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Investment Institute

Market Commentary

Weekly perspective on current market sentiment July 6, 2023

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Last week's S&P 500 Index: +2.4%

Duration, etc.

Key takeaways

- Over the course of the upcoming 6 – 18 months, we anticipate a number of different scenarios that should keep fixed-income investors on their toes.
- We believe the ebb and flow of interest rates in the coming quarters should provide opportunities for investors to benefit from increasing duration and to potentially take advantage of downside volatility in stocks.

A basic concept in fixed-income markets is that of "duration." Duration is defined as a measure of the sensitivity of a bond's price to a change in interest rates. Longer-term bonds have longer durations because their periodic coupon payments (and repayment of principal) stretch further into the future, making them more susceptible to future interest rate changes than shorter-term securities.

In terms of practical portfolio application and taking our current "favorable" guidance on duration into account, our advice is for investors to consider buying longer-maturity bonds at current interest rate levels as we find these yields attractive for a long-term portfolio. For example, the yield on the 10-year Treasury note is 3.85% at the time of this writing. And, as we have indicated numerous times in prior communications, we believe long-term rates are near their peak and so we favor adding longer-term bonds (and therefore duration). This could be an effective strategy for a long-term investor, particularly one who prioritizes income.

While we continue to be fans of extending duration and locking in longer-term interest rates, part of our defensive portfolio strategy has been to decrease exposure to equities overall and "park" some of those funds in short-term fixed-income securities. For example, Treasury securities with 3-month, 6-month, and 12-month maturities are currently yielding 5.30%, 5.44%, and 5.42%, respectively. We find these yields to be quite attractive and a good place to wait out what we believe will be increased downside volatility in the equity market over the coming six-to-nine months. We view downside equity volatility as an opportunity to put sidelined funds to work for long-term investors, especially those who favor equity exposure for potential long-term capital appreciation.

Over the course of the upcoming 6 – 18-month tactical time horizon, we anticipate a number of different scenarios that should keep fixed-income investors on their toes. In the near term, we think that short-term interest rates could move just a bit higher as the Federal Reserve is likely not done with efforts to knock down inflation toward its 2% long-term average goal. The next possible scenario would be that rates would move lower as the economy gradually slows and tips into a recessionary period. We would expect inflation to ratchet lower during this time as well. Typically, both longer-term and shorter-term rates have eased in the initial stages of a recessionary period. Then, finally, at some point, likely next year in our view, financial markets would anticipate an economic recovery that could move rates somewhat higher again.

We believe the ebb and flow of interest rates and the fixed-income market in the coming quarters should provide opportunities for investors to benefit from increasing duration as well as using some of the funds currently in short-term instruments to potentially take advantage of downside volatility in stocks.

Risk considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets** are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation, and other risks. Prices tend to be inversely affected by changes in interest rates. Although **Treasuries** are considered free from credit risk, they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate.

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