Looking to US Treasuries

David Sack highlights the case for adding US Treasuries to a portfolio's allocation

Inflation is climbing, central banks are withdrawing monetary stimulus, and 10-year US Treasury (UST) yields are rising. No, this isn't today, but September 1981, when the 10-year US Treasury yield was almost 15.9%[1], the Consumer Price Index (CPI) was 10.1%[2] year-on-year and the federal funds rate was 15.50%[3]. Since September 1981, bond yields have trended lower and lower, hitting a low of around 0.5%[4] in early April 2020. Today, at the time of writing, the 10-year UST yield is 2.40%[5], the federal funds rate is 0.50%[6], and CPI is 7.9%[7]. In the face of rising inflation and less accommodative monetary policy however, the current outlook for bonds is challenging.

At The People's Pension, our bond portfolio has three different building blocks: gilts, sterling corporate bonds, and global bonds. This portfolio has benefitted from three coinciding tailwinds: falling interest rates (bond prices rise as interest rates fall), which has been of greatest benefit to the longer-dated gilts held in our portfolios; narrowing credit spreads (corporate bond values tend to increase as spreads narrow), which has helped the allocation to sterling corporate bonds, especially those with longer maturities; and the general performance of sterling debt, which over the past decade has been among the best performers in the investment grade universe and represents a sizable proportion of our bond allocation.

Due to current market trends, we think it's time to harvest the gains and review these strategies, then plot an appropriate progressive structure for the fixed income content of our portfolios.

This is also of paramount importance when constructing a multi-asset portfolio, one that is sufficiently diversified so it can withstand adverse movements in asset prices without sacrificing too much return. Holding decorrelated assets helps us to build more resilient portfolios for our members, as it lowers performance dispersion with the aim of providing more predictable returns. This doesn't remove the effects of market turbulence but mitigates them to some degree.

We believe it's appropriate to start adding USTs, funded by the sale of gilts and sterling corporate bonds, for several reasons, one of which is their ability to diversify our multi-asset portfolios, as they have less correlation with the equity components compared to our current bond allocation. USTs also provide a 'left-tail' risk hedge, ie a buffer when risk assets fall or when investor sentiment turns negative.

Due to its shorter duration, an all-maturity UST index is less sensitive to rate increases than gilts. An all-maturity gilts index contains bonds which mature in 30, 40, and 50-years' time, whereas in the US, the longest-dated bond matures in around 30 years. In a rising rate environment, these longer bonds tend to suffer, hurting portfolio performance. The same is true of sterling corporate bonds, which aside from having several long-dated issues within the index, also have narrow spreads over gilts.

We think that rising rates also carry a risk of either a policy mistake or a derating of some of the growth mega caps that have been driving performance in the pre-eminent equity market of the last decade – the US. Any slide in equities could trigger a widening of credit spreads, which, all other things being equal, would likely cause corporate bonds to fall.

USTs have the highest quality credit rating from the rating agencies (AAA). In summary, we think that adding USTs makes the portfolio more robust in the event of a negative market environment.

USTs should therefore help our members' portfolio performance over the long term. Four different economic regimes are possible over the next 12 to 18 months, of which the first two are most likely:

1) Slowing growth, rising inflation, and a neutral monetary policy

2) Accelerating growth, rising inflation, and a hawkish monetary policy

3) Weakening growth and inflation, and a dovish monetary policy

4) Accelerating growth, slowing inflation, and a neutral monetary policy

We think that increasing our portfolio's exposure to USTs at the expense of gilts and sterling corporate bonds will pay off in regimes 1 and 2 and help to add value to our members' savings.

Written by B&CE – provider of The People's Pension – head of investment strategy and asset allocation, David Sack

In association with the people's pension

[1] Bloomberg (Data as at 30/09/1981)
[2] US Bureau of Labor Statistic, YoY, not seasonally adjusted (Data for September 1981, published in October 1981)
[3] US Federal Reserve (Data as at 30/09/1981)
[4] Bloomberg (Data for April 2020)
[5] Bloomberg (Data as at 04/04/2022)
[6] US Federal Reserve (Data as at 16/03/2022)
[7] US Bureau of Labor Statistic, YoY, not seasonally adjusted (Data for February 2022, published in March 2022)