

FULL DISCRETION

Extra Credit

Considerations for the Next Step Up in Duration

One of the questions frequently received by the Full Discretion team in 2022 was ‘when would you look to take the next step up in duration?’ The movement in interest rates over the course of the past year has certainly been a topic of discussion. The team continues to have a defensive view on rate risk, but to a lesser extent than earlier in 2022. This has been largely driven by:

1. The move higher in Treasury rates to levels where rate sensitivity becomes less of a concern.
2. From a risk management perspective, we felt the risk of downturn/recession was increasing.

We now believe much of the movement from the Federal Reserve (Fed) has occurred or is currently being priced into the market, which in turn may also put a cap on the Treasury curve. We are expecting an additional 50 bps of tightening in first quarter of 2023, which would bring the policy rate up to 5.00% after the March meeting. The market seems to want to compress this cycle and lean towards a Fed pivot, but we believe inflation is structural at this point and likely to recede slowly.

While inflation has likely peaked and positive real rates should have the effect of slowing growth and rolling inflation down over time, we believe inflation will remain ‘sticky’ and above the Fed's target throughout 2023, primarily as a result of wage and labor market pressures. Currently, the forward curve is pricing in almost 50 bps of cuts by the end of 2023 (and another 20 bps in 2024). However, we believe it will be difficult for the Fed to begin cutting rates when inflation remains above its target. In addition, given longer-term structural concerns, including deglobalization, decarbonization, changing demographics and deficits, inflation could remain elevated for an extended period.

That said, we are anticipating a Fed pause after the March meeting, which extends into the latter stage of 2023 and we have not eliminated the possibility of the Fed raising rates after the pause. This leads us to maintain a defensive view on a rates basis, albeit less so than 2022, and to be patient with regard to adjusting duration. We do see value in long-term real yields between 1.5%-2.0%, which, based on the structural factors discussed above, is somewhere between 4.0% - 4.5% on the nominal 10 year US Treasury.



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