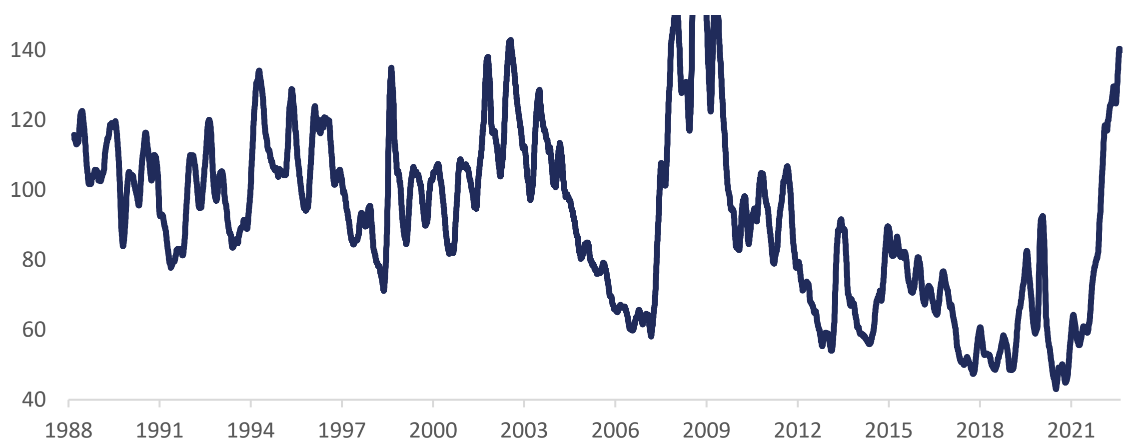
December 1, 2022

2023's Best Asset Class: Long-Term Treasuries?

Our last fixed income insight focused on the 4 stages of the interest rate cycle. We conclude that we entered stage 3 at the end of the second quarter. Despite demonstrating that Treasury yields eventually tend to stabilize even as the Federal Reserve hikes aggressively - and outright decline during periods of earnings recession - many investors still don't understand how RBA can be overweight long-term Treasuries given high inflation and our view that the Fed is nowhere close to a pivot*.

For all the concern about interest rates over the last several months, remember that on June 14th the 10-year yield hit what was then a cycle peak of 3.47%. The 10-year yield has stayed within 50bps of that June peak, apart from a few weeks. Although catching yields at their top would always be preferable, the unprecedented volatility and detachment from fundamentals have made that nearly impossible in 2022 (Chart 1).

Chart 1: Option-implied interest rate volatility as measured by MOVE Index, 50 days moving average (April 4, 1998 – November 18, 2022)



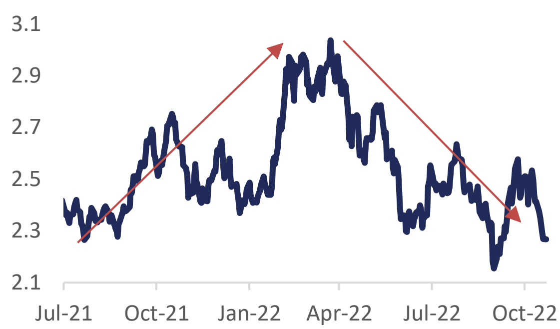
Source: Bloomberg, Richard Bernstein Advisors LLC, ICE BofA

Instead of trying to time the market, our process looks for inflection points that will drive medium to longer term performance. To this point, the times to really be worried about higher yields were in Stages 1 and 2 of the rate cycle (when we were very underweight duration) as the Fed tried to "hunt elephants with a pea shooter" and lost control of inflation expectations, growth and realized inflation (Chart 2). During this time, the 10-year yield increased 300bps from 0.5% on August 4th, 2020, to 3.5% on June 14th, 2022. Perhaps more astounding, 212bps of that increase, coinciding with a 15% loss in 7-10-year Treasuries, came in the 6 months between last December and June as the Fed hiked just 75bps and was still engaged in Quantitative Easing (QE).

* *In this case we define a pivot as going from tight policy, including holding the Fed Funds Rate at a high level, to cuts.*

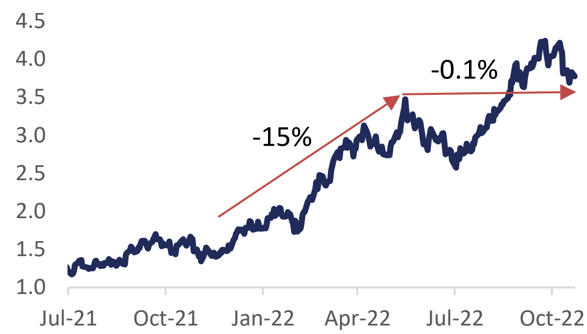
Since June 14th, however, the Fed has engaged in massive Quantitative Tightening (QT) and has hiked 300bp with the market pricing in 100bp of additional increases. If periods of aggressive Fed action were the worst times to own long-term Treasuries, then such unprecedented hikes during this period should have led to massive losses. Instead, as of November 28th, the return of the 7-10-year Treasury index is just -0.1% since June 14th (Chart 3). How could this be the case?

Chart 2: 10-year inflation expectations skyrocketed earlier this year as the Fed lost credibility, but have since collapsed



Source: Bloomberg

Chart 3: 10-year yields had their biggest move between Dec 2021 and Jun 2022… with the Fed behind the curve



Source: Bloomberg

Remember, the Fed hikes short-term interest rates to slow long-term growth and inflation. They also often continue to do so at a time even when growth begins to slow, many inflation measures have peaked, and an earnings recession is imminent. The reason for the hawkish tendency today is clear: The Fed is laser focused on two numbers: 3.7% (unemployment) and 7.7% (CPI) and cannot make the mistake of loosening policy prematurely. Consequently, the risk of recession continues to climb the longer employment remains tight and inflation elevated.

As a result, long-term Treasury yields tend to peak well before the rate hiking cycle concludes. Since the Fed began targeting the Fed Funds rate in 1982, on average, 30-year Treasury yields have peaked 3 months before the Fed reaches the terminal rate (Table 1). Further, on average the Fed hikes rates 133bps more after the 30-year yield peaks. The 30-year yield also tends to peak at a time when inflation is still near cyclical highs for that period, economic growth is slowing, and earnings are about to turn negative. This sounds awfully familiar to today's macro environment.

Table 1: 30-year Peaks before Terminal Rate and before growth collapses

Peak of Hiking Cycle	30Y Peak	Days from last hike to 30Y peak	PMI at Peak Fed Funds rate	Core Inflation peaked before 30Y peak (Y/N)	Amount of hikes post 30Y peak
21-Aug-84	29-Jun-84	-53	56.1	Y	2.25
24-Feb-89	25-Aug-88	-183	54.7	N	1.50
01-Feb-95	07-Nov-94	-86	57.4	Y	1.75
16-May-00	20-Jan-00	-117	54.9	N	1.00
29-Jun-06	17-May-06	-43	53.7	N	1.00
19-Dec-18	06-Nov-18	-43	58.6	N	0.50

Source: Bloomberg, Richard Bernstein Advisors LLC

If the 20-year yield falls by 150bps over the next 12 months - levels we last saw in April 2022 – the total return would equal 21%. What other investment has the potential to reward investors with a 20% return against a backdrop of an earnings recession and tightening liquidity? We think we are at a place where risk/reward is compelling for long-term Treasuries.

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