SEGALL BRYANT & HAMILL
ASSET MANAGEMENT

Maximizing Short-Term Bond Opportunities in Today's Market

After a year of Fed rate hikes, **Mike Diehl, CFA, Senior Portfolio Manager**, discusses the benefits and opportunities he is finding in short-term bonds.

Mike Spitz: Today, we are going to be talking about opportunities we are seeing in the taxable space on the short end of the yield curve that investors have not seen in the past 16 plus years.

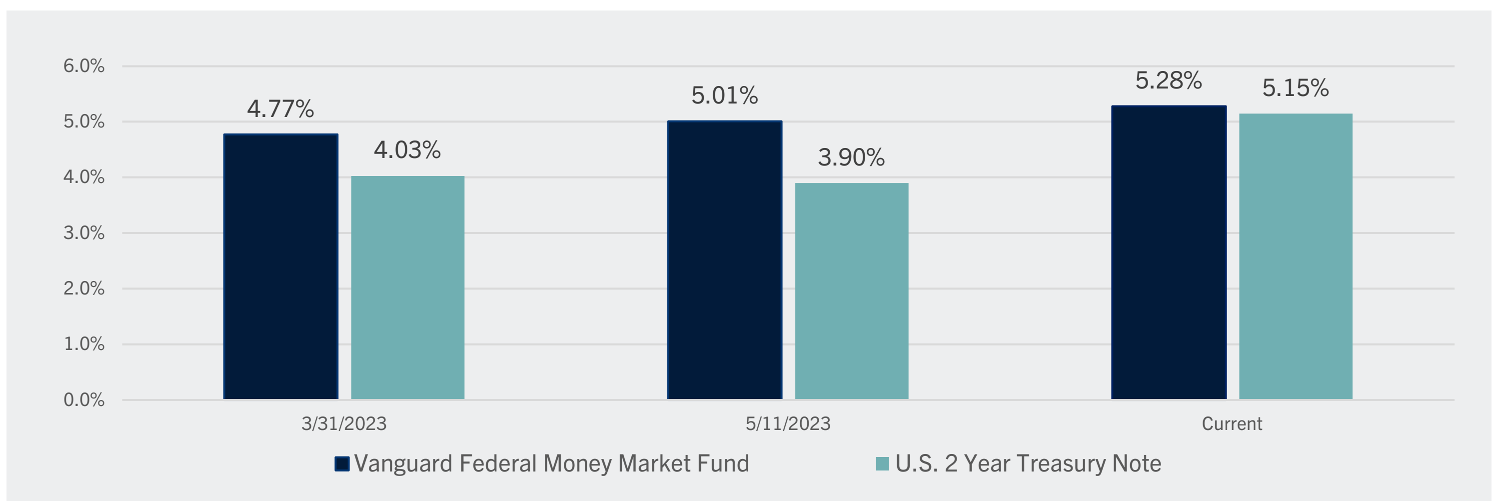
Mike Diehl: It has been an exciting time in short duration. Yields are higher, and there are certainly good opportunities out there.

Mike Spitz: Short duration securities have become an attractive space to capitalize on the rising interest rate environment. Since the Federal Reserve (Fed) began their tightening cycle, about a trillion dollars has moved into the cash space, in particular money market funds with total assets hovering around the $5.7 trillion mark at the end of the third quarter 2023.

Something that investors may not realize is that yields on money market funds are directly tied to the Fed funds rate. For much of 2023, the rate has been higher than other short duration securities that SBH and the fixed income team manage, like Treasuries and corporate bonds. **Exhibit 1** shows that the yield difference between money market funds and other shorter duration securities has diminished. You have seen the relative value of 2 year Treasuries become more compelling.

Is today a good time to lock in these rates by owning these securities outright, or is it a better time to keep money in a money market fund?

Exhibit 1: Yield Gap Between Money Markets and 2 Year Treasuries Has Narrowed



Source: Bloomberg as of 9/21/23.

Diehl: Over the last 15 months, the Fed has been aggressively raising rates, with the current Fed funds rate at 5.25%. Since July, the Fed has paused its rate increases, leaving us wondering if we are nearing the peak. We believe that we are getting closer than we were before when the Fed had to continually raise rates. To your point, the 2 year Treasury is now at 5% and we feel it is an attractive time to diversify by expanding short duration holdings out of just money market funds and into short duration investments.

The yield gap between money market funds and 2 year Treasuries has narrowed significantly from over 100 basis points (bps) in May to as low as 10 bps recently. We believe now is a compelling time for investors to consider other alternatives besides a money market fund for their short duration assets. A 0 to 3 year strategy will have a higher return rate than most money market funds while still providing liquidity, quality, and protection if interest rates do rise.

What would a 0 to 3 year strategy offer compared to a money market fund? If the Fed decides to cut rates, a money market fund's yield is immediately impacted. By using a 0 to 3 year strategy, an investor receives some protection from reinvestment risk by locking in today's elevated rates for 1 to 3 years. Investors would still receive a positive total return from bond yields falling and prices going up while also locking in a yield for a slightly longer time frame that offers some reinvestment risk protection. Investors are protected from a rate increase, are now capturing higher yields than money market funds, and receiving some protection if interest rates should fall by locking in short duration funds for up to a three-year period.

Spitz: If the 2 year Treasury looks attractive today, what about looking further out along the curve? What are your thoughts about locking in longer rates relative to 2 year Treasuries or shorter duration taxable securities?

Diehl: We believe it does not make sense for retail investors to lock in past around 10 years. This is due to what we call investment "cushion," which is when a bond's yield is higher than its duration. **Exhibit 2** shows that if the yield on a 2 year Treasury was around 5% and the duration about 2 years, this would offer an investor a significant amount of yield cushion. The 2 year Treasury could go up 300 bps and an investor would still receive a zero positive return. If rates were to go up 1% on a 2 year Treasury, the return would still be positive at 2%. Investors have a lot of cushion on the front end to deal with credit spread and/or interest rate volatility.

Exhibit 2: Current Yields Are Providing Investors with Cushion

	2010 - 2015	2015 - 2020	2020	2021	2022	10/31/2023
Price drop if rates increase 1%	-1.89%	-1.91%	-1.90%	-1.93%	-1.90%	-1.84%
Plus: Yield	0.68%	1.70%	0.55%	0.39%	3.29%	5.40%
Total Return	**-1.21%**	**-0.21%**	**-1.36%**	**-1.54%**	**1.39%**	**3.56%**

Source: Bloomberg as of 10/31/23.

10 year rates have gone up significantly over the last two years, similar to all other rates on the curve. However, a 10 year Treasury is still going to have a duration of about eight years so if the yield goes up 1%, the price return will be minus 8% due to that duration and the cushion, say it is even 5%, the yield is only 3%. Investors will still have a negative return of almost 3% on that 10 year Treasury; the cushion becomes less and less the further out on the yield curve an investor goes.

In our opinion, the math is better than it was in 2022 when we saw poor bond returns and zero cushion in the fixed income market. Now the cushion is better, but investors are still taking significant interest rate risk with longer duration securities. This is why we like the front end of the curve: it offers investment cushion. Investors receive the highest yields on the yield curve, are protected if rates go higher, are continually reinvesting maturities, and are protected if yields go lower while locking in their money for a little bit of time.

In our mind, it is the “sweet spot” of the yield curve offering protection and liquidity for individuals. We believe it is an attractive place for investors today.

Spitz: In summary, right now is a good time to lock in rates on the short end of the curve using short duration strategies over money market funds, which are tied to the Fed funds rate. This allows an investor the ability to help protect against some reinvestment risk. If rates do move down, the investor has locked in a good income stream. At the same time, investors do not need to take on extended duration risk; stay in the short space where investors have that cushion, which we are defining as the yield relative to duration.

Diehl: That is exactly it. We believe the market has been extremely volatile, but it has given us opportunities with higher yields not just in the money market space, but in that 0 to 3 year space that we find attractive at the moment.

Key Takeaways

- With the 2 year Treasury yielding around 5%, we believe this presents an attractive opportunity to diversify short-duration allocations beyond just money market funds.
- Utilizing a 0-3 year strategy can protect against rate cuts, which have a more immediate impact on money market yields. Locking in attractive rates for a slightly longer period can help mitigate reinvestment risk.
- We believe that the front-end of the curve now offers attractive cushion. While longer-term yields have risen, the math favors short-term bonds. We see this area as a “sweet spot,” offering high income, liquidity, and protection against reinvestment risk.

To learn more about SBH Fixed Income Strategies, please reach us at (800) 836-4265 or contactus@sbhic.com.

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